COMPETITION
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GROUP

Diverted profit tax economic substance

Submission to Commonwealth Treasury

17 June 2016

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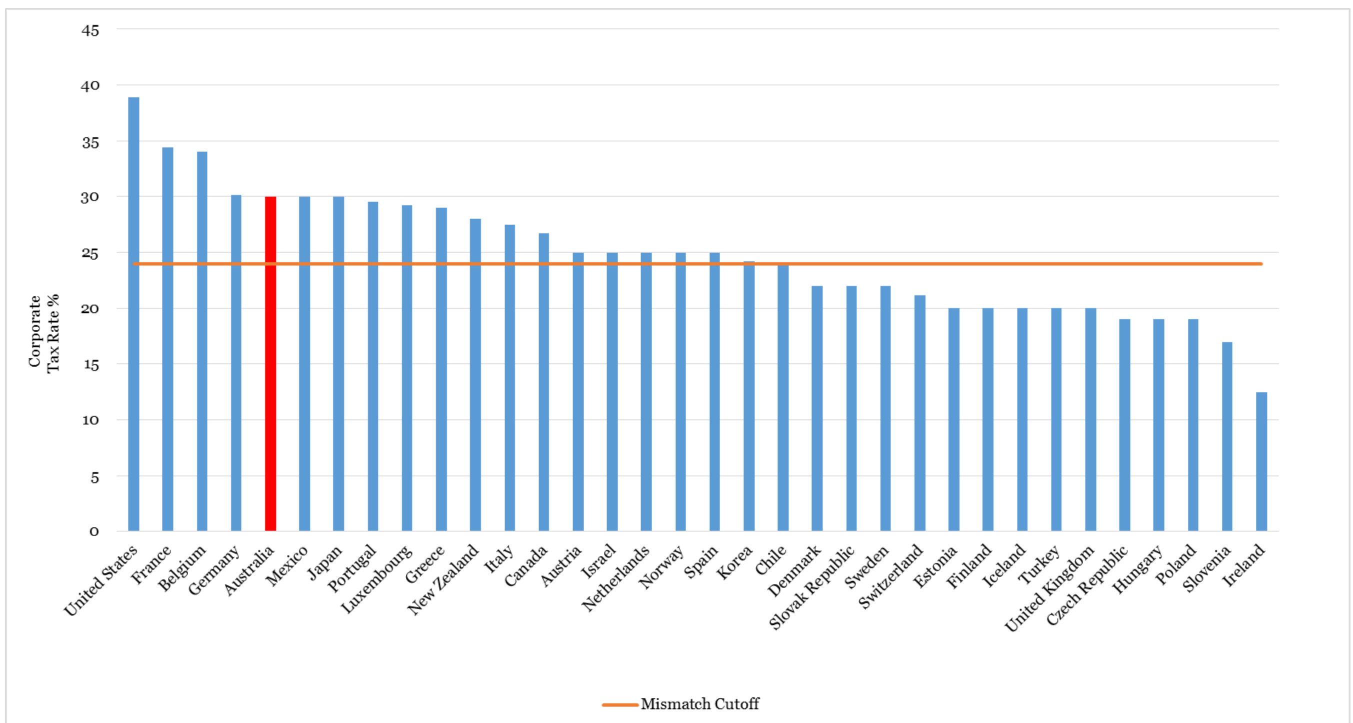
1 Introduction

1. The Commonwealth Treasury are consulting on the implementation of a Diverted Profit Tax (or DPT). The DPT will target related party transactions (or related entities involved in those transactions) that are designed to secure a tax reduction. It is specifically aimed at large multinational corporations with global revenues over $1 billion and a turnover of greater than $25 million in Australia.

2. The DPT will target transactions with entities located in jurisdictions with corporate tax rates that are less than 24% (i.e., 80% of Australia's current 30% tax rate). Given Australia's high corporate tax rate relative to some of its major trading jurisdictions, a large number of transactions will be targeted - including transactions with entities in Singapore (17%) and the UK (20%).[1] Figure 1 below shows corporate tax rates for OECD countries, including those that fall below the 80% tax mismatch with Australia.

Figure 1: OECD countries with a tax mismatch with Australia



3. It is notable that the United Kingdom, which has also implemented a DPT, has a much lower corporate tax rate than Australia (at 20%) and therefore targets significantly fewer jurisdictions. For example, the only OECD country captured by the UK DPT is Ireland.

[1] A list of countries that appear to be targeted is provided in Table 1 in the Appendix.

4. The DPT operates as a penalty tax on non-arm's length transactions with related entities located in these jurisdictions. If transactions with those jurisdictions are found to fall foul of the general transfer pricing provisions, the Australian Taxation Office (ATO) may have the discretion to impose an additional DPT assessment. In practice this means that corporations face greater risks in transacting with related entities in those jurisdictions.

5. In order to avoid a DPT assessment, corporations will need to demonstrate that transactions with entities in these jurisdictions have 'economic substance'. The Treasury's consultation paper proposes a test to determine whether transactions have insufficient economic substance. This test deems a transaction or entity's involvement in the transaction as sufficient if:

   > *the non-tax financial benefits of the arrangement* <u>*exceed*</u> *the financial benefit of the tax reduction*[2]

6. In our view, the application of this test will require the ATO to step into the shoes of the corporation and understand the incentives and motives for entering into transactions and arrangements. For corporations, this imposes a responsibility to review transactions *ex ante*, to determine whether they might satisfy this test as well as the robustness of their evidence supporting the economic effect of the transaction.

7. Testing the 'economic substance' of a transaction will likely require an economic valuation of transactions, assets and risks that goes beyond ordinary accounting principles. The non-tax financial benefit of transactions may accrue in a range of ways, for example, they might accrue in the form of lower costs due to economies of scale from centralising functions across jurisdictions or from improving coordination of activities including the use of intellectual property within the group.

8. Assessing the financial benefit of the tax reduction will also likely require economic analysis, particularly for Australian owned multinational corporations where the financial benefit of reduced corporate tax will depend on shareholder's personal tax rates (as a result of Australia's imputation credit arrangements).

9. This submission will seek to discuss some of the issues raised by the 'economic substance' test and evaluate a few examples of transactions that might be affected by the DPT. We will also consider similar legislation introduced in the UK and the US that may be potentially relevant when understanding the application of Australia's DPT.

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[2] This can be contrasted with the general anti-avoidance rule for income tax in Part IVA of the Income Tax Assessment Act (ITAA) 1936which relies on a "sole or dominant purpose" test to assess arrangements entered into by persons that are for the purpose of obtaining a tax advantage. In contrast, the DPT specifically seeks a comparison of tax benefits versus non-tax benefits, and only applies to corporations with global revenues over $1 billion and Australian turnover greater than $25 million.

2 Australia's economic substance test

10. The insufficient economic substance test appears to introduce a number of concepts that are open to interpretation. As a result, there may be some risks for legal practitioners and corporations when structuring their transactions in a way that complies with requirements of the legislation. This section will seek to discuss some of those terms and potential implications.

2.1 Potential ambiguity in the economic substance test

11. The first limb of the economic substance test introduces the notion of "non-tax financial benefits". A non-tax financial benefit may simply be considered an accounting profit, given the tax is titled "Diverted Profits Tax". However, firm decisions are often motivated by financial gains that may not be readily identifiable as accounting profit in the upcoming financial year. For example, the financial benefit to firms from entering into transactions may be uncertain (i.e., contingent on particular outcomes) and may not be expected to be realised for some period of time.

12. Therefore, in order to properly assess the non-tax financial benefit from a transaction it may be necessary to consider the *ex-ante* expectations of the firm entering into such arrangements. That is, to assess what non-tax financial benefit the firm might have reasonably expected at the time it entered into the transactions, rather than what financial benefit was ultimately realised (assuming that can be identified). This requires valuing financial benefits that will not readily appear in financial statements. One method that has been used to evaluate the economic substance of tax-motivated transactions is a discounted cash flow analysis.[3] This analysis compares the incremental, risk adjusted benefits of the activities with the incremental risk-adjusted costs, ignoring taxes.

13. Another element is to consider the timing of the financial benefits. Do they need to be expected to be realised in the coming financial year, or can they be expected to materialise over a longer time horizon? And if so, are the tax benefits cumulatively valued over the time horizon? If we are looking at one accounting period, there would be questions as to whether the rationale behind firm decisions is accurately represented by the balance sheet for one accounting period. Arguably, if a firm enters into a transaction based on the expected non-tax financial benefits, this would require the ATO to make a judgement on the probability of those financial benefits materialising in the future and whether that probability sufficiently concurs with the

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3 Borek, T., Fratarelli, A. & Hart, O., *Tax Shelters or Efficient Tax Planning? A Theory of the Firm: Perspective on the Economic Substance Doctrine,* April 2013, PRT Paper, available at < http://www.law.nyu.edu/sites/default/files/upload_documents/2014-03-04%20Hart_Tax%20Shelters%20or%20Efficient%20Tax%20Planning.pdf>

firm's assessment of risk and uncertainty.[4] As noted by Borek et al (2013), such analysis will be dependent on the robustness of forecasts.

14. Whilst discounted cash flow analysis may be helpful in identifying non-tax financial benefits in some circumstances, in many cases assessing the financial benefits from entering into transactions requires an analysis and quantification of the economic benefits from centralising functions with the multinational firm. Economic theory has examined extensively the gains from centralising activity within a firm – Coase's (1937) seminal paper[5] discusses the role of reduced transaction costs in the formation of firms. A more recent survey by Hart discusses the range of economic motives for firms to centralise its functions, including to resolve principal agent issues, reduce transaction costs and address the problem of incomplete contracts.[6] For the purposes of the DPT, these economic motives need to be quantified and assessed by reference to the associated tax reduction.

1.1 Why MNCs do the things they do: opening the black box of internal transactions

15. Given that the goal of the insufficient economic substance test is to determine whether it is reasonable to conclude that the arrangement was designed to secure a tax reduction, it is important to understand why firms enter into certain transactions.

16. Adopting the view that multinational corporations (MNCs) exclusively transact to avoid tax ignores the economic and international business literature and empirical evidence[7] that suggest non-tax motivations for MNC transactions.

17. Firms, particularly MNCs, face a complex set of choices when deciding to where to invest or locate its functions. Although tax is one consideration it is certainly not the only consideration, with other factors such as risks, wage rates and political stability all playing a part in firm decision-making. One way of rationalising MNC internal transactions is that firms establish foreign operations in order to capitalise on their ownership of certain assets which can be transferred across different parts of the firm

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4 Discounting the expected future benefits at an appropriate rate is also required to take into account the time value of money. This is one of the key principles of corporate finance.

5 Ronald Coase, *The Nature of the Firm, Economica*, New Series, Vol. 4, No. 16 (Nov, 1937), pp. 386-405

6 Oliver Hart, An Economist's Theory on the Perspective of the Firm, *Columbia Law Review*, vol. 89, no.7, Contractual Freedom in Corporate Law (Nov., 1989), pp. 1757-1774

7 Borek, T., Fratarelli, A. & Hart, O., *Tax Shelters or Efficient Tax Planning? A Theory of the Firm: Perspective on the Economic Substance Doctrine,* April 2013, PRT Paper, available at < http://www.law.nyu.edu/sites/default/files/upload_documents/2014-03-04%20Hart_Tax%20Shelters%20or%20Efficient%20Tax%20Planning.pdf>

at a relatively low cost.[8] Examples of the kinds of assets that firms may seek to capitalise on include technologies, patents, brands, know-how, managerial capabilities and organisational routines.[9] These advantages have economic value, through the way they lower costs, increase efficiency and productivity, and expand market power. Ultimately, the size and scope of the firm can increase due to the ability to utilise these assets in different jurisdictions. This is the essence of globalisation.

18. Implementing different ownership structures over these assets across the firm is one motivation for corporate restructuring and entry into intra-firm transactions. Firms when making these decisions consider a number of trade-offs arising from different ownership structures, weighing up factors such as incentives for value creation, distribution of risk, bargaining problems and administrative complexity. For example, although shared ownership of an asset may incentivise both co-owners to contribute to the value creation process together, there is risk of duplication of effort as well as bargaining problems arising from conflict over how the asset should be managed. In contrast, centralised ownership of an asset allows for lower administrative complexity and greater efficiency, while imposing all the risk of the asset on the sole asset owner.

2 Examples applying the economic substance test

The examples below identify a number of scenarios where transactions or involvement of entities generate non-tax financial benefits. These examples relate to non-tax financial benefits including: experience and specialisation in managing assets; economies of scale in combining functions and activities; increasing asset value through improved coordination of assets; and improved access to capital markets.

2.1 Experience in managing asset, specialisation and economies of scale

19. In this section we consider the example of an Australian firm (e.g., a major retailer) seeking to centralise the management of its real estate holdings. The firm enters into

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8 Hymer S.H. (1976), *The International Operation of National Firms: A Study of Direct Foreign Investment*, MIT Press, Cambridge, MA, United States

9 Birkinshaw, J., Nobel,R., and Riddensdale,J. (2002), *Knowledge as a contingency variable: do the characteristics of knowledge predict organisation structure?*, Organisation Science 2002 May/Jun Vol 13:3 p274-289

a sale and lease back arrangement with a related property management firm located in Singapore.

20. In this example, we imagine a case in which the ATO finds that the $10 million lease payments from the Australian firm were above arm's length terms. The transaction is potentially subject to the DPT (due to the corporate tax differential between Australia and Singapore). In order to avoid a DPT assessment, the firm would need to demonstrate that the arrangement had economic substance, that is, that the non-tax financial benefit of the transaction exceeded the financial benefit of the tax reduction.

21. The financial benefit of the tax reduction may simply be calculated using the corporate tax rate of 30% in Australia and 17% in Singapore. Base on a $10 million lease payment this will yield a corporate tax reduction of $1.3 million ($\$10\ million \times 30\% - \$10\ million \times 17\% = \$1.3\ million$). However, this simple calculation of the tax reduction may not quantify the financial benefit of the tax reduction due to the operation of the imputation system in Australia. For example, if we were to assume that the firm was 100% owned by Australian shareholders with marginal tax rates above the 30% threshold, the financial benefit of reducing the tax paid at the corporate level would arguably be zero. This is because any reduction in corporate tax will be fully offset by higher personal tax paid by Australian resident shareholders (resulting in no financial benefit from the tax reduction). Assuming a mix of foreign and Australian resident shareholders with different marginal tax rates would mean the financial benefit was reduced, but not to zero.[10]

22. The financial benefits from the tax reduction will then need to be compared with the non-tax financial benefits.

23. There may be strong economic justifications for centralising the real estate property through a separate property management firm. These would include the ability to specialise and gain know how in property management as well as potential cost savings that can be realised due to the economies of scale enjoyed by the Singaporean firm (particularly if the Singaporean firm managed all property assets globally). It avoids the costs involved for local Australian management in managing its real estate assets, though it may create diseconomies if the property management functions are not well coordinated.

24. The financial benefit derived from management experience and specialisation may be measured in a number of ways, including by reference to the capital costs involved in training and setting up the necessary facility to achieve the efficiency of the specialised firm. Another approach may be to value the margins earned by property management firms over time.

[10] There are a number of economic approaches to quantifying the utilisation of imputation credits including through the use of dividend drop off studies and tax statistics.

2.2 Increasing asset value

25. In this section we consider the example of an Australian subsidiary transferring intellectual property to a related party in the United Kingdom. In this example, the royalty rates are revised upwards from $10 million to $20 million following the transfer of the intellectual property.[11]

26. Since the corporate tax rate in UK is 20%, which is less than 80% of the Australian corporate tax rate which is 30%, the royalty earned by the UK firm may be subject to DPT. We imagine a scenario in which the ATO finds that the arm's length royalty amount was $10 million.

27. Assuming 100% foreign ownership, in this scenario the tax benefit from the transaction might be calculated either based on the $20 million royalty actually paid (yielding a tax benefit of $2 million per year (or $\$20\,million \times 30\% - \$20\,million \times 20\% = \$2\,million$)), or based on determined arm's length royalty of $10 million (yielding a tax benefit of $1 million per year). Arguably, if the purpose of demonstrating economic substance is to test the commerciality of decisions to transact with entities in low tax jurisdictions, the financial benefit of the tax reduction would be based on arm's length rates (in this case $1 million).

28. As above, the financial benefits from the tax reduction then need to be compared with the non-tax financial benefits.

29. The value of intellectual property can often be increased when it is pooled with other related intellectual property (IP). This occurs as a result of:

- technological synergy;
- product bundling;
- increased bargaining power; and
- increased market power.

30. The foreign related firm's own IP can synergise with the acquired IP to allow the foreign entity to extend the research and develop new IP. The economic benefits created by the synergy are the difference in the profit of the newly developed IP compared to the original. The analysis may involve determining the difference in how much a downstream firm is willing to pay for the newly developed IP due to pooling and the original IP without pooling. Furthermore, the analysis may involve forecasting the future expected profit under pooling and without pooling.

31. There are several ways in which product bundling can increase the value of IP. For example, if the foreign entity already owns an IP which has strong market power, bundling can increase the quantity demanded for additional IP. Even if the foreign

[11] We assume that the sale price for the intellectual property was consistent with the $10 million royalty.

firm's IP does not possess strong market power, bundling increases the overall demand for both IP. This is because the downstream firm may not be willing to pay for either IP on their own, but bundling the IP may create sufficient value for the downstream firm to induce purchase. To measure the value of product bundling requires a thorough analysis of the market demand. This requires economic counterfactual analysis in order to investigate the possible current and future royalties that can be earned when the IP is not bundled together and compare that to the total current and future profit earned through the bundled IP.

2.3 Improved access to capital

32. In this section we consider the example of an Australian subsidiary paying a fee to a related party for guaranteeing locally sourced debt (i.e., a fee for credit support). We assume that based on an analysis of what third party financial institutions would pay to insure the debt of the subsidiary that the ATO has determined that the credit support fee is above arm's length rates. Assuming also that the related party was in a jurisdiction with a tax mismatch with Australia, the ATO has the discretion to impose a DPT assessment.

33. In this case the ATO may need to assess the non-tax financial benefits from centralising the balance sheet of the multinational in a single entity and compare that to the tax reductions from that entity being in a tax mismatch jurisdiction. One reason for raising debt through a foreign firm is having improved access to financial markets. Centralising the balance sheet of the multinational may lower the transaction costs associated with establishing credit ratings, reduce information asymmetry with lenders and lower premiums on new debt issues.

34. The economic benefits through improved access to capital can be measured by the potential difference in the borrowing costs of firms with different debt raising practices.

3 Looking abroad: how the UK and US have dealt with issues surrounding "economic substance"

2.4 The UK DPT: some limited guidance

35. The UK government provided some interim guidance following the introduction of the UK DPT. The goal of the UK DPT is similar to the Australian DPT in that it seeks to capture contrived arrangements either through transactions or the involvement of entities. It also uses an economic substance test comparing non-tax financial and tax benefits.

36. The UK Interim Guidance describes the 'economic substance' test as essentially a test of commerciality. It highlights an important distinction when valuing the "economic substance" of a transaction – it is not the amount of the transaction or the value of whatever is bought or sold through it that is being tested with reference to the amount of the tax reduction, rather it is the non-tax economic value the particular transaction generates and whether that is greater than the tax reduction.[12] In addition, the guidance identifies that the calculation of the value added by the transaction takes into account both the direct and indirect effects of the transaction.

37. One of the examples used in the Interim Guidance may be helpful in understanding how the UK tests may be applied. The example focuses on a UK-based group that decides to centralise its technical support activities which had always been carried out by each company separately. After considering a number of options, it ultimately decides on a European country with a corporate income tax rate that is less than 80% of the UK rate. The UK companies contract to pay the new company for its services based on standard terms.

38. In this scenario, the Interim Guidance states that the centralisation creates synergies and it would "not be reasonable to conclude that any of the transactions were designed to secure a tax reduction". However, one outstanding issue is the possibility that the UK company chose this location, despite the availability of other options, on the basis of securing a tax reduction. The Interim Guidance states that the way the UK company might respond to this issue, is by demonstrating that the non-tax financial benefit from the contribution of the new company's staff (via its functions and activities) to the transaction would exceed the financial benefit of the tax

[12] HM Revenue & Customs, *Diverted Profits Tax: Guidance*, 20 November 2015, available at < https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/480318/Diverted_Profits_Tax.pdf>

reduction. Specifically, it suggests the company could show this by "providing financial projections showing that at the time the technical support centre was established the productivity and efficiency savings the group expected to achieve by co-locating all support activity in one location were greater than the potential tax savings"[13].

39. However, not all issues are resolved in the UK DPT. One of the key concerns surrounding the DPT provision was that Her Majesty's Revenue and Customers (HMRC) did not clearly explain how non-tax benefits are to be valued for the purpose of comparison, aside from articulating that all circumstances must be taken into account.

2.5 United States: lessons on the interpretation of "economic substance"

40. The United States has historically recognised and sought to capture those circumstances where the taxpayer's participation in a transaction lacked economic motivation other than tax considerations through an "economic substance doctrine" (ESD). The way the US has approached this issue may be potentially relevant in understanding the application of the economic substance test under the DPT in Australia. Originally a judicial doctrine, the ESD was codified as part of the Health Care and Education Affordability Reconciliation Act of 2010. In the legislation, the doctrine provides that a transaction will be treated as not having economic substance unless the taxpayer can show both that:

- the transaction changes in a meaningful way the taxpayer's economic position (objective test) and
- the taxpayer has a substantial non-tax business purpose for entering into the transaction (subjective test)[14]

41. In addition to this, the legislation sets out a special rule[15] where the taxpayer can rely on profit potential to satisfy either of the two prongs of the above test. The taxpayer must establish that the present value of the reasonably expected pre-tax profit is "substantial" in comparison to the present value of the expected net tax benefit, in

[13] HM Revenue & Customs, *Diverted Profits Tax: Guidance*, 20 November 2015, available at < https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/480318/Diverted_Profits_Tax.pdf> p.34

[14] New York University, *Economic Substance*, November 2011, 70th Institute on Federal Taxation, Presentation by Dewey & LeBoeuf LLP, Steptoe & Johnson LLP and Ernst & Young LLP.

[15] U.S. Code, s7701(o)(2)

each case resulting from the transaction.[16] The determination of pre-tax profits will take into account fees and other transactions costs as expenses.

42. This interpretation of profit to include expected profit would arguably resolve some ambiguity in the Australian economic substance test and would align with ordinary business objectives when entering into transactions. It would also safeguard bona fide business transactions which, contrary to expectations, yield a loss due to unforeseen circumstances or unexpected risks.

43. However, the US legislation is not without its own limitations. It has left to the courts to determine what is meant by changing the taxpayer's economic position is a meaningful way. By way of contrast, this is one thing that the Australian legislation has attempted to clarify through its non-tax financial benefits vs tax benefits test.

[16] New Code Sc. 7701(o)(2)(A)

4 About CEG

44. The Competition Economists Group (CEG) commenced operations in 2007 and now has offices in Australia, Europe, and the Americas. CEG brings together experts who have many years of experience in advising regulators and competition authorities as well as clients in the private sector. CEG is recognised by Global Competition Review as one of the top 20 competition economics consulting firms in the world, with two Directors of CEG's Australian practice recognised by The International Who's Who of Competition Lawyers & Economists, 2013. Our work has been presented to courts, regulatory and competition authorities in Australia and in international fora (see www.ceg-ap.com).

45. CEG's Australian based economists have provided expert testimony in a variety of different contexts, including in regulatory proceedings, to the Australian Competition Tribunal and oral and written testimony in proceedings in the Federal Court of Australia and the UK Competition Commission. CEG has provided expert reports that have been relied on in six (6) successful appeals of the Australian Energy Regulator's decisions. In each of those decisions the Australian Competition Tribunal (ACT) relied heavily on CEG expert evidence including by asking for new reports from CEG to address specific issues. In one decision the Tribunal defined the nature of the AER error as:[17]

> *"The choice of the APA bond and the weighting applied to it are attended by the same error as the decision to reject the sole use of the EBV,* ***namely the failure to have sufficient regard to the expert report of CEG."*** (emphasis added)

46. CEG was also jointly awarded Global Competition Review's award for "M&A Transaction of the Year – Asia-Pacific, Middle East & Africa" in relation to advice provided on the BHP and Rio Tinto joint venture proposal. CEG provided numerous expert reports that were submitted to the European Commission, the ACCC and other regulators around the world.

47. CEG has advised on a number of transfer pricing cases. CEG's Australian Directors were previously managers in the transfer pricing practice of a global accounting firm. For further information in relation to this submission, please contact:

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[17] Allgas vs. AER, http://www.austlii.edu.au/au/cases/cth/ACompT/2012/5.html, para. 104

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Appendix A Countries that appear to fail tax mismatch test

Table 1: Countries that fail tax mismatch test

OECD Members		**Non-OECD members**			
Country	*Tax rate*	*Country*	*Tax rate*	*Country*	*Tax rate*
Czech Republic	19%	Afghanistan	20%	Lebanon	15%
Denmark	22%	Albania	15%	Libya	20%
Estonia	20%	Bahamas	0%	Liechtenstein	12.5%
Finland	20%	Bahrain	0%	Lithuania	15%
Hungary	19%	Belarus	18%	Macau	12%
Iceland	20%	Bermuda	0%	Macedonia	10%
Ireland	12.5%	Bonaire, Saint Eustatius and Saba	0%	Mauritius	15%
Slovak Republic	22%	Bosnia and Herzegovina	10%	Moldova	12%
Slovenia	17%	Botswana	22%	Montenegro	9%
Sweden	22%	Bulgaria	10%	Oman	12%
Switzerland	21.15%	Cambodia	20%	Paraguay	10%
Turkey	20%	Cayman Islands	0%	Poland	19%
United Kingdom	20%	Croatia	20%	Portugal	21%
		Curacao	22%	Qatar	10%
		Cyprus	12.5%	Romania	16%
		Ecuador	22%	Russia	20%
		Egypt	22.5%	Saudi Arabia	20%
		Fiji	20%	Serbia	15%
		Georgia	15%	Singapore	17%
		Gibraltar	10%	Sri Lanka	15%
		Guernsey	0%	Syria	22%
		Hong Kong SAR	16.5%	Taiwan	17%
		Iraq	15%	Thailand	20%
		Isle of Man	0%	Ukraine	18%
		Jersey	20%	Vanuatu	0%
		Jordan	20%	Vietnam	22%
		Kazakhstan	20%	Yemen	20%
		Kuwait	15%		

Source: Tax rate for OECD Countries are collected from the OECD Tax database. Non-OECD countries are collected from the KPMG Corporate Tax Rates table.