MINERALS COUNCIL OF AUSTRALIA

SUBMISSION TO SENATE ECONOMICS COMMITTEE - TREASURY LAWS AMENDMENT (COMBATING MULTINATIONAL TAX AVOIDANCE) BILL 2017 AND DIVERTED PROFITS TAX BILL 2017

MARCH 2017

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EXECUTIVE SUMMARY

The Diverted Profits Tax (DPT) Bill 2017 has a number of flaws which will impose heavy compliance burdens and uncertainty on businesses investing in Australia and Australian businesses operating across borders. The DPT represents extreme overreach and uncertain poorly drafted law. Unintended consequences have not been thought through and there has been minimal consultation.

Consideration should be given to suspending further progression of the legislation until appropriate consultations are undertaken to rectify unintended consequences. At the very least, amendments are required to provide greater certainty for taxpayers whether an arrangement falls outside the scope of the DPT. Legitimate transactions and cooperative taxpayers should more clearly be excluded.

The Minerals Council of Australia (MCA) does not dispute the need for new integrity rules where they are clearly targeted at an identified tax mischief. There is a case for a DPT to target situations involving clear elements of artificial arrangements and unco-operative behaviour of multinationals in delaying resolution of transfer pricing disputes. Despite initial broad support across most industries and the tax community, the legislation has moved well beyond this to a poorly targeted and broad measure cutting across Australia's transfer pricing and anti-avoidance rules. It introduces new and undefined concepts into the tax law with uncertain application.

The legislation has not had adequate consultation, despite the fact that it represents a fundamental and uncertain change to Australia's transfer pricing and anti-avoidance rules with complex interactions with Australia's tax treaties and the BEPS process.

The DPT is a unilateral action that departs from the global co-ordinated response to Base Erosion and Profit Shifting (BEPS). Unilateral measures that are out-of-step with the multilateral approach can be counterproductive and the OECD itself has warned countries against unilateral measures like the DPT (see appendix). The introduction of the DPT is a parochial measure which undermines Australia's standing as a stable and predictable place to invest.

The DPT's administrative arrangements are harsh and without precedent. It lacks procedural fairness by handing extraordinary new powers to the ATO without adequate oversight or protections for taxpayers. The DPT allows the ATO to effectively impose penalty assessments without meeting a reasonable standard of evidence before doing so.

The MCA recommends that:

- The DPT be applied, consistently with the announced policy intention, as a measure of last resort to target artificial and contrived transactions or where the ATO is not able to obtain any meaningful information to apply Australia's existing tax laws.
- It should be made clear in the law that existing transfer pricing provisions that are aligned with international standards and guidelines are the first port of call and that where taxpayers have an open and cooperative approach with the ATO they are excluded from the DPT.
- An independent panel to oversee the ATO's application of the rules be put in place in consultation with taxpayers to ensure a fair and sensible framework.
- Clearer objective tests based on international standards and guidelines should be included in the 'economic substance' test having regard to whether there is sufficient economic substance. The DPT should not impose a modified standard.
- The DPT should be subject to international dispute resolution procedures.

The introduction of poorly drafted and ill-considered legislation needs to be viewed in the broader context of Australia's lack of corporate tax competiveness and the need to attract investment. Taken together with Australia's high company tax rate, while competitor countries have progressively lowered theirs, this legislation is another blow to Australia's reputation as a stable and attractive investment destination.

1. CHANGES SINCE THE EXPOSURE DRAFT LEGISLATION

The MCA acknowledges that a number of sensible changes and clarifications have been made to the law since the exposure draft legislation was released in January 2017 for a very short consultation round. The MCA supports these changes including:

Commencement date

The legislation clarifies the proposed commencement date to income years commencing on or after 1 July 2017.

Interaction of the DPT and the thin capitalisation rules

The legislation confirms that the DPT applies to the interest rate applied to debt and not to the debt amount itself which is subject to the thin capitalisation rules.

Interaction of the DPT with the Controlled Foreign Company (CFC) rules

The legislation recognises Australian income tax paid through the CFC rules when considering whether DPT has been triggered. This sensibly recognises that amounts paid under Australia's CFC regime which do not raise avoidance conferences, prevent double taxation and not unfairly harm Australian headquartered international companies.

2. The DPT HAS BROAD AND UNCERTAIN APPLICATION

Overriding the international transfer pricing rules

The DPT can be applied to ordinary cross-border dealings as an alternate transfer pricing provisions in Division 815. The Government acknowledges that Australia's anti-avoidance and transfer pricing rules are *already amongst the strongest in the world* and, with the new international rules coming into play, it is unclear why it so keen to add another tax. The DPT is punitive to Australian operations and not aligned with international standards. The OECD Transfer Pricing Guidelines (TPG), which provides guidance on the application of the 'arm's length principle', should remain the authoritative and only method to effectively and efficiently allocate the income of multinationals among taxing jurisdictions. The arm's length principle reflects the international consensus on the appropriate allocation of profits between cross-border transactions.

The DPT could, as currently drafted, be used to adopt non-standard transfer pricing positions. It is entirely possible for a commercial transaction to be compliant with the internationally agreed tax rules, but for the ATO to override these rules and apply the DPT to adopt unilateral transfer pricing positions, resulting in double taxation and increasing the cost of doing business. Undermining the transfer pricing rules and deviation from the arm's length principle will create uncertainty for businesses operating in Australia, increasing the cost of capital and potentially harming Australia's cross-border investment and trade.

Given that the stated intention of the DPT was to be applied as a measure of last resort and to taxpayers who do not cooperate with the ATO, these principles should have been carried into the legislation and should ensure that the DPT cannot be applied where the arrangement can be dealt with by Australia's existing transfer pricing rules (or other provisions of the tax acts), and, indeed, where taxpayers are cooperating with the ATO.

As a measure of last resort, the ATO should exhaust all information request avenues before seeking to apply the DPT provisions. This would include all powers available under the current taxation laws and exchange of information provisions that are contained in Australia's Double Taxation Agreements (DTAs) and Taxation Information Exchange Agreements (TIEAs).

A principle purpose

The DPT substantially 'lowers the bar' from a 'sole and dominant' purpose in Part IVA to a 'principal purpose' test. It need only be one principle purpose amongst others and is to be applied objectively.

Essentially this means that legitimate transactions entered into for a principal purpose that is **not** to obtain a tax benefit may be deemed to have been entered into for such **a** purpose and subject to the DPT. This is because it could be concluded, objectively, that obtaining a tax benefit might have been **a** principal purpose. Given that any transaction with a related party in a country with a tax rate lower than 24 per cent (which is most other countries and the OECD) will yield benefits of at least 6 cents in every dollar, most will come within the scope of the DPT. Indeed, it will be difficult to resist this assertion on objective grounds and many taxpayers are likely to find themselves subject to the DPT and looking to the 'economic substance' test for exclusion. Australia's relatively high tax rate will ensure that many large corporate taxpayers dealing internationally will be drawn into the scope of this tax without any intention of avoidance at all. There is not real tax avoidance threshold in the application of the DPT.

Overriding the internationally agreed dispute mechanisms

The DPT should be subject to international dispute resolution procedures because it has been implemented as a broadly based alternative transfer pricing provision and not as a true anti-avoidance measure. There may be legitimate disputes on the allocation and taxation of business profits and Australia's DTAs require tax administrations to resolve double taxation issues. The OECD recognises

that double taxation of businesses has a negative impact on investment, growth and employment globally[1].

As part of the OECD BEPS project, countries have agreed to important changes in their approach to improve dispute resolution. Australia is one of a large group of countries that has committed to adopt and implement independent binding arbitration as a way to resolve disputes that would otherwise remain unresolved through the mutual agreement procedure. The MCA strongly supports independent binding arbitration as a mechanism to guarantee that treaty-related disputes will be resolved within a specified timeframe and prevent double taxation.

However, it is understood from Treasury's consultation paper on Australia's adoption of the OECD Multilateral Instrument that the Australian Government proposes to exclude Australia's general anti-avoidance rules from the scope of arbitration thereby denying taxpayer access to independent binding arbitration for DPT assessments. This raises the risk of double taxation for Australian taxpayers and by-passes international efforts to avoid this.

If Australia excludes the DPT from independent binding arbitration (under the OECD Multilateral Instrument, BEPS Action 14) the ATO could effectively use the DPT to ignore the arm's length principle and coerce taxpayers into accepting the ATO's position. This will circumvent access to independent binding arbitration as a means of resolving a genuine cross border disputes with another tax authority and give the ATO unilateral powers to deny a fair hearing be given to transfer pricing issues raised by taxpayers and other taxing authorities, each of whom have a legitimate interest in the outcome.

As the legislation is very broad in its potential application and drafted without sufficient regard to OECD TPG and the arm's length principle, the DPT should not be excluded from independent binding arbitration to limit the potential for double taxation. Furthermore, the statutory provisions must ensure that the DPT must not apply to matters which can be resolved by applying Australia's transfer pricing rules, particularly where the taxpayer is cooperating with the ATO and the transaction is not artificial or contrived.

Flaws in the legislation already evident

Haste in introducing new and undefined concepts into the tax law with uncertain application creates unintended consequences. The flaws in the legislation are already evident and these are only expected to exacerbate over time as the full ramifications of the DPT unfold.

The following example highlights potential flaws from the poorly considered legislation:

Australia Co pays a $100 royalty to Foreign Co which is subject to pay tax on the royalty income at 25% and in addition Australia Co withholds 10% in royalty withholding tax (WHT). The policy intention would be that this transaction meets the sufficient foreign tax paid and not be subject to DPT (ie 25% is greater than 80% of Australia's 30% corporate tax rate). However, due to flaws in the legislation, this transaction would in fact be within the scope of the DPT.

If the ATO assert that the whole $100 is a tax benefit, under the DPT the reduced Australian tax liability will be $20 (ie 30% less the 10% royalty WHT multiplied by $100). For the sufficient foreign income test to be met, the foreign tax paid should be at least $16 (ie 80% of $20). However, as the actual total foreign tax paid is only $15 (ie $25 less foreign tax credit of $10), and despite the Foreign Co being subject to a tax rate of 25%, the transaction would be in scope of the DPT.

Ironically, if no WHT was applicable on the royalty income and thereby Australia did not receive any tax revenue, then this transaction **would not be** in scope of the DPT (which is indeed the intention of the policy). This simple example highlights the flaws and unintended consequences arising from the poorly drafted law. Further consultations are required to rectify unintended consequences.

[1] http://www.oecd.org/ctp/beps-frequentlyaskedquestions.htm

3. ECONOMIC SUBSTANCE TEST – SUBJECTIVE AND UNCERTAIN

The ‘economic substance’ test is critical to the operation of the DPT – ensuring that it targets situations that are artificial or contrived because they lack ‘economic substance’. The issue, however, is that ‘economic substance’ is a subjective concept. The lack of a clear objective test to determine sufficient economic substance means that the DPT can apply to legitimate commercial transactions.

The use of subjective and ambiguous terms such as ‘reasonably reflects the economic substance’ with minimal legislative or objective reference points or precedent will result in unrestrained application and will only create significant uncertainty, a large compliance burden and a potential impact that will affect the attractiveness of Australia as a place to invest.

This may also require taxpayers to undertake extremely difficult and burdensome additional transfer pricing analysis. This comes on top of the increased compliance costs of transfer pricing imposed since the strengthening (supported by the MCA) of Australia’s transfer pricing rules.

Objective tests could include situations where a cross-border transaction between two related parties is comparable to uncontrolled transactions and, similar to the UK approach in their DPT, the non-tax financial benefit test should be included in Section 177L. Where these tests are satisfied the DPT should not apply.

The ‘sufficient economic substance test’ is not intended to apply where the Commissioner may not have sufficient information to be satisfied that the relevant entity has sufficient economic substance. While this may seem reasonable at first, the legislation will require **every** foreign associate entity (other than those whose role in minor or ancillary) that is connected with any part of the scheme to satisfy the condition that its income reasonably reflects the economic substance of the entity’s activities. This can present an overly onerous evidentiary burden that taxpayers may not be able to meet.

As noted in our submission on the exposure draft legislation, suppose Country A develops and owns all the intellectual property for widgets. Country A enters into an agreement with affiliates in over 100 countries, including Australia, to distribute the widget. All the affiliates are in some way connected to the scheme and therefore will be required to satisfy the economic substance test. The taxpayer will be obliged to provide information (whether requested or not by the ATO) to the effect that all the entities have sufficient economic substance. This will likely prove to be impractical for many taxpayers.

Exclusions

The MCA’s original proposal for a tight gateway to target the DPT at the areas of concern for the Government would have minimised compliance costs and impacts on legitimate transactions. As currently drafted, the legislation does not adequately allow for taxpayers who are cooperative and open with the ATO on transfer pricing matters. Legitimate transactions and cooperative taxpayers should be expressly excluded from the scope of the DPT.

The statutory provisions must ensure the DPT can only apply to matters where the taxpayer is not cooperating with the ATO and where the transaction is clearly artificial or contrived.

The DPT should not apply where the taxpayer has entered into a Key Taxpayer Engagement (KTE) (including Annual Compliance Arrangements (ACAs) and Pre-lodgement Compliance Review (PCR)) with the ATO that sits in the ‘Partnering’ Client Risk Continuum. The KTE provides a real-time transparent, engagement approach to working co-operatively with the ATO and encouraging ‘justified trust’ with the ATO. The KTE environment encourages an environment where the taxpayer can raise compliance risks and other technical and administrative matters and resolve issues in a constructive, efficient manner.

To incentivise an ongoing open and transparent relationship between taxpayers and the ATO, provision should be made to exclude taxpayers who have entered into a KTE or similar arrangement.

4. HARSH ADMINISTRATIVE AND DISPUTE PROCEDURES

The DPT administrative arrangements are extremely harsh:

- Upfront payment of a DPT assessment within 21 days
- The Tax Commissioner can issue a DPT assessment within 7 years (rather than the standard 4 year period for review and amendment of assessments including where the general anti-avoidance provision applies)
- A short objection period of 12 months
- No access to arbitration under the OECD Multilateral Convention
- Restrictions on taxpayers providing evidence to the court in a dispute.

Given the serious penalty imposed by the DPT (40 per cent tax), uncertain application of the rules and the wide reach of the laws, the DPT requires stronger oversight and safeguards for taxpayers who are cooperative and trying to 'do the right thing'.

Independent DPT panel and guidance material

An independent panel of taxation experts should be established to determine whether an arrangement is ought to be subject to the punitive treatment under the DPT. This is critical to ensuring that there is some form of procedural fairness in the application of the law.

The MCA acknowledges that the explanatory memorandum and the ATO state that a 'rigorous' framework will be introduced and that 'the Commissioner will establish a panel similar to the general Anti-Avoidance Rule Panel to make determinations on DPT assessments in all but 'very limited circumstances.' The ATO will also consult on DPT guidance materials for taxpayers.

The MCA supports this as a way of ensuring that appropriate checks and balances are in place and are implemented by an independent panel before the ATO imposes the DPT. However, the guidance and words in the explanatory memorandum giving these assurances are not binding on the ATO because it is not in the law. An independent DPT panel should be embedded into the legislation, as the UK has done with the GAAR Advisory Panel.

The MCA strongly supports the commitment outlined in the explanatory memorandum that the ATO provide draft guidance to taxpayers at the time of introduction of the DPT legislation to Parliament. This guidance should reflect the stated purpose of the DPT as outlined above. Ideally draft administrative guidance would have been issued by the ATO in advance of the introduction of the DPT legislation to Parliament to allow sufficient time for consultation to ensure the ATO guidance is in line with the final legislation and EM.

Restricted evidence

The DPT proposes to impose strict rules that would deny evidence being admitted to court in defence of a taxpayer – unless the Commissioner approves. It would apply to evidence an entity had in its custody or review under its control at a time before, during or after a period of review of the application of the DPT and the Commissioner did not have in his or her custody or control at any time in the period of review will not be admissible if an appeal is made to the Federal Court.

The MCA understands that an aim of the law is to encourage taxpayers to be cooperative and open with the ATO during an audit or review and to provide information at this time, and while the MCA has sympathy for the need to target taxpayers who are uncooperative with the ATO (Commissioner Jordan outlined legitimate issues with taxpayers dragging their feet on providing information held offshore in Senate estimates hearings in 2016), this restriction of evidence will result in perverse outcomes, and is fundamentally unfair for the following reasons:

- Where the Commissioner simply does not ask for specific documentation/information during the period of review, then the law restricts this specific documentation/information from being admissible as evidence despite a cooperative taxpayer obliging with all information requests

made in a timely manner. It requires a taxpayer to provide every piece of information to the ATO that may be in existence which could be remotely linked with an arrangement in case the matter ever goes to court.

- Information that the entity has in its possession after the period of review would be excluded even if the taxpayer provides all information that is requested and in existence which is relevant to the review. The measure should only be targted at situations where information that is requested during a period of review but not provided because it is held offshore.
- It is common that only once matters proceed to litigation that taxpayers incur significant expenditure on opinions from external experts and other evidence that a party to a court proceeding can effectively address or defend the position they have taken. The ATO may raise new contentions and assertions that the taxpayer will need to address at this time and should not be constrained from addressing these contentions when they are made. It would be inappropriate to limit the rights of either party to present evidence as the case develops and positions are taken. If an important precedent case is decided after the period of review that may assist the taxpayer's appeal, this information would not necessarily be allowed to be used as evidence.

The DPT confers unilateral powers on the ATO to raise tax assessments that are supported by minimal evidence of arm's length pricing and where genuine differences of view may exist between them and taxpayers. In these circumstances it is critical that safeguards be put in place to minimise risk of abuse and to reduce uncertainty. The DPT also imposes additional compliance for taxpayers who are 'doing the right thing' and are in compliance with the existing transfer pricing rules. Guidelines should be put in place to minimise the incremental administrative burden so that taxpayers do not need to substantially increase transfer pricing documentation above what is already required.

The DPT is a punitive measure that departs significantly from the international tax standards. As the DPT currently stands, it will inject uncertainty and unpredictability into Australia's tax arrangements and impose ongoing compliance costs to taxpayers investing in Australia and for Australian based international companies.

APPENDIX

The proposed DPT is a unilateral action that significantly departs from the international tax framework and Australia's commitment to a global co-ordinated response to Base Erosion and Profit Shifting (BEPS). Introducing new tax rules that are ambiguous, complex and poorly targeted creates significant uncertainty, increases compliance burdens and potentially affects Australia's reputation as a safe and fair place for international trade and investment.

OECD warnings against taking unilateral actions:

> [this] would have a negative impact on investment, growth and employment globally. There is therefore a need to provide an internationally coordinated approach which will facilitate and reinforce domestic actions to protect tax bases and provide comprehensive international solutions to respond to the issue.[2]

> Pascal Saint-Amans, Director of the Center for Tax Policy and Administration at the OECD stated in an interview to the Sydney Morning herald 5 October 2015 regarding Australia's MAAL: 'These measures were not helpful' and '..And may not happen to extent that they will be superseded by BEPS measures.'[3]

Treasury and Government commentary

Then Parliamentary Secretary to the Treasurer, and the now Minister for Trade and Investment, Hon Steve Ciobo MP said:

> [G]iven the cross-border nature of BEPS, national efforts need to be complemented by appropriate, coherent international responses. These are needed for two reasons. Firstly, to prevent new gaps and arbitrage opportunities from emerging; and secondly, to help prevent individual countries putting in place damaging unilateral measures.[4]

Treasury's 2013 Scoping Paper on Risks to the Sustainability of Australia's Corporate Tax Base concluded:

> There are some actions Australia can and has taken unilaterally; these are primarily focused on improvements that can be made without significant divergence from international tax settings. But the key focus of Australia's efforts should be working multilaterally through international organisations to modernise international tax rules.[5]

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[2] http://www.oecd.org/ctp/beps-frequentlyaskedquestions.htm, accessed 17 June 2016.
[3] SMH, October 5 2015: http://www.smh.com.au/business/the-economy/hockeys-laws-to-fight-multinationals-will-be-superseded-by-final-beps-plan-oecd-says-20151005-gk1ait.html
[4] The Hon Steve Ciobo, Parliamentary Secretary to the Treasurer, Address to Clayton Utz BEPS Workshop, 16 May 2014.
[5] The Treasury, 'Scoping Paper on Risks to Australia's Corporate Tax Base', July 2013.