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30 November 2011

The Principal Adviser
International Tax and Treaties Division
The Treasury
Langton Crescent
PARKES ACT 2600

By email: transferpricing@treasury.gov.au

Dear Sir/Madam

Consultation Paper – Income Tax: Cross Border Profit Allocation – Review of Transfer Pricing Rules

BDO welcomes the opportunity to provide submissions on the matters raised by Treasury in the Treasury Consultation Paper: *"Income Tax: Cross Border Profit Allocation-Review of Transfer Pricing Rules"*, (the Consultation Paper) released for public consultation on 1 November 2011.

Our submission on a number of the issues raised by the Consultation Paper is attached as an Appendix. We have also therein, where appropriate, made reference to the content of Media Release No. 145 from the Assistant Treasurer entitled "*Robust Transfer Pricing Rules for Multinationals*".

Should you have any questions, or wish to discuss any of the comments made in the submissions, please do not hesitate to contact me on (02) 9286 5527 or Vince Tropiano on (02) 9286 5491.

Yours sincerely,

Matthew Wallace
National Tax Counsel
Corporate & International

APPENDIX

This document sets out the submissions of BDO in relation to the Treasury Consultation Paper: *"Income Tax: Cross Border Profit Allocation-Review of Transfer Pricing Rules"*, (the Consultation Paper) released for public consultation on 1 November 2011. We have also, where appropriate, made reference to the content of Media Release No. 145 from the Assistant Treasurer entitled "*Robust Transfer Pricing Rules for Multinationals"* (the Media Release).

Statutory references are to the Income Tax assessment Act 1936 (ITAA 1936), unless otherwise indicated.

References to:

- the ITAA 1997, are to the Income Tax Assessment Act 1997
- the Agreements Act are to the International Tax Agreements Act 1953, and
- DTAs are to the double tax agreements forming schedules to the Agreements Act.

Executive Summary

As explained below, we make the following submissions in respect of the Consultation Paper and Media Release:

- In light of extent of the proposed change to the existing law, inadequate time has been provided for consultation.

- The characterisation of the announced change as a "clarification of the existing law" is incorrect. The proposal represents a significant change to the existing law.

- In light of the extent of the proposed change to the existing law, there is no justification for making the changes retrospective.

- In light of the proposal to incorporate the transfer pricing rules into the self-assessment regime, the provision of "broad, high level rules" which require supplementation from other external information sources would provide inadequate guidance to taxpayers who are attempting to meet their compliance obligations.

- Before any change is made to Australia's transfer pricing rules, those of Australia's major trading partners should be carefully analysed.

- If a self assessment regime is to be imposed, a "reasonably arguable position" should provide a complete defence against any penalties imposed for taxation shortfalls. A similar defence should be provided in respect of any penalties imposed in respect of record keeping requirements.

- The Commissioner should not be given a power of "reconstruction" under the new transfer pricing measures. As is currently the case, the transfer pricing rules should apply to the legal

relationships that are, in fact, in place between the parties. The Commissioner is given an adequate reconstruction power under Part IVA in circumstances where there is evidence of a tax avoidance scheme.

- The proposed change in the method of calculating the profits attributable to a permanent establishment is not integral to the proposed changes to the transfer pricing rules and requires much greater consideration and consultation than is allowed for in this consultation process. Any change would have material consequences for a much broader class of taxpayers than might be affected by the transfer pricing rule changes.

- Of even broader impact would be the proposal to make changes to the interpretation of DTAs, generally. It is concern that a proposal carrying such a broad impact as that addressed in paragraphs 46 and 47 of the Consultation Paper is dealt with briefly in a Consultation Paper addressing proposed changes to the transfer pricing rules. The proposal to change the interpretation rules applicable to DTAs, generally, should be subject to separate and much wider consultation.

1. Inadequate time allowed for consultation for proposed significant change in the taxation law

In light of extent of the proposed change to the existing law, inadequate time has been provided for consultation.

Although acknowledged in neither the Media Release nor the Consultation Paper, the proposals in each of those documents are not the mere clarification or elucidation of the existing Australian taxation law. They instead represent a significant change to Australia's income tax laws as they apply to taxpayers, whether resident or non-resident, who participate in cross-border dealings.

The Australian taxpaying community has become used to an orderly and consultative approach to taxation reform. The *raison d'être* of the Board of Taxation is the facilitation of such consultation. Where proposed changes have been substantial, or have been likely to impose substantial taxation or compliance burdens on taxpayers, the consultation process and time allocated to such process have been similarly substantial. However, notwithstanding the revolutionary nature of the changes announced in the Media Release:

- Those changes have largely been announced as *fait accompli*.
- A very short time has been made available for interested parties to make submissions. This provides little time for taxpayers to assess the impact of the proposed changes, let alone provide considered and reasoned responses to the Consultation Paper.
- The breadth of alternative design choices addressed by Consultation Paper is very limited.

2. Significant changes to the taxation laws proposed

The characterisation of the announced change as a "clarification of the existing law" is incorrect. The proposal represents a significant change to the existing law.

While "profit based methods" have been utilised in the past as a necessary proxy for transactional methods in determining transfer prices, under Australia's current taxation laws, they are just that, proxies. Such an interpretation of Australia's current tax laws is endorsed in the judgment of the Full Court of the Federal Court of Australia in *FCT v SNF (Australia) Pty Ltd* [2011] FCAFC 74.

Even where profit based methods are utilised, they must still currently result in an adjustment to the transfer price paid for the cross-border supply of a good or service in determining the quantum of an amount of assessable income or an allowable deduction. As the income tax provisions apply in this manner, so, ultimately, should and do the transfer pricing rules, as illustrated in the *SNF case*.

The assertion by the ATO, adopted by the Assistant Treasurer in the Media Release and by the authors of the Consultation Paper, that the Associated Enterprises articles of Australia's DTAs confer a taxing power on the ATO, separate from, and in addition to, those conferred by the ITAA 1936 and ITAA 1997 is not sustainable on a correct interpretation of the law.

It is noteworthy that in *SNF (Australia) Pty Ltd v FCT* [2010] FCA 635 and (by inference) *FCT v SNF (Australia) Pty Ltd* [2011] FCAFC 74 the Commissioner conceded that if he "*could not succeed ... under Div 13, he could not otherwise succeed under the relevant DTA*" (see paragraph 21 of the judgment in the first mentioned case).

It is well acknowledged that, in the absence of express authority to the contrary, DTAs can only operate to limit taxing rights and do not operate to confer taxing rights. This was clearly articulated in the judgment of the Federal Court of Australia in the In *Undershaft No.1 Ltd v FCT* and *Undershaft No. 2 BV v FCT* [2009] FCA 41which provides (at paragraph 46):

> *"A DTA does not give a Contracting State power to tax, or oblige it to tax an amount over which it is allocated the right to tax by the DTA. Rather, a DTA avoids the potential for double taxation by restricting one Contracting State's power to tax".*

Thus an example that might be provided would be that where Australia imposes withholding tax on interest at the rate of 10% and a treaty permitted withholding tax up to a rate of 20% of the gross amount of such interest, the rate that would be applied would be the 10% domestic rate, not the 20% rate authorised under the DTA. The anomalous interpretation of the Associated Enterprises Article in Australia's DTAs advocated in the Media Release and the Consultation Paper is akin to saying that the DTA, in the withholding tax example, would apply to impose a withholding tax at the rate of 20%.

Looking at the Associated Enterprises Article in Australia's DTAs, the correct interpretation, from the perspective of Australian taxation, would be that it authorises Australia to apply its transfer pricing rules in Division 13 to adjust the amounts dealt with under the other articles of each relevant DTA. However, such application is subject to additional restrictions, being that those provisions can only apply where the parties have the defined "association". In this context, "profits" is merely 'shorthand' for the individual items and classes of income and expenditure dealt with under the individual articles of the relevant DTA. Such an interpretation is also consistent with s3(2) of the Agreements Act which provides:

> *"For the purposes of this Act and the Assessment act, a reference in an agreement to profits of an activity or business shall, in relation to Australian tax, be read, where the context permits, as a reference to taxable income derived from that activity or business"*

In many respects the argument for the conferring of a taxing power by the Associated Enterprises article reflects similar errors of interpretation to those underpinning the unsuccessful arguments of the Commissioner in *GE Capital Finance Pty Ltd (as Trustee for the Highland Finance Unit Trust) v FCT* [2007] FCA 558.

3. No justification for retrospective change

In light of the extent of the proposed change to the existing law, there is no justification for making the changes retrospective.

The changes to Australia's transfer pricing laws are announced in the Media Release to be retrospective as to nine years. Such an outcome is justified on the basis of:

- The mischaracterisation of the changes as a "clarification" – addressed above, and

- An assertion that "[t]he Parliament has indicated the law should operate in this way on a number of occasions, most recently in 2003".

As the proposals represent a very substantial change to the existing law, retrospective application of the changes are unjustified. The Parliament has always had a clear mechanism for communicating dissatisfaction with the existing transfer pricing laws – appropriately drafted, prospective legislation.

Preserving Australia's attractiveness as a place for multinationals to invest and do business requires that the changes be prospective in operation, applying no earlier than the date of the announcement.

4. Clear and detailed legislation required

In light of the proposal to incorporate the transfer pricing rules into the self-assessment regime, the provision of "broad, high level rules" which require supplementation from other external information sources would provide inadequate guidance to taxpayers who are attempting to meet their compliance obligations.

The Consultation Paper suggests that the new transfer pricing rules will be brought within the "self assessment" regime by making them self-executing. Where non-compliance carries penalties and uncertain guidance from the legislation imposes substantial compliance costs, there is an obligation on the legislature to provide clear and detailed rules which produce clear outcomes.

If the legislature desires to impose a self assessment regime in respect of transfer pricing, then it should, as an integral part of those laws, provide clear guidance to taxpayers to facilitate their compliance.

In this respect it is of concern that paragraph 28 of the Consultation Paper states that:

> *"Like many other jurisdictions the rules would generally reflect high-level principles, rather than being overly prescriptive, supported by reference to the 2010 OECD Guidelines and supplemented where necessary by rulings".*

The rules should be able to "stand alone". Relying on external sources of information outside the control or oversight of Parliament reflects an incomplete response to the needs of taxpayers confronting their self assessment obligations and represents an undesirable delegation of legislative power by the Parliament.

The reference to rulings pays insufficient regard to the role of rulings in the Australian taxation system. Rulings are not a source of law. The ATO is not an independent referee. Drafting broad rules and leaving the detail to be filled in by the ATO represents an inappropriate delegation of legislative power and responsibility to the ATO.

5. Consistency with the rules of major trading partners

Before any change is made to Australia's transfer pricing rules, those of Australia's major trading partners should be carefully analysed.

While the Consultation Paper makes broad assertions about the content and nature of the transfer pricing rules of our major trading and investment partners, and relies on different approaches adopted internationally as justification for the proposed changes, it provides little detail of such laws. As there is generally at least two jurisdictions with an interest in any transfer pricing situation, there are obvious benefits to aligning our rules with those of major trading partners to the extent reasonably possible and practicable.

If the intention of the proposed changes to the transfer pricing rules is to better align such rules with those applied by our major trading partners, then a more substantial analysis and articulation of the features of such rules would facilitate that process.

6. A "reasonably arguable position" should provide a complete defence against penalties

If a self assessment regime is to be imposed, a "reasonably arguable position" should provide a complete defence against any penalties imposed for taxation shortfalls. A similar defence should be provided in respect of any penalties imposed in respect of record keeping requirements.

The Consultation Paper suggests that the new rules will be "self executing" in line with self assessment principles (paragraphs 69 and 70). It also makes it clear that the rules will "not depend on the existence of a tax avoidance purpose for their application" (paragraph 31.1). In light of these two features, the proposed penalty provisions as described in paragraphs 93.1 and 93.2 do not seem appropriate.

In the absence of recklessness or a failure to exercise due care, a "reasonably arguable position" should provide a complete defence against any tax shortfall penalty. This would better align the outcomes under the transfer pricing provisions with the outcomes that apply elsewhere in the self-assessment regime. The imposition of any additional penalties would be inappropriate when no tax avoidance purpose is required.

Due to the degree of uncertainty in the area, similar defences should be available in respect of documentation requirements and the penalties imposed in respect of failures in that area.

7. The Commissioner should not be given an additional reconstruction power

The Commissioner should not be given a power of "reconstruction" under the new transfer pricing measures. As is currently the case, the transfer pricing rules should apply to the legal relationships that are, in fact, in place between the parties. The Commissioner is given an adequate reconstruction power under Part IVA in circumstances where there is evidence of a tax avoidance scheme.

There is well-established jurisprudence for the proposition that it is not for the Commissioner to substitute his decisions for those of a taxpayer in determining the manner in which the taxpayer

achieves or pursues that taxpayer's commercial goals. Instead it is for the Commissioner to apply the tax laws to the commercial outcomes as he finds them.

Particularly where it is intended that the transfer pricing rules should be applied on a self assessment basis, it would not seem appropriate for the Commissioner to be given a general discretion to "reconstruct" the commercial relationships that he finds. Apart from any other considerations, such a power would undermine the rationale for making the measures self-executing.

In circumstances where there is an "abuse" by the taxpayer, such that the taxpayer is participating in the scheme with a dominant purpose of producing a "tax benefit", the Commissioner is given an existing reconstruction power under the general anti-avoidance rule in Part IVA.

8. Reform of the method of calculating the profits attributable to a permanent establishment should be left to a later and wider consultation process

The proposed change in the method of calculating the profits attributable to a permanent establishment is not integral to the proposed changes to the transfer pricing rules and requires much greater consideration and consultation than is allowed for in this consultation process. As any change would have material consequences for a much broader class of taxpayers than might be affected by the transfer pricing rule changes, more extensive consultation should be undertaken before any change is made in this regard.

While it might be timely to give some consideration to the model used for the calculation of profits attributable to a permanent establishment, the implications of any such change are extremely wide-reaching. In particular it would have a material impact, outside any transfer pricing considerations, on all resident taxpayers carrying on operations outside Australia and all non-residents carrying on business in Australia. Certainly, this issue needs more thorough consideration than is possible in the month allowed under this consultation process.

9. Changes in the manner in which Australia's DTAs are interpreted and applied, generally, should be the subject of separate and wider consultation

Of even broader impact would be the proposal to make changes to the interpretation of DTAs generally. It is of concern that a proposal carrying such a broad impact as that addressed in paragraphs 46 and 47 of the Consultation Paper is briefly addressed in a Consultation Paper addressing proposed changes to the transfer pricing rules. The proposal to change the interpretation rules applicable to DTAs, generally, should be subject to separate and much wider consultation.