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The Manager
International Tax Integrity Unit
The Treasury
Langton Crescent
PARKES CANBERRA ACT

Treaty Equivalent Cross Border Transfer Pricing Rules
Response to Exposure Draft

Dear Sir,

Thank you for the opportunity to make submissions on the Exposure Draft of the *Tax Laws Amendment (2012) No. 3 Bill 2012* ("the Exposure Draft") and the accompanying Draft Explanatory Memorandum.

Consistent with our earlier submission, we fundamentally oppose retrospective legislation that adversely affects taxpayers' rights. Such retrospective legislation is particularly inappropriate where such changes will adversely affect taxpayers that have applied the transfer pricing provisions consistent with the law.

The Commissioner has long been aware that the argument that there exists a transfer pricing "treaty power" is controversial at best. We consider that the operation of the existing transfer pricing measures is properly a matter for the judiciary, irrespective of any assertions regarding previous Parliament's intentions. Further, we consider that any retrospective legislation will increase investors' concerns about the stability of the Australian business environment.

We recognise that the Government's priority is to develop and introduce the transfer pricing changes already announced by the former Assistant Treasurer. However, the *Consultation Paper - Income Tax: Cross Border Profit Allocation - Review of Transfer Pricing Rules* indicated that, as part of the current review, consideration will be given to introducing a separate entity rule for permanent establishments. We would like to engage with you on this matter at your earliest convenience. To this end, we are in the process of preparing a submission on this matter.

Leaving aside our fundamental opposition to the retrospective aspects of the proposed legislation, we submit that the principles underlying the Exposure Draft should be modified and its structure improved. We have set out our concerns and recommendations in Attachment 1.

If you have any comments or questions about matters contained in our response, please do not hesitate to contact either of the undersigned.

Yours sincerely

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ATTACHMENT 1

Submission

Our primary areas of concern with the Exposure Draft include the following:

1. Staged introduction of the changes to the transfer pricing legislation
2. Pricing of transactions versus profitability considerations
3. Re-characterisation/Reconstruction of transactions
4. Retrospective application of the 2010 OECD Transfer Pricing Guidelines
5. Interaction with the thin capitalisation provisions
6. Process for adjusting taxable income
7. Conflicting bases for transfer pricing adjustments
8. Application of penalties

Each of these areas of concern and related recommendations are discussed below.

1. Staged introduction of the changes to the transfer pricing legislation

Although we understand the reasoning behind the Treasury's staged introduction of the changes to the transfer pricing legislation, this approach creates potential issues. In particular, this approach may impact on the overall effect and operational consistency of the entire legislative rewrite. Further, we anticipate that some of the concerns/issues with the first Exposure Draft will also be relevant for the second Exposure Draft.

Recommendation

No part of the first Exposure Draft should proceed until there has been full consultation and agreement on the second Exposure Draft. This approach will ensure that all of the changes to the transfer pricing legislation are internally consistent and appropriate and that issues associated with the first Exposure Draft may be considered in the initial drafting of the second Exposure Draft before its release.

2. Pricing of transactions versus profitability considerations

As a general principle, it is appropriate to align Australia's transfer pricing rules with international standards. We consider that, in practice, most transfer pricing analysis is performed under the traditional methods or under the Transactional Net Margin Method with occasional recourse to Profit Splits. We anticipate that, in most circumstances, the proposed changes will recognise a process commonly used by the ATO and taxpayers. However, each of these methods commonly used focus on the pricing of a transaction (or a bundle of like transactions).

It could be argued that the Exposure Draft appears to provide a basis for the Commissioner to continue his propensity to determine transfer pricing adjustments based on overall profitability (usually at the net profit level) and what he believes to be commercially realistic behaviour and outcomes, rather than the arm's length price of the transactions. This movement is also reflected in Taxation Rulings TR 2010/7 *Income tax: the interaction of Division 820 of the Income Tax Assessment Act 1997* and TR 2011/1 *Income tax: application of the transfer pricing provisions to business restructuring by multinational enterprises*. In this regard, the Exposure Draft and these Rulings would appear to depart from the approach generally endorsed by the OECD Guidelines for the time period this retrospective legislation will apply. More specifically, we are concerned that the proposed Subdivision 815-A, by reference to "profits" in section 815-20 and the adjustment for a net amount in section 815-30, departs from the principle that transfer pricing should be primarily concerned with the pricing of transaction/s.

Properly interpreted, we consider proposed Subdivision 815-A t does not allow the Commissioner to depart from the arm's length price of transactions (refer to our comments at Attachment 2). However the matter is unclear.

Recommendation

Consistent with the OECD Transfer Pricing Guidelines and for the avoidance of doubt, it should be unambiguous that the proposed Subdivision 815-A is primarily intended to address the pricing of transactions. In particular there should be further clarification that the references in section 815-20 and 815-30 do **not** endorse a departure by the Commissioner from the pricing of transaction/s.

3. Re-characterisation/Reconstruction of transactions

We are concerned with the lack of clarity in connection with the interpretation of conditions that would be expected between independent parties. In particular, we are concerned that the Exposure Draft will fuel the Commissioner's increasing propensity to reconstruct or re-characterise transaction/s when determining the "arm's length price". Such reconstruction or re-characterisation is impermissible under the OECD 2010 Guidelines in all but "exceptional circumstances" and it appears to us that Treasury agrees.

Recommendation

Consistent with the OECD Transfer Pricing Guidelines, the proposed legislation should clearly reflect the circumstances under which the reconstruction principle may be applied. These exceptional circumstances can best be interpreted by reference to the OECD Transfer Pricing Guidelines (paragraph 1.65) and Example 1.4 in paragraph 1.41 in the Explanatory Memorandum. In this regard, the fundamental principle that should be used as the basis for determining the arm's length pricing is that the actual transactions should be recognised unless:

1. the legal form of the transaction does not match the economic substance; or
2. there is no evidence of similar arrangements (as opposed to the transaction) between unrelated parties, **and** the arrangement when viewed in its totality would not reasonable be expected to exist between unrelated parties dealing in a commercially rational manner, **and** the actual structure practically impedes the Commissioner from determining an appropriate transfer price for the transaction.

4. Retrospective application of the 2010 OECD Transfer Pricing Guidelines

Currently, any OECD Guidelines are irrelevant to the application of Division 13 (per the SNF decision). They may have some relevance if a treaty power exists (and we maintain that it does not) but there is no basis to assert that they will be uniformly relevant across all of Australia's treaty partners. Therefore, we consider that the use of **any** of the OECD Guidelines for years prior to the enactment of proposed Subdivision 815-A represents a retrospective application of OECD Guidelines. However, we consider that the retrospective application of the 1995 OECD Transfer Pricing Guidelines (as updated to 1999) is equitable. These Guidelines had been in place for many years and were understood by taxpayers and the Commissioner's views on the practical application of those Guidelines were also understood. Conversely, the OECD 2010 Guidelines were not immediately understood and taxpayers have taken time to come to terms with these Guidelines.

Recommendation

The application of the OECD 2010 Guidelines under Subdivision 815-A should be deferred until, *at the earliest*, an income year commencing after the date of enactment of the legislation, which we expect will be the income year commencing on or after 1 July 2013 (or 1 January 2013 for early balancing companies). Deferring the application of the OECD 2010 Guidelines will assist taxpayers in reviewing their arrangements to ensure that they comply with these Guidelines.

5. Interaction with the thin capitalisation provisions

We support the policy, expressed in proposed section 815-22(4) that the transfer pricing provisions do not apply to re-characterise debt as equity. Further, although we agree there may be exceptional circumstances in which the determination of the arm's length pricing of debt will require having regard to a level of debt that is lower than the actual debt level of the borrower, we have concerns as to how this may be applied by the Commissioner in practice.

Recommendation

There should be further clarification as to what circumstances would require a hypothetical level of debt for purposes of pricing the interest associated with such debt. In this regard, the threshold should ensure that such an approach is only used in truly exceptional circumstances. Limitations similar those suggested above for the re-characterisation of other related party arrangement/s may be appropriate.

6. Process for adjusting taxable income

The process for the adjustment to taxable income is to add a net amount to taxable income. We are concerned that this approach may create difficulties with respect to how such net adjustments are applied to particular transactions. This would appear to involve reverse engineering of the transfer pricing benefit associated with the net adjustment into the specific transactions which underpin the financial performance of a taxpayer. This process creates a number of issues, not the least of which is that such a process could involve a series of transactional based analyses.

Depending on the process involved, the approach may create significant issues in resolving transfer pricing cases through Mutual Agreement Procedures where the transactions are undertaken by a number of different counter parties that are resident in different tax jurisdictions. Further, there may also be issues associated with the consequential adjustments depending on the particular transaction that is adjusted.

Further discussion of the issues associated with the determination of the adjustment to taxable income is set out in Attachment 2.

Recommendation

The Commissioner should describe this process in detail. Further, given the practical difficulties associated with this process the Explanatory Memorandum would benefit from a series of examples which illustrate the application of this principle.

7. Conflicting bases for transfer pricing adjustments

If proposed Division 815 is enacted in its current form it appears that there are potentially three separate bases under which the Commissioner might make a transfer pricing adjustment for income years up to 30 June 2012 (or a later date), namely:

- Division 13 of the of the ITAA 1936 (with an unlimited time period to adjust);
- Subdivision 815-A of the ITAA 1997 (with retrospective effect from 1 July 2004); and
- the treaty power asserted by the Commissioner (we reiterate our view that such power does not exist).

The purpose of the proposal to retrospectively amend the transfer pricing legislation is to "clarify" the existing policy by unambiguously providing to the Commissioner the power to make a transfer pricing adjustment under the treaty.

However, even if a treaty power exists, it is arguable that such power is limited to allow the Commissioner to make adjustments in excess of an adjustment under proposed Subdivision 815. In this regard, given that the adjustment under proposed subdivision 815-A will be based on OECD Guidelines the scope for any further adjustment should only arise in exceptional cases.

Recommendation

Given that the proposed retrospective legislation is intended to be the supposed basis for the treaty taxing power, there is no reason that the Commissioner should have any scope to assert a residual treaty taxing power to make transfer pricing Determinations for income years for which proposed Subdivision 815-A covers. This should be unambiguously stated in the Explanatory Memorandum, or preferably in Subdivision 815-A.

8. Application of Penalties

As discussed above, we are strongly opposed to the introduction of retrospective legislation particularly in the currently situation where such legislation is inherently unfair to taxpayers. To introduce some degree of fairness, the issue of penalties arising from any transfer pricing adjustments from such retrospective legislation should be addressed.

Recommendation

The retrospective application of proposed Subdivision 815-A should not give rise to penalties under Division 284 of the *Taxation Administration Act 1953*) or to a shortfall interest charge ("SIC") under Division 280 of that Act.

We further submit that, if Treasury is not inclined to accept our position regarding the SIC, we submit that the SIC should not exceed the "base interest rate".

- End -

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ATTACHMENT 2

Process for adjusting taxable income

We consider that the adjustment to taxable income under section 815-30 is merely the **mechanism** to ensure that the adjustments to the pricing of transactions are reflected in the assessment of the taxpayer.

The mechanism is novel. There is no adjustment to assessable income and allowable deductions outside of proposed section 815-30. This is confirmed at paragraph 1.52 of the Explanatory Memorandum. This approach is novel and is inconsistent with other provisions of the Tax Acts, which focus on assessable income and allowable deductions.[1] We are concerned that there has been insufficient time to examine the impact of this novel process. If there is a reason why this approach has been preferred over the more straightforward approach, we submit that this should be explained in the Explanatory Memorandum.

However, we consider that the **process** for arriving at amount of the adjustment to taxable income is more important than this novel mechanism by which the adjustment is made. We consider that this process is the means by which the transfer pricing rules are applied by reference to the **pricing of a transaction**, which is in accordance with the OECD principles.

The process for calculating the adjustment to taxable income

As we understand the process involves the following steps.[2]

- Step one: Calculate the taxpayer's existing taxable income.
- Step two: Calculate a taxable income on the assumption that (put broadly) the parties were at arm's length.
- Step three: Measure the excess of result of Step two over the result of Step one, which is the transfer pricing benefit.
- Step four: To the extent that the Commissioner exercises the discretion to increase taxable income, add the amount to the taxable income.
- Step five: At the Commissioner's discretion, the adjustment is taken to be attributable to certain provisions of the Act.

It therefore appears that there are (at least) three calculations of taxable income.[3]

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[1] **Section 815-30 has similarities with the structure of Part IVA of the ITAA 1936 which is, arguably, also an assessing provision for tax benefits that relate to assessable income. However, the essential difference is an adjustment under s 177F is not based on a net amount, since the Commissioner has the discretion to cancel the *particular* tax benefit in question, not the net of all tax benefits.**

[2] The administrative processes for issuing notices of the determinations etc have not been reflected here.

[3] There may be more calculations of hypothetical taxable income depending on how many determinations are considered. For example, in an Article 9 case, the Commissioner may choose to examine the pricing for transactions with associates a number of jurisdictions.

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The first calculation is the amount of the taxable income before the application of Division 815. Because draft Subdivision 815-A deals only with a Commissioner's discretion and this would usually be exercised after a tax return has been lodged, as a matter of practice this first calculation would be the taxable income as already assessed.

The second calculation is a hypothetical amount. It is the amount that might be the taxable income if transactions were at arm's length. This second calculation necessarily requires consideration of which transactions were impacted by the application of the arm's length principle and the application of the Act to that changed pricing. These changes to pricing of transactions are then used to re-calculate assessable income and allowable deductions. This part of the process has some similarities with the process under Division 13, in that it prices transactions and the Commissioner has no discretion to determine which provisions of the Tax Acts operate to make hypothetical calculation of taxable income. However, the deeming of an arm's length consideration in respect of a transaction under Division 13 and the consequent adjustment to taxable income based upon these assumed facts is a *result* of the exercise of the Commissioner's discretion. Under proposed Subdivision 815-A, the deeming of an arm's length consideration under Division 13 is a *precondition* to the application of the Commissioner's discretion to adjust taxable income.

It is only when the amounts of the assessable income (including the notional assessable income arising from the re-pricing of the transactions) and the allowable deductions are known can it be determined whether there a transfer pricing benefit and the amount of that benefit. If there is a transfer pricing benefit and the Commissioner makes a determination under proposed section 815-30(1), there is a third, and final, calculation of taxable income.

The discretion to attribute the adjustment

Because of the novel mechanism for adjusting taxable income, we consider it imperative that the net adjustment can be bifurcated into its component parts. However, the proposed Commissioner's discretion under proposed section 815-30(2) is insufficient.

In particular, the Commissioner is not obliged to issue a determination under proposed section 815-30(2)[4] and the taxpayer cannot demand a determination. In addition, while we do not consider that the Commissioner can issue a determination arbitrarily, there are no express matters to which he must have regard in making the determination. We consider that a taxpayer is entitled to have full particulars of how the transfer pricing benefit was established. We therefore submit that:

- The Commissioner must make a determination under proposed section 815-30(2). Alternatively, a determination under proposed section 815-30(2) might be discretionary. However, the discretion must be exercised if the taxpayer so requests; and

- In making a determination under proposed section 815-30(2) the Commissioner must set out the basis for the calculation of the transfer pricing benefit.

[4] We have proceeded on the basis that this is what is intended, since it is in accordance with paragraph 1.56 of the Explanatory Memorandum. Arguably, as phrased, the transfer pricing benefit must be attributable to provisions of the Tax Acts. The discretion relates only to which provision. We suggest that it is possible to rephrase the provision to put the matter beyond doubt.