THE TAX INSTITUTE

8 December 2011

Mr Neil Motteram
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The Treasury
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Dear Mr Motteram

SUBMISSION: CONSULTATION PAPER "INCOME TAX: CROSS BORDER PROFIT ALLOCATION – REVIEW OF TRANSFER PRICING RULES"

The Tax Institute welcomes the opportunity to make this submission to Treasury in response to the Consultation Paper entitled "*Income tax: cross border profit allocation – review of transfer pricing rules*" released on 1 November 2011.

From conversations with Treasury, it is also our understanding that the Government is open to receiving submissions in relation to the Assistant Treasurer's announcement on 1 November 2011 that the Government will be introducing amendments to the transfer pricing rules with retrospective effect to apply to income years commencing on or after 1 July 2004.

Structure of submission

Our submission is divided into three parts:

Part One focuses on the Assistant Treasurer's announcement on 1 November 2011 that the Government would be introducing amendments to the transfer pricing rules with retrospective effect (i.e. to apply to income years commencing on or after 1 July 2004) and sets out our comments on the retrospective application of tax legislation;

1. Part Two also focuses on the Assistant Treasurer's announcement but provides comments of a more technical nature in relation to retrospectivity in the context of transfer pricing, including issues relating to the scope of the taxing powers under the Associated Enterprises Articles in Australia's double tax agreements; and

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2. Part Three provides comments on Treasury's Consultation Paper , specifically:

   (a) Adoption of the OECD Guidelines and selection of methods;

   (b) Comparability criteria;

   (c) Customs implications;

   (d) Documentation requirements, safe harbours and penalties;

   (e) Self-assessment;

   (f) Time limits on amendments; and

   (g) Separate entity methodology for permanent establishments.

The comments in the second part should not be misconstrued as in any way diminishing the significance of the concerns raised in the first part in relation to the retrospective amendments.

Summary of recommendations

In summary, The Tax Institute:

- Does not support the introduction of retrospective transfer pricing legislation that may be disadvantageous to taxpayers. Retrospective legislation may be appropriate in rare circumstances to deal with an unintended consequence where taxpayers have applied the law as intended or to deal with significant tax avoidance, neither of which exist in the present case;
- Considers that the introduction of a separate and unconstrained power in relation to transfer pricing under Australia's double tax agreements should be prospective in nature only. Taxpayers should not face potential adverse consequences of amendments being made to assessments in reliance on powers that could result in different outcomes under Division 13, including amendments contrary to existing rulings, amendments pursuant to reconstruction powers or "commensurate-with-income" adjustments;
- Supports the prospective alignment of Australia's transfer pricing legislation with internationally accepted best practice such as the OECD Transfer Pricing Guidelines. We do not support the introduction of prescriptive method selection rules in the domestic legislation which may be inconsistent with this best practice. To the extent retrospective amendments are made, the 1995 version of the OECD Transfer Pricing Guidelines should be relied upon for such amendments for income years beginning prior to 22 July 2010. The 2010 version of the Guidelines should not be used in such cases;
- Recommends that consideration be given to the potential for conflicts with Australia's non-discrimination obligations under certain double tax agreements;
- Recommends that consideration be given to the interaction of the transfer pricing laws and Australia's customs duty laws;

- Considers that taxpayers should be entitled to determine the appropriate documentation in their circumstances, that *de minimis* protection from documentation requirements should be available, that documentation requirements should be aligned with penalties and that taxpayers should not be penalised merely because they hold transfer pricing documentation overseas;

- Supports the introduction of self-assessment principles into domestic transfer pricing provisions;

- Considers that amendments to assessments relating to transfer pricing should be subject to standard time limitations. In any case, time periods should not be determined by reference to commencement of audits; and

- Supports the adoption of separate entity methodology for permanent establishments at the same time as transfer pricing amendments are introduced.

We understand that many of the issues raised in the Consultation Paper will be the subject of ongoing consultation. We look forward to participating in such ongoing consultations and making further submissions as appropriate.

We have copied this submission to the Treasurer and Assistant Treasurer due to the level of concern that exists amongst our members in relation to the proposed retrospective amendments to the transfer pricing rules.

Should you wish to discuss any aspect of our submission, please do not hesitate to contact The Tax Institute's Tax Counsel, Deepti Paton on (02) 8223 0044 in the first instance.

Yours sincerely

Peter Murray
President

CC: The Hon Wayne Swan MP, Deputy Prime Minister and Treasurer

CC: The Hon Bill Shorten MP, Assistant Treasurer and Minister for Financial Services and Superannuation

Submission of The Tax Institute on

Treasury Consultation Paper 'Income tax: cross border profit allocation – review of transfer pricing rules' dated 1 November 2011

and

Assistant Treasurer's announcement on 1 November 2011 that the Government will be introducing amendments to the transfer pricing rules to apply to income years commencing on or after 1 July 2004

Date: 8 December 2011

Interpretation

In this submission:

1995 OECD Guidelines means the version of the OECD Guidelines published in 1995;

2010 OECD Guidelines means the version of the OECD Guidelines published in 2010;

2003 Amendments Act means the *International Tax Agreements Amendment Act 2003*;

2003 Amendments EM means the Explanatory Memorandum to the 2003 Amendments Act.

Agreements Act means the *International Tax Agreements Act 1953*;

Associated Enterprises Article means the Article in a DTA dealing with adjustments of profits between associated enterprises;

ATO means the Australian Taxation Office;

Commissioner means the Commissioner of Taxation;

Consultation Paper means the Treasury Consultation Paper dated 1 November 2011 and titled *Income tax: cross border profit allocation - Review of transfer pricing rules*;

CWI means "commensurate-with-income";

Division 13 means Division 13 of Part III of the ITAA 1936, containing the domestic law transfer pricing provisions;

Division 13 EM means the Explanatory Memorandum to the *Income Tax Assessment Amendment Bill 1982*;

Division 820 means Division 820 of the ITAA 1997, containing the thin capitalisation provisions;

DTA means double tax agreement;

ITAA 1936 means the *Income Tax Assessment Act 1936*;

ITAA 1997 means the *Income Tax Assessment Act 1997*;

Media Release means the Media Release No 145 of the Assistant Treasurer dated 1 November 2011 and titled "Robust Transfer Pricing Rules for Multinationals";

OECD Guidelines means the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations;

OECD Model DTA means the *Model Tax Convention on Income and on Capital* published by the OECD;

SNF means *FCT v SNF (Australia) Pty Ltd* [2011] FCAFC 74;

TAA means the *Taxation Administration Act 1953*; and

Part One - General submissions on the Assistant Treasurer's Media Release

Principles underpinning tax law amendments

1. The importance and relevance of tax laws to taxpayer decision-making and behaviour cannot be underestimated. As such, The Tax Institute strongly supports working within a framework of guiding principles when introducing tax laws in order to provide taxpayers with greater certainty in relation to their tax liabilities and affairs.

2. Of these principles, among the most fundamental is that legislative changes should not apply retrospectively except in very specific circumstances and after thorough public consultation. Where the Government considers a deviation from this principle to be warranted, any such deviation should be thoroughly consulted on and explained.

3. It is our view that the application of this principle should not be dependent on the number, business, investment or tax profile of the taxpayers that may be affected by any specific tax law amendment.

Retrospective legislation

4. The Tax Institute does not recommend or support retrospective tax law amendments that may be disadvantageous to taxpayers for a number of reasons, including:

   (a) Taxpayers enter into transactions on the basis of the law as it is, not the law as it is rewritten after transactions have occurred. As a result, retrospective changes in tax law that alter a taxpayer’s tax liability are likely to disturb the substance of a bargain struck between taxpayers who have made every effort to comply with the prevailing law as at the time of the agreement. In addition, typically taxpayers undertake transactions based on what they considered to be known exposures to tax liabilities. Retrospective amendments could give rise to unexpected joint and several liabilities.

   (b) A significant change in tax liability may render incorrect the inputs taken into account in calculating tax expense and current tax liability/assets as disclosed in a company’s financial accounts. Subsequent changes to the financial statements as a result of retrospective legislation would have adverse implications for investors and capital markets that have relied on the financial statements.

   (c) Taxpayers have committed to investment decisions on the basis of a particular tax profile for an entity. Retrospective amendments to change such a tax profile can materially impact the financial viability of investment decisions and the pricing of those decisions.

   (d) Foreign investors have recently expressed concerns in relation to the increased “sovereign risk” of investing in Australia due to significant changes in tax policy. A retrospective amendment with an application date of more than 7 years before the date of enactment, especially without thorough consultation with the taxpayer community or clear reasons for the retrospectivity, is likely to exacerbate these concerns.

5. We acknowledge that in some rare circumstances retrospective legislation may be appropriate, such as for instance where the amendment corrects an unintended consequence of a provision and taxpayers have applied the law as intended, or in order to address a significant tax avoidance issue.

6. However, where the Government is of the view that such circumstances exist:

(a) Thorough consultation should be undertaken with the taxpayer population in relation to the appropriate date of application of the amendments; and

(b) Should a retrospective date of application be determined to be appropriate following such consultation, the rationale for the retrospectivity should be clearly enunciated and publicised via any relevant press release on introduction of the Bill and via the Explanatory Memorandum to the relevant Bill.

Parliamentary procedures to safeguard against retrospective legislation

7. We also note that Parliament, especially the Senate, has expressed reluctance to pass retrospective laws except in very limited circumstances. Specifically, Senate Standing Order 24 and the resolution of the Senate of 8 November 1988 set out the Senate's concerns with respect to deliberations regarding retrospective legislation. Relevantly, Senate Standing Order 24 provides as follows:

> 24. (1)(a)….the Scrutiny of Bills Committee shall be appointed to report, in respect of the clauses of bills introduced into the Senate, and in respect of Acts of the Parliament, whether such Bills or Acts, by express words or otherwise: i) trespass unduly on personal rights and liberties…

8. The following commentary by the Committee is also relevant to Senate Standing Order 24:

> 2.5 The Committee endorses the traditional view of retrospective legislation. Its approach is to draw attention to Bills which seek to have an impact on a matter which has occurred prior to their enactment. It will comment adversely where such a Bill has a detrimental effect on people. However, it will not comment adversely if:
>
> - apart from the Commonwealth itself, the Bill is for the benefit of those affected;
> - the Bill does no more than make a technical amendment or correct a drafting error; or
> - the Bill implements a tax or revenue measure in respect of which the relevant Minister has published a date from which the measure is to apply and that publication took place prior to that date.

9. This is a limitation that the Senate has sought to impose to essentially protect the 'rule of law', and the objectionable nature of retrospective legislation.

Trend towards retrospectivity

10. We are increasingly concerned by the trend in the last two months of the Government announcing retrospective changes to the tax law. The Media Release must be considered in the context of other announced retrospective amendments, such as:

(a) The recent amendments to the Petroleum Resource Rent Tax contained in the *Tax Laws Amendment (2011 Measures No. 8) Act 2011* that apply from 1 July 1990; and

(b) The announced retrospective amendments to the income tax consolidation laws as set out in the Assistant Treasurer's Media Release No 159 of 2011 (released 25 November 2011) entitled "Changes to the Income Tax Law

Affecting Consolidated Groups". These changes are due to apply from 1 July 2002.

11. We are also concerned by the tendency of the Government to brand such retrospective amendments as "clarifications" to the tax laws, without preceding extensive consultation and agreement by the taxpayer population. Such a classification understates the significant impact that such amendments will have on the tax affairs, and more widely the investment decisions, of a significant number of taxpayers.

12. We urge the Government to reconsider the circumstances in which retrospective legislation is appropriate in light of the principles and consequences set out above. Certainty in relation to the operation of tax laws is in the best interests of taxpayers, the ATO and the broader economy.

Part Two - Technical Submissions on the Assistant Treasurer's Media Release

1. The Media Release states that the Government will introduce "amendments to the law to clarify that transfer pricing rules in our tax treaties operate as an alternative to the rules in the domestic law". Based on discussions with the Assistant Treasurer's office and with Treasury since the Media Release was issued on 1 November 2011, it is our understanding that the underlying intention of the proposed amendments is to provide the Commissioner with an unconstrained separate head of taxing power under Australia's tax treaties to that currently provided in, in particular, Division 13. The date of effect of this change would be retrospective to income years commencing on or after 1 July 2004.

2. Tax laws are relevant to the investment decisions of multinational enterprises and the Government needs to be mindful of how its proposed amendments to Australia's transfer pricing rules are likely to present Australia in the global marketplace. In our view, the proposed retrospective amendments, if passed by Parliament, will increase the sovereign risk of making long term investments in Australia. Foreign investment into Australia requires a stable or at least predictable environment and therefore retrospective amendments to existing tax frameworks reduce the attractiveness of Australia as an investment destination.

3. Additionally, the proposed retrospective amendments will directly affect a number of cases currently under audit by the ATO or appeals which are currently pending before the courts. These taxpayers do not know at the present time what the full scope of a tax treaty-based power might be nor whether the ATO will use such a power against them in their current disputes in the event a legislative basis for doing so has been provided to the ATO. Placing these taxpayers in such an uncertain position is unacceptable.

4. Further, the Media Release has created tremendous uncertainty for taxpayers who may in the future be subject to audit or compliance review by the ATO. In such cases, and in the absence of a legislative constraint being imposed on the ATO to prevent it from doing so, it is not unrealistic to anticipate that the ATO would place reliance on a wider tax treaty-based power when conducting such audits and compliance reviews. This is notwithstanding the ATO's long held view that there should be no fundamental difference between Division 13 and a tax treaty-based power.

5. As a consequence, the proposed retrospective amendments have created not only significant uncertainty but also give rise to a significant risk of new and additional tax liabilities on a large number of taxpayers.

6. As discussed below, it is neither reasonable nor accurate to represent the proposed amendments as a clarification. First, we have been unable to find compelling evidence that Parliament has made explicit comments in relation to providing the Commissioner with a separate and unconstrained DTA-based power. Second, the ATO's long held view has been that there should be no fundamental difference between Division 13 and a DTA-based power. Third, it is nevertheless clear that a DTA-based power is much broader than the transfer pricing rules in the domestic tax law (i.e. those contained in Division 13) and accommodates *inter alia* a reconstruction mechanism, a mechanism which does not currently exist in the domestic tax law. Fourth, the introduction of a DTA-based power, retrospective or otherwise, could result in outcomes that are inconsistent with the Non-discrimination Article included in some of Australia's DTAs.

There is a lack of compelling evidence that Parliament has provided the Commissioner with a separate and unconstrained DTA-based power

7. We note that there is a considerable level of disagreement on the existence or scope of the Commissioner's power to make or amend assessments in reliance on an Associated Enterprises Article. Although the Commissioner has maintained for some time that he has such a power, case law on the issue is inconsistent and inconclusive. Further, even if the Commissioner does have such a power, it has not been clear whether there are constraints imposed on that power under the ITAA 1936, ITAA 1997 or the Agreements Act, as those Acts interact.

8. By way of background, we welcomed the release by the ATO on 16 December 2009 of the legal advice it obtained from Ron Merkel QC and Diana Harding on the interaction between Division 820 and the transfer pricing provisions in Division 13 and the Associated Enterprises Articles of Australia's DTAs.

9. While we agree with the opinion of counsel that subsections 170(9B) and (9C) of the ITAA 1936 enable the Commissioner to issue an amended assessment in reliance upon the Associated Enterprises Article of an applicable DTA, we note in particular, that counsel's opinion did not address the issue of whether the grant of power is constrained or unconstrained. That is, the legal advice obtained by the ATO does not provide any basis for the view that the power granted to the Commissioner under subsection 170(9B) to amend an assessment in reliance upon the Associated Enterprises Article of an applicable DTA can be used in such a way as to produce a result where a taxpayer could be assessed on a higher amount of tax than would otherwise be payable if section 136AD in Division 13 had been applied.

10. In contrast, we refer to the article titled 'The associated enterprises articles in Australia's DTAs and Division 13' by Damian Preshaw in the November 2009 issue of *Taxation in Australia*. This article reaches the same conclusion that subsections 170(9B) and (9C) of the ITAA 1936 enable the Commissioner to issue an amended assessment that relies upon the Associated Enterprises Article of an applicable DTA in certain circumstances.

11. However, and importantly, after examining the Division 13 EM, the article also concludes that there is very little in the Division 13 EM to support the view that the power granted to the Commissioner under subsection 170(9B) to amend assessments entitles the Commissioner to apply the associated enterprises articles of Australia's DTAs at large and without constraints on how that power should be exercised (other than with respect to any limitation imposed by the arm's length principle as reflected in the associated enterprises articles of Australia's DTAs).

12. On the contrary, the article concludes that the Division 13 EM provides strong support for the view that the amendment of an assessment under subsection 170(9B) is only countenanced in circumstances where there is a need to give effect to, for example, the associated enterprises articles of Australia's DTAs due to an inconsistency existing within the meaning of subsection 4(2) of the Agreements Act. This was necessary for a number of reasons not least of all being that there is no mechanism or discretion in Division 13 to enable the Commissioner to raise an amended assessment on an amount less than the arm's length consideration as determined in accordance with section 136AD. Such a mechanism would be necessary, for example, where application of the DTA power would result in a more favourable outcome for a taxpayer. Subsection 170(9B) therefore provides the legislative machinery by which the Commissioner is able to give effect to subsection 4(2) of the Agreements Act.

13. In our view, subsection 170(9B) was not intended to provide the Commissioner with a separate and unconstrained head of taxing power to that contained in section 136AD.

Whether Parliament has indicated the law should operate in this way on a number of occasions, most recently in 2003

14. Based on discussions with Treasury, we understand that the reference in the Media Release to Parliament having most recently indicated its view of the operation of the law "in 2003" is to the 2003 Amendments Act which gave the force of law in Australian to the new Australia / UK DTA.

15. We note that the Act itself does not provide any express power to the Commissioner in this regard. Although legislation is generally the most appropriate place for Parliament to express its operation of the law, in certain circumstances, it is permissible to have regard to extrinsic materials in the interpretation of a law, including explanatory memoranda.

16. However, even on a review of the 2003 Amendments EM, there is a far from compelling case that Parliament has made explicit comments that a DTA-based power is unconstrained. One set of comments that seem to be of some relevance are contained in consequential amendments introduced in the same Act which are described in the relevant Explanatory Memorandum as follows:

> **Reasons for the amendments**
> **New definition of "relevant provision"**
>
> 3.4 This is a consequential amendment following the replacement of the 1967 United Kingdom tax treaty with the new United Kingdom tax treaty and the Exchange of Notes.
>
> 3.5 170(9B) and (9C) of the ITAA 1936 deal with time limits for amending income tax assessments for the purpose of giving effect to a relevant provision. Paragraph (a) of the definition for relevant provision in subsection 170(14) defines relevant provision as paragraph (3) of Article 5 or paragraph (1) of Article 7 of the existing tax treaty with the United Kingdom (currently defined as United Kingdom agreement within subsection 170(14)), or a provision of any other tax treaty that corresponds with either of those paragraphs. **These paragraphs in Australia's tax treaties allow for adjustments to the profits of permanent establishments or associated enterprises on an arm's length basis**.
>
> 3.6 This amendment replaces the references to the provisions in the existing tax treaty with the United Kingdom with a broad, generic description of the relevant provisions found in Australia's tax treaties. Examples of such provisions in Australia's tax treaties are paragraph 2 of Article 7 (Business profits) and paragraph 1 of Article 9 (Associated enterprises) of the new tax treaty with the United Kingdom [Schedule 1, item 14]). Substituting this general description will reduce the need to amend the definition of relevant provision as a result of future tax treaty changes.
>
> 3.7 As a consequence of the change to a generic description of paragraph (a) of the definition of relevant provision, the definition of United Kingdom agreement in subsection 170(14) is no longer necessary and will be repealed by this bill. [Emphasis added]

17. Other comments, also from the 2003 Amendments EM, that may allude to a separate taxing right are:

> 1.101 This Article deals with associated enterprises (parent and subsidiary companies and companies under common control). **It authorises the reallocation of profits** between related enterprises in Australia and the United Kingdom on an

> arm's length basis where the commercial or financial arrangements between the enterprises differ from those that might be expected to operate between unrelated enterprises dealing wholly independently with one another…
>
> 1.105 **Where a reallocation of profits is made (either under this Article or, by virtue of paragraph 2, under domestic law)** so that the profits of an enterprise of one country are adjusted upwards, a form of double taxation would arise if the profits so reallocated continued to be subject to tax in the hands of an associated enterprise in the other country. To avoid this result, the other country is required to make an appropriate compensatory adjustment to the amount of tax charged on the profits involved to relieve any such double taxation. [Emphasis added]

18. Nowhere in the above extracts is there anything to indicate that Parliament has made explicit comments in relation to providing an unconstrained DTA-based power or that Parliament has explored the scope of a DTA-based power vis-à-vis the scope of the domestic tax law in Division 13.

19. To the contrary view, there is evidence that Parliament did not consider that an unconstrained DTA-based power exists in Australian income tax law. In April 1987, Treasurer Keating announced that the tax laws would be amended to introduce thin capitalisation rules which had previously been administered by FIRB under the *Foreign Acquisitions and Takeovers Act 1975*. In Press Release No.37 dated 30 April 1987 titled "*Thin Capitalisation and Corporate Restructures*", Treasurer Keating said:

> The Government has decided to replace the thin capitalisation and corporate restructuring conditions of approval that have been imposed on foreign investors under foreign investment policy by introducing legislation to amend the income tax law. The Government recognises that it is desirable to incorporate taxation requirements in legislation rather than impose them under foreign investment policy.
>
> To continue to protect Commonwealth revenues, the Government will introduce legislation to prevent losses arising from thinly capitalised foreign investment in Australian companies and businesses.

20. It is clear from the press release that the then-government did not consider that thin capitalisation issues could be addressed under Division 13 or a DTA-based power by means of an amended assessment under section 170(9B). This is presumably because if a DTA-based power had existed, there would have been little practical need to introduce the thin capitalisation rules in Division 16F into the ITAA 1936.

21. Later in 1987, the thin capitalisation rules in Division 16F were introduced into the income tax laws by *Taxation Laws Amendment Act (No.4) 1987*. There is nothing in the Explanatory Memorandum to that Act to suggest that Parliament had a different view to that of the then-government (i.e. that thin capitalisation issues could be addressed under Division 13 or a DTA-based power by means of an amended assessment under section 170(9B).

22. Further, the issue has not been brought before a court for proper consideration, even though the Commissioner has had opportunity to do so. Nonetheless, courts and tribunals have made comments on the issue by way of *obiter dicta* but have not come to consistent conclusions. In *SNF*, the Federal Court at first instance considered that there was "some force" in an argument the Commissioner may amend an assessment in reliance on an Associated Enterprises Article but the Court was not called upon to enunciate the scope of the power. The Full Court on appeal, unfortunately, did not address the issue. By contrast, the Federal Court in *Undershaft (No 1) Ltd v Federal Commissioner of Taxation* (2009) 175 FCR 150 commented that:

> A DTA does not give a Contracting State power to tax, or oblige it to tax an amount over which it is allocated the right to tax by the DTA. Rather, a DTA avoids the potential for double taxation by restricting one Contracting State's taxing power." (per Lindgren J at paragraph 46).

See also *Re Roche Products Pty Ltd and Federal Commissioner of Taxation* [2008] AATA 639, Downes J, at paragraph 19.)

23. The Commissioner recently conceded that the question remained unresolved in his Decision Impact Statement on *SNF*, in which he stated:

> This litigation did not resolve the question of whether the Associated Enterprises Articles in Australia's Double Tax Treaties give the Commissioner a basis for making transfer pricing adjustments separately from Division 13.

The Tax Institute's recommendations

There is a lack of compelling evidence that Parliament has provided the Commissioner with a separate and unconstrained DTA-based power.

As the Parliament has not made any clear statement about the nature or scope of DTA-based taxing powers and judicial comment has been inconsistent though inconclusive, the introduction of separate and unconstrained DTA-based powers should be prospective in nature only.

The ATO has long held the view that there should be no fundamental inconsistency between Division 13 and a DTA-based power

24. As discussed below, a DTA-based power is much broader than Division 13, yet for more than 17 years, the ATO has been saying that there should be no fundamental inconsistency in the outcomes under a DTA-based power and under Division 13.

25. The following examples clearly show the ATO's position over this period:

(a) In TR 94/14, the ATO said:

> **There should be no fundamental inconsistency between the results under Division 13 and the relevant provisions of the double taxation agreements since both are based on the arm's length principle**, though due regard has to [be] had to the precise wording of the relevant provision(s) being applied. Accordingly, the Commissioner may apply the provisions of Division 13 and/or the treaty provisions. However, in the event of any inconsistency, the treaty provisions will prevail unless the treaty itself gives precedence to the domestic law. A detailed discussion of the interaction between certain provisions of Australia's double taxation agreements and Division 13 will be dealt with in later Rulings. [At paragraph 186, emphasis added]

(b) In TR 97/20, the ATO said:

> **There are some differences in scope between Division 13 and the Associated Enterprises Article of Australia's DTAs which will be the subject of a further Ruling**. In relation to the issues covered by this Ruling, it is considered that the same principles apply generally to both provisions; this is why they are collectively referred to as Australia's transfer pricing rules. [At paragraph 1.10, emphasis added]

(c) In TR 2001/13, the ATO said:

> In the same way, the ATO considers that the DTA Associated Enterprises Article (Article 9 in most of Australia's DTAs) could similarly apply to adjust profits of

separate but related enterprises in cases **where Division 13 of our domestic law is not relied on**. [At paragraph 33, emphasis added]

(d) In the Decision Impact Statement issued by the ATO following the decision of Downes J in *Roche Products Pty Ltd v Commissioner of Taxation* [2008] AATA 639, the ATO said:

> **Treaty Power** - The Commissioner is not bound by the observations made by His Honour on this point and will continue to adhere to the position outlined in TR 92/11, TR 94/14 and TR 2001/13 that the business profits or associated enterprises article of a DTA **may provide a separate basis for assessing transfer pricing adjustments, independently of Division 13**. [Emphasis added]

(e) More recently, the ATO has said the following in TR 2010/7:

> 40. The Commissioner has long considered that an adjustment applying the arm's length principle to the pricing or profit allocation in respect of a taxpayer's international dealings is authorised on the basis of Australia's transfer pricing provisions in Division 13 and those related treaty provisions. This view had been questioned following the Administrative Appeals Tribunal decision *In Re Roche Products Pty Ltd and the Federal Commissioner of Taxation*.
>
> 41. Amendments made at the time of the introduction of Division 13 in 1982 **appeared to signal an intention on the part of the Parliament** that amended assessments could be made to give effect to 'a provision of a double taxation agreement that attributes to a permanent establishment or to an enterprise the profits it might be expected to derive if it were independent and dealing at arm's length' (see subsection 170(9B) of the ITAA 1936 and the definition of 'relevant provision' in subsection 170(14) of the ITAA 1936). [Emphasis added]

(f) And earlier this year, the ATO said in TR 2011/1:

> 10. **Division 13 and treaty Article 9 are both based on the arm's length principle, so there should be no fundamental inconsistency in the outcomes under the two sets of provisions.** Like Division 13, the practical application of treaty Article 9 involves a comparison of the pricing of a transaction or arrangement between associated enterprises in implementing a business restructuring and the pricing of a similar transaction or arrangement between independent enterprises dealing at arm's length in similar circumstances.
>
> 11. **Accordingly, the ATO approach is to adopt the same process in applying Division 13 and treaty Article 9 to a business restructuring**. [Emphasis added]

26. In 1994, the ATO foreshadowed that it would issue a taxation ruling providing a detailed discussion of the interaction between certain provisions of Australia's DTAs and Division 13, a position which it reiterated 3 years later in TR 97/20. Seventeen years later the ATO has still not issued this ruling. It is also evident from the above extracts that the ATO does not see the issue of whether the business profits article or associated enterprises article of a DTA provides a separate basis for assessing transfer pricing adjustments, independently of Division 13, as being free from doubt. These are matters which the ATO could have addressed through a taxation ruling at any time over the past 17 years but chose not to.

27. Under Part 5-5 of Schedule 1 to the TAA and the predecessor provisions to that Part, taxpayers are entitled to rely on rulings issued by the Commissioner on his view of the operation of the law if the ruling applies to the taxpayer. Section 357-85 provides that, if a provision is re-enacted or remade (with or without modification), a ruling continues to apply to the remade or re-enacted provisions "but only so far as the new provision expresses the same ideas as the old provision". Nothing in Part 5-5 deals specifically

with the effect on rulings of retrospective amendments to the law. In principle, taxpayers should be entitled to rely on the Commissioner's rulings on Division 13 and the Associated Enterprises Articles, notwithstanding any amendments to the law that may arise from the current review, particularly to the extent the amendments are retrospective.

28. Given there are doubts about the existence and scope of the Commissioner's powers under the Associated Enterprises Articles, it would be preferable that the law specifically provides for taxpayers to be entitled to rely on such rulings, rather than taxpayers needing to rely on section 357-85. Any such amendment would be consistent with the Government's view that the retrospective amendments merely clarify the law.

The Tax Institute's recommendations

The ATO has long held the view that there should be no fundamental inconsistency between Division 13 and a DTA-based power

- Taxpayers should not face potential adverse consequences of amendments being made to their income tax assessments, particularly in a self-assessment environment, where the ATO could place reliance on a DTA-based power that could result in fundamentally different outcomes to that which would otherwise arise under Division 13 (and also Division 820).
- In particular, specific provision should be made in the law entitling taxpayers to continue to rely on rulings issued by the Commissioner in relation to transfer pricing, notwithstanding any retrospective amendments made to the law as a result of the current review.

The scope of a DTA-based power is much broader than Division 13

29. For the purpose of this section, these comments will only consider a DTA-based power that is broadly the same as Associated Enterprises Article of the OECD Model DTA and that the Commentary to the Associated Enterprises Article of the OECD Model DTA and the OECD Guidelines describe the scope of the power.

30. It is clear that a DTA-based power is much broader than the transfer pricing rules in the domestic tax law (i.e. those contained in Division 13). The following examples clearly show this to be the case:

31. A DTA-based power accommodates:

    - The reconstruction of transactions;
    - The ability to address thin capitalisation issues; and
    - The use of commensurate-with-income (CWI) rules.

32. This outcome reflects the fact that Associated Enterprises Article of the OECD Model DTA, the Commentary to that Article and the OECD Guidelines have to accommodate the domestic tax law positions of its member countries.

33. The existence of a reconstruction mechanism in a DTA-based power is acknowledged in paragraph 82 of the Consultation Paper. Division 13 does not contain a reconstruction mechanism in the sense used in paragraphs 1.64-1.65 of the 2010 OECD Guidelines (paragraphs 1.36-1.37 of the 1995 OECD Guidelines).

34. A DTA-based power accommodates thin capitalisation rules (paragraph 3 of the Commentary to the Associated Enterprises Article of the OECD Model DTA). Division 13 does not deal with thin capitalisation issues and Australia has had thin capitalisation rules since 1987 (originally in Division 16F of Part III of ITAA 1936 and since 2001 in Division 820).

35. A DTA-based power also accommodates CWI rules (see for example, paragraphs 1.10 and 6.34-6.35 of the 1995 OECD Guidelines). Australian domestic tax law does not include anything similar to a CWI mechanism.

36. It is critically important in the context of the Assistant Treasurer's announcement on 1 November 2011 that the scope and potential impact of a DTA-based power is fully understood by all parties. In this context, it is also particularly relevant to have regard to the ATO's interpretation of its powers under existing tax laws and its administrative practice since Division 13 and section 170(9B) of the ITAA 1936 were introduced into Australia's income tax law through the same Bill in 1982. In this respect, we are not aware that the ATO has ever claimed that it has the ability to issue amended assessments in reliance on a DTA-based power that enabled it to do any of the following:

- Reconstruct transactions;
- Address thin capitalisation issues independently of domestic thin capitalisation rules (in either Division 16F or Division 820); or
- Impose taxation on the basis of applying a CWI mechanism.

37. These are all "powers" that the OECD recognises as being able to be introduced into domestic tax law and to be applied consistently with Associated Enterprises Article of the OECD Model DTA. However, countries are not compelled to introduce such powers into their domestic tax law.

38. A real concern also exists that the ATO would use a retrospective DTA-based power to commence new audits or compliance reviews where reliance would be placed on a wider DTA-based power rather than being based on the ATO's view (discussed above) that there should be no fundamental difference between Division 13 and an Associated Enterprises Article. In raising this concern, we wish to make it clear that we are not seeking to restrict in any way the Commissioner's ability to undertake audits or compliance reviews that may seek to ensure compliance with Division 13 as it currently stands.

Reconstruction of transactions

39. We are particularly concerned about the potential for the ATO to raise amended assessments on a retrospective basis that are based on a reconstruction power that is not currently possessed under Australian domestic tax law. Paragraph 1.65 of the 2010 OECD Guidelines states that "there are two particular circumstances in which it may, exceptionally, be both appropriate and legitimate for a tax administration to consider disregarding the structure adopted by a taxpayer". However, the 2010 OECD Guidelines do not provide any guidance as to the meaning of the word "exceptionally".

The Tax Institute's recommendations

Reconstruction of transactions

- The Commissioner should not be allowed to amend assessments in reliance on a retrospective DTA-based power that would enable the Commissioner to reconstruct transactions.
- The Commissioner's ability to amend assessments on a prospective basis in reliance on a DTA-based power that would enable the Commissioner to reconstruct transactions should be strictly limited, for example by:
  - Only being applicable to transactions entered into after the date on which the relevant bill is introduced into the House of Representatives;
  - Setting out clearly the types of transactions and circumstances in which a reconstruction mechanism could be applied (i.e. the exceptional circumstances in which a reconstruction mechanism might be applied consistently with the OECD Guidelines);
  - Introducing clear and objective criteria, all of which must be satisfied, before a reconstruction mechanism could be applied;
  - Requiring the Commissioner to make a determination to apply a reconstruction mechanism that has regard to the matters raised in the preceding dot points (noting that, as discussed below, we does not otherwise support the retention of discretionary powers for the Commissioner);
  - Allowing for merits review by the Administrative Appeals Tribunal of any determination made by the Commissioner to apply a reconstruction mechanism; and
  - Placing the onus of proof on the Commissioner rather than the taxpayer in litigation to show what the reconstructed (counterfactual) transaction would be.

Addressing thin capitalisation issues independently of domestic thin capitalisation rules

40. One of the two circumstances in which the OECD Guidelines acknowledges that it would be appropriate to reconstruct a transaction is where its economic substance differs from its legal form. In such cases, the parties' characterisation of the transaction may be disregarded and the transaction re-characterised in accordance with its substance. The example is given of an investment that is in legal form interest-bearing debt when, at arm's length, having regard to the economic circumstances of the borrowing company, the investment would not be expected to be structured in this way. The OECD Guidelines state that it might be appropriate for a tax administration to characterise the investment in accordance with its economic substance with the result that the loan may be treated as a subscription of capital.

41. In broad terms, the above example is attempting to address concerns relating to thin capitalisation. However, Australia has comprehensive thin capitalisation rules in Division 820. It is far from clear at the present time as to how a DTA-based power (which in many cases is likely to result in outcomes less favourable to taxpayers than those provided by the safe harbour rules contained in Division 820) would interact with the thin capitalisation rules in Division 820.

42. In particular, the question arises as to whether the safe harbour rules in Division 820 are still safe?

Imposing taxation on the basis of applying a CWI mechanism

43. As mentioned above, Australian domestic tax law does not include a CWI mechanism. Further, we are not aware that the ATO has ever claimed that it has the ability to issue amended assessments in reliance on a DTA-based power that enabled it to impose taxation on the basis of applying a CWI mechanism.

The Tax Institute's recommendations

Imposing taxation on the basis of applying a CWI mechanism

- The Commissioner should not be allowed to amend assessments in reliance on a retrospective DTA-based power that would enable the Commissioner to impose taxation on the basis of applying a CWI mechanism.
- The Commissioner's ability to amend assessments on a prospective basis in reliance on a DTA-based power that would enable the Commissioner to impose taxation on the basis of applying a CWI mechanism should be strictly limited, for example by:
    - Only being applicable to transactions entered into after the date on which the relevant bill is introduced into the House of Representatives;
    - Setting out clearly the circumstances in which a CWI mechanism could be applied;
    - Setting out clearly how a CWI mechanism would be applied consistently with the OECD TP Guidelines;
    - Requiring the Commissioner to make a determination to apply a CWI mechanism that has regard to the matters raised in the preceding dot points (noting that, as discussed below, we do not otherwise support the retention of discretionary powers for the Commissioner);
    - Allowing for merits review by the Administrative Appeals Tribunal of any determination made by the Commissioner to apply a CWI mechanism; and
    - Placing the onus of proof on the Commissioner rather than the taxpayer in litigation where a CWI mechanism has been applied.

The Tax Institute's recommendations

The scope of a DTA-based power is much broader than Division 13 (in general)

The Commissioner should be prevented from commencing new audits or compliance reviews of taxpayers where reliance is placed on a wider DTA-based power rather than being based on the ATO's view that there should be no fundamental difference between Division 13 and an Associated Enterprises Article. In this respect, the approach taken in section 842-5 of the Investment Management Regime *Exposure Draft Bill 2011: FIN 48* released on 16 August 2011 could be used as a guide – see Attachment A.

Use of OECD Guidelines as a means of interpreting a DTA-based power

44. As noted in paragraph 16 of the Consultation Paper, the OECD Guidelines were first published in 1979. They were comprehensively reviewed in 1995 and substantially revised in July 2010.

45. Apart from specific matters referred to in this submission, there is broad support for the OECD Guidelines being used as a means of interpreting the arm's length principle on a prospective basis. However, in the context of amendments to the transfer pricing rules retrospective to 1 July 2004, we could not accept that the 2010 OECD Guidelines should be able to be relied upon by the ATO as a means of supporting an amended assessment in any year of income that commenced on or before 22 July 2010, being the date on which the OECD Council approved the 2010 OECD Guidelines. For years of income commencing on or before 22 July 2010, the 1995 OECD Guidelines constitute the relevant point of reference.

46. The OECD Guidelines should not be viewed as ambulatory (in a similar way to the OECD Model DTA) as some of the changes made in the 2010 OECD Guidelines are incompatible with the position reflected in the 1995 OECD Guidelines. For example, in the 1995 OECD Guidelines, transactional profit methods were regarded as methods of last resort. It is only with the issue of the 2010 OECD Guidelines on 22 July 2010 that the status of transactional profit methods was put on a similar footing to traditional transactional methods with the adoption of most appropriate method approach.

47. Reliance upon the 2010 OECD Guidelines prior to their date of issue would be inappropriate given taxpayers could not possibly have been aware of what changes would be made in 2010 to the 1995 OECD Guidelines.

The Tax Institute's recommendations

Use of OECD Guidelines as a means of interpreting a DTA-based power

- The 2010 OECD Guidelines should not be able to be relied upon by the ATO as a means of supporting an amended assessment in any year of income that commenced on or before 22 July 2010, being the date on which the OECD Council approved the 2010 OECD Guidelines.
- For years of income commencing on or before 22 July 2010, the 1995 OECD Guidelines constitute the relevant point of reference.
- The OECD Guidelines should not be viewed as ambulatory (in a similar way to the OECD Model DTA) as some of the changes made in the 2010 OECD Guidelines are incompatible with the position reflected in the 1995 OECD Guidelines.

Potential conflict with Non-discrimination Article in some of Australia's DTAs

48. In our view, the introduction of a DTA-based power, retrospective or otherwise, could result in outcomes that are inconsistent with Australia's obligations under one or more of its DTAs that include a Non-discrimination Article.

49. Our analysis indicates that Australia currently has 7 DTAs which include a Non-discrimination Article (United Kingdom, USA[1], New Zealand, Japan, Norway, Finland

[1] It is noted that Article 23 (Non-discrimination) of the Australia/United States DTA was not given the force of law in Australia (see clause 4 of the *Income Tax (International Agreements) Amendment Act 1983*). Nevertheless, as stated in the Explanatory Memorandum to that Act: "This article, which was included specifically at the request of the United States, represents, in effect, a government to government assurance of each country's intentions that in enacting taxation legislation, citizens or residents of the other country, and enterprises or companies wholly or partly owned by them, will not be treated in a less favourable way than that in which each country treats its own citizens, residents, enterprises or companies.".

and South Africa) with the Non-discrimination Article typically taking the following form:

> Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, **shall not be subjected in the first-mentioned State to any taxation or any requirement connected therewith which is more burdensome than the taxation or connected requirements to which other similar corporations of the first-mentioned State in the same circumstances are or may be subjected.** [Emphasis added]

50. Having regard to the emphasised words above, and without more, the introduction of a DTA-based power would be inconsistent with Australia's obligations under the typical Non-discrimination Article in the event that it resulted in a more burdensome outcome than that imposed on similar corporations under, for example, Division 13 and Division 820.

51. However, the analysis needs to go further as the Non-discrimination Articles in these 7 DTAs also typically include a paragraph similar to the following, together with the accompanying explanation:

> This article shall not apply to any provision of the laws of a Contracting State which is designed to prevent the avoidance or evasion of taxes.
>
> The expression "any provision of the laws of a Contracting State which is designed to prevent the avoidance or evasion of taxes" includes:
>
> (a) Measures designed to address thin capitalisation, dividend stripping and transfer pricing;…

52. It is noted that the Protocol to the Australia/Japan DTA specifically mentions Division 13 and Division 820 (paragraphs 21(c) and 21(i) respectively).

53. The purpose of the above carve out is explained in the 2003 Amendments EM*:*

> 1.267 **Subparagraph (6)(a) of this Article ensures that the operation of domestic measures to combat avoidance and evasion is not affected by this Article**. The Notes provide that the reference to laws designed to prevent avoidance or evasion of taxes includes thin capitalisation, dividend stripping, transfer pricing and controlled foreign company, trust and foreign investment fund provisions. Although it is commonly accepted by most OECD member countries that such provisions do not contravene Non-discrimination Articles, this outcome is specifically provided for in this treaty by the exclusion of such rules from the operation of this Article. ***[Exchange of Notes, Item 1(d)]*** [Emphasis added]

54. The effect of the above carve out is that the operation of Division 13 and Division 820 will not be affected by the Non-discrimination Article in a relevant DTA. However, in our view, it does not follow from this that the Non-discrimination Article in a DTA could not be relied upon by a taxpayer where a DTA-based power resulted in a more burdensome outcome than that imposed on similar corporations under Division 13 and Division 820. That is, the scope of Division 13 and Division 820 set the height of the bar. Where reliance on a DTA-based power resulted in a more burdensome outcome than would otherwise result from application of Division 13 and Division 820, then this would be inconsistent with the Non-discrimination Article in a DTA.

Part Three - Submissions on the Consultation Paper

Adoption of OECD Guidelines and selection of methods

55. We are encouraged by the Assistant Treasurer's initiative to prospectively align Australia's transfer pricing legislation with internationally accepted best practice such as the 2010 OECD Guidelines and OECD Model DTA. We note that the OECD Guidelines are periodically updated and consider that any changes made to the OECD Guidelines in the future should:

    (a) be automatically incorporated into Australian law, without the requirement for further legislative action, such as a disallowable instrument; and

    (b) have effect only prospectively from the time of publication of the changes.

56. The Tax Institute is of the view however that it is important to recognise that adopting the OECD Guidelines will not solve all transfer pricing issues or disputes. This is because the application of the arm's length principle is not an exact science and can be open to different views or interpretations, particularly when applied to complex real world fact patterns.

57. We further consider it is important that if changes are made to Division 13, the changes should not go beyond the OECD Guidelines. For example, care should be taken that any attempt to put the profit-based methods on the same footing as the transactional methods does not inadvertently over-reach and favour the profit-based methods (which would be inconsistent with the OECD Guidelines).

58. Specifically, paragraph 58.5 of the Consultation Paper is concerning since it appears to imply some form of profit test or 'cross-check' might be required regardless of which transfer pricing method is selected as most appropriate in the circumstances (which is inconsistent with the OECD Guidelines).

59. Although the OECD Guidelines put the transaction and profit-based methods more or less on an equal footing, paragraph 2.3 of the OECD Guidelines clearly state that where transaction methods and profit methods can be applied in an equally reliable manner, the transactional method should be chosen over the profit method. The premise for this is that where comparable data is available at a transactional level, the transactional methods are generally a more direct and reliable means of estimating arm's length prices than profit methods.

60. The Consultation Paper seems to suggest that the definition of the arm's length principle in Article 9 of the OECD Model DTA and in the OECD Guidelines is based on the outcomes or profit allocations arising from a group of transactions, as opposed to the arm's length 'price' of specific transactions. We do not believe this is a correct interpretation of the OECD Guidelines, which are principally about arm's length <u>pricing</u>. In circumstances where they are the most appropriate method, profit-based methods are simply a tool – i.e. an indirect means – to achieve arm's length pricing.

61. Critically, paragraph 2.7 of the 2010 OECD Guidelines also cautions on over-reliance on profit-based approaches:

    > In no case should transactional profit methods be used so as to result in over-taxing enterprises mainly because they make profits lower than average, or in undertaxing enterprises that make higher than average profits. There is no justification under the arm's length principle for imposing 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.

62. The arm's length pricing of transactions between independent parties does not guarantee a profit for either or both parties. As was recognised by the Full Federal Court in *SNF*, losses may be incurred by parties to an arm's length transaction for a variety of commercial reasons.

63. The OECD has suggested factors that should be used to determine the most appropriate transfer pricing method in its 'Suggested Approach to Transfer Pricing Legislation' released in June 2011. These factors include: the strengths and weaknesses of the methods under consideration; the appropriateness of the methods in light the functions performed, assets utilised and risks assumed; the availability of reliable information to apply the method; and the degree of comparability with the related party transaction in question.

The Tax Institute recommendations

Adoption of OECD Guidelines and selection of methods

The definition of the arm's length principle in Australia's transfer pricing legislation should not go beyond the definition in the 2010 OECD Guidelines on a prospective basis and OECD Model DTA. In particular:

- a 'most appropriate method' approach should be used with no bias towards profit method application;
- if a transactional method has been selected as most appropriate, a profit or outcomes-based test should not also be required;
- Australia's legislation should refer to OECD guidance instead of containing prescriptive method selection rules;
- any guidance in Australia's transfer pricing rules on method selection should not go beyond the criteria in the OECD's 'Suggested Approach to Transfer Pricing Legislation', so that taxpayers can rely on this OECD guidance; and
- any changes to the OECD Guidelines in the future should apply in Australia automatically and only prospectively.

Comparability criteria

64. The OECD Guidelines provide a list of factors to be considered when assessing comparability. Australia's transfer pricing legislation does not need to contain additional guidance on comparability over and above the OECD Guidelines. Any such additional guidance could risk inconsistency with the OECD Guidelines or risk imposing a higher comparability standard than the OECD Guidelines.

65. The same comparability factors and the same standard of comparability should apply to all transfer pricing methods, including transaction-based methods and profit-based methods. This is recognised at paragraph 2.5 of the 2010 OECD Guidelines, which states that:

> …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 same criteria . . . that were used to reach the initial conclusion that none of the traditional transactional methods could be reliably applied under the circumstances must be considered again in evaluating the reliability of the transactional profit method.

66. That is, the 2010 OECD Guidelines do not endorse 'defaulting' to a profit-based method where 'perfect' comparables are not available to apply a transactional method. We believe this is a critical point because experience with ATO practice suggests that the ATO tends to apply a more stringent comparability standard to the transaction-based methods than the profit-based methods, which it commonly uses as a default or fallback.

67. The Consultation Paper considers the issue of the circumstances of the taxpayer, i.e. the extent to which the taxpayer's circumstances are relevant in a comparability analysis. The OECD Guidelines set out five comparability factors which clearly state what the relevant circumstances of the taxpayer are when evaluating comparability. For example, these comparability factors include 'the functions performed by the parties (taking into account the assets used and risks assumed)', 'the economic circumstances of the parties' and 'the business strategies pursued by the parties'[2]. Therefore, our view is that that there is no need for an additional rule requiring that the taxpayer's circumstances to be taken into account. We believe that the comment at paragraph 55 of the Consultation Paper, that the absence of a specific rule (and reliance on the OECD Guidelines alone) could lead to a conclusion that the taxpayer's circumstances of the taxpayer are not particularly relevant, is misguided and inaccurate.

68. We are also concerned that a separate rule on the taxpayer's circumstances might be inappropriately interpreted by the ATO in administering the law. For example, the ATO may seek to interpret such a rule as a requirement to take the profitability of the taxpayer into account as a comparability criteria, as it tried to argue in *SNF*, or as a form of compulsory profitability cross-check. This risks creating an impossibly high comparability hurdle and giving the profit-based methods priority over the transactional methods, which is clearly inconsistent with the OECD Guidelines.

69. Similarly, in our view no specific guidance is required *"to ensure that a strict market valuation approach is not adopted in favour of an 'arm's length outcome'"*. Again, the five comparability factors in the OECD Guidelines provide an adequate comparability framework and there is no need for Australia's transfer pricing legislation to include an additional rule regarding the taxpayer's circumstances.

The Tax Institute's recommendations

Comparability criteria

Australia's transfer pricing rules should adopt the same comparability criteria as the 2010 OECD Guidelines on a prospective basis and should not include an additional rule on the circumstances of the taxpayer.

Customs implications

70. It will be important to consider the interaction between Australia's transfer pricing legislation and customs duty laws. Transfer pricing adjustments involving the importation of goods can cause customs duty problems, because a separate adjustment then needs to be sought to the customs value of the goods.

71. Seeking such customs adjustments is not straightforward, particularly for transfer pricing adjustments which go back a number of years (because customs adjustments can't go back as far as transfer pricing adjustments) or which relate to a large number

[2] Paragraph 136 of the OECD Guidelines.

of individual import transactions (because customs rules focus on values for individual import transactions). If the changes to Australia's transfer pricing legislation increase the use of profit methods, this will lead to more cases where significant and burdensome problems arise due to the disconnect between the customs and transfer pricing rules.

The Tax Institute's recommendations

Customs implications

Any rewrite of Australian's transfer pricing laws needs to consider the interaction between these laws and Australia's customs duty laws. Specifically any increase in the use of profit methods that results from these changes will heighten the urgent need for a mechanism to align both customs and transfer pricing compliance and reporting for business.

Documentation requirements, safe harbours and penalties

72. We agree that, under a self assessment system, it is reasonable for taxpayers to be expected to maintain documents evidencing compliance with Australia's transfer pricing legislation.

73. Any such documentation requirement should provide taxpayers with some discretion to determine what documentation is appropriate in their circumstances, taking into account the materiality of the relevant transactions and the risk involved. This flexibility is important so that the compliance costs are not disproportionate to the risk. Any guidance on transfer pricing documentation requirements should be consistent with the OECD Guidelines and should not be unduly prescriptive.

74. Any guidance on documentation should also make clear that the ATO should not use hindsight in evaluating such documentation or in assessing compliance with the arm's length principle. Instead what is relevant is the information that was reasonably available to the taxpayer at the time. This is consistent with the OECD Guidelines which warn against the use of hindsight when applying the arm's length principle.

75. We agree with the comments in the Consultation Paper that if a legislative requirement to maintain contemporaneous transfer pricing documentation is introduced, there should be a *de minimis* rule to avoid taxpayers facing compliance costs disproportionate to the potential transfer pricing risk. our view is that such a *de minimis* rule should not only contain thresholds on a per-taxpayer basis, but also on a transaction-type basis. In the absence of a per-transaction *de minimis* rule, taxpayers may bear significant compliance costs in documenting smaller transactions of negligible value and little risk.

76. Consideration should also be given to developing such rules as 'safe harbours' from the application of the transfer pricing provisions generally, and not simply as exemptions from specific documentation requirements. This is consistent with the objectives of simplicity and lower compliance costs. In addition, failure to do so would expose taxpayers to a greater risk of being unable to defend a transfer pricing provision due to lack of evidence, even though they have met the *de minimis* documentation requirements. This will be consistent with current OECD work on simplification of transfer pricing measures driven by the need to strike a balance between the development of sophisticated guidance for complex transactions and the cost-effective use of taxpayers' and tax administrations' resources for improved compliance and enforcement processes.

77. We support the proposition in the Consultation Paper that documentation requirements should be linked to the penalty regime. Penalties should be reduced to

nil where the taxpayer has made good faith attempts to determine an arm's length price and has maintained contemporaneous documentation.

78. The bar should not be set unrealistically high when establishing the documentation requirements that will be linked to penalty protection, nor should these rules be administered in such a way that the bar is raised to an unrealistically high standard. Experience with current ATO practice is that the ATO often has unrealistically high expectations in relation to transfer pricing documentation.

79. The 'prudent business management' concept suggested in the Consultation Paper for transfer pricing documentation has merit; however it will be important that sufficient guidance is provided on this concept if it is to be formally adopted. This is particularly important given the potential subjectivity involved in such judgements.

80. Any documentation requirements should not require a particular transfer pricing method or methods, nor should they mandate an explanation of profit outcomes as this should not be relevant in all cases (for example where sufficiently comparable uncontrolled prices are available).

81. We disagree with the suggestion in the Consultation Paper that taxpayers which do not keep their documentation in Australia should be penalised. It is common, and entirely appropriate, for multinational groups to centrally prepare transfer pricing documentation. Taxpayers should not face a penalty for keeping the documentation overseas provided it can be provided to the ATO if requested and is contemporaneous and meets the required documentation standards.

82. Consideration should be given to providing for a reduction of penalties to nil where a foreign revenue authority disagrees with the Commissioner's determination of an arm's length price.

The Tax Institute's recommendations

Documentation requirements

- Taxpayers should have discretion to determine what documentation is appropriate in their circumstances, taking into account the materiality of the relevant transactions and the risk involved.
- Any documentation requirements should not mandate an explanation of profit outcomes.
- Consistent with current ATO practice, 'contemporaneous' documentation should be taken to mean documentation that existed at the time the income tax return for the relevant year was lodged.
- Penalties relating to transfer pricing adjustments by the Commissioner should be reduced to nil where the taxpayer has made good faith attempts to determine an arm's length price and has maintained contemporaneous documentation.
- Consideration should be given to development of 'safe harbours' from the application of transfer pricing rules generally to promote simplicity, reduce compliance costs, and ensure that taxpayers are not unduly exposed where they otherwise meet *de minimis* documentation requirements.
- Taxpayers should not be penalised merely because they hold their transfer pricing documentation overseas.

Self-assessment

83. We support the proposition that taxpayers self-assess their assessable income and allowable deductions consistently with the arm's length principle. This is consistent with the general self-assessment principles in the income tax law and is likely to reflect the approach already taken by prudent taxpayers under the current Division 13.

84. We do not support the proposition that further discretionary powers would be required by the Commissioner to properly administer the law for periods in which self-assessment applies. In particular:

    (a) We agree that section 167 of the ITAA 1936 provides the Commissioner with sufficient power to make assessments where the Commissioner considers insufficient information has been provided by a taxpayer or is otherwise unsatisfied with the taxpayer's return.

    The scope of section 167 has been judicially considered, providing taxpayers and the Commissioner with some degree of certainty. The Commissioner's broad information gathering powers under sections 263, 264 and 264A of the ITAA 1936 are also noted in this regard; and

    (b) Where the Commissioner considers that the legal arrangements between parties differ from those which would have been made by independent parties behaving in a commercially rational manner, he already has powers to assert the arrangements are shams (and may therefore be ignored for tax purposes) to or make a determination under Part IVA of the ITAA 1936 to deny perceived tax benefits arising from those arrangements. As a result of the current review, he may also have, or be given additional powers under the Associated Enterprises Articles in Australia's DTAs.

    In this regard, the OECD Guidelines note that the sets of circumstances in which reconstruction may be suitable are those in which the character of the transaction may derive from the relationship between the parties rather than be determined by normal commercial conditions and may have been structured by the taxpayer to avoid or minimise tax. The Guidelines state that an Associated Enterprises Articles would allow adjustments in such circumstances.[3]

    It is also noted that, as noted in paragraph 31 of the Consultation Paper, the rewritten transfer pricing provisions are likely to continue to apply to dealings or arrangements beyond legal arrangements, such as those which are informal, implied or not intended to be enforceable.

85. If it is considered appropriate to grant any additional powers to the Commissioner, the scope of these powers should be made clear. In accordance with the OECD Guidelines, any such powers should only be able to be invoked in exceptional circumstances. The Commissioner should not be permitted to 'pluck a figure out of the air' and should be required to provide taxpayers with sufficient information to be able to understand the Commissioner's position and, if appropriate, to challenge it.

86. Consideration should be given to allowing taxpayers with appropriate supporting documentation to self-assess in circumstances other than where there is a detriment to the Australian revenue. This would be consistent with Australia's DTAs under

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[3] OECD Guidelines at paragraph 1.66.

which the Associated Enterprises Articles allow adjustments in both directions, in contrast to Division 13 and the suggestion at paragraph 31.5 of the Consultation Paper.

The Tax Institute's recommendations

Self-assessment

- Taxpayers should be able to self-assess their assessable income and allowable deductions in accordance with the arm's length principle.
- The Commissioner should not be given any additional discretionary powers in respect of transfer pricing matters prospectively.
- If the Commissioner is to retain certain additional discretionary powers in respect of transfer pricing prospectively, the scope of these powers should be made clear and appropriate limitations placed on them (please refer to The Tax Institute's recommendations in relation to reconstruction and CWI in Part Two).

Time limits on amendments

87. We support the introduction of a time limit for the Commissioner to make amendments to assessments in respect of transfer pricing adjustments.

88. Consistent with the position taken in our submission to the *Review of Unlimited Amendment Periods in the Income Tax Laws*, we do not consider there are issues peculiar to transfer pricing to justify a longer amendment period than the standard periods provided in section 170 of the ITAA 1936. Arguments that transfer pricing is more complex and difficult than other adjustments cannot be sustained given:

    (a) In considerably shorter timeframes, taxpayers face the same complexity and difficulty in obtaining verification information in order to prepare their returns; and

    (b) Information is readily available to the Commissioner as taxpayers are required to provide the Commissioner with detailed information on their international dealings in Schedule 25A of their return.

89. Additionally, we note:

    (a) The Commissioner has unlimited powers of amendment where he is of the opinion that there has been fraud or evasion under item 5 of the table in section 170(1);

    (b) The Commissioner can request extensions of time from taxpayers or the Federal Court where he has not been able to finalise an investigation by the end of the period for amendment under section 170(7);

    (c) The Commissioner frequently relies on information from third parties in making assessments in respect of non-transfer pricing matters without any automatic extension of time limits. Further, Australia's network of DTAs and Tax Information Exchange Agreements now provides the Commissioner with greater information gathering powers in respect of other countries, including tax havens, than he had previously. Consequently, failures or delays of other countries to provide information should not justify extending the standard amendment periods in transfer pricing cases, nor should

taxpayers be exposed to additional interest charges as a result of such failures which are not caused or contributed to by the taxpayer; and

(d) Noting the comments on the Commissioner's powers of assessment above, lack of cooperation, hindrance or obstruction by taxpayers is currently and properly dealt with under penalty provisions.

90. If it is considered that a unique amendment period should be provided for transfer pricing adjustments, we consider that any such period should be set by reference to the issue of an assessment, rather than the commencement of an audit. Unlike assessments, an audit is not a concept that is well-defined in the tax law and the timing at which an audit commences may be inherently uncertain. For instance, the Commissioner is not required to notify a taxpayer of the commencement of an audit (and, in some circumstances, may not wish to do so) so it may not be clear when the time would begin to run.

91. Further, a period defined by reference to the commencement of an audit would be akin to an unlimited amendment period if the Commissioner was able to simply commence an audit without any obligation to duly and promptly finalise it.

The Tax Institute's recommendations

Time limits on amendments

- Transfer pricing should be subject to the standard periods for amendments of assessments.
- If a unique amendment period is to be provided for transfer pricing adjustments, it should be defined by reference to the issue of an assessment, not the commencement of an audit.

Separate entity methodology for permanent establishments

92. We support the adoption of a separate entity methodology for permanent establishments and considers that the opportunity should be taken to make any changes to the law in this regard at the same time as the introduction of revised transfer pricing provisions.

93. As noted in earlier discussions, we will make a further submission on this issue in due course.

The Tax Institute's recommendations

Separate entity methodology for permanent establishments

A separate entity methodology for permanent establishments should be adopted at the same time as the revised transfer pricing provisions.

Attachment A

Excerpt of *Exposure Draft Bill 2011: FIN 48*

842-5 Commissioner to disregard certain amounts in respect of IMR foreign funds and trustees

[…]

(2) In making an assessment for the income year the Commissioner must not take IMR income or an IMR loss into account in calculating:

(a) the taxable income of the IMR foreign fund; or

(b) the amount in respect of which the trustee is assessed and liable to pay tax (if any).

Fraud

(3) Subsection (2) does not apply if the Commissioner is of the opinion there has been fraud by the IMR foreign fund.

Audit or compliance review

(4) Subsection (2) does not apply if before 18 December 2010 the Commissioner notified the IMR foreign fund that an audit or compliance review would be undertaken.