THE TAX INSTITUTE

THE MARK OF EXPERTISE

14 July 2014

Mr Greg Wood
Manager
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Tax System Division
The Treasury
Langton Crescent
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By email: taxtreatiesunit_consultation@treasury.gov.au

Dear Mr Wood,

Revised Tax Treaty with Switzerland

The Tax Institute welcomes the opportunity to comment on the *International Tax Agreements Amendment Bill (No.1) 2014 Exposure Draft* (**Exposure Draft**) and its accompanying Explanatory Memorandum (**EM**) which is intended to give the force of law in Australia to the *Convention between Australia and the Swiss Confederation for the Avoidance of Double Taxation with Respect to Taxes on Income, with Protocol* (**the revised Swiss Convention**) signed in Sydney on 30 July 2013.

We also thank Treasury for the opportunity to discuss our concerns with the EM in a teleconference on 27 June 2014 prior to making our submission. We understand from our discussions that Treasury had already taken into account a number of our concerns in the version of the EM that was provided to the Minister for approval (**Approved EM**). Notwithstanding that, we repeat below the concerns discussed more broadly with Treasury in our teleconference. We understand that not all issues have been able to be taken into account at this time and note that the issues will be relevant when international tax agreements are given the force of law in the future.

Summary

Our submission below addresses our main concern in relation to the EM, which is that insufficient consideration has been given to the interaction between Australia's new domestic transfer pricing rules and the revised Swiss Protocol in the EM.

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Discussion

General Comments

The Tax Institute considers that amendments are needed to the EM prior to the Exposure Draft being finalised and introduced into the House of Representatives. In particular, amendments are needed in relation to the EM's discussion on 'Article 7 – Business Profits' and 'Article 9 – Associated Enterprises' which do not sufficiently consider the enactment of Australia's new domestic transfer pricing rules in Subdivisions 815-B and 815-C of the *Income Tax Assessment Act 1997* (**ITAA 1997**). These new domestic transfer pricing rules apply to years of income commencing on or after 29 June 2013 and replace Division 13 of Part III of the *Income Tax Assessment Act 1936* (**ITAA 1936**) (which was repealed) and Subdivision 815-A of the ITAA 1997 (which does not apply to a taxpayer where Subdivision 815-B or 815-C applies to a taxpayer).

Further, as the new domestic transfer pricing rules in Subdivision 815-B apply the arm's length principle consistently with the associated enterprises articles of Australia's tax treaties[1], it is far from clear what is the intended scope of operation or residual operation of paragraph 6 of the Protocol to the revised Swiss Convention. Paragraph 6 of the Protocol to the revised Swiss Convention reflects Australia's reservation to Article 9 (Associated Enterprises) of the OECD Model Tax Convention (**OECD MTC**) and in broad terms enables each country to apply its domestic law in cases where the available information is inadequate to determine the profits of an enterprise on which tax may be imposed in accordance with this article. Corresponding explanations in prior explanatory memoranda – which made sense when Division 13 (and in particular, subsection 136AD(4)) contained Australia's domestic transfer pricing rules – are no longer appropriate given that there is no similar provision in Subdivision 815-B to subsection 136AD(4), which enabled the Commissioner of Taxation to deem an arm's length consideration in cases where it was not possible or practicable to ascertain the arm's length consideration. This matter is not addressed in the EM and should be addressed in the form of a clear statement that the law to apply to taxpayers in Australia is the domestic law which is contained in Division 815.

The introduction of Subdivisions 815-B and 815-C of the ITAA 1997 also raises the further question whether Australia's reservations to Articles 7 and 9 of the OECD MTC continue to be necessary. If Australia's reservations to Articles 7 and 9 of the OECD MTC are still considered necessary, it would be helpful for the EM to clearly indicate why they are still needed. The better position would seem to be for Australia to remove its reservations to Articles 7 and 9 of the OECD MTC.

We set out below our comments on particular paragraphs of the EM.

[1] See paragraph 2.23 of the Explanatory Memorandum to *Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Act 2013*

Specific Comments

Summary of new law

In paragraph 1.4 (the 7th bullet point that relates to Article 9) on page 6 of the EM, we recommend the words "are to be adjusted" be replaced with the words "may be adjusted[2]". Article 9(1) of the revised Swiss Convention is permissive rather than mandatory and does not impose an obligation on either Australia or Switzerland to adjust the profits of an enterprise. The amended wording proposed reflects the corresponding drafting used in explanatory memoranda for other recent tax treaties that have been given the force of law in Australia, for example, the Explanatory Memorandum to *International Tax Agreements (No.1) Act 2011* with respect to the new Conventions with Chile and Turkey (**Chile and Turkey EM**).

Comparison of key features of new law and current law

On page 14 in relation to the box comparing the old and new Article 9, we recommend the wording "the revenue authorities of the other country are required to make a correlative adjustment" be replaced with the wording "the revenue authorities of the other country are required to make an appropriate adjustment". The EM is not consistent with Article 9(2) of the revised Swiss Convention nor with paragraph 1.123 of the EM. The change proposed reflects the corresponding drafting used in the Chile and Turkey EM.

Article 7 – Business Profits

We recommend the words "correspond to international practice and" contained in the second sentence of paragraph 1.98 of the EM be changed to "are similar to". The reference to "international practice" in this context is no longer appropriate given the introduction of a new Article 7 (Business Profits) and corresponding Commentary in the OECD MTC in July 2010 (**new Article 7**). While Australia has not yet adopted the "functionally separate entity" approach underlying the new Article 7, Australian practice does not reflect international practice in this regard.

Further, it would be helpful if the EM included text relating to the following matters:

- that Article 7 of the revised Swiss Convention should, to the extent possible, be interpreted consistently with the revised Commentary to Article 7 of the OECD MTC as it read prior to 22 July 2010;

[2] In discussions with Treasury, it was confirmed that the wording contained in the Approved EM had been changed to "may be adjusted".

- that the attribution of profits to permanent establishments under Article 7 of the revised Swiss Convention should be based on the relevant business activity approach, consistent with Australia's current tax treaty practice; and
- details of other relevant guidance material that should be used for purposes of determining the profits attributable to a permanent establishment under Article 7 of the revised Swiss Convention.

Paragraphs 1.103 and 1.104 of the EM should be reviewed because, as stated in our general comments above, it is far from clear what is the intended scope of operation or residual operation of paragraph 6 of the Protocol to the revised Swiss Convention, given the introduction of Australia's new transfer pricing laws in Subdivisions 815-B and 815-C. This matter should be clearly addressed in the EM.

Article 9 – Associated Enterprises

The last sentence of paragraph 1.120 should be revised as it has not been updated to reflect the introduction of Australia's new domestic transfer pricing rules in Subdivision 815-B. More particularly, the last sentence indicates that the words "'might be expected to operate' in paragraph 1" are intended to allow Australia to apply its domestic transfer pricing rules to make adjustments where it is not possible to determine the conditions that 'would have been made or occurred' between the associated enterprises (ie arm's length conditions). However, Australia's new domestic transfer pricing rules in Subdivision 815-B require that arm's length conditions be used to determine whether an entity gets a transfer pricing benefit (section 815-115). The EM should clearly explain what is the intended scope of operation of the words "'might be expected to operate' in paragraph 1" in light of Subdivision 815-B.

The last sentence of paragraph 1.121 should be revised as it is not correct[3]. Again, the sentence has not been updated to reflect the introduction of Australia's new domestic transfer pricing rules in Subdivision 815-B. More particularly, Australia's new domestic transfer pricing rules in Subdivision 815-B do not contain an equivalent provision to subsection 136AD(4) of the ITAA 1936 which enabled the Commissioner of Taxation to deem an arm's length consideration in cases where it was not possible or practicable to ascertain the arm's length consideration.

Paragraph 1.122 should be reviewed because, as indicated in our general comments above, it is far from clear what is the intended scope of operation or residual operation of paragraph 6 of the Protocol to the revised Swiss Convention in light of the introduction of Subdivision 815-B. This matter should be clearly addressed in the EM[4].

[3] In discussions with Treasury, it was confirmed the last sentence of paragraph 1.121 had been removed from the Approved EM.

[4] Treasury advised in discussions that paragraph 1.122 in the Approved EM had been amended to refer to "only in cases where the available information is inadequate".

If you would like to discuss any of the above, please contact either me or Tax Counsel, Stephanie Caredes, on 02 8223 0059.

Yours sincerely

Michael Flynn
President