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## **Public advice and guidance compendium – PCG 2018/5**

This is a compendium of responses to the issues raised by external parties to draft Practical Compliance Guideline PCG 2018/D2 *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**

<b>Issue No.</b>	<b>Issue raised</b>	<b>ATO Response/Action taken</b>
1	<p>Provide guidance on how the ATO will apply the concepts in subsection 177H(1).<sup>1</sup></p> <p>Provide guidance on a non-exhaustive list of factors that would cause the Commissioner to consider that a taxpayer may have engaged in a contrived arrangement with a related party (subsection 177H(1)) such that there is a principal purpose to obtain a tax benefit (subsection 177J(1)).</p> <p>Provide guidance on features of a transaction that would be likely to cause the ATO concern.</p>	<p>The framing questions in the Guideline have been included to assist affected taxpayers in understanding the matters we are likely to consider in assessing whether the diverted profits tax (DPT) applies to an arrangement.</p> <p>In particular, in response to this feedback, the transaction-specific framing questions have been revised (paragraph 29) and are provided to demonstrate our approach to assessing DPT risk.</p> <p>In addition, we will generally consider the principal purpose test framing questions to assist us to determine whether a requisite purpose is likely to exist.</p> <p>Refer to paragraphs 30 and 31 of the final Guideline.</p>
2	<p>Provide guidance as to when the DPT will apply to the exclusion of the primary taxing provisions, in particular the transfer pricing provisions.</p> <p>The ATO should include a reference to the effect that it will take into account the words of paragraph 1.18 of the EM<sup>2</sup> in administering the DPT.</p>	<p>Paragraph 8 has been inserted into Law Companion Ruling LCR 2018/6 <i>Diverted profits tax</i> to highlight that the principal purpose test in paragraph 177J(1)(b) is the central provision around which the DPT operates and must be satisfied for the DPT to apply. It also notes that, consistent with Part IVA more generally, the DPT is only expected to apply in limited circumstances.</p>

<sup>1</sup> All legislative references are to the *Income Tax Assessment Act 1936* unless otherwise indicated.

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	<p>Provide guidance that regard will be given to Law Companion Ruling LCR 2015/2 <i>Section 177DA of the Income Tax Assessment Act 1936: schemes that limit a taxable presence in Australia</i> and the revised Explanatory Memorandum when applying the principal purpose test.</p>	<p>Paragraph 15 has been inserted into the final Guideline to address this feedback. It makes it clear that the DPT, unlike the transfer pricing rules in Division 815 of the <i>Income Tax Assessment Act 1997</i>, can only apply if the principal purpose test and the other conditions contained in subsection 177J(1) are satisfied.</p> <p>Paragraph 15 also clarifies that an analysis of the potential application of the DPT may be undertaken concurrently with an analysis of the ordinary provisions in the income tax law.</p> <p>Footnote 2 of the final Guideline provides that in considering the application of the principal purpose test we will have regard to paragraphs 11-16 of LCR 2015/2 <i>Section 177DA of the Income Tax Assessment Act 1936: schemes that limit a taxable presence in Australia</i>.</p>
3	<p>Provide guidance as to the triggers which may lead to the commencement of a DPT analysis.</p>	<p>Paragraph 29 of the final Guideline has been revised to incorporate additional framing questions to indicate the kinds of features that may trigger consideration of the DPT.</p> <p>Paragraph 8 has been inserted into the final Guideline to reference Law Administration Practice Statement PSLA 2017/2 <i>Diverted profits tax assessments</i> to highlight the rigorous internal process to be followed by staff in order to make a DPT assessment and after a DPT assessment is made.</p> <p>Paragraph 12 has been inserted into the final Guideline and outlines when you can expect communication from the ATO.</p> <p>Refer also to our response to issue 2 regarding the concurrent analysis of the DPT and other income tax provisions.</p>

<sup>2</sup> Revised explanatory memorandum to the Treasury Laws Amendment (Combating Multinational Tax Avoidance) Bill 2017 (EM)

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4	<p>Revise the PCG to clarify that an arrangement will not be high risk if:</p> <ul style="list-style-type: none"> <li>• it does not exhibit high risk features for the sufficient economic substance test (SES test), and</li> <li>• the taxpayer provides supporting documentation within a reasonable timeframe acceptable to the ATO.</li> </ul>	<p>The Guideline includes low risk scenarios to highlight the circumstances in which we consider it is likely the SES test will be satisfied, such that the DPT will not apply.</p> <p>The framing questions for the SES test (paragraph 31 of the final Guideline) have been revised to outline that affirmative answers to the questions increase the likelihood that the SES test will be satisfied.</p>
5	<p>Request the scenarios address:</p> <ul style="list-style-type: none"> <li>• principal purpose</li> <li>• the need for the arrangement to display indicators going to artificiality or contrivance</li> </ul>	<p>The scenarios address the SES test to reflect feedback that some affected taxpayers are likely to assess the risk of their arrangements by reference to the SES test.</p> <p>Ascertaining a conclusion in relation to principal purpose in respect of a transaction or arrangement will be based on the specific facts and circumstances of the case and is a different examination to that required in considering the SES test.</p> <p>The scenarios are provided for guidance on our approach to assessing risk in the context of the SES test.</p> <p>We consider that incorporating additional DPT conditions may complicate the scenarios.</p> <p>The framing questions provide guidance on our approach to administering the principal purpose test. This is consistent with our general approach to providing guidance on 'purpose' in respect of other anti-avoidance provisions.</p> <p>Refer also to our response to issue 2 regarding the additional content included in LCR 2018/6 on the principal purpose test.</p> <p>No change has been made to the final Guideline.</p>
6	<p>Suggestion that additional transaction specific framing questions</p>	<p>In response to this feedback, additional questions, being the 'warning signs' identified in Law Administration Practice Statement</p>

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	<p>be included. Delete the transaction specific framing question in paragraph 45(h) in the draft PCG (i.e. '<i>any other features that are unusual having regard to the nature of the relevant business operations</i>').</p>	<p>PS LA 2005/24 <i>Application of General Anti-Avoidance Rules</i> (at paragraph 151) have been inserted in the final Guideline where appropriate. These warning signs may be indicative of a requisite purpose and may trigger a purpose analysis. Additional changes have also been made to the transaction-specific framing questions in paragraph 29 of the final Guideline. Further clarification has been provided in the framing question at paragraph 29(i) in the final Guideline relating to '<i>other features that are unusual</i>'.</p>
7	<p>Provide a paragraph to highlight that the scenarios relate specifically to the SES test and are not intended to represent, and do not contain, a full analysis of the DPT.</p>	<p>Paragraph 33 has been included in the final Guideline to clarify that the scenarios illustrate our approach to assessing the risk in the context of the SES test. This paragraph is included in the section of the Guideline that addresses matters relevant to the application of the SES test.</p>
8	<p>Request a statement be included in the PCG that the objects are relevant to the principal purpose test (PPT) and the application for the prescribed matters for consideration. In our view the objectives are a guide and their relevance is explained in section 950-150 ITAA 1997.</p>	<p>The DPT is inserted into Part IVA. For the DPT to be applied the conditions in section 177J must be satisfied. This issue is addressed at Issue 9 of the compendium for LCR 2018/6.</p>
9	<p>Concerned that the documentation identified in the draft PCG means that the ATO is requiring information that is not required in the application of the transfer pricing rules. Specifically paragraphs 56, 58 and 59 of the draft PCG. Concerned that an anti-avoidance analysis will be part of ordinary transfer pricing compliance. (Paragraph 60(h) of the draft PCG refers to documentation relating to the rationale for a change in transfer pricing policy).</p>	<p>Paragraph 61 of the final Guideline explains that the documentation section provided in the Guideline is intended to be a general guide as to what documentation we will have regard to but it is not a mandatory or exhaustive list of documentation you must be able to present. The revised EM (at paragraph 1.133) refers to compliance and documentation in the context of the SES test and not more broadly in the context of the DPT.</p>

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	It is considered that this could result in increased costs and compliance burden (whereas paragraph 1.133 of the revised EM refers to the SES test not requiring a greater evidentiary or compliance burden to that required by the OECD Transfer Pricing Guidelines for transfer pricing).	Importantly, consideration of the DPT is a different enquiry to that of transfer pricing and, accordingly, the documentation that may be relevant could be different. No change has been made to the final Guideline.
10	The ill-defined application of the law will unfairly disadvantage Australian taxpayers when dealing with offshore related parties and tax authorities. The approach will constrain access to proper mechanisms available under tax treaties and supported by internationally recognised methods for the fair review and resolution of cross border transfer pricing issues.	This is an issue related to policy which is outside the scope of this guidance. No change has been made to the final Guideline.
11	Concerned that access to an Advance Pricing Arrangement (APA) may be denied where it is not possible to resolve a DPT risk. If the SES test is determined on a basis inconsistent with the associated enterprises articles contained in the tax treaties, there is a question as to whether Australia will have met its treaty obligations if an APA is not proceeded with – refer to paragraph 21 of the draft PCG.	The DPT has been inserted into Part IVA as an anti-avoidance provision. When we are considering entering into an APA we will consider the anti-avoidance rules. Where DPT is a collateral issue it may make it inappropriate for us to proceed with an APA.
12	Concerned that taxpayers cannot assess risk as there is no discussion on the identification of DPT risk. The framing questions are of no assistance in determining DPT risk. Inadequate explanation of how the framing questions and components will be brought together to apply the tax.	The framing questions have been separated into various categories with the aim of providing guidance in assessing DPT risk. The SES test questions at paragraph 31 of the final Guideline have been re-framed to indicate where affirmative responses are more likely to indicate that the profit made reasonably reflects the economic substance of the relevant entity's activities in connection with the scheme.

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		The client engagement section of the final Guideline (paragraphs 47 to 58) provides a number of ways that a taxpayer can engage with us to obtain more certainty about their arrangements.
13	It would be useful if the guidance included an explanation of how the use of CUPs as a primary transfer pricing method can be approached under the SES test. This should include recognition of intangible assets (formal and informal) as contributing value to the activities and representing economic substance beyond personnel and other tangible factors.	Paragraphs 36 and 37 of the final Guideline have been revised to make it clear that we will consider, when we are determining whether the profit of an entity reasonably reflects the economic substance of the entity's activities in connection with the scheme, both the traditional transaction methods and the transactional profit methods. The appropriate method will depend on the specific facts.
14	<p>Recommend that the guidance:</p> <ul style="list-style-type: none"> <li>• stipulates that the ATO will adopt an administrative practice of accepting viable Australian based transfer pricing positions as meeting the requirements of the SES test</li> <li>• sets out the relationship between reasonable profits and the arm's length standard.</li> </ul>	<p>The recommendation is not consistent with the legislative requirements of the SES test.</p> <p>Paragraph 36 of LCR 2018/6 sets out our view that the SES test requires determination of whether the profit made by an entity in respect of the relevant activities represents a reasonable reward in relation to those activities.</p> <p>No change has been made to the final Guideline.</p>
15	<p>The PCG should explain the measurement of economic substance using the OECD guidelines and the relationship between reasonable profits and the arm's length standard. The draft PCG is unsatisfactory as the initial assessment of economic substance could rely on the Commissioner's judgement of the relevant facts and circumstances.</p> <p>A DPT assessment could result even where the taxpayer has used comparable uncontrolled pricing as 'the most direct and reliable way' to apply the arm's length principle.</p> <p>The PCG should make it clear that the DPT will operate within the international transfer pricing rules and guidelines. The</p>	Paragraphs 36 and 37 of the final Guideline have been revised to provide further guidance in relation to the relevance of the OECD guidelines (including the use of the transfer pricing methods) and other documents covered by section 815-135 of the ITAA 1997 for the purpose of the SES test.

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	implications of any other position are too significant to be dealt with by inadequate guidance.	
16	<p>The concept 'reasonably reflects the economic substance of the entity's activities' is a critical concept of the law. Reasonable has been purposefully added to lower the threshold.</p> <p>The term reasonably or reasonable is defined in the Oxford English Dictionary as 'in a sensible way, to a moderate or acceptable degree; fairly.' Therefore, the profits made by each entity are only required to moderately reflect the economic substance, not absolutely.</p>	<p>Paragraph 36 of LCR 2018/6 in (determining whether the sufficient economic substance test is satisfied), provides our view that this requires a determination of whether the profit made by an entity in respect of the relevant activities represents a reasonable reward in relation to those activities.</p> <p>It is therefore considered that the Commissioner's view of what is a reasonable reflection in this context is explained by the second last sentence in that paragraph and no further clarification is considered necessary.</p> <p>No change has been made to the final Guideline.</p>
17	Taxpayers should be able to lodge a private ruling request on the application of the DPT (paragraph 36 of the draft PCG does not include this as a suggested subject for a ruling request).	<p>There is nothing to prevent a taxpayer applying for a private ruling on the application of the DPT. However we do not consider the private ruling process would be the most suitable avenue to address issues such as the SES test.</p> <p>Our client engagement framework in paragraphs 47 to 58 of the final Guideline has been provided to assist taxpayers in identifying the most suitable option for engaging with us based on the relevant circumstances.</p> <p>No change has been made to the final Guideline.</p>
18	Recommended change to paragraph 32 of the draft PCG that addresses APAs. Proposed wording: '... if the procedures set out in the APA are not followed or if adjustments are not otherwise made in tax returns to reflect ranges agreed in an APA.'	Revisions have been made in the final Guideline to the APA content addressing the monitoring of compliance. Paragraph 21 specifies that a breach will be dealt with in accordance with Law Administration Practice Statement PS LA 2015/4 <i>Advance Pricing Arrangements</i> .
19	Paragraph 45(g) of the draft PCG should specifically mention, in	Paragraph 29 of the final Guideline (which contains the questions

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	addition to staff headcount and /or capability, '... functions, assets and risks ...' as they are directly relevant to economic substance.	<p>previously addressed in paragraph 45 of PCG 2018/D2) provides the transaction specific framing questions, whereas paragraph 31 contains the questions that may be specifically relevant to the application of the SES test.</p> <p>The question identified (now in paragraph 29(g) of the final Guideline is merely an indicator of risk, rather than an assessment of the entire position.</p> <p>No change has been made to the final Guideline.</p>
20	<p>Paragraph 46 of the draft PCG – some of the SES framing questions in this paragraph appear to be more relevant to purpose and contrived arrangements. The SES test has a factual basis as per paragraph 34 of the draft LCG.</p> <p>Paragraph 46(a)(b)(c)(d)(e) and (f) of the draft PCG – these paragraphs contain references to genuine commercial rationale, expected changes, legal form and documentation, evidence of market conduct, aspects that are not expected and whether centralisation is common in the relevant industry. These matters are not relevant to economic substance.</p>	<p>Paragraph 30 of the final Guideline which addresses 'framing questions relevant to the principal purpose test' specifically mentions that a number of the questions outlined in the 'framing questions relevant to the SES test' section may also be relevant to the application of the principal purpose test.</p> <p>The questions in the 'framing questions relevant to the SES test' section (paragraph 31 of the final Guideline) are indicative of risk and we acknowledge that there is overlap in questions specific to the SES test and the understanding of the overall scheme. We specify this in paragraph 26 of the final Guideline.</p>
21	Paragraph 55 of the draft PCG – this paragraph should be revised to make it clear it is not an exhaustive list of documentation (in the ATO's possession) that the ATO will consider in relation to the DPT.	<p>Paragraph 62 of the final Guideline (which addresses this documentation) specifies that this is documentation '... including, but not limited to ...'.</p> <p>We consider the use of these words clarifies that the list is not exhaustive.</p> <p>No change has been made to the final Guideline.</p>
22	It should be clarified that the scenarios addressing the SES test are only relevant if the principal purpose test is satisfied.	Paragraph 33 and 34 of the final Guideline have been revised and make it clear that the scenarios are relevant to illustrating the consideration of risk in the context of the application of the SES test.

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23	<p>The SES test scenarios in the draft PCG do not adequately explain how the ATO reaches the conclusion that the SES exemption does not apply. This rationale should be explained in more detail.</p>	<p>The SES test analysis section in each scenario (in Appendix 2) has been revised to clarify how we approach the assessment of risk in the context of the SES test.</p> <p>This is in keeping with the paragraphs explaining the purpose of the scenarios (in paragraphs 33 and 34 of the final Guideline).</p>
24	<p>Recommend changes to paragraph 12 of the draft PCG. Proposed rewording: 'We will discuss our proposed compliance approach with you, which may include informing you that we have decided that based on the information provided, the DPT does not apply to the arrangement as currently structured'. Similar changes were also proposed for paragraphs 16 and 24 of the draft PCG.</p>	<p>Paragraphs 12 and 13 of the final Guideline have been revised to clarify our intended approach to communicating with affected taxpayers when we intend to commence active consideration of a DPT risk and when we have concluded our examination.</p> <p>The client engagement framework outlined in paragraphs 47 to 58 of the final Guideline also clarifies that further certainty can be obtained through a private ruling or the APA program.</p>
25	<p>The guidance should acknowledge the role and importance of transfer pricing documentation and specify that the application of the SES test is limited to circumstances where:</p> <ul style="list-style-type: none"> <li>• the conditions of paragraph 1.135 of the EM exist; and</li> <li>• the information has been requested by the Commissioner and has not been made available in a reasonable period of time.</li> </ul>	<p>This recommendation is not the basis for the legislative requirements as set out in the SES test.</p> <p>No change has been made to the final Guideline.</p>
26	<p>Request that taxpayers that are eligible for simplified transfer pricing records options (Practical Compliance Guideline PCG 2017/2 <i>Simplified Transfer Pricing Record Keeping Options</i>) should be viewed as low risk for the purpose of the DPT and a statement to this effect be included in the PCG.</p>	<p>PCG 2017/2 is designed to minimise record-keeping requirements for eligible taxpayers.</p> <p>Paragraphs 42 and 43 have been incorporated in to the final Guideline and outline that where taxpayers qualify for three of the specified simplified transfer pricing record keeping options in PCG 2017/2 we will generally only dedicate compliance resources in</p>

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		accordance with that Guideline.
27	<p>Scenario 5 of the draft PCG creates some confusion in the background facts in paragraphs 116 and 117.</p> <p>Paragraph 117 refers to the functions, risks etc. as per the contract as opposed to the actual arrangement. It therefore appears that the ATO is taking a form over substance approach. This could be a more appropriate Subdivision 815-B of the ITAA 1997 case.</p> <p>Suggested that improvements are made to clarify this issue.</p>	<p>Paragraph 120 in Scenario 5 of the final Guideline has been revised to clarify that the economic substance of an entity's activities are determined by reference to the available evidence rather than the terms set out in the contract.</p>
28	<p>A consistent approach to inbound and outbound arrangements would be more in line with the preferred OECD methodology for re-sellers of products. References made to scenarios 5, 6 and 9 in the draft PCG in regards to an appropriate profit level indicator being operating margin or similar, whereas PCG 2017/1, in relation to hubs, refers to a net cost plus profit level indicator.</p>	<p>The matters relevant to the application of the SES test are set out at paragraphs 32 to 38 of the final Guideline.</p> <p>Importantly, these paragraphs clarify that 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, the appropriate method will depend on the circumstances of the particular case.</p>
29	<p>Request a low risk example for a marketing hub is included in the PCG.</p>	<p>A low risk marketing hub scenario (Scenario 10 in Appendix 2 of the final Guideline) has been incorporated in response to this feedback.</p>
30	<p>Question why scenario 10 in the draft PCG only addresses captive insurance arrangements and not reinsurance generally.</p>	<p>The insurance scenario (Scenario 12 in Appendix 2 of the final Guideline) has been revised in response to this feedback. The scenario outlines a low risk general reinsurance arrangement in the context of the SES test.</p>
31	<p>Request guidance on what the ATO considers would indicate sufficient economic substance for a financing arrangement.</p>	<p>A financing scenario (Scenario 11 in Appendix 2 of the final Guideline) has been incorporated in response to this feedback. Whilst the scenario outlines a high risk arrangement in the context of the SES test, we provide guidance on where an entity providing financing is likely to have profit that reasonably reflects the economic</p>

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		substance of its activities in connection with the scheme.