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A WHK Group Firm

6 December 2011
The Principal Adviser
International Tax and Treaties Division
The Treasury
Langton Crescent
PARKES ACT 2600

Sent via email: transferpricing@treasury.gov.au

Dear Sir/Madam

RE: CONSULTATION PAPER – INCOME TAX: CROSS BORDER PROFIT ALLOCATION – REVIEW OF THE TRANSFER PRICING RULES

We welcome the opportunity to comment on the Consultation Paper – Income Tax: Cross Border Profit Allocation – Review of the Transfer Pricing Rules which outlines the proposed

We work with Small and Medium Enterprises (SME) and are concerned about the potential 'compliance' burden imposed on SME in applying the current transfer pricing rules. Our attached comments (Appendix A) highlight a number of commercial and practical issues that we have identified with the Consultation Paper and believe may adversely affect SMEs.

The comments below are the opinions of the writers only.

If you have any queries or require any further information please contact Tristan Webb on (02) 9367 3035

Yours sincerely
WHK GROUP PTY LTD

TRISTAN WEBB
WHK/Crowe Horwath National Tax Director

APPENDIX A: COMMENTS ON THE REVIEW OF THE TRANSFER PRICING RULES

As mentioned above our firm acts on behalf of taxpayers which would be classified as SMEs. The majority of our firm's SME clients which have transfer pricing issues are overseas subsidiaries of multinational enterprises (MNEs). Whilst these clients are MNEs, they are generally not significantly large or well known MNEs (such as those which may be listed on international stock exchanges) that have internal resources to deal with the tax implications of their cross border transactions. We also act for various Australian-based entities with foreign operations.

In particular our comments will focus on the following practical issues:

- Relative lack of In-house technical knowledge of the Transfer Pricing regime;
- Uncertainty in relation to selecting and applying the most appropriate transfer pricing methodology in establishing arms' length prices which would be acceptable to the ATO;
- Difficulty in obtaining relevant comparable benchmarking data for the SME market, particularly those which available within Australia; and
- Uncertainty over documentation requirements to support the selection and application of the transfer pricing methodology

Whilst we welcome the current review of Australia's transfer pricing rules, particularly in light of updates which have been made to the OECD guidelines in 1995 and 2010 we also wish to highlight the practical implications of applying Australia's transfer pricing rules that are experienced by our clients. We would expect that the International Tax and Treaties Division of Treasury take these into consideration as part of its review and recommendations.

We therefore support all measures that can assist in alleviating the practical issues highlighted above which may lead to higher costs of compliance incurred by SMEs for international related party dealings, while still providing a robust regulatory environment having regard to the practical and commercial reality of these operators. Overall we agree with Treasury in that a balance must be achieved between the cost of compliance and potential revenue leakage from this type of taxpayer such that it does not unreasonably inhibit Australia's attractiveness as a destination for new investment and business activity for which clients in our segment contribute greatly to.

Policy objectives

We agree with the comment that the objects clause of the redesigned legislation could reflect the objective in paragraph 26 (i.e. interpreted consistently with international transfer pricing standards).

Design of the rules

We agree with comment that the new legislation should reflect high-level principles rather than being overly prescriptive, in particular supported by reference to the OECD Guidelines.

However, the rules should only be supplemented by rulings where necessary and after consultation with taxpayers, the professional bodies, Treasury and again, with reference to the OECD Guidelines. We would also expect that the Explanatory Memorandum to the new rules would contain sufficient guidance to direct taxpayers and the ATO to an acceptable

outcome. This concern is driven by the current rules which require taxpayers to rely on ATO rulings, which are generally over 100 pages long and may not provide any additional certainty to an outcome acceptable to the ATO.

Overview

We specifically agree with the following comments, which we believe would benefit SMEs:

SMEs would support the proposed removal of the wide discretionary powers provided to the ATO to determine an arm's length consideration. We also agree that such a proposal should be consistent with taxpayers complying with Australian transfer pricing rules on a self assessment basis. SMEs should be given every opportunity to demonstrate the arms' length nature of their international related party dealings that is also acceptable to the ATO in administering Australia's transfer pricing rules. We believe this would also reduce the inefficiencies caused to both the ATO and SMEs, particularly where disputes in respect of arm's length consideration arise during ATO audit activity.

Removing an unlimited time period for transfer pricing amendments provides greater assurance to SMEs. In respect of this we emphasise the unwarranted risk and uncertainty raised at paragraph 101 which is of most concern to SMEs. Furthermore, we also highlight the administrative inconsistencies between the time period under the transfer pricing rules with other Australian taxation matters particularly with respect to the problems associated with record keeping and substantiation requirements over an unlimited period.

In general, SMEs would like a level of certainty that a chosen transfer pricing method is appropriate and will not be unduly scrutinised by the ATO. The proposal to include certain approved transfer pricing methods and provide guidelines for the selection criteria is a step in the right direction. As stated above, SMEs face problems in selecting and applying a methodology which would be acceptable to the ATO under the current rules where taxpayers and tax professionals are guided by lengthy and extremely technical rulings. This is further compounded by the difficult experienced with obtaining reliable comparables which are specific to the SMEs circumstances and industry.

ARM'S LENGTH PRICIPLE

We support any measures which clarify the application of the arm's length rule and ensure consistency with the OECD's Model Tax Convention (MTC). Where inconsistencies exist, any overriding principles which direct taxpayers to a preferred interpretation should be included in the explanatory material relating to the new rules, or the specific double tax treaty.

OECD guidelines

The new rules should be as consistent as possible with the OECD guidelines and contain the same wording and interpretations, as far as reasonably possible.

For flexibility purposes, we would expect that the new legislation would specifically make reference to the OECD's guidelines, where the legislature intended that due regard should be given to that commentary in applying the rules.

OECD MTC Commentary

Again, we emphasise that where inconsistencies exist, any overriding principles which direct taxpayers to a preferred interpretation should be included in the explanatory material relating to the new rules, or the specific double tax treaty.

Comparability

We generally agree with the comments in paragraphs 50 to 52. The new rules should specifically require due regard to the taxpayers specific circumstances and allow adjustments (i.e. be flexible).

Given the issues raised on comparability at paragraphs 53 to 55 we would recommend that the new rules allow comparability to be determined by taxpayers on a 'reasonable' or 'material' basis. One of the main issues highlighted by SMEs is the uncertainty related to determining the level of similarity or comparability with independent dealings, particularly in light of the availability of comparable information in this segment (many selected comparable SMEs in a particular industry do not publicly release information on pricing, margins or earnings). Increasing rigidity in the determination of comparables could potentially make applying approved transfer pricing methodologies extremely difficult, if not, impossible.
In respect of market valuation approaches to pricing we believe that it is not a preferred approach as it ignores the special factors relating to the parties to the transactions. However, we believe that it can be incorporated in evaluating the arms length nature of a taxpayer's transfer price to the extent that the taxpayer's specific circumstances do not materially affect the price or if it does it can be quantified to the extent that it allows a reasonable adjustment that can be demonstrated by the taxpayer.

METHODOLOGIES

We agree with the proposal to implement recommended methodologies and guidance on the appropriate methodology into the new rules. Where relevant, guidance can be provided on the appropriate methodology for various transaction 'classes' (e.g. sale of goods, intangibles).

We acknowledge that the new rules are shifting towards preference towards profit based methods over traditional transactional transfer pricing methods in line with practice among taxpayers and tax administrators as well as the updates made to the OECD guidelines in 2010. However, we would advise caution in overly relying on profit based methods in assessing whether an arm's length outcome is achieved.

There are numerable internal factors which could influence the net results that are achieved by SMEs other than the pricing of its products or services sourced or provided between international related parties. These can include amongst other things:

- Organisation structure and internal processes
- Whether it possesses any market differentiating intangibles
- The experience and capabilities of its human and other resources
- Its business life cycle stage in Australia or its other geographical segments
- Its corporate objectives and culture

In respect of the overseas subsidiary SMEs that we deal with, management of these Australian subsidiaries is often independent to the management of the parent. In most circumstances they are accountable to the parent in respect of the performance of the

subsidiary on the Australian market who often make decisions regarding the viability of their Australian operations. As such related party prices are often set which enable both parties to reliably assess the performance of the business on the Australian market.

Purely relying on say a transactional net margin method to evaluate the net results achieved by an SME against its industry segment may ignore a lot of the above factors. Furthermore, these factors are naturally not identifiable or quantifiable as part of selecting appropriate comparables. These circumstances were highlighted in the recent SNF case where the circumstances internal to the taxpayer were significantly attributable to the results achieved despite that taxpayer's ability to show that its transfer prices were on an arms' length footing.

As such we would be advocating that any 'approved' or 'recommended' transfer pricing approach allows a taxpayer:

- To reasonably demonstrate the factors contributing to its net result where its results are materially disparate with its selected comparables where a profit based approach is adopted; or
- Where a taxpayer is able to show the arms' length nature of its international related party dealings using a traditional method, it is also able to demonstrate the factors contributing to its net result where a profit based methodology shows an inconsistency with a traditional method.

In relation to the attribution of profits to permanent establishments (PE), it is our experience that SMEs do not generally maintain a PE unless the activities are preparatory or purely administrative (i.e. they generally incorporate a new entity to undertake the activities). As such, assuming the activities do not fall within the exclusions to the PE definition, a deminimus limit could be introduced for the documentation requires for PEs, on the basis that only a small amount of profit may be attributable to the activities of the PE. In that respect, we would also recommend a simplified approach to compliance be adopted where purely administrative services are provide similar to the Commissioners' ruling Tax Ruling 1999/1 – international transfer pricing for intra-group services.

SELF EXECUTING RULES

We support a self assessment regime for the new rules. We would not recommend a Commissioner's discretion where insufficient information difficulties arise. Instead, the taxpayer could obtain an expert opinion to support an arm's length outcome. The Commissioner would then only need to consider the reasonableness of the outcome, rather than have the power to 'pluck a figure out of the air'.

Specific rules to deal with reconstruction difficulties would be preferred to a Commissioner's discretion.

We noted obtaining sufficient comparable information is a key issue for SMEs. The ability to source comparable information which meets the requirements of determining an arm's length allocation of profits in this space can be extremely onerous for SMEs and can lead to drawn out disputes with the Commissioner over the level of comparability. In line with paragraph 32.4, a mechanism or approved transfer pricing method would be required to mitigate some of the uncertainty faced by SMEs where insufficient information exists.

RECORD KEEPING

The proposal to require taxpayers to maintain contemporaneous records which fully explain the basis on which prices have been charged for all goods and services have been established to be on arm's length terms needs to be further clarified in terms of what would be accepted as contemporaneous. Again we emphasize the need for certainty amongst SMEs to ensure that they comply with Australia's transfer pricing rules. This should be considered in light of the relative quantum of revenue leakage from this segment as well as the need to prevent unreasonable inhibitions to Australia's attractiveness to new investment and business activity.

SMEs would require certainty on the basis of the following:

- The type and level of records that would be required to be kept in order to ensure compliance with Australia's transfer pricing rules. There currently exists uncertainty in this area with the percentage of documentation requirement to be disclosed on Schedule 25A which causes taxpayer's to estimate whether they have sufficient documentation to prove the arms' length nature of their dealings. It would be recommended that the ATO clearly and concisely outline what they would consider as acceptable which would be tailored to each specific segment of taxpayers. Because of its relatively lower scale of operation and dollar value of related party transaction it would be expected that SMEs it would be required to prepare a lower and more simplified level of documentation to meet the requirements under the proposed changes.
- Further guidance on contemporaneity of documentation in terms of how often it needs to be prepared or updated. It would be unreasonable for SMEs to be required to prepare or update documentation each fiscal year unless there are substantial changes in the business or the nature of transactions. Perhaps there may be a requirement to have documentation prepared on a basis consistent with the proposed time limits for transfer pricing amendments.

In addition the proposed measure to include a de-minimus rule for documentation where certain thresholds are met would greatly assist SMEs who lack the internal resources available to prepare appropriate documentation in line with guidelines.

We acknowledge that a deminimus rule may be based on a specific dollar value (e.g. $10 million) or as a percentage of related party dealings. There should not be a distinction as to whether the Australian entity is part of a larger multinational group. In line with an arm's length approach, many such subsidiaries are required to be independent ad self sustained from the parent entity and may not have the capacity to fully apply onerous documentation requirements. Parent company documentation may not be appropriate in the Australian context.

DOCUMENTATION PENALTIES

The proposal to apply specific penalties where taxpayers fail to keep contemporaneous record for the basis of the profit allocation positions adopted is broadened and appears to be inconsistent with the overall intention to reduce the compliance burden on taxpayers. The imposition of documentation penalties should be commensurate with what the contemporaneous record keeping requirements entail. On this we emphasize the certainty and simplification of the contemporaneous record keeping requirements for SMEs which may

lack the resources to ensure compliance with an exhaustive record keeping requirement and thus face an unnecessary high risk of penalties.

In addition to the above we highlight that in addition to the compliance burden of some of the proposed new measures the Commissioner has proposed to replace the current Schedule 25A and Thin Capitalisation Schedules with a new International Dealings Schedule. This schedule further adds to the compliance burden for SMEs and negates any of the proposed amendments that would provide benefit to SME taxpayers.

We recommend that where taxpayers have kept documentation in line with the new legislation, the taxpayer has acted in good faith, the taxpayer has cooperated with the ATO and there is no tax avoidance purpose, then there should be no penalties imposed. This recommendation appears consistent with paragraph 97 of the consultation paper.

TIME LIMITS FOR AMENDMENT

We recommend a four year time limit for the Commissioner to make an amendment and a requirement for the taxpayer's permission for an audit to continue beyond this time limit.

TREATY ISSUES

Inline with classic treaty interpretation, the DTA should not form a separate taxing head to the domestic rules ('sword' approach), instead it should 'shield'/limit taxing rights.

Again, we emphasise that where inconsistencies exist, any overriding principles which direct taxpayers to a preferred interpretation should be included in the explanatory material relating to the new rules, or the specific double tax treaty.

OTHER SUGGESTIONS

The review of the transfer pricing regime should result in rules that assist SMEs in complying with Australia's transfer pricing rules. Fundamental to this, the proposed rule changes should:

- Be simplified so as to reduce the compliance burden on SMEs
- Provide greater certainty for both the taxpayer and ATO.

Based on our experiences, SMEs would like to see the revised regime result in the following outcomes:

- Reduce uncertainty with the selection of 'approved' transfer pricing methods;
- Greater certainty that legislated transfer pricing methods will be accepted by the ATO;
- Reduced ATO audit activity where approved methods are utilised (to reduce the onerous costs associated with extensive ATO audits that are disproportionate to revenue risk); and
- Simplified documentary requirements and compliance burden (eg. income tax return schedules) where international related party dealings are below certain thresholds.

In order to transform the revised transfer pricing regime to assist rather than hinder SMEs, we provide some addition suggestions as follows:

- Legislate approved transfer pricing methods that when utilised provides the taxpayer with certainty that the position will not be challenged (ie. standard methods);
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- Allow profit based methods consistent with the OECD guidelines but enable the taxpayer to be able to explain results achieved for a particular year which are not consistent with selected comparables; and
- Remove uncertainty for SMEs where there is insufficient information on comparable information. The Commissioner's scope is too far reaching and can result in assessments being issued that do not reflect the practical and commercial realities of SME business. This is particularly relevant in the SME space where comparable information is generally difficult to obtain.