Australian Government

The Treasury

Income Tax: cross-border profit allocation - review of transfer pricing rules

Consultation Paper

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Consultation Process

Request for feedback and comments

The Government is seeking your views on updating Australia's transfer pricing rules to incorporate the latest OECD Guidance on Transfer Pricing.

While submissions may be lodged electronically or by post, electronic lodgement is preferred. For accessibility reasons, please submit responses sent via email in a Word or RTF format. An additional PDF version may also be submitted.

All information (including name and address details) contained in submissions will be made available to the public on the Treasury website, unless you indicate that you would like all or part of your submission to remain in confidence. Automatically generated confidentiality statements in emails do not suffice for this purpose. Respondents who would like part of their submission to remain in confidence should provide this information marked as such in a separate attachment. A request made under the *Freedom of Information Act 1982* (Commonwealth) for a submission marked 'confidential' to be made available will be determined in accordance with that Act.

Closing date for submissions: 26 February 2016

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Introduction

Transfer pricing rules are designed to make sure Australia receives an appropriate share of tax from multinational firms. They ensure tax is based on profits reflecting the economic activity attributable to Australia in accordance with an arm's length principle.

Countries around the world recognise the benefits of a consistent approach to cross border profit allocation with most of our trading and investment partners looking to the Organisation for Economic Cooperation and Development (OECD) material on transfer pricing to provide that consistency.

In 2010 the OECD updated the *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (the 2010 OECD Guidelines). This provided an update to the OECD international approach to transfer pricing.

Following consultation,[1] new Australian domestic transfer pricing legislation was introduced in 2012 and 2013 to specifically reference the implication of the then updated OECD Guidelines to Australia's transfer pricing legislation.[2] This legislation aligned Australia's domestic legislation with the then OECD international standards by requiring the interpretation of the arm's length principle for cross-border transactions between entities to 'as best' achieve consistency with the 2010 OECD documents: the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the OECD Transfer Pricing Guidelines).[3]

Specifically the legislation confirmed that the internationally consistent transfer pricing rules contained in Australia's tax treaties and incorporated into Australia's domestic law provide assessment authority to address treaty related transfer pricing; confirmed the ability of the Commissioner to rely on the most appropriate method including profit based transfer pricing methods.

In 2013 as part of the G20/OECD Base Erosion and Profit Shifting Project (BEPS Project) it was acknowledged that the existing international standards for transfer pricing rules could be misapplied so that they resulted in outcomes in which the allocation of profits was not aligned with the economic activity.[4] Consequently, under action items 8, 9 and 10, of the BEPS Project, further work has been undertaken to strengthen the OECD Transfer Pricing Guidelines.

In October 2015, the OECD released the report, 'Aligning Transfer Pricing Outcomes with Value Creation', (the 2015 OECD Report) to address issues with appropriately allocating returns for risk, and capital functionality. The 2015 OECD Report has a specific focus on providing further explanation

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[1] *Income tax: cross border profit allocation Review of transfer pricing rules & Consultation Paper 1 November 2011*. http://www.treasury.gov.au/~/media/Treasury/Consultations%20and%20Reviews/Consultations/2011/Transfer%20Pricing%20Rules/Key%20Documents/PDF/Review_of_transfer_pricing_rules_CP.ashx.

[2] *The legislation was a two-stage process with the introduction of Tax Laws Amendment (Cross-Border Transfer Pricing) Act (No. 1) 2012 (the 2012 reforms) and the Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Act 2013 (the 2013 reforms).*

[3] *See, sub-section 815-135(2) of the ITAA 1997 which requires that for the purposes of Subdivision 815-B the arm's length principle should be worked out and identified so as to best achieve consistency with the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations.*

[4] *See, 'Aligning Transfer Pricing Outcomes with Value Creation' Action 8-10: 2015 Final Reports, page 9.*

of the core elements of the arm's length principle as encapsulated in Article 9 of the OECD Model Tax Convention and specific guidance on the application of that principle in relation to intangible assets, intra-group services, and cost contribution arrangements.

The Council of the OECD has approved the 2015 OECD Report. This will not automatically update Australia's transfer pricing laws in respect of cross-border transactions between entities as Australia's transfer pricing legislation contained in subdivision 815-B of the ITAA 1997 refers to the 2010 OECD Transfer Pricing Guidelines as 'last amended on 22 July 2010'.[5] As such, in order to ensure Australia has the best transfer pricing rules possible, this reference will need to be modified so as to refer to the latest OECD Transfer Pricing Guidelines (those contained in the 2015 OECD Report).

Importantly, this consultation paper does not propose an update to Australia's transfer pricing rules in relation to permanent establishments (contained in subdivision 815-C of the ITAA 1997) as this is subject to on-going OECD work. The Government will consider this further work relating to permanent establishments, and its impact on Australia, once it is finalised.

Purpose of this Consultation

As Chair of the G20 in 2014, Australia was closely involved in the development of the BEPS project and the 2015 OECD Report. The final BEPS recommendations, including the 2015 OECD Report have been endorsed by OECD members and the G20 (including Australia) and the Council of the OECD has also approved the 2015 OECD Report.

Australia will be working towards a broad international take-up of the recommendations contained in the 2015 OECD Report.

This consultation paper is seeking industry feedback on the endorsed 2015 OECD Report in the context of the Australian tax system, particularly in addressing issues related to the potential implementation of its recommendations or any unintended consequences that might need to be addressed.

Currently, the OECD 2010 Guidelines as approved by OECD Council and last amended on 22 July 2010 are included as guidance material to the extent that they are relevant by direct references in Australia's transfer pricing rules contained in Subdivisions 815-A and B of the ITAA 1997, although further OECD guidance can be expressly included or excluded by regulation. This paper is also seeking comment on any impact that incorporating the 2015 OECD Guidance into Australia's domestic transfer pricing rules through legislation or regulation would have.

Adopting the new guidance will ensure that Australia has the best possible transfer pricing rules to help prevent multinationals from using excessing related party payments to shift profits overseas.

[5] *Note, section 815-235 of the ITAA 1997 requires that when interpreting the arm's length principle in relation to permanent establishments, it is to be interpreted with reference to the Model Tax Convention on Income and on Capital and its Commentaries, as adopted by the Council of the Organisation for Economic Cooperation and Development and last amended on 22 July 2010, to the extent that document extracts the text of Article 7 and its Commentary as they read before 22 July 2010.*

2010 OECD Guidelines

Comprehensive OECD guidance on transfer pricing was first published as a Report in 1979. In response to emerging transfer pricing issues in the dynamic setting of global trade and investment, it was subsequently reviewed and issued as the 1995 OECD Transfer Pricing Guidelines and last amended on 22 July 2010.

The nine chapters of the 2010 Guidelines set out the framework for the application of the arms-length principle to the evaluation of transfer pricing between associated entities.

- Chapter I sets out the Arm's Length Principle and provides guidance in its application including the factors to be considered in comparability analysis, losses and government policies;
- Chapter II describes the transfer pricing methods under the framework. These include the traditional transaction methods used to apply the arm's length principle (the comparable uncontrolled price (CUP) method, the resale price method, and the cost plus method) and add the transactional profit methods that may be used to approximate arm's length conditions where such methods are the most appropriate;
- Chapter III sets out a methodical, consistent approach for the Comparability Analysis specified in section D of Chapter I;
- Chapter IV & V set out alternative approaches to avoid and resolve transfer pricing disputes and provide guidance on documentation rules and procedures;
- Chapter VI covers special considerations on applying the arm's length principle to intangible assets. These include identifying arrangements made for the transfer of intangible property, calculation of an arm's length consideration, and arm's length pricing when valuation is highly uncertain at the time of the transaction; and
- Chapters VII, VIII and IX cover the special considerations for intra-group services, cost contribution arrangements, and the transfer pricing aspects of business restructuring.

The arm's length principle reflects the international consensus on the appropriate allocation of profits between parties that enter into non-arm's length arrangements in cross-border transactions. The arm's length principle underpins double tax treaty provisions dealing with the allocation and taxation of business profits in OECD and non-OECD countries alike.

Current Australian Transfer Pricing Legislation

In 2012 and 2013 Australia's transfer pricing rules were amended to ensure the application of the arm's length principle in Australia's domestic rules better aligned with the international transfer pricing standards contained in the 2010 OECD Guidelines.

This was achieved through a two-stage process, with the introduction of *Tax Laws Amendment (Cross-Border Transfer Pricing) Act (No. 1) 2012* (the 2012 reforms) and the *Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Act 2013* (the 2013 reforms).

The 2012 Reforms

The 2012 reforms introduced subdivision 815-A of the ITAA 1997, which:

- confirmed that the principles contained in the Business Profits and Associated Enterprises Articles in Australia's tax treaties were incorporated into Australia's domestic tax law and were able to be applied and provide assessment authority independently of Division 13 of the ITAA 1936; and
- required the working out of whether an entity gets a transfer pricing benefit and the interpreting of the provisions of a tax treaty to be done as consistently as possible with the relevant OECD guidance.

Subdivision 815-A was a transitional measure and applied to all income years commencing on or after 1 July 2004 and ending before 29 June 2013.

The 2013 Reforms

The 2013 reforms introduced subdivisions 815-B, 815-C and 815-D of the ITAA 1997 with effect from 29 June 2013. The 2013 reforms encapsulated the principles in Australia's DTAs and applied them on a self-assessment basis to all cross-border dealings (regardless of whether a treaty applies) and required the arm's length principle to be interpreted as consistently as possible with the relevant OECD guidance. The amendments confirmed authority for the use of OECD guidance material to assist in interpreting and applying the arm's-length principle in domestic law and ensuring consistent rules apply to both tax treaty and non-treaty cases.

The 2013 reforms sought to ensure an arm's-length tax outcome is achieved for non-arm's-length arrangements or transactions.

The new rules operate on a self-assessment basis, bringing the transfer pricing rules in line with the overall design of the Australian tax system. In contrast to the old rules, which relied upon the Commissioner making a determination, taxpayers are now able to self-assess their Australian tax position in accordance with the arm's-length principle.

In working out amounts such as taxable income, particular losses, tax offsets and withholding tax, the actual conditions arising from the commercial or financial relations between entities are compared to the arm's length conditions that might reasonably be expected to have operated between independent entities in comparable circumstances.

The new rules included specific measures to apply the arm's length principle to the attribution of profits of permanent establishments according to the 'single entity' basis in domestic law and to trusts and partnerships in the same way they apply to the taxable income of a company engaging in cross-border transactions

The new rules introduced a time limit within which the Commissioner may amend a taxpayer's assessment to give effect to a transfer pricing adjustment. Under the previous rules, the commissioner had an unlimited period in which to amend an assessment. The 2013 amendments reduced this period to seven years.

The amendments also clarified the interaction between the transfer pricing and thin capitalisation rules.

2015 G20/OECD Recommendations

The 2015 OECD Report entitled 'Aligning Transfer Pricing Outcomes with Value Creation' (Actions 8 to 10 Report) was released on 5 October 2015 and is part of the 'Base Erosion and Profit Shifting (BEPS) Action Plan' developed by the OECD to address BEPS in a co-ordinated and comprehensive manner.

The Report provides additional guidance and revised recommendations in response to Actions 8 to 10 of the BEPS Action Plan.

Action 8 focused on transfer pricing issues relating to transactions involving intangibles, since misallocation of the profits generated by valuable intangibles has contributed to base erosion and profit shifting.

Action 9 focused on the contractual allocation of risks, and the resulting allocation of profits to those risks, which may not correspond with the activities actually carried out. It also addressed the level of returns to funding provided by a capital-rich MNE group member in the event those returns do not correspond to the level of activity undertaken by the funding company.

Action 10 focused on other high-risk areas, including the scope for addressing profit allocations resulting from transactions which are not commercially rational for the individual enterprises concerned (re-characterisation), the scope for targeting the use of transfer pricing methods in a way which results in diverting profits from the most economically important activities of the MNE group, and neutralising the use of certain types of payments between members of the MNE group (such as management fees and head office expenses) to erode the tax base in the absence of alignment with value creation.

The Council of the OECD has approved the 2015 OECD Report, and it is proposed that the 2010 Transfer Pricing Guidelines will be formally updated in 2016 to reflect the above amendments. It is then expected that the 2015 OECD Report will be further updated in 2017 to incorporate additional guidance on outstanding matters that remain the subject of ongoing work in 2016, including practical examples of the application of profit split methods.

The 2015 OECD Report proposed amendments to chapters I, II, VI, VII and VIII of the OECD Guidelines. These amendments seek, amongst other things, to ensure that the transfer pricing analysis looks at the substance of transactions (particularly those involving intellectual property). This is achieved by delineating which entity bears the risk of the transaction and which entity derives the actual economic value of the transaction. This will result in transfer pricing analysis better reflecting which parties substantively assume the risk and derive the economic benefit of the transaction.

This approach is largely reflective of the approach that currently underlies Division 815, that is, to price the economic substance of the transaction. If adopted, the updated OECD Guidelines will help ensure that Australia continues to have best practice transfer pricing rules to help prevent multinationals from using excessive related party payments to reduce their Australian tax payable.

Chapter I. Arm's Length Principle:

The revisions and further guidance are aimed to ensure that the transfer pricing analysis is based on an accurate delineation of what the associated enterprises actually contribute, and is not based on contractual arrangements which may not reflect economic reality.

This is consistent with how the ATO currently applies the transfer pricing rules. These amendments will further assist the ATO as they provide additional guidance on how this interpretation should work in practice.

- Contractual allocations of risk are respected only when the party assuming the risk has the ability to control the risk and the financial capacity to assume it and the allocation of risk between the parties makes commercial sense.
  - This ensures that the allocation of assets is in line with arm's length pricing by reflecting the actual risk assumed in allocating assets. This also ensures that a transfer pricing analysis considers the range of risks likely to arise from the commercial or financial relations of associated enterprises.
- An entity with capital but without any additional functionality will generate no more than a risk-free return, assuring that no premium returns will be allocated to cash boxes without relevant substance.
  - This ensures that capital rich entities without any other relevant economic activities ("cash boxes") will not be entitled to any excess profits.
- Tax administrations may disregard transactions when the exceptional circumstances of commercial irrationality apply.
  - This ensures that the transfer pricing analysis reflects the economic substance of the transaction.

Chapter II. Transfer Pricing Methods:

Chapter II of the Transfer Pricing Guidelines has been amended to include new guidance especially applicable to commodity transactions. The new guidance includes:

- Clarification of the existing guidance on the application of the comparable uncontrolled price (CUP) method to commodity transactions. The new guidance states that:
  - the CUP method would generally be an appropriate transfer pricing method for commodity transactions between associated enterprises;
  - quoted prices can be used under the CUP method as a reference to determine the arm's length price for the controlled commodity transaction; and

- reasonably accurate comparability adjustments should be made, when needed, to ensure that the economically relevant characteristics of the controlled and uncontrolled transactions are sufficiently comparable.

- A new provision on the determination of the pricing date for commodity transactions.

  - This provision allows tax authorities to impute, under certain conditions, the shipment date (or any other date for which evidence is available) as the pricing date for the commodity transaction.

Chapter VI. Special Considerations for Intangible Property:

The special considerations around the treatment of intangible assets were one of the main areas of unfinished business of the 2010 Report.

Specifically, Chapter VI is to be amended to better ensure that:

- Legal ownership of intangibles by an associated enterprise is not sufficient by itself to determine entitlement to returns from the exploitation of intangibles;

- Associated enterprises performing important value-creating functions related to the development, maintenance, enhancement, protection and exploitation of the intangibles are credited with appropriate remuneration;

- An associated enterprise assuming risk in relation to the development, maintenance, enhancement, protection and exploitation of the intangible assets must exercise control over the risks and have the financial capacity to assume the risks, in accordance with the guidance on risks in chapter 1 (the Arm's Length Principle), including the control requirement;

  - Entitlement of any member of the multinational enterprises group (MNE Group) to profit or loss relating to differences between actual and expected profits will depend on which entity or entities assume(s) the risks that caused these differences and whether the entity or entities are performing the important functions in relation to the intangibles or contributing to the control over the economically significant risks and it is determined that arm's length remuneration of these functions would include a profit sharing element; and

  - An associated enterprise providing funding and assuming the related financial risks, but not performing any functions relating to the intangible, could generally only expect a risk-adjusted return on its funding. If the associated enterprise providing funding does not exercise control over the financial risks associated with the funding, then it is entitled to no more than a risk-free return.

- Hard-to-value intangibles will be subject to a rigorous transfer pricing analysis to ensure they are priced at arm's length. The guidance on the situations in which valuation techniques can appropriately be used is expanded so that tax administrations can consider ex-post outcomes as presumptive evidence about the appropriateness of the ex-ante pricing arrangements, and the taxpayer must demonstrate that the uncertainty has been appropriately taken into account in the pricing methodology adopted. Guidance on the implementation of this approach will be provided during 2016.

Chapter VII. Special Considerations for Intra-group Services

An elective, simplified approach to value-adding services has been introduced to balance the need to protect the tax base of payor countries by appropriately allocating member charges for intra-group services in accordance with the arm's length principle with the need to ensure compliance costs are proportional to the amount of revenue at risk. This approach:

- Specifies a wide category of common intra-group services which command a very limited profit mark-up on costs;
- Applies a consistent allocation key for all recipients for those intra-group services; and
- Provides greater transparency through specific reporting requirements including documentation showing the determination of the specific cost pool.

This simplified approach replaces the detailed testing of the benefits received that has been customary for other intra-group service charges, with an assumption that businesses are only willing to incur costs if there is a business reason to do so and that the approach leads to an equal treatment of these costs for MNE group members in similar circumstances. As a result, it is expected that adoption of the elective, simplified approach is likely to free up resources for tax administrators in identifying and examining cross border dealings with significant transfer pricing and BEPS risks.

Chapter VIII. Cost Contribution Arrangements.

The guidance ensures that cost contribution arrangements (CCAs) cannot be used to circumvent the new guidance on the application of the arm's length principle in relation to transactions involving the assumption of risks, or on intangibles.

Consistent with the framework set out for risk and intangibles, the cost contribution framework is being amended so that:

- The same analytical framework for delineating the actual transaction, including allocating risk, is applicable to CCAs as to other kinds of contractual arrangements;
- The same guidance for valuing and pricing intangibles, including hard-to-value intangibles, is applicable to CCAs as to other kinds of contractual arrangements;
- The analysis of CCAs is based on the actual arrangements undertaken by associated enterprises and not on contractual terms that may or may not reflect economic reality;
- An associated enterprise can only be a participant to the CCA if there is a reasonable expectation that it will benefit from the objectives of the CCA activity it exercises control over the specific risks it assumes under the CCA and has the financial capacity to assume those risks; and

- Contributions made to a CCA, with specific focus on intangibles, should not be measured at cost where this is unlikely to provide a reliable basis for determining the value of the relative contributions of participants, since this may lead to a non-arm's length result.

In summary the guidance ensures that CCAs are appropriately analysed and produce outcomes that are consistent with how and where value is created. Parties performing activities under arrangements with similar economic characteristics should receive similar expected returns, irrespective of whether the contractual arrangement in a particular case is termed a CCA.

Further work being undertaken:

The Report notes that further work will be undertaken by the OECD on financial transactions and profit splits (in particular, the circumstances in which transactional profit splits are the most appropriate method for a particular case and to describe what approaches can be taken to split profits in a reliable way). As such, this does not form part of the Report.

Any additional recommendations on financial transactions and profits splits will form the basis for further draft guidance to be developed by OECD Working Party 6 during 2016 (regarding hard to value intangibles, low value adding services, and materiality thresholds) and is expected to be finalised in the first half of 2017. The OECD plans to release a discussion draft for public comment in May 2016.

The Government will consider the implications of this further OECD work for Australia once it is finalised.

Process for Implementation of New Guidance

Mechanism for implementation

Section 815-135 of the ITAA 1997 provides that, in relation to cross-border dealings between entities, the arm's length conditions should be identified so as to best achieve consistency with the 2010 OECD Guidelines.

- Subsections 815-135(2) to (4) allow for the arm's length conditions to be interpreted according to Guidelines (as last updated on 22 July 2010) or a document prescribed by Regulations.

To incorporate the 2015 OECD Report as the relevant guidance for the purposes of interpreting and applying Division 815, either the reference in the legislation to the 2010 OECD Guidelines in subsections 815-135(2)(a) and 815-235 (2)(a) will need to be updated, or alternatively, the 2015 OECD Report could be prescribed by regulation as relevant guidance for the purposes of sub-paragraphs 815-135(2)(b) and 815-235(2)(b).[6]

[6] *See, Explanatory Memorandum to the Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill, paragraph 3.32.*

Start date

The 2012 Reforms received Royal Assent on 8 September 2012 and applied to all income years commencing on or after 1 July 2004 and ending before 29 June 2013. The 2013 Reforms received Royal Assent on 29 June 2013 and applied to all income years starting on or after 29 June 2013.

The approaches to the 2012 and 2013 reforms indicate that if Australia adopts the updated OECD Guidelines (either by legislation or regulations) it would probably apply to income years starting on, or after 1 July 2016.

Consultation Questions

Australia was closely involved in the development of the 2015 OECD Report and its recommendations. Both the 2015 OECD Report and its recommendations have been endorsed by the G20 and OECD, and the Government is currently working towards a broad international take-up of the recommendations.

In this context, we seek feedback on the following questions:

1	Would there be any significant unintended consequences for Australia if these recommendations are incorporated as relevant guidance for the purposes of applying Division 815 of the ITAA 1997?
2	Are there any significant challenges with commencing the new Guidance for income years starting on or after 1 July 2016?
3	It is envisaged in section 815-135 of the ITAA 1997 that documents to be relied upon in applying Australia's transfer pricing rules can be prescribed by way of regulation. Are there any reasons why regulation (as opposed to legislative amendment) is not the appropriate method for incorporating the recommendations contained within the 2015 OECD report.
4	What new ATO guidance / explanatory materials do you think the ATO will need to prepare (and what existing ATO guidance / explanatory materials will need to be updated) if the changes by the 2015 OECD Report are adopted?