KPMG submission

Senate Economics Reference Committee

Inquiry into Tax Laws Amendment (Combating Multinational Tax Avoidance) Bill 2017 and Diverted Profits Tax Bill 2017

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Executive Summary

KPMG supports the underlying objectives of the package of measures in the last Federal Budget which gave rise to the Diverted Profits Tax (DPT). They are:

(i) a more competitive tax system and in particular supporting a reduction in the company tax rate;

(ii) clamping down on tax avoidance; and

(iii) leadership in reform of the international tax framework through implementation of the agreed OECD BEPS Action Plan items.

However, we note that the DPT is very uncertain in its scope, it does not deal with the real issues facing transfer pricing and gives significant implicit discretion to the ATO in an environment which can cause significant reputational and financial damage to MNEs.

This submission looks at whether the DPT solution matches the real problems in transfer pricing and the role of substantial implicit discretion in our tax system.

We recognise the political realities of where we are in the process of implementation of the DPT. As a result our main recommendation does not involve amending the Bill or otherwise changing the law.

Rather, we would like to see an administrative change through the creation of a DPT review Panel within the ATO which would contain ATO and independent representatives who will make an evaluation before a DPT assessment is issued. We recognise embodying this in legislation is difficult. As a result the tax system may benefit if the Senate Economics Reference Committee recommended that the ATO give deep consideration to this approach. We note that on this approach ultimately it is a decision of the Commissioner of Taxation.

If adopted we believe it would reduce the likelihood of the ATO using the DPT for unfair strategic advantage in the future.

However, the 'independence' of the DPT Panel would give greater gravity to the decision to level a DPT assessment. This would be of considerable benefit to the ATO.

Detailed comments

1.0 General

1.1 KPMG welcomes the opportunity to make a submission to the Senate Economics Reference Committee Inquiry into *Tax Laws Amendment (Combating Multinational Tax Avoidance) Bill 2017 and Diverted Profits Tax Bill* 2017 referred to below as the DPT.

1.2 It is recognised that the proposed DPT is one of a package of measures announced in the 2016-17 Budget. That package embraces three broad objectives which are to be applauded: (i) a more competitive tax system and in particular supporting a reduction in the company tax rate; (ii) clamping down on tax avoidance; and (iii) leadership in reform of the international tax framework through implementation of the agreed OECD BEPS Action Plan items.

1.3 As we have stated previously, KPMG supports these objectives. Moreover, we recognise the complex dynamics between each of them. Thus, in asking the community to accept a reduction in the company tax rate to promote investment in the long term, the community rightly should have an expectation that the payment of tax by corporates meets community standards. The public is also right to expect that Australia embraces reform of the international tax framework with other OECD & G20 countries. There are elements of a broad trade-off and the DPT can be seen as part of that trade-off.

1.4 We have also noted that as one delves into greater specifics of the DPT, things become more difficult. The impression that the DPT lies outside the agreed OECD BEPS Action Plan items is a very strong one in the international tax community. This is, and should be, a very real concern. That concern partly lies in the detriment that Australia faces in being perceived to be a tax "outlier" on international norms. This potentially impacts inward investment. That concern also partly lies in the precedent our DPT rules create for other countries to put in place rules outside the newly negotiated OECD international tax framework. This potentially impacts outward investment.

1.5 The shape and scope of the DPT will have a real bearing on the nature and extent of the international reaction. In particular if the manner in which it is implemented and

administered is considered to be supportive of a path that the international community is embracing, a negative reaction and response by international business will be limited. If, on the other hand, it is considered to be an over-reach, there is the potential for quite a different reaction and potential reputational harm. That reaction would be focused on the level of discretion implicit in the DPT and the disparate balance of power between the ATO and multinational enterprises (MNEs). It would be a discussion about Australia's respect for the rule of law.

1.6 KPMG has held a number of workshops with clients, both in Australia and in the US, on the DPT. We have also spoken to a number of academics and others in the tax community. What was clear from the outset, and is still true as the Bill is discussed in Parliament, is that there are a wide variety of views on the scope of the proposed provisions.

1.7 The diversity of views on how the DPT might apply has at two main dimensions. The first is the number of transactions to which it could apply - large or small. The second is the extent to which it deals substantially with transfer pricing, including the reconstruction power, or that it goes well beyond transfer pricing into other areas of tax structuring.

1.8 From the perspective of the tax administrator, that question has at least partially been answered in the Explanatory Memorandum. We are told that the DPT could potentially apply to 1,600 taxpayers with 8% or 128 being high risk and it is clear that the ATO believes it will apply well beyond transfer pricing.

1.9 We do not doubt the accuracy of the ATO's view on its potential application. What is interesting is the inherent greyness in its potential application - for 92% of the 1,600, who do not fall into the high risk category, but are low or medium risk - one cannot simply determine that the rule does not apply. It is the nature of the rule that gives that result. It is inherently uncertain in its reach.

1.10 Given this uncertainty, the future – being years after the new legislation is passed – is likely to give rise to a potentially troublesome discourse on the 'real purpose' and 'intended scope' of the provisions. Reasonable minds may well be a long way apart on this question, notwithstanding the existence of an objects clause in the provisions. Arguably, it may become *the* major focus of our international tax rules in the future.

1.11 The uncertainty of the DPT is a power provided to the ATO in its own right. The way in which the ATO operates within this uncertainty is an implicit discretion. As

discussed below, this is dual-edged. The use of implicit discretion has many advantages – here it is envisaged to be a tool to get aggressive MNEs to "toe the line". That is for MNEs to deal with uncertainty by gaining acquiescence of the ATO to any arrangements undertaken. But there are also disadvantages in basing tax law on implicit discretion. These are dealt with below.

1.12 Prior to that we will deal with this question: what is the problem that the DPT is trying to fix? Although there will be many with strong views for and against the question concerning the desirability of the DPT is not an easy one. In our view, Parliament needs to ask two broad questions.

1.13 The first concerns the relationship between the DPT and what might be called "the problem". Is the DPT clear about the problem it is trying to address? Does it address what might be called "the real problem"?

1.14 The second concerns the question of whether the balance is right between the ATO and taxpayers? Are there sufficient and appropriate limitations on how the ATO will use the DPT, not so much now, but in the future? If there were more limitations, would the DPT be emasculated from an administrator's perspective?

1.15 The lens through which these questions should be asked must be a long term one, rather than one grounded in our current times with our current focus and our current rhetoric. That is, is the DPT good long term revenue law or not?

1.16 Three other observations should be made. The first is that the Treasury consultation process has been at least appropriate, if not exemplary. The tax advisory and business community appreciate broad and deep consultation. Notwithstanding that many would disagree with the shape and balance struck in the DPT Bill, we acknowledge the efforts of Treasury to understand the concerns of business and the advisory community.

1.17 Following the release of the paper titled *Implementing a Diverted Profits Tax* in the May Budget and the submissions that followed, Treasury embraced at least three rounds of consultation: once in response to the submissions, then through one public Exposure Draft, and then through a limited release confidential Exposure Draft, before the final bill was presented to Government. The final concepts adopted in the DPT are a clear improvement on those originally envisaged. Thus the consultation process has proved to be very worthwhile.

1.18 The second observation concerns the guidance the ATO provides in relation to new law. In 2015, the ATO introduced a new form of guidance called a Law Companion Guide. This guidance is released around the time of a Bill receiving Royal Assent and explains to taxpayers what, in the ATO's view, the new law means, what processes the ATO will adopt in administering the law and what the ATO expects taxpayers to do to comply with it. This is a most welcome addition to tax administration. What it seeks to do is to reduce the potential gap or lacuna between how the law is intended to apply, when first legislated and how it is actually applied by the ATO.

1.19 As noted above, the difficulty with the DPT is that it is a very "grey" piece of legislation. Importantly, the manner in which it could be applied can change over time. That change could be dramatic. The Law Companion Guide is unlikely to deal with this potential lacuna for the DPT unlike other pieces of standard legislation for which there are similar guides. What will have some solidity in the Law Companion Guide is the *process* of evaluation of whether the ATO should apply the DPT or not in a particular circumstance.

1.20 We believe that the process of evaluation could be improved if the ATO established a DPT review Panel (as distinct from the General Anti-Avoidance Review (GAAR Panel) with a combination of ATO and independent experts. Such a DPT Panel would make an evaluation of whether a DPT assessment should be issued, before the issue of such an assessment. This would take away the ability of the ATO to use the DPT as a strategic or tactical instrument in an unreasonable manner without emasculating the provision from an administrator's perspective.

1.21 It is important that this independence of mind is brought to bear early in the piece, before the reputational and financial damage resulting from tax provisioning and cash outlays, arising from the penalty rate of tax and procedural disadvantages, come into play.

1.22 It is recognised that it would be difficult to change the legislation to require independent review before a DPT assessment is issued. What would be useful is if the Senate Economics Reference Committee requested the ATO give deep consideration to ensuring that there is independent representation on a to be established, DPT review Panel that would evaluate whether an assessment should be issued.

1.23 This would give appropriate gravity to a DPT assessment. It would contribute to undermining both the argument and the fear that the DPT was being used in an unreasonable strategic manner by the ATO.

1.24 Finally, it should be acknowledged that the politics of changing the DPT are very difficult, both now through an amendment to the Bill and in the future which would require amendment to the legislation. Thus we are relying on the savviness of future revenue officers in the ATO to ensure that the DPT is administered in a balanced manner.

2.0 What is the perceived problem?

2.1 The DPT seeks to deal with two broad areas – transfer pricing and tax structuring.

There are four perceived flaws in the system of transfer pricing rules grounded in the arm's length principle that has developed over the last century. They are:

Problem 1: The ability to locate residual profit arising from the synergies of a MNE in a low tax jurisdiction;

Problem 2: The ability of the MNE to choose the specific transactions or structures;

Problem 3: The inherent drive for more and more elaborate detail in finding an appropriate price or arrangement; and

Problem 4: That there is no clear consensus on key elements of our international transfer pricing rules. China is developing strong and divergent views on the weight one gives to marketing in a transfer pricing analysis. There is a developing delineation between the value of an intangible legally located in one jurisdiction and the capacity to sell the product arising from the intangible in another jurisdiction.

Problem of the ability to locate residual profit arising from the synergies of a MNE

2.2 At the root of this problem is that the very nature of a successful MNE is it is not acting as disparate arm's length parties do. Synergies arise from the co-ordinated activities of a MNE, which present a residual profit that would not arise for disparate parties acting at arm's length. Certain planning may lead to such a profit being located in a low tax jurisdiction. This has been of concern in the OECD BEPS Action Plan. There are three main approaches to dealing with this problem.

2.3 The first is to replace the arm's length principle with a system that would allocate profits to various jurisdictions based on a defined formula. The recent international consensus has rejected this formulary apportionment approach on the basis that it creates greater problems than it solves.

2.4 The second approach, which has been adopted by the OECD and G20, is to reformulate the guidelines surrounding the arm's length principle to enhance established risk and function tests to better determine where the profit actually lies. This path, which Australia has adopted, substantially reduces the problem.

2.5 The third approach is to recommend changes to Controlled Foreign Companies (CFC) rules, globally. Australia's strong CFC rules mean that the issue does not arise for Australian MNEs, but could apply to foreign MNEs where the parent jurisdiction does not have CFC rules or they are not in accordance with the OECD recommendations.

2.6 The question arises as to whether the DPT deals with this problem and, if so, in the most appropriate manner under the current formulation. In our view, the DPT is not a direct solution to finding and taxing residual profit of a MNE. Arguably, in its form and substance, it is not aimed at that. It is to ensure that the right amount of tax is paid in Australia. One could argue that it has the indirect consequence of limiting a MNE's residual profit to the extent that there is an inappropriate transfer of profit from Australia to a "residual profit bucket". But that problem is dealt with, and better dealt with, by the resetting of the transfer pricing rules embedded in the OECD BEPS Action Plan changes, which Australia has rightly embraced.

The ability of the MNE to choose the specific transactions or structures

2.7 Prima facie, a multinational can choose how it structures its international arrangements and an arm's length analysis is overlaid on that structure. In the OECD guidelines, this has been subject to an important exception which suggests that a Revenue Authority should be able to reconstruct those arrangements in exceptional circumstances only. Australian transfer pricing rules contain a reconstruction power which is relatively broad compared to the reconstruction power in the OECD guidelines. It can apply, amongst other circumstances, where independent parties would have entered into commercial or financial relations which differ in substance from the actual arrangements that the MNE has put in place. This is an extensive power for the Commissioner and was introduced not without some controversy.

2.8 It is noted that the UK does not have a similar power in its transfer pricing rules. The UK DPT acts as a reconstruction power, albeit more limited than Australia's broad power in Section 815-130.

2.9 There is uncertainty as to whether the proposed Australian DPT has a more limited, a more extensive, or an overlapping scope when compared with the Australian reconstruction power. In our view, the reconstruction power embodied in Section 815-130 is a much better reconstruction power than the DPT, notwithstanding the criticism of many that it provides the ATO with the ability to second guess how an MNE should have arranged its affairs. Section 815-130 compares actual conditions with hypothetical or postulated "independent" conditions. The DPT asks a different question. It is more focused on, albeit an objective construction, of what the MNE was *in part* trying to do. Whether one of its purposes was tax based or not.

The inherent drive for more and more elaborate detail on transfer pricing

2.10 The provision of information is an important element in the ATO gaining comfort that appropriate transfer pricing has been adopted. Some requests will be based on the need for the ATO to gain an understanding of the commercial drivers behind an arrangement. This is certainly reasonable and appropriate. For many significant transactions, there may be a large body of material contained in different departments and business units of an MNE, both domestically and internationally. Sometimes it is difficult to know where that information is located or whether it even exists. There will be a tension between an MNE wanting very precise and targeted requests for information and the ATO who wants to "see the whole picture" and indeed may be fishing for information. Dealing with this issue is one of getting the right balance.

2.11 There is a separate, but related issue. Given that transfer pricing is at its essence a "comparative project", where actual arrangements are compared with an abstract arm's length notion, there is a substantial drive to deal with more and more detail as one seeks to find greater and greater delineation or coalescence. This is a structural issue and will not be solved unless a safe-harbour is put in place (which has its own difficulties), or a common sense limit is set in place, by revenue authorities in dealing with an issue.

2.12 The information tensions on understanding vs fishing, available knowledge vs disparate knowledge and the drive to greater detail are real and practical. They are not circumstances where there is a clear delineation between the compliant and the

non-compliant, between the recalcitrant and the amenable, and the willing and the unwilling.

2.13 That is, the provision of information by an MNE in a transfer pricing dispute is complex and full of tensions. Sometimes a revenue authority will not appreciate what is readily available knowledge and what is not. Sometimes they will not have a clear understanding of what they want and why they want it. Sometimes there will be simply a quest for greater and greater detail to draw greater and greater distinctions or comparisons. This is not to say that MNEs will never undertake a deliberate strategy of obfuscation and a lack of co-operation, but the matter is not simple. The fear is that in the future the DPT will be used as an unfair strategic tool in this complex world.

Evolving differences in how transfer pricing is applied

2.14 There are tensions within the current transfer pricing framework that are likely to grow in the future. The world in which the DPT is proposed to operate is not a simple one in which there is consensus on where value is located and how that value should be taxed.

2.15 The detail of the Chinese view of the role of the market in transfer pricing – capacity to sell – is not directly relevant to the DPT as such. What is relevant is that the transfer pricing world contains, and will continue to contain, incoherent rules based on different - but not incorrect for the countries making them - value judgements. The extent of the future incoherence is unknown, but likely to grow as more developing countries adopt the Chinese refocus on the market. This is particularly likely in the Asia-Pacific region, where countries like India, Indonesia, Philippines and Vietnam to name a few may well see value in the purchasing power of their respective rising middle classes rather than in intellectual property located in Australia, Singapore and Switzerland. MNEs will need to navigate that incoherence. It is likely that the claim of value by revenue authorities in the Asia Pacific region will be greater than 100% of that value, and that dispute resolution procedures will be time-consuming and problematic. Indeed the prospect of double taxation is very real.

2.16 Thus the DPT will apply in a setting of competing claims for value. Those competing claims are not artificial but will have a very strong intellectual foundation and represent deeply and soundly held views by different countries in different stages of development. For example, consider the transfer of intellectual property from

Australia to Singapore which is then used to sell products in China, India, Vietnam, Indonesia and the Philippines. That is not simply a matter of Australia putting one's hand into a box of value located in Singapore and bringing it back home. The value in that box will be highly contested by other countries in the region. This is likely to increase dramatically in the future. The DPT is not a complex tool that confronts this issue. Rather it may well be seen as a tool for an unfair grab in the future.

2.17 The second problem area concerns tax arrangements. That is, there is an argument that the DPT deals with tax arrangements where there is currently a gap or a problem to be addressed. That gap is the difference in the manner in which the bar is set for evaluating the *purpose* of the arrangement. For the general provisions in Part IVA introduced in 1981, that bar is set at the *sole or dominant purpose.* That is, the provision could apply if the dominant purpose was to obtain a tax benefit. The DPT seeks to lower that bar to "*one of the principal purposes*". This language is consistent with the recently introduced Multinational Anti-Avoidance Law or MAAL. It is also consistent with the OECDs anti-treating shopping language.

2.18 We accept that the business world, tax community and judiciary will need to get used to this lower bar.

3.0 Good taxation law and the role of discretion

3.1 Good taxation law should have the following six characteristics. It should be

- clear;
- stable;
- prospective in nature;
- capable of guiding taxpayers;
- fairly enforced; and
- open to independent judicial review and adjudication.

These elements are fundamental to a system based on the rule of law. It would be wrong to think that such an ideal should not have discretionary elements – whether explicit or implicit. Anti-avoidance rules have implicit discretionary features.

However, those features should, as far as possible, abide by good taxation law principles noted above.

3.2 As noted above the uncertainty and potential scope of the DPT provide the ATO with an implicit discretion. It is also noted that this discretion can change with time. Moreover it can be used strategically and possibly in an unreasonable manner.

3.3 Against this line of thinking it will be said that the purpose test in the DPT will be construed to be an objective test by the Explanatory Memorandum introducing it, by Rulings in providing guidance on it, and by the Courts in applying it. Thus, it has been said in relation to the word "purpose" in the general provisions of Part IVA that it is about the 'what' and the 'how" and not the 'why'. While the concept of '*sole or dominant purpose*' or, in this case, '*one of the principal purposes*' are construed to be objective tests, the practical reality is that the discourse between the ATO and taxpayers – emails, presentations and board papers – will be about the subjective 'why'. That is, the objective 'what' and 'how' is reconstructed from the subjective 'why'.

3.4 Thus at a practical level, the purpose is all about the ATO's *construction* of why someone did something and, in particular, whether they *tried too hard* – that is, one of the principal purposes was to reduce their tax. The objectiveness of the *purpose* elements of an anti-avoidance provision is illusory.

3.5 What this means is that it is important to put in place as many truly objective features as possible in an anti-avoidance provision such as the DPT.

3.6 The DPT has a number of "clear line" objective features

- There is a de minimis size threshold so that it only applies to large MNEs, but limited to those who have more than negligible operations in Australia;
- There is the effective tax paid in the jurisdiction where the income or profits are diverted. This is the 80% test.

3.7 To these the consultation process has added

- A carve-out for managed investment trusts, sovereign wealth funds and foreign pension funds; and
- That the DPT can only apply to the rate on a loan rather than a quantum of a loan if the safe harbour thin capitalisation test is satisfied.

These additional tests are most welcome.

3.8 The contentious tests will be the purpose test and the insufficient economic substance test. Both tests are very grey and contain high degrees of subjectivity. The business community will benefit from strong guidance from the ATO on how the tests are likely to be applied.

4.0 Conclusion

4.1 KPMG supports the underlying objectives of the package of measures which gave rise to the DPT. That said, we note that the DPT is very uncertain in its scope, it does not deal with the real issues facing transfer pricing, gives significant implicit discretion to the ATO in an environment which can cause significant reputational and financial damage to MNEs.

4.2 We would like to see the creation of a DPT Panel with ATO and independent representatives who will make an evaluation before a DPT assessment is issued. We recognise embodying this in legislation is difficult.

4.3 As a result the system may benefit if the Senate Economics Reference Committee recommended that the ATO give deep consideration to this approach.