Submission

Income tax: cross border profit allocation, review of transfer pricing rules

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1.0 EXECUTIVE SUMMARY

Chevron is currently developing two of Australia's largest resources projects in the North-west of Western Australia. The Chevron-operated Gorgon and Wheatstone Projects represent over $70 billion of investment and will position Australia as a leading liquefied natural gas (LNG) supplier in the Asia-Pacific region.

Gorgon and Wheatstone will create significant benefits for the Australian economy, including substantial revenues to the Australian Government throughout their operations – estimated to be at least forty years.

Resource security continues to underpin Chevron's investment in petroleum exploration and development. Strong investment in petroleum exploration and development in Australia has been facilitated to date by low sovereign risk, a stable legislative regime and the region's prospectivity.

Whilst Chevron agrees with the proposal to introduce time limits for the Commissioner of Taxation to make transfer pricing adjustments, Chevron is concerned that the retrospective nature of the proposed transfer pricing rules undermine Australia's low sovereign risk profile due to the diminution of taxpayers' ability to rely on the law.

Chevron further submits that:

(i) It is not appropriate for the legislative amendment announced in the media release, which will provide Australia's double tax agreements ("DTA") with a separate taxing power, to be treated as a 'clarification' of the existing law, as the proposed law change is clearly retrospective. The 1 July 2004 start date is unfounded, and would appear to breach the terms of Australia's double tax agreement ("DTA") with the USA.

(ii) It is not clear that any differences in outcomes between Division 13 and the OECD Guidelines are as significant as the Consultation Paper suggests. Any proposed amendments to Division 13 of the *Income Tax Assessment Act 1936* ("Division 13") made on this basis should therefore be carefully considered.

(iii) While Chevron does not concede that any changes are necessary, if changes are made to Division 13, these should not go beyond the OECD Guidelines. In Chevron's view:

- a broad based reconstruction power is not warranted in any potential rewrite of Division 13; and
- there is no need for any further rule requiring that the circumstances of the taxpayer be taken into account.

(iv) Any new legislative requirement to maintain contemporaneous transfer pricing documentation should include de minimis rules on both a 'per taxpayer' and 'per transaction' basis.

These points are expanded further below.

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2.0 ABOUT CHEVRON AUSTRALIA

Chevron has been present in Australia for more than 45 years and is the operator for the Gorgon Project, the Wheatstone Project and the Barrow and Thevenard Island oilfields. The company is a foundation partner in the North West Shelf Venture and is a significant investor in exploration and appraisal activities offshore North-Western Australia.

The $43 billion Gorgon Project is the single largest ever Australian resource investment. The project has been in construction for two years on Barrow Island and will consist of a three LNG trains with a total capacity of 15 million tonnes per annum, and a domestic gas plant.

In September 2011, Chevron also took a final investment decision on the $29 billion Wheatstone project. Gas will be processed at an onshore facility located at Ashburton North, 12km west of Onslow. The foundation project will include two LNG trains with a combined capacity of 8.9 million tonnes per year and a domestic gas plant.

The Gorgon and Wheatstone Projects are expected to bring many benefits to Australia including direct and indirect employment, government revenues, economic growth, investment in local goods and services and security of natural gas supply.

Chevron shares the Government’s objective of a regulatory framework that promotes, rather than impedes, investments in LNG projects and the exploration that underpins them. Certainty with regard to regulation and tenure is critical to investment in LNG projects and in promoting ongoing exploration.

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3.0 DOUBLE TAX AGREEMENTS AS A 'TAXING POWER'

The media release accompanying the Consultation Paper announced proposed law changes to "*clarify that the transfer pricing rules in our tax treaties act as an alternative to the rules currently in the domestic law*" and states that these 'clarifications' will apply to income years commencing on or after 1 July 2004 in treaty cases. The reason offered for the start date is "*the Parliament has indicated the law should operate in this way on a number of occasions, most recently in 2003*".

Chevron does not accept that the proposed changes are simply clarifications to the existing law, for two reasons.

Firstly, the reference to an 'indication by Parliament' in 2003 appears to refer to discussions regarding the renegotiation of Australia's Double Tax Agreement with the United Kingdom. The related material in no way suggests, infers or provides that the treaty should be an alternative to, or override, our domestic laws.

Secondly, the Courts have refuted the notion that separate taxing power is conferred by the DTAs on several occasions. *Lamesa, Chong* and *Undershaft* are all authority for the proposition that the DTA's do no more than allocate taxing rights[1]. In Undershaft, Lindgren J stated[2]:

> "*A purpose of a DTA is to avoid the potential for the imposition of tax by both of the Contracting States on the same income. It is appropriate to say that the Contracting States achieve their objective by "allocating" as between themselves the right to bring to tax a particular item to one Contracting State while the other State agrees to abstain from doing so ...*
>
> *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 taxing power*" (emphasis added).

The Commissioner of Taxation has made it clear that he believes Australia's DTAs provide a separate taxing power. As such, a challenge on that point to the High Court following *SNF* would have been a logical course of action.

In the absence of such an appeal by the Commissioner of Taxation, taxpayers are entitled and obliged to rely on the Courts' interpretations of the law, i.e. that DTAs allocate rights to tax, they do not impose taxes. Under Australia's self assessment system, taxpayers are required to file in accordance with the law as written and any interpretations determined by the Courts.

We further note that in its recent report on *Tax Laws Amendment (2011 Measures No. 8) Bill 2011*, the Senate Economics Legislation Committee stated:

> *"The committee is firmly of the view that legislating retrospectively should not be an approach that is frequently used, nor one pursued without careful consideration. Retrospective legislation can lead to potential uncertainty and has the ability to significantly impact the rights of those affected. In the sphere of tax*

[1] Commissioner of Taxation v Lamesa Holdings BV (1997) 77 FCR 597 at 600, Chong v Commissioner of Taxation (2000) 101 FCR 134 at 24 to 27, Undershaft (No 1) Limited v Commissioner of Taxation [2009] FCA 41 at 46

[2] Undershaft (No 1) Limited v Commissioner of Taxation [2009] FCA 41 at 45 - 46.

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laws, retrospective changes can also pose practical difficulties for those affected in managing their affairs."[3]

Notably, the Committee went on to say:

> *"It is important to note that with respect to TLAB 8, the changes imposed by schedule 2 are not retrospective in the sense that they do not impose any additional tax liabilities. Instead the change seeks to affirm and provide further statutory support for the decision made by the Federal Court on the taxing point issue in April this year."*[4]

These same circumstances do not apply in the case of the proposed retrospective changes to the transfer pricing law. As noted above, there has been no judicial consideration of the issue of whether Australia's DTAs contain a separate taxing right. Furthermore, feedback from Treasury's consultation process with industry bodies indicates that one of the key drivers for retrospectivity is concern that in the absence of retrospective legislation, taxpayers will seek amendments to their prior year income tax returns that will result in significant tax refunds. As such, it cannot be argued that the proposed retrospective changes do not affect tax liabilities which have been calculated under the existing law.

Accordingly, in Chevron's view it is not appropriate for the legislative amendment announced in the media release, which will provide Australia's DTAs with a separate taxing power, to be treated as a 'clarification' of the existing law, as the proposed law change is not a clarification. It is retrospective law. 1 July 2004 start date is unfounded, and would appear to breach the terms of Australia's DTA with the USA.

Chevron's concerns in relation to the proposal to retrospectively treat Australia's DTAs as containing a separate taxing right are summarised below.

(i) A retrospective change would be an impermissible attempt by Australia to change how bilateral treaties are interpreted.

As was made clear by the Full Federal Court in *SNF*, as a matter of customary and public international law, Australia's DTAs are to be interpreted in accordance with Article 31 of the *Vienna Convention on the Law of Treaties* concluded at Vienna on 23 May 1969. Under Article 31(3), the OECD Guidelines can only be examined in interpreting Australia's DTAs if they reflect the subsequent agreement of the States in question or, under Article 31(3)(b), "*any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation"*.

A retrospective change to apply treaty rules 'in a manner that promotes consistency with the OECD Guidelines' would be a unilateral and impermissible attempt by Australia to change how bilateral treaties are interpreted.

(ii) Retrospective law is not in accordance with established practice in Australia.

Retrospective legislation is not justified or in accordance with established practice in Australia, except in extremely limited circumstances. Retrospective legislation has been introduced in limited circumstances to stamp out blatant tax avoidance, but this exception is <u>not</u> applicable in relation to the proposed retrospective

[3] Paragraph 2.41 of the Senate Economics Legislation Committee report into TLAB 8 2011.
[4] Paragraph 2.42 of the Senate Economics Legislation Committee report into TLAB 8 2011.

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extension of Australia's transfer pricing rules from 1 July 2004. There has been no suggestion of tax avoidance in relation to Australian transfer pricing rules and in any event, Australia has a comprehensive general anti-avoidance provision which has operated since 1981.

The ATO has already backdated their view of the operation of aspects of the transfer pricing rules as they relate to intra-group financing by issuing *Taxation Ruling TR 2010/7* with retrospective application, notwithstanding that TR 2010/7 is inconsistent with the ATO's previously issued *Taxation Ruling TR 92/11*. The proposal to retrospectively give Article 9 of the DTAs a separate taxing power is a disturbing continuation of this trend.

(iii) Retrospective change would appear to breach the terms of Australia's DTA with the USA.

Article 1(2) of the Australia/USA DTA makes it clear that the treaty cannot create a tax liability that does not otherwise exist under domestic law. This interpretation is clearly supported in associated explanatory material[5]:

"... Paragraph 2 states the generally accepted relationship both between the Convention and domestic law and between the Convention and other agreements between the Contracting States. That is, no provision in the Convention may restrict any exclusion, exemption, deduction, credit or other benefit accorded by the tax laws of the Contracting States, or by any other agreement between the Contracting States.

... Paragraph 2 also means that the Convention may not increase the tax burden on a resident of a Contracting States beyond the burden determined under domestic law. Thus, a right to tax given by the Convention cannot be exercised unless that right also exists under internal law.

It follows that, under the principle of paragraph 2, a tax-payer's U.S. tax liability need not be determined under the Convention if the Code would produce a more favourable result."

Chevron seeks confirmation from Treasury that this aspect will be considered in detail, and that the proposal to retrospectively change the law will not affect taxpayers' rights under the Australia/USA DTA.

(iv) Retrospective legislation creates regulatory uncertainty for investment in Australia.

Unjustified retrospective legislation may undermine trust and respect in the Government and Australian commerce. This could have flow-on consequences including:

- Regulatory uncertainty for investment in Australia (tax becomes a risk rather simply a cost).
- Potential for Constitutional challenges as well as possible breaches of Free Trade and Investment Protection Agreements.

[5] *2006 US Model Income Tax Convention Technical Explanation.* (Article 1, Paragraph 2).

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(v) Retrospective law change creates further uncertainty for taxpayers in an already complex and uncertain area of taxation law.

With regard to Australia's transfer pricing rules, the law has been applied in its current state for over a decade and has been administered[6] in a manner which is not consistent with retrospective change.

[6] Despite a number of opportunities in transfer pricing litigation, the Commissioner has declined to test its long-held and controversial view that tax treaties create an income tax liability, for example, SNF.

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4.0 ADEQUACY OF EXISTING TRANSFER PRICING RULES

The Consultation Paper canvasses a review of Australia's existing transfer pricing rules in Division 13. It purportedly focuses on the extent to which Australia's domestic legislation does and should align with international standards such as the OECD's *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD Guidelines). It is therefore critical that any analysis of perceived inconsistencies between Division 13 and the OECD Guidelines is balanced and objective.

However, aspects of the Consultation Paper appear to contain a distorted or unbalanced view of the OECD Guidelines. As such, it is not an appropriate platform for canvassing the relevant issues, including the extent to which the domestic legislation should align with international standards.

For example the Consultation Paper and the accompanying press release both cite recent litigation (i.e. the *Roche* and *SNF* cases) as reasons for the need to review the extent to which Division 13 is consistent with international guidance. However, neither the Consultation Paper nor the Press Release acknowledges that it is not clear that the decisions in *Roche* and *SNF* would have been any different if Australia's domestic transfer pricing legislation was based on the OECD Guidelines.

In the case of the decision by the Full Federal Court in *SNF*, the judges went so far as to indicate that their view was that the decision would have been the same under the OECD Guidelines[7] and ultimately agreed with the conclusions reached by the taxpayer in applying the comparability framework and factors recommended in the OECD Guidelines.

The Consultation Paper also seems to infer that there is commonly a wide gap between the outcomes from applying Division 13 compared to the outcome that would result from applying the OECD Guidelines. There does not appear to be any evidence to support this.

Division 13 arguably allows the use of profit-based methods as an indirect means of testing the arm's length nature of transfer prices, provided no comparables are available to apply one of the transactional methods.

The OECD Guidelines are not, as seems to be inferred by parts of the Consultation Paper, written in such a way that they are about profit allocation and profit-based methods instead of the pricing of transactions. Instead, the OECD Guidelines consider the pricing of transactions between associated enterprises[8]. This is very clear in the way that the OECD Guidelines are written. However this is not acknowledged in the Consultation Paper, which heavily uses the term 'profit allocation' and seems to avoid explicitly mentioning pricing of transactions and dealings where possible, in contrast to the OECD Guidelines.

The discussion about profit-based methods in the OECD Guidelines makes it clear that the relevance of the profit-based methods is as a tool to achieving arm's length prices for transactions. Specifically, Paragraph 2.6 of the OECD Guidelines states that:

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[7] Specifically, Paragraph 104 states that the approach applied by the taxpayer was the same as that recommended by the OECD Guidelines and paragraph 103 states that certain outcomes proposed by the Commissioner are not contemplated at all in the OECD Guidelines.

[8] For example, Paragraph 1.2, at the start of the first Chapter of the OECD Guidelines, introduces the OECD Guidelines with a discussion about associated enterprises transacting with each other and the price of good transferred or services provided.

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"Methods based on profits can be accepted only insofar as they are compatible with Article 9 of the OECD Model Tax Convention, especially with regard to comparability. This is achieved by applying the methods in a manner that approximates arm's length pricing. The application of the arm's length principle is generally based on a comparison of the price, margin or profits from particular controlled transactions with the price, margins or profits from comparable transactions between independent enterprises" (emphasis added).

Chevron submits that the differences in outcomes between Division 13 and the OECD Guidelines not as significant as the Consultation Paper suggests. Accordingly any amendments proposed on this basis should be carefully considered.

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5.0 CERTAINTY AND THE PROPOSED NEW LAW

The Consultation Paper seems to imply that an OECD Guidelines-based approach would substantially reduce uncertainty regarding the application of the arm's length principle. However, the OECD Guidelines themselves are open to interpretation and are commonly the subject of debate.

As such, alignment with the OECD Guidelines would not remove uncertainty when applying the arm's length principle. Chevron has concerns that the proposed changes may in fact create even more uncertainty, because some aspects of the ATO's interpretation of the OECD Guidelines go beyond the generally accepted intention of the OECD Guidelines (see comments below regarding the 'circumstances of the taxpayer'). These factors need to be given careful consideration before any decision is made on changing Australia's existing transfer pricing rules.

As discussed above, Chevron contends that changes to Division 13 are not necessary. Notwithstanding, some comments on the proposal to change the operation of Division 13 are discussed below.

As an overarching principle, Chevron submits that, if changes are made to Division 13, those changes should not go beyond the OECD Guidelines. Specifically, care should be taken that any attempt to put the profit-based methods on the same footing as the transactional methods should not 'over reach' and effectively favour the profit-based methods.

Two particular areas where it is critical that any changes to Division 13 do not go beyond the principles set out in the OECD Guidelines are reconstruction and the consideration of the 'circumstances of the taxpayer' when considering comparability.

1) Reconstruction

The discussion on reconstruction in the Consultation Paper creates a distorted and somewhat misleading impression of the relevant commentary in the OECD Guidelines.

The OECD Guidelines clearly state that restructuring controlled transactions is generally inappropriate and that a tax administration's examination should be based on the transaction actually undertaken by the associated enterprises as structured by them. Specifically, the paragraph 1.65 of the OECD Guidelines states the tax administration should not disregard the actual transactions or substitute other transactions for them other than in 'exceptional cases', such as where the economic substance of a transaction is clearly at odds with its form.

However, the Consultation Paper appears to suggest an approach that goes significantly beyond the OECD Guidelines. In particular, paragraph 82 of the Consultation Paper suggests a "*voiding rule that puts the taxpayer in an 'as you were' position, unaffected by the non-arm's length arrangement*" to allow reconstruction "*where the actual related party dealings and transactions prevent the ascertainment of a truly arm's length outcome"*.

The example at paragraph 81 of the Consultation Paper, appears to suggest that where an intra-group loan is made to a related party that is insufficiently capitalised and does not have the necessary financial attributes to obtain the loan from an independent lender, the entire loan would be 'void' for transfer pricing purposes, even if the borrower could have obtained a smaller loan from a third party lender.

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Attempting to address reconstruction by introducing a voiding rule is an extreme approach which is inconsistent with the approach endorsed by the 2010 OECD Guidelines. The OECD Guidelines refer to the "adjustment of conditions"[9], not the voiding of transactions.

Further, it should be reiterated that the OECD Guidelines make it very clear that reconstruction is only appropriate in exceptional circumstances.

Chevron notes that there are also a number of significant practical problems with reconstruction:

(i) Reconstruction of most transactions would be largely an arbitrary exercise because for most transactions and in most situations there is a wide range of potential ways in which arm's length parties choose to structure their transactions in the real world, depending on factors such as their specific commercial objectives, strategies, appetite for risk and so forth.

(ii) Reconstruction therefore creates considerable further uncertainty for potentially affected taxpayers, which is undesirable from a policy and tax design perspective and contrary to the stated purpose of reducing uncertainty at paragraph 3 of the Consultation Paper.

(iii) Reconstruction also increases the likelihood of double taxation and may therefore give outcomes contrary to the intention of Australia's DTAs. This is because, as recognised at paragraph 1.64 of the OECD Guidelines, the arbitrary nature of reconstruction means tax administrations may not share the same views as to how the transaction should be structured.

(iv) In some areas, reconstruction could create outcomes which have unintended consequences for other provisions of the tax law or even render certain provisions of the legislation redundant.

For example, reconstruction of debt funding arrangements, where the debt amount is within the safe harbour limits in the thin capitalisation rules, would seem contrary to the policy intent of the thin capitalisation (Division 820) and debt/equity (Division 974) regimes. The ATO recognises this in TR 2010/7, by including a specific example (Example 4) that clarifies that the thin capitalisation safe harbour should not be made inoperative by the transfer pricing rules.

If the Government intends to change the transfer pricing law in a way that limits the effectiveness of the thin capitalisation and debt/equity rules, this should be clearly stated and included in the consultation process.

(v) Australia has a comprehensive general anti-avoidance rule (Part IVA) which prevails over Australia's DTAs[10] and is consistent with OECD DTA principles[11]. The ATO has recently indicated its intent to consider the application of Part IVA to business restructurings[12].

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[9] See paragraph 1.66

[10] Section 4(2) *International Tax Agreements Act 1953.*

[11] Refer Commentary to Article 1 of the *OECD Model Tax Convention* (e.g. Paragraphs 9.5 and 22).

[12] Refer paragraph 9 and 68 of TR 2011/1 (Income tax: application of the transfer pricing provisions to business restructuring by multinational enterprises).

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Chevron submits that the existence of a general anti-avoidance rule means that there should be no circumstances in which a reconstruction under the transfer pricing rules will be warranted in Australia.

In summary, Chevron submits that a broad based reconstruction power is not warranted in any potential rewrite of Division 13. Any changes to Division 13 should be consistent with the OECD Guidelines and should make it clear that reconstruction is generally inappropriate.

Chevron also submits that reconstruction in the context of funding conflicts with the policy intent behind the combined operation of the thin capitalisation rules, the debt/equity 'substance-over-form rules' and to a certain extent the general anti-avoidance rule. This policy intent is clear and has been consistent for some time. The proposed amendments to the transfer pricing rules may result in outcomes that are in direct conflict with that policy, and should be carefully considered and explained.

2) The 'circumstances of the taxpayer'

The Consultation Paper correctly acknowledges that the Full Federal Court in *SNF* found that the circumstances in which the actual transaction occurred were relevant to establishing arm's length prices. In evaluating the circumstances of the actual transaction, the Full Federal Court considered the taxpayer's application of the five comparability factors listed by the OECD as a framework.

These five comparability factors set out what the relevant circumstances are (including the relevant circumstances of the taxpayer) when evaluating comparability in the context of establishing arm's length prices. For example, these comparability factors include 'the functions performed by the parties (taking into account the assets used and risks assumed)', 'the economic circumstances of the parties' and 'the business strategies pursued by the parties'[13].

This being the case, Chevron submits that there is no need for any further rule requiring that the circumstances of the taxpayer be taken into account. A separate rule of this nature would be inconsistent with the OECD Guidelines.

Chevron believes the comment at paragraph 55 of the Consultation Paper that the absence of a specific rule (and reliance on the OECD Guidelines alone) could lead to a conclusion that the circumstances of the taxpayer are not particularly relevant is misguided and inaccurate.

Chevron is also concerned that a separate rule on 'the circumstances of the taxpayer' might also be inappropriately interpreted by the ATO in administering the law. For example, the ATO may seek to interpret such a rule as a requirement to take the profitability of the taxpayer into account as a comparability criteria when selecting the most appropriate method, as it tried to argue in *SNF*, or as a form of compulsory profitability cross check. Not only does this create an impossibly high comparability hurdle, it is in effect a 'back door' means of giving the profit-based methods priority over the transactional methods, which is inconsistent with the OECD Guidelines.

[13] Paragraph 136 of the OECD Guidelines.

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6.0 RECORD KEEPING AND PENALTIES

Chevron agrees with the comments in the Consultation Paper that if a legislative requirement to maintain contemporaneous transfer pricing documentation is introduced, there should be a *de minimis* rule to avoid taxpayers facing compliance costs disproportionate to the potential transfer pricing risk.

Chevron submits that such a de minimis rule should not only contain thresholds on a per taxpayer basis, but also on a transaction-type basis.

That is, larger taxpayers commonly have a small number of large international related party transactions, and a larger number of small, low risk international related party transactions. In the absence of such a per-transaction *de minimis* rule, larger taxpayers may bear significant compliance costs in documenting transactions of negligible value and little risk.

Chevron supports the proposition in the Consultation Paper that the documentation requirement should be linked to the penalty regime. That is, penalties should be reduced to nil where the taxpayer has made good faith attempts, commensurate with the relative importance of the transaction in the context of the taxpayer's business, to determine an arm's length price and has maintained contemporaneous documentation.

The link between contemporaneous documentation and penalties should not be linked to an assessment of the 'quality' of the documentation such that only the very highest quality ratings achieve penalty protection (as is the case to an extent with the ATO's Guidance in *Taxation Ruling TR 98/16*). Experience with this current approach suggests that it sets an unattainable high standard in many cases, and appears to discourage the ATO from rating most taxpayers' transfer pricing documentation as meeting the required quality standard, even in cases where a substantial level of analysis has been performed. At the very least, there needs to be:

(i) a review of the existing checklist used by the ATO in transfer pricing record reviews; and/or

(ii) a review of the current ATO policy of limited ability to respond to documentation quality ratings issued by the ATO given the impact on penalty assessments further down the track.

Chevron further submits that, if the proposed retrospective amendments is enacted, taxpayers should not be exposed to additional penalties and interest by reason of those amendments, particularly where the position was reasonably arguable prior to the amendments.

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