Minerals Council of Australia

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RESPONSE TO EXPOSURE DRAFT TAX LAWS AMENDMENT (CROSS-BORDER TRANSFER PRICING) BILL 2013: MODERNISATION OF TRANSFER PRICING RULES

The Minerals Council of Australia (MCA) welcomes the opportunity to comment on the exposure draft of the *Tax Laws Amendment (Cross-Border Transfer Pricing) Bill 2013: Modernisation of Transfer Pricing Rules.*

The MCA represents Australia's exploration, mining and minerals processing industry, nationally and internationally, in its contribution to sustainable development and society. MCA member companies produce more than 85 per cent of Australia's annual minerals output and account for more than 50 per cent of Australia's exports.

The MCA welcomes the decision to align Australia's transfer pricing legislation more closely with international best practice as set out by the OECD in its *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* and the *OECD Model Tax Convention on Income and on Capital.* This will help to provide greater certainty for multinational enterprises operating or considering investing in Australia.

However, the MCA has serious concerns about the way the Bill is currently drafted. In a number of aspects, we do not believe it reflects the Government's stated intent and we are concerned that, as currently worded, it would enact tax rules which are unclear, complex and difficult to uphold in practice. Further time and discussion is required to ensure the proposed legislation is workable and that the supporting Explanatory Memorandum (EM) is clear and informative. Without additional consultation and amendment, the Exposure Draft (ED) would significantly increase the compliance burden for Australian taxpayers with little value to the administration of the law.

The issues of most concern to the MCA are itemised below together with recommendations to improve the clarity, efficiency and effectiveness of the proposed changes and their application.

1. SECTIONS 815-115, 120, 125

These subsections are unnecessarily prescriptive. The OECD Guidelines thoroughly and adequately describe the arm's length principle and its operation. By introducing an interpretation of the OECD Guidelines, the ED creates parallel definitions and introduces the potential for conflict with recognised and understood international best practice.

There appears to be a mismatch between the OECD Guidelines, which primarily address the application of the arm's length principle, and the ED's focus on identifying the arm's length conditions. In applying the arm's length principle, the OECD recognises "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" (paragraph 1.13). In contrast, in defining meanings of "transfer pricing benefit" and "the arm's length conditions", the ED appears focussed on identifying a single set of arm's length conditions. The nature of transfer pricing makes this unrealistic. If the intention is to align with international best practice, the OECD Guidelines should be sufficient.

Specific examples of issues arising with 815-125 are provided below.

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MCA recommendation:

- That the definition of "the arm's length conditions" be removed, including as part of the definition of the "transfer pricing benefit".
- That a less prescriptive approach be adopted - a clearer reliance on OECD Guidelines would affirm the intent of the legislation and improve the efficiency of its application for both taxpayers and the revenue authority.

2. SUBSECTION 815-115

The substitution of "the arm's length conditions" in all cases where there is deemed to be a transfer pricing benefit affords the Commissioner a very broad power of reconstruction. This appears to apply irrespective of the magnitude of any benefit. It does not differentiate between instances where an adjustment to pricing is contemplated and those where the Commissioner might seek to recharacterise the transaction.

With any individual transaction there may be many variables found between arms-length parties. The fact that another arms-length condition is possible should not give rise to the reconstruction of an actual transaction that is also observed in a similar arms-length transaction. This will create an uncertainty for both taxpayer and tax administrator that is unworkable in practise.

This issue is fundamental to the application of the transfer pricing rules and to allowing taxpayers transparent guidance in complying with their obligations.

MCA recommendation:

- That it is clearly stated that a recharacterisation should only be considered in the two exceptional circumstances set out in the OECD Guidelines at paragraph 1.65. If the position of the Australian Taxation Office (ATO) differs from that of the OECD on this point, this should be clearly identified in the proposed legislation, and the ATO's preferred position set out in detail in the EM.
- That in arriving at a position regarding recharacterisation, the ATO should consider the wider implications of recharacterising transactions under broader circumstances (rather than re-pricing the actual transaction as entered into). These implications could include, for example, a reputational risk to the taxpayer and consequent potential to impact on earnings and profitability; or undue influence on an investor's choice of business model - for example, doing business *with* instead of *in* Australia.

3. SUBSECTION 815-120

As noted above, the MCA regards 815-120(1)(a) to be unnecessarily prescriptive. The requirement to identify "the arm's length conditions" and compare with the actual conditions is particularly onerous. The focus should instead be on applying the arm's length principle.

The operation of Subsection 815-120(2), and in particular (2)(b), is not clear. Paragraph 2.26 of the EM adds little. It is difficult to envisage how this subsection might be applied in practice, unless a specific condition can be shown to be *always* present between independent parties, but absent in the actual conditions; or can be shown to be *always* absent between independent parties but present in the actual conditions. However, this level of proof is unlikely to be available in many cases and the need for such proof would be contrary to paragraph 2.88 of the EM.

MCA recommendation:

- That the requirement to identify "the arm's length conditions" and compare with the actual conditions be removed.
- That how subsection 815-120(2) is intended to operate in practice be clarified.

4. SUBSECTION 815-125

This subsection demonstrates why reinterpreting the OECD Guidelines generates unnecessary confusion. Defining "the arm's length conditions" as a parallel definition implies that there is a best position that can be identified as "the arm's length conditions". While this may be possible in certain instances, in the majority of transactions it will be highly subjective.

Further, it is not necessary to paraphrase the wealth of detailed guidance set out by the OECD with regards to selection of method.

MCA recommendation:

- That subsection 815-125 be removed.
- That if retained, the ED should place greater reliance on existing international best practice as set out in the OECD Guidelines and not introduce parallel definitions.

5. SUBSECTION 815-125 (5)

In the MCA's view, the phrase "*have regard to* the economic substance of what was actually done" *[emphasis added]* does not give sufficient weight to the need to recognise the substance of what was actually done. The economic significance of functions performed (OECD paragraph 1.43); economic substance of risk allocation (OECD paragraphs 1.48 – 1.49); and actual conduct of the parties (OECD paragraph 1.53) are highly relevant. Paragraph 1.64 onwards of the OECD Guidelines is also of importance.

MCA recommendation:

- That 815-125(5) be reworded to clarify that the ATO's examination of a controlled transaction should be based on the transaction actually undertaken and using the methods applied by the taxpayer (OECD Guidelines paragraph 1.64).
- That it be recognised that contractual terms should only be set aside in favour of economic substance where it can be demonstrated that the conduct of the parties does not conform to the terms of the contract or where the parties' conduct indicates that contractual terms have not been followed.

6. SUBSECTION 815-125 (6) AND (7)

These subsections (and paragraph 2.86 of the EM) lack clarity. Paragraphs 2.87 – 2.90 are clearer. The statements in the EM that "the mere fact that independent entities have not been *observed* to have done something ... will not of itself mean that independent entities would not have [done so]" [paragraph 2.88]; and "any substituted arrangements ... must ... be substantially similar to the economic substance of what was actually done" [paragraph 2.89] provide some reassurance that the substance of the actual arrangements will not be disregarded, even if no specific examples exactly matching the actual arrangements are observed between independent entities.

However, if paragraphs 2.87 to 2.90 are taken as the intent of the proposed provisions, then their meaning is not adequately conveyed by Subsections 815-125(6) and (7) of the ED as currently worded. This is fundamental to the operation of the provisions and should be addressed.

MCA recommendation:

- That these subsections be reworded to clarify that, as noted above, any recharacterisation would only occur under the specific exceptional circumstances noted in the OECD Guidelines.

7. USE OF THE DEFINITE ARTICLE

The use of the definite article in the phrase "the arm's length conditions" implies an expectation that there is a single set of conditions that will be considered arm's length. It fails to recognise that there is a multitude of different scenarios which may equally represent arm's length conditions between independent enterprises.

MCA recommendation:

- That "the arm's length conditions" be changed to "arm's length conditions" throughout.

8. SECTION 815-130

The phrase "except where the contrary intention appears" suggests that any part of the OECD Guidelines could be disregarded by the tax authority and a court of law. This contrasts with the Government's stated intent to better align with the international standards set out by the OECD.

MCA recommendation:

- That this phrase be removed.
- That where specific parts of the proposed legislation are contrary to the OECD Guidelines, that each be separately identified within the relevant section and the divergence fully explained in the EM.
- That if future amendments to the OECD Guidelines appear contrary to the intent of this legislation, this be identified at such time as it becomes relevant, with reference to the ATO's recognition of this - for example, where Australia has reserved its position in relation to OECD proceedings or where Australian legislation does not yet reflect a revised OECD position (as is the case in relation to the functionally separate entity approach for Permanent Establishments);
- That if the phrase is retained, it be relegated to a separate (lower) subsection 815-130(5) and material contrary to OECD Guidelines be clearly stated.
- That if other international standards become relevant (such as United Nations commentary for developing countries), any specific area of relevance and/or difference between that and the intent of this proposed legislation be identified at such time as it is introduced into s815-130 by regulation.

9. SECTION 815-145

The time limit for amendment of assessments is not consistent with time limits relating to other areas of the taxation legislation.

With the recent introduction of the International Dealings Schedule (IDS), considerably more information is routinely available to the ATO at the date of filing the income tax return. This allows more timely identification of issues so the need for an extended time-frame is unclear. Transfer pricing is complex but other areas of equal complexity are managed within a four year timeframe (such as Capital Gains Tax and other areas involving valuations).

A four year time limit would also be more in line with other major economies, including the United States (three years), South Africa (three years from filing of tax return), the United Kingdom (four years from the end of the tax period), France (four years from the end of the tax period), Germany (four years from the end of the tax period) and Canada (six years from initial assessment after filing return).

The MCA notes that the ATO has the ability to extend the time limit under ITAA 1936 s 170(7) in cases of fraud or similar complexities and this legislation would not curtail that authority.

Further, in order to provide greater certainty to taxpayers, the time limit for the ATO to amend an assessment should also apply to all open years, which are currently without time limit.

MCA recommendation:

- That the time limit at 815-145(1)(a) should be revised to four years.
- That the time limit should apply to all years of assessment that remain open at the date of enactment of the proposed legislation (ie all earlier years would be closed, unless under dispute, after four years).

10. SECTION 815-C

The MCA submits that the comments on 815-B above are also relevant to 815-C.

11. SECTION 815-D

The documentation requirement appears considerably more onerous than current rules and will significantly increase the burden on taxpayers. Further, it appears to impose a significantly higher requirement than current international best practice.

There is no tangible point at which a taxpayer can reliably conclude that it has sufficient documentation in applying 815-B to the "entity" (815-305(2)(a)). This is in direct contrast to the approach of applying prudent business management principles in preparing or referring to written material as used by most multinational enterprises in identifying documentation requirements for specific transactions and as set out in the OECD Guidelines at paragraphs 5.4 to 5.28 and TR 98/11 paragraphs 1.5 – 1.10.

Further, the "best" requirement (815-305(2)(b)) is particularly onerous. For example, benchmarking studies are often carried out at three yearly intervals. The ED implies this should be carried out annually, even in the absence of any material change. This would significantly increase compliance costs and is not in line with current ATO practice.

The MCA agrees that it is not unreasonable to require contemporaneous documentation. However, we believe the ED imposes an unrealistic view of the time and effort required. Whilst an entity can certainly be expected to have sufficient information at the time of filing the income tax return to support the disclosures made therein, considerable additional time and effort is required to produce full, compliant documentation in the prescribed format and level of detail. Therefore a reasonable timeframe must be allowed for final documentation. This section removes the ability of the tax authority to set reasonable practical guidelines as is currently the case.

As currently worded, more taxpayers are likely to seek rulings and/or APAs with significant resourcing implications for the ATO. There is no mention in the EM as to the extent to which earlier material such as TR 98/11 and TR 1999/1 remain valid. If the underlying policy intent of the Government is not to change the ATO's current practice with regards to documentation, then this should be made clear.

Finally, the EM is silent on how the proposed section 815-D is intended to interact with the general record-keeping provisions of ITAA 1936 section 262A. Clarity is needed as to how this does (or does not) apply with regards to transfer pricing.

MCA recommendation:

- That 815-305(2)(a) "the way the entity.... treated 815-B as applying to the entity..." to be amended to "the way the entity... treated 815-B as applying to the transaction..."
- That 815-305(2)(b) "best" be removed.
- That 815-305(4)(a) and (c) be revised.
- That 815-305(5) be amended to provide for a more realistic deadline for preparation of documentation of 12 months from the end of the period to which the documentation relates.
- That if TR 98/11, the existing ATO guidance on documentation requirements, remains applicable, this be clearly stated in the EM.
- That the EM include a clear statement that this legislation is not intended to create a diversion from existing ATO practice with respect to documentation as set out in TR 98/11 or administrative practices as set out in TR 1999/1.
- That the EM include clear guidance for advisers representing taxpayers and the tax authority on the standard and timing of documentation expected. This could simply be achieved by reference to existing materials.

12. ALIGNMENT WITH CUSTOMS

The ATO and taxpayers should expect that alignment between transfer pricing adjustments and consequential adjustment to customs values can be achieved.

MCA recommendation:

- That the legislation commit the ATO and customs authority to co-operate to ensure consequential adjustments can be achieved wherever possible and in the majority of cases.

13. SUBDIVISION 284-165

The presence of a de minimis limit for penalties is logical but the limits set out in 284-165 are likely to be irrelevant for the majority of multinational companies and should be substantially increased. As companies may go into a loss position from time to time, it is critically important that a reasonable de minimis value is part of this subdivision.

MCA recommendation:

- That the de minimis limits be increased to (a) $10 million or (b) 2% of the income tax payable for the income year.

Thank you for the opportunity to contribute to the development of this legislation. Should you require further explanation of any issues raised above, please contact me in the first instance (john.kunkel@minerals.org.au or 02 6233 0649).

Yours sincerely,

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