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Dear Kristy

Modernisation of the transfer pricing rules: **Exposure Draft of *Tax Laws Amendments (Cross-Border Transfer Pricing) Bill* 2013**

The Institute of Chartered Accountants Australia (the **Institute**) welcomes the opportunity to comment on the exposure draft legislation of *Tax Laws Amendments (Cross-Border Transfer Pricing) Bill* 2013 (**ED**) and the explanatory material (**EM**) released by the Assistant Treasurer, the Hon David Bradbury MP, on 22 November 2012.

The proposed amendments aim to modernise the transfer pricing rules contained in Australia's domestic law to better align them with the international standards set out by the Organisation for Economic Co-operation and Development (**OECD**). They represent stage two of the government's reforms to domestic transfer pricing laws.

The Institute is the professional body for Chartered Accountants in Australia and members operating throughout the world. Representing more than 70,000 current and future professionals and business leaders, the Institute has a pivotal role in upholding financial integrity in society. Members strive to uphold the profession's commitment to ethics and quality in everything they do, alongside an unwavering dedication to act in the public interest.

The Institute's comments are set out below.

1. Reconstruction of transactions

Our members are concerned that the ED, as it currently stands, appears to provide for a broader application for the reconstruction of transactions than was intended by the Organisation for Economic Co-operation and Development (**OECD**) in the transfer pricing guidelines (**TPGs**). This could lead to:

- an increased risk of double taxation
- increased uncertainty for taxpayers under a self assessment regime.

Whilst our members understand that the policy intent of Subdivision 815-B is to align Australia's domestic transfer pricing (**TP**) rules closely with the OECD TPGs, they are concerned that the drafting of the ED and EM, as it currently stands, goes beyond the scope of the intent of the TPGs. Our members note that the proposed rules require taxpayers to substitute the arm's length conditions for the actual conditions (if the conditions in section 815-120(1)(c) are met) and that the term "conditions" is intended to be interpreted broadly.

In identifying the arm's length conditions, section 815-125(6) does not require this to be limited to the economic substance of what was actually done nor is it limited to by the legal form of what was actually done (section 815-125(8)). Also there is a positive obligation for the taxpayer to disregard the actual transaction in the circumstances set out in section 815-125(7).

Our members consider that these provisions taken together place an excessive and onerous burden on the taxpayer and go beyond the intent of the OECD TPGs. It is important to bear in mind that many parts of the OECD TPGs are directed at tax administrations to help them resolve double tax that can arise under Article 9 of the Model Tax Convention. It is arguable that the references to reconstruction in the OECD TPGs are an example of this, especially the commentary in paragraphs 1.64 and 1.65 of the OECD TPGs.

These paragraphs are clearly directed at tax administrations seeking to review transfer prices and make it clear that the review should be of the "actual transactions undertaken". They do not appear to be drafted with a view to be included in domestic legislation.

Paragraph 1.64 states that only in "exceptional circumstances" should tax administrations disregard the actual transactions or substitute other transactions for them and paragraph 1.65 gives examples of the "exceptional circumstances":

- Controlled transactions can be recharacterised where their economic substance is different to their legal form (eg converting debt into equity);
- Controlled transactions can be reconstructed where independent parties would not have entered into a particular transaction in the way the actual transaction was entered into and the structure impedes the tax administration from determining an appropriate transfer price (see the second circumstance described in paragraph 1.65 of the OECD TPGs).

Our members note there is an absence of the limiting language ("exceptional circumstances") that appears in the OECD TPGs around reconstruction, in the ED. There is real concern at the present time amongst taxpayers and advisors that the ATO will consider that powers to reconstruct actual transactions extend beyond that envisaged in the OECD TPGs. In this respect, we also draw your attention to recent discussions with the ATO’s Transfer Pricing Working Group (**TPWG**). The TPWG is a working group of the ATO’s National Tax Liaison Group (NTLG) International Subgroup and was established in the latter half of 2012 to consider potential administrative and interpretative matters arising in the context of the recently enacted Subdivision 815-A of the *Income Tax Assessment Act 1997* (**ITAA 1997**).

From the very first meeting of this new group, it became evident that there was a difference of understanding between the ATO representatives and external members of the TPWG as to what constituted circumstances under which the reconstruction of a controlled transaction should proceed as distinct from the re-pricing of a controlled transaction having regard to comparable uncontrolled transactions.

Discussions within the TPWG are continuing, however, this illustrates the need for the ED to clearly set out that reconstruction should only proceed in “exceptional circumstances” in light of paragraphs 1.64 and 1.65 of the OECD TPGs. The absence of such a change in the ED could increase the level of uncertainty to taxpayers and ATO auditors as to whether the ATO will seek to reconstruct actual transactions. Such uncertainty has the potential to heighten the risk of double taxation and increase the compliance burden on our members. This uncertainty will make Australia a less desirable location for capital investment.

Where reconstruction is considered necessary in line with the OECD TPGs, our members are of the view that the ability to reconstruct should only be relevant on determination by the Commissioner where the basis for the determination is clearly set out. The current drafting of the ED requires taxpayers to self assess a reconstruction of a transaction which is an overly complex and unnecessary exercise.

2. Section 262A of the *Income Tax Assessment Act 1936* (ITAA 1936)

The ED proposes that Subdivision 815-B and Subdivision 815-C are to be self-assessed. In a self-assessment environment, taxpayers are required by section 262A of the ITAA 1936 to keep records that explain all transactions that are relevant for any purposes of the Act. The record keeping rules in section 262A of the ITAA 1936 apply irrespective of any optional record keeping rules that might be provided in Subdivision 815-D with a view to facilitating taxpayers getting a reasonably arguable position (**RAP**).

Taxpayers and public officers are potentially exposed to administrative penalties under section 288-25 of the *Taxation Administration Act 1953* (**TAA 1953**) and also to criminal penalties for failing to comply with section 262A (see PS LA 2005/2 (Penalty for failure to keep or retain records)). These administrative penalties are separate to and independent of any administrative penalties that might apply under Subdivision 284-B or 284-C of the TAA 1953.

It is not, however, clear what records taxpayers will need to maintain to avoid administrative penalties arising for failing to keep the records required by section 262A of the ITAA 1936.

Further, it is not clear how proposed Subdivision 815-D sits with section 262A of the ITAA 1936.

As such, the ED should provide clearer guidance as to what records taxpayers will need to maintain to avoid administrative penalties arising under section 288-25 of the TAA 1953 for failing to keep the records required by section 262A of the ITAA 1936.

3. Record keeping and penalties

Subdivision 815-D has been drafted on the basis that *all* of the requirements set out in subsections 815-305(2)-(5) must be satisfied to enable a taxpayer to potentially have a RAP and thereby have administrative penalties reduced to 10 per cent (from a minimum of 25 per cent). This approach:

- Is contrary to the ATO’s current administrative approach set out in paragraphs 36 and 39 of TR 98/16 under which taxpayers with transfer pricing documentation rated as being at least medium-to-high quality generally have administrative penalties reduced to *nil* in the event of a transfer pricing adjustment;
- Does not leave any meaningful scope for the ATO to remit penalties under section 298-20 of the TAA 1953 to a rate less than 10 per cent; and

- Does not encourage voluntary compliance.

The Institute submits that the approach adopted in the ED to penalties needs to be revised in order to address these shortcomings.

4. *De minimis* exception for penalties

As noted above, we consider that the proposed penalty structure needs revision as does the exception from penalties.

Treasury's November 2011 Consultation Paper recognised that if a legislative requirement to maintain contemporaneous documentation was introduced, some taxpayers would face increased compliance costs which could outweigh the potential risk faced by the failure to maintain contemporaneous documentation. A *de minimis* rule for taxpayers was recommended "so that documentation would only be required for taxpayers that meet a particular threshold, such as the value of their international dealings, or some other measure. This is in line with current ATO practice, which allows for simplified documentation for taxpayers meeting particular criteria."

The Institute submits that the (*de minimis*) exceptions proposed in section 284-165 of the TAA 1953 do not go anywhere near achieving the correct balance between compliance costs and the potential risk to revenue. This is particularly true for taxpayers in the small and medium enterprise (SME) segment. Our view is that the monetary threshold of the scheme shortfall amount should be at least $5 million to achieve the right balance. (Please also refer to section 9 below for other SME segment comments).

5. Lack of clarity and overlap between 'conditions', 'circumstances' and 'factors'

The ED does not clearly define or differentiate key terms used in the drafting of Subdivision 815-B, in particular key sections 815-115, 815-120 and 815-125, nor has a single consistent meaning for each term on each occasion in which it is used in these provisions been adopted. For example, the term *"conditions'* does not appear to have a consistent meaning on each occasion in which it is used in these provisions. Further, the ED does not sufficiently differentiate between the terms *'conditions'* and *'circumstances'* used in these provisions.

6. Secondary adjustments

Under 815-115(2), the arm's length conditions are deemed to replace the actual conditions where a taxpayer obtains a transfer pricing benefit. The drafting of subsection 815-115(2) is potentially broad enough to also require taxpayers to make secondary adjustments[1] consistent with arm's length conditions.

However, there is nothing in 815-115(2) or elsewhere in the ED that clearly states whether secondary adjustments are required or not required to be made. In this respect, we note that Treasury's Consultation Paper of November 2011 did not discuss the potential inclusion of a secondary adjustment mechanism into Australia's transfer pricing rules. Further, we note that in the ATO's view (prior to the introduction of Subdivision 815-A), Australia's transfer pricing rules do not include a general power to make secondary adjustments (see Appendix 1 of TR 2007/1 at paragraphs 34 and 35).

[1] A secondary adjustment can broadly be described as an adjustment arising from a secondary constructive transaction that can be triggered by a primary transfer pricing adjustment made under Article 7 or 9 of a DTA, or under domestic law anti-transfer pricing measures (paragraph 35 of TR 2007/1).

As such, the ED should clearly state that the scope of s815-115 is limited to the making of primary transfer pricing adjustments and does not extend to the making of secondary adjustments.

7. Permanent establishments (PEs)

Subdivision 815-C states that it applies the internationally accepted arm's length principle in the context of PEs. The Institute considers that it seems inconsistent to advocate a clear move to OECD guidance but to defer or avoid a similar move to accept OECD guidance on profit attribution (ie the 'functionally separate entity approach' rather than the 'relevant business activity approach').

The method of attributing profits to PEs is currently the subject of review by the Board of Taxation. Depending on the Board's findings and the government's response, proposed Subdivision 815-C could change significantly. Given that the Board's report is due at the end of April 2013, the Institute queries whether it might be appropriate to delay finalisation of Subdivision 815-C until after this time.

8. Time limits for amending assessments

A compelling case has not been made as to why the Commissioner should be given an 8-year time limit for amending assessments under sections 815-145(1) and 815-235 rather than applying the normal time limits for amending assessments under section 170 of the ITAA 1936.

In this respect, it is particularly important to note that subsection 170(7) of the ITAA 1936 provides the Commissioner with the ability to obtain additional time in which to complete an examination of a taxpayer's affairs.

On this basis:

- The normal time limits for amending assessments under section 170 of the ITAA 1936 should also apply in transfer pricing cases.
- To ensure consistency with the preceding recommendation, subsection 170(9B) of the ITAA 1936 should also be amended to limit the Commissioner's ability to issue amended assessments in reliance on:
  - Applying the business profits article or the associated enterprises article of a relevant DTA;
  - Division 13; and
  - Subdivision 815-A;

  to the normal time limits for amending assessments under section 170 of the ITAA 1936 after the date of effect of the ED.

9. SME segment concerns

In our view, in a proper balancing of compliance costs against revenue risks, it is essential that some taxpayers are completely carved out of the transfer pricing rules. This is on the basis that below a certain point it is just not cost effective or practical to impose transfer pricing guidelines. The UK has recognised this in its transfer pricing rules which provide that SMEs are exempt from the transfer pricing rules. An SME under this definition is one that has less than 250 employees and either:

- turnover of less than €50m; or
- assets with a balance sheet total of less than €43m.

We note that this approach of completely carving SME taxpayers out of the transfer pricing rules need not however, prevent the ATO from still being able to gather information to address any concerns it has around related party dealings by SMEs.

In any event, the Institute believes that penalties should not be imposed for any adjustment made under Subdivisions 815-B to 815-E on a SME taxpayer that has made reasonable efforts to comply with the legislation.

That is, it would be unfair in our view to impose transfer pricing penalties on any SME taxpayer that has made reasonable efforts to determine an arm’s length price - notwithstanding that they may not have contemporaneous transfer pricing documentation.

For many SME taxpayers, putting together full contemporaneous transfer pricing documentation for every international transaction will simply be cost prohibitive - i.e. regardless of the potential penalties. However, if such taxpayers could prevent penalties by making reasonable efforts to determine an arm’s length price, with a much lower compliance cost than that imposed by full transfer pricing documentation, then they would certainly be motivated to do so.

We note for completeness that the Canadian transfer pricing regime allows for a reduction in penalties where, inter alia, the taxpayer has made reasonable efforts to determine and use arm’s length transfer prices.

10. Customs

The *Customs Act 1901* focuses on transactions whereas the ED looks at overall profitability. Transfer pricing adjustments relating to some imported goods, particularly profit based transfer pricing adjustments, lead to a requirement to seek customs refunds which are administratively very difficult to obtain. Every effort should be made to take positive steps to address this issue in the new legislation.

11. Commencement

It is crucial the new transfer pricing rules are prospective only from, at earliest, income years commencing on or after the date of royal assent of the enacting bill . This is because sufficient time must be allowed for taxpayers (dealing with treaty and also non-treaty parties) to adjust to the new rules. This includes having their systems and documentation requirements in place.

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If you would like to discuss any aspect of our comments, please contact me on 02 9290 5609.

Yours sincerely

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