RSM! Bird Cameron
Chartered Accountants

RSM Bird Cameron
Level 8 Rialto South Tower
525 Collins Street Melbourne VIC 3000
PO Box 248 Collins Street West VIC 8007
T +61 3 9286 1800 **F** +61 3 9286 1999
www.rsmi.com.au

30 November 2011

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

Dear Sir/Madam

Consultation Paper – Income Tax: Cross Border Profit Allocation: Review of Transfer Pricing Rules ("Rules")

We refer to the release of the above Consultation Paper and welcome the opportunity to provide our comments.

According to the Consultation Paper, our transfer pricing rules have two principal objectives. Firstly, that Australia receives an appropriate share of tax from multinational companies reflecting the "economic activity attributable to Australia". Secondly, the Rules "should not unreasonably inhibit Australia's attractiveness as a destination for new investment and business activity". Treasury goes on to say that the purpose of this review is to ensure our transfer pricing rules "reflect international best practice and are consistent with internationally accepted transfer pricing principles and concepts".

Our comments and feedback are made with these two principals at the forefront of our thinking. We highlight below our concerns that the proposals put forward, in their current form, do not meet these objectives and fear in fact these principals are actually being eroded by the changes proposed.

Background and summary of submission

We agree with Treasury that the importance of international related party transactions is extremely significant from a macroeconomic perspective. As globalisation continues it is imperative that the Australian Rules are seen to be modern, clear, understood and aligned with international best practice. The establishment and maintenance of a level playing field is absolutely vital for businesses operating in Australia. Accordingly, in light of recent judicial interpretation of the existing transfer pricing Rules, most notably in *Roche*[1] and *SNF*[2], a review of the existing Rules is necessary and welcome.

[1] *Re Roche Products Pty Limited and Commissioner of Taxation* [2008] AATA 639.

[2] *Federal Commissioner Taxation v SNF (Australia) Pty Ltd* [2011] FCAFC 74.

Liability limited by a scheme approved under Professional Standards Legislation

Birdanco Nominees Pty Ltd ABN 33 009 321 377 Practising as RSM Bird Cameron ABN 65 319 382 479

Major Offices in: Perth, Sydney, Melbourne, Adelaide and Canberra

RSM Bird Cameron is an independent member firm of RSM International, an affiliation of independent accounting and consulting firms. RSM International is the name given to a network of independent accounting and consulting firms each of which practices in its own right. RSM International does not exist in any jurisdiction as a separate legal entity.

The Consultation Paper outlines several areas of the transfer pricing Rules that may be changed. Whilst some proposals are welcome, we have some fundamental concerns as to the overall approach and direction being adopted and whether these proposals actually achieve Treasury's stated objectives.

Further, we are concerned by the extremely limited initial consultation period for such an important reform. We see no reason for such a short consultation period. We note the proposed legislative timetable and very strongly doubt this will provide sufficient time for Treasury to digest all the salient feedback. Accordingly, we are concerned the comments and suggestions of the business community and the profession will not be reflected in the legislation proposed.

Detailed below are our comments. We do not propose to discuss in detail all of the proposed changes but intend to focus on our major areas of concern. In making our comments, we note the references throughout the Consultation Paper to 'allocation of profit'. Such language is of major concern to us. Transfer pricing is not concerned with allocating profit. It is concerned with adherence to the arm's length principle and its application to related party transactions. These two concepts are fundamentally different and should not be confused.

Interpretation of the Arm's Length Principle

The "cornerstone" of the OECD Transfer Pricing Guidelines ("OECD Guidelines") is the arm's length principle. The Consultation Paper appears to seek to redefine the interpretation and application of this globally accepted principle. Redefinition that is not in accordance with international consensus will undermine Treasury's justification of reviewing the transfer pricing Rules. There can be no leeway in articulating beyond doubt what this principle is and means from an Australian perspective.

The Consultation Paper raises the proposition clearly - "Can the arm's length principle be better reflected"? It addresses this issue from a number of angles and concludes the arm's length principle does not necessarily encompass looking at the arm's length nature of a transaction; rather "...the ***overall profits*** of the parties reflect an ***arm's length outcome*** given their respective ***economic contribution***". Such an interpretation is concerning and appears an attempt to achieve the most expansive and broad interpretation of the arm's length principle possible. The Paper also concludes profit allocation rules in our DTA's look at the "totality" of arrangements rather than the actual arrangement that exist between parties.

The Paper repeatedly refers to the concept of '*economic contribution*'. It is our understanding that, in interpreting this term, Treasury is looking at the contribution of the Australian entity relative to the whole of the Group's contribution. That is, in looking at the whole of the Group's economic output, what portion of this is attributable to Australia? We interpret this to mean Treasury is seeking to bring within Australia's jurisdiction a relative share of profit.

We draw this conclusion based on the language used in the Consultation Paper. For example, we refer to paragraph 3 of the Paper (our emphasis):

"In accordance with the arm's length principle as articulated in the OECD MTC, the ultimate goal of the *profit allocation rules* is to ensure an *arm's length outcome* for each party, reflective of their relative *overall economic contributions*, by *allocating profits* consistently with the conditions that would most likely have operated between independent parties in comparable circumstances. While in practice this *may* be achieved by determining the arm's length price for a particular transaction(s), the consideration of a transfer price for a transaction seen in isolation *may not always address the broader arm's length principle* as required by our treaties."

We consider the conclusion reasonably to be drawn from this extract is that Treasury is seeking to tax a portion of the world wide profits of a multinational group.

The OECD Guidelines do not support the notion of taxing based on '*economic contribution'*. Firstly, a "contribution" is extremely hard to measure hence its rejection as a sound taxing concept. What amount of 'economic contribution' do you attribute to a subsidiary's marketing activities when without the ability to utilise its parent's intellectual property the local brand would not exist at all. The only way to reliably and economically measure such a relationship is on a transaction by transaction basis. That is, a royalty payment for the use of intellectual property and a services fee for the marketing.

As discussed further below under the 'OECD Guidelines', to attribute a level of profit, or impose an expected profit margin is entirely at odds with the Guidelines, and the concept of competitive advantage. All entities have their strengths and weaknesses and it is these strengths and weaknesses that ultimately determine their profit or loss. The only way to ensure entities are not under or overtaxed is to continue to recognise these individual and unique characteristics on an individual transactional basis.

As per the OECD 2010 Guidelines (our emphasis):

"In *no case* should transactional *profit methods* be used so as to result in overtaxing enterprises mainly because they make profits lower than the average, or in under-taxing enterprises that make higher than average profits. There is no justification under the arm's length principle for imposing additional tax on enterprises that are less successful than average, or conversely, for under-taxing enterprises that are more successful than average, when the reason for their success or lack thereof is attributable to commercial factors."[3]

Therefore the concept of '*economic contribution*' cannot be measured by simply attributing a share of profits to each entity. This would be akin to reverting to a quasi-formulatory approach, strongly rejected by the OECD. For this reason, an objects clause in any future transfer pricing legislation containing the term 'economic contribution' would be confusing and at odds with the arm's length principle and global practice.

In any event, we find it difficult to imagine situations where a profit method would be the "most appropriate method", (other than the example referred to in the OECD Guidelines of a highly integrated organisation) given it does not take into account the nature of an actual transaction, nor can it take into account the circumstances of each particular dealing between the related parties. As stated in the OECD Guidelines:

"...it is not appropriate to apply a transactional profit method merely because data concerning uncontrolled transactions are difficult to obtain or incomplete in one or more respects."

The language and justification used throughout the Consultation Paper regarding the interpretation and application of the arm's length principle is, in our opinion, selective, skewed towards a support of comparative profit methods, and does not fairly reflect the treatment within the OECD Guidelines of the interaction of transaction methods and profit methods.

In particular, we seek clarification on whether there is an intent by Treasury to move to a US style comparable profits method system? This should not be the intent of the proposed changes and if it is, this should be stated clearly with sufficient support as to why such an internationally incompatible approach is being considered.

Separate Ability to Tax under a Double Tax Agreement ("DTA")

The Assistant Treasurer has stated that, regardless of the outcomes of the consultation process, the Government intends to *'clarify'* that Australia's tax treaties confer a separate right to tax. By 'clarifying' this point, the Paper assumes Australia's treaties already provide an alternative right to tax. This assumption is made with a significant body of opinion in opposition. For example, the cases of *Roche* and *SNF* lend support to the position this is not the correct interpretation. Further, treaties have traditionally been drafted as confining the jurisdiction and scope of

[3] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, 2010, p 2.7

a country's taxing ability, not imposing a right to tax in themselves. They are a shield, not a sword, to use a common phrase.

While OECD commentary is silent as to the ability of a treaty to independently impose transfer pricing adjustments, most of our key trading and investment partner jurisdictions (Germany, France, UK, NZ, Canada and the US) have held such a power is not conferred.[4] This suggests the international position is supportive of the position treaties do not impose a right to tax/make adjustments on their own. Put simply, domestic law imposes the tax, and the treaty then allocates the right to tax.

Further, the Federal Court decision in *Chong*[5] suggested the wording of the DTA's themselves may not be amenable to imposing tax. Accordingly, while the Parliament may be able to clarify that a DTA can impose taxation, it may not ensure that they *do* actually impose taxation.

Notwithstanding these comments however, it would appear the only rationale for such an application is to allow the ATO to make transfer pricing adjustments based on profit methods. For as stated in the Consultation Paper, once Division 13 is amended to allow the use of profit methods (ie 'the most appropriate method'), a separate but identical power under the DTA is no longer relevant.

We therefore refer you to our discussion further below on the retrospectivity of this amendment and submit, along with being out of step with international practice, such a move creates considerable Sovereign risk and will leave entities open to potential double taxation.

Are we 'Out of Kilter' with International Best Practice?

What is best practice should be ascertained with reference to our major trading partners, and the OECD and UN models that countries follow. It is difficult to have a discussion on international 'best practice' when only the transfer pricing regimes of the UK, and to a limited extent, New Zealand are discussed in the Paper. There is no discussion in the Paper of the transfer pricing regimes of the majority of our largest trading partners. This is a considerable omission and gives the impression, real or not, that Treasury has cherry picked evidence from certain regimes to support a desired outcome, rather than engaging in a robust alignment exercise with international best practice. How can there be real alignment without consideration of these transfer pricing regimes?

To illustrate this, Appendix A summarises the transfer pricing rules of our top ten trading partners. Of these, five have a clear preference for transactional methods.

Essentially, the assertion in the Paper that Australia is 'out of kilter' with our international trading partners is incorrect. Findings by the Courts in both *Roche* and *SNF* were in line with the international community's preference for transactional methods over profit methods. This position is supported in the OECD Guidelines which state the use of transactional methods is preferred over profit based methods where both are equally and reliably available.

[4] For example, under the US Constitution, treaties are the responsibility of the President with the advice and consent of the Senate. However, the USA Constitution conversely provides revenue raising bills must originate in the House of Representatives. Arguably therefore, tax treaties cannot constitutionally impose tax in the US. Tax treaties are enacted in Canada via an act of Parliament which approves the treaty, declares it to have the force of law in Canada and gives it priority over any inconsistent Canadian law . However, it is a general principal in Canada that tax treaties are exclusively relieving, and do not act to impose taxes which do not otherwise apply under domestic law (refer The Queen v. Melford Developments Inc (1982) 82 DTC 6281). Tax treaties are given effect in NZ in accordance with an Order in Council, in accordance with a statutory section which refers to relief from tax, and without further approval by Parliament. Therefore it is considered a DTA cannot impose tax in NZ.

[5] *Chong v Federal Commissioner Taxation* [2000] ATC 4322.

The argument raised by the Court in *SNF,* that the use of the term 'transaction' in Division 13[6] may be limiting when profit methods are required, is important and should be addressed. This does not mean however, that profit methods are to be given equal billing. We refer again to the OECD's draft legislation[7] and the 2010 Guidelines on this point and suggest, if the legislation is to be as prescriptive as proposed, this would be a good starting point.

Also deserving of mention is the OECD guidance that "other" appropriate applicable methods may be used if relevant. There appears no reference to this in the Paper, notwithstanding that an increasing number of jurisdictions are specifically legislating such a clause, for example China and the US. Provision must be made for this to allow compatibility with these jurisdictions.

United Kingdom Guidance

The Consultation Paper relies heavily, if not uniquely, on the UK's transfer pricing legislation to support its proposals. Firstly, we refer to the discussion of the term 'provision' at paragraphs 37-39. We note there is no intention in the UK legislation for the term 'provision' to capture a larger portion of transactions, or indeed to refer to economic contribution of an entity. The term 'provision' was formulated and introduced, rather than the term 'transaction', in order to encompass transactions which do not 'occur' but should have occurred at arm's length. For example, HQ costs that have not been recharged.

Secondly, we note Treasury's interpretation of the term 'series of transactions'. The Paper appears to incorrectly interpret this as justifying its whole of entity approach through suggesting a 'series' of transactions is a series of transactions between company A and B and is therefore akin to the entirety of economic contribution of the entity. This interpretation is incorrect on two fronts. Firstly, the UK legislation refers to a 'series' of transactions as being from points A►B►C►D. This was primarily designed as an integrity measure to prevent interposed entities allowing the transaction to fall outside the scope of the legislation.

Further, and more importantly, if you accept the ATO's interpretation (which we do not for the above reason) of a series of transactions being several transactions between points A to B, this does not justify assessing the entire entity on the basis of this 'series' of transactions. An entity undertakes a multitude of transactions, all of different types and relative importance to the entity, and all of which contribute to (or diminish) the returns of that entity. These transactions have different margins and imposing one return on a 'series' of transactions at the level of the entire entity would lead to a complete misrepresentation of the transaction being undertaken. As an example, the ATO itself allows different mark-ups on services in its Rulings.

The difference in interpretation is represented diagrammatically at Appendix B, illustrating the incorrect application of this concept and how the Consultation Paper seeks to justify a whole of entity approach in this manner.

The ultimate consequence of a different approach to interpreting or applying the OECD Guidelines is the double taxation of entities. This makes Australia's position uncompetitive and will discourage investment. We refer to Treasury's stated aim of the Paper to maintain Australia's attractiveness as an investment destination, and submit this will diminish this position.

OECD Guidelines

Methods

The Consultation Paper repeatedly refers to the 2010 update of the OECD Guidelines as containing new guidance on selecting the "most appropriate" method, and replacing the hierarchy previously giving preference to

[6] *Income Tax Assessment Act 1936*

[7] OECD, *Transfer Pricing Legislation – A suggested Approach*, June 2011

transactional methods. This is an incorrect statement. The 2010 Guidelines do indeed promote a ‘most appropriate method’, yet still maintain a strong preference for transactional methods. While this represents an evolution from the strict hierarchy previously preferred by the OECD, it is clear profit methods are not given equal status, unless transactional methods cannot be applied. In essence, a hierarchy is still maintained. We note the below passage from the 2010 Guidelines which supports this contention:

“...As a result, where, taking account of the criteria described at paragraph 2.2, a traditional transaction method and a transactional profit method can be applied in an equally reliably manner, the traditional transactional method is preferable to the transactional profit method.....”.[8]

This position is only a slight modification to the previous practical operation of the old Guidelines. The old Guidelines were rather more explicit in stating that profit methods were a method of “last resort” rather than last among equals.

The 2010 Guidelines also maintain a hierarchy between the transactional methods: CUP, as the most preferred transactional method, and the Cost Plus and Resale Price methods, to be used when an appropriate CUP cannot be obtained. Discussion of this nature is not provided in the Consultation Paper, nor is reference to the 2011 suggested legislation[9] which reiterates this position. We therefore seek clarity as to what Treasury means by the statement that profit based methods are given “equal status”.

Use of Guidance

In light of the *SNF* decision, it should be made clear that reference is to be had to OECD Guidelines to ensure legislation is interpreted in accordance with international practice. Maintaining international alignment is critical for Australia’s economic competitiveness. There are however, problems with a direct reference to the Guidelines for more than interpretation assistance as it may delegate the law making power of Parliament.

Finally, we are greatly encouraged by the Consultation Paper’s comment that OECD draft legislation contains “features which may be attractive in the Australian context”. Given there is essentially no discussion of the draft legislation in the Paper, we are hopeful many of these principles will, in fact, be incorporated into draft legislation.

Retrospective Application

While we note the proposed retrospective application of the ‘treaty power’ is not mentioned in the Consultation Paper, it was raised in the media release accompanying the Consultation Paper. Accordingly, we would voice our considerable concern to this proposed unarticulated and unsupported position. This is another example of a worrying trend that appears to be emerging.[10] Taxpayers cannot be expected to comply with laws because they have been ‘indicated by Parliament’ retrospectively. Legislation in this area could be complex and it is unfair taxpayers should be expected to comply with this. Taxpayers should only be expected to comply with the law as it stands at the time they enter into a transaction, and should be protected accordingly. The Taxpayer uncertainty of such an application and the perception of Sovereign risk diminishes our attractiveness as an investment destination.

Further, if the legislation applies retrospectively, will rulings also apply retrospectively? If so, to what extent? We strongly support the move to limited amendment periods to create certainty, however retrospective application of the law is somewhat contradictory to creating certainty as it creates significant amounts of uncertainty.

[8] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, 2010, p 2.3

[9] OECD, *Transfer Pricing Legislation – A Suggested Approach*, June 2011

[10] For example, amendments to the Consolidation regime recently announced by the Government.

We cannot emphasise enough our opposition to the retrospective amendments proposed by the Assistant Treasurer. We also note the publicity given to this particular matter by the American Chamber of Commerce.[11]

Self assessment and time limits

We welcome the move to include transfer pricing in the self assessment regime and with it, the removal of the Commissioner's discretionary powers. In addition, inclusion within the self assessment regime will remove the unlimited time period in which this discretionary power can be exercised – another positive step.

However, we are unsure as to why an extended period of 8 years is required for transfer pricing matters. In our opinion the self assessment time limits are more than sufficient. We note the record keeping requirement time for corporations is 7 years. Notwithstanding the comments in the 2007 review of amendment periods, Australia is increasingly entering tax information sharing agreements which reduce the time required to gather information. Further, the complexity of transfer pricing issues is no greater (and often considerably less) than many corporate restructures, which are covered by the standard amendment time limits. These reasons, coupled with Australia's documentation requirements and ability to raise amended assessments under section 167 the *Income Tax Assessment Act 1936* with the resulting burden of proof to be borne by the taxpayer is sufficient to ensure the ATO is provided with information where required.

Should penalties be imposed for not keeping documentation in Australia as proposed (which we do not support due to the disproportionate compliance requirements it places on taxpayers especially those SME's), the argument for extended amendment periods for transfer pricing adjustments is further diminished.

Documentation & Penalties

Movement to legislate documentation standards is welcome. However, taxpayers already face significant documentation and disclosure requirements. Examples include the introduction of a lengthy IDS schedule and the new reportable tax position schedule. The costs associated with the preparation of these schedules and adequate transfer pricing documentation are prohibitive to taxpayers and, in practice, may ultimately lead many to bear the risk of having inadequate, or no, documentation. We therefore think any specific documentation requirements should be introduced on a scalable and manageable basis, particularly with regard to SME's.

A de minimus threshold is strongly supported, and we suggest such a threshold be aligned with the IDS threshold, but not less than $2 million in total international related party dealings, with provision for indexation.

The standard of contemporaneous documentation is accepted; therefore this should remain intact, subject to a de minimus rule, and be relative to the risk of both the taxpayer and transaction. Extensive comparable searches should not be required for transactions where the de minimis disclosure threshold is not exceeded.

Regarding the penalty regime, the Commissioner already has significant power to impose penalties for inadequate documentation. Additionally, a penalty for not keeping documentation in Australia is excessive. It should be sufficient to impose an obligation to ensure documentation is produced within a reasonable period.

Transitional Arrangements

There is no discussion in the Paper on transitional arrangements. Clarification will be required on the standing of current APA's, transfer pricing issues currently being negotiated and matters currently in dispute based on

[11] Briefing note dated 21 November 2011, circulated to the members of The American Chamber of Commerce in Australia by the National Director, Mr Charles Blunt.

existing rules. Additionally, rulings and ATO guidance will need to be clarified or amended accordingly, particularly given the proposed retrospectivity of some of the changes.

Conclusion

We are grateful for the opportunity to respond to the Consultation Paper and thank you for considering our response. We do however again reiterate our concerns over the lack of time provided to us and other interested parties for consultation given the considerable macro economic and fiscal impact of the transfer pricing legislation. We look forward to a protracted and collaborative consultation period prior to, and after, the release of draft legislation.

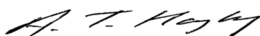
Please note, we have not included any comments on the attribution of profits to permanent establishments in this submission as the Consultation Paper states this will be treated as a separate question. We look forward to being able to comment specifically on this particular issue.

To summarise, the remaining consultation period should focus, in our view, on the following key points:

- Clarity on the interpretation and application of the arm's length principle. Does it at its core remain transactional and not based on the profit of an entity;
- Whether or not the hierarchy of methods as outlined in the OECD Guidelines is to be followed;
- Reconsideration of the proposal to retrospectively apply the DTA's taxing power;
- To review the proposed eight year timeframe for adjustments;
- Further clarity on what transitional provisions will be put in place; and
- To commit to further consultation on the proposed amendments prior to the introduction into Parliament of the enabling legislation.

It is critical that the modernisation of the transfer pricing Rules is thoughtfully implemented rather than rushed through. Certain proposed changes and proposals may be construed as a "knee jerk" reaction to the findings in *Roche* and *SNF* rather than a modernisation. The decisions in these cases no doubt predicate the need for a review of the transfer pricing Rules and it is our view such a process requires maximum input from business and the professional community.

Yours Faithfully,



Anthony Hayley
Associate Director
Global Transfer Pricing Services
RSM Bird Cameron

Paul Heiler
Director – Taxation Services
Head of Taxation
RSM Bird Cameron

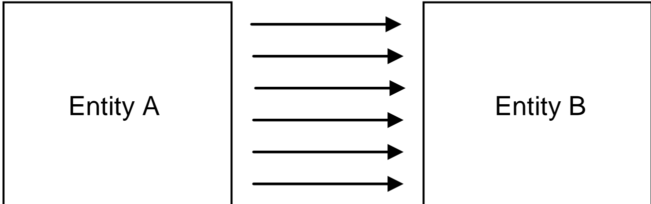
APPENDIX A

JURISDICTION	OECD PRINCIPLES	HEIRARCHY	REFERENCE
China	Follow but reserve right to depart	Reasonable method following the arm's length principle	Chap 6, Enterprise Income Tax Law
Japan	Generally follow but not bound	Transaction based preferred over profit based	Article 66-4, 68-88 Special Taxation Measures Law
US	Consistent with OECD	The best (most reliable) method	S 482 Internal Revenue Code
Korea	OECD recognised but not legally binding	Most appropriate method to circumstances	Paragraph 1 Article 4 Coordination of International Tax Act
UK	Based on OECD model	Most appropriate method to circumstances	Part 4 Taxation (International and Other Provisions) Act 2010
New Zealand	Fully endorse	Transaction based preferred over profit based	S YD5, GB2, GC 6-14 Income Tax Act 2007
Germany	Follow	Transaction preferred where data available	S 1 Foreign Tax Code
Malaysia	Follow	Transaction methods preferred	S 140A Income Tax Act 1967

APPENDIX B

Interpretation of the term ‘series of transactions’

ATO Interpretation



UK Interpretation