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30 November 2011

Mr Neil Motteram
International Tax and Treaties Division
The Treasury
Langton Crescent
PARKES ACT 2600

Response to Treasury Consultation Paper of 1 November 2011
Income tax: cross border profit allocation and review of transfer pricing rules

Dear Neil,

We provide comments on the abovementioned Treasury Consultation Paper issued pursuant to the media release by Assistant Treasurer Mr Bill Shorten on 1 November (ATMR). This is in two parts.

1. The discussion paper

The attached Appendix A is focused on the discussion paper. As agreed in discussions with Ms Kirsten Baker and Ms Lisa Clifton, our comments are focussed at a high level on key principles to address the framework issues nominated by Treasury as its primary concern.

As also discussed, our comments do not address the Permanent establishment - attribution issues in the Consultation Paper, which we understand are to be considered by Treasury at a later time. We will provide a further submission to address those issues.

Our comments are provided in the spirit of mutual and transparent cooperation to ensure that Australia's domestic transfer pricing rules operate effectively and its treaty rules align with international standards and global best practice. We have discussed the paper with our UK colleagues, given that many aspects of the proposals have drawn on the UK experience in the late 1990's. Their insights are reflected in our comments.

We look forward to further consultation when the exposure draft legislation has been prepared, with ongoing dialogue and debate on the issues.

2. Retrospective application of the position that double tax agreements create taxing power

Appendix B and its attachments highlight our concerns regarding the retrospective nature of the proposal to "clarify" that the Associated Enterprises Articles or Business Profits Articles under double tax agreements provide a separate head of taxing power for income years commencing on or after 1 July 2004. This "clarification" does not, in our view, align with the generally accepted view of the operation of the relevant Articles.

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We do not share the view that the Australian Parliament has indicated that the law should work in this way, including most recently in 2003 (as was advised to the Assistant Treasurer and was included in his media release on 1 November 2011).

In our view that analysis raises significant issues about the date of effect of any such measure and in particular whether it is appropriate for it to have retrospective effect for all taxpayers.

The contentious and retrospective nature of this proposal will escalate investors' concern about the stability and sovereign risk issues inherent in the Australian tax system.

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

Yours sincerely

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cc, Mr Glen McCrea, Office of Assistant Treasurer Mr Bill Shorten

Appendix A

1. Policy Objectives and Design

At the broad level, we welcome many of the policy and design features of the proposed new legislation and see them as a positive contribution to providing greater certainty and clarity to taxpayers with transfer pricing issues. In some respects, the proposed legislation will codify existing practice and 'lore' (for both taxpayers and the Commissioner).

We agree in principle with the Policy Objectives at paragraphs 25-27 of the consultation paper - namely that tax should be based on transactions priced by reference to the arm's length principle and regard should be had the economic contribution made in Australia, and the rules should be aligned with international standards for application of the arm's length principle.

In our view, the Policy Objectives mentioned in paragraph 26 concerning the facilitation of international trade and direct investment are highly important. However, it is wrong to assume that the explicit alignment of redesigned legislation will, in of itself, achieve this. The OECD publish guidelines only, and the interpretation and implementation of the OECD Guidelines can vary considerably between OECD members. The Guidelines represent a consensus view of the OECD and as such the level of specificity on particular issues and transactions is low. Accordingly, in our view, any legislative action must consider the impact on the promotion of trade, which relies on appropriate levels of certainty and efficiency.

In our comments below, we have noted the specific areas of concern that we have in relation to the proposed legislative changes. These include aspects of retrospectivity and the proposed power to substitute a hypothetical transaction that differs from the economic substance of the actual dealing.

We have concerns that certain proposals may impact on taxpayers who have undertaken their intercompany arrangements in line with the current law. In our view, implementation of some of the proposals may also result in inconsistent policy outcomes (based on whether or not the counterparty to the transaction is located in a tax treaty country). These transitional issues and potential asymmetries remain a concern.

Paragraph 25.1 provides an example of a proposal (i.e. the power to reconstruct transactions) which may adversely impact arrangements otherwise in line with the current law or result in an outcome inconsistent with overall policy. Our concerns are discussed in more detail at section 4 of this paper.

2. General agreement with key elements of proposal

We are in general agreement with key elements contained in the Overview at paragraphs 29 to 32 of the Consultation Paper:

- The arm's length principle will be clearly reflected in the revised rules;
- Relevant OECD Guidance will be applied to the revised laws;
- The new rules will apply on a self assessment basis;

- Revised rules will introduce time limits for amendments
- A number of the features of the existing rules are unlikely to change; and
- Legislative design is expected to be relatively high level, setting out the main principles.

However, there are specific aspects of proposals that cause us concern, either from a policy perspective or for their practical implementation, and these are discussed in the following sections.

3. Reservations for some key elements of proposal

We hold reservations for the following elements of the proposal/s.

3.1 Incorporation of the OECD Guidelines in the operative rules of the law *(paragraphs 40 to 58)*

We agree conceptually with the design feature whereby the 2010 OECD Guidelines will be legislatively incorporated into Australia's domestic law, however, we will reserve our final position until we see how the incorporation will operate in the exposure draft of the legislation.

We consider the approach adopted by the United Kingdom, as discussed at paragraphs 42 and 43 of the Consultation Paper, has general merit but would note the following qualifications:

- the Legislation should not permit any departure from the OECD Guidelines; or
- any departure from the OECD Guidelines should be set out in Public Rulings in order to ensure consistent and transparent treatment by the ATO.

Our main concern is the risk of double taxation arising where Australia departs from OECD guidance and we would be concerned if the Commissioner could effectively 'pick and choose' which aspects of the guidance would apply in certain circumstances.

We also note the proposal for the rules to include examples of approved transfer pricing methods and criteria for selection *(paragraph 58)*. Given that the OECD Guidelines already contain examples of approved transfer pricing methods and criteria for their selection, we question the benefit of including examples and criteria in the legislation itself.

3.2 The concept of a self-executing rules and self-assessment regime *(paragraphs 69 to 70)*

We agree with the introduction of a self-assessment regime for Australia's profit allocation rules but note the following reservations in respect of the proposals:

- Refer to comments in Section 4 for reservations concerning retention of discretionary powers for the Commissioner in *Insufficient information* and *Reconstruction* cases.

- Paragraph 31.5 notes an obligation to substitute an arm's length price or profit only where the non-arm's length price or profit is detrimental to the Australian revenue. It is silent on whether an arm's length price or profit <u>may</u> be substituted where the non-arm's length price or profit is <u>not</u> detrimental to the Australian revenue,

  In our view, the price or profit adjustment mechanism from a policy design perspective should work in both directions, with the aim being that the taxpayer achieves an arm's length price or profit, either for a given year or over a period of time.

Further, the OECD Guidelines support the view that any transfer pricing analysis should be conducted on a multi-year basis, recognising that the outcomes of an enterprise can fluctuate from year to year and over the life of a business cycle. For illustrative purposes, take for example the situation of a taxpayer who achieves the following EBIT/Sales profit outcomes over a five year period:[1]

Year 1	3%
Year 2	7%
Year 3	1%
Year 4	2%
Year 5	4%

Assuming that the taxpayer applies a Transactional Net Margin Method (TNMM) on a whole of entity level and that the benchmarked arm's length outcome for the taxpayer's functions, assets and risks is determined to be 3% EBIT/Sales, the proposed Treasury approach would seem to indicate a pricing adjustment in Years 3 & 4, but not years 2 & 5. The proposed one sided approach could lead to this type of unfair situation or alternatively it might influence taxpayer behaviour in a negative way.

The aim of a self assessment regime, in our view, should be that taxpayers achieve the correct arm's length position with respect to their intercompany dealings.

3.3 Introduction of the *de minimis rule* for low value transactions as part of documentation requirements *(paragraph 91)*

The introduction of a *de minimis rule* for low value transactions is a positive component of the documentation requirements but we note the following comments:

- we understand that there is a proposed $2 million *de minimis* threshold for lodgement of the 2012 International Dealings Schedule, however, we consider that this threshold is insufficient for purposes of the transfer pricing documentation requirements;

[1] The example is for illustration purpose only and based on the assumption that the underlying facts for all years are similar

- we appreciate, however, the desire for consistency and symmetry between the *de minimis rules* for transfer pricing documentation and the new International Dealings Schedule;
- we suggest a possible compromise - while the legislation might require transfer pricing documentation for related party transactions in excess of $2 million, the proposed penalty provisions will only apply in cases where transactions exceed $10 million; and
- we also recommend that the value of any loan balances be excluded in calculating either the $2 million or the $10 million threshold.

3.4 Time limits for the Commissioner to amend an assessment *(paragraphs 99 to 101)*

While the reduction in the time limit for ATO amendments in relation to profit allocation is a positive step, we note the following reservations:

- the proposed 8 year time limit is still excessive given the level of uncertainty that would still remain for taxpayers. We note that the amendment period allowed for the application of Part IVA by the Commissioner is 4 years (except in cases of fraud and evasion) and it is not apparent why transfer pricing issues should be treated differently. In our view, there is no reason why the amendment periods should not be aligned;
- many of our major trading partners (including USA, Canada, New Zealand, France and Germany) have an amendment time limit of 4 years or less for transfer pricing cases;
- the proposed 8 year time limit does not align with the position in Australia's recently negotiated double tax treaties (e.g. Japan and New Zealand) which prescribe a time limit of 7 years from the completion of tax filing requirements (New Zealand) or for initiation of enquiries into the profits of an enterprise (Japan).; and
- in order to align the overall regime for time limits on amendment periods with respect to transfer pricing issues (to the maximum extent possible), we recommend that the proposed legislation should specify the higher of 4 years in the domestic rules or the time limit specified under the treaty.

4. Specific areas of concern

We have concerns with several aspects of the Consultation Paper and these are outlined below.

4.1 Should treaty rules provide separate authority for profit allocation assessments *(paragraphs 113 - 114)*

We do not agree with the alternative view outlined in paragraph 113 that "*... the Associated Enterprises Article or Business Profits Article (as appropriate) can be relied upon to give a separate source of assessment power for a profit allocation adjustment.*"

At Appendix B is a detailed analysis of the reasons why we disagree with that view.

4.1.1 *No consensus on alternative view*

While the matter is of course open to debate, we remain firmly of the view that the legislative amendments often referred to by senior ATO officials as support for the above hypothesis (and presumably also referenced in the Treasury Paper), should only be used where there is a need to give effect to, for example, the Associated Enterprises article of an Australian DTA due to an inconsistency existing within the meaning of subsection 4(2) of the International Agreements Act 1953.

This may occur in a situation where the application of the treaty would give a more favourable outcome than application of Division 13. That is, the treaty provisions would be used as a 'shield' for the taxpayer and not a 'sword' for the Commissioner to subject a taxpayer to tax on an amount that would not otherwise be captured by Division 13.

4.1.2 *Application on a prospective basis*

If the separate source of assessment power is ultimately adopted it should only be applied on a prospective basis, given the current lack of consensus on the matter, the level of uncertainty that a retrospective application would create and the inherent unfairness of such a position.

4.2 Retrospective Aspects *(Assistant Treasurer Media Release No. 145)*

We consider that any legislation proposed to "clarify" that the Associated Enterprises Articles or Business Profits Articles provide a separate head of power for taxation applies to income years commencing on or after 1 July 2004 would amount to significant retrospective legislative change.

4.2.1 *'Clarification' or 'Retrospective'*

The perceived need for a legal clarification is in itself in an indicator of the uncertainty of the hypothesis that treaties confer a separate and unconstrained taxing power. While the Commissioner might argue that this has been his longstanding view in various taxation rulings, the fact is that there will be **new legislation** in place that taxpayers will now need to follow (which they did not before). As such, it appears a self serving argument to assert that the proposed legislative change does not amount to retrospective legislation.

Where a taxpayer has relied upon the legislation as enacted in structuring their transfer pricing arrangements, rather than on an untested interpretation of the law by the Commissioner, any "clarification" of the law extending back to 1 July 2004 represents retrospective legislation with all its inherent unfairness, and the likely negative impact on trade and direct investment.

The proposal by Treasury for amendments to Division 13 to apply only on a prospective basis is in line with proper practice for changes to income tax law. We consider that any legislation providing a separate head of power under the treaty should also apply only on a prospective basis.

We would be concerned if the legislative proposal is based on the ATO 'protecting' its revenue position with respect to current audit cases or audits (involving debt pricing or business restructures) which might commence at a future date, in respect of income years from July 2004.

4.2.2 *Why is the retrospectivity such a concern?*

Retrospectivity is a significant concern because of the negative impact on the sovereign risk associated with trade and investment with Australian enterprises. Retrospectivity is also a concern because of the uncertainty created by the specific legislative changes.

The OECD Guidelines and Commentary reflect the extent of consensus between the OECD members. They are not necessarily binding and are often not prescriptive in their approach. In practice, there is a wide range of approaches taken to fundamental questions and transfer pricing issues by the various OECD members. While the Guidelines are a valuable starting place to promote common approaches, that support international trade and investment, they do not of themselves provide consistency or certainty. In fact, the Guidelines and Commentary themselves note (and indeed accept) the differences that exist between different countries in relation to some important issues.

It is the approach of Governments and Treasuries in applying the OECD Guidelines that determine the relative extent of consistency and certainty. Accordingly, it should not be assumed that the legislative incorporation of the OECD Guidelines will inherently produce consistency and certainty. It is therefore incumbent upon Treasury to propose and enact principles and legislation that will clearly enhance consistency and certainty.

In our view, the retrospective nature of the proposal will potentially raise transitional issues for taxpayers. The recent SNF case highlighted the transactional nature of Division 13 and while it is perhaps highly arguable that treaties may provide a profits based approach to transfer pricing issues, many taxpayers will be faced with the prospect of great uncertainty in respect to income years from 1 July 2004.

Further, taxpayers with non-treaty country transactions may be placed in a different situation than similar taxpayers with identical transactions involving treaty countries.

Take for example, the situation of two taxpayers with identically constructed related party loans - one with the counterparty in a tax treaty country and the other with the counterparty in a non-treaty country. Based on our understanding of how the retrospective application of the separate taxing power principle would work, that is to potentially allow for a reconstruction of the loan arrangements, the taxpayer with the loan with a related party in the tax treaty country would most likely be disadvantaged.

Australia's key trading partners are countries with which Australia has tax treaties. It seems to be a controversial and arbitrary approach to legislate an outcome that most adversely affects those very countries with which we should most seek to support ongoing trade and direct investment. The potential adverse affect of heightened sovereign risk in relation to investment and business in Australia will not quickly dissipate.

Given that retrospectivity is seemingly linked directly to revenue protection and ensuring the ability of the Commissioner to reconstruct transactions, there is a real possibility that this type of asymmetry will exist.

4.3 Power to reconstruct *(paragraphs 80 - 83)*

We are concerned about the proposal to specifically provide the Commissioner with power to reconstruct transactions.

We note that paragraph 30.1 of the Consultation Paper states that:

"Self assessment is generally inconsistent with the retention of wide discretionary powers to determine the arm's length outcome for particular dealings."

However, paragraph 72.2 of the Consultation paper proposes wide discretionary powers in certain situations. In our view, these two statements are not compatible - in fact they seem contradictory.

The paper cites paragraph 1.65 of the 2010 OECD Guidelines as support for the proposal. In our view, the overall intent of the OECD view is to ensure that regard should be had to the economic substance of the underlying transaction. The proposed legislative approach seems to be moving away from that principle, whereby the Commissioner would hypothecate an alternative transaction to the one that actually occurred. In our view, the role of the transfer pricing provisions to seek to price the underlying economic transaction.

We do not question the right for the Commissioner to ascertain whether the pricing of the transaction reflects an arm's length outcome. We do not accept, however, that the Commissioner should have the ability to question whether the transaction would have been undertaken in the first place and then to hypothecate an alternative transaction, even in situations where the transaction is not readily observable between independent parties.

Under accepted transfer pricing practice, the pricing of transactions and taxing of profit outcomes focuses on the economic substance of the dealings as reflected in the actual mix of functions, assets and risks involved. This approach provides a common starting point for the various countries involved to start the process of selecting and applying the most appropriate transfer pricing methodology. This approach provides for the legal form of a transaction to be disregarded where it does not reflect the circumstances that exist - the key point being the <u>actual</u> mix of functions, assets and risks involved.

In our view it would be bad policy to adopt a principle that enabled a transaction or arrangement to be hypothecated that does not reflect the actual mix of functions, assets and risks. In our view it is important that the concept of economic substance is not misinterpreted and misused to include other transactions that could conceivably have been entered into, but that do not reflect the circumstances that actually exist. There is a real risk of this occurring if the Treasury's apparent view on reconstructing transactions is reflected in legislation.

For example, a company may relocate part of its operations from Australia to Singapore and shift assets and personnel to Singapore as part of a business restructure. While we agree the Commissioner should have the right to ascertain any arm's length value issues associated with the relocation (e.g. exit charge, sale of intellectual property, etc), the Commissioner should not have the power to disregard the relocation itself on the basis that he/she is of the view that an arm's length party would not have entered into the arrangement. It is not the Commissioner's role to 'second guess' the business decisions of taxpayers - his/her role is to price the transactions that actually took place.

This could lead to the situation where a taxpayer's commercial arrangements could be physically in place but they might be disregarded for taxation purposes. This would seem to be a highly undesirable outcome, both from a policy and practical perspective. At a minimum, it should be made abundantly clear in the legislation that reconstruction of a transaction should only be allowed in truly exceptional circumstances (per paragraph 1.65 of the 2010 OECD Guidelines). Please also note our comments below at section 4.5, dealing with the need for a transparent process where the Commissioner considers that a reconstruction is required.

We are also concerned that the transfer pricing rules are currently being used, and will be legislated for the future, in a distorted manner to overcome perceived flaws in the policy design of taxation rules. For example, if the concern is that the 3:1 thin capitalisation safe harbour has led to inappropriate and increased levels of related party debt and interest deductions in Australia, the correct policy response would be to review the provisions of Division 820.

4.4 Transitional arrangements needed

The proposed changes to Division 13 may result in adverse consequences for taxpayers undertaking transactions (including through non-treaty countries) because alternative transfer pricing methodologies may result in differing outcomes. For example, where a transactional approach may produce an outcome that differs from that achieved using a profit based method.

In order to remedy any adverse impact on taxpayers from proposals for changes to Division 13 or the proposed application of the treaty articles to their transfer pricing arrangements, we submit that transitional arrangements should form part of any new legislation. Rather than a firm cut-off date (presumably the 1 November 2011 announcement date), we consider that on equity grounds transitional arrangements should apply for any affected transactions.

Transitional arrangements could take one of several forms:

- "grandfather" arrangements for specific transactions that were in place prior to 1 November 2011; or

- allowing a reasonable time (e.g. 12 months) for arrangements that were in place prior to 1 November 2011 to be reviewed and repriced as they expire where a profit based approach results in a different outcome to that achieved from a transactional approach.

4.5 Discretionary powers – need for a transparent approach

Paragraph 72 of the Consultation paper envisages retention of the Commissioner's discretionary powers in cases where there is insufficient information (where there are no comparable dealings or the details of them are held back or otherwise not available to the ATO) or where arrangements are structured in a way that independent parties would not have structured them, or would not have entered the arrangement at all.

While we recognise that the Commissioner should have some discretion in his review of related party arrangements (even in a self assessment environment), we believe that the exercise of such discretion should be only applied as a matter of last resort. The Commissioner should not be able to resort to these powers merely because he/she is unable to identify similar transactions between unrelated parties. As we have indicated above, the Commissioner's role should be to price the transaction/s that actually took place.

We would suggest therefore that there should be a legislative burden of proof on the Commissioner in these types of situations. The legislation should also make it clear that the provisions only be applied in limited circumstances. In cases where the Commissioner intends to exercise his/her discretion, the taxpayer should be informed and given the opportunity to comment and if required, to refer the decision of whether the discretion should be exercised to some form of binding arbitration (or a similar process).

4.6 1995 OECD Guidelines

Even if the proposed retrospective legislation is adopted, it should be made clear that the basis for any analysis and selection and application of methodology should be the 1995 OECD Guidelines (at least up to the date the 2010 Guidelines were released). For example, in the 1995 OECD Guidelines profit approaches were to be used as a 'last resort', and the ATO should follow that paradigm when looking at transactions that occurred prior to the new legislation (or the release of the 2010 Guidelines as a compromise). To do otherwise would be grossly unfair, given that taxpayers structured their transactions and methodologies having regard to the law and OECD guidance that existed at that time.

4.7 Penalties

If the Government proceeds with the proposed retrospective amendment, we submit that consequential amendments should made to ensure that no administrative penalties, including general interest charge, can be imposed where the amended assessment is permissible solely because of the retrospective amendment. If the Commissioner were to impose penalties, the taxpayer should retain the right to appeal against that penalty (or refer a matter to the AAT) without the need to prove that the assessment itself is excessive. The only point at issue would be the application of the Associated Enterprise Article of the DTA as it stood prior to the retrospective amendment. We envisage that the penalty matter would only be judicially considered once. Any other approach would mean that a taxpayer will be exposed to both retrospective tax and retrospective penalties/ interest.

5 Issues not addressed in the consultation paper

There are several features present in other foreign transfer pricing regimes that have not been considered in the consultation paper.

5.1 Secondary adjustment provisions

We agree with the proposal outlined in paragraph 31.6 of the consultation paper that a compensating adjustment mechanism similar to the current section 136AF will also be a feature of any new transfer pricing regime. However, we consider that it would be a lost opportunity not to also consider introduction of a full secondary adjustment regime to complement the overall provisions of a new transfer pricing regime.

5.1.1 OECD consensus on secondary adjustments

The OECD's *Manual on Effective Mutual Agreement Procedures* ('MEMAP") sets out considerations on secondary adjustments at section 4.6 and there is international consensus on conceptual issues around the application of secondary adjustment provisions.

A competent authority agreement for a transfer pricing adjustment will typically include agreed terms for repatriation of funds involved in the primary adjustment.

5.1.2 Consistency for MAP

As a number of Australia's major trading partners include secondary adjustment provisions in their transfer pricing rules, it would lead to greater consistency for MAP outcomes if Australia also adopted secondary adjustment provisions.

5.2 Interaction with other provisions of the income tax law

The consultation paper does not address how the transfer pricing rules will interact with other provisions of the income tax law.

For example:

- the interaction under the Capital Gains Tax provisions, for example, where there are differences in how the disposal of an asset is calculated in a business restructure; and
- the interaction with the Division 974 debt equity rules and Part IVA anti-avoidance rules also need to be considered.

Appendix B

Is the technical basis for Treasury's assertion that treaties provide a separate taxing power correct?

In our view, the answer is no.

ATO View

The ATO has for many years espoused the view that the associated enterprises articles in Australia's tax treaties provide the Commissioner with a separate head of taxing power to that contained in Division 13 of the ITAA 1936. However, the ATO has not issued a taxation ruling to explain the technical basis for that view.

The explanation for the ATO's position has been made in several speeches by senior ATO officials in recent years. The most detailed analysis was given in respective speeches by Michael D'Ascenzo, Commissioner of Taxation on 15 June 2009[2] and by Jim Killaly, Deputy Commissioner, Large Business and International on 9 October 2008.[3]

Briefly stated, the key arguments put forward by the ATO have been as follows:

- the introduction of subsection 170(9B) in 1982 provided for a separate power to amend, using the associated enterprise article;
- the former ss226(2B)-(2F) and ss225 could arguably be seen as support for the view that there is a separate head of power under Australia's treaties;
- the various AAT and Court decisions which have looked at the issue focussed on the International Agreements Act 1953 and did not consider the power to assess in accordance with the provisions of the ITAA, in particular the introduction of the s170 provisions at the time of the introduction of Division 13 in 1982; and
- the ATO has received advice from Counsel (Ron Merkel QC) which supports the view that the treaties as incorporated into the ITAA 1936 provides a separate taxing power. That advice relied heavily on the legislative amendments made to s 170 of the ITAA 1936 at the time of the introduction of Division 13.

Analysis of the ATO View

1982 Introduction of ss170(9B) & (9C)

In our view the legislative introduction of ss 170(9B) and (9C) were technical, rather than substantive amendments. They were introduced to retain the policy to allow the

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[2] In the best interests of Australia, speech by the Commissioner of Taxation Michael D'Ascenzo to the Corporate Tax Association Convention, Melbourne, 15June 2009

[3] Distinguishing between business driven and tax driven restructuring, Jim Killaly, Deputy Commissioner, Large Business and International (Case Leadership), speech given to the Tax Institute of Australia's Victorian State Convention on 9 October 2008

Commissioner an unlimited time period in which to apply the domestic transfer pricing provisions.

Clause 21 of the Explanatory Memorandum to the Income Tax Assessment Amendment Bill (the EM) discussed when these provisions could be used:

> " In their practical effect, proposed sub-sections 170(9B) and (9C) will clarify the powers of the Commissioner to amend an assessment where a provision of a double taxation agreement that deals with profit shifting may be applicable. Sub -section 4(2) of the Income Tax (International Agreements) Act 1953 provides that the provisions of that Act are to have effect notwithstanding anything inconsistent with those provisions contained in the Principal Act. Technically, therefore the provisions of a double tax agreements that deal with profit shifting, either under a "business profits" article (eg Article 5 of the Australia/UK agreement), or an "associated enterprises" article (eg Article 7 of that agreement), may have to be applied instead of Division 13. Where the profit shifting provisions of a double tax agreement are to apply in these circumstances, sub-sections 170(9B) and (9C) confer the same powers of amendment of an assessment as are to be provided in relation to revised Division 13 "

Based on the above, we accept that the Commissioner has been granted a power to amend an assessment under ss 170(9B) and (9C). However, we strongly suggest that it clearly provides a strong basis for the view that an amendment under ss170(9B) was only ever anticipated where there was a need to give effect to, for example, the associated enterprise article of Australia's treaties where there is an inconsistency within the meaning of ss 4(2) of the International Agreements Act 1953.

This may occur in a situation where the application of the treaty would give a more favourable outcome than application of Division 13. That is, the treaty provisions would be used as a 'shield' for the taxpayer and not a 'sword' for the Commissioner to subject a taxpayer to tax on an amount that would not otherwise be captured by Division 13.

2003 Amendment to ss 170(14))

The 2003 amendment highlighted by the Assistant Treasurer in his press release of 1 November 2011, as the basis for the view that the legislation would be retrospectively applied from 1 July 2004, was purely technical and administrative in nature.

The amendment simply updated the definition of a 'relevant provision' in ss 170(14), following the replacement of the 1967 United Kingdom tax treaty with the new United Kingdom tax treaty and the Exchange of Notes.

Of note, Clause 3.6 and 3.7 of the relevant Explanatory Memorandum states:

> "3.6 This amendment replaces the references to the provisions in the existing tax treaty with the United Kingdom with a broad, generic description of the relevant provisions found in Australia's tax treaties. Examples of such provisions in Australia's tax treaties are paragraph 2 of Article 7 (*Business profits*) and paragraph 1 of Article 9 (*Associated enterprises*) of the new tax treaty with the United Kingdom ***[Schedule 1, item 14]***). Substituting this general description will reduce the need to amend the definition of *relevant provision* as a result of future tax treaty changes.
>
> 3.7 As a consequence of the change to a generic description of paragraph (a) of the definition of *relevant provision*, the definition of *United Kingdom agreement* in subsection 170(14) is no longer necessary and will be repealed by this bill."

Summary

The 1982 introduction of ss 170(9B) &(9C) were technical in nature. They were intended to operate only in cases where there was an inconsistency with the meaning of ss4(2) of the International Agreements Act 1953. They were only ever intended to act as a 'shield' for the taxpayer and not a 'sword' for the Commissioner.

The 2003 amendments referred to by the Assistant Treasurer were routine legislative amendments, done to delete specific references to the former UK treaty and replace them with generic references (largely to avoid the need to amend the definition of a relevant provision as a result of future treaty changes).

As such, we disagree strongly with the statement, including the assertion in the Consultation Paper, that the associated enterprises articles of Australia's treaties provide for an unconstrained and unlimited taxing power.

This has been a long held view of our firm and the tax profession

We restate our view that the abovementioned analysis, that the associated enterprises articles of Australia's treaties do **not** provide for an unconstrained and unlimited taxing power, has been expressed extensively in the past.

We attach:

a) a letter from Alf Capito of our firm to Mr Chris Bowen the then Assistant Treasurer, in 2009seeking a statutory clarification that Australia's thin capitalisation safe harbour rules were not, when introduced, intended to be subject to transfer pricing modifications including those arising from double tax treaties; and

b) an article by Paul Korganow and Jean Paul Donga of our firm, entitled "Safe harbour or "rule of thumb" in the peer-reviewed journal "The Tax Specialist" in 2010, which considers inter alia this very issue.

That paper reviews the history of this issue and its coming to prominence only in the period since 2008. The paper quotes from a QC opinion sought by the ATO in 2009 and comments:

> "The ATO view is controversial and at odds with how companies and their tax advisors have interpreted the thin capitalisation and transfer pricing rules since their introduction, an approach that has been known for years by the ATO and has remained unchallenged until recently. Furthermore, there is considerable doubt whether the ATO view is correct at law. If the ATO persists in its view, taxpayers will face increased compliance, potential double taxation and occasionally anomalous outcomes. Pending further clarification of the ATO view, taxpayers are faced with the uncertainty as to what extent they are in jeopardy of retrospective application of the ATO view and what approach they should currently adopt. Should they undertake the costly and complex compliance exercise of undertaking an arm's length debt analysis even when they are operating within the safe harbour or should they adopt the ATO's "rule of thumb" for no better reason than convenience and prudence? "

This is clearly an area that requires further clarification from the ATO. Furthermore, legislative clarification of the issue would put this issue beyond doubt and allow taxpayers to plan their tax and financing affairs with certainty and within the confines of a settled legal framework."

Conclusion

As stated, we disagree strongly with the statement, including the assertion in the Consultation Paper, that the associated enterprises articles of Australia's double tax agreements provide for an unconstrained and unlimited taxing power.

In our view a taxation policy adjustment of this nature should be made with prospective effect and not merely as a claimed 'clarification' of a view which was not expressed in a reasoned manner until recently.