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For the attention of Mr Neil Motteram

30 November 2011

Dear Mr Motteram

Submission to Treasury

Income Tax: Cross border profit allocation: Review of Transfer pricing rules Consultation Paper 1 November 2011

PwC welcomes the opportunity to provide a submission to treasury in response to the Income Tax: Cross Border Profit Allocation Review of Transfer Pricing Rules Consultation Paper 1 November 2011.

We acknowledge the benefits of clarifying the operation of Australia's transfer pricing rules to ensure they better reflect global best practice and, in particular, latest Organisation for Economic Cooperation and Development (OECD) guidance. Modernising the transfer pricing rules may help to reduce some of the complexity involved in applying the arm's length principle and should be welcomed by multinational enterprises (MNEs) who are well versed in applying OECD guidance in their day to day transfer pricing. Having said this, transfer pricing is not an exact science and there will always be issues which are open to interpretation. Rewriting the transfer pricing rules to better incorporate OECD guidance will not provide a solution to all transfer pricing issues which are debated between taxpayers and the Australian Taxation Office (ATO).

We understand that Treasury is concerned that the existing law could lead to a substantial leakage of revenue. While we are not privy to the data underlying this proposition, we are aware that, in some circles, there is a view that the Division 13 rewrite is an overreaction to the Commissioner's loss in the SNF case.

In our view, the Commissioner's loss in SNF was not due to flaws in the existing law. Had the OECD guidelines been applied to the facts as they were presented to the Court, we are of the opinion that the result would have been the same. We also hold the view that if the case had been run differently applying the existing law, a different decision may have been reached. Having said this, given the uncertainty that exists, we consider it worthwhile to clarify prospectively the operation of Australia's transfer pricing rules.

It is important that the new law is drafted based on a principled approach and has the arm's length principle, as set out in OECD guidance, as the anchor point. It is important that Australia's transfer pricing rules do not go beyond what is included in relevant OECD guidance. While we understand that this is not the intention of Treasury and the Government, it will be important to ensure that any Australian interpretation on the OECD Guidance is consistent with the interpretation of our major treaty partners. Taking the Australian rules beyond OECD guidance would create further uncertainty for Australian taxpayers and would increase the risk of double taxation, not to mention imposing on Australian taxpayers additional compliance costs.

Profit attribution to permanent establishments (PEs)

The Consultation Paper states that the decision on the treatment of PEs will be treated as a separate policy question to those outlined in the Consultation Paper. We consider that the OECD's functionally separate entity approach should be adopted for profit attribution to PEs and should be incorporated into the proposed Division 13 rewrite. However, given the importance of this policy question, our detailed views are outlined in a separate submission.

Assistant Treasurer's media release

The Assistant Treasurer's media release announcing the review of the transfer pricing rules included a comment that the Government intends to make legislative amendments to 'clarify' that a taxing power exists under Australia's double tax treaties. It is proposed that the amendments will be effective from 1 July 2004. We understand the Government intends to implement these particular amendments without any public consultation process.

PwC has a number of concerns with this act of "clarification" and we have included comments on these in our submission. In brief, we are of the opinion that this is not a mere "clarification" but a retrospective change to the law. We do not consider retrospective changes of law to be good tax policy and consider that such changes have the potential to harm Australia's standing with foreign investors and our treaty partners.

Format of our submission

We have prepared our submission in the following sections:

1. Retrospective amendments on the application of treaties
2. Adequacy of the existing transfer pricing rules
3. Specific comments on the Consultation Paper
4. Other considerations.

We would be pleased to discuss the comments in our submission with you further.

Yours sincerely

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1. Retrospective changes to treaty application

Observations and issues

- The question of whether treaties give rise to a taxing power is contentious. This is acknowledged in the Consultation Paper. The ATO has publicly and regularly[1] stated that treaties can create tax obligations that do not arise under domestic law. However, despite ample opportunities to do so, the ATO has chosen not to test this view in the Courts. On the other hand, taxpayers and the profession have held the view that treaties merely allocate taxing rights in accordance with internationally accepted practice.[2] It has been unnecessary for taxpayers to argue this point in the context of Article 9 because, as noted above, the Commissioner has chosen not to test his views in Court. However, in the context of treaty taxing powers more generally, the Commissioner has been unsuccessful in the Courts on a number of occasions.[3] In our view, it is clear that Article 9 does not provide the Commissioner with a right to impose tax.

- Parliament has specifically recognised the role and status of the domestic transfer pricing provisions and we do not believe it has in any way indicated that "the law should operate so that Australia's treaties are an alternative to our domestic law". References in the Press Release to amendments made to section 170 are tenuous at best and do not evidence that the intent of Parliament was that our treaties would operate to impose tax on residents of our tax treaty partners.

- We consider the "clarification" of the application of a taxing power under the treaties to be a retrospective law change which would be open to further legal challenge and would be negatively perceived by the business community. As mentioned above, a number of legal cases have specifically considered that DTAs limit the operation of existing domestic taxing provisions rather than providing a separate taxing power.

- The retrospective nature of the change may have the unintended, but real consequence of discriminating against taxpayers dealing with related entities in Treaty countries (viz our major trading partners). Put another way, a company established in the Cayman Islands gets a "better deal" than a resident of the USA, China or Japan. It seems very strange to us that Australia intends to impose higher taxes on our treaty partners.

- We also observe that none of our major trading partners seek to use Article 9 to impose additional taxes. Instead, and in line with international practice, they accept that domestic transfer pricing legislation (as restricted by Article 9) is the relevant taxing provision.

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[1] Refer *TR 2001/11 Income tax: international transfer pricing - operation of Australia's permanent establishment attribution rules* at para 2.3 and *TR 2001/13 Income tax: Interpreting Australia's Double Tax Agreements* para 32.
[2] Klaus Vogel, *Double Taxation Conventions* (3rd ed, 1997), referred to in the decision in *Chong* at para 19
[3] Refer *Undershaft (No 1) Limited v Commissioner of Taxation* [2009] FCA 41 at paras 44-45, *Chong v Commissioner of Taxation* [2000] FCA 635 at para 26, *GE Capital Finance Pty Ltd v Commissioner of Taxation [2007]* FCA 558 at para 29, *Roche Products Pty Limited and Commissioner of Taxation* [2008] AATA 639 and *Commissioner of Taxation v SNF (Australia) Pty Ltd* [2011] FCAFC 74.

- It is widely accepted that retrospective legislation is justified in extremely limited circumstances such as to mitigate blatant tax avoidance. These circumstances do not exist in relation to the application of Division 13. There has been no suggestion that changes to Australia domestic transfer pricing rules are required to stop blatant tax avoidance. In any case, Australia's tax laws include a comprehensive general anti-avoidance provision which can deal with cases of tax avoidance.

- If the proposed changes were to go ahead they would effectively widen the Commissioner's powers retrospectively. The Commissioner could have greater ability to reallocate profits through reconstructing transactions. As far as we are aware, the boundaries of this power have not been tested in the courts. Accordingly, this could lead to a greater number of disputes that cannot be resolved between the Commissioner and taxpayers. Where these cases are referred to MAP for resolution, we are concerned that there may be an increased risk of double taxation, as the Competent Authorities of our treaty partners may not agree with the reconstruction proposed by the Commissioner.

- Legislating that the treaties allow the Commissioner a power to tax may in fact undermine other areas of Australia's domestic tax legislation where a policy decision has been made to adopt a taxing treatment more favourable than that under the treaty. For example, the thin capitalisation regime may be undermined if the Commissioner were to adopt a taxing position under the treaty that was in contradiction to the position allowable under domestic rules.

Recommendations

- Any changes to transfer pricing rules should apply prospectively.

- The issue of DTAs providing a taxing power should be clarified by the Courts.

- If the retrospective change is legislated, we recommend that the ATO issue a public ruling on how the ATO interprets its power under Article 9.

2. Adequacy of existing rules

Observations and issues

- We are aware that there is a view that the existing drafting of Division 13 is inadequate and that the existing law is inconsistent with the OECD guidelines. While we are not necessarily of this view, we consider that seeking to align Australia's transfer pricing laws with OECD guidance will improve certainty for taxpayers.
- The ATO has made a significant effort to incorporate OECD guidance in its taxation rulings on transfer pricing. In practice, most taxpayers follow the guidance provided by the ATO and OECD in setting and reviewing their Australian transfer pricing policies. For most taxpayers, there would be no material difference in their position under the existing regime and a new law based on OECD guidelines.
- We are of the opinion that the recent decision in the SNF case was not necessarily due to differences between Division 13 and OECD guidelines. Had the Court been asked to decide on SNF applying the OECD guidelines to the same facts as they were presented by the taxpayer and Commissioner, it is uncertain that the result would have been any different.
- Furthermore, comments in the SNF decision provided a roadmap on how the Commissioner could ensure the OECD guidelines can be considered a relevant authority in future cases.
- It is important to note that the OECD guidelines are open to interpretation. Incorporating the guidelines into our law will not solve all transfer pricing problems

Recommendations

- Any proposed changes should be limited to clarifying that the arm's length principle should be interpreted in a way that is consistent with the OECD Guidance, limiting time for amendments and, if documentation rules are to be legislated, clear guidance on penalty remission.

3. Responses to Consultation Paper proposals to general transfer pricing rules

3.1. Definition and interpretation of the arm's length principle

Observations and issues

- PwC supports Treasury's view that the arm's length principle should continue to underpin the domestic transfer pricing rules. PwC supports the broader policy principle of *prospectively* aligning the domestic definitions, including the arm's length principle, with globally accepted best practice such as the 2010 OECD guidelines and model taxation treaty.
- The arm's length principle can be open to interpretation. The definition of the arm's length principle in the Australian transfer pricing rules should not be different from or go beyond the OECD guidance.
- Based on the Consultation Paper, it appears that Treasury's interpretation of 'arm's length' is based on the 'outcome' of a transaction or group of transactions, rather than the arm's length 'price' of specific transactions. Our view is that the word "outcome" is interpreted by the ATO as a proxy for profit regardless of the pricing of the actual transaction. We consider this to be inconsistent with OECD guidance.
- Profit methods are a means to an end (the 'end' being identifying an arm's length price), and are not an end in themselves.
- The OECD Guidelines refer to the definition of arm's length principle in Article 9 of the model treaty. Article 9 specifically considers adjustments where *transactions* have been entered into between related parties on other than arm's length terms. The commentary on Article 9 goes on to state:

  "No re-writing of the accounts of associated enterprises is authorised if the transaction between such enterprises have taken place on normal open market commercial terms (on an arm's length basis)"

- OECD guidance makes it clear that the arm's length principle does not necessarily mean that profits will result. Parties dealing at arm's length can (and do) incur losses for commercial reasons. If the conditions of a transaction are arm's length, then the 'outcome' of that transaction must be arm's length, regardless of whether that outcome is a profit or loss.

Recommendations

- The definition of the arm's length principle in our domestic law should not go beyond the definition in the OECD guidelines and model treaty and application of the arm's length principle does not mean losses cannot occur.

3.2. Comparability

Observations and issues

- The concept of comparability is critical in applying the arm's length principle. In order to apply the arm's length principle, it is necessary to identify suitably comparable transactions.

- In our view, the purpose of reviewing comparable transactions is to identify an arm's length *price*. This may be done *directly*, in the case of the CUP method, or *indirectly*, in the case of a gross profit or net profit based method.

- Paragraph 48 of the Consultation paper states "the internationally accepted approach to determining an arm's length outcome for dealings … requires that the economically relevant characteristics of the situations being compared are sufficiently comparable to arrive at a reliable an arm's length **outcome".** The emphasis on outcomes or profits does not accurately reflect OECD guidance.

- The OECD guidelines set out factors which are relevant when assessing comparability. In our view, the comparability factors in the OECD guidelines provide an adequate framework for assessing comparability.

- There is no need for Treasury to provide additional guidance on comparability issues over and above the OECD guidance. We submit the issue of interpreting the OECD Guidance should be left to a facts and circumstances analysis. If the Commissioner considers there is a need for guidance on the ATO approach to comparability over and beyond the guidance of the OECD, this is best done through a Taxation Ruling on the topic, rather than written into the legislation.

- The Consultation Paper requested input on the extent to which the taxpayer's circumstances are relevant in a comparability analysis, citing the Canadian transfer pricing legislation as an example. PwC submits that while the circumstances of the taxpayer should be considered, this should be limited to the five comparability factors in the OECD Guidelines. Comparable transactions should not be rejected on the basis that the circumstances of the parties are not identical.

- The Consultation Paper raises the question of whether specific guidance is required to ensure that a strict market valuation approach is not adopted in favour of an 'arm's length outcome'. The inference is that the decision in SNF somehow acknowledged that the outcome achieved was not arm's length. In fact, in that decision the Court accepted that the losses of the taxpayer were entirely due to commercial factors unrelated to the transfer pricing. In this regard, we submit that there is no need to legislate guidance as to the relevance of the

'circumstances of the taxpayer'. Again, the OECD adequately deals with the consensus view of its members on the comparability standards appropriate – any attempt to enshrine an additional standard will likely result in an inconsistency with the arm's length standard and increased risk of double taxation.

Recommendations

- The transfer pricing rules should not be overly prescriptive on comparability issues.
- The Australian rules should not include additional comparability requirements. There is no need to restate, qualify or otherwise constrain the factors as set out in the OECD guidelines. If further guidance is required, this should be addressed in a public Taxation Ruling.

3.3. Selection of methods

Observations and issues

- The 1995 version of the OECD guidelines emphasised a preference for the use of Transactional methods to test the arm's length nature of transactions. Profit based methods were considered methods of 'last resort'. Similarly, the existing wording in Division 13 of the ITAA 1936 has been interpreted by the courts in SNF to focus on the pricing of individual transactions.
- The 2010 OECD guidelines no longer refer to profit based methods as methods of 'last resort', and now encourage selection of the most appropriate method. Treasury has extended this observation to say that a profit based method should be used wherever it is the most appropriate method.[4] It should also be noted that the OECD Guidelines state that where a transactional method and profit method are equally reliable, the transactional method should be preferred[5].
- There is an undue focus on profit outcomes (and implicitly, profit based methods) in the Consultation Paper. This does not seem consistent with the wording of the 2010 OECD guidelines, or the spirit of the arm's length principle as discussed earlier. At heart, the arm's length principle is focused on identifying comparable transactions to determine an arm's length price for a particular transaction. Where comparable data is available at a transactional level, this will usually produce a more reliable measure of the arm's length price than a profit based analysis.
- In June 2011 the OECD released a Suggested Approach to Transfer Pricing Legislation. In Section 4 of that report they note that the arm's length remuneration of a controlled transaction should be determined by applying the most appropriate transfer pricing method having regard to:
    - The respective strengths and weaknesses of the approved methods
    - The appropriateness of an approved method in view of the functions undertaken, assets utilized and risks assumed

[4] Consultation Paper, paragraph 56
[5] Para 2.3 of the OECD Guidelines 2010

- The availability of reliable information needed to apply the selected method; and
- The degree of comparability between the controlled and uncontrolled transactions.

- PwC submits that the guidance on method selection in the Australian transfer pricing rules should not go beyond these criteria. If Treasury or more particularly the ATO feel that further commentary on method selection is necessary, this should be contained in Taxation Rulings so as not to constrain the ability of taxpayers to rely on the OECD Guidance directly.

Recommendations

- A 'most appropriate method' approach is suitable.
- There should be no bias for any one particular approach.
- There should be no requirement to use a profit based method to test the arm's length nature of the outcome where a transactional method has been selected as most appropriate.
- Legislation should reference OECD guidance rather than provide prescriptive rules on method selection.

3.4. Self executing rules

Observations and issues

- We support a move to applying the transfer pricing rules on a self assessment basis. In our experience, taxpayers usually make their best efforts to comply with the tax law, including the transfer pricing rules.
- Currently, the only mechanism by which non-arm's length prices can be amended to reduce income in Australia is if an adjustment is initiated by an overseas tax authority and a correlative adjustment is provided under the Mutual Agreement Procedure (MAP) process. If we are to move to a full self assessment regime for transfer pricing, consideration should be given to whether the law should enable taxpayers to adjust their income downwards to correct a non-arm's length price, provided there is a solid basis and appropriate evidence is available to support such an adjustment.

Recommendations

- Consideration should be given as to whether the self assessment rules should permit taxpayers to make transfer pricing adjustments in either direction to correct a non-arm's length price.

3.5. Discretionary powers

Observations and issues

- We agree that retention of the wide discretionary power in Section 136AD(4) is inconsistent with self assessment and agree it should be limited to exceptional cases. The examples in the Consultation Paper are discussed below.

Insufficient data

A discretionary power based on inadequate data would be problematic for a number of reasons. These include:

- Perfect comparable data is rarely available in practice. It should be possible to identify arm's length prices based on the best comparable data available (even if this is the 'least worst' data). The Commissioner should have an obligation to seek to identify appropriate comparable data and should not be able to apply a discretionary power merely because such data is difficult to find. This is a common issue for transfer pricing globally. The analysis should be based on the most reliable and appropriate analysis and not allow a default to the Commissioner's averment position simply because there are no comparable dealings.

- A discretionary power based on insufficient data may encourage the ATO to adopt a standard of comparability which is so high that this power would be applied by the Commissioner frequently. We have seen in the courts (in *SNF* in particular) that the standard of comparability expected by the Commissioner can "set the bar at an unattainable height".

- The Commissioner has wide ranging power to access information held by taxpayers. In light of the powers held by the Commissioner, any discretionary power should be limited to only extreme situations where the taxpayer has withheld information or refused to cooperate with requests from the Commissioner.

Reconstruction

We anticipate several problems could arise with granting the Commissioner a power to 'reconstruct' transactions.

- The OECD Guidelines state that in all but exceptional cases, tax authorities should respect the actual transactions undertaken and should not disregard them or substitute other transactions for them.[6] The OECD Guidelines explain that restructuring legitimate business transactions is arbitrary and is more likely to lead to double tax.[7]

- OECD guidelines acknowledge MNEs may enter transactions that third parties may not. The guidelines state that "the mere fact that a transaction may not be found between independent parties does not mean that it is not arm's length".[8] A requirement for taxpayers to demonstrate that the structures of their transactions are similar to arrangements between independent parties would be onerous and would be likely to lead to non-arm's length outcomes. Tax authorities cannot and

[6] OECD Guidelines, paragraph 1.64
[7] OECD Guidelines, paragraph 1.64
[8] OECD Guidelines, paragraph 1.11

should not dictate how MNEs structure their operations and should take care in assessing whether a transaction is "commercially realistic"

- The question of whether a transaction 'would have' occurred between independent parties is highly subjective and ignores the fact that MNEs may choose, for commercial reasons, to structure their businesses differently from independent parties.

- The exceptional circumstances contemplated in the OECD Guidelines are where either:

    - The economic substance of an arrangement differs from its legal form; or

    - The arrangements between related parties, when viewed in totality, differ from what would have been "adopted by independent enterprises behaving in a commercially rational manner ***and the actual structure practically impedes the tax administration from determining an appropriate transfer price"*** (emphasis added).

- The general anti-avoidance rules in Part IVA provide the Commissioner a broad power to challenge non-commercial arrangements which have been entered into for the purposes of tax avoidance.

Thin capitalisation and capital structures

- We note that the Consultation Paper includes the example of a loan to a thinly capitalised entity as a transaction that could potentially warrant reconstruction. We understand that a review of Australia's thin capitalisation rules is not within the scope of Treasury's review of the transfer pricing rules, and the only reason this example was included is because it is mentioned in the OECD Guidelines.

- The context for the inclusion of this example in the OECD Guidelines is that in some other countries, the transfer pricing rules operate to determine an arm's length amount of debt that an entity may borrow. In Australia, the thin capitalisation rules provide a specific safe harbour on the amount of debt in respect of which interest deductions may be claimed. We suggest removing this example in any further consultation over the proposed changes to the transfer pricing rules.

- The interaction of the transfer pricing rules with the thin capitalisation rules and debt-equity rules has been a contentious area of debate for several years. In 2010, the ATO issued a Taxation Ruling (TR 2010/7) which clarified that the transfer pricing rules should not override the thin capitalisation safe harbour.[9]

- The new law needs to explicitly confirm that the transfer pricing rules are not to be used as a 'back door' way to override the thin capitalisation safe harbour or Division 974 debt equity rules.

Recommendations

- A discretionary power for cases where there is insufficient data should be limited to situations where the taxpayer has intentionally withheld information. The

[9] See Example 4 in TR 2010/7

Commissioner already has significant formal powers to gather information and does not need additional discretionary powers to meet his needs.

- The Commissioner should not be given a discretionary power in situations where it is difficult to identify comparable dealings.
- If there is to be a discretionary power to reconstruct transactions, this should be limited to the exceptional circumstances contemplated in the OECD Guidelines.
- It should be made clear in the new law that the transfer pricing rules will not override the thin capitalisation rules in Division 820 in respect of determining an arm's length capital structure, nor will they override the rules in Division 974 which determine whether an instrument is considered debt or equity for tax purposes.
- We would welcome legislation that specifically confirms that the transfer pricing provisions should be applied to the actual transactions entered into.

3.6. Record keeping requirements

Observations and issues

- In light of the taxpayer's onus of proof under a self-assessment based system, we agree that it is appropriate for taxpayers to be required to maintain documents which demonstrate their compliance with the transfer pricing rules.
- A documentation requirement needs to be balanced with the risk involved and compliance costs to taxpayers.
    - We agree with the Consultation Paper suggestion that legislative documentation requirements should not be overly prescriptive. Taxpayers should be given discretion to apply the principles of 'prudent business management' to determine what documentation is appropriate based on the materiality of and potential risk associated with their transfer pricing arrangements.
    - We support the inclusion of a *de minimis* threshold within the documentation requirements. We agree that the value of related party dealings may be an appropriate criterion upon which to base the threshold. We recommend considering a threshold for entities, and a threshold for specific transactions. Consistency with the threshold in the International Dealings Schedule of the income tax return would be sensible.
    - If guidance will be provided on the 'minimum requirements' to be included in a taxpayer's transfer pricing documentation, these should not be overly prescriptive and should not go beyond the OECD Guidelines.
- In our opinion, the ATO's expectations of a taxpayer's documentation are too high. Taxpayers should not be measured against a set of 'ideal' documentation criteria. If a taxpayer has acted with due care and diligence in preparing its documentation, we consider that penalties should be reduced to nil.
- The law must be carefully drafted to ensure the documentation requirements do not force taxpayers to use a particular transfer pricing method. Taxpayers should select the most appropriate method for their transactions based on the various criteria we discussed above at section 3.3.

- The suggestion in the Consultation Paper that documentation should include an explanation of the profit outcomes may force taxpayers into applying some form of profit based method, even where they have comparable data available to apply a traditional transactional method. In our view, this would be beyond OECD Guidance. A requirement for a taxpayer's documentation to explain the profit outcomes will not be relevant in all cases.

Recommendations

- The documentation requirements should provide flexibility to taxpayers to determine what documentation is appropriate for their business and related party dealings having regard to the complexity and value of the transaction and perceived level of risk in the transactions.
- If the documentation rules require taxpayers to explain why the profit outcomes of their dealings are reasonable, care must be taken to ensure this does not force taxpayers to apply profit based transfer pricing methods.
- The proposed legislation should state that "contemporaneous documentation" means documentation that was in place prior to the lodging of the tax return.

3.7. Penalties

Observations and issues

- It is acknowledged by the ATO and transfer pricing practitioners that transfer pricing is rarely free from some doubt and differences of opinion. Therefore, Treasury's intention to reduce penalties is welcomed and encouraged.

- The Consultation Paper suggests that penalties should be reduced where 'taxpayers act with due care and diligence and make reasonable efforts to apply the arm's length principle'. We agree with this suggestion.

- We agree with the suggestion to reduce penalties to zero where the taxpayer 'has made good faith attempts, commensurate with the relative importance of the profit allocation issue in the context of the taxpayer's business, to determine an arm's length price and has maintained contemporaneous documentation.'

- It is reasonable to link the preparation of contemporaneous documentation to penalties for any tax shortfall resulting from a transfer pricing adjustment. For example, we understand that in the United States, where a taxpayer has prepared contemporaneous documentation that satisfies certain requirements, penalties on transfer pricing adjustments can be reduced to zero.

- The Consultation Paper's direct link to a prudent business management test is encouraged; however, more guidance will be required to clarify this matter further. In our experience, most taxpayers prepare documentation commensurate with their perceived level of risk, the complexity of the transactions and the relative value of the international related party transactions. However, this is subject to personal interpretation and therefore, taxpayers should not be penalised merely because an ATO officer believes more documentation should have been prepared. Further, the Commissioner should not rely on hindsight to make a judgment on whether a taxpayer's response, at the time of dealing with international related parties, was appropriate. Regard should be had to what a prudent business person would do at the time.

- We understand and agree that more complex issues and transactions (e.g. transfer of intellectual property, cost sharing arrangements) would ordinarily require more detailed documentation than more routine and simpler transactions such as the sale or purchase of goods, or provision or receipt of services.

- The Consultation Paper contemplates penalising taxpayers who do not hold their documentation in Australia. We do not agree with this suggestion. Multinational companies often prepare documentation centrally to support the arm's length nature of transactions. In particular, it is more efficient for taxpayers to prepare documentation centrally from some transactions such as services provided by head office management teams. Provided the documentation relevant to Australian transactions, meets Australia's requirements, was in existence prior to lodgement of the tax return and is made available to the ATO upon request, there should be no penalty for storing the information offshore.

Recommendations

- We recommend that penalties for a shortfall arising from transfer pricing adjustment should be zero percent where taxpayers have made a genuine and reasonable attempt to comply with the transfer pricing rules having regard to the nature of the taxpayer's business (e.g. size, financial position, available resources etc), complexity of transfer pricing issues and value of the transactions subject to transfer pricing.

- Penalties should only apply where a taxpayer has:

  – Made no attempt to support its transfer pricing position,

  – Been reckless or intentionally disregarded the requirements, or

  – Obstructed the Commissioner in making his assessment.

  To the extent possible, where penalties are applied (i.e. above 0%), the regime for penalties should be consistent with other general tax matters resulting in shortfalls.

- The location where documentation is held should not be a driver for penalties. Regard should be had to whether the documentation meets Australia's requirements, supports an arm's length price, the taxpayer has transacted in accordance with the documentation and whether additional analyses in Australia would have resulted in a materially different price.

3.8. Time limits for amendments

Observations and issues

- The Consultation Paper refers to two time limits; one for the initiation of a transfer pricing audit and the second for the making of an amended assessment. In our view, a time limit for amendment is more consistent with other areas of tax and is therefore preferable. There are strong arguments that the time limit for amendment should be reduced in line with the normal time limits for amendments, 4 years. The proposal to legislate transfer pricing documentation, the increased disclosure requirements of the International Dealings Schedule and the Reportable Tax Positions Schedule and the ATO's stated move to carry out risk reviews in "real time", would suggest that any time limit beyond 4 years is no longer required. At worse, time limits for amendments involving transfer pricing should be no more than the 6 year time limit for general anti-avoidance.

Recommendations

- We support the introduction of time limits for making transfer pricing adjustments and consider that a 4 year amendment limit is appropriate.

3.9. Treaty Issues

Observations and issues

- We note that the Consultation Paper states that domestic profit allocation rules could be redesigned to 'clearly act as the principal source of authority for profit allocation assessment' and that treaty provisions will only seek to 'limit any power contained in the domestic law'. In our view, this would be the correct approach and would be preferable to the Assistant Treasurer's suggestion that the law may be clarified to give treaties a taxing power.

- Attempting to apply a taxing power under the treaties would be open to legal challenge, even if the law is amended prospectively. It will also mean that our treaty countries are prejudiced in comparison to non-treaty countries. We do not consider that the wording variations between Australia's concluded treaties and the OECD model treaty are likely to have any material impact on the question of whether a particular transaction between associated enterprises has been conducted on an arm's length basis.

Recommendations

- The domestic transfer pricing rules should be formally recognised as the principal authority for the Commissioner to enforce Australia's transfer pricing rules. We do not support the notion of the treaties creating a taxing power.

4. Other considerations

Observations and issues

We note that there are several other issues that may need to be considered in redrafting the transfer pricing rules. These include:

- If profit based methods are to be embedded in the law, consideration will need to be given to how a profit based transfer pricing analysis will be linked to assessable income and allowable deductions from a practical perspective.
- The interaction of the transfer pricing and customs rules should be considered. Tension has always existed between the transfer pricing and customs rules. Where an adjustment is made to the price of imported goods for tax purposes under the transfer pricing rules, there is no automatic adjustment to the customs value of the goods. Seeking an adjustment for customs purposes can be problematic because the timeframes within which adjustments can be made are shorter under the customs rules, and because customs rules focus on the value of specific import transactions. If changes to the transfer pricing rules promote the use of profit methods, this will only increase the number of instances in which the customs and transfer pricing rules are misaligned.
- Consideration should be given to clarifying the application of the transfer pricing provisions to equity instruments. The existing transfer pricing provisions are widely drafted and can arguably apply to an equity instrument such as a share. In the years since the introduction of Division 13, Australia has introduced debt equity provisions which allow certain equity instruments to be regarded as debt for tax purposes. These rules have limitations on the amount of 'interest' deductible which are similar in nature, but more prescriptive than the transfer pricing provisions. It is, in our view, unnecessary to have the transfer pricing provisions apply to such instruments and creates additional compliance burdens in ensuring the level of debt deductions is allowable under both sets of provisions. In our view, there is no need for the transfer pricing provisions to apply to equity instruments.

Recommendations

- Drafting of legislation will need to address the practical application of the transfer pricing rules in determining income and deductions.
- PwC submits that government should consider and address the customs implications of the new transfer pricing rules. We encourage dialogue between Treasury and the Department of Home Affairs in order to align transfer pricing legislation with Customs legislation.
- The new transfer pricing provisions should not apply to equity instruments.