Submission in response to Treasury Consultation Paper "Income tax: cross border profit allocation – Review of transfer pricing rules"

Focus: Proposal for new tax treaty interpretive rule

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1. Introduction

This submission responds to the suggestions in the 1 November 2011 Treasury Consultation Paper, "Income tax: cross border profit allocation – Review of transfer pricing rules", that Treasury is considering implementing:

> "an interpretation rule to promote consistency with the arm's length principle, the 2010 OECD [Transfer Pricing] Guidelines and Article 9 of our treaties." (Paragraph 32.6)[1]

and, going beyond transfer pricing:

> "a specific rule to ensure interpretive consistency between tax treaty provisions *generally* and the explanations provided in the OECD materials, where the treaty provisions reflect those in the OECD [Model Convention]." (Paragraph 47).

In my view this is a positive development, although it may not technically be a development at all in relation to treaty interpretation. The Organisation for Economic Cooperation and Development (**OECD**) materials, particularly the Model Tax Convention and the Commentaries thereto, are already legitimate means of interpretation in Australia under the Vienna Convention on the Law of Treaties.

However, if Treasury wishes to entrench OECD materials even further, this is hardly rash. The OECD is the primary international tax forum for Australia and most of our trading partners, and Australia is an OECD member and participates in the drafting of the OECD tax material. International harmonisation is a virtue when it comes to transfer pricing, where inconsistent rules cause double taxation or double non-taxation, and the OECD is probably best placed to coordinate harmonisation efforts.

That said, in my view such a rule should only entrench the ability to take the OECD material into account; it should not give it binding effect.

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[1] A form of similar interpretive rule has been included in the Minerals Resource Rent Tax (**MRRT**) legislation currently before the Senate.

[2] The other significant Australian transfer pricing decision is that of Downes J, sitting as

A number of specific questions are raised by the proposal for an OECD-consistency interpretive rule, such as:

1. Is it necessary, given the Vienna Convention and other existing interpretive rules?
2. If there is to be a new rule, what level of compulsion it should involve (should it require the OECD material to be taken into account, or just facilitate this)?
3. Should the rule be extended beyond transfer pricing to all tax treaty provisions?

This submission first outlines the context of the suggested changes, then explores these questions, and concludes with some recommendations.

2. Background to the proposal

The immediate trigger for the Treasury consultation paper appears to have been the Full Federal Court's decisions in *Commissioner of Taxation v SNF (Australia) Pty Ltd* [2011] FCAFC 74 and, to a lesser extent, *Russell v Commissioner of Taxation* (2011) 190 FCR 449.

In *Russell*, Dowsett J (Edmonds and Gordon JJ agreed on this point) suggested at [30] that certain post-*Thiel* migration jurisprudence means that more care is required in referring to material such as the OECD Commentaries. The analogy may not be apt: in the migration cases the *Migration Act 1958*, which fell for construction, gave partial effect to the UN Refugees Convention, whereas tax treaties are themselves international agreements and are incorporated in their very terms in domestic law. However, note that Dowsett J ultimately dismissed the taxpayer's argument that the primary Judge used the OECD commentary to "override" the treaty.

SNF is the first transfer pricing methodology case to reach final judgment in the Australian Courts.[2] The Full Court upheld the primary Judge's decision in favour of the taxpayer. While the Full Court adhered to the principle that the OECD Model Convention and Commentaries may be considered in interpreting a tax treaty based on that model, it held that the OECD Transfer Pricing Guidelines "are not a legitimate aid to the construction of the double taxation treaties."[3]

Given that the Guidelines are the location of most of the OECD's know-how on transfer pricing, have been developed by OECD member countries over many years, and are referred to in the Commentary on Article 9, one can see how OECD devotees would be disappointed by this finding.

The primary Judge in *SNF* rejected the use of the profit-split "Transactional Net Margin" method (**TNMM**) under Australia's transfer pricing rules in Division 13 of

[2] The other significant Australian transfer pricing decision is that of Downes J, sitting as President of the Administrative Appeals Tribunal, in *Roche Products Pty Ltd v Commissioner of Taxation* 2008 ATC 10-036.

[3] At [118]. The Full Court did explain at [117] that the Guidelines may be a legitimate aid to interpretation if it can be shown that they reflect subsequent practice or agreement of the treaty partners per Article 31(3) of the Vienna Convention.

the Income Tax Assessment Act 1936, on the basis that these rules refer to transactions, not profits. The Full Court's reasons do not directly discuss this issue.

Even without *SNF*, it seems that reform to Australia's transfer pricing legislation probably would have come on to the agenda in at least the medium term, owing to the advanced age of the rules (in international tax legislation terms) and the Ralph Review transfer pricing recommendations.

The *SNF* impetus is that it has two distinct parts. The primary Judge's dismissal of TNMM seems to have spurred reform most urgently. The Australian Taxation Office (**ATO**), and some taxpayers, want to be able to continue to use TNMM and profit split methods under Division 13. The ATO also seeks to bolster its view – almost unique amongst OECD nations – that treaties confer an independent taxing power. Thirdly, *SNF* casts some doubt on the ability of the ATO to use other non-transactional transfer pricing tools, such as the controversial reconstruction power.

At the same time, the proposed reform attempts to neutralise the Full Court's finding that the OECD Guidelines were not a legitimate aid to interpretation.

Ultimately, the two issues are related: Treasury proposes modernising our transfer pricing legislation, ensuring that the full range of contemporary OECD methodologies are available to the ATO. This could be achieved by just re-drafting Division 13. Introducing an OECD-consistency rule as well, however, could both (1) alleviate the need to copy the current OECD material into domestic law, and (2) "future-proof"[4] the domestic law – and possibly Australia's treaties – against the risk of lagging behind the OECD again in future.

3. Australia's role in the production of the OECD materials

Australia has been a member of the OECD for 40 years and it plays an active role in the OECD's Centre for Tax Policy and Administration, the area responsible for international tax. Officials from Treasury and the ATO regularly participate in OECD Working Parties involved in drafting the OECD material and reporting on current international tax issues. Other Australian tax experts from academia and the private sector also participate in OECD work.

Most of Australia's tax treaty and trading partners are also OECD members, although a couple of major partners, such as China, are not. However, many non-OECD countries agree to tax treaty provisions based on the OECD model, and many of these play an active role in the CTPA as well. The United Nations has also developed a model tax treaty, the provisions of which are followed by many developing countries in preference to those of the OECD Model.

Within the process of formulating the OECD Model Convention and Commentaries, member countries not agreeing with the consensus wording have the formal ability to enter a "reservation" or "observation" while non-member countries can record similar views in what are called "positions."

[4] Treasury Consultation Paper, [43].

A reservation is a statement that that country reserves the right to deviate in its treaties from the language of the treaty article in question (or to not adopt the article, or to adopt a different article). Countries do not record a reservation if they follow one of the very many variants authorised by the Commentaries; this drastically reduces the number of reservations.

An observation is similar, but relates to the Commentaries and therefore to matters of treaty interpretation. All reservations, observations and positions are published along with the Model Convention and Commentaries.

4. Is a new interpretive rule necessary?

There already exists a rule for taking into account the OECD Model Convention and Commentary (and probably the Transfer Pricing Guidelines and other reports such as the Partnership Report) in interpreting a tax treaty based on the OECD model – the Vienna Convention on the Law of Treaties. Australia is a signatory and most of its treaty partners are as well, but as the Vienna Convention also reflects customary international law, the same principles apply even where a treaty party is not a signatory.

An important general principle of treaty interpretation is that a more liberal and purposive approach is usually given to treaty interpretation than to domestic statutory interpretation, in light of the fact that treaties span countries with different legal systems and lexicons – although the text of the Treaty is always the starting point.[5]

It is fairly certain that the version of the OECD Model Convention and Commentaries that was in force at the time a given tax treaty, based on the OECD model, was agreed (the "original" Model Convention and Commentaries) may be taken into account in interpreting the treaty pursuant to Article 32 of the Vienna Convention as "supplementary means of interpretation".[6]

More uncertain are the questions of (1) whether the "original" Model Convention and Commentaries are also within Article 31; (2) whether later versions of the Model Convention and Commentary are within Article 31; and (3) whether OECD reports such as the Transfer Pricing Guidelines or the Partnership Report are within Articles 31 or 32.

Regarding question (1), those in favour of having recourse to the OECD material would prefer it to be within Article 31 and not just Article 32. This is because under Article 32, supplementary means of interpretation are only to be considered where there is ambiguity or absurdity, or to confirm the meaning arrived at under Article 31. Of course, parties to a treaty dispute will often believe that ambiguity is present – but that is no guarantee that the decision maker will agree.

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[5] *Morrison v Peacock* (2002) 210 CLR 274 at 279; *Applicant A v Minister for Immigration & Ethnic Affairs* (1997) 190 CLR 225 at 240 and cases cited therein.
[6] *Thiel v Commissioner of Taxation* (1990) 171 CLR 338 at 344, 357; *Commissioner of Taxation v Lamesa Holdings BV* (1997) 77 FCR 597 at 604.

The question of the interaction of Articles 31 and 32 may mirror that currently being tested out in relation to statutory interpretation in Australia: whether the modern approach insists that extrinsic materials going to statutory context be considered in the first instance regardless of ambiguity, or whether it is wrong to look at extrinsic materials without exhausting the "ordinary" rules of statutory construction.

In any event, there is a good argument that the "original" Model Convention and Commentaries do come within Article 31(1)(b), as "instrument[s] made by one or more parties in connection with the conclusion of the treaty and accepted by the other parties as an instrument related to the treaty."

It must be kept in mind that the Vienna Convention applies to all international treaties, not just tax treaties, and is intended to be adaptable to a wide variety of different treaty contexts. Given that the OECD Model and Commentaries form the backdrop to all treaty negotiations where the model is being followed, and given the formal reservation and observation process, if these documents are not Article 31(1)(b) instruments in the tax treaty context, it is hard to see what would be.

Regarding question (2), whether versions of the Model Convention and Commentary which post-date the relevant treaty are within Article 31, opinions are divided. There is, though, a respectable argument that these come within Article 31(3)(b) as "subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation", subject to two qualifications. First, the relevant change to the Model Convention or Commentary cannot be fundamentally at odds with the prior version on which the treaty was based; and secondly, a treaty partner cannot have disavowed the point by way of a relevant reservation or observation.

Regarding question (3), whether OECD reports can have the same Vienna Convention status as the Model Convention and Commentaries, it probably depends on whether the report is subject to a comparable level of member country input and consensus within the OECD. For example, the fact that the Transfer Pricing Guidelines are almost the "de facto" commentary on Article 9 supports an assimilation of them with the Commentary when it comes to a transfer pricing dispute. However, the fact that these reports do not have the same formal reservation and observation process (except to the extent that they give rise to new Commentary, eg the Partnership Report) may point against this conclusion.

Of course, if a taxpayer or the tax authority can show that there is a specific agreement or practice between the treaty partners to construe the relevant treaty article by using certain OECD material (ie, not just a practice implied from the country's OECD participation and the absence of a reservation or observation), then this is likely to fall within Article 31 regardless of the nature of the OECD material.

Because Australia's tax treaties are incorporated into domestic law, the OECD material is probably also a relevant aid under s 15AB of the Acts Interpretation Act 1901 and under the "modern approach" to statutory interpretation.[7] Further, it

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[7] *CIC Insurance Ltd v Bankstown Football Club Ltd* (1997) 187 CLR 384 at 408; cf *Saeed v Minister for Immigration and Citizenship* (2010) 241 CLR 252 at [33].

appears likely that the OECD material will be expressly reproduced or cross-referenced in the extrinsic material to the new domestic transfer pricing legislation, inviting it to be taken into account in construing those rules even absent a treaty. Some judges may even treat the OECD material like a textbook: not binding, but equally not requiring any Vienna Convention or other pretext before it can be considered.[8]

Thus, it is possible to justify having recourse to OECD material in interpreting tax treaties at present – and will likely also be so in interpreting the new domestic transfer pricing legislation – by reference to existing principles.

However, given that some of these justifications are open to debate (as the recent case law has shown), or even just to shortcut the labyrinthine Vienna Convention analysis, there may be merit in legislating a new interpretive rule.

5. New interpretive rule – what level of compulsion?

If there is to be a new interpretive rule, it is preferable, in my view, for the rule to be facilitative only. It would provide that in interpreting a treaty based on the OECD model (and Australia's transfer pricing legislation) regard *may* be had to the OECD Model Convention, Commentary, Transfer Pricing Guidelines (and possibly other OECD material).

If the word "must" (or "shall") is used instead of "may", it could open up endless challenges to decisions made under treaties or transfer pricing legislation on the basis that a sentence in a corner of the Commentaries, say, was erroneously not taken into account. More fundamentally, it is hard to see how a decision maker can compulsorily take into account material which is, in the main, not prescriptive in nature. For example, of the OECD Transfer Pricing Guidelines, the Full Court in *SNF* stated at [116]: "the guidelines are just that – guidelines".

One of the most important functions performed by the OECD material is sparing administrators and courts from having to reinvent the wheel. The collective experience and ideas, gathered over decades, of the large number of jurisdictions who participate in its drafting is invaluable. Decision-makers consulting the OECD material are conscious of this and are likely to take the material seriously even if they are not statutorily bound to apply it.

Another problem with a "must" rule is that it may go beyond what was actually agreed between Australia and the other country when the relevant tax treaty was concluded. At that time, the other country would reasonably have expected Australia to interpret the treaty in accordance with the Vienna Convention, but it is unlikely to have guessed that Australia would in future consider making the OECD material binding by way of a domestic interpretive rule which must, by reason of its very existence, go beyond Vienna Convention principles.

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[8] Justice Hill, 'The Interpretation of Double Taxation Agreements – The Australian Experience' *IBFD Bulletin* (August/September 2003) 320 at 325.

A "must" rule, could also have the result, contrary to its spirit, of causing Australia to register more observations to the OECD Commentaries. That is, the Australian officials participating in the drafting of the Commentaries, acutely aware that its every word could be fixed upon by taxpayer to support an argument under which their tax liability is reduced, may be unwilling to agree to the (compromise-wrought) wording of a particular part of the Commentaries. The Commentaries are often deliberately ambiguous, to accommodate different shades of opinion.

As for a rule that requires interpretation of the treaty and domestic transfer pricing law to be made "consistently" with the OECD material, this has similar difficulties. They may be largely latent: in most cases, decision-makers are likely to continue to treat the OECD material as just a guideline. For example, the facts in *DSG Retail Limited v HMRC* (2009) UKFTT 31 (TC) 1, the UK's first transfer pricing case, spanned the periods before and after the UK introduced a consistency interpretation rule but the status of the OECD Guidelines in the Special Commissioners' reasons is not relevantly different across the two periods.

The main problem with a mandatory consistency rule is that it would elevate material which is of a guidance nature to the level of legislation. And while each paragraph of the OECD material is generally the result of much consideration and deliberation, it is not drafted in a rules-based way. Disputes would inevitably arise as to what the OECD material means or implies, leading to spiralling enquiry into what materials can be used to help interpret the OECD material, and so on.

For example, consider the recent tax treaty case *IBM Corp v Commissioner of Taxation* (2011) 91 IPR 120 under a mandatory consistency or a "must" interpretive rule. In a nutshell, the dispute was whether payments made by IBM Australia to its US parent under a "software licence agreement" were royalties under the treaty in circumstances where the taxpayer was in essence just the Australian distributor (the Court held that they were royalties). First, under a mandatory interpretive rule the ATO may not have been able to impose the royalty withholding tax in the first place, at least not on the whole amount, in light of paragraphs 14 to 14.4 of the OECD Commentary on Article 12 (2010 version) which note that some payments which are technically partially in respect of software copyright should still not be regarded as royalties.

But the ATO may have persisted, arguing in Court that the contract in question was not what paragraphs 14-14.4 actually had in mind, with the taxpayer disputing this and saying that those paragraphs are binding. This does not seem to me to be a useful way to conduct a tax dispute, even before you get to the debate about whether the absence of some of these paragraphs at the time the treaty was negotiated means anything. Rather, a court should be free to consider the OECD material, either of its own initiative or because one of the parties has put it forward (as one or both parties usually will where there is a treaty dispute), as part of the suite of useful but not binding sources of interpretation.

The real difficulty is where a passage in the OECD material is hard to reconcile with the text of the treaty. Arguably, this is the case in *IBM*, where under the treaty a payment for the right to use copyright is a royalty, but the Commentary says some royalty amounts can be disregarded. It could be argued, from a practical perspective, that certain treaty wordings are now too intransigent to modify and that the OECD material is where the nuanced thinking takes place and therefore it should take precedence. But all the orthodoxy maintains that in a conflict between the words of the treaty (or legislation) and the words of any other material, the other material must yield.

There is another solution to these hard cases, though. It is using the conventional treaty interpretation devices of (1) recognising that treaty wording may be interpreted more liberally than if it were a domestic statute;[9] and (2) the "special meaning" provision in Article 31 (4) of the Vienna Convention. These devices can both be accessed under a facilitative ("may") interpretive rule.

True it is that a mandatory consistency rule would address the risk of a "rogue" or under-informed administrator or judge interpreting a treaty in a way that flies in the face of the OECD consensus. But in most instances the decision-maker will be aware of or directed to the OECD material, and it is reasonable to expect that it will only be in rare cases that they will choose not to follow it; furthermore, they will usually give reasons for this choice. Those few rogue decisions which slip through may serve a useful purpose, by informing subsequent OECD and treaty negotiations and perhaps prompting changes to the drafting of OECD material.

Ultimately, whether one prefers a "may" or a "must" rule is likely to depend one's position on whether the OECD material is within Article 31 of the Vienna Convention. Those who, unlike myself, dispute that it is and see it as relevant only in cases of ambiguity (Article 32) may be understandably keen to bolster its relevance by way of a mandatory interpretive rule. Whereas, if it is already within Article 31 as "context" then this provides a more appropriate avenue for having recourse to it (even where there is some ambiguity about whether there is ambiguity) than an unwieldy "must" rule.

A different model would be to simply legislate to say that the OECD material is to be treated by the ATO and the Australian courts as if it is within Article 31 of the Vienna Convention – or s 15AA of the *Acts Interpretation Act* for the transfer pricing legislation. This would be closer to a "may" rule than a "must" rule, but it may raise further issues.

The MRRT Bill 2011, currently before the Senate, contains within proposed s 205-15 a list of four matters to which regard is to be had in selecting the transfer pricing method to use in checking that the taxpayer is not using non arms-length dealings to shift profits out of the reach of the mining tax. The last of these listed is the OECD Transfer Pricing Guidelines.[10]

While the MRRT Bill does mandate that regard is had to the Guidelines, they are not elevated to the level of legislation, but instead used as an aid in the weighing-up of different transfer pricing methods, a task appropriate to their nature as guidelines. This model hints at what Treasury has in mind in the consultation paper, but it can't

[9] Note 5 above.
[10] The preceding three factors all feature predominantly in the Guidelines anyway – it is unclear why they need to be separately listed.

thoughtlessly be exported into the treaty context, as the MRRT is a domestic and highly specific tax, and the rule is used in the MRRT Bill in a narrow functional context.

As Treasury considers drafting options for this potential new rule, it should consider not only the experience of the jurisdictions identified in the consultation paper as having a mandatory consistency interpretive rule (the UK) or reproducing OECD material in their legislation (New Zealand, India), but also jurisdictions like the US which have to reconcile voluminous transfer pricing regulations with each other and with the treaty and legislative text.[11] These can be contrasted with, say, Canada, where all that is law is the arm's length principle, with the OECD material, tax rulings and other sources just non-binding guidance.[12]

Also relevant is the experience within other spheres of Australian law in which international conventions or model law are incorporated or referred to in domestic statutes. Examples are the Cross-Border Insolvency Act 2008 and the International Arbitration Act 1974. It may be that the reason these international regimes can be incorporated so extensively into Australian law is that they are procedural and prescriptive in nature, whereas the OECD material is largely substantive and written at a high level of generality, but these comparisons are still useful.

Other questions that arise in trying to formulate the rule are: which OECD material will be included, and will it be a static version of the OECD material or ambulatory? How is it determined whether the treaty or article in question is based on the OECD Model? What if one of the countries has a relevant reservation or observation? And should the rule be limited to transfer pricing, or extend to all tax treaty provisions? It is beyond the scope of this submission to explore all of these issues, but the last one is discussed further below.

6. New interpretive rule – all treaty provisions or just transfer pricing?

Like tax treaty arbitration, the legislating of treaty interpretation rules is a new initiative spurred primarily by transfer pricing disputes. Similarly too, although in theory it is extendable to all other treaty disputes, it is harder to see the practical out-workings beyond the transfer pricing context.

There are a couple of features of transfer pricing which mark it out from other areas of international tax disputation and make it potentially more suitable to arbitration, and to more flexible law-interpretation practices. First, a transfer pricing dispute can be resolved by splitting the difference between the parties and the "right answer" is usually a range of outcomes, whereas most other tax disputes are "all or nothing". Second, unlike most other international tax legislation, transfer pricing legislation (and the wording of Article 9) tends to be very brief, essentially legislating the "arm's length standard". Its brevity stands in contrast to the lengthy, practical OECD Guidelines and other material providing assistance on how one arrives at (or

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[11] Sometimes they cannot be reconciled, as in the *Xilinx* litigation in the US.

[12] See Nathan Boidman "The Implications in and for Canada of the IRS's Final Section 482 Services Regulations" (2009) 61(6) *The Tax Executive* 6, 445 at 446.

approximates) the arm's length price. The increasing practice of bilateral Advance Pricing Agreements shows that countries are regularly agreeing on arm's length prices.

These features of transfer pricing: brief, "principle-based" law plus detailed, practical (but generally not prescriptive) guidance, and amenability to a compromised, practical result, are not generally seen in other treaty dispute situations (such as whether a payment is a dividend or interest, or a taxpayer is a beneficial owner, or a permanent establishment exists). However, with the growing consensus that certain tax treaty terms have an "international fiscal meaning",[13] and the need to avoid double taxation ever rising along with globalisation and economic expansion, there is good reason to allow the other tax treaty articles to benefit from the work proposed to be done to entrench the OECD material in the transfer pricing context.

If the interpretive rule is to be facilitative only, then in my view it is quite appropriate to extend it beyond Article 9 to all tax treaty articles. This would not alter the position for those decision-makers who are currently disposed to consider the OECD material. Those decision-makers who may be skeptical about the relevance of the OECD material, for example a judge unaccustomed to international tax disputes, would be made more likely to consider it by reason of the express reference to it in the legislation.

7. Conclusion

Treasury's proposal to include a tax treaty interpretive rule alongside the revised transfer pricing legislation is a positive development. It should result in Australian transfer pricing (and, if the rule is extended beyond Article 9) other tax treaty decisions being made in a way that conforms more closely to the international tax norms developed by the OECD with the aim of preventing double taxation and double non-taxation.

There is a legal question as to whether this rule is necessary given the Vienna Convention, but because of the capacity to debate this issue, at a practical level it can be accepted that an explicit interpretive rule would be useful.

In my view, the rule should expressly facilitate the taking into account of the OECD material in interpreting tax treaties (and the transfer pricing legislation), but it should not give that material a binding status, for the reasons discussed above.

[13] *Indofood International Finance Limited v JP Morgan Chase Bank NA* (2006) 8 ITLR 653; [2006] STC 1195 (UK Court of Appeal), in reference to the "beneficial owner" qualification in the interest article of the relevant treaty.