The Key Battleground of the Australian Diverted Profits Tax: The Sufficient Economic Substance Test

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This article was selected as a winning entry in *Tax Notes* annual student writing competition.

In this article, the author discusses the proposed sufficient economic substance test for multinationals seeking an exemption from Australia's diverted profits tax.

The international tax sphere is rife with movements to counter tax avoidance and base erosion and profit shifting by multinational enterprises. Amid that worldwide effort, on April 4, 2017, Australia passed the Diverted Profits Tax (DPT) Act 2017 as Schedule 1 to the Treasury Laws Amendment (Combating Multinational Tax Avoidance) Act 2017. Australia's DPT went into effect July 1, 2017, and brought with it controversy and, unfortunately for taxpayers, uncertainty.

On February 7 the Australian Taxation Office released a draft practical compliance guideline (PCG 2018/D2) to assist taxpayers in complying with the DPT.[1] However, the draft lacks the clarification taxpayers might have expected, including that regarding the sufficient economic substance (SES) test, which provides an exception to the application of the DPT.

This article explores the difficulties MNEs will face in satisfying the vague SES test. Under the legislation alone, it is essentially impossible to establish what is required to fulfill the test, and although the draft guideline sheds light on the requirements, the test is administered with abundant discretion. MNEs therefore face great uncertainty in their ability to rely on the test and avoid the DPT. This article also suggests that it is likely that the SES test was intentionally drafted to apply to few, if any, cases. The draft guideline sets an exceedingly high threshold to satisfy the test, and the DPT is likely to become a safety net to catch any cases that fall through Australia's antiavoidance laws. This article is not intended to discuss how the SES test could be improved but instead to analyze the difficulties in satisfying it.

I. Background

The DPT provisions are the newest additions to the antiavoidance sections of the Income Tax Assessment Act 1936 (ITAA 1936) and impose a 40 percent tax rate on DPT benefits incurred in tax years beginning on or after July 1, 2017. The DPT has two key objectives: prevent "significant global entities" from diverting profits offshore and ensure that they pay an amount of Australian tax that accurately reflects their activities in Australia. It is also intended to encourage the transfer of information between significant global entities and the Australian Tax Office.

The DPT is a response to public concern that MNEs are not paying their fair share of tax in Australia. Tech giants Apple Inc., Google LLC, and Microsoft Corp. were among the companies paying startlingly low taxes on their Australian sales.[2] The public outcry prompted the Australian Senate to request an inquiry into tax avoidance by MNEs operating in Australia that led to six public hearings and 121 public submissions. The resulting recommendations suggested that

[1] The DPT provisions are also accompanied by a law compliance ruling (LCR 2017/D7 (Mar. 28, 2018)) and a practice statement law administration (PS LA 2017/2 (Dec. 18, 2017)).

[2] H. Khiem (Jonathan) Nguyen, "Australia's New Diverted Profits Tax: The Rationale, the Expectations and the Unknowns," 71 *Bull. Int'l Tax'n* 513 (2017).

Australia take unilateral action, which goes against the objectives of the OECD's BEPS project, a multilateral initiative.

Even so, the Australian government chose to accept the recommendation and take unilateral action. On May 3, 2016, Treasury released a consultation paper on DPT implementation, as well as the 2016-2017 budget, which promised to introduce the DPT as a measure to "strengthen the integrity of Australia's tax system."

The DPT is one of many measures the Australian government has introduced to address tax avoidance by MNEs. In 2013 it changed its transfer pricing rules, and in December 2015 it introduced the Multinational Anti-Avoidance Law (MAAL) to target MNEs that erode the Australian tax base.[3] Although not directly targeting base erosion by MNEs, new sections 815(B-D) of the Income Tax Assessment Act 1997 (Cth) (ITAA 1997) are considered part of the arsenal to bring MNEs into line.[4] It is unclear how the DPT fits into that mosaic of laws; at the very least, it will intimidate MNEs into opening their books to the ATO or seeking an advance pricing agreement. Given the DPT's wide scope, it is possible that the DPT is a safety net for the ATO to catch any MNEs that manage to avoid penalization under Part IVA of ITAA 1936.

II. Application of the DPT

The DPT is notoriously discretionary, with one commentator going so far as to call it a "highly discretionary nuclear option."[5] That discretion becomes clear when analyzing the DPT's possible application — particularly which schemes are targeted. To be liable for DPT, a taxpayer must be a relevant taxpayer who has obtained a DPT benefit for a scheme in a year of income on or after July 1, 2017.

A. Who Is a Relevant Taxpayer?

A relevant taxpayer for the DPT is a significant global entity, defined as a large multinational entity with annual global income of at least AUD 1 billion, in the specified year of income.[6] That aligns with the more specific qualification of the same term in ITAA 1997 section 960-555(1).[7] Managed investment trusts, foreign investment vehicles with wide membership, entities owned by foreign governments, complying superannuation entities, and foreign pension funds are exempt from the DPT regardless of whether they meet the threshold.

B. What Is a Scheme?

Determining whether a scheme qualifies as being meant for a DPT benefit requires establishing whether it (or any part of it) was entered into or carried out with the principal purpose of obtaining a tax benefit and reducing tax liabilities under a foreign law. The second purpose does not reflect the objective of protecting the Australian tax base but does ensure that the DPT will apply if avoiding foreign tax is a main goal of the scheme.

The ATO has said the principal purpose test involves a lower threshold than the other antiavoidance provisions in Part IVA of ITAA 1936, which use a sole or dominant purpose test when determining a scheme's purpose.[8]

C. Exceptions to the DPT

Once it has been established that the entity is a relevant taxpayer that has obtained a tax benefit from the scheme, three further tests can render the DPT inapplicable. The first is the AUD 25 million income test, which is the DPT's de minimis threshold. Under that test, a taxpayer will be exempt from the DPT if the sum of its total assessable income, exempt income, nonassessable nonexempt income, and DPT benefit is less than AUD 25 million in the year of income. The

[3] ITAA 1936 section 177DA; LCG 2015/2 describes the purpose of the MAAL.

[4] Richard Gelski, "Law, Morality and Multinationals," 20(4) *Tax Specialist* 174, 182 (2017).

[5] *Id*.

[6] Revised Explanatory Memorandum, Treasury Laws Amendment (Combating Multinational Tax Avoidance) Bill 2017 (Cth), Diverted Profits Tax Bill 2017 (Cth), 21, 1.6.

[7] ITAA 1997 section 960-555 clarifies that an entity is a significant global entity if it is a global parent entity whose global annual income for the period is at least AUD 1 billion, or is a member of a group of entities consolidated for accounting purposes as a single group and one of the other members is a global parent entity with an income of AUD 1 billion for the period.

[8] *Supra* note 6, at 1.46.

exemption was likely included to ensure that ATO resources are concentrated on cases that will have the greatest effects on the Australian tax base.

The second test is the sufficient foreign tax test, which excludes a taxpayer from DPT liability if its foreign tax liability equals or exceeds its reduced Australian tax liability. Foreign tax liability refers to the total increase in liability for foreign income tax resulting from the scheme during the corresponding foreign tax period. Reduced Australian tax liability can either be the amount of the DPT benefit, or the product of the DPT benefit and the standard corporate tax.[9]

The final test is the SES test. There is little room for interpretation of the other two tests, given their numerical thresholds. The SES test does not incorporate thresholds like those, and therefore creates a gray area capable of dispute. It is likely that significant global entities that do not qualify for exemption under the first two tests will argue that they satisfy the SES test. It is the most accessible option for significant global entities that find themselves subject to the DPT. That likelihood and the SES test's disputable nature has earned the test the reputation of "key battleground" of the DPT.[10]

III. The SES Test

To be eligible for relief under the SES test, a significant global entity must show that the profit resulting from the scheme reasonably reflects the economic substance of the entity's scheme-related activities. That will be established by examining the entity's functions, assets, and risks, as well as any relevant documents and other matters. The ability to refer to any other relevant matters makes the test highly malleable.

The ATO has "received feedback that affected taxpayers are likely to assess the risk of their arrangements by reference to the SES test before considering other aspects of the DPT."[11] For that reason, the draft guideline tries to clarify the test by offering a non-exhaustive list of framing questions, as well as 10 scenarios that qualify as either high- or low-risk schemes.

A. The Framing Questions

To determine whether the DPT will apply to a scheme, the draft guideline contains both transaction-specific and SES-specific framing questions. The guideline is clear that the questions are not exhaustive and are intended merely as a general guide to the kinds of matters the ATO might take into account. Additional matters might be considered depending on the circumstances.[12] Again, the framing questions demonstrate the huge amount of flexibility the ATO has in pursuing MNEs under the DPT, which translates directly into uncertainty for targeted entities.

Uncertainty is something taxpayers scramble to avoid. A significant global entity that is facing the possibility of a 40 percent penalty tax rate will not want to be unsure of aspects that determine whether it will be subject to that penalty. That feeling of unease is not lessened by looking at the transaction-specific framing questions, which are not actually questions at all. The guideline states that the ATO "may ask a number of transaction-specific framing questions" and lists several factors the questions could focus on.

Without question marks, the statements cannot be considered questions; that aspect of the draft guideline would be better titled "transaction-specific matters relevant in assessing risk." Title aside, the matters listed still leave much to the imagination. No guidance is provided regarding how much weight is given to each matter, and presumably, some matters would be more problematic than others. MNEs are thus faced with the possibility that the ATO will use its discretion in assigning weight to various features, which could theoretically empower it to deem an arrangement high risk based on a single framing question. That highlights the uncertainty that makes it difficult for MNEs to assess their DPT risk.

Fortunately, the SES-specific framing questions are actually questions. While there is once again no clarity regarding the weight of

[9] The product method applies if the DPT benefit could fall within the definition of a scheme in section 177C(1)(a), (b), (ba), or (bc).

[10] Tony Frost, Richard Vann, and Hugh Paynter, "Diverted Profits Tax," Greenwoods Herbert Smith Freehills Tax Brief (Feb. 16, 2017).

[11] LCR 2017/D7, *supra* note 1.

[12] *Id*. at 42.

individual questions, some patterns do emerge, and a general analysis of the questions allows an MNE to assess what aspects of its arrangements might be scrutinized.

The first principle that can be gleaned from the questions is that there must be consistency between the arrangement's purpose and its verified outcome. The SES test requires that the arrangement carry out its purposes and cannot be fulfilled merely by representations; it requires proof of action.

The second principle follows from the first. If an arrangement involves the transfer of valuable intangible assets, functions, and economically significant risks offshore, there must be corresponding changes. Further, the recipient entity must be competent in managing those assets, performing those functions, and managing the contractually assumed risks.

Under the third principle, the transfer of risk must be accompanied by a transfer of control, and the circumstances of the transfer will be closely evaluated. Like the first principle, practical truths, not mere representations, are key. The questions ask whether the receiving entity has the financial capacity to bear the risks or is bearing economically significant risks that do not align with its contractual assumption of risks, and whether the consequences of the risks being assumed are already known or reasonably knowable. The focus suggests that generally, any transfer of risk has the potential to prevent the SES test from applying.

The fourth principle that emerges is that the arrangement must be in accord with its commercial environment. The questions require evidence of market conduct that resembles the arrangement. This inquiry is framed so that if the market or industry generally centralizes assets, functions, and risks, then the arrangement should follow that pattern. If the industry generally does not centralize these aspects, then the relevant arrangement should not do so either. Further, the arrangement must of course comply with the arm's-length principle. That focus suggests that the SES test might not be fulfilled if it can be proven that the arrangement is not in accord with other arrangements in the same market or industry.

The SES-specific framing questions are therefore not hopelessly vague. The four distinct principles can help MNEs gauge their prospective success under the SES test. What remains unsettling is the discretion the ATO has in deciding which questions apply and how much weight to give them, and whether to consider non-listed factors. Thus, while the principles can help guide MNEs, there are no hard and fast rules for them to follow. It is likely that with such broad discretion, the ATO could challenge any taxpayer that asserts its arrangements satisfy the SES test.

The draft guideline also provides several framing questions for the principal purpose test, and states that several of the SES test questions are relevant to the principal purpose test. It is arguable that the requirements for the SES test are so closely aligned to those for the principal purpose test that the SES exception is an artificial device. The questions regarding the principal purpose test relate only to the availability of alternatives; aside from that, the principal purpose and SES tests ask the same questions. It is therefore likely that if a significant global entity is found to have entered into a scheme for the principal purposes described in ITAA 1936 section 177J(1)(b), it will not obtain relief under the SES test. Therefore, the SES test is unlikely to ever be met and could be considered unnecessary.

B. Examples of High- and Low-Risk Schemes

To assess risk as part of the SES test, the draft guideline does not incorporate colored zones, as used in draft guidelines 2017/1 and 2017/4, for example. Instead, MNEs must assess themselves as having either a high- or low-risk arrangement by drawing analogies to the 10 high- or low-risk scenarios in the draft guideline. That design helps put the framing questions in context and offers additional matters to consider — which could either increase or decrease the difficulties in satisfying the SES test. On the one hand, the framework gives MNEs more material to work with in assessing their risk (but also brings some non-listed matters to the surface). On the other hand, it creates an observable — and high — threshold regarding what constitutes a low-risk arrangement.

The assessment framework provides an example of a high-risk scenario, followed by a low-risk scenario based on the same facts. High-risk scenarios are drafted to be obviously contrived schemes; for example, one scenario involves a low-risk, low-function, high-profit subsidiary being imposed between foreign and domestic related parties. The low-risk scenarios vary significantly from their high-risk counterparts. They list numerous differences but again lack guidance regarding how factors are weighted, which suggests there is no range of risk as there is with other draft guidelines. Instead, significant global entities are required to closely affiliate with one of the low-risk scenarios, all of which set the bar especially high. It will therefore be difficult for entities that affiliate partly with a high-risk scenario and partly with a low-risk scenario to argue that they satisfy the SES test. Even if a significant global entity's arrangement comes close to resembling a low-risk scenario, there is no guarantee that it will satisfy the test.

IV. Conclusion

The Australian DPT is controversial. To satisfy public outcry, it punishes MNEs that threaten the Australian tax base. For DPT provisions with nonnumerical thresholds, the SES test provides an exemption — that entities will struggle to rely on. The test is drafted in a way that provides the ATO with broad discretion to decide whether it applies, which makes outcomes for MNEs highly uncertain. The guidance suggests that MNEs will need to overcome an extremely high threshold to qualify for relief. Further, the test aligns so closely with the principal purpose test that it may never be satisfied. ■