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The Manager
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20 December 2012

Dear Sir

Re: Comments on Exposure Draft legislation on cross-border transfer pricing

Deloitte welcomes the opportunity to comment on the Exposure Draft of *Tax Laws Amendment (Cross-Border Transfer Pricing) Bill 2013: Modernisation of transfer pricing rules*.

Executive summary

The key points arising from our comments are:

- As self-assessment provisions, Subdivisions 815-B and 815-C should authorise both increases and decreases in tax outcomes in compliance with the arm's length principle;
- Where the Commissioner applies Subdivision 815-B to negate a transfer pricing benefit, there should be a requirement to attribute that adjustment to a particular amount of income or expense;
- Subdivision 815-B should not be drafted so that profit is of itself an arm's length condition;
- Attempting to unpack elements of the OECD Transfer Pricing Guidelines into Subdivision 815-B creates an unnecessary risk of inconsistency with the Guidelines and should be avoided. In particular, economic substance and reconstruction are matters that should be addressed solely through reference to the OECD Guidelines and not in Subdivision 815-B itself;
- Any reconstruction rule in the legislation should be explicitly limited to the exceptional circumstances prescribed in the OECD Guidelines;
- The operation of Subdivision 815-B to adjust debt deductions should be clarified to ensure the intention that section 815-115 has no application to such amounts independent of section 815-135;
- A taxpayer who has documented in accordance with Subdivision 815-D should qualify for no penalty, consistent with the effect of current transfer pricing laws and ATO rulings;
- Subdivision 815-C should be redrafted so that, as intended, it legislates an approach to permanent establishment profit attribution that accords with the approach that is currently incorporated into Australia's tax treaties; and
- The time limit for amending assessments to give effect to Subdivisions 815-B and 815-C should be 4 years, not 8 years.

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1. Introduction

The Explanatory Memorandum (EM) to the Bill indicates that Subdivisions 815-B and 815-C have a fairly clear and simple key objective. In a nutshell, that is to ensure that the Australian tax outcomes for an entity accord with the application of the arm's length principle consistent with the transfer pricing articles in Australia's tax treaties and internationally accepted guidance on their interpretation. This objective should be relatively easy to achieve. Unfortunately, the current drafting of the provisions is anything but clear and simple. It is substantially over-engineered, and as a result is susceptible to ambiguity, differing interpretations as to its scope, meaning and intention, and as a result creates uncertainty that will make it difficult for the ATO to administer and for taxpayers to comply with. We urge the Government to substantially revise the drafting of these provisions, in particular taking account of the issues and comments raised below.

2. Self-assessment

Paragraph 1.22 of the EM confirms a fundamental distinction between the new provisions in Subdivisions 815-B and 815-C and the current provisions in Division 13 ITAA 1936 and Subdivision 815-A: *"Unlike the current transfer pricing rules in Division 13 and in Subdivision 815-A, which both rely on the Commissioner of Taxation making a determination, these provisions will be self-executing in their operation. This will bring the rules in line with the design of Australia's taxation system which generally operates on a self-assessment basis."*

On the other hand, the new provisions, like the current provisions, only authorise increases in tax outcomes. Subdivisions 815-B and 815-C do this by applying only where there is a transfer pricing benefit, defined in section 815-120 and 815-220 as essentially a greater tax outcome if arm's length conditions had operated instead of the actual conditions.

In our view, it is inappropriate to have a self-assessment provision that only authorises increases in tax outcome. The fundamental objective of the provision is that the tax outcome reflects the operation of arm's length conditions. Consistent with this objective, it should authorise a taxpayer to self-assess on the basis of such an outcome, whether the operation of arm's length conditions produces a greater or lesser tax outcome than the actual conditions. A key point here is that the requirement is for an entity's tax return to be lodged with tax outcomes that reflect arm's length conditions; the requirement is not for the entity to have relations (eg. transactions) whose actual conditions are arm's length. In other words, Subdivisions 815-B and 815-C contemplate being applied by way of tax return-only adjustments.

As an example, say that an Australian distributor entity purchases products from a foreign affiliate. The invoiced price is $100. For purposes of lodging its tax return the entity applies the most appropriate arm's length pricing method (say TNMM). Whether the outcome of that method is a price of $100, $95, or $105, that outcome should be able to be used by the entity to self-assess its taxable income. As drafted, Subdivision 815-B would only authorise the $95 to be used; the $105 is not expenditure actually incurred, and given that it is not within Subdivision 815-B it cannot be used. If the arm's length price is $105, it is not appropriate policy to require the entity to self-assess itself on the $100 and then be forced to use treaty processes (eg. correlative relief under article 9(2) or Mutual Agreement Procedure), if available, to obtain a credit amendment to recognise the $105 price. This is particularly so given that Subdivision 815-B applies to both treaty and non-treaty cases, so that in the latter there will be no ability to recognise the $105.

The concept of "transfer pricing benefit" used in Subdivisions 815-B and 815-C is reminiscent of the concept of "tax benefit" used in Part IVA ITAA 1936. It is suited to such an anti-avoidance provision designed for use by the Commissioner to authorise adjustments to deny such a benefit. It may be suitable for Subdivision 815-A, which is similarly designed for use by the Commissioner to authorise adjustments to deny such a benefit. However, it is not suited to provisions such as Subdivisions 815-B and 815-C, which are intended for use by both the Commissioner and taxpayers to achieve tax outcomes that comply with the arm's length principle. Paragraph 2.19 of the EM explicitly recognises that the concept of "transfer pricing benefit" is purely notional in the context of Subdivision 815-B as a self-assessment provision, which merely highlights its unsuitability for that provision.

3. Adjustments negating a transfer pricing benefit

We are concerned about the potential for Subdivision 815-B to operate unreasonably and unfairly for a taxpayer entity where the Commissioner uses it to make an adjustment to negate a transfer pricing benefit.

For purposes of Subdivision 815-B, section 815-120 defines "transfer pricing benefit" very broadly, essentially as the amount of the entity's taxable income would be greater, or its loss or tax offset would be less, if arm's length conditions had operated in the entity's commercial or financial relations with another entity instead of the actual conditions. In turn, section 815-125 defines "arm's length conditions" very broadly, and paragraph 2.34 of the EM states that *"the concept of commercial or financial relations is intended to be broad"*.

We understand that this requires the Commissioner to identify a transfer pricing benefit by reference to conditions operating between two identified entities. Thus, in a scenario where the taxpayer entity has dealings with multiple foreign affiliates, we understand that the Commissioner would need to attribute any adjustment to dealings with a particular affiliate.

However, we are concerned that Subdivision 815-B can authorise the Commissioner to make an adjustment to negate a transfer pricing benefit without attributing that adjustment to any particular amount of income or expense. In this regard, we note that Subdivision 815-B does not contain any equivalent to section 815-30(2) of Subdivision 815-A, which requires the Commissioner to do this when applying that provision. In our view it should.

The unfair and unreasonable outcomes that can otherwise arise for taxpayers can be illustrated by a simple example. Say that an Australian entity has several categories of transactions with its foreign parent entity, being product purchases, a licensing agreement under which it pays royalties, and an agreement under which it provides services. The entity has made operating losses for several years. Applying Subdivision 815-B, the ATO identifies non-arm's length conditions operating between these entities and uses a TNMM on a whole of entity basis as the most appropriate method to quantify an adjustment to the entity's losses to negate the transfer pricing benefit. The adjustment may be attributable to any or all of the following: the entity's purchase expenses; its royalty expenses; and its service fee income. Unless the ATO is required to attribute the adjustment amount, the entity or group can be unfairly and unreasonably disadvantaged in challenging the adjustment and/or knowing whether and to what extent it can seek a consequential adjustment under section 815-140 for any withholding tax overpayment on the royalties. In our view, it would not be fair and reasonable in this scenario for the Commissioner to exercise his discretion under section 815-140(1)(c) and not make a consequential adjustment on the grounds that he has not attributed the section 815-115 adjustment to the royalty payments.

4. Meaning of arm's length conditions

We query the appropriateness of the meaning given to the term "arm's length conditions" for purposes of Subdivision 815-B.

Section 815-125 requires that in identifying the arm's length conditions the most appropriate and reliable method(s) be used. In our view this is inappropriate. Arm's length pricing methods don't identify or determine arm's length conditions, they determine whether the outcomes of the conditions operating between the entities are arm's length. In terms of the definition of "transfer pricing benefit" in section 815-120, the pricing method determines whether, for instance, the entity's taxable income would be greater if arm's length conditions had operated instead of the actual conditions.

Similarly, the note to section 815-115(1)(b) states that *"[t]he conditions that operate include, but are not limited to, such things as price, gross margin, net profit, and the division of profit between the entities"*. Again, in our view this is inappropriate. The language used in Subdivision 815-B, referring to conditions operating in the commercial or financial relations of the entities, is clearly based upon and mirrors the language of Article 9(1) of the OECD Model Tax Convention, and thus the Associated Enterprises articles in Australia's tax treaties. Treaty Article 9 essentially refers to profits not accruing to an enterprise that would have been expected to accrue but for the non-arm's length conditions. Subdivision 815-B uses the concept of a transfer pricing benefit rather than profits, but in section 815-120 it links that concept to non-arm's length conditions differing from the actual conditions in a way that the outcomes under Article 9 and Subdivision 815-B should be the same. We understand that this is what is intended (see paragraph 1.42 of the EM). Clearly, under Article 9, profits cannot be conditions, otherwise the language would be totally circular and nonsensical. Article 9(1) is drafted so that profits are the outcomes of conditions, not conditions in themselves. Similarly, under Subdivision 815-B, profits may quantify the transfer pricing benefit and are outcomes of conditions, not conditions in themselves. We would also point out that if profits can be arm's length conditions, then so too can losses; there is nothing inherently non-arm's length about a loss.

We are concerned about the practical implications of the breadth of the drafting used in Subdivision 815-B, and the resulting potential for the Commissioner to make adjustments under the provision that have no demonstrable or attributable connection with cross-border related party transactions or the pricing of such transactions. The provision seems to us to be drafted so as to be capable of authorising an ATO approach, for example in the *SNF Australia*-type scenario, of treating the incurrence of losses which could not be sustained by independent parties as of itself evidencing non-arm's length conditions, whether or not those losses arise from third party or even domestic transactions. In this regard, we understand from recent dealings with the ATO that it holds the view that the economic rationale for the existence of a subsidiary is to add to the profitability of the multinational enterprise, so that if the subsidiary is in a situation of systemic loss (for whatever reason) and requiring parental financial support, it is to benefit the multinational in some unidentified manner and not arm's length by definition. The ATO considers the absence of cross-border related party transactions in this situation as irrelevant. It is sufficient for Subdivision 815-B purposes under this approach to have commercial or financial relations between the Australian subsidiary and its foreign parent to which to connect the conditions. This ATO thinking equates the arm's length principle with a requirement to make profits. Such thinking is facilitated by inappropriately describing profits and the allocation of profits as "conditions" for Subdivision 815-B purposes, as discussed above.

We are concerned that such an approach is inconsistent with treaty Article 9 applied in accordance with the OECD Guidelines, particularly given the intention that the outcomes under Article 9 and Subdivision 815-B are the same, and that both are to be interpreted consistently with the Guidelines. The new provisions appear to be based on the incorrect premise that Article 9 simply focuses on profit outcomes. In practice, the application of Article 9 calls for a transactional approach. The arm's length pricing methods used in applying Article 9 under the OECD Guidelines are all, except in limited prescribed circumstances, intended to be applied on a transactional basis. For this reason, the methods are referred to in the Guidelines as the "traditional transaction methods" and the "transactional profit methods". The transactional profit methods are in turn called the "transactional net margin method" and the "transactional profit split method". There is no authority under the Guidelines to simply default to a highly aggregated approach of determining an arm's length profit outcome for a taxpayer with cross-border related party transactions.

Section 815-125 requires the use of the most appropriate and reliable method, and the EM reiterates the methods recognised in the OECD Guidelines. We suggest that the EM should also give recognition to the administrative practices for certain intra-group services as per paragraphs 75 to 102 of TR 1999/1, confirming that where a taxpayer qualifies for and correctly applies these practices then it will be treated as not getting a transfer pricing benefit for Subdivision 815-B purposes. We can see no policy reason why these administrative practices, which have had substantial value for taxpayers in reducing compliance costs and providing certainty under the current transfer pricing provisions, should not apply for purposes of Subdivision 815-B.

5. Incorporation of OECD Guidelines

Section 815-130 requires that Subdivision 815-B is to be interpreted so as to best achieve consistency with the OECD Transfer Pricing Guidelines. This accords with a key objective of the new provisions, as per paragraph 1.1 of the EM, of having transfer pricing rules that *"better align with the internationally consistent transfer pricing approaches set out by the OECD"*. Given this requirement and key objective, we do not understand why certain selected elements of the 2010 Guidelines have been "unpacked" into section 815-125. Thus, section 815-125(2) appears to paraphrase paragraph 2.2 of the Guidelines, section 815-125(3) appears to paraphrase paragraph 1.36 of the Guidelines, and section 815-125(4) seems to paraphrase paragraph 1.33 of the Guidelines. Paragraphs (5) to (8) of section 815-125 deal with the relevance of economic substance, which is also a matter specifically addressed in considerable detail in the OECD Guidelines (see eg. paragraphs 1.64 to 1.69).

This either involves unnecessary duplication, in which case these paragraphs of section 815-125 should be deleted, or it reflects an intention for Subdivision 815-B to differ or depart from the Guidelines in some way. Any such intention would be inappropriate as contrary to the above key objective of the provisions. For example, section 815-125 is headed *"Most appropriate and reliable method to be used"*. The OECD guidelines only refer to using the most appropriate method. Are the words "and reliable" intended to impose an additional requirement under Subdivision 815-B, or otherwise indicate that what is required for Subdivision 815-B is intended to differ in some way from the OECD Guidelines? As another example, the requirements in section 815-125(5) to (8) in relation to economic substance do not mirror language found in the OECD Guidelines on this subject, although paragraphs 2.82 to 2.91 of the EM do contain language and principles that are clearly based upon or extracted from what is said in the OECD Guidelines. Does this mean that the relevance of economic substance under Subdivision 815-B is intended to differ in some way from the OECD Guidelines?

In this regard, we note that paragraph (1) of section 815-130 states that the requirement for Subdivision 815-B to be interpreted so as to best achieve consistency with the OECD Guidelines is qualified by the words "except where the contrary intention appears". Does section 815-125 represent a contrary intention appearing? This is a source of confusion and uncertainty and would best be avoided by deleting the relevant paragraphs of section 815-125. We also suggest that the EM address what is intended by the words "except where the contrary intention appears".

6. Relevance of economic substance

The OECD Guidelines contain considerable guidance on the relevance of economic substance which, given the requirement in section 815-130 to interpret Subdivision 815-B so as to best achieve consistency with the OECD Guidelines, are effectively incorporated into the operation of that provision. We therefore do not consider it necessary or appropriate to include provisions in Subdivision 815-B (paragraphs (5) to (8) of section 815-125) that also address the relevance of economic substance, as this creates potential differences, inconsistencies and uncertainties. We strongly recommend that those provisions be deleted.
It is clear from paragraphs 2.82 to 2.91 of the EM that paragraphs (5) to (8) of section 815-125 are primarily intended as conferring a reconstruction or recharacterisation power to be used by the Commissioner. Paragraphs 1.64 to 1.69 of the OECD Guidelines already confer this power, and it is not clear as to whether, and to what extent, the power under Subdivision 815-B is intended to be the same as, or broader or more limited than, the power under the OECD Guidelines. In this regard, the OECD Guidelines stress that such a power should only be exercised in "exceptional cases" and prescribe two "exceptional circumstances" in which it may be appropriate. There is no similar wording found in either section 815-125 or paragraphs 2.82 to 2.91 of the EM. We are extremely concerned about the potential for ATO auditors to seek to use section 815-125 to reconstruct or recharacterise the actual arrangements in cases or circumstances that are outside those contemplated by the OECD Guidelines.

The scope and meaning of paragraphs 1.64 to 1.69 of the OECD Guidelines were the subject of extensive debate, discussion and public consultation, in which Australia was heavily involved, during the course of the OECD's project on business restructuring which led to Chapter IX of the OECD Guidelines. Paragraphs 9.168 to 9.194 of Chapter IX reflect the outcomes of this process, and paragraph 9.168 reiterates the OECD view that non-recognition of the actual transactions as structured by the parties is something that is to be reserved for exceptional cases. There is no policy basis for Australia enacting a domestic law provision which confers a reconstruction power beyond that available under the OECD Guidelines. To do so would put Australia out of step with the international consensus position on this subject, and create an unacceptable risk of double taxation. As paragraph 1.64 of the OECD Guidelines states, *"In other than exceptional cases, the tax administration should not disregard the actual transactions or substitute other transactions for them. Restructuring of legitimate business transactions would be a wholly arbitrary exercise the inequity of which could be compounded by double taxation created where the other tax administration does not share the same views as to how the transaction should be structured."*

7. Modification for thin capitalisation

Subdivision 815-B contains a specific provision (section 815-135) dealing with adjustments to debt deductions to which Division 820 ITAA 1997 applies. Section 815-135 explicitly says that it "modifies" the way an entity to which section 815-115 applies works out its taxable income or its loss where Division 820 debt deductions are involved. Paragraph 2.96 of the EM confirms that section 815-135 *"is a special rule"* that *"applies in working out the transfer pricing adjustment. The rule modifies the way in which Subdivision 815-B applies to an entity."* Paragraph 2.97 states that "[t]he rule preserves the role of Division 820 as the comprehensive regime in regards to an entity's amount of debt." Paragraph 2.99 goes on to reiterate that under section 815-135 *"…the calculation of a transfer pricing benefit relating to those debt deductions is modified so that only the rate may be adjusted."*

In our view, the interaction between sections 815-135 and 815-115 should be made clearer, ideally in the provisions themselves or at least in the EM. It should be made clearer that section 815-135 covers the field in respect of the application of Subdivision 815-B to amounts that are debt deductions, so that it is clear that such amounts are not subject to the independent application of section 815-115.

Section 815-135 adopts the administrative approach provided in TR 2010/7: an interest rate is determined applying the arm's length principle (as per the OECD Guidelines), and that rate is applied to the actual amount of the entity's debt. According to the EM, in determining an arm's length interest rate, regard may be had if necessary to an arm's length debt amount.

For example, say that a taxpayer entity AusCo borrows $200M from its foreign parent @ 6%. The ATO determines that AusCo is thinly capitalised; had it not been (based upon benchmarking against its industry peers) it would have been creditworthy to borrow $100M @ 5%. The adjustment under section 815-135 is $2M (ie. $200M @ 5% compared to $200M @ 6%).

Note that section 815-135 does not fully disallow AusCo a deduction for interest on the $100M of debt that is considered to exceed an arm's length amount of debt. Division 820 applies, after section 815-135 is applied, to disallow such deduction if that amount of debt exceeds the amount allowed under Division 820 (eg. the relevant safe harbour amount). In other words, section 815-135 effectively precludes the ATO from arguing for 815-B purposes that the amount of debt that exceeds an arm's length amount is in the nature of equity, and thus has no (deductible) interest cost.

In our view, Section 815-135 means that the ATO cannot apply the general power to deny a transfer pricing benefit under section 815-115 in a way that is inconsistent with section 815-135, for instance to fully disallow a deduction for interest on debt that is considered to exceed an arm's length amount. Take our example. If AusCo has a history of losses and the ATO concludes that this is due to its excessive debt (and resulting interest expense), the ATO cannot simply use a TNMM to benchmark AusCo's profitability (at the PBT level) and then apply section 815-115 to disallow its related party interest expense to achieve that profitability. To the extent that TR 2010/7 (eg. paragraphs 53 and 60) can be interpreted as saying something different, then it is inconsistent with section 815-135. The EM does not explicitly reiterate such parts of TR 2010/7.

Thus, if the outcome for the taxpayer of allowing an arm's length interest rate on its actual related party debt amount (albeit that this exceeds an arm's length debt amount) is losses or "less than commercially realistic" profitability, then this is an outcome that accords with section 815-135 and is therefore not the basis of an adjustment under Subdivision 815-B. In other words, in order to warrant a Subdivision 815-B adjustment, the result of any such TNMM/commercial realism analysis must accord with allowing an arm's length interest rate on the actual related party debt amount. So, in our example, if achieving the ATO's view of a "commercially realistic" profitability for AusCo would translate into applying a demonstrably non-arm's length interest rate to the $200M debt (eg. a rate below a relevant risk free rate such as LIBOR), then Subdivision 815-B would not authorise this adjustment.

8. Guidance documents

Sections 815-130 and 815-230 require that Subdivisions 815-B and 815-C be interpreted "so as to best achieve consistency with" the prescribed documents (eg. relevant OECD documents). The words "so as to best achieve consistency with" are used instead of "consistently with" as used in the equivalent provision in Subdivision 815-A (section 815-20). We question why there is this difference. We note that the Exposure Draft to Subdivision 815-A used the words "so as to best achieve consistency with", but that Subdivision 815-A as enacted uses "consistently with". We support consistent language being used and prefer the phrase "consistently with" as it is simpler, clearer and less open to differing interpretations. For instance, the phrase "so as to best achieve consistency with" can arguably be satisfied without there actually being consistency.

<u>Regulation powers</u>

We have concerns about the powers under sections 815-130 and 815-230 to regulate the documents covered for purposes of interpreting Subdivisions 185-B and 815-C. Specifically, we are concerned about the powers under section 815-130(3) to exclude all or part of the OECD Guidelines for purposes of Subdivision 815-B, and under section 815-230(3) to exclude all or part of the OECD Model Tax Convention and its Commentaries for purposes of Subdivision 815-C.

Australia is an OECD member and actively participates in the development of the OECD views in these documents. The OECD Guidelines are a consensus document developed by OECD Working Party 6, of which Australia is a member and an active participant. The Guidelines are approved for publication by the OECD's Committee on Fiscal Affairs, on which Australia is represented. Paragraph 2.8 of the EM recognises Australia's OECD involvement in this regard. It is therefore implicit that Australia has agreed at OECD level to all of what is in the OECD Guidelines, and it would therefore be inappropriate for any regulation to be made under section 815-130 excluding some part of the Guidelines for purposes of interpreting Subdivision 815-B.

Similar comments apply to section 815-230 in respect of the OECD Model Tax Convention and its Commentaries. We also note that Australia is able to make a formal Reservation or Observation if it does not wish to follow or adopt some aspect of the OECD Model Tax Convention and its Commentaries. Unless it has done so, it would be inappropriate for any regulation to be made under section 815-230 excluding some part of the Guidelines for purposes of interpreting Subdivision 815-C.

9. Documentation and penalties

The exposure draft includes proposed amendments to Schedule 1 to the *Taxation Administration Act 1953* (TAA) to include Subdivision 284-CA to provide that an entity that does not have the documentation required by Subdivision 815-D is treated as not having a reasonably arguable position (RAP) about the application of Subdivisions 815-B or 815-C. The Notes to sections 815-305(1) and 815-310(1) make similar statements. On the other hand, section 815-301 states that documentation that meets the requirements in Subdivision 815-D is necessary, but not sufficient, to establish a RAP about the application of Subdivisions 815-B or 815-C.

Whilst it may be appropriate policy to provide that a taxpayer can't have a RAP without the documentation required by Subdivision 815-D, it is not obvious to us why a taxpayer might be considered not to have a RAP if it has that documentation. Presumably, the documentation listed in Subdivision 815-D is that which is considered necessary to evidence that a taxpayer has complied with the arm's length principle in applying Subdivision 815-B or 815-C, as relevant. What more is the taxpayer expected to do to establish a RAP? The EM should at the very least indicate this. In any event, we consider that a taxpayer who has documented in accordance with Subdivision 815-D should be treated as having a RAP about the application of Subdivision 815-B or 815-C.

Paragraph 1.47 of the EM states that entities that do not have documentation in accordance with Subdivision 815-D will be deemed not to have a RAP, *"[h]owever, this does not preclude the Commissioner from using his discretion to remit administrative penalties where appropriate (currently available under the law)".*

The Commissioner's views on penalty remission for keeping documentation under Australia's current transfer pricing rules are as stated at paragraphs 2.9 to 2.14 of TR 98/11, and paragraphs 34 to 41 of TR 98/16. TR 98/11 states:

> *"2.10 The existence of adequate contemporaneous documentation is an indicator that the efforts of a taxpayer are such that penalties should be remitted in the event of a transfer pricing adjustment.*
>
> *2.11 Taxpayers who have in good faith followed the four steps outlined in Chapter 5 of this Ruling in the preparation of their returns and kept sufficient and relevant contemporaneous documentation to show compliance with the arm's length principle will not be subject to penalties under section 225."*

(TR 98/11 makes reference to the penalty and penalty remission provisions in sections 225 and 227 of the ITAA 1936, now contained in Part 4-25 of Schedule 1 to the TAA).

In addition, TR 98/16 states:

> *"36. ...remission of section 225 penalty will be made under subsection 227(3), reducing the penalty rate otherwise applying from 10% to nil, where the taxpayer:*
> *(1) has genuinely made a reasonable attempt in good faith to comply with the arm's length principle in preparing the tax return, having regard to what a reasonable business person in the taxpayer's circumstances would do (see Chapter 1 of Taxation Ruling TR 98/11);*
> *(2) has used its best endeavours to document the process of selecting and applying an arm's length method at the time the transaction was negotiated, or at the time the relevant income tax return was prepared, on the basis of the information in the taxpayer's possession and any other information that was reasonably available to the taxpayer at the time (see also Taxation Rulings TR 98/11);*
> *(3) can satisfy the ATO that there was no tax avoidance intention or purpose in adopting the pricing outcomes arrived at from performing the process mentioned in subparagraph (2) above; and*
> *(4) where the transfer pricing adjustment is made as a result of audit action, the taxpayer has fully co-operated with the ATO, including providing all relevant information in the taxpayer's possession or reasonably available to the taxpayer so as to achieve an expeditious conclusion of the audit.*
>
> *39. Taxation Ruling TR 98/11 recommends that taxpayers adopt a quality process, such as the four steps explained in Chapter 5 of that Ruling, when developing and documenting international transfer prices. The quality of a taxpayer's process and the adequacy and relevancy of documentation created and maintained in applying the arm's length principle to international dealings with associates, are relevant to the exercise of the remission discretion. Taxpayers assessed as falling in the medium-high quality and high quality categories under Chapter 4 of Taxation Ruling TR 98/11 will be regarded as having satisfied the requirements of paragraphs 36(1) and (2) above."*

The above-quoted paragraphs from TR 98/11 and TR 98/16 clearly indicate that a taxpayer who has documented in accordance with the 4-step process in TR 98/11 will have penalties remitted in full. Given this, it makes no sense to us from a policy perspective for a taxpayer who has documented in accordance with Subdivision 815-D to be treated as not having a RAP, and thus subject to a base penalty of at least 25%. Subdivision 815-D should reflect a position on penalties that accords with that under the current law as per paragraphs 2.10-2.11 of TR 98/11 and paragraphs 36 and 39 of TR 98/16, ie. taxpayers who have documented in accordance with Subdivision 815-D will not be subject to penalties under Subdivision 284-C TAA 1953.

The EM should address how and to what extent the documentation required under Subdivision 815-D aligns with that produced in accordance with the ATO's 4-step process under TR 98/11 and the OECD's 9-step process as per paragraph 3.4 of the OECD Guidelines. This would clarify the requirements under Subdivision 815-D and give certainty to taxpayers. It would reduce their compliance burden to the extent that their existing processes performed and documentation prepared for purposes of Australia's current transfer pricing laws remain appropriate for Division 815 purposes. At the very least the EM should address how and to what extent the documentation required under Subdivision 815-D might differ from that expected for purposes of Australia's current transfer pricing laws in accordance with TR 98/11. In this regard, as TR 98/11 applies for purposes of treaty article 9, and as Subdivision 815-B mirrors the language of, is intended to give the same outcome as, the arm's length principle under treaty article 9, it would be expected that documentation that satisfies TR 98/11 in respect of the application of treaty article 9 should also satisfy requirements in respect of the application of Subdivision 815-B.

Both TR 98/11 and the OECD Guidelines apply a "reasonable business person" test to the level of documentation a taxpayer is expected to have, recognising that this may appropriately vary depending primarily upon the value and complexity of the taxpayer's transfer pricing issues. This strikes an appropriate balance between a tax administration's need for records to monitor compliance and a taxpayer's compliance burden. It is particularly important from the perspective of SMEs and taxpayers with low levels of transfer pricing issues. We believe that compliance with Subdivision 815-D should be assessed on a similar basis to what is expected under existing laws and ATO rulings. We consider it appropriate for this policy position to be captured in the drafting of Subdivision 815-D itself, or at least a policy intention in this regard to be evidenced in the EM.

10. Permanent establishments

In accordance with paragraph 3.2 of the EM, we understand that the intention of Subdivision 815-C is to codify the "relevant business activity approach", so that *"...Subdivision 815-C reflects the approach to the attribution of profits to permanent establishments that is currently incorporated into Australia's tax treaties"*. This is stated to be on the basis that the Government is yet to decide on whether to adopt the authorised OECD approach (functionally separate entity approach) in Australia's tax treaties in accordance with the new Article 7 under the 2010 OECD Model Tax Convention and its Commentary.

In our view, this reflects a fundamental misunderstanding of the position under Australia's tax treaties. Whilst the relevant business activity approach may be consistent with Division 13, it is not consistent with the Business Profits articles of Australia's tax treaties, in accordance with the 2008 Commentary to Article 7 of the OECD Model Tax Convention. Section 815-230(2)(a) recognises the relevance of these documents for Subdivision 815-C purposes. We note that Australia has made no Observation to this Commentary as regards retaining the relevant business activity approach. Australia's adoption of the new Article 7 under the 2010 OECD Model Tax Convention has no relevance to this.

We urge that Subdivision 815-C be redrafted so that it legislates an approach to PE profit attribution that does in fact reflect the approach that is currently incorporated into Australia's tax treaties.

11. Amendment of assessments

Sections 815-145 and 815-235 provide for an 8 year time limit for amending assessments to give effect to sections 815-115 and 815-215 respectively. We welcome the change from the current unlimited time period for amendments to give effect to Division 13. However, we consider that the general 4 year time limit in section 170 ITAA 1936 is more appropriate. We believe that, given the introduction of self-assessment and contemporaneous documentation requirements under the new provisions, along with expanded disclosure requirements in the International Dealings Schedule and the Reportable Tax Position Schedule, there is no longer a case for different time limits for transfer pricing and other tax amendments. We also note that the Commissioner can, where necessary, seek to extend the normal 4 year period with taxpayer consent or on application to a Court made following commencement of an audit and within that period.

We also question the point of having a time limit for amendments under Subdivisions 815-B and 815-C, when the Commissioner is of the view that the treaty transfer pricing articles are a separate power to amend assessments and there remains under section 170(9B) ITAA 1936 an unlimited time period for amendments to give effect to the treaty articles. We suggest that section 170 be amended to ensure that the same time limit apply to amendments to give effect to all transfer pricing provisions.

Deloitte will be pleased to provide representatives to meet with treasury to further discuss our views and/or participate in consultation forums.

Yours sincerely

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