The Institute of Chartered Accountants in Australia

5 December 2011

Mr Neil Motteram
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Dear Neil

Consultation Paper - *Income Tax: Cross Border Profit Allocation - Review of Transfer Pricing Rules*

The Institute of Chartered Accountants in Australia (the Institute) welcomes the opportunity to put forward its views on the Consultation Paper, *Income Tax: Cross Border Profit Allocation - Review of Transfer Pricing Rules* (the Consultation Paper) released by the Assistant Treasurer on 1 November 2011.

Firstly, it will be well known to Treasury that the Institute remains concerned about yet another retrospective amendment to the law being proposed in circumstances where it cannot be justified on either a policy or revenue integrity basis.

Some of the reasons why retrospective amendments are not justified in the context of these proposed reforms include:

- The decision in *SNF (Australia) Pty Ltd v Commissioner of Taxation* [2011] FCAFC 74 (SNF) is not relevant to the issue of whether the Associated Enterprise Articles of the Double Tax Agreements (DTAs) give rise to a separate power to amend assessments. Indeed, the Commissioner chose not to have the full Federal Court declare the law on this issue.

- If, as the Commissioner contends, the Associated Enterprise Articles of the DTAs operate to provide a separate taxing power there is no need to retrospectively amend the law. If the Associated Enterprise Articles do not operate to provide a separate taxing power, the proposed amendment would not be a mere 'clarification'. Irrespective of whether there was any parliamentary indication that the DTAs operate as an alternative to the transfer pricing rules, the effect of the proposed amendment could be that a taxpayer that fully complied with the law – as then enacted – will be retrospectively exposed to tax. We believe that any amendment that has this effect is inequitable.

- The Commissioner's analysis of the law, no matter how considered or long held, cannot substitute for the correct application of the law. In the absence of judicial precedent, taxpayers were entitled to take a position that is contrary to the Commissioner's view of the operation of the arm's length provisions of the DTAs and expect to have the right to challenge any assessment to confirm the position taken. The proposed retrospective amendments considered here will have the effect of completely removing the right of taxpayers to challenge the Commissioner's view of the law.

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- The proposed treaty based power would potentially be broad, not well defined and high impact. Notwithstanding the Mutual Agreement Procedure (MAP) mechanism, if these retrospective treaty based amendments were to proceed, there would be a much higher risk of unresolved double tax to arise. This in turn would negatively impact the profile of Australia as an OECD tax jurisdiction and as a safe and stable destination for offshore investment.

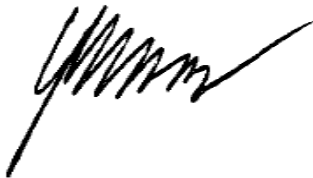
Despite our concerns with the proposal, if the government decides to proceed with the retrospective amendment of the law, it will be critically important that the level of power to be exercised by the Commissioner under the treaties be clearly defined and understood. Further details on how to achieve this are set out in the attached submission.

The attached submission identifies a number of preliminary policy issues with the proposals set out in the Consultation Paper. It is likely that the Institute will put forward to Treasury a supplementary submission, in due course, once our members have had the opportunity to fully consider certain aspects of the Consultation Paper.

We would like to take this opportunity to thank Treasury for hosting the stakeholder consultation meeting on 18 November 2011, which provided a valuable opportunity to kick-start some initial discussions on certain matters raised in the Consultation Paper, as well as this submission. The Institute will continue to make representations to the government over coming weeks about the concerns held in relation to the proposed retrospective amendments included in this reform package.

In the meantime, if you need to discuss any aspect of this submission further please do not hesitate to contact me on (02) 9290 5623 or Karen Smith on 0425 326 564.

Yours sincerely



Yasser El-Ansary
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The Institute of Chartered Accountants in Australia

The Institute's comments on the Consultation Paper, *Income Tax: Cross Border Profit Allocation - Review of Transfer Pricing Rules* (the Consultation Paper) released on 1 November 2011 by the Assistant Treasurer are set out below.

RETROSPECTIVE AMENDMENT

General – retrospective changes are highly undesirable

From the outset, it is important to state that the Institute remains concerned that yet another retrospective amendment to the tax law is being contemplated. This amendment is being proposed at the same time as recent announcements and changes in relation to other high profile examples such as the changes to the tax consolidation regime rights to future income rules, as well as recent amendments to the Petroleum Resources Rent Tax regime which date back over 20 years.

It has been a long-standing practice of the legislature that retrospective tax laws will only be passed in exceptional circumstances where the integrity of the tax system would be fundamentally jeopardised if not for the introduction of back-dated taxation laws. Recent reviews into the policy-making processes surrounding the development of taxation law in Australia have supported the conclusion that tax measures introduced by the government should generally operate on a prospective basis only.

Where retrospective tax laws have been contemplated, it has been broadly accepted that such situations would be limited only to instances where taxpayers were either not adversely impacted (i.e. neither worse off nor better off), or were in fact, favourably impacted.

Paragraph 3.21 of the 2008 report of the Tax Design Review Panel does acknowledge that in rare cases, retrospective tax laws may be appropriate where the changes 'rectify technical deficiencies from the date of the original legislation or where there is a serious risk to the revenue'.

A signal of the importance of freedom from retrospective laws has been held to be so critical to the basic rights of individuals and corporations that the constitutions of both the United States and Sweden have explicitly prohibited such a practice. Whilst Australia's constitution does not expressly prohibit the making of retrospective laws, the generally accepted practice of parliament has been to only exercise those powers sparingly, often only in extreme and exceptional circumstances.

From a practical perspective, businesses that have fulfilled their tax obligations and complied with the law as it existed are now being asked to go back and re-assess their positions in light of the new version of the old law. Needing to do this causes significant frustration, imposes considerable administrative costs, and in some cases may lead to an obligation to pay more tax than paid previously if appropriate safe-guards are not put in place. These problems are amplified by the impact on the perception of Australia in the international marketplace as a stable environment in which to do business.

The Institute considers that retrospective amendments are undesirable and can only be justified in exceptional circumstances.

Specific issues with the proposed tax treaty retrospective change

In the Media Release of 1 November 2011, the Assistant Treasurer stated that the law will be amended to "clarify that transfer pricing rules in our tax treaties operate as an alternative to the rules currently in the domestic law". The change is to have effect from 1 July 2004. The announcement also includes the statement that "recent court decisions suggest our existing transfer pricing rules may be interpreted in a way that is out-of-kilter with international norms".

We agree that the recent decision in *SNF (Australia) Pty Ltd v Commissioner of Taxation* [2011] FCAFC 74 ("SNF") indicated that some changes to Division 13 of the *Income Tax Assessment Act 1936* (ITAA 1936), may be appropriate. However, the decision in SNF is not relevant to the issue of whether the Associated Enterprise Articles of the Double Tax Agreements (DTAs or treaties) give rise to a separate power to amend assessments.

If, as has been maintained by the Commissioner, the Associated Enterprise Articles of the DTAs operate to provide a separate taxing power, we submit that there is no need to retrospectively amend the law. If the Associated Enterprise Articles do not operate to provide a separate taxing power, the proposed amendment would not be a mere clarification. Irrespective of whether there was any parliamentary indication that the DTAs operate as an alternative to Division 13 of the ITAA 1936, the effect of the proposed amendment could be that a taxpayer that fully complied with the law as then enacted will be retrospectively exposed to tax. We consider that any amendment that has this effect is inequitable.

It appears that the Treasury's view of the application of the Associated Enterprise Articles of the DTAs may have been influenced by the Commissioner's interpretation of the law as expressed in Taxation Ruling TR 1992/2 and, as far as is relevant to loans, in TR 2010/7. This view of the law has no judicial support and was, and remains, controversial.

We will not repeat the arguments here due to time constraints but the Institute is of the view that technically, outside the context of resolving a double tax issue, the ATO does not have the power to raise an assessment under a DTA that increases the tax payable position of a taxpayer.

This view is supported by statements in various judicial decisions, even though in obiter, that tax treaties do not confer power to the Commissioner to assess (e.g. Downes J in *Roche Products Pty Ltd v FC of T* [2008] AATA 639).

The Commissioner's analysis of the law, no matter how considered or long held, cannot substitute for the correct application of the law. In the absence of judicial precedent, taxpayers were entitled to take a position that is contrary to the Commissioner's view of the operation of the arm's length provisions of the DTAs and expect to have the right to challenge any assessment to confirm the position taken. Any retrospective amendment will take away a taxpayer's ability to challenge the Commissioner's view of the law. We consider this a breach of the rule of law.

We note that it would be bizarre if a challenge to the Commissioner's position for an income year prior to 1 July 2004 in a DTA case was successful but the retrospective "clarification" gave a different result.

In SNF, the Commissioner had the opportunity to have the Full Federal Court declare the law on the operation of the arm's length rule in a DTA. For whatever reason, the Commissioner chose not to have the Federal Court declare the law. Had the Commissioner not abandoned the DTA argument during the course of the SNF proceedings, there would be no need to legislatively clarify the existing operation of the law or, in the alternative, any retrospective amendments would unambiguously alter the existing operation of the law. While the timeframe of this submission does not allow a full discussion of the merits of the Commissioner's argument, it is clear that taxpayers may, potentially, be retrospectively and adversely affected by the proposed "clarification", which is a consequence of the Commissioner's decision to not pursue his argument in SNF.

The Institute therefore concludes that the case for a retrospective amendment simply cannot be justified given the circumstances.

Potential double tax and MAP implications

Notwithstanding this conclusion, if such a power was to be provided to the ATO by way of a retrospective amendment to the law, there would be potentially significant and far reaching unintended consequences. Not least of these consequences is the potential for significant unresolved double tax to be brought into existence for which positive resolution would be unlikely. This in turn would have a negative impact on the profile of Australia as an OECD member country and raise issues of sovereign risk for prospective future investment decisions.

In brief, the following key factors are noted:

- By way of important background, the OECD guidelines represent a consensus document outlining broad principles that have been agreed between participant OECD countries. However, the implementation of matters covered in the guidelines by individual OECD countries is open to significant interpretation. It is the form of this implementation of OECD principles that establishes the profile of a taxing jurisdiction, and determines the level of risk for double tax to arise.
- It is a fundamental principle underpinning the OECD guidelines and DTAs that OECD member countries should act in a manner to avoid the imposition of double tax (the situation where two jurisdictions both tax the same profit). Where it occurs, the double taxing of transactions represents a highly inefficient outcome that has the impact of undermining otherwise economically viable trade. As such, steps should be taken whenever possible to avoid the risk of this outcome.
- If provided to the ATO, retrospective treaty powers would have the potential of bringing into existence a significant new risk of double tax. To illustrate this point, it should be understood that Australian taxpayers who have lodged tax returns for the years commencing 1 July 2004 and onwards have a settled tax paid position in Australia, and the overseas related party entity transacting with the Australian taxpayer has a settled tax paid position in its jurisdiction. In a vast majority of cases, the tax returns lodged in relation to the related party transactions provide a symmetry of tax outcome (i.e., of the total profit earned on a transaction, tax will be paid on a portion in one jurisdiction and for the remaining portion in another). By implementing the retrospective treaty powers and raising assessments retrospectively, the ATO would necessarily bring into existence a situation where additional tax would become payable in Australia on transactions for which tax has already been paid in another jurisdiction. Thus a position of double tax would be brought into existence.
- If provided to the ATO retrospectively, the unconstrained power to raise debit assessments under the treaties would have potentially high impact on taxpayers while having largely undefined boundaries. In brief, the key issues that arise are:
  - the extent to which focus can be placed on the application of profits based transfer pricing methods, and
  - the extent to which the ATO would have the power to disregard the legal form of transactions and reconstruct arrangements in order to define a different taxing outcome. In particular, the broad power to reconstruct would potentially affect all taxpayers with related party loan arrangements, related party guarantee arrangements and entities that have entered into transactions with related party entities in relation to cross border restructures.

  In summary, this retrospective treaty based power would have the potential to significantly over-reach the position outlined in Income Taxation Rulings TR 2010/7 and TR 2011/1 and therefore place taxpayers who have lodged prior tax returns consistent with this stated ATO position from 1 July 2004, open to significant adjustment.
- Where double tax arises in this way under a treaty, the counterparties to the treaty have the power under Mutual Agreement Procedure (MAP) to attempt to relieve the burden of double tax. Although Australia currently has a good record of resolving MAP issues, this record has been forged in an environment where taxpayers have had the opportunity to follow largely stable and well understood ATO policies in a self assessment environment. It is considered likely however, where there is a substantial retrospective change in the implementation of OECD powers of the type envisaged through the increased treaty powers that counterparty OECD treaty partners would be much less inclined to find a solution that involves reducing their taxing outcome in order to allow Australia to increase its taxing profile. If this was to occur, at best taxpayers would be drawn into protracted and expensive MAP processes and it is submitted that there would be an increased likelihood that taxpayers would find themselves in a situation of unresolved double tax.

In summary, the proposed treaty based power would potentially be broad, not well defined and high impact. Notwithstanding the MAP mechanism, if these retrospective treaty based amendments were to proceed, there would be a much higher risk of unresolved double tax to arise. This in turn would negatively impact the profile of Australia as an OECD tax jurisdiction and as a potential future recipient of overseas investment.

Imperative that DTA powers are restricted

If a decision was made to proceed with the retrospective amendment of the law, it would be imperative as a minimum that the level of power to be exercised by the Commissioner under the treaties be clearly defined and understood. In the absence of securing such a position of clarification and given the potential broad scope of these powers, there would be significant uncertainty in the context of the Australian self assessment environment. Given this context, the Institute submits that if not defined in detail in the amending legislation (our preferred position), this clarification as a minimum should be provided by way of formal ATO ruling.

At the recent meeting with Treasury in Canberra on 18 November 2011, Treasury clearly stated that the driver behind the proposed retrospective amendment to the law was concern over the risk to revenue collections caused by the decision in SNF. These risks were identified as follows:

1) Refunds via amended assessments as taxpayers revised previous transfer pricing positions following SNF.
2) Audits currently underway- assessments raised/ATO positions.
3) Prospective impacts as taxpayers revise their transfer pricing following SNF.

(In discussions with our members, we do not consider there to be any validity around the concern involving refunds (1 above). We do not have any evidence of taxpayers "taking advantage of SNF" by seeking refunds through retrospectively changing their transfer prices. Further, although it is possible for taxpayers to prospectively change their transfer pricing policies as a result of SNF (3 above), this issue can be dealt with through prospective legislation. While we are not privy to the revenue projections supporting 2 above, we assume that they must be very significant to warrant such a drastic action as the retrospective "clarification" announced in the media release).

Given the clear statements made by officials of the Treasury and the Assistant Treasurer’s office that the objective of the retrospective change is to protect and not expand the pre SNF revenue position, the Institute submits that the following key restrictions of power are of critical importance:

- The ATO would apply the transfer pricing transactional net margin profits based method in a manner that is consistent with the “most appropriate method” approach of the OECD.
- The ATO would apply transfer pricing principles in relation to related party loans and guarantees in a manner that is consistent with its recent Taxation Ruling TR 2010/7 and would not seek to over-reach the application of this Taxation Ruling by accessing additional treaty powers that were provided to it. (This issue is elaborated on below).
- The ATO would not attempt to over-reach the stated position in TR 2011/1 in relation to intergroup transactions related to group restructures.

Taxation ruling TR 2010/7

The Commissioner has issued TR 2010/7 concerning the application of the transfer pricing provisions to loans, and in particular the interaction of the transfer pricing provisions with Division 820 of the *Income Tax Assessment Act 1997* (ITAA 1997). This ruling was subject to long and intensive consultations between the Commissioner and the industry, in which the Commissioner’s position changed until the final ruling was issued. Notwithstanding that we do necessarily agree with the principles set out in TR 2010/7, if there is a power to assess taxpayers using the Associated Enterprises Articles of the DTAs, the Commissioner’s retrospective application of TR 2010/7 is not precluded.

It is regrettable that the Commissioner did not take the opportunity to clarify the interaction of the transfer pricing provisions with Division 820. Different to a direct application of the Associated Enterprises Article, there was clear and expressed intent by the parliament when the thin capitalisation rules were introduced, that taxpayers could rely on the thin capitalisation safe harbour rule without undertaking an arm’s length test of the debt amount borrowed. Taxpayers therefore acted in accordance with the gearing ratios permitted under Division 820 and what they understood to be the correct setting of an arm’s length interest rate in accordance with Division 13. It is doubtful that, absent an ability to apply the arm’s length rules of the DTAs, the Commissioner’s approach is supportable.

This is a difficult area and as the matter was not clarified by the Commissioner, taxpayers have considered the interaction of Division 820 with Division 13 and have made genuine attempts to comply with a contentious area of the law.

Given the Commissioner's failure to make his views known on a timely basis, we consider that any retrospective amendment only applies for income years commencing after the date that TR 2010/7 was finalised.

Penalties

If, contrary to these submissions, the government proceeds with the proposed retrospective amendment, limitation should be placed on the effect of those amendments. In the first place, it should be clear that a taxpayer will not be subject to penalties if the transfer pricing adjustment is made under the Associated Enterprises Article of a DTA. Further, it should be clear that a taxpayer will retain the right to appeal against a penalty (or refer a matter to the AAT) if the penalties arise solely because of the Associated Enterprises Article of a DTA. To do otherwise would be to impose retrospective penalties.

OTHER ISSUES

The Institute has already identified a number of issues with the Consultation Paper that we have included below. However, we consider these as preliminary comments as it has not been possible for us to conduct a fuller analysis in the very short consultation period allowed. Therefore it is likely that we will make a supplementary submission in due course once our members have had the opportunity to digest the contents of the Consultation Paper.

OECD Guidelines

We note the objective of clearly incorporating OECD guidance in to the new law. We consider that OECD guidance is open to interpretation and the mere incorporation of the guidance into legislation will not eliminate transfer pricing disputes between taxpayers and the ATO in application of the guidelines.

The Consultation Paper infers a preference for profit methods over transactional methods. Care needs to be taken in drafting the new rules so that the legislation does not go beyond the OECD guidance on comparability and method selection.

Self assessment

We acknowledge the objective of making the transfer pricing rules self-executing and agree with the need to limit the Commissioner's wide discretion currently afforded by s 136AD(4) of the ITAA 1936. Any power to reconstruct transactions should be limited to exceptional circumstances as acknowledged by the OECD.

Time limits for amendment

We agree with the suggestion to introduce time limits for amending assessments for transfer pricing and consider that no longer than a 6 year period should be required by the Commissioner. Taking into account the current proposals, there are strong arguments for this time limit to be introduced into the law now to limit the Commissioner's power to amend prior year assessments.

Profit attribution to Permanent Establishments (PEs)

It seems inconsistent to advocate a clear move to OECD guidance for companies but to defer or avoid a similar move to accept OECD guidance on profit attribution to PEs. We recommend that OECD guidance applies to all legal entities equally.

Record keeping requirements

The Consultation Paper discusses the issue of whether there should be a legislative requirement that taxpayers maintain contemporaneous transfer pricing documentation that evidences the application of the arm's length principle. We generally support this proposition (but see below).

Small to medium size entities (SME)

Transfer pricing raises particular concerns in the SME area as the rules impose significant compliance obligations. Unless a taxpayer is of a certain size, compiling and maintaining contemporaneous documentation is simply too expensive but not doing so exposes the taxpayer to penalties. The Institute submits that the review needs to explore appropriate carve-outs for SMEs.

As a start, the Institute believes that there should be a de minimis test below which SMEs do not have to comply with transfer pricing at all. Blatant schemes could be attacked under Part IVA of the ITAA 1936 or other anti-avoidance legislation. The Institute considers that the revenue risk on the balance is likely to be low in the context of the compliance costs to satisfy these onerous new rules. A de minimis approach is currently applied in the United Kingdom.

The Institute is also of the opinion that lack of full contemporaneous documentation should not mean the imposition of penalties for SMEs. The cost of such documentation is extremely high and is likely to be cost prohibitive in the SME market even with the threat of penalties for non-compliance. We would propose the inclusion of an objective test that precludes the imposition of penalties where taxpayers have made reasonable efforts to determine an arm's length price, notwithstanding that they may not have put together full contemporaneous transfer pricing documentation. We believe that this is an achievable benchmark that SMEs would strive to meet and would likely encourage a higher level of compliance than requiring full contemporaneous transfer pricing documentation.

Board of Taxation's role in consultation

The Assistant Treasurer's November 2011 media release makes it clear that the government intends to engage with the Board of Taxation "where appropriate in this review". Given the scale of the review, the ever-growing role played by cross-border transactions, and the need for Australia to protect its appropriate share of tax revenues while providing an attractive destination for capital inflows, it is imperative that changes to the transfer pricing rules should be carefully developed and subject to intensive consultation with external stakeholders as well as the Board of Taxation.

It would be useful to obtain further information around precisely how the Board will be involved in this consultation process over the coming weeks and months.