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5 December 2011

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

By e-mail: transferpricing@treasury.gov.au

Dear Sir/Ms

Consultation Paper - Income tax: cross border profit allocation - Review of transfer pricing rules ("the Consultation Paper")

Pitcher Partners comprises 5 independent firms operating in Adelaide, Brisbane, Melbourne, Perth and Sydney. Collectively we would be regarded as one of the largest accounting associations outside the Big Four. Our specialisation is advising smaller public companies, large family businesses and small to medium enterprises ("SMEs") - which we refer to as "the middle market" in this submission. Thus, our main focus in writing this submission is on the implications of the proposals in the Consultation Paper for the middle market.

General comments

We welcome the opportunity for the transfer pricing rules to be clarified. Their complexity has long been a significant challenge for the middle market.

In this regard we welcome a number of the proposed areas for amendment including:

- The introduction of time limits on transfer pricing amendments;
- Curtailing the Commissioner's wide discretionary power in s136AD(4); and
- The introduction of a de minimis rule with respect to documentation requirements for taxpayers satisfying the relevant criteria.

However we are concerned that the proposal does not adequately address the high compliance costs for transfer pricing compliance and documentation in the middle market.

Therefore in order to ensure the fairness of these measures we believe that the following should also be implemented:

- A meaningful de minimis threshold below which the transfer pricing rules do not apply – this is in line with systems in countries such as the United Kingdom;

- Safe harbours for the most common international related party transactions – again this is consistent with many of our trading partners;

- No penalties where reasonable efforts have been made to transact at an arm's length price – even if full documentation has not been prepared contemporaneously; and

- Removal of the Commissioner's discretionary power under section 136AD(4) and replacement with an objective test.

We believe that the implementation of the proposals above would represent an appropriate balancing of revenue risk with the compliance cost burden on middle market taxpayers.

Specific comments

Some additional comments together with a more detailed discussion on the points raised above are set out in the attached Appendix.

Further information

We believe that the issues raised in this submission are of critical importance to the middle market and we would appreciate a meeting with Treasury to discuss these issues further.

Please contact the writer on 03 8610 5401 if you would like more information on, or clarification of, any of the issues raised in this submission or to organise a meeting to discuss this further.

Yours faithfully
PITCHER PARTNERS ADVISORS PROPRIETARY LIMITED

DENISE HONEY
Executive Director

APPENDIX
SPECIFIC COMMENTS ON THE CONSULTATION PAPER - INCOME TAX: CROSS BORDER PROFIT ALLOCATION - REVIEW OF TRANSFER PRICING RULES ("THE CONSULTATION PAPER")

We have had the benefit of reading the ICAA's submission in draft and we concur with the comments made in that submission. In particular we agree that a retrospective change to the law to allow transfer pricing amendments to be made via the Transfer Pricing article in a double taxation agreement is inappropriate.

However our focus in making this submission is on the compliance burden faced by the middle market and therefore our specific comments are focused on the issues that we believe to be particular to such taxpayers.

1. Introductory comments

Every major review of the Australian taxation system has stressed the fact that any changes in the taxation system should:

(a) seek to lower compliance costs for business; and
(b) simplify administration for tax authorities.

In particular the Ralph and Henry Reports emphasised that the tax system should not inadvertently add to the costs faced by Australian taxpayers by excessive complexity and compliance costs.

In our view the Consultation Paper does not adequately address whether the application of strict transfer pricing rules across all taxpayers provides the correct balance between compliance costs and revenue risk for taxpayers in the middle market.

Transfer pricing is a highly specialised area which requires access to skills and information that middle market taxpayers do not have internally. Therefore their only way to comply with both the pricing and documentation requirements is to engage an external firm to perform this work. Due to the nature of the work, such services are generally very expensive.

For taxpayers with hundreds of millions of dollars of international related party transactions we can see that the potential revenue risk may justify the imposition of such compliance costs.

However for taxpayers in the middle market with international related party transactions in the hundreds of thousands of dollars or even millions, the cost benefit analysis is quite different.

For example, a middle market taxpayer who has an interest bearing loan of $2,500,000 with an international related party will be required for the year ending 30 June 2012 to: (i) complete the new International Dealings Schedule ('IDS'); and (ii)

put in place contemporaneous documentation that supports the interest rate being adopted as being at arm's length.

If 8% is being charged on the loan, the revenue collected on the interest will be $60,000. Should the ATO then determine that the interest rate being adopted is not at arm's length and a transfer pricing adjustment is made, the revenue at risk for (say) a 200 basis point adjustment would only amount to $15,000.

The cost of complying with the IDS and proposed transfer pricing legislation is likely to be (conservatively) at least half of this amount which does not seem to represent an appropriate balance between revenue risk versus the compliance costs for taxpayers and revenue authorities.

We believe that there must be a way to better balance revenue risk concerns against the compliance burden on taxpayers. It is in this regard that we believe it is essential to include the following in the transfer pricing amendments:

- A meaningful de minimis threshold below which the transfer pricing rules do not apply – this is in line with countries such as the United Kingdom;

- Safe harbours for the most common international related party transactions – again this is consistent with many of our trading partners;

- No penalties where reasonable efforts have been made to transact at an arm's length price – even if full documentation has not been prepared contemporaneously; and

- Removal of the Commissioner's discretionary power under section 136AD(4) and replacement with an objective test.

We will discuss each of these essential elements in more detail below.

2. De Minimis Threshhold

While the Consultation Paper has flagged a proposed de-minimis rule its scope appears to be very limited on the basis that:

- It only covers the documentation requirement – not the requirement to comply with transfer pricing generally; and

- It refers to the ATO's current simplified transfer pricing guidelines which are extremely limited in scope[1] and which do not offer a meaningful reduction in the documentation burden for middle market taxpayers.

[1] For example, the ATO allows a simplified approach to transfer pricing documentation and risk assessment for small to medium businesses with an annual turnover of less than $100 million. However it does not apply where the business is part of a multinational group that is listed on any stock exchange or part of a private group with any international subsidiary or other offshore related party that has the resources to deal with global transfer pricing issues.

In our view, in a proper balancing of compliance costs against revenue risks, it is essential that some taxpayers are completely carved out of the transfer pricing rules. This is on the basis that below a certain point it is just not cost effective or practical to impose transfer pricing guidelines. The UK has recognised this in its transfer pricing rules which provide that small and medium enterprises[2] are exempt from the transfer pricing rules. A small or medium enterprise under this definition is one that has less than 250 employees and either:

- turnover of less than €50m; or
- assets with a balance sheet total of less than €43m.

This test is undertaken taking into account the whole of the group of which the UK enterprise is a member. Therefore a large multinational group with the resources to comply with transfer pricing legislation would not be carved out of the rules even if its local subsidiary was a relatively small operation.

The Consultation Paper recognises the desirability of having rules which are consistent with international standards, therefore we believe the starting point for considering an SME carve out would be the UK thresholds.

3. Safe Harbours

A further way to reduce compliance costs without placing the revenue at risk would be to implement safe harbour transfer pricing methodologies for common transactions. Given the high level of expense associated with transfer pricing compliance we believe that it is essential that such safe harbours are incorporated into the new transfer pricing rules.

We believe that this would be very easy to legislate. We would propose that the legislation allow the introduction of safe harbours via regulation. The legislation could set out the parameters for this regulation making power. We would see this as being:

- Defining a series of transaction classes;
- Specifying an approved transfer pricing methodology for each transaction class; and
- Specifying an approved range within the approved transfer pricing methodology for each class.

Examples of this type of approach can be found in the service trust guide issued by the ATO[3]. Another example might be non-core administration services (a matter

[2] As defined in the Annex to European Commission recommendation 2003/361/EC of 6 May 2003.
[3] See NAT 13086-04.2006

considered to a limited extent in TR 1999/1[4]) which could be set out in a table in the legislation as follows:

- Class – Non-core administration services – with an appropriate definition;
- Methodology – Cost plus; and
- Approved range – Mark up of between 5 – 7.5%.

Other examples of common transactions are as follows:

- Group finance services;
- Group management services;
- On-charging of personnel;
- Unsecured loans in AUD;
- Fully secured loans in AUD;
- Provision of a guarantee;
- Sale of manufactured goods; and
- Sale of raw materials.

We believe that the middle market would be likely to choose the safe harbour rather than seek to do their own detailed transfer pricing analysis in most instances. This would have the dual benefit of keeping compliance costs relatively modest and limiting revenue risk. In fact it may well increase revenue on the basis of increased compliance from the middle market with respect to transfer pricing legislation.

The United States[5] and New Zealand[6] already have safe harbours for some transactions to ensure transactions are on an arm's length basis, as discussed above.

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[4] See paragraph 87

[5] The USA allows taxpayers to choose to use a safe harbour interest rate that is based on the applicable federal government rate ("AFR"). In general, the rule allows interest to be charged at a rate not less than the AFR and not greater than 130% of the AFR - which is determined monthly and is based on the average interest rate on federal government debt with similar maturity dates.

There is also a services cost method ("SCM") in the USA that allows taxpayers to choose to price services at cost rather than the actual arm's length price. Cost reimbursement is deemed to be the arm's length price if the taxpayer properly chooses to apply this method.

[6] New Zealand has a simplified transfer pricing method for loans. That is, if the rate charged is less than the relevant base indicator plus 300 basis points (3%), the rate will be regarded as broadly indicative of an arm's length rate - i.e. in the absence of a readily available market rate for a debt instrument with similar terms and risk characteristics.

Therefore the utilisation of safe harbours would be in line with international standards.

4. Documentation - No Penalties if Reasonable Efforts made

The Consultation Paper proposes that:

- a legislative change is made that will require taxpayers to maintain transfer pricing documentation that evidences the adoption of an arm's length principle; and

- a specific penalty provision is introduced that will broaden the situations in which penalties can be imposed on taxpayers who have failed to keep contemporaneous records in Australia.

While we understand the importance of incentivising taxpayers to comply with legislation, we believe that it would be unfair to impose transfer pricing penalties on taxpayers who have made reasonable efforts to determine an arm's length price, notwithstanding that they may not have contemporaneous transfer pricing documentation.

For many middle market taxpayers, putting together full contemporaneous transfer pricing documentation for every international transaction will simply be cost prohibitive, regardless of the potential penalties. However if such taxpayers could prevent penalties by making reasonable efforts to determine an arm's length price, with a much lower compliance cost than that imposed by full transfer pricing documentation, then they would certainly be incentivised to do so.

In our view, revenue is only likely to be enhanced by this approach, as more taxpayers would seek to apply transfer pricing principles.

We have put together an example of a scenario in which we believe the 'reasonable efforts' threshold would be met below.

A taxpayer borrows $2m from a related party. In order to work out the most appropriate interest rate, they go to their local bank and ask for the interest rate on a $2m unsecured loan. The bank quotes a rate of 12%. The taxpayers then applies this interest rate to the loan. Subsequently the ATO reviews the transaction and finds that the correct rate should be 10%. Under the proposed rules the taxpayer has not undertaken the full transfer pricing analysis required, however they have made reasonable efforts to determine an arm's length price. Therefore penalties should not apply to this taxpayer.

We note for completeness that the Canadian transfer pricing regime allows for a reduction in penalties where, inter alia, the taxpayer has made reasonable efforts to determine and use arm's length transfer prices.

5. Replacing Commissioner's 136AD(4) Discretion with an Objective Test

The Consultation Paper also canvasses the removal of the wide discretionary powers currently provided to the ATO to determine an arm's length consideration.

We support this proposal, which is consistent with the Government's proposal in 1991[7] (and subsequent discussion paper in 2007[8]), whereby it was stated that (where possible) discretions would be removed from the Tax Acts and replaced with specific criteria or objective tests to which the taxpayer can refer in determining the relevant amount, apportionment, and the like.

Accordingly, the Government should replace the wide discretions in section 136AD(4) with an objective test which is limited in scope to situations where the taxpayer has not provided the Commissioner with a reasonable level of information regarding the relevant transactions.

In our view, there is no need to have a discretion to deal with situations where there are no comparable dealings. This is on the basis that profit based transfer pricing methods could be used in this instance.

Similarly, we do not believe that a residual discretion is necessary to address cases where arrangements are structured in a way that independent parties dealing at arm's length with each other would not have structured them. This is on the basis that such situations could be addressed via the use of the objective transfer pricing tests and in extreme cases, Part IVA.

We believe that limiting the scope of the Commissioner's discretion in this way would provide an appropriate balance between revenue risk and the reduction of uncertainty and compliance costs for taxpayers.

In order to make such an objective test meaningful it is important that it be drafted in terms that taxpayers can apply themselves. In particular the terminology needs to be such that taxpayers do not find themselves in a position where they need to apply for a Private Binding Ruling with respect to every transaction.

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[7] Department of Treasury, 'Improvements to Self-Assessment Priority Tasks Information Paper', August 1991, at page 10.

[8] Department of Treasury, 'Review of Discretions in the Income Tax Laws Discussion Paper', June 2007.