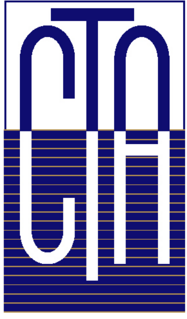


# Income tax: cross border profit allocation

# Review of transfer pricing rules

## Submission by

## Corporate Tax Association of Australia

## 30 November 2011

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**Review of Transfer Pricing Rules**

Thank you for the opportunity to comment on the 1 November Consultation Paper "Income tax: cross border profit allocation – Review of the transfer pricing rules" (the CP). We have taken the liberty of also addressing the Assistant Treasurer's Media Release No. 145 of the same date, and the announcement therein of the government's intention to 'clarify' that the treaty rules operate independently of Australia's domestic transfer pricing rules.

*The Consultation Paper*

Turning first to the CP, the CTA agrees there may be merit in considering making prospective changes to our domestic transfer pricing rules to align them more closely to international norms – in particular the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations as revised in July 2010 (the OECD Guidelines).

In doing so, however, care should be taken to avoid relying on interpretations about the OECD Guidelines which are not warranted by their actual wording and reflecting a distorted view about them in our domestic law. In particular, we are concerned that the ATO (and perhaps Treasury) may believe that the OECD Guidelines provide authority for tax administrations to apply profit allocation methods in almost all circumstances – even where reliable comparable transactions are available.

In reaffirming the arm's length principle as the international norm, the OECD Guidelines make it clear that the "selection of a transfer pricing method always aims at finding the most appropriate method for a particular case" (at para 2.2). Depending on the nature of a particular intra-group transaction, that is likely to be "generally based on a comparison of the conditions in a controlled transaction with the conditions in transactions between independent enterprises" (at para 1.33).

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While profit allocation methods do focus on the respective profits of the related suppliers and recipients of goods or services, they do not give tax administrations unfettered power to substitute a higher net profit figure than that actually achieved by the taxpayer, nor the power to convert losses into profits. We think that para 23 of the CP places undue emphasis on the overall profits of the parties. The various profit allocation methods should be seen as a means to an end, which is to price transactions in a way that produces a profit outcome that more closely reflects the respective functions, assets and risks of the parties.

Specifically, the CP references the Canadian transfer pricing legislation's unique commentary in considering to what extent a taxpayer's specific circumstances are relevant when undertaking a comparability analysis, including the selection of appropriate methods. In this regard the CP considers the merits of including specific guidance to ensure a strict 'market valuation approach' is not adopted where it could prejudice an 'arm's length outcome'.

The concerning conjecture in the CP on this point is that the findings in the Full Federal Court decision in *FC of T v SNF (Australia) Pty Ltd* [2011] FCAFC 74 somehow achieved a 'non arm's length outcome' despite the Court concluding that the losses of the taxpayer arose not from transfer pricing but from general commercial factors and conditions. [1] If we are reading the CP correctly, Treasury is proposing to apply the arm's length standard in relation to profit allocation, which is not in accordance with the framework set out in the OECD Guidelines.

Indeed, the OECD Guidelines recognise that low profits (as well as high profits) can occur for a range of reasons that are unrelated to transfer pricing:

> "There is no justification under the arm's length principle for imposing additional tax on enterprises that are less successful than average or, conversely, for under-taxing enterprises that are more successful than average, when the reason for their success or lack thereof is attributable to commercial factors." (at para 2.7)

The CTA contends that traditional comparable price or transaction methods should not be rejected if the circumstances of the parties are not identical. The CTA contends that any evaluation as to the specific circumstances of the taxpayer should be aligned with the five comparability factors outlined in the OECD Guidelines and not customised to preference or prioritise a profit allocation method.

To sum up, the CTA would not see anything objectionable in principle about giving consideration to importing the OECD Guidelines into the Australian domestic law, provided what is reflected in our laws are the OECD Guidelines and not some modified version that reflects the ATO's (or Treasury's) views about what they should say.

[1] At para 56

Although there may be merit in importing the OECD Guidelines into Australian domestic law (as the inclusion of OECD Guidelines should go some way to ensuring consistency), we still need to be mindful of dealings with non-OECD countries with which Australia has entered into a Double Tax agreement (e.g. China and India). In such cases, the CTA supports the use of the arm's length principle as the appropriate method for establishing prices for international related party transactions (which is the OECD position) and not allocating group profits between parties, as the avoidance of double taxation in these cases is critical.

There are a number of technical issues that will arise under a major revision of the domestic transfer pricing laws. One issue is the one-way operation of Division 13, which can only operate to increase taxable income. Under a full self-executing system there would be no reason for the domestic transfer pricing rules not to also permit a reduction in taxable income, given that it is possible an Australian entity will have overcharged or underpaid a related entity when compared to an arm's length outcome.

If the OECD Guidelines are to be incorporated into the domestic law, we see no good reasons for the Commissioner to have any residual discretion as in sec 136AD(4) of the 1936 Act. The Guidelines provide that the most appropriate arm's length method should be employed to price the relevant transaction, and it gives tax administrations the power (albeit in limited circumstances) to recharacterise the transaction actually entered into. No additional discretion should be required to make any necessary transfer pricing adjustments and the Commissioner having such discretion would be inconsistent with a full self-assessment system.

In relation to time limits on amendments, we think the current open-ended system is conducive to poor administration. Because the law gives the ATO unlimited time in which to conduct a review and make a transfer pricing adjustment, our members' experience is that is how long it will usually take. Transfer pricing reviews can be complex and time consuming, but the same could be said about many other areas of the tax law. There are a number of factors that suggest the time limit for making transfer pricing adjustments should be aligned with the general law (i.e. four years), including:

- the current trend for the ATO to carry out its risk review process in "real time";
- the introduction of the International Dealings Schedule from 2011-12;
- the introduction of the Reportable Tax Positions Schedule from 2011-12;
- the proposed mandatory record keeping requirements will create an increased focus on achieving outcomes that are consistent with the OECD Guidelines; and
- systems drive behaviour - the ATO will get the major cases done in four years if it only has four years in which to make any adjustments.

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As a compliance saving, there should be an annual statutory threshold of at least $10 million in related party cross-border dealings before taxpayers become liable to transfer pricing adjustments (or examinations). There is unlikely to be a material threat to the revenue when the level of transactions potentially subject to review is below this level. The compliance costs associated with mandatory record keeping are likely to be significant and transfer pricing reviews are usually a very costly and time consuming exercise. ATO and business resources should not applied to chasing down non-material amounts of potential revenue.

In addition, there should be another layer of materiality according to the type of transactions engaged in by the taxpayer. For example, a taxpayer which has a material claim for debt deductions in respect of related party loans may also have management fees and/or royalty payments for amounts that are each less than $5 million. In such a case only the debt deduction should be open for review or adjustment (or be subject to mandatory record keeping requirements), the other cross-border transactions being immaterial.

*Customs Issues*

We would have concerns about the interaction between valuations for tax and Customs if the incorporation of the OECD Guidelines into Australia's domestic transfer pricing rules resulted in a shift away from a transactions based approach to one that focuses more on profits allocation. We note again that the OECD Guidelines give both equal weight – they do not favour profit allocation over comparable transactions.

Our Customs valuation arrangements are driven by the WTO rules, which are very much transactions based and are unlikely to change. The OECD Guidelines make a rather brief reference to Customs issues in paras 1.78 and 1.79. After noting that an importer would generally want import prices to be low for duty purposes but high for tax purposes, the Guidelines engage in what amounts to no more than wishful thinking by observing:

> "Cooperation between income tax and customs administrations within a country in evaluating transfer prices is becoming more common and this should help to reduce the number of cases where customs valuations are found unacceptable for tax purposes or vice versa. Greater cooperation in the area of exchange of information would be particularly useful, and should not be difficult to achieve in countries that already have integrated administrations for income taxes and customs duties." (at para 1.79)

That is not particularly helpful if the reality is a tax administration that is increasingly looking to employ profit allocation methods. It is unacceptable for a business to be required to satisfy two arms of the same government, one demanding a higher price and the other a lower price in respect of the same transaction.

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In addition, the OECD guidelines express a higher level of preference for the use of traditional transaction methods for testing the arm's length character of transfer prices for transfers of tangible property. Where the importation of tangible property is involved the ATO and Customs should be compelled to reach agreement of what the arm's length price is, with appropriate input from the taxpayer.

*'Clarification' of the operation of tax treaties*

As a preliminary point, we note that both the minister's media release[2] and the CP[3] appear to regard *SNF* as having created some major difficulties for the effective enforcement of Australia's transfer pricing rules. We do not share that view about the decision. While it is true that the Full Court in *SNF* explicitly rejected the application of the OECD Guidelines (and may have been rather more emphatic about that than was necessary), what it said has to be seen in the context of the case and the evidence that was adduced.

There was evidence of SNF (Australia)'s foreign associate charging *higher* prices for the same products to third party customers, suggesting that it was the foreign associate supporting SNF (Australia) rather than the other way around. What also emerged in the case was that the losses were due more to poor business practices than to price support from the foreign associate. The court did not rule out profit allocation methods *per se* – it merely held that an adjusted comparable uncontrolled price (CUP) was the most appropriate method of determining the arm's length price, and that the Commissioner's insistence that the comparator counterparties be identical to SNF (Australia) in every respect set the bar far too high.

Given the facts considered in SNF, in our view it is highly likely the decision would have turned out exactly the same had the OECD Guidelines been embodied in our legislation at that time or alternatively had the case been decided only under the business profits article of the treaty. Accordingly, the premise on which the retrospective 'clarification' is considered necessary is seriously flawed and the decision should be reconsidered.

Importantly, while the outcome of the SNF case may not have changed due to its specific facts, the CTA does consider significant business uncertainty will be created if the proposed treaty legislative changes were to go ahead. Specifically, it is evident that the proposed changes would act to significantly widen the Commissioner's existing taxing powers retrospectively. Paradoxically, this is likely to lead to a greater number of disputes that cannot be resolved between the Commissioner and taxpayers on retrospective matters. Further, the impact and associated uncertainty businesses will face as a result of this proposed retrospective change will not be known until the proposed taxing powers are comprehensively tested in the courts.

[2] At para 9
[3] At p iv, and at paras 22, 53, 54, 55

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We would also observe that the retrospective 'clarification' of the treaty powers would discriminate against treaty countries, since related party dealings would clearly be less vulnerable to a transfer pricing adjustment if they were routed through a non-treaty country. Treaties may confer benefits in some instances, for example through reduced withholding taxes, but this is not so in the more difficult and complex transfer pricing cases involving related party loans. The domestic interest withholding tax rate of 10 per cent is not improved upon in any of Australia's treaties.

A further observation is that none of our major trading partners rely on Article 9 of the treaty to make transfer pricing adjustments. This may not be an area where Australia wants to be breaking new ground.

The CTA participated in the Treasury consultation meeting held in Canberra on 18th November 2011. This was a useful opportunity to better understand some of the reasoning behind the government's decision and to put the views of business and tax advisers. In view of these discussions we provide our response to the 'clarification' of the operation of tax treaties concept in detail below.

As we understand it, the reference in the minister's media release to Parliament having indicated as recently as 2003 that the treaties confer a separate taxing power relies on sec 170(9B) and 170(14) which, in combination, purport to give the Commissioner unlimited time in which to make an adjustment under either the domestic law or the relevant article of the treaty. Sec 170(14) was last amended in 2003 to reflect the renegotiation of the UK treaty, at which time Parliament's intention regarding the power of treaties was said to be confirmed. Hence the 2004 start date.

Since Parliament arguably had the intention asserted by Treasury (the argument goes on), legal disputes about how effective the legislative provisions may have been are just that – they should not foreclose on the government now reinforcing or clarifying its earlier intention.

The difficulty with that tenuous argument is that the courts have consistently held that tax treaties allocate taxing powers between States – they are not of themselves a separate head of power. There is a consistent line of cases going back at least as far as *Lamesa* (1997), *Chong* (2000), *McDermott Industries* (2005), *GE Capital Finance* (2007), *Virgin Holdings* (2008), *Roche* (2008), *Undershaft* (2009) and now *SNF (Australia)* (2011) which reinforce this view. It is true that with the exception of *SNF,* those cases involved withholding tax or capital gains tax rather than transfer pricing. However, some of the comments are quite unequivocal and invite a broader interpretation:

> "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." (Lingren J at para 46 in *Undershaft*)

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The Commissioner of Taxation has indicated[4] that he nevertheless holds a contrary view – namely that the treaties do confer a separate power to tax. In 2009 he foreshadowed that if necessary he would raise this issue with Treasury to determine whether a law change is required to put the matter beyond doubt (although he refrained from venturing that any such law change should be retrospective).

The Commissioner's opinion about how the law operates is always a matter of interest to the business community, particularly in the context of avoiding unnecessary risk. However, it carries no greater weight than many other opinions, and in recent times in particular, the ATO can hardly claim to have been on the right end of many court decisions. Absent a timely response to whatever representations the ATO may have been making to the government, taxpayers have been entitled to rely on what the courts have consistently said about the operation of our tax treaties.

*Is this really a retrospective new tax?*

One of the arguments that was put to participants at the 18th November meeting was that the proposed clarification is not really a retrospective new tax because it is doing no more than putting beyond doubt that treaties can have the power to impose a tax, which was always the government's view.

We consider that is the wrong way of looking at things. Retrospectively 'clarifying' the role and power of treaties in the manner proposed would put significant additional powers in the Commissioner's hands as it will give him greater latitude to apply profit allocation methodologies than he would enjoy under the domestic laws. Incidentally, we are far from confident that the ATO would exercise much restraint in exercising such newfound powers. These new powers would create the potential to change tax outcomes for affected businesses that have arrived at their transfer pricing position on the basis of the law as it has been interpreted by the courts. In practical terms, that makes it no less a retrospective new tax than, say, a rent tax on existing mining projects.

*Revenue considerations*

We are concerned that, based on advice received from the ATO, the government may have made the retrospective 'clarification' decision for all the wrong reasons. We can only surmise what that advice may have been, but it would be an enormous exaggeration to say that the *SNF* decision forecloses on the possibility of using one or other of the recognised profit allocation methods. Far from emasculating our domestic transfer pricing rules, the decision rests entirely on its own facts. There were comparable uncontrolled prices the ATO should have respected and the prolonged losses were found to be attributable to commercial factors.

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[4] Address to CTA Convention 15 June 2009, *In the best interests of Australia*

The Decision Impact Statement (DIS) recently published by the ATO refers to an alternative argument about SNF (Australia) perhaps being entitled to compensation for the costs involved in prosecuting its strategy of building market share for the group in Australia. The DIS does not explain why the ATO failed to put that argument in the course of the litigation. Accordingly, we are left to speculate how such an argument might have been received by the court.

It was also suggested that the *SNF* decision could somehow trigger off a flood of claims from taxpayers seeking to adjust their prior year transfer pricing outcomes in a more favourable way. It is difficult to understand how this could come about since Div 13 only operates in one direction – to increase taxable income. Moreover, taxpayers will have closed their accounts for earlier years; they will have had their transfer pricing negotiations with related parties and documented the outcomes. We can see no valid reasons for these concerns.

We understand also that the ATO has for some time been examining a small number of related party debt cases involving significant amounts. Some of these cases, incidentally, have been undergoing transfer pricing reviews for eight years or longer – a good reason for imposing time limits. It may well be that the ATO rates its prospects of success on those cases more highly if it had greater powers to recharacterise the transactions actually entered into. In fact, the ATO considers it already has the power to recharacterise transactions under sec 136AD(4)[5], and in any event the OECD Guidelines stress the need for tax administrations to respect transactions actually entered into and to limit recharacterisation to exceptional cases only[6].

The exception to recharacterisation in para 1.65 of the OECD Guidelines for interest bearing loans carries less weight in Australia, given our specific provisions dealing with the debt/equity distinction and our thin capitalisation rules.

Without purporting to speak for any of the taxpayers involved, it seems likely that a significant amount of additional revenue could be raised from these cases under the existing domestic transfer pricing rules – provided the ATO stops being dogmatic and doesn't overreach. For those audit case that are in progress, it would not be accurate to say that there are no prospects of collecting any significant additional revenue under the existing law nor, for that matter, that the collection of a very large amount of additional revenue is virtually assured by 'clarifying' the power of the treaties retrospectively.

Because the ATO has what we regard as an exaggerated view about what it might be able to achieve under the treaties, it must be highly likely that the relevant audit cases will end up being litigated, with the outcomes highly uncertain and many years distant.

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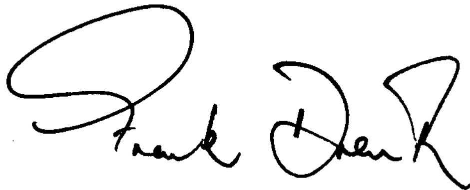
[5] TR 2010/7 on transfer pricing and thin capitalisation
[6] OECD Guidelines, para 1.64

The interaction of the Australia's transfer pricing rules with the thin capitalisation debt-equity safe harbor rules has long been a contentious area for business. With cross-border funding being a cornerstone of foreign direct investment, it is important that the new law explicitly confirms that the transfer pricing rules may not be used as an avenue to override the thin capitalisation safe harbour or Div 974 debt equity rules. Clarification of this issue is urgently required to create certainty for MNCs investing in Australia and to avoid the incidence of audits on significant related party funding transactions involving Div 13.

As a final point, we would submit that it is bad practice to tailor the tax laws to assist the tax administration in relation to a small number of significant audit cases. The courts are the most appropriate place to settle these matters. If the government is unhappy with the outcome, it is free to change the law on a go forward basis. Retrospective law changes that adversely impact on taxpayers after investment decisions have been made should be avoided except to counter cases of egregious tax evasion or avoidance. That is clearly not an issue here.

Yours sincerely,



(Frank Drenth)

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