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Dear Sir / Madam

Consultation Paper
Income tax: Cross border profit allocation - Review of transfer pricing rules

We refer to the announcement made by Assistant Treasurer, The Hon Bill Shorten, MP on 1 November 2011 and to the Consultation Paper issued on the same date titled: "Income tax: cross border profit allocation – Review of transfer pricing rules" (the "Consultation Paper").

As professional advisers dealing on a day-today basis with taxation matters, transfer pricing which is one of those, we herein provide our submission in response to the Assistant Treasurer's announced reform to the Australian transfer pricing rules, rules which we note, in part at least, are to be backdated to 1 July 2004.

Transfer pricing continues to be viewed by multinational taxpayers as an area of substantive "risk" in the conduct of their businesses. It consumes substantive taxpayer resources in completing necessary documentation (including attendant income tax return related schedules) and often significant costs are borne in justifying positions adopted when the Australian Taxation Office reviews the transfer pricing affairs of taxpayers. We submit that any reform of our transfer pricing rules should recognize this administrative burden and also recognize that, in our experience, taxpayers as a general rule are good corporate citizens that pay their fair share of income tax.

We appreciate the opportunity to respond to the Consultation Paper and attach a document that addresses a number of important issues raised in the Consultation Paper and/or which we believe arise out of any review of our transfer pricing rules. Time permitting, we would have contributed a more substantive response to the Consultation Paper.

We would welcome the opportunity to provide further input and to discuss our submission with you.

If you have any queries please contact Daren Yeoh on (03) 8635 1800.

Yours sincerely

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APPENDIX 1

1 Proposed Back-dating Legislative Reform

Assistant Treasurer, The Hon Bill Shorten, MP in his media release of 1 November 2011[1] states that our transfer pricing rules enshrined in our tax treaties will operate, as an alternative to those in our domestic law, for income years commencing on or after 1 July 2004 ..." The Assistant Treasurer also states:

> "Whilst there is a strong argument that tax treaty rules 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".

With respect, the "argument" to which the Assistant Treasurer refers (an argument more fully canvassed at Paragraph 12 et al and pages 22 and 23 of the Consultation Paper) has been in discussion for many years past. The decision by the Australian Taxation Office (the "ATO") not to run this 'argument' in the matter of *The Commissioner of Taxation vs. SNF (Australia) Pty Ltd [2011] FCAFC74* (the "SNF Case") is curious to say the least. Curious insofar as the Commissioner suffered a similar outcome to that borne in the SNF case in the decision of *Roche Products Pty Ltd vs. The Commissioner to Taxation [2008]*.

We submit that the back-dating of legislation is only ever warranted or justified in very special circumstances; arguably, for example, where there is a malicious intent to defraud the public. Changing the law, following agitation by the Commissioner of Taxation[2], arguably because the SNF Case was (viewed by some at least) poorly run by the ATO (insofar as it did not contend that the relevant treaty provisions applied in the alternative to our domestic transfer pricing provisions) is unacceptable and counter to the ATO commitment "…to being open, accountable and transparent …"[3] in its dealings with taxpayers.

The backdating of the proposed legislation is unacceptable as it is unfair and unjust. The ATO has for many years argued for greater transparency, cooperation and openness, trust and mutual respect in its dealings with the taxpayers. "Transparency is what makes our self-assessment tax system work …" says Deputy Commissioner of the ATO, Mark Konza[4]. Mr Konza also states: "Like any relationship, the ATO's relationship with taxpayers is built progressively over time on a foundation of trust and mutual respect". It is instructive to reflect on a speech by our Commissioner of Taxation, Mr Michael D'Ascenzo. In a speech to the Australian Institute of Company Directors on 16 February, 2010 Mr D'Ascenzo said:

> "Therefore, a shift in thinking is needed from seeing the ATO simply as a tax gatherer or regulator, to viewing us as mutual stakeholders in an efficient, internationally competitive taxation system that is an asset to you (in helping to **minimise compliance costs**, providing you with **practical certainty** and in **promoting a level playing field**) and to the Australian community". [Our emphasis].

From a taxpayer and professional advisor perspective, trust in the "system", mutual respect, a level playing field and so on are key elements "expected" of our tax system; however, our Government and the ATO must "walk the talk", the umpire must always be above and beyond reproach; that is, not only open and transparent but "seen" to be so in all its dealings.

The backdating of the legislation to 1 July 2004 has been set, we suggest, to capture SNF Australia Pty Ltd (and no doubt other taxpayers too), as the ATO was unsuccessful at the Full Federal Court in this case. The SNF Case concerned SNF's international related party dealings (and relevant

[1] Media Release No. 145
[2] Commissioner of Taxation Annual Report 2010-2011, Page 10 and paragraph 112
[3] Second Commissioner Bruce Quigley speech to CTA titled: We can see clearly now: growing transparency with large business: 7 June, 2011
[4] Speech by Mark Konza, Deputy Commissioner of Taxation titled: "A World Without Audits",17 October 2011.

Australian income tax returns) for years up to and including 30 June, 2004. By backdating the proposed legislative reform to 1 July, 2004 the ATO is open to criticism that it has effectively "lost the battle but won the war". This is not only inappropriate but unfair, we suggest, as one now expects that the ATO will return to the SNF door and attack their income tax returns commencing on and after 1 July 2004. This attack will take place relying upon laws that are presently operative but unknown and unwritten. If the Government proceeds with the proposed backdating of the legislative reform, "trust" in the ATO is likely to be seriously damaged as one is led to question the veracity of representations that the ATO:

- is **accountable** for its actions;
- operates on a **level playing field**; and/or
- seeks to minimize **compliance costs of taxpayers**.

As alluded to above, there is a perception that the ATO is seeking retrospective amendment to achieve a different outcome in relation to its case with SNF so far as it relates to open years. In our opinion, the ATO's actions in agitating to have the law backdated sends the wrong messages in terms of honesty, fairness, equity, integrity and transparency to multinational taxpayers. If our law is backdated, as is proposed, the message to taxpayers is clear, the ATO is above the law and will win at all costs. This is most unfortunate when the ATO is "talking the talk" of a " … commitment to being open, accountable and transparent … which underpins the no-surprises approach we seek to demonstrate in our work…".[5]

We submit that any change in the law as it relates to transfer pricing should operate prospectively and not retrospectively.

2 Model Tax Convention – the Arbitration Option

The Consultation Paper refers to the importance of aligning Australia's transfer pricing rules with elements of the OECD, Model Tax Convention on Income and on Capital ("OECD MTC").

We submit that any amendments to our transfer pricing legislation should include an in-principle agreement that the Government will proactively adopt all elements of the OECD MTC in relation to all future treaty negotiations. We particularly refer to Article 25 of the OECD MTC and the **arbitration provision** enshrined therein. A real disappointment in the case of a number of Australia's more recent tax treaties has been that no arbitration provision has been included therein (refer, for example, to Japanese treaty).

Nearly all of Australia's tax treaties operate in a manner that requires the competent authorities of Australia and our tax treaty partners to " ... seek to come to agreement …"[6] in the case of a transfer pricing dispute with the objective of avoiding taxation on the same income in both countries involved in the dispute. Those treaties state that the competent authorities " … may agree …"; however, there is no requirement that they actually reach agreement. Accordingly, from time to time, taxpayers are taxed on the same income in both Australia and in the other treaty country with which the relevant transactions have occurred. This is a most unsatisfactory situation from a taxpayer perspective and it is incumbent upon the Government to prevent such situations occurring.

An in-principle Government directive that Australia would proactively seek inclusion of a mechanism for the independent review and arbitration to be available to taxpayers where the Revenue authorities are unable to reach mutual agreement would be a valuable way forward insofar as it would evidence Government approval and support for an arbitration provision in all our tax treaties.

We believe that an arbitration provision in all our treaties would provide a powerful motivation to the relevant competent authorities to search out and find a "solution" to all transfer pricing disputes (rather,

[5] Second Commissioner, Bruce Quigley speech to the CTA 7 June, 2011
[6] Refer agreement with the United States of America. Other treaties such as those with Japan and New Zealand state that the competent authorities " … shall endeavour …" to reach agreement " … with a view to the avoidance of taxations …" not in accordance with the provisions of this Agreement / Convention.

as noted above, than have taxpayers suffer double taxation as it sometimes the case in practice). Further, the arbitration provision must be at the option of the taxpayers concerned and not conditional upon the agreement of the competent authorities concerned.

We further submit that the Government should proactively review Australia's tax treaties commencing with those of our main trading partners and methodically, over an agreed time frame, ensure that all are reviewed and updated to accord with the OECD MTC. They should be "modernised" so that they all accord with the OECD MTC and that Government does not just "cherry pick" those provisions that enable it to seek to deal with the ATO recent loss in the SNF case.

3 De Minimus Test

In recent years taxpayers with more than $1 million dollars in international related party transactions have been required to complete Schedule 25A as an annexure to their income tax returns along with being encouraged, via a punitative penalty regime, to maintain attendant documentation to evidence that pricing outcomes achieved are arm's length. This "threshold" has been foreshadowed to increase to $2 million under the new International Dealings Schedule ("IDS") foreshadowed to apply effective 1 July 2011[7].

The draft IDS is a far more comprehensive, burdensome information gathering schedule than the former Schedule 25A that taxpayers with international related party transactions greater than $2 million are required to complete and file with their income tax returns for the year ending 30 June, 2012.

We submit that the so-called "de minimus" test, of $2 million, should be significantly increased to reduce the compliance burden on taxpayers. If there are concerns with this recommendation, then we submit that a less information demanding schedule, than the IDS presently proposed, could adequately address ATO concerns so far as they relate to smaller taxpayers. Perhaps, for example, taxpayers with international related party transactions of between certain dollar levels (such as $10 million to $50 million, for example) should merely complete a schedule quantifying their international related party transactions with no further legislated documentation requirements on their part.

4 Time Limitations on Transfer Pricing Adjustments

Australia presently has no statutory time limits imposed upon the ATO within which to make transfer pricing adjustments. Technically, the ATO may conduct a transfer pricing audit that goes back in time to the introduction of Division 13 in 1982. In the present climate of greater taxpayer disclosure requirements and enhanced ATO real-time monitoring of the income tax affairs of taxpayers coupled with a focus, globally, by taxpayers on risk management and 'no surprises' in their financial reporting, we welcome the Consultation Paper proposal to introduce time limits[8] within which the ATO must make transfer pricing adjustments. We note that the time limit proposed in the Consultation Paper is eight years, from the date of issue of a notice of assessment.

In the present environment of real time income tax reviews being conducted by the ATO and significantly greater disclosure requirements[9] in relation to transfer pricing matters by taxpayers, we submit that there should be several elements to any time limitation, within which the ATO may process a transfer pricing adjustment.

We accept the concept of a "general" time limitation of 7 to 8 years subject to the proviso that the time limit must be automatically extended, where necessary, to accommodate tax treaty mutual agreement procedures (refer also section 2 hereof). In addition, we submit that, absent fraud on the part of a taxpayer, if the ATO has conducted a transfer pricing record review (or transfer pricing review by

[7] We note for completeness that at this stage the IDS is in draft form only and well the $2 million threshold may change prior to finalization.
[8] Consultation Paper, paragraph 101
[9] Refer for example to the new International Dealings Schedule and Reportable Tax Positions Schedule.

whatever name) then following any such review, absent adjustment and amended assessments issuing at that time, the ATO should be prevented from reopening that matter at any time in the future.

5 Requirement to Retain Contemporaneous Documentation

The proposition at Paragraph 70 of the Consultation Paper that taxpayers maintain contemporaneous documentation that explains the arm's length basis of profit allocation to Australia prima facie appears onerous. We harbour significant concerns as to how one is to assess the adequacy or otherwise of these records with attendant issues around the impact on penalties and interest.

In the experience of our transfer pricing team there is often a wide disparity of views as to the adequacy of records in demonstrating arm's length pricing outcomes. Indeed it is perhaps instructive to note that in the SNF Case, independent economists consulted by the ATO downgraded (to 1.7%) the operating net margin when compared to that which the ATO initially argued should have been derived by SNF (Australia) Pty Ltd for each of the years that it operated in Australia. In the experience of our colleagues in audit situations, the ATO, more often that not, has argued for an unreasonably high operating net profit margin when compared to benchmarking studies that taxpayers have submitted (as was clearly the case with the independent economist in the SNF Case).

In essence, we believe that only the very large taxpayers have the financial resources to regularly produce the level and quality of documentation that the ATO can be expected to seek to have enshrined in the law; even then, questions arise as how often this documentation is to be prepared (annually?) and whether a comprehensive study every, say, three to five years is appropriate (which, we submit, should often be the case).

We further submit that should the Government proceed with the documentation proposals set down in the Consultation Paper, taxpayers in the SME market should have a materially lesser documentation requirement, if any, when compared to those of the very large taxpayers.

One substantive issue, from an Australian perspective, is the scarcity of truly comparable independent companies against which one may "benchmark" the financial performance (and therefore profitability) of taxpayers.

As part of the Government's reform of Australia's transfer pricing rules we submit that it must give consideration to the scarcity of independent Australian taxpayers against which a company may compare its profitability and in this regard the question arises as to whether overseas companies may be used as "comparables". We also raise as an issue the fact that we have grave concerns at the ATO use of private companies (where results are often materially distorted) and divisions of public companies (where allocation of costs and revenue may, equally, be materially distorted). In short, any reform of our transfer pricing rules must recognize the documentation challenges that taxpayers (and the ATO) face in seeking to benchmark a company's profitability performance.

Committing to "black letter law" transfer pricing documentation standards will likely lead to extensive debate and dispute as to what is "appropriate" so far as the quality of documentation is concerned. We recommend that a consideration of documentation standards be deferred and debated at length before any substantive change is contemplated in this area. To do otherwise will create a compliance burden on affected taxpayers that is not only an unreasonable impost but is also disproportionate to the revenue at risk.

6 Business Reorganizations

Paragraph 9 of the Consultation Paper refers to concerns raised by the ATO in relation to business reorganizations; the implication is that the concern is with artificial arrangements to "shift or shelter profits". Suffice it to say that the Government is right to be concerned about artificial arrangements; however, restructuring Australian-based operations to shift functions, assets and risks, whatever the profit outcome, should not be prejudged as inappropriate provided such reorganizations are soundly

based in commercial principles and an arm's length result follows both the relevant transactions and the ultimate "reorganized" outcome.

7 Advance Pricing Arrangements

As noted in the Consultation Paper, Advance Pricing Arrangements ("APAs")[10] allow taxpayers to agree a framework for profit allocation with the ATO and other relevant tax authorities. We submit that notwithstanding the Consultation Paper goes no further than this, in its consideration of APAs, we recommend that it should do so.

In many respects APAs have become a taxpayer's "weapon of choice" for addressing transfer pricing risk. We note that in recent times there has been a significant taxpayer interest in entering into APAs largely driven by their desire for greater certainty in their related party dealings (and desire to remove the possibility of double taxation in relation thereto).

We recommend that the Government engage with the ATO to further consider how APAs may be entered into more cost effectively than is presently the case. In this regard, we recommend that further consideration be given to creation of a separate group within the ATO to deal with all APAs and, for the avoidance of any doubt, as part of the "reform" process we submit that taxpayers with APAs should be required to do no more than complete an annual compliance report during the term of their APA (and that no additional compliance burden is cast on this taxpayer group as a result of the "reform" of Australia's transfer pricing rules).

[10] Consultation Paper, paragraph 20