

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

30 November 2011

Dear Sir

Re: Australian Government Treasury Review of Transfer Pricing Rules - Deloitte Comments

Deloitte welcomes the opportunity to comment on the proposal to amend the transfer pricing rules as set out in the Consultation Paper *“Income tax: cross border profit allocation - review of transfer pricing rules”* and the associated press release of 1 November 2011 made by the Assistant Treasurer the Hon Bill Shorten MP.

1. Introduction

We generally welcome the review by the Government of Australia’s transfer pricing rules, which pre-date a significant amount of work over the past 25 years at Organisation for Economic Cooperation and Development (OECD) level on transfer pricing. Notwithstanding guidance provided by the Australian Taxation Office (ATO) in the form of many taxation rulings that provide its interpretation of the transfer pricing rules and its view that the rules can be interpreted as essentially aligned to the OECD Transfer Pricing Guidelines, there remains uncertainty as to their practical application, as evidenced in recent court decisions. For this reason, we welcome the review, although as set out below, we are cautious of changes that are not fully considered and developed through proper consultation with taxpayers and advisors. Given this, and potential interactions of the transfer pricing provisions with other provisions in the law, we are concerned that the timetable proposed for the introduction of legislation as outlined by Treasury in discussions is too ambitious and recommend that a longer consultation period be applied. We also recommend that the changes to the permanent establishment profit attribution rules be developed in tandem with the changes to the transfer pricing rules for separate legal entities.

As a general proposition we agree that the current domestic transfer pricing rules embodied within Division 13 have been read to reflect a traditional “market value” approach to transfer pricing, which is not always aligned with current international thinking found in the OECD Guidelines and the domestic rules of Australia’s major trading partners. As a result, the possibility of unintended double taxation arising from transfer pricing adjustments is increased, and as noted above, some uncertainty exists in the applicability of OECD guidance to transfer pricing arrangements involving Australian taxpayers.

Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee, and its network of member firms, each of which is a legally separate and independent entity. Please see www.deloitte.com/au/about for a detailed description of the legal structure of Deloitte Touche Tohmatsu Limited and its member firms.

Liability limited by a scheme approved under Professional Standards Legislation.

Member of Deloitte Touche Tohmatsu Limited

The proposal to better align our domestic rules with the wider international community must improve certainty for multi-national groups, both domestic and foreign, and their advisors and reduce the possibility of double taxation.

We also agree that, consistent with the tax laws generally, taxpayers should self-assess their transfer prices and profits and there will need to be consequential amendments to existing Commissioner discretions, record keeping requirements and time limits for amendments.

While accepting Treasury's request for comment on broad principles, we believe that, as with most legislative change, the devil is in the detail and the Consultation Paper and associated proposals raise areas of concern for taxpayers and advisors. Set out below are our comments on the proposed retrospective application of the treaty rules (Section 2), the proposed changes to the transfer pricing rules for separate entities (Sections 3 to 12) and considerations specific to permanent establishments (Section 13).

2. Retrospective application of treaty rules

Although not a matter on which consultation was sought, the announcement by the Minister that he intends to introduce law to retrospectively allow the Commissioner to raise transfer pricing adjustments on treaty law as an alternative to domestic law raises very serious issues of fairness and arbitrariness in the application of Australian international tax laws. Indeed, the introduction of such law would create the absurd situation whereby non-treaty transactions will potentially be treated more favourably than transactions involving Australia's major trading partners.

The claim that Parliament has always intended this to be the case is not a justification for specific targeting of certain existing audit cases which, according to Treasury, the ATO appears to be of the view might otherwise fail based on the decisions in Roche and SNF. The validity of this legal position has been in dispute for years and the Commissioner has had ample opportunity in Roche and SNF to test his interpretation of the law. Only in SNF at first instance did the Court provide obiter in favour of the Commissioner. The Full Court on Appeal did not address the matter. The passing of retrospective law is not the approach to international tax law expected from a sophisticated trading nation and does considerable damage to Australia's reputation for fair dealing in international trade and taxation.

A further reason offered by Treasury for the Government's decision to retrospectively amend the law is the prevention of taxpayers making credit amendments to reduce taxable profit following the SNF decision. We are of the view that this concern is unfounded, both in practice and as a matter of law. In relation to audit cases and APAs that have been previously settled or agreed with the ATO, we note that there would be practical (and possibly legal) impediments to reopening these cases.

In relation to other cases, there are legal impediments to taxpayers effecting credit amendments under Division 13. The legislative purpose behind Division 13 is to ensure Australia can counter non-arm's length transfer pricing or international profit shifting arrangements in order to protect Australian tax revenue. One of the pre-conditions to the application of Division 13 is that the Commissioner must determine that the relevant sub-sections apply, i.e., it is a discretionary provision. The Explanatory Memorandum (EM) to Division 13 makes it clear that the provisions are anti-profit shifting provisions intended to apply where there is a shifting of taxable income from Australia. In addition, the EM makes it clear that the intention behind the granting of the Commissioner's discretion to apply Division 13 is to have regard to whether the use of non-arm's length prices has resulted in a shifting of taxable income from Australia.

Against this background, taxpayers have no basis to amend their tax returns to decrease their taxable income under Division 13, and it is difficult to see how the Commissioner could exercise his discretion to apply Division 13 in these circumstances, and it is unlikely that he would feel so inclined. We strongly recommend

that any revenue estimates established to support the retrospective amendments be re-considered in light of the fact that the claims regarding levels of anticipated credit amendments appear unfounded.

As discussed above, retrospective amendments to law also raise issues of fairness. In the current proposals, the ATO will arguably have a power it currently does not have under existing law. The issue of fairness is paramount as, once the law is amended, the ATO's power to go back and reopen old cases (or start new ones given the absence of time limitations) is unfettered and the power may well be abused.

Retrospective amendments to Australian tax law have on occasion been made to correct inequalities in the existing income tax legislation. However, the proposal to retrospectively amend domestic law in relation to the application of the treaty rules for transfer pricing matters is not an example of this and should be clearly distinguished.

3. Revised transfer pricing rules for separate entities

We agree that the decision in SNF in particular has cast doubt on the ATO's view that the existing rules are essentially aligned to the OECD Guidelines and in particular the comparability factors set out in those Guidelines. Recent judges' opinions have applied the rules in a way more associated with a market valuation approach, as they do not take into account the circumstances of the taxpayer, or broader comparability factors. This approach is at odds with the international approach found in the OECD Transfer Pricing Guidelines and most of Australia's trading partners' domestic rules (although we note that the Full Federal Court in SNF did in fact base its assessment of the reliability of SNF's CUP evidence on the OECD comparability factors). We also agree that the decision in SNF, by not endorsing direct resort to the OECD Guidelines in interpreting the transfer pricing rules, raises considerable uncertainty for taxpayers and advisors.

The policy objective of basing transfer pricing on the functional analysis and broadly reflecting the parties' economic contributions is well understood and accepted by multi-national enterprises and professionals in the field. Accordingly, the proposal of mandating the use of the OECD Guidelines in tax legislation is supported. However, we do not agree with the view (refer paragraphs 12 and 23 of the Consultation Paper) that the current Division 13's transactional approach to the arm's length principle and its focus on pricing transactions is "in contrast to treaty rules".

The Consultation Paper appears to be based on the incorrect premise that the Associated Enterprises Article simply focuses on profit outcomes. In practice, the application of the treaty rules calls for a transactional approach. The arm's length pricing methods used in applying the treaty rules 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 in applying the treaty rules 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. Any new domestic rules drafted so as to permit such an approach would not accord with the treaty rules as interpreted under the Guidelines.

4. Design of the rules

We support the proposal that the new rules reflect high level principles supported by reference to the OECD Guidelines and should not be overly prescriptive.

5. Self assessment

As taxpayers will need to self-assess under the proposed new rules, accordingly, the Commissioner's discretions should be removed altogether. In order to self assess, taxpayers need to be able to rely on the guidance found in the Guidelines.

The intention to retain the existing feature of Division 13 of extending the rules to dealings with unrelated parties is difficult to reconcile with a self assessment environment. Dealings with unrelated parties are at arm's length by definition, unless there is the existence of collusion or concealment e.g. bearer share entities. Such cases are more readily appropriate for general anti-avoidance rules than transfer pricing rules, particularly in a self assessment environment.

The anti-avoidance measure currently in Division 13 provided by the definition of an international agreement, designed to attack back-to-back arrangements or collusion with unrelated entities, is not suitable in a self assessment environment. As a matter of general design, with the advent of self assessment the new rules should dispense with the anti-avoidance aspects of Division 13 and instead seek to apply the OECD Guidelines to the issue of transfer pricing. Any anti-abuse rules which extend beyond those found in the OECD Guidelines should be dealt with under the existing anti-avoidance provisions in the domestic law. In addition, it seems to us to be consistent with this approach to allow the arm's length principle to apply whether or not there is a detriment to the Australian revenue. The new rules should focus exclusively on taxpayers being able to self assess their arm's length position with some certainty provided by the Guidelines.

We note that in practice the transactional profit methods are commonly selected by taxpayers as the most appropriate method for taxpayers and that taxpayers must be able to self assess the price of transactions or transactional profits as appropriate.

6. Discretions

As indicated above, the retention of Commissioner's discretions in the new rules would be inconsistent with self-assessment. We therefore agree with eliminating the current broad discretion in s.136AD(4), but do not agree with the appropriateness of retaining discretions for cases involving insufficient information or reconstruction.

Regarding reconstruction, paragraphs 1.64 to 1.69 of the 2010 OECD Guidelines provide for non-recognition of the actual transactions undertaken in exceptional circumstances. Given the proposal to include these guidelines in the new rules (as per paragraph 32.5 of the Consultation Paper), there is no need for any additional Commissioner's discretion to deal with this. These paragraphs of the Guidelines also sufficiently address reconstruction in relation to debt/equity issues and business restructures. Specifically, Chapter IX of the 2010 Guidelines provides considerable guidance on how these paragraphs apply in a business restructure context. It is difficult to understand what further discretion is seen as being required.

Between them, the OECD Guidelines and Division 820 protect the revenue against any debt related transfer pricing arrangements. The Guidelines allow the re-characterisation of debt to equity in appropriate cases, and Division 820 places a limit on the level of debt funding of Australian business. There is no need for any further Commissioner's discretion in relation to debt funding.

The need for a discretion where there is an insufficiency of information is to be addressed by the need for mandatory transfer pricing documentation in a self assessment environment. If a problem of insufficient information still exists in isolated cases that can be addressed through existing formal powers and ultimately section 167. Any further specific discretion for transfer pricing issues is unwarranted.

In our view, it is not generally appropriate for a tax authority to determine, by discretion, whether business decisions are commercially realistic or indicative of commercially rational behaviour. Again, paragraphs 1.64 to 1.69 of the OECD Guidelines address the exceptional circumstances where this may be appropriate.

7. UK legislation/OECD suggested legislation

Both the UK legislation and the OECD suggested legislation are useful guides to any new law in Australia. Potentially, the OECD suggested legislation is preferred. The UK legislation attempts to use transfer pricing rules to deal with abuse better dealt with under our existing anti-avoidance rules. This is because the UK does not have a general anti-avoidance rule. We agree that contrary to the UK, incorporation of the both the OECD Model Tax Convention (MTC) and the Guidelines in the new rules is preferred. We understand that the UK, in its recent rewrite of its transfer pricing legislation, considered similar retrospective amendments but decided, in principle, that retrospective amendments are generally not good law.

8. Comparability factors

We agree the OECD suggested legislation is a suitable model for ensuring comparability requirements are met.

9. Record keeping requirements

The explicit requirement to maintain contemporaneous transfer pricing documentation in Australia is consistent with self assessment and the Ralph Review and is supported for the reasons given in the Consultation Paper. However, the compliance burden on taxpayers relating to the requirements of transfer pricing documentation should not increase as a result of any changes to the domestic law, consistent with our comments at section 3 above.

The failure to keep appropriate transfer pricing documentation as evidence of the self assessment of the arm's length principle in the law would be evidence of not using reasonable care as suggested.

As suggested, the question of proportionality of transfer pricing risk for particular taxpayers requires a de minimis rule. The threshold for documentation requirements should be more generous than the existing administrative rule. The nature of transfer pricing, its relative imprecision and the costs and complexity of compliance mean that only significant international dealings where any adjustment justifies the costs to all parties should exceed the threshold.

10. Penalties

A penalty regime for transfer pricing documentation is in accordance with the Ralph Review. In accordance with Ralph, any penalty regime should recognise the reasonable efforts made to apply the arm's length principle. Under the existing Division 284 Tax Administration Act, penalties are still imposed in cases where documentation has been prepared in good faith but the ATO disagrees with the approach.

Where taxpayers self assess their transfer prices/profits in accordance with the OECD Guidelines and maintain contemporaneous documentation, no transfer pricing documentation penalties should apply.

11. Time limits

We agree that time limits for transfer pricing adjustments must be introduced. We understand that the eight year limit was based to some extent at least on ATO risk assessment and external data base requirements at

the time of the 2007 review. We believe that, given the introduction of self-assessment and contemporaneous documentation requirements under the new rules, 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 adjustments. Accordingly, we consider that the general time limits in section 170 should apply to transfer pricing adjustments.

12. Should treaty rules provide a separate authority for assessments?

This issue has been debated ever since the introduction of the existing rules. In supporting transfer pricing adjustments in practice, the ATO makes Division 13 determinations, on legal advice, on a belts and braces theory, covering ss.136AD(1), (2) or (3), s.136AD(4) and in the alternative applies the relevant treaty article.

The Commissioner has had ample opportunity to have the Courts decide the issue for transfer pricing and has declined. If the domestic rules are designed to encompass the OECD MTC and Guidelines, it appears prima facie unnecessary to legislate for the treaty rules to provide a separate authority for assessments. We have already made strong objection to the Minister's decision to retrospectively legislate to provide treaty authority under the existing law.

Furthermore, the stated policy rationale for having treaties is to avoid double taxation and to prevent fiscal evasion. The proposed amendment to give treaties a separate taxing power is not needed for either of these purposes.

13. Permanent establishment profit attribution issues

The OECD invested considerable effort in the work on the attribution of profits to PEs precisely because of the inconsistent treatment by OECD member countries, notwithstanding years of effort to reconcile issues under the MTC on Article 7. The inconsistency of interpretation of the profit attribution rules led to great uncertainty and numerous instances of double taxation. The OECD considered this issue in depth for many years before coming to the existing position. Very few countries (specifically, New Zealand and the Slovak Republic) have not endorsed the approach.

There is an inherent inconsistency within Article 7 in applying the arm's length independent enterprise test within a single legal entity. It is not useful in solving this problem to resort to the obvious legal reality that an entity cannot transact with itself.

The new Article 7 and the functionally separate entity approach to attributing profits has, or will be adopted by most OECD member countries and already has been included in new and re-negotiated US treaties. As a practical matter, the existing position in Australia is already causing concerns, particularly in the financial sector.

We consider it imperative that Australia keep in step with the countries that have sophisticated financial sectors as otherwise there is a risk of creating unnecessary tax hurdles for the industry. The new OECD authorised approach ('AOA') benefits the source country, particularly those countries with an active financial industry with foreign bank presence.

The existing official ATO interpretation of Article 7 using the 2008 Commentary recognises that internal dealings, such as swaps and other derivatives between parts of the same legal entity, should be recognised as being analogous to transactions and accepted where they represent an arm's length attribution of actual third party income or expense. However, the ATO's own Taxation Rulings do not seem to be understood or accepted by those who maintain that such transactions cannot be recognised because an entity cannot legally

transact with itself. This is causing considerable distress to taxpayers attempting to achieve arm's length attributions of profit.

The major difference between the new OECD Article 7 and Commentary is that notional income and expenses can be recognised e.g. the payment of a royalty to the "economic" owner, which is barred by the 2008 Commentary. The new approach does not treat a PE the same as a subsidiary and specifically recognises the economic differences such as the efficiency of capital. Accordingly PEs have the same creditworthiness as the rest of the legal entity and no attempt is made to determine an independent credit rating.

We note that in practice the AOA should give similar profit attribution outcomes to the approach under Australia's current PE profit attribution rules. For instance, TR 2005/11 on the application of the current Division 13 and treaty Article 7 to bank inter-branch funds transfers gives similar outcomes for attribution of interest income and expense as under the AOA. We believe that the AOA, properly applied, should not in practice result in the attribution of significantly increased expenses or reduced income to an Australian PE relative to under Australia's current PE profit attribution rules. On this basis, we would expect that there should not be significant revenue consequences of adopting the AOA.

We recommend that the changes to the PE profit attribution rules be developed in tandem with the proposed changes to the transfer pricing rules for separate legal entities.

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

Yours sincerely



Fiona Craig
Australia National Leader – Transfer Pricing
Partner, Deloitte



Paul Riley
Asia Pacific Leader – Transfer Pricing
Partner, Deloitte