Law Council
OF AUSTRALIA

Professor (Emeritus) Sally Walker
Secretary-General

17 December 2012

The Manager
International Tax and Integrity Unit
The Treasury
Langton Crescent
PARKES ACT 2600

Via email: transferpricing@treasury.gov.au

Attention: Ms Lisa Clifton and Ms Kristen Baker

Dear Ms Clifton and Ms Baker

Modernisation of Transfer Pricing Rules: Exposure Draft of Tax Laws Amendment (Cross Border Transfer Pricing) Bill 2013 (Stage Two TP Reforms)

The Taxation Committee of the Business Law Section of the Law Council of Australia (the Committee) welcomes the opportunity to provide comments and submissions in relation to the proposed Stage Two Transfer Pricing (TP) Reforms. This follows on from the Committee's submissions in relation to previous consultations, including its letter of 30 November 2011 regarding Treasury's original consultation paper on the TP reforms (Consultation Paper Response) and its submissions to Treasury of 13 April 2012 (Stage One Submission) and the Senate Economics Legislation Committee of 11 July 2012 (Senate Submission) in relation to Subdivision 815-A of the *Income Tax Assessment Act 1997* ('ITA Act 1997') (collectively, the 'previous Committee submissions').

Outline of submission

1. In this submission, the Committee:

   - provides some introductory observations in relation to the proposed Stage Two TP Reforms and the consultation process;

   - comments on the arm's length principle and the manner in which the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines) are used in the proposed reforms;

   - expresses its concerns with respect to the power for the Commissioner of Taxation (the Commissioner) to reconstruct transactions having regard to their economic substance;

GPO Box 1989, Canberra
ACT 2601, DX 5719 Canberra
19 Torrens St Braddon ACT 2612

Telephone **+61 2 6246 3788**
Facsimile +61 2 6248 0639

Law Council of Australia Limited
ABN 85 005 260 622
www.lawcouncil.asn.au

- suggests that fairness would require that the reforms be accompanied by a reversal of the onus of proof where the Commissioner wishes to make an adjustment to the amounts self-assessed by a taxpayer; and

- submits that, given the new, effectively mandatory, documentation requirements, there is a need to introduce a real *de minimis* threshold to mitigate the compliance costs for taxpayers and ensure that such costs are reasonably proportionate to the revenue likely to be raised from the measures. The Committee has also suggested a number of other changes to make the operation of the regime clearer and more consistent with general tax principles.

Introductory comments

2. The Committee observes that the proposed Stage Two TP Reforms are intended to replace Division 13 of the *Income Tax Assessment Act 1936* (ITA Act 1936) and supersede Subdivision 815-A of the ITA Act 1997 as the domestic transfer pricing regime for income years commencing on or after the date of Royal Assent. Accordingly, it is critical that the new regime be considered carefully to ensure that it works effectively so that Australia gets its 'fair share' of tax from the activities of multinationals, but in doing so does not inappropriately deter investment in Australia or impede expansion of Australian businesses offshore.

3. In this regard, the Committee is concerned that, despite the delay in releasing an exposure draft of the Stage Two TP Reforms, only a short period of one month leading into Christmas has been allowed for consultation. This limits the opportunity for reflection on the measures which might better inform their design and avoid the kinds of issues which have arisen in relation to the operation of Division 13.

4. The Committee urges the Treasury to consider releasing a second exposure draft for further consultation as early as possible in 2013 to allow for the introduction of the rules in the Autumn sittings of Parliament.

Arm's length principle and the use of OECD Guidelines

5. As indicated in the previous Committee submissions, the Committee endorses the move to expressly adopt the arm's length principle as the basis for establishing prices for international related party transactions. However, the Committee has the following concerns regarding the manner in which this is done in the proposed Stage Two TP Reforms:

   (a) Proposed Subdivision 815-B focuses on the arm's length conditions of a transaction. This does, of course, reflect the words used in associated enterprises articles of Australia's Double Taxation Agreements (DTAs). However, the broad and potentially ambiguous words are given content through the OECD Guidelines. Importantly, the OECD Guidelines emphasise that the focus remains on pricing the relevant transactions undertaken by the parties (see, for example, paragraph 1.64 of the OECD Guidelines). As indicated in section 4 of the Committee's Stage One Submission, this should be reflected in the explanatory memorandum (the current draft of which mostly avoids any reference to transactions), if not in the legislation itself.

(b) Section 815-130 requires that the provisions be interpreted 'consistently' with the OECD Guidelines. As a general observation, this drafting technique creates some ambiguity about what 'consistently' means, particularly where the terms used in our domestic legislation differ from those used in the OECD Guidelines. If it is simply intended to suggest that the OECD Guidelines are a legitimate aid to construction, then it ought to be reflected in the language of the provision. If it is intended to convey that the OECD Guidelines are effectively incorporated into our legislation, then the Committee has real concerns about the impact on the sovereignty of the Australian Parliament given that the OECD Guidelines are developed by an unelected group of tax administrators from a limited number of (OECD member) countries.

(c) The Committee also has concerns about the powers contained in section 815-130(2)(b), (3) and (4) to select parts of the OECD Guidelines and other materials to use, and other parts to ignore. This could, in an extreme example, be used to discriminate against a certain class of taxpayer, and creates a lacuna as to the interpretation to be applied where the OECD Guidelines include commentary which is ignored.

Reconstruction of transactions

6. The potential for the Commissioner to 'reconstruct' all or part of a transaction seems to be embodied in the references in section 815-125(5) to the 'economic substance' of a transaction. Thus, in the explanatory material to the exposure draft, the following comment is made:

> *'2.87 If it were the case that independent entities would not have dealt with one another in the way that the two entities did, the transfer pricing question can extend to identifying what would have instead been done by entities dealing wholly independently with one another in comparable circumstances, and the arm's length conditions that would have arisen from those dealings. In* ***substituting*** *actual dealings or arrangements, a necessary precondition is that independent entities would not have done what was actually done given the options that are realistically available to them - it is not of itself sufficient to propose that independent entities would have done something else.'* (Emphasis added)

7. The Committee is extremely concerned with an attempt to give the Commissioner power to reconstruct all or part of a transaction. As observed in the OECD Guidelines, any attempt at reconstruction is necessarily an arbitrary exercise which is prone to result in double taxation where the other jurisdiction involved respects the form of the transactions entered into by the parties (at paragraph 1.64).

8. In the Committee's view, the references to 'economic substance' should mean no more than that it is necessary to identify the real transaction entered into by the parties, which may in some cases require an examination of functions, assets and risks beyond the pure contractual terms. However, where the contractual terms reflect the allocation of functions, assets and risks between the parties, there should be no warrant for substituting some other, allegedly more commercially realistic, arrangement.

9. To the extent that these arguments are not accepted, and there will be a power to reconstruct transactions, the Committee considers this should be subject to a determination being made by the Commissioner where 'exceptional circumstances' exist as set out in paragraph 1.64 of the OECD Guidelines, and that the legislation should set out criteria to be considered by the Commissioner in exercising what is otherwise an unbridled and potentially arbitrary power. This will obviate the risk of inadvertently expanding (or contracting) the scope of the power in circumstances where there is no international consensus as to when and, if so, how such a power applies.

Reversal of onus of proof

10. In the previous Committee submissions, the Committee has indicated the need for a reversal of the onus of proof to reflect the shift in the 'information balance' between the Commissioner and taxpayers brought about by the move away from traditional transaction methods to profit methods. By that the Committee means that the Commissioner has access to information on profits across the full taxpayer pool, whereas taxpayers are limited to information from their related parties and what can be gleaned from commercial databases.

11. This issue is even more critical in the self-assessment environment contemplated by the proposed Stage Two TP Reforms than it was in relation to Subdivision 815-A. The Committee considers that, provided a taxpayer has documentation to reasonably support its chosen methodology, the onus should shift to the Commissioner to prove that the methodology is not, in fact, the most appropriate method (see also paragraph 37 of the Committee's Consultation Paper Response). This aligns with the comments in the OECD Guidelines (at paragraph 2.11) that it should not be necessary for taxpayers to apply multiple methods, which would otherwise create a significant burden for taxpayers.

12. Further, in the event the Commissioner makes adjustments, it should be incumbent on him to identify the specific items of income or deductions which are the subject of adjustment, as is the case in section 815-30(2).

13. In the alternative, as indicated in section 3 of our Stage One Submission, an alternative to reversing the onus of proof would be to remove the presumption in appeals under Part IVC of the *Taxation Administration Act 1953* (TAA) to the Administrative Appeals Tribunal or the Federal Court in respect of Division 815 that the Commissioner of Taxation's decision is correct.

Documentation obligations

14. The Committee agrees with the approach of incorporating base documentation requirements into the legislation (proposed ss.815-305 and 815-310) and tying these to the level of penalties. However, the Committee has a number of concerns with the manner in which this is currently proposed to occur, as follows:

    De minimis exception

15. The only exception to penalties, and hence to the documentation requirements, is where the relevant adjustment is less than (the higher of) $10,000 or 1% of tax payable (proposed s.284-165(1) of the TAA). This will effectively make the documentation mandatory (notwithstanding the suggestions to the contrary at paragraph 1.24 of the explanatory material to the exposure draft), even where the cost of maintaining documentation is disproportionate to the likely revenue to be raised.

16. The Committee believes that there should be a more sensible *de minimis* exclusion that is tied to the value or significance of the dealing in the context of the taxpayer's business.

Transitional relief

17. The Committee notes that, for those taxpayers with extensive intercompany dealings, it will be a significant task to review and update their existing documentation and, where necessary, create new documentation to ensure compliance with the requirements in proposed Subdivision 815-D. Accordingly, the Committee recommends that a transitional provision be included in the proposed provisions enabling an entity to have up to six months after the date on which the relevant entity lodges its income tax return for the income year first occurring after the commencement of Subdivision 815-B, to prepare the records in accordance with proposed Subdivision 815-D.

Reasonably arguable position

18. The Committee also has concerns that the effect of proposed sections 815-305(1) and 815-310(1) is that the absence of a Reasonable Arguable Position (RAP) hinges conclusively on the non-fulfilment of the base documentation requirements. The assessment of whether a RAP exists is an objective one.[1] Accordingly, while the Committee has no objection to the level of penalties being higher if appropriate documentation is not in place, this should not be by way of deeming there to be no RAP.

19. In this regard, the Committee considers it more appropriate to tie the documentation to the question of whether reasonable care has been taken or, alternatively, the remission of penalties, rather than whether or not a RAP exists. Further, guidance should be provided as to:

    a. the impact of immaterial errors or omissions in the relevant documentation on the application of the penalty; and

    b. the interaction of the relevant provision with the Commissioner's guidelines on remission in Taxation Ruling TR 98/16.

Privilege/Accountants' Concession

20. The Committee is concerned that the documentation requirements may implicitly incorporate a requirement to provide the documentation to the Commissioner and result in the abrogation or waiver of client legal privilege or the accountants'

[1] Refer, for example, to *Walstern v Commissioner of Taxation* (2003) 138 FCR 1.

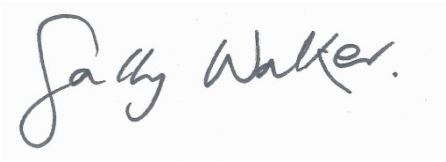
concession. It is reasonable to expect that, under the documentation obligations, records kept by taxpayers will include discussion of alternate methodologies to the approach taken. If it is the case that taxpayers will waive privilege (or any entitlement to the concession) upon the submission of documentation, the proposed documentation and disclosure requirements, which are mandatory in substance, will invariably put taxpayers at a significant disadvantage in tax disputes. Further, this may also lead to advisers providing less comprehensive written advice than is otherwise desirable.

21. Under paragraphs 9.10 to 9.14 of Taxation Ruling TR 98/11, the current requirement for documentation does not abrogate or override privilege or the concession. This should also be reflected in the explanatory material for the proposed legislation.
22. Further, while the failure to hand over the documentation to the Commissioner where privilege or the concession applies might lead to him imposing the higher rate of penalty, the Committee considers that a Court or the Tribunal should still have the ability to subsequently determine that appropriate documentation was in place to justify the lower rate of penalty**.**

The Committee trusts these comments are of assistance. Please do not hesitate to contact Teresa Dyson, the Committee Chair, on (07) 3259 7369 or Reynah Tang, the Committee's representative in relation to the Treasury consultation meetings, on (03) 9672 3535 should you require any further information.

This submission has been lodged by the authority delegated by Directors to the Secretary General, but does not necessarily reflect the personal views of each Director of the Law Council of Australia.

Yours sincerely



Professor Sally Walker
Secretary-General