LCR 2018/6EC - Compendium

Public advice and guidance compendium – LCR 2018/6

This is a compendium of responses to the issues raised by external parties to draft Law Companion Ruling LCR 2017/D7: *Diverted profits tax*.

This compendium of comments has been edited to maintain the anonymity of entities that have commented.

Summary of issues raised and responses

Issue No.	Issue raised	ATO Response/Action taken
1	**The amount of the tax benefit mentioned in paragraph 177J(1)(b)* (for the purposes of applying the principal purpose test)** It is contended that the better view is that the reference to tax benefits obtained by other taxpayers under the scheme in subparagraph 177J(1)(b)(ii) is that they are only referred to for the purposes of identifying the relevant scheme and, in particular, to ensure that schemes that the taxpayer is not the only participant in are included. It is understood that the rationale in the draft Ruling is supported by paragraph 177J(1)(b) referring to 'having regards to the matters in subsection (2)' and that paragraph 177J(2)(d) refers to the amount of the tax benefit mentioned in paragraph 177J(1)(b). It is contended that the better interpretation is that the tax benefit referred to in paragraph 177(1)(b) should only be the tax benefit of the relevant taxpayer and	In order for the tax benefit to be as described in the feedback (that is to the relevant taxpayer's tax benefit only) the paragraph would need to identify the tax benefit described in paragraph 177J(1)(a) (which is the DPT tax benefit) or the tax benefit described in subparagraph 177J(1)(b)(i) rather than the tax benefit described in paragraph 177J(1)(b). Note that the reference to paragraph 177J(1)(b) is in relation to consideration of the principal purpose (rather than working out the assessment of liability to the DPT – where the DPT base amount is worked out by reference to the more limited DPT tax benefit described in paragraph 177J(1)(a)). The legislation says to have regard to the tax benefit in paragraph 177J(1)(b), not just to subparagraph 177(1)(b)(i). It is clear that in considering purpose regard should be had to any tax benefit connected to the scheme and not only to the relevant taxpayer's tax benefit. Paragraph 1.41 of the revised explanatory memorandum (EM) to the Treasury Laws Amendment (Combating Multinational Tax Avoidance) Bill 2017 supports that approach.

* All legislative references are to the *Income Tax Assessment Act 1936* (ITAA 1936) unless otherwise indicated.

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	not include the tax benefits of other taxpayers that are party to the scheme. It is contended that this interpretation avoids the problem of including tax benefits that do not have any relevance to the tax benefit received by the taxpayer.	We do not agree with the suggestion that this could lead to inappropriate outcomes given other taxpayers' tax benefits would need to be connected with the scheme. Depending on the specific facts, if necessary the types of circumstances referred to in the submission might be managed by giving appropriate weight to the different purposes. In light of this analysis, no change has been made to the final Ruling.
2	**Delineation between when the DPT, as opposed to other provisions, will apply** It is contended that there needs to be clear guidance to both taxpayers and their advisers as to when the provisions of the DPT will apply to the exclusion of the primary taxing provision in the ITAA (in particular the transfer pricing provisions in Division 815 of the *Income Tax Assessment Act 1997*). It is argued that two of the objects (in referring to the Australian tax payable and Australian tax that is paid by significant global entities (SGEs) signal Parliament's intention of ensuring that the correct amount of income tax is paid by SGEs (rather than DPT being paid as the DPT does not meet the definition of income tax). It is argued that the ATO should confirm that it will administer the DPT assessment provisions in line with the wording of paragraph 1.18 of the EM (including that the DPT will be applied in only very	Paragraph 8 has been added to the final Ruling to: • highlight the 'purpose' element that needs to be present in order for the DPT to have potential application, and • acknowledge that, consistent with the operation of Part IVA generally, it is expected that the DPT will be applied in limited circumstances. The inclusion of this paragraph addresses the delineation between the DPT and other provisions (in particular, emphasising the central 'principal purpose test' provision – which needs to be satisfied before the DPT can apply).

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	limited circumstances) and extracts from the second reading speech that the DPT will not replace the transfer pricing rules and that those rules will remain the primary mechanism for pricing cross-border transactions.	
3	**Inclusion of internationally-specific 'warning signs'** The Ruling would benefit from the inclusion of 'warning signs' that might suggest to the ATO that the scheme had a principal purpose of obtaining a tax benefit. It is submitted that existing ATO guidance (including PSLA 2005/24 *Application of General Anti-Avoidance Rules*) do not have a specific international dimension and therefore not sufficiently relevant to the context in which the DPT could apply. This does not need to be an exhaustive list however it is considered that it would be beneficial to have these matters included.	There a number of framing questions in PCG 2018/5: *Diverted profits tax* (paragraph 29) that outline our approach to conducting a preliminary assessment of risk (specifically, in the context of particular arrangements for taxpayers that are otherwise within the scope of the DPT) that address international aspects. We consider that the 'risk assessment' approach used in PCG 2018/5 effectively acts to provide these 'warning signs'.
4	**Documentation** The Ruling should provide guidance on the documentation and evidence that the ATO will expect in reviewing the taxpayer's calculation of the non-tax financial benefits of a scheme.	PCG 2018/5 (paragraphs 59–72) provides general guidelines on the kinds of documentation we may take into account when considering the application of the DPT. This includes the kinds of source documents that would be specifically relevant to the application of the principal purpose test (including documentation relevant to quantifiable non-tax benefits resulting from the scheme – refer to item (c) of paragraph 65 of PCG 2018/5). As guidelines are provided about this documentation in PCG 2018/5 no change has been made to the final Ruling.

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5	**Reference to additional extrinsic materials about arrangements that are the focus of the DPT** The Ruling and Guideline should reference the statements in the EM and Second Reading Speech to the Bills which introduced the DPT. For example, paragraph 6 of the draft Ruling, which identifies that the EM contains a detailed summary of the measure (with paragraphs 1.9 to 1.15 of the revised EM containing a summary of the new law), should directly quote paragraph 1.18 of the EM (which specifies that the DPT expands the scope of Part IVA and is still focused on tax avoidance arrangements that are of an artificial or contrived nature).	Refer to issue 2 for our response (including the emphasis on the principal purpose test being the central provision around which the DPT operates).
6	**Inclusion of a summary of the criteria that must be satisfied before the DPT can apply** The Ruling should (in the legally binding section) include a summary of the conditions (contained in subsection 177J(1)) that need to be satisfied before the DPT can apply.	Paragraph 7 has been added to the final Ruling to summarise the criteria that must be satisfied in order for the DPT to be able to apply. This paragraph has been inserted into the non-binding 'Outline of the law' section of the Ruling as it is merely a summary of the criteria set out in subsection 177J(1). A summary of the conditions (before the DPT can apply) has also been added to the 'Background' section (paragraph 6) of PCG 2018/5.
7	**Inclusion of a reference to reasonable alternative postulate** The Ruling should (in the section entitled 'Consideration of the eleven matters') quote paragraph 1.27 of the revised EM (which refers to	These are matters that are common to the operation of Part IVA more generally. Therefore, the guidance in PS LA 2005/24 is equally relevant to guiding ATO officers in their approach to identifying the reasonable alternative postulate.

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	consideration being given to the reasonable alternative postulate determining the tax outcomes with reference to the ordinary provisions arising under that alternative). Further, reference should be made to the identification of the tax benefit and the operation of section 177CB in identifying the reasonable alternative postulate.	Footnote 4 has been added to the final Ruling for clarification.
8	**Reference to profit in the context of the sufficient economic substance test** The Ruling should stipulate that the sufficient economic substance (SES) test requires the examination of the profit not taxable income (and refer to *Chevron Australia Holdings Pty. Ltd. v. FC of T* 2017 ATC 20-615; – the 'Chevron case').	The Ruling refers to the SES test being satisfied where the profit made as a result of the scheme by each relevant entity reasonably reflects the economic substance of the entity's activities in connection with the scheme. An additional sentence has been added to paragraph 36 of the final Ruling to clarify that the term 'profit' in section 177M is used in a more general sense than 'taxable income'. It was not necessary to refer to the Chevron case in order to provide this clarification.
9	**Treating the objects of the DPT as a 'Guide'** The objects of the DPT (in section 177H) should be treated as a 'Guide' (within the meaning given by section 950-150 of the *Income Tax Assessment Act 1997* with their relevance being provided by that provision). The objects should be used to guide the application of the principal purpose test in paragraph 177J(1)(b) and the appropriate weighting given to the matters set out in subsection 177J(2).	The usual approach to statutory interpretation (including having regard to sections 15AA and 15AB of the *Acts Interpretation Act 1901*) would equally apply in considering the relevance of the objects (in section 177H) in determining whether the conditions in paragraph 177J(1)(b) are met. The Ruling stipulates that, consistent with Part IVA generally, regard must be had to all of the 11 matters in ascertaining whether there is a principal purpose of obtaining a tax benefit. No further clarification can be provided as this would be determined having regard to the specific facts and

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		circumstances.
10	**Economic substance being used in a relative sense** Disagree with paragraph 38 of the draft Ruling because the profit that is made by an entity can reasonably reflect the economic substance of its activities without reference to the relative economic significance of the functions performed or contributions made to the overall value chain. Economic substance in section 177M is not used in a relative sense because it is focused on each entity separately and the test is a singular test that looks at each entity separately.	We consider that the interpretation provided in paragraph 38 of the draft Ruling reflected the words of subsections 177M(1) and 177M(4). The provision requires consideration of the profit made by each of the relevant entities as a result of the scheme. We consider that in determining whether the profit made reasonably reflects the economic substance of the entity's activities in connection with the scheme, it is relevant to consider the entity's relative contribution (in order to determine if the reward, ie 'profit made', is reasonable). Accordingly, this paragraph (which is now paragraph 41 of the final Ruling) reflects our view.
11	**Arm's length pricing for the sufficient economic substance test** Contention that the application of the SES test and the assessment of economic substance will usually be determined by an assessment of the arm's length pricing particularly for intangible assets. Recommends that the ATO adopts an administrative practice of accepting viable Australian based transfer pricing positions as also meeting the requirements of the SES test.	Paragraphs 36-37 of PCG 2018/5 have been included to address the relevance of traditional transaction methods and transactional profit methods to consideration of the SES test. Paragraph 36 of PCG 2018/5 states: > When we are determining whether the profit made by an entity reasonably reflects the economic substance of the entity's activities in connection with the scheme, to the extent relevant, we will have regard to the OECD Guidelines in relation to the use of transfer pricing methods including both the traditional transaction methods and the transactional profit methods. The appropriate method will depend on the circumstances of the particular case.
12	**The use of 'reasonably reflects' in the context of the sufficient economic substance test** Under the sufficient economic substance test, the	Paragraph 36 of the final Ruling explains that the sufficient economic substance test requires a determination of whether the profit made by an entity in respect of the relevant

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	DPT will not apply in relation to the relevant taxpayer, in relation to a DPT tax benefit, if it is reasonable to conclude that the profit made as a result of the scheme by each entity covered by subsection 177M(2) reasonably reflects the economic substance of the entity's activities in connection with the scheme. The term 'reasonably' is a critical concept of the law, and in line with the purpose of the Ruling, needs to be explained. The addition of the word 'reasonably', unquestioningly lowers the threshold and it is not necessary that the profits made **actually** reflect the economic substance of the entity's activities.	activities represents a reasonable reward in relation to those activities. It is therefore considered that the Commissioner's view of what is a reasonable reflection in this context is explained by the fourth sentence in paragraph 36 and no further clarification is considered necessary.
13	**Inclusion of a new paragraph in relation to the quantification of non-tax financial benefits** Suggestion that a new paragraph be included to reflect the material in the EM about the temporal aspect of the quantification of non-tax financial benefits (ie that the quantification should generally be based on the anticipated outcomes at the time of entry into the scheme) and the proviso that the anticipated outcomes be based on reasonable commercial assumptions (paragraphs 1.53 and 1.54 of the revised EM).	An additional sentence has been added to paragraph 15 of the final Ruling.