Law Council
OF AUSTRALIA

30 November 2011

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

Via email: transferpricing@treasury.gov.au

Attention: Mr Neil Motteram

Dear Mr Motteram,

WITHOUT PREJUDICE

Consultation Paper - Income Tax Cross Border Profit Allocation - Review of transfer Pricing Rules

Thank you for the opportunity to provide comments, observations and submissions in relation to the Treasury Consultation Paper - *Review of Transfer Pricing Rules***.** The Taxation Committee of the Business Law Section of the Law Council of Australia ('the Committee') considers the policy and legislative considerations in this area are both important and complex and that equity and fairness considerations are difficult to achieve given the diverse range of taxpayers and cross border transactions and the difficulty in obtaining information for taxpayers and the ATO alike.

The Committee's key submissions are set out below. The Committee would welcome the opportunity to discuss these submissions with you further if that would be of assistance.

Executive Summary

1. The Committee considers that any legislative amendments should have prospective and not retrospective operation.

2. The Committee does not support the provision of an independent taxing power contained in double tax agreements (DTAs).

3. The Committee supports the use of the arm's length principle as the appropriate method for establishing prices for international related party transactions. The Committee submits that this should be by way of legislative amendment to Division 13 and should reinforce the

internationally-accepted (and OECD) position that an arm's length price is used for international related party *transactions* and not merely as a means of allocating global group profits between parties.

4. The Committee does not support the mandatory application of the OECD guidelines. While it is accepted that, in matters of transfer pricing, international consistency is generally desirable, the Committee has a number of concerns with the proposal.

5. There should be no discretion to apply a transfer pricing methodology in a way that allows the ATO to reconstruct transactions or to tax an enterprise on profits that it does not earn merely on the basis that the group overall is in a profitable position where this does not otherwise reflect the adoption of an arms length pricing for transactions which have occurred between those parties. The operative rule should continue to refer to *transactions* between international related parties having an arm's length price. The OECD Guidelines support this submission. To the extent the ATO has concerns that multinational enterprises may enter into transactions that are uncommercial and tax driven, the Committee considers the proper approach is to apply Part IVA where the relevant purpose exists, rather than adopt a strained approach to transfer pricing.

6. The Committee considers that a reverse onus of proof in transfer pricing adjustments should apply and that the question of the appropriate burden of proof should be investigated by Treasury as part of the transfer pricing review.

Retrospective Laws

7. The Committee considers that any legislative amendments should have prospective and not retrospective operation. The Committee considers that retrospective laws:

    (a) are contrary to the rule of law, destroy certainty of law and undermine the international confidence in our legal systems;

    (b) create adverse perceptions of sovereign risk in relation to Australian taxation laws generally;

    (c) are quite simply 'bad for business'.

8. The Committee is very concerned with the statements from the Assistant Treasurer that aspects of the proposed changes that may be implemented following the Review of Transfer Prising Rules will be made retrospective, to income years commencing on or after 1 July 2004. In short the Committee sees no justification for making any of the proposed rule changes retrospective.

9. The reference to, and justification for, the retrospective operation of part of the proposed amendments are stated as follows in the Assistant Treasurer's Press Release dated 1 November 2011:

Mr Shorten indicated the Government will also address a related area of potential uncertainty: whether tax treaties provide a power to make transfer pricing adjustments independently of the transfer pricing rules in the Income Tax Assessment Act 1936.

"I'm therefore introducing amendments to the law to clarify that transfer pricing rules in our tax treaties operate as an alternative to the rules currently in the domestic law."

The Parliament has indicated the law should operate in this way on a number of occasions, most recently in 2003. Therefore, the clarifications will apply to income years commencing on or after 1 July 2004 in treaty cases.

"While there is a strong argument that tax treaty rules already operate independently of the domestic rules, the Government has decided to put this beyond doubt to promote consistency between Australia's rules and the international approach."

These amendments will also clarify that the treaty rules are to be applied in a manner that promotes consistency with the OECD Guidelines.

10. The suggestion from the Press Release is that the changes that will allow the tax treaty rules to operate as an alternative to the domestic law are made to "clarify" the existing position. It is then stated that there are "*strong arguments that tax treaty rules operate independently of the domestic rules*". The suggestion appears to be that the proposed change is a clarification of an accepted position rather than a change of law operating retrospectively.

11. The Committee disagrees that there is any certainty regarding the position that a double tax treaty has the power to make transfer pricing adjustment independently of the domestic transfer pricing provisions. Indeed, there are various examples of recent case law that take a contrary view. For example:

    (a) A number of decisions have stated the position that double tax treaties operate to allocate taxing rights, rather than giving a contracting state the power to tax. That is, the power to tax itself is predicated on the existence of domestic taxation legislation. In *Undershaft (No 1) Limited v Commissioner of Taxation* [2009] FCA 41, Lindgren J summarised the purpose of a double tax treaty as follows (at para 45 to 46):

        A purpose of a DTA is to avoid the potential for the imposition of tax by both of the Contracting States on the same income. It is appropriate to say that the Contracting States achieve their objective by "allocating" as between themselves the right to bring to tax a particular item to one Contracting State while the other State agrees to abstain from doing so (Lamesa at 600, Chong v Commissioner of Taxation (2000) 101 FCR 134 at [24]-[27]).

A DTA does not give a Contracting State power to tax, or oblige it to tax an amount over which it is allocated the right to tax by the DTA. Rather, a DTA avoids the potential for double taxation by restricting one Contracting State's taxing power.

(b) In Undershaft, Lindgren J referred to the decision in Chong v Commissioner of Taxation [2000] FCA 635. In that decision, Goldberg J stated (at para 26):

As a matter of principle it is appropriate to describe the purpose and effect of a double tax agreement, where there are two existing tax systems in two contracting states, as one where areas of taxation are allocated between the two contracting states. <u>The allocation of taxing power in a double tax agreement is predicated on the existence of a sovereign right by a contracting state to impose taxation and the existence of taxation legislation</u>. When one refers to an allocation of taxing power one is doing no more than saying that in an area where both contracting states have the right to impose taxation, and may have already imposed taxation, they have agreed that one contracting state, rather than the other or, as the case may be, both contracting states, shall have the right to impose taxation in that area. Whether one uses the language of allocation of power or the language of limitation of power, the result is the same; there is designated or agreed who shall have the right under the agreement to impose taxation in the particular area" (emphasis added)

(c) Interestingly, in *Chong*, the Commissioner took the position that a double tax treaty imposes conditions on the power of a contracting state to tax, rather than allocating taxing jurisdiction to a contracting state.

(d) In GE Capital Finance Pty Ltd v Commissioner of Taxation [2007] FCA 558 Middleton J stated:

36. It is important to recall that s 3(11) was introduced to amend the Agreements Act and to impact upon the operation of the USA Double Tax Treaty. The Agreements Act and the USA Double Tax Treaty, and in particular Art 7, establish the scope within which the Australian legislature may impose tax. Article 7 provides that in certain circumstances the Contracting State may tax the business profits (which is permissive), but only so much of the business profits as is attributable to the permanent establishment (which involves a prohibition or limitation). Section 3(11) is similarly directed to the ability to impose a tax or the allocation of the power to tax. It is a provision which is to be read and used "for the purpose of determining whether the beneficiary's share of the income may be taxed in Australia".

(d) In *Roche Products Pty Ltd v Commissioner of Taxation*, 2008 ATC 10-036, Justice Downes (President AAT) at paragraph 191 stated:

" In the result I do not need to decide the issue although I note that there is a lot to be said for the proposition that the treaties, even as enacted as part of the law of Australia, do not go past authorising legislation and do not confer power on the Commissioner to assess. They allocate taxing power between the treaty parties rather than conferring any power to assess on the assessing body. On this basis Division 13 should be seen as the relevant legislative enactment pursuant to the power allocated."

12. The Committee therefore considers that since 1 July 2004 (the proposed date for application of the measures as referred to in the Assistant Treasurer's Press Release), taxpayers could legitimately have adopted a contrary view of the operation of the law, namely that the tax treaty rules do not operate independently of, and do not provide a separate taxing power from the domestic law. The Committee therefore regards the proposed amendments as implementing a significant *change* to the existing law, rather than merely clarifying the operation of the existing law. It is unclear what justification there is, if any, for this change being made retrospective to 1 July 2004.

13. The Press Release states that "*Parliament has indicated that the law should operate in this way on a number of occasions, most recently in 2003*." The Committee has been unable to locate a specific reference to Parliament indicating that the law should operate this way. Ordinarily, it would be expected that Parliament's position on an important matter of tax law would be expressed clearly in the form of amending legislation. No such amending legislation has been passed by Parliament.

Independent Taxing Power under Article 9

14. The Committee does not support the provision of an independent taxing power contained in double tax agreements (DTAs) for the following reasons:

    (a) The stated objectives of the DTAs are the avoidance of double taxation and the prevention of fiscal evasion. Prevention of double-taxation is based on the allocation of taxing rights, rather than the expansion of tax jurisdictions. DTAs deal with dual residency and dual sources by defining and allocating residence to one of the competing states, and by defining and prescribing source rules applicable to various income categories. Conflicts between source and residency jurisdictions are addressed by DTAs by classification and assignment of income conferring full or partial taxing rights on one or another of the competing states. The respective taxing rights of each state are delineated with respect to each income category. The residence state prevents double taxation by either exempting income allocated to the source state or by crediting source state taxes against its own taxes. The source state, in turn, lowers its tax rates where source jurisdiction is retained, essentially in relation to dividends, interest and royalties. As to fiscal evasion, no avoidance or evasion purpose is required under the "Associated Enterprises"

articles, and thus this objective is unable to support the creation of independent/positive taxing powers under DTAs;

(b) It does not seem appropriate from a policy viewpoint, for taxpayers with associates in countries with which Australia has a DTA (ie, its major trading partners) to be subject to greater taxation, in certain areas, than taxpayers with associates in non-treaty countries, including tax havens;

(c) A broader issue which requires consideration, is that, if DTAs are to be a source of taxing power, it should be clear what the relevant powers are and what is their scope. For example, will DTAs be considered a source of taxing power generally or only in respect of transfer pricing? Can other amounts can be taxed under a DTA even though the domestic law does not seek to tax those amounts or provides clear exemptions for such amounts. For instance, could it be argued that withholding rates specified in the DTAs are applicable regardless of the rates imposed under the domestic law or regardless of an exemption provided under domestic law (such as the exemption from interest withholding tax provided under section 128F of the *Income Tax Assessment Act, 1936*) (**ITAA 1936**)?

(d) Further, what limitations, if any, will apply to DTA powers? The *International Tax Agreements Act* as currently drafted, overrides the ITAA 1936 and the *Income Tax Assessment Act, 1997* to the extent of inconsistency, rather than the other way around. If the DTA provides positive sources of taxing powers, these would therefore appear to be unconstrained by limitations in the domestic law such as the limits on the Commissioner's powers to amend assessments under section 170. The limitations on the Commissioner's powers, and the general interaction between the domestic law and the treaties would need to be made clearer.

15. The position has been uncertain, as can be seen from the examination of the few judicial observations on this question:

(a) *Re Roche Products Pty Ltd and Federal Commissioner of Taxation* [2008] AATA 639 - Downes J, President of the AAT, at paragraph 191 (quoted above);

(b) *Undershaft (No 1) Ltd v Federal Commissioner of Taxation* (2009) 175 FCR 150 - Lindgren J at paragraph 46 (quoted above);

(c) *SNF (Australia) Pty Ltd v Federal Commissioner of Taxation* (2010) 79 ATR 193 - Middleton J at first instance took a different approach and said at paragraph 23:

"As the stand alone taxing power issue was raised in written submissions, I make the following very brief comment. I do see some force in the argument that by operation of s 170(9B) of the ITAA 1936

and the terms "prescribed provision" and "relevant provision" as defined in s 170(14) of the ITAA 1936, there is a clear legislative intention (at least from the time of the introduction of s 170(9B)) that the Commissioner may in amending an assessment, rely on either s 136AD or the relevant associated enterprises article, as conferring upon the Commissioner, as a separate power, a power to amend an assessment. I say this although there is no provision expressly stating that "the relevant provision" (namely, the associated enterprises article) has been incorporated into the ITAA 1936. However, it seems to me that the express words in the ITAA 1936 necessarily and naturally imply the required incorporation of the relevant associated enterprises article into the ITAA 1936."

The question of whether DTA's confer additional taxing powers does not appear to be addressed in the Appeal judgment.

16. Whilst the Commissioner may have clear views on this question, he has acknowledged that uncertainty continues to surround this question:

(a) ATO Decision Impact Statement - SNF Australia Pty Ltd VID 731 of 2010 noted that:

"This litigation ***did not resolve the question*** *of whether the Associated Enterprises Articles in Australia's Double Tax Treaties give the Commissioner a basis for making transfer pricing adjustments separately from Division 13. The ATO will maintain its long-held view that they do, and will seek to test this point when a suitable case arises." (****Emphasis added****)*

(b) Taxation Ruling TR 2010/7 - Income tax: the interaction of Division 820 of the Income Tax Assessment Act 1997 and the transfer pricing provisions - noted that

39. Provisions of Australia’s tax treaties, notably the Business Profits Article and the Associated Enterprises Article, contemplate adjustments to profits to reflect the outcome that would be achieved if cross-border dealings had been conducted in accordance with the internationally accepted arm’s length principle. Australia’s tax treaties are included as schedules to the *International Tax Agreements Act 1953* (the Agreements Act). All of Australia’s treaties preserve the operation of subsection 136AD(4) of Division 13 provided the subsection is applied consistently with the principles in the relevant treaty article. Depending on the facts and circumstances of the case the relevant treaty article may also apply according to its own terms without the assistance of subsection 136AD(4).

40. The Commissioner has long considered that an adjustment applying the arm’s length principle to the pricing or profit allocation in respect of a taxpayer’s international dealings is authorised on the

basis of Australia's transfer pricing provisions in Division 13 and those related treaty provisions. **This view had been questioned following the Administrative Appeals Tribunal decision *In Re Roche Products Pty Ltd and the Federal Commissioner of Taxation*.**

41. Amendments made at the time of the introduction of Division 13 in 1982[1] appeared to signal an intention on the part of the Parliament that amended assessments could be made to give effect to 'a provision of a double taxation agreement that attributes to a permanent establishment or to an enterprise the profits it might be expected to derive if it were independent and dealing at arm's length' (see subsection 170(9B) of the ITAA 1936 and the definition of 'relevant provision' in subsection 170(14) of the ITAA 1936).

42. The proposition that there is a power to assess in reliance on the Associated Enterprises Articles in Australia's treaties received **favourable comment,** in *obiter*, from the Federal Court (Middleton J) in *SNF (Australia) Pty Ltd v Commissioner of Taxation*. (Emphasis added, footnotes omitted))

Arms Length Principle and OECD Pricing Methods

17. The Committee supports the use of the arm's length principle as the appropriate method for establishing prices for international related party transactions. The Committee submits that this should be by way of legislative amendment to Division 13 and should reinforce the internationally-accepted (and OECD) position that an arm's length price is used for international related party *transactions* and not merely as a means of allocating global group profits between parties.

18. The Committee does not support the mandatory application of the OECD guidelines. While it is accepted that, in matters of transfer pricing, international consistency is generally desirable, the Committee has a number of concerns with the proposal as follows:

(a) it is not the case that each OECD jurisdiction applies the OECD Guidelines in their domestic law and, accordingly, there is no need to do so to achieve cross jurisdictional consistency;

(b) the domestic law applies to transfer pricing involving residents of countries outside the OECD and countries with whom Australia may not have any tax treaty. Adopting the "arm's length" principle" may be justified but the rationale for the mandatory application of the OECD Guidelines falls away in such cases, and

(c) the Committee understands that the OECD Guidelines are developed by a committee of tax administrators from the OECD countries, without any legislative oversight, and which may change from time to

[1] See subsections 170(9B) and 170(9C) of the ITAA 1936 and the now replaced subsections 225(2) and 226(2B) to 226(2F) of the ITAA 1936

time and without certainty as to which interpretations should be applied to any given transaction. This has the potential to usurp the role of Parliament;.

(d) although the Committee agrese that the OECD Guidelines are relevant in transfer pricing disputes between Competent Authorities and accordingly some alignment with domestic rules may be generally desirable, the object and purpose of the Guidelines does not support their mandate for domestic tax purposes, as noted below:

17. These Guidelines are also intended primarily to govern the resolution of transfer pricing cases in mutual agreement proceedings between OECD member countries and, where appropriate, arbitration proceedings. They further provide guidance when a corresponding adjustment request has been made. The Commentary on paragraph 2 of Article 9 of the OECD Model Tax Convention makes clear that the State from which a corresponding adjustment is requested should comply with the request only if that State "considers that the figure of adjusted profits correctly reflects what the profits would have been if the transactions had been at arm's length". This means that in competent authority proceedings the State that has proposed the primary adjustment bears the burden of demonstrating to the other State that the adjustment "is justified both in principle and as regards the amount." Both competent authorities are expected to take a cooperative approach in resolving mutual agreement cases.

19. Accordingly, the Committee's preferred approach would be for the legislation to incorporate so much of the Guidelines as are relevant for domestic purposes and to clarify that the OECD Guidelines per se may only be used as an aid to construction of the relevant provisions, but that every attempt is made to ensure the legislative regime is clear such that use of the OECD Guidelines is effectively a matter of last resort. This approach may of course lead to a need to amend the legislation if and when there are developments in the OECD approach to transfer pricing. The Committee sees this as entirely appropriate as this provides the requisite legislative oversight.

20. If, notwithstanding these views, it is considered appropriate to "mandate" the use of the Guidelines, then the Committee considers that there is still a need to have legislative oversight. This might be achieved by providing that the Commissioner of Taxation can adopt the OECD Guidelines (with or without modification) by a gazetted determination and subject to the usual procedures for disallowable instruments.2

[2] *Legislative Instruments Act 2003*, ie. tabling in Parliament for a period during which a notice of motion to disallow may be given.

21. In summary, while consistency among jurisdictions is desirable, the Guidelines are developed by the tax administrators in the OECD countries and should not be allowed to usurp the role of Parliament. Accordingly, the Committee does not support the OECD Guidelines being mandated.

22. The Committee agrees that further guidance should be introduced to confirm when indirect methods (such as TNMM) can be used, but do not consider that this requires abandonment of a hierarchy that expresses a preference for the direct methods.

    (a) At the outset, the Committee observes that, contrary to the suggestion in the Discussion Paper, the Ralph Review did not specifically recommend that legislation be enacted to require the most appropriate transfer pricing method to be adopted. Rather, it was suggested that this was one of a number of issues in relation to transfer pricing which "could be further developed".

    (b) In any event, the Committee acknowledges that the OECD has moved away from the "hierarchy of methods" approach[3] - and the historical preference for traditional or direct methods – to an approach which treats all methods as being equal and the objective being to determine the most appropriate method in the particular case.[4]

    (c) While the Committee accepts there is a need to clarify the circumstances in which it is appropriate to employ the indirect methods, the Committee does not agree that it is necessary to move away from a hierarchy method. As indicated in *Commissioner of Taxation v SNF*,[5] a great difficulty with profit based methods is that the profit outcomes for any given company may be affected by a multitude of factors, of which the transfer price of goods and services is just one.[6]

    (d) Further, the great advantage of the direct methods is that they are matters which can largely be proved based on evidence of actual transactions, with expert evidence being limited to issues of comparability and applicable adjustments. However, once you move to the indirect methods, it is necessarily the case that there is a higher level of abstraction and a greater reliance on expert evidence and the likelihood of equally valid, but differing, approaches to the exercise. While it is accepted that transfer pricing is different to valuation,[7] the hierarchy approach is consistent with the preference in valuation law for evidence of comparable sales, where available.[8]

23. If, notwithstanding the Committee's submissions above, it is decided to move to a "most appropriate method" approach, then the Committee

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3 OECD Guidelines, 1995, paragraphs 2.49 and 3.49.
4 OECD Guidelines, 2010, Chapter II.
5 [2011] FCAFC 74.
6 Ibid, paragraph 7.
7 Ibid, paragraph 43.
8 See, for example, *Mauricі v Chief Commissioner of State Revenue* (2003) 212 CLR 111, at p.120.

considers it important that the relevant legislation provides clarity in relation to:

(a) the need (or otherwise) to undertake analysis of alternate methods to validate the choice as to the most appropriate method. In the Committee's view, if there is a requirement to do so, then this will add considerably to the costs of compliance which are already likely to rise under the proposed regime; and

(b) whether the "most appropriate method" is to be determined on a subjective or objective basis and, if the latter, what factors a taxpayer (and ultimately a Court) should have regard to in selecting the method in order to provide greater certainty.

24. There should be no discretion to apply a transfer pricing methodology in a way that allows the ATO to tax an enterprise on profits that it does not earn merely on the basis that the group overall is in a profitable position where this does not otherwise reflect the adoption of an arms length pricing for transactions which have occurred between those related parties. For example, the comment at paragraph 33 that an operative rule could be included so that an entity's *taxable income* is determined a manner that is consistent with arm's length principles is not consistent with the arm's length principle. The operative rule should continue to refer to *transactions* between international related parties having an arm's price. The OECD Guidelines support this submission as follows.

> *2.7 In no case should transactional profit methods be used so as to result in over-taxing enterprises mainly because they make profits lower than the average, or in under-taxing enterprises that make higher than average profits. There is no justification under the arm's length principle for imposing additional tax on enterprises that are less successful than average or, conversely, for under-taxing enterprises that are more successful than average, when the reason for their success or lack thereof is attributable to commercial factors.*

25. The associated enterprises articles in Australia's Double Tax Agreements do not support an operative transfer pricing rule based on an allocation of profits. With respect, it is not correct to state that these articles set "an overarching objective of allocating cross border profits" (at paragraph 35). These articles only apply where related parties are not acting at arm's length: i.e. where related parties' "commercial or financial relations differ from those... between independent enterprises." Where related parties are acting at arm's length, the articles do not permit an allocation of profits. For example, the associated enterprises article will not be operative if a related party is in a loss position but its international related party dealings are at arm's length. Given the practical need for different countries to agree on a consistent approach, an allocation of profits rule based on taxable income should never be used as a substitute for arm's length pricing.

26. In the Committee's view, the policy emphasis on *profits* stated in the following paragraphs is the wrong starting point and a potential source of confusion for taxpayers seeking to apply transfer pricing under domestic laws, that is:

[25] Consistent with the arm's length principle, profit allocation rules should ensure that cross border profits attributed to the Australian tax base appropriately reflect the economic activity undertaken here. Broadly, tax should be based on Australia's economic contribution: through functions performed in Australia, the assets used or contributed by Australian entities, and the risks assumed on the Australian side.

[34] 'where ... conditions are made or imposed between two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would but for those conditions have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly'

(a) The ITAA 97 determines taxable income by reference to assessable income and allowable deductions. Aside from including profits arising in relation to certain events, there is no overarching concept of profit.

(b) The International Tax Agreements Act 1953 recognises the same point through section 3(2).

(c) Profit is a legally uncertain principle – see just about any case on the issue in the context of dividends/maintenance of capital in relation to corporate law – although the concept of profit here is different again as it is drawn from economic concepts for transfer pricing purposes informed by that clear and simple proposition – "obtaining [our] legitimate amount of tax" – see [87].

27. Any legislative reform that proposes an allocation of profits based on an entity's taxable income is not consistent with effective, equitable and transparent tax administration. Taxpayers are not in a position to obtain comparable data of other taxpayers' taxable income. Taxpayers are often unable to obtain taxable income data from their own related parties overseas. In a self-assessment environment, operative rules based on achieving a particular taxable income result would be impractical, unnecessary and generate uncertainty.

28. The Committee supports amendments that ensure that transactional profit methods (i.e. the transactional net margin method (TNMM) and profit split) are available provided this is to determine an arm's length price for *transactions*.

2.6 Methods that are based on profits can be accepted only insofar as they are compatible with Article 9 of the OECD Model Tax Convention, especially with regard to comparability. This is achieved by applying the methods in a

manner that approximates arm's length pricing. The application of the arm's length principle is generally based on a comparison of the price, margin or profits from particular controlled transactions with the price, margin or profits from comparable transactions between independent enterprises. In the case of a transactional profit split method, it is based on an approximation of the division of profits that independent enterprises would have expected to realise from engaging in the transaction(s) (see paragraph 2.108).

29. The amendments should not undermine the taxpayer's ability, and obligation, to choose the most appropriate method in the circumstances. In accordance with OECD Guidelines, the taxpayer should be free to use the methodology that is the most appropriate and accordingly the method to be used should not be prescribed.

2.9 Moreover, MNE groups retain the freedom to apply methods not described in these Guidelines (hereafter "other methods") to establish prices provided those prices satisfy the arm's length principle in accordance with these Guidelines. Such other methods should however not be used in substitution for OECD-recognised methods where the latter are more appropriate to the facts and circumstances of the case. In cases where other methods are used, their selection should be supported by an explanation of why OECD-recognised methods were regarded as less appropriate or non-workable in the circumstances of the case and of the reason why the selected other method was regarded as providing a better solution. A taxpayer should maintain and be prepared to provide documentation regarding how its transfer prices were established. For a discussion of documentation, see Chapter V.

2.10 It is not possible to provide specific rules that will cover every case. Tax administrators should hesitate from making minor or marginal adjustments. In general, the parties should attempt to reach a reasonable accommodation keeping in mind the imprecision of the various methods and the preference for higher degrees of comparability and a more direct and closer relationship to the transaction. It should not be the case that useful information, such as might be drawn from uncontrolled transactions that are not identical to the controlled transactions, should be dismissed simply because some rigid standard of comparability is not fully met. Similarly, evidence from enterprises engaged in controlled transactions with associated enterprises may be useful in understanding the transaction under review or as a pointer to further investigation. Further, any method should be permitted where its application is agreeable to the members of the MNE group involved with the transaction or transactions to which the methodology applies and also to the tax administrations in the jurisdictions of all those members.

2.11 The arm's length principle does not require the application of more than one method for a given transaction (or set of transactions that are appropriately aggregated following the standard described at paragraph 3.9), and in fact undue reliance on such an approach could create a significant burden for taxpayers. Thus, these Guidelines do not require

either the tax examiner or taxpayer to perform analyses under more than one method. While in some cases the selection of a method may not be straightforward and more than one method may be initially considered, generally it will be possible to select one method that is apt to provide the best estimation of an arm's length price. However, for difficult cases, where no one approach is conclusive, a flexible approach would allow the evidence of various methods to be used in conjunction. In such cases, an attempt should be made to reach a conclusion consistent with the arm's length principle that is satisfactory from a practical viewpoint to all the parties involved, taking into account the facts and circumstances of the case, the mix of evidence available, and the relative reliability of the various methods under consideration. See paragraphs 3.58-3.59 for a discussion of cases where a range of figures results from the use of more than one method.

30. The information most readily available to the Commissioner is net profit data, often extracted at the earnings before interest and tax (EBIT) level. It is easy for the Commissioner to use this data to establish comparables using the TNMM. However, the process of applying the TNMM, which includes identifying comparable enterprises, is inherently subjective and open to a wide range of outcomes and consequent uncertainty.

31. The legislation should not allow the TNMM to be used where a more appropriate, reliable method such as a comparable uncontrolled price (CUP) is available. This is consistent with the Commissioner's public ruling TR 97/20 and the OECD Guidelines at paragraph 2.2 – 2.3:

*"**The selection of a transfer pricing method always aims at finding the most appropriate method for a particular case**. For this purpose, the selection process should take account of the respective strengths and weaknesses of the OECD recognised methods; the appropriateness of the method considered in view of the nature of the controlled transaction, determined in particular through a functional analysis; the availability of reliable information (in particular on uncontrolled comparables) needed to apply the selected method and/or other methods; and the degree of comparability between controlled and uncontrolled transactions, including the reliability of comparability adjustments that may be needed to eliminate material differences between them. **No one method is suitable in every possible situation***

*"**Traditional transaction methods are regarded as the most direct means of establishing whether conditions in the commercial and financial relations between associated enterprises are arm's length**. This is because any difference in the price of a controlled transaction from the price in a comparable uncontrolled transaction can normally be traced directly to the commercial and financial relations made or imposed between the enterprises, and the arm's length conditions can be established by directly substituting the price in the comparable uncontrolled transaction for the price of the controlled transaction."*

32. The legislation should continue to protect taxpayers such as SNF (Australia) Pty Ltd from the Commissioner amending assessments simply on the basis that an Australian entity has not been profitable in circumstances where those losses are caused by factors other than related party transactions.

33. It is not appropriate, for example, for the Commissioner to conclude, based on the TNMM, that taxpayers importing particular goods should return a net profit of 3% based on their functions, assets and risk profile, and amend assessments to achieve this result. This is consistent with the OECD 2010 Guidelines at paragraph 2.7:

"In no case should transactional profit methods be used so as to result in over-taxing enterprises mainly because they make profits lower than the average, or in under-taxing enterprises that make higher than average profits. There is no justification under the arm's length principle for imposing additional tax on enterprises that are less successful than average or, conversely, for under-taxing enterprises that are more successful than average, when the reason for their success or lack thereof is attributable to commercial factors."

34. Where no better information is available to determine an arm's length price, the TNMM should be available used. However, the amendments should make it clear that where a more appropriate and reliable method is available, this method should be used.

35. However, the Committee support's the inclusion of 'safe harbours' in de minimus circumstances – for example further legislative guidance in relation to the application of the specific methodologies for taxpayers that are small to medium taxpayers and below de-minimus thresholds.

36. The Committee also notes that the OECD Guidelines are primarily relevant in transfer pricing disputes between Competent Authorities and accordingly outline the methodologies that should be accepted for mutual agreement proceedings. This factor should be considered in 'adopting' the Guidelines for domestic purposes.

17. These Guidelines are also intended primarily to govern the resolution of transfer pricing cases in mutual agreement proceedings between OECD member countries and, where appropriate, arbitration proceedings. They further provide guidance when a corresponding adjustment request has been made. The Commentary on paragraph 2 of Article 9 of the OECD Model Tax Convention makes clear that the State from which a corresponding adjustment is requested should comply with the request only if that State "considers that the figure of adjusted profits correctly reflects what the profits would have been if the transactions had been at arm's length". This means that in competent authority proceedings the State that has proposed the primary adjustment bears the burden of demonstrating to the other State that the adjustment "is justified both in principle and as regards the amount." Both competent authorities are expected to take a cooperative approach in resolving mutual agreement cases.

Onus of Proof in Transfer Pricing Disputes

37. The Committee considers that a reverse onus or burden of proof in transfer pricing adjustments should be investigated by Treasury as part of the broader transfer pricing review. The Committee considers that this proposal should (in part) address issues of equity and access to information. The following extracts from the OECD Guidelines provide some basis to reverse the burden of proof in transfer pricing disputes.

> *18. In seeking to achieve the balance between the interests of taxpayers and tax administrators in a way that is fair to all parties, it is necessary to consider all aspects of the system that are relevant in a transfer pricing case. One such aspect is the allocation of the burden of proof.* ***In most jurisdictions, the tax administration bears the burden of proof, which may require the tax administration to make a prima facie showing that the taxpayer's pricing is inconsistent with the arm's length principle.*** *It should be noted, however, that even in such a case a tax administration might still reasonably oblige the taxpayer to produce its records to enable the tax administration to undertake its examination of the controlled transactions.* ***In other jurisdictions the taxpayer may bear the burden of proof in some respects.*** *Some OECD member countries are of the view that Article 9 of the OECD Model Tax Convention establishes burden of proof rules in transfer pricing cases which override any contrary domestic provisions. Other countries, however, consider that Article 9 does not establish burden of proof rules (cf. paragraph 4 of the Commentary on Article 9 of the OECD Model Tax Convention).* ***Regardless of which party bears the burden of proof, an assessment of the fairness of the allocation of the burden of proof would have to be made in view of the other features of the jurisdiction's tax system that have a bearing on the overall administration of transfer pricing rules, including the resolution of disputes. These features include penalties, examination practices, administrative appeals processes, rules regarding payment of interest with respect to tax assessments and refunds, whether proposed tax deficiencies must be paid before protesting an adjustment, the statute of limitations, and the extent to which rules are made known in advance.*** *It would be inappropriate to rely on any of these features, including the burden of proof, to make unfounded assertions about transfer pricing. Some of these issues are discussed further in Chapter IV.*
>
> *4.14 When transfer pricing issues are present, the divergent rules on burden of proof among OECD member countries will present serious problems if the strict legal rights implied by those rules are used as a guide for appropriate behaviour. For example, consider the case where the controlled transaction under examination involves one jurisdiction in which the burden of proof is on the taxpayer and a second jurisdiction in which the burden of proof is on the tax administration. If the burden of proof is guiding behaviour, the tax administration in the first jurisdiction might make an unsubstantiated assertion about the transfer pricing, which the taxpayer might accept, and the tax administration in the second jurisdiction would have the burden of disproving the pricing. It could be that neither the*

taxpayer in the second jurisdiction nor the tax administration in the first jurisdiction would be making efforts to establish an acceptable arm's length price. This type of behaviour would set the stage for significant conflict as well as double taxation.

Attribution of Profits to PEs

38. The Committee submits that the PE attribution rules should similarly follow OECD Guidelines for the reasons noted below:

(a) The issues discussed in the OECD Guidelines also arise in the treatment of permanent establishments. The Committee recommends that Treasury align the arm's length principle as it applies to permanent establishments consistent with OECD Guidelines, including OECD Model Tax Convention, OECD Report on the *Attribution of Profits to Permanent Establishments* and the OECD Report *International Tax Avoidance and Evasion (1987)*. The Committee suggests that a review of existing ATO rulings & practice concerning PE attribution should be undertaken for this purpose.

(b) The OECD Report on the *Attribution of Profits to Permanent Establishments* that was adopted by the OECD Council in July 2008 states at paragraph B-2(12):

12. The authorised OECD approach does not dictate the specifics or mechanics of domestic law, but only sets a limit on the amount of attributable profit that may be taxed in the host country of the PE. ***Accordingly, the profits to be attributed to a PE are the profits that the PE would have earned at arm's length if it were a legally distinct and separate enterprise performing the same or similar functions under the same or similar conditions and dealing wholly independently with the enterprise of which it is a PE****, determined by applying the Guidelines by analogy. This is in line with one of the fundamental rationales behind the PE concept, which is to allow, within certain limits, the taxation of non-resident enterprises in respect of their activities (having regards to assets used and risks assumed) in the source jurisdiction.*

(c) The ATO approach to profit attribution for permanent establishments is set out in TR 2001/11. This approach is not necessarily consistent with OECD arm's length Guidelines.

1.18 The words of Article 7(2) of the OECD Committee on Fiscal Affairs, Model Tax Convention on Income and Capital, OECD, Paris (OECD Model Convention) and Australia's DTAs have been regarded in cases overseas as clear and directive: ***a separate enterprise is to be hypothesised, transactions between it and the head office constructed on the basis of its accounts, and the arms length principle applied to those transactions in calculating the PE's profits, notwithstanding domestic law to the contrary.***

...

1.20 The ATO does not accept that the business profits article in Australia's tax treaties operates on a strict separate entity basis. *Further, there are foreign decisions to the same effect. In Cudd Pressure Control Inc v. The Queen at first instance the judge held that the business profits article of the Canada/US tax treaty did not require that a PE in Canada be treated as having rented equipment from its head office but instead applied the depreciation regime of the domestic law, considering that the treaty could not displace the domestic rules for dealing with the situation which were based on actual expenditure, not notional expenditure. On appeal, the decision was affirmed on the basis of the finding of fact that a PE would not in any event, as a separate enterprise, have leased the equipment. While one judge expressed the view that the business profits article could give rise to deductions for notional expenditure, the other two judges expressly left the issue open. There are also foreign decisions reaching the same conclusion as Max Factor & Co . v . FC of T in relation to exchange control.*

1.21 The Ralph Report recommended a progressive introduction in appropriate circumstances of separate entity treatment in Australia.[F19] *The Ralph Report also notes that some caution needs to be exercised in this direction where there is no consensus within the OECD.*

39. The Committee also notes that the ATO approach in the ruling does not support the view that the DTA is the relevant source of a taxing power but merely a means of resolving disputes between Competent Authorities in relation to double taxation disputes. Accordingly, it appears to be inconsistent with the view taken in relation to Article 9.

1.13 Further, the purpose of the rules about taxation of business profits under tax treaties is different to the purpose of Division 13. ***The tax treaties serve to divide tax revenue from business profits between countries and to relieve double taxation either by conferring exclusive taxing rights on the residence country in the absence of a PE or profits attributable to a PE, or by requiring the residence country to grant double tax relief where the other country has a taxing right. Division 13 by contrast is designed to ensure that Australia obtains its fair share of tax and only leads to primary adjustments to increase Australian tax.***

Self assessment – removing 136AD(4) discretion

40. The Committee supports the proposal to allow taxpayers to self-assess their assessable income and allowable deductions to include arm's length amounts. This does not require the Commissioner to inherit a residual discretionary power to properly administer the law. With respect, neither of

the reasons cited in the consultation paper supports the retention of a residual discretionary power.

(a) If the Commissioner is not satisfied with the taxpayer's supporting information, the Commissioner has the power to amend the taxpayer's assessment and put the taxpayer to proof through Part IVC proceedings.

(b) The Commissioner is entitled to estimate an amount for an amended assessment to be valid, so nothing is gained by giving the Commissioner a separate discretion to determine and substitute an arm's length price. The Committee's view is that this is likely to create unnecessary confusion with respect to the taxpayer's objection and appeal rights.

(c) In addition, if the Commissioner is not satisfied that the legal agreements reflect commercial reality (as expressed in the Treasury paper at 80), then this can be remedied on the basis that the transaction is a sham, or alternatively under Part IVA.

(d) There is no reason why the Commissioner needs a separate discretion for transfer pricing matters. To promote consistent and efficient tax administration, the Committee requests that these residual discretions are removed and administration of the transfer pricing laws is dealt with in the same manner as other income tax reviews, assessments and objections.

(e) There is no need for the Commissioner to retain a specific discretion to deal with "reconstruction" of transfer pricing matters. For example, there is no equivalent discretion in the CGT provisions dealing with transactions between related parties where the Commissioner does not accept a taxpayer's market value.

Legislative Design

41. The Committee understands that the legislative design is expected to be relatively high level, setting out the main principles and that the key features could include the following:

Clear identification of the purpose of the profit allocation rules in an objects clause.	The Committee agrees this would be useful
Incorporation of the OECD arm's length principle in the operative rules of the law.	The Committee considers the OECD arm's length principle should be restated in the domestic law for the reasons noted at paragraph 17.

A rule setting out when material circumstances of non-arm's length cross border dealings are comparable to the circumstances of dealings between independent parties dealing at arm's length. Consideration will be given to expressly referring to the 2010 OECD Guidelines' comparability factors.	The Committee agrees this would be useful.
The inclusion of approved transfer pricing methods, along with criteria for selection of such methods. The 'most appropriate' transfer pricing method for any particular situation would be applied in determining the arm's length outcome. Consistent with the 2010 OECD Guidelines, a combination of these methods could be used where appropriate.	The Committee agrees this would be useful but suggest that some further guidance will be necessary for the reasons noted at paragraph 22 and 35.
The inclusion of rules authorising reconstruction of dealings in specific circumstances consistent with the 2010 OECD Guidelines.	The Committee disagrees where this suggests that the purpose of the methodology is not to obtain an arm's length price for transactions.
An interpretation rule to promote consistency with the arm's length principle, the 2010 OECD Guidelines and Article 9 of our treaties. Note that our treaties and our purely unilateral rules will have a slightly different scope.	The Committee agrees subject to our comments at paragraph 17.

42. The Committee understands that a number of features of the existing rules are unlikely to change, including:

The rules will not depend on the existence of a tax avoidance purpose for their application.	The Committee agrees this is appropriate.
The rules will only apply to international dealings.	The Committee agrees this is appropriate.
The rules will extend to dealings or arrangements which are formal or informal, express or implied, whether or not they are intended to be enforceable.	The Committee agrees provided there is no basis for reconstructing arrangements which do not and did not exist. The Committee considers reverse onus of proof measures should be considered.

The rules will extend to non-arm's length dealings of unrelated parties as well as intra-entity dealings (permanent establishments).	The Committee agrees and note its comments at paragraph 38.
The obligation to substitute an arm's length price or profit for a transaction or series of transactions in place of the actual price or profit will only arise when the non-arm's length price or profit has been detrimental to Australian revenue.	The Committee agrees except where this allows transfer pricing to be used where Australia wants to collect more revenue because of the groups overall global profitability.
Similarly to the current section 136AF, tax relief can be provided by making compensating adjustments to ensure excessive taxation does not arise in relation to economic profit that was the subject of the primary transfer pricing adjustment (ie adjustments currently made under section 136AD). The tax positions of all the relevant taxpayers would be able to be adjusted to reflect the outcomes that would have occurred if the relevant dealings had been conducted on an arm's length basis.	It would be preferable if there was notice of these as part of any taxpayer communications.
Similarly to the rule in current subsection 136AB(1), other provisions will not limit the operation of profit allocation rules.	The Committee disagrees to the extent this conflicts with our comments at paragraph 22.

Record Keeping Requirements

43. The Committee understands the proposal at [84] is to impose an obligation on the taxpayer to:

(a) Maintain contemporaneous transfer pricing documentation.

(b) In Australia.

(c) That evidences the application of the arm's length principle (see [34]).

This would be:

(d) Subject to a *de minimus* rule [91].

(e) Underpinned by penalties for non-compliance [89] and [92] to [98].

44. The Committee has no issues with the proposal in principle, although in relation to d, we consider this will depend on what is understood by *de minimus* – which presumably will be tested by reference to (i) a gross value of affected transactions and (2) a percentage of all transactions.

45. With respect to c, presumably the legislation would be framed so that the taxpayer could make an adjustment purely for tax purposes (allowing it to increase or decrease, as the case may be what would otherwise be its taxable income/loss) and to justify that as an application of the arm's length principle.

46. The burden that is likely to be imposed to evidence the arm's length principle will be significant. The proposal at [91] for the recordkeeping rules to be relatively prescriptive as to what must be recorded is appropriate. The more prescriptive the rules as to what must be recorded to satisfy the requirements in paragraph (c), the greater the likelihood of a taxpayer complying with the recordkeeping rules.

Penalties

47. The Committee understands the need to apply documentation penalties for taxpayers who fail to provide reasonable co-operation but submit that such penalties should recognise the inherent difficulty in supporting an arm's length principle.

> *1.13 Both tax administrations and taxpayers often have difficulty in obtaining adequate information to apply the arm's length principle. Because the arm's length principle usually requires taxpayers and tax administrations to evaluate uncontrolled transactions and the business activities of independent enterprises, and to compare these with the transactions and activities of associated enterprises, it can demand a substantial amount of data. The information that is accessible may be incomplete and difficult to interpret; other information, if it exists, may be difficult to obtain for reasons of its geographical location or that of the parties from whom it may have to be acquired. In addition, it may not be possible to obtain information from independent enterprises because of confidentiality concerns. In other cases information about an independent enterprise which could be relevant may simply not exist, or there may be no comparable independent enterprises, e.g. if that industry has reached a high level of vertical integration. It is important not to lose sight of the objective to find a reasonable estimate of an arm's length outcome based on reliable information. It should also be recalled at this point that transfer pricing is not an exact science but does require the exercise of judgment on the part of both the tax administration and taxpayer.*

48. The need for fairness in the penalty regime is also recognised in OECD Guidelines.

> *4.27 It is generally regarded by OECD member countries that the fairness of the penalty system should be considered by reference to whether the*

penalties are proportionate to the offence. This would mean, for example, that the severity of a penalty would be balanced against the conditions under which it would be imposed, and that the harsher the penalty the more limited the conditions in which it would apply. 4.28 Since penalties are only one of many administrative and procedural aspects of a tax system, it is difficult to conclude whether a particular penalty is fair or not without considering the other aspects of the tax system. Nonetheless, OECD member countries agree that the following conclusions can be drawn regardless of the other aspects of the tax system in place in a particular country. First, ***imposition of a sizable "no-fault" penalty based on the mere existence of an understatement of a certain amount would be unduly harsh when it is attributable to good faith error rather than negligence or an actual intent to avoid tax.*** *Second, it would be* ***unfair to impose sizable penalties on taxpayers that made a reasonable effort in good faith to set the terms of their transactions with associated enterprises in a manner consistent with the arm's length principle.*** *In particular, it would be inappropriate to impose a transfer pricing penalty on a taxpayer for* ***failing to consider data to which it did not have access, or for failure to apply a transfer pricing method that would have required data that was not available to the taxpayer.*** *Tax administrations are encouraged to take these observations into account in the implementation of their penalty provisions.*

49. TR 98/16 Income tax: international transfer pricing – penalty tax guidelines provides the following guidance on penalties in the context of transfer pricing:

    (a) 50% of the tax avoided for transfer pricing arrangements entered into with the sole or dominant purpose of enabling a taxpayer to pay no or less tax; reducing to 25% if the taxpayer has a reasonably arguable position (paragraph 225(1)(d));

    (b) 25% of the tax avoided for other transfer pricing arrangements; reducing to 10% if the taxpayer has a reasonably arguable position (paragraph 225(1)(e)).

    Higher penalty rates under paragraph 225(1)(d) can apply where the ATO is satisfied on reasonable grounds that the transfer pricing adjustment relates to a scheme within the meaning of Part IVA and the scheme was entered into for the sole or dominant purpose of avoiding tax. For schemes without such a sole or dominant purpose, the ATO is not required to establish the taxpayer's purpose or intention as a precondition for the lower penalty rates to apply.

50. The Committee considers the level of penalties under the existing regime is excessive, particularly in view of the high rate of interest also imposed by way of SIC and then GIC and the proposal at [97] to reduce or eliminate penalties for good faith efforts is a sensible approach.

Amendments and time limits

51. In view of the proposal to impose an obligation on the taxpayer to self-assess in relation to transfer pricing, it is unclear why it is necessary to allow the Commissioner any more than the normal 4 year amendment period (subject to the need to continue to allow an unlimited period for consequential adjustments).

52. When the revised record keeping obligation is added to:

    (a) the existing disclosure obligations imposed most notably through Schedule 25A and

    (b) the Commissioner's power to seek an extension of time beyond the 4 years under section 170(7) of the 1936 Act,[9]

    the case for transfer pricing to be subject to the standard limitation period is compelling.

53. It is noted that the Commissioner appears to have never approached the Federal Court under section 170(7). In view of the existing power under section 170(7) and the significant number of DTAs and TIEAs, arguments about hindrance, lack of co-operation and the difficulties associated with information exchange also fall away.

The Committee trusts these comments are of assistance. Please do not hesitate to contact Ms Karen Payne, a member of the Committee on 02 9921 8719 should you require any further information.

Yours sincerely,

Bill Grant
Secretary-General

[9] That section allows for the period to be extended either by consent or by Federal Court order.