THE TAX INSTITUTE

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Dear Tony

EXPOSURE DRAFT: MODERNISING AUSTRALIA'S TRANSFER PRICING RULES

The Tax Institute thanks you for the opportunity to make this submission in response to the exposure draft of legislation ("**ED**") and draft explanatory memorandum ("**Draft EM**") to effect the Government's announced intention to modernise Australia's transfer pricing rules.

OVERVIEW

Aligning with international comparisons

As noted in our submission in response to the Consultation Paper that preceded this ED and draft EM (attached at Appendix A), we are broadly supportive of the Government's efforts to more closely align Australia's transfer pricing rules with OECD guidelines. A cohesive and co-ordinated approach to transfer pricing between Australia and our major trading partners is essential to ensure that multi-national enterprises ("**MNEs**") are broadly taxed in line with mutually agreed principles as encapsulated in the OECD Guidelines. MNEs also stand to benefit via lower compliance costs stemming from consistency across the many compliance frameworks to which each enterprise is likely to be subject.

Conversely, a disassociation between Australia's domestic transfer pricing rules and the domestic rules of our major trading partners and other OECD member countries is undesirable. Such a disassociation will unnecessarily increase compliance obligations and will have a negative impact on foreign investment in Australia – a necessary driver of growth and employment.

On our reading, the ED is drafted in line with the appropriate policy principles, but suffers from a lack of clarity and consistency of application. The current laws and Australian Taxation Office ("**ATO**") rulings on transfer pricing, as well as taxpayer and ATO understanding of the same have developed over a significant period of time. The replacement of such detailed guidance with the high-level principles-based rules contained in the ED, without further clarification on a number of key matters risks causing uncertainty and an increase in compliance costs for taxpayers and administrative costs for the ATO, especially in a self-assessment environment.

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These matters include:

- The power to reconstruct actual transactions
- Legislating current administrative practices
- Interaction of transfer pricing rules and other provisions of the Income Tax Assessment Acts

Further discussion on these matters is set out below. Nevertheless we note that additional information on domestic transfer pricing rules in internationally comparable jurisdictions would further add to our capacity to evaluate the ED as against the Government's policy intention.

Setting the benchmark

In order to evaluate our current and the proposed domestic transfer pricing rules, regard must be had to the domestic tax laws that other OECD member countries have introduced to deal with tax matters falling within the ambit of, in particular, the Associated Enterprises Article of the OECD Model DTC ("**Art.9**") on which the Associated Enterprises Article in Australia's Double Tax Agreements ("**DTAs**") is based. A proper comparison can then be made as against this benchmark of international best practice.

In order to align Australia's domestic transfer pricing rules with international best practice, regard should also be had to:

- The balance that other OECD countries have chosen to strike between specific domestic transfer pricing rules and a domestic general anti-avoidance rule ("**GAAR**"), including consideration of where particular countries do not have a domestic GAAR; and

- The manner in which domestic transfer pricing rules in other OECD countries interact with other domestic tax law provisions, including how the rules of statutory interpretation followed by the courts in certain countries might enable or require a substance over form approach to be applied to particular transactions for tax purposes before domestic transfer pricing rules are applied.

We encourage Treasury to share any analysis undertaken in relation to the above matters, particularly in relation to domestic tax law provisions in other OECD countries that allow actual transactions to be reconstructed for tax purposes, record keeping and penalties.

Access to such analysis would assist us in evaluating the ED as against the international benchmark in determining the extent to which the ED achieves its stated intention of closer alignment.

Striking the right balance: impact of proposed changes on taxpayers

As aptly noted in the Consultation Paper[1]:

> "While the role of [transfer pricing] rules is often seen as limiting the erosion of the tax base through profit shifting, they perform an equally important role for investors and treaty partner governments by clarifying the rules for cross border profit allocation and ensuring broad parity between the tax treatment of multinational enterprises and businesses that operate entirely domestically.

[1] Paragraph 2.

> These rules need to be sufficiently robust to protect the Australian tax base – <u>but they also need to be balanced so as not to overreach or impose transaction costs which may inhibit Australia's international competitiveness</u>." *(emphasis added)*

The appropriate balance between revenue protection and Government overreach, and consideration of the likely transaction costs/compliance burden imposed by transfer pricing rules is essential to securing taxpayer confidence and voluntary compliance.

In our view, the ED does not strike the appropriate balance in a number of key areas, in particular, in relation to reconstruction powers, record keeping and penalties. If enacted in its current form, the ED will impose a disproportionate compliance burden on many taxpayers and will inhibit rather than promote Australia's international competitiveness.

In light of this, we strongly urge the Treasury to undertake further consultation with relevant stakeholders before a Bill is introduced into Parliament with a view to achieving a more appropriate balance between these competing objectives.

Self-assessment

We are broadly supportive of the move to a self-assessment system for transfer pricing issues. The ability to self-assess tax liability will encourage taxpayers to take ownership of their compliance obligations and will increase autonomy and flexibility in the management of compliance obligations and tax risk.

Nevertheless, the ED leaves a number of issues unresolved in relation to how a self-assessment system would operate for a range of matters including the Commissioner's ability to reconstruct transactions for tax purposes and how the record keeping requirements under section 262A of the *Income Tax Assessment Act 1936* ("**ITAA1936**") are intended to operate and to interact with the record keeping and penalty provisions contained in the ED.

In addition, we are of the view that the ED as currently drafted does not constitute a set of provisions that most taxpayers will be able to self-assess against with reasonable certainty and in a cost-effective manner.

As such, we recommend that further consultation be undertaken to fully explore the difficulties and costs that the ED will impose on taxpayers so that the right balance can be struck in the context of this rewrite for both the ATO and taxpayers.

Policy underpinning the ED

Our detailed comments on the ED and draft EM are set out below. These comments are set out on the basis of our understanding as to the policy principles underpinning the ED as discussed in the stakeholder meeting hosted by Treasury on 7 December 2012:

1. To align Australia's transfer pricing rules with international best practice as expressed in the 2010 OECD Transfer Pricing Guidelines ("**2010 OECD TP Guidelines**");
2. To maintain the 'single entity' approach with respect to the attribution of profits to permanent establishments ("**PEs**"); and
3. To give legislative effect to the current administrative practices set out in ATO transfer pricing rulings in relation to record keeping and penalties (in particular TR 98/11 and TR 98/16).

If this understanding is not correct, we would appreciate clarification from Treasury so that we can more effectively contribute to the consultation process.

Timing

The proposed amendments are complex, extensive and have far-reaching implications for a significant number of taxpayers. As such, the amendments should be implemented only after thorough consideration and consultation, and after every effort has been made to ensure that unintended consequences are avoided.

As the amendments constitute a modernisation project, there should be no integrity concern that prevents Treasury from taking the time required to appropriately consider all the consequences of the ED on taxpayer behaviour and compliance costs in determining the right balance. It is essential that the ED strike the appropriate balance in order to achieve the relevant policy intention and minimise the need for rectifying amendments in years to come.

DETAILED COMMENTS

Reconstruction of actual transactions

The potential for the Commissioner to reconstruct actual transactions for tax purposes as set out in the ED is not in keeping with policy objective 1 (as set out above).

Notably, under proposed subsection 815-115(1)(b), the arm's length conditions replace the actual conditions in *all* cases where a taxpayer obtains a transfer pricing benefit. As a result, this proposed section does not limit the potential for the ATO to reconstruct transactions. This position is in sharp contrast to the 2010 OECD TP Guidelines, in line with which transactions may only be reconstructed in 'exceptional circumstances' (paragraph 1.64 of the 2010 OECD Transfer Pricing Guidelines).

Providing the Commissioner with such a broad power without clear constraints risks creating significant uncertainty for taxpayers seeking to comply in a self-assessment system, is likely to lead to misalignment between Australia's domestic transfer pricing rules and international best practice and constitutes significant Government overreach – such an extensive power is unnecessary to tackle any of the stated objectives of transfer pricing rules, as set out in the Consultation Paper, and establishing appropriate boundaries for the exercise of such a power will not result in any integrity concerns of note.

While we do not intend to suggest that the ATO would seek to abuse such a broad power, there is significant uncertainty at the present time as to the manner in which such a power could be used, and whether the exercise of such powers is required to be consistent with the 2010 OECD TP Guidelines. Greater guidance in the ED on this point is necessary.

For example, recent discussions at the ATO's Transfer Pricing Working Group[2] ("**TPWG**") in the context of the recently enacted Subdivision 815-A have highlighted the lack of common understanding between the ATO and external members of the TPWG as to what constitutes the reconstruction of a controlled transaction as distinct from the re-pricing of a controlled transaction having regard to comparable uncontrolled transactions. Such differences of opinion highlight the need for the ED to provide clear

[2] The TPWG is a working group of the ATO's National Tax Liaison Group's International Sub-committee and was established in the latter half of 2012 to consider potential administrative and interpretative matters arising out of the recently enacted Subdivision 815-A.

guidance to taxpayers, the ATO and to the Courts in relation to a range of matters relevant to the use of any powers to reconstruct actual transactions.

Reconstruction powers under the 2010 OECD TP Guidelines

Notwithstanding the above, we do not recommend an exact importation of the restrictions placed on the reconstruction power in the 2010 OECD TP Guidelines. This is because the Guidelines envisage a broad range of circumstances in which it may be appropriate for a transaction to be reconstructed for tax purposes consistently with the arm's length principle in Art.9. The breadth of discussion in the 2010 OECD TP Guidelines reflects the consensus nature of the document. Such a potentially broad scope for the reconstruction power is also likely to result in uncertainty.

For example, the Guidelines note that transactions may be reconstructed in the following circumstances:

- Controlled transactions can be recharacterised where their economic substance is different to their legal form (e.g. converting debt into equity – see the first circumstance described in paragraph 1.65 of the 2010 OECD TP Guidelines);
- Controlled transactions can be reconstructed where independent parties would not have entered into a particular transaction in the way the actual transaction was entered into (see the second circumstance described in paragraph 1.65 of the 2010 OECD TP Guidelines);
- Transactions can be imputed in certain cases (e.g. in cases involving losses continuing indefinitely – see paragraph 1.71 of the 2010 OECD TP Guidelines); and
- Commensurate-with-income (CWI) rules can be applied (see for example, paragraphs 6.28-6.35 of the 2010 OECD TP Guidelines)[3].

We note that most OECD countries have not introduced domestic tax law provisions that cover the full range of circumstances discussed in the 2010 OECD TP Guidelines in which it may be appropriate for a transaction to be reconstructed for tax purposes.

Economic substance – subsections 815-125(5)-(7)

The Tax Institute has three key concerns with subsections 815-125(5)-(7).

Subsection 815-125(5) requires that regard be given to the economic substance of what was actually done for purposes of identifying the 'arm's length conditions'. However, in construing the words "the economic substance of what was actually done", it is unclear whether these words permit going beyond considering the 'economic substance' of a single transaction compared to the legal form of *that* transaction, to potentially also considering the economic substance of the totality of the arrangements entered into by the Australian taxpayer, which may involve transactions with multiple parties located in multiple jurisdictions.

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[3] In this respect, we note the following statement from the United States Treasury Department Technical Explanation to Article 9 of the U.S.-Japan income tax treaty: "The "commensurate with income" standard for determining appropriate transfer prices for intangibles, added to Code section 482 by the Tax Reform Act of 1986, was designed to operate consistently with the arm's-length standard. The implementation of this standard in the section 482 regulations is in accordance with the general principles of paragraph 1 of Article 9 of the Convention, as interpreted by the OECD Transfer Pricing Guidelines. See paragraphs 6.28 through 6.35 of the Transfer Pricing Guidelines."

Related to the above concern is the question of whether, in having regard to “the economic substance of what was actually done”, the Commissioner is able to have regard to only a segment or aspect of the arrangements between the parties. The ED is not clear.

Third, and most importantly, notwithstanding subsection 815-125(5), subsection 815-125(7) provides that where independent entities would not be expected to have done anything, the economic substance of which is substantially similar to the economic substance of what was actually done, the arm’s length conditions *are* to be identified as if what was actually done had not been done. Subsection 815-125(7) in conjunction with paragraph 815-115(1)(b) effectively operates as an annihilation provision (similar to section 260 of the ITAA 1936) with the actual arrangement between the parties being ignored for tax purposes. Such a provision is likely to result in harsh or potentially oppressive outcomes in cases where real activities are being undertaken by the Australian taxpayer. Further, insufficient regard has been given to the cautionary words in paragraph 1.11 of the 2010 OECD TP Guidelines which state that “The mere fact that a transaction may not be found between independent parties does not of itself mean that it is not arm’s length”.

Further, given that paragraph 815-115(1)(b) deems the arm’s length conditions to operate rather than the actual conditions, the potential for unintended consequences to arise is likely to be substantial.

Dealings entered into before date of effect of ED

The ED is silent with respect to whether the reconstruction powers in Subdivision 815-B are able to be applied to dealings entered into prior to the intended date of effect of the ED, notwithstanding that the ability to amend an assessment based on applying Subdivision 815-B may only relate to a year of income commencing on or after the date of effect of the ED.

If dealings entered into prior to the date of effect of the ED are able to be reconstructed under Subdivision 815-B then, in our view, the ED will have retrospective application. Taxpayers, particularly those dealing with entities in non-tax treaty countries to which only Division 13 would currently have potential application, could not possibly have been aware at the time of entering into such dealings that they could be reconstructed in a way envisaged in the ED.

In light of the potential broad scope of reconstruction powers as described in the 2010 OECD TP Guidelines, and the uncertainty that the potential use of such powers will create for taxpayers, we make the following recommendations.

Recommendations

In the context of the ED giving the ATO potentially very broad powers to reconstruct actual transactions, the ED should clearly set out:

- The situations in which powers to reconstruct, recharacterise or to impute transactions are intended to be used;
- What is to be regarded as ‘exceptional circumstances’ in light of paragraphs 1.64 and 1.65 of the 2010 OECD TP Guidelines;
- Clear boundaries with respect to when such broad powers are to be applied and not to be applied;

- How the expression ‘the economic substance of what was actually done’ used in subsections 815-125(5) to (7) is to be interpreted;
- How such broad powers are to be applied, for example:
  - how the alternative postulate corresponding to the ‘arm’s length conditions’ is to be determined and preferred over other alternative postulates that might reasonably exist;
  - the nature of the evidence required to support the alternative postulate most likely to correspond to the ‘arm’s length conditions’;
- How powers to reconstruct, recharacterise or to impute transactions interact with other provisions of the tax acts that cover the same or similar territory (discussed further below);
- How powers to reconstruct, recharacterise or to impute transactions apply with respect to dealings entered into prior to the date of effect of the ED; and
- Whether there are any exceptions to the application of such rules.

Further, as currently drafted, there is capacity for subsection 815-125(7) to result in unintended and inappropriate outcomes and/or consequences (e.g. where real activities are being undertaken by the Australian taxpayer). We recommend that this subsection be revised to prevent such outcomes.

Legislating current administrative practice

The Tax Institute broadly supports the policy objective of giving legislative effect to the current administrative practices of the ATO as set out in ATO transfer pricing rulings. However, the ED is not consistent with this policy objective in a number of key respects.

Business restructures (TR 2011/1)

Where it applies, subsection 815-125(7) requires the arm’s length conditions to be identified as if what was actually done by the parties had not been done. As noted above, subsection 815-125(7) operates as an annihilation provision with the actual arrangement between the parties being ignored. By contrast, paragraphs 19 (Step 3, sixth dot point) and 41 of TR 2011/1 state that where an the examination shows that the pricing of the business restructuring arrangement does not make commercial sense, the Commissioner would in the first instance seek to make a pricing adjustment by reference to the arrangement as entered into by the parties (emphasis added).

Record keeping and penalties (TR 98/11 and TR 98/16)

- Subdivision 815-D has not been drafted having regard to prudent business management principles as endorsed by the ATO in paragraphs 1.5-1.10 of TR 98/11[4];
- Subdivision 815-D does not distinguish between the quantum, proportion or complexity of a taxpayer’s cross-border dealings contrary to the ATO’s current administrative approach set out in, in particular, paragraph 1.9 of TR 98/11;
- Subdivision 815-D has been drafted on the basis that *all* of the requirements set out in subsections 815-305(2)-(5) must be satisfied to enable a taxpayer to potentially

[4] Based on paragraphs 5.4 and 5.28 of the 2010 OECD TP Guidelines.

have a reasonably arguable position (RAP) and thereby have administrative penalties reduced to 10%. This approach:

- is contrary to the ATO's current administrative approach set out in paragraphs 36 and 39 of TR 98/16 under which taxpayers with transfer pricing documentation rated as being at least medium-to-high quality generally have administrative penalties reduced to *nil* in the event of a transfer pricing adjustment;
- does not leave any meaningful scope for the ATO to remit penalties under section 298-20 of the *Taxation Administration Act 1953* ("**TAA 1953**") to a rate less than 10%; and
- does not encourage voluntary compliance;

- Subdivision 815-D has not been drafted having regard to reducing documentation requirements for small businesses contrary to the approach taken in Chapter 6 of TR 98/11;
- Subdivision 815-D requires taxpayers to prepare records that satisfy *all* of the requirements set out in subsections 815-305(2)-(5) for *each* year of income to enable a taxpayer to potentially have a RAP contrary to the ATO's current administrative approach set out in the Four Step Process described in TR 98/11 (in particular Step 4).

Recommendations

The ED should be reviewed with a view to providing taxpayers with an incentive to prepare appropriate transfer pricing documentation while keeping compliance costs to the minimum necessary, consistent with the principles in Chapter V of the 2010 OECD TP Guidelines and with current ATO administrative practices of many years standing.

Further, as the record keeping requirements are necessary but not even sufficient to establish a RAP, the proposed requirements will create a reverse incentive to not voluntarily comply with the requirements where the cost of compliance exceeds the potential penalty that is likely to be levied by the Commissioner for the failure to establish a RAP. This outcome is not in the interests of either taxpayers or the ATO.

In particular:

- The concept of 'reasonableness' should be reflected in the design of record keeping and penalty provisions that in large part rely on economic concepts rather than interpretations of the law;
- Prudent business management principles should be reflected in the design of record keeping and penalty provisions;
- Adequate room should be left for the ATO to review existing administrative practices or to develop new administrative practices that enable penalties to be remitted to nil (under section 298-20 of the TAA 1953) in appropriate cases;
- Reduced record keeping requirements should be developed for SMEs; and
- Record keeping requirements should be minimal where transactions cross more than one income year but where there have been no other material changes in the circumstances (consistent with the ATO's current administrative practice as set out in step 4 of the Four Step Process described in TR 98/11).

We would be pleased to discuss the above in greater detail with Treasury in the New Year with a view to achieving this objective in a manner that will yield an appropriate balance between the competing objectives of revenue protection and minimising compliance costs.

Section 262A of the ITAA 1936

The ED proposes that Subdivision 815-B and Subdivision 815-C are to be self-assessed. In a self-assessment environment, taxpayers are required by section 262A of the ITAA 1936 to keep records that explain all transactions that are relevant for any purposes of the Act. The record keeping rules in section 262A of the ITAA 1936 apply irrespective of any optional record keeping rules that might be provided in Subdivision 815-D with a view to facilitating taxpayers getting a RAP.

Taxpayers and public officers are potentially exposed to administrative penalties under section 288-25 of the TAA 1953 and also to criminal penalties for failing to comply with s262A (see PS LA 2005/2 (Penalty for failure to keep or retain records)). These administrative penalties are separate to and independent of any administrative penalties that might apply under Subdivision 284-B or 284-C of the TAA 1953.

It is not, however, clear what records taxpayers will need to maintain to avoid administrative penalties arising for failing to keep the records required by section 262A of the ITAA 1936.

Further, it is not clear how proposed Subdivision 815-D sits with section 262A of the ITAA 1936.

Recommendation

The ED should provide clearer guidance as to what records taxpayers will need to maintain to avoid administrative penalties arising under section 288-25 of the TAA 1953 for failing to keep the records required by section 262A of the ITAA 1936.

Penalties – de minimis thresholds

The *de minimis* thresholds of $10,000 and $20,000 in proposed section 284-165 of the TAA 1953 are too low to achieve their intended purpose. These thresholds will not carve out most enterprises operating in the small to medium enterprise market as intended, as the international operations of these entities typically exceed the proposed thresholds.

Recommendation

The *de minimis* thresholds should be raised to $5,000,000 in order to achieve their intended effect.

Terms used: definition, meaning and differentiation

The drafting of key terms used in Subdivision 815-B, in particular in key provisions such as sections 815-115, 815-120 and 815-125, do not always have a single consistent meaning on each occasion in which a particular term is used and are not sufficiently differentiated from other terms covering similar territory:

- In particular, the term '*conditions*' does not have a single consistent meaning on each occasion in which it is used in these provisions; and
- The term 'circumstances' also does not have a single consistent meaning on each occasion in which it is used in these provisions; and

- The ED does not sufficiently differentiate between the terms '*conditions*' and '*circumstances*' used in these provisions.

This creates confusion and is bound to create compliance difficulties for the ATO and taxpayers alike. The following examples illustrate the above concerns.

The term 'conditions' does not have a single consistent meaning

A taxpayer gets a transfer pricing benefit in an income year where 'conditions' operating between the entity and another entity differ from the 'arm's length conditions'. The word 'conditions' in this context is used in the sense of the conditions which operate in connection with the commercial and financial relations between the entity and another entity (subsection 815-120(1)). The term 'arm's length conditions' is defined in subsection 815-125(1) as meaning the conditions that might be expected to operate between independent parties dealing wholly independently with one another in comparable circumstances.

However, subsection 815-125(2) states that in determining the 'arm's length conditions' use the method or combination of methods that is the most appropriate and reliable having regard to a range of specified factors. The word 'conditions' in this context is used in the sense of conditions relevant to the application of the most appropriate transfer pricing method. Further, paragraphs 815-125(4)(a) and (b) refer to a difference between the 'actual circumstances' and comparable circumstances in the context of a difference affecting a condition that is relevant to the method. In these contexts, the word 'condition' has both a broader and narrower meaning to that used in subsection 815-120(1):

- The word 'condition' has a narrower meaning in the sense that the condition has to be relevant to the method used rather than a condition which operates in connection with the commercial and financial relations between the entity and another entity; and
- The word 'condition' also has a broader meaning in the sense that the condition encompasses not only those conditions which operate in connection with the commercial and financial relations between the entity and another entity but also the conditions which operate between the independent parties dealing wholly independently with one another in comparable circumstances which are being used as comparables.

The term 'circumstances' does not have a single consistent meaning

The term 'arm's length conditions' is defined in subsection 815-125(1) as meaning the conditions that might be expected to operate between independent parties dealing wholly independently with one another in *comparable circumstances*. The term 'comparable circumstances' is used in subsections 815-125(1), (3), (6) and (7).

However, subsection 815-125(2) requires that in identifying the 'arm's length conditions' (and the concomitant requirement to use the most appropriate method in doing so) regard must be given to *all relevant factors* including 'the *circumstances*, including the functions performed, assets used and risks borne by the entities' (paragraph 815-125(2)(b)). It is not clear what meaning the word 'circumstances' is intended to have in paragraph 815-125(2)(b) and whether its meaning is the same as or different to the meaning of the word '*circumstances*' in the term '*comparable circumstances*'.

In addition, subsection 815-125(3) requires that in identifying comparable *circumstances*, regard must be given *inter alia* to *all relevant factors* in identifying 'comparable *circumstances*' which includes 'the *economic circumstances'* (paragraph 815-125(3)(d)). It is not clear what meaning the word '*circumstances*' is intended to have in the term '*economic circumstances*' in paragraph 815-125(3)(d) and whether its meaning is the same as or different to the meaning of the word '*circumstances*' in the term '*comparable circumstances*'.

The terms 'conditions' and 'circumstances' are not sufficiently differentiated

As mentioned above, paragraphs 815-125(4)(a) and (b) refer to a difference between the '*actual circumstances'* and '*comparable circumstances*' in the context of a difference affecting a condition that is relevant to the method. The terms *'conditions' and 'circumstances' seem to overlap in their meaning in these paragraphs and i*t is not clear how they are intended to be interpreted or differentiated.

Recommendations

Key terms used in the drafting of Subdivision 815-B:

- Should have a single consistent meaning on each occasion in which they are used (e.g. '*conditions*'); and
- Should be clearly differentiated from other terms covering similar territory (e.g. '*conditions*' and 'circumstances').

<u>Interaction with other provisions of the Income Tax Assessment Acts</u>

The ED does not clearly indicate how proposed Subdivisions 815-B and Subdivisions 815-C interact with a number of other key areas of the income tax laws and will therefore result in increased uncertainty and additional compliance costs for taxpayers. For example, a number of provisions of the Tax Acts contain specific valuation rules which apply, including in some cases where parties do not deal with each other at arm's length. Further, some provisions of the Tax Acts already require a substance over form approach to be adopted.

Examples of provisions containing specific valuation rules

- The capital gains and loss provisions in Parts 3-1 to 3-3 of the *Income Tax Assessment Act 1997* ("**ITAA 1997**") contain their own market value substitution rules[5]
- The capital allowance rules in Division 40 of the ITAA 1997 contain their own market value rules[6]
- The trading stock provisions in Division 70 of the ITAA 1997 contain their own market value rules[7]
- Section 974-145 (benchmark rate of return) of the ITAA 1997 contains valuation rules relevant to sections 25-85 and 230-15

It is not clear to us how the transfer pricing rules in the ED will interact with other provisions of the Tax Acts containing specific valuation rules, especially where the

[5] Section 116-30 in relation to capital proceeds and section 112-20 in relation to cost base.

[6] Section 40-300.

[7] Section 70-20.

valuation rules differ and yield different results. Specifically, it is not clear to us whether the transfer pricing rules are intended to have residual or concurrent application, and if the latter, how differences between the two sets of rules are intended to be resolved in a self-assessment environment and in a way which keeps compliance costs for taxpayers to the minimum necessary.

Recommendation

The ED should clearly set out how the proposed transfer pricing rules will interact with other provisions of the Tax Acts containing specific valuation rules, especially where the valuation rules differ and yield different results.

Examples of provisions requiring the use of economic substance over legal form

The most obvious example of a provision or set of provisions requiring the use of economic substance over legal form is the debt/equity rules in Division 974 of the ITAA 1997. However, the ED is silent with respect to how Subdivisions 815-B and 815-C interact with Division 974. This raises an obvious question from a policy perspective as to what is the intended scope (or residual scope) of Subdivisions 815-B and 815-C to enable financial instruments to be recharacterised differently to how they are characterised under Division 974? We note that the ATO has stated in TD 2008/20 that Division 974 does not apply for purposes of Division 13. However, the tax determination does not address the policy question raised above.

Recommendations

The ED should clearly:

- Set out how Subdivisions 815-B and 815-C interact with Division 974 of the ITAA 1997;
- State that either Subdivisions 815-B and 815-C will <u>not</u> affect the characterisation of a financial instrument for purposes of the Debt/Equity rules (given that Division 974 sets out rules which do apply a substance over form approach) in Division 974 or alternatively should clearly set out the residual scope of operation that Subdivisions 815-B and 815-C are intended to have ie where a different characterisation might arise.

<u>Secondary adjustments</u>

Under paragraph 815-115(1)(b), the arm's length conditions are deemed to replace the actual conditions where a taxpayer obtains a transfer pricing benefit. The drafting of paragraph 815-115(1)(b) is potentially broad enough to also require taxpayers to make secondary adjustments[8] consistent with arm's length conditions.

However, there is nothing in paragraph 815-115(1)(b) or elsewhere in the ED that clearly states whether secondary adjustments are required or not required to be made. In this respect, we note that the Consultation Paper did not discuss the potential inclusion of a secondary adjustment mechanism into Australia's transfer pricing rules. Further, we note that in the ATO's view (prior to the introduction of Subdivision 815-A), Australia's transfer pricing rules do not include a general power to make secondary adjustments (see Appendix 1 of TR 2007/1 at paragraphs 34 and 35).

[8] A secondary adjustment can broadly be described as an adjustment arising from a secondary constructive transaction that can be triggered by a primary transfer pricing adjustment made under Article 7 or 9 of a DTA, or under domestic law anti-transfer pricing measures (paragraph 35 of TR 2007/1).

Recommendation

The ED should clearly state that the scope of s815-115 is limited to the making of primary transfer pricing adjustments and does not extend to the making of secondary adjustments.

Application to permanent establishments

We request clarification as to whether the proposed amendments are intended to be affected by any Government-accepted recommendations made by the Board of Taxation following its *Review of Tax Arrangements applying to Permanent Establishments* pursuant to which the merits of a separate entity approach for permanent establishments is being considered. In this regard, we have attached our submission to the Board of Taxation in response to the Board's Discussion Paper at Appendix B for your ease of reference.

Amendment period

A compelling case has not been made as to why the Commissioner should be given an 8-year time limit for amending assessments under sections 815-145(1) and 815-235 rather than applying the normal time limits for amending assessments under section 170 of the ITAA 1936. In this respect, it is particularly important to note that subsection 170(7) of the ITAA 1936 provides the Commissioner with the ability to obtain additional time in which to complete an examination of a taxpayer's affairs.

We are nevertheless broadly supportive of the position taken in the ED that the amendment period for the purposes of making transfer pricing adjustments should begin on the date of assessment.

Recommendations

- The normal time limits for amending assessments under section 170 of the ITAA 1936 should also apply in transfer pricing cases. In this respect, it is particularly important to note that subsection 170(7) of the ITAA 1936 provides the Commissioner with the ability to obtain additional time in which to complete an examination of a taxpayer's affairs.
- To ensure consistency with the preceding recommendation, subsection 170(9B) of the ITAA 1936 should also be amended to limit the Commissioner's ability to issue amended assessments in reliance on:
    - Applying the business profits article or the associated enterprises article of a relevant DTA;
    - Division 13; and
    - Subdivision 815-A;

  to the normal time limits for amending assessments under section 170 of the ITAA 1936 after the date of effect of the ED.

Interaction between transfer pricing rules and customs duty rules

The ED does not address the interaction between the transfer pricing rules and customs duty rules. As noted in our submission in response to the Consultation Paper that preceded the ED[9] transfer pricing adjustments involving the importation of goods

[9] Appendix A, paragraphs 70-71.

can cause customs duty problems, because a separate adjustment then needs to be sought to the customs value of the goods. This is particularly problematic where a transfer pricing adjustment results from the use of a profit method.

A whole-of-government approach is needed with the aim of creating a simple legislative mechanism by which taxpayers can obtain refunds of any overpaid customs duty following the making of a transfer pricing adjustment by the ATO.

Comments relating to the draft EM

Paragraphs 2.41-2.44

This section of the draft EM should include a reference to the Full Federal Court's recent decision in *Commissioner of Taxation v AXA Asia Pacific Holdings Ltd* [2010] FCAFC 134 that considered the meaning of the expression "did not deal with each other at arm's length", albeit in the context of subsection 124-780(4) of the ITAA 1997.

Paragraph 2.101

The Tax Institute notes that the first sentence of the second dot point of paragraph 2.101 of the draft EM is not consistent with section 815-135(2)(b).

The inconsistency arises because the first sentence of the second dot point of paragraph 2.101 of the draft EM states that "the arm's length rate is applied to the entity's actual amount of debt", however, section 815-135(2)(b) states that "(the arm's length rate is applied) to the debt interest the entity actually issued." Section 815-135(2)(b) clearly contemplates that a taxpayer may have more than a single debt interest on issue at any time and that the arm's length rate may be different for each debt interest. On the other hand, following the approach as stated in the draft EM would require that a single rate be applied to all of an entity's debt, irrespective of whether such debt was with independent parties or related parties. Such an outcome is not consistent with the OECD's Model Tax Convention or the OECD's Transfer Pricing Guidelines.

The Tax Institute recommends that the draft EM be amended to ensure consistency with section 815-135(2)(b) and to avoid the potential for confusion.

* * * * *

Should you wish to discuss any of the above, please do not hesitate to contact either me or Tax Counsel, Deepti Paton on 02 8223 0044.

Yours sincerely

Ken Schurgott
President

THE TAX INSTITUTE

8 December 2011

Mr Neil Motteram
The Principal Advisor
International Tax and Treaties Division
The Treasury
Langton Crescent
PARKES ACT 2600

Email: transferpricing@treasury.gov.au

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

P Murray

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, <u>exceptionally</u>, 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.

THE TAX INSTITUTE

19 December 2012

Review of Tax Arrangements Applying to Permanent Establishments
The Board of Taxation
c/- The Treasury
Langton Crescent
CANBERRA ACT 2600
Attn: Ms Annabelle Chaplain

By email: taxboard@treasury.gov.au

Dear Ms Chaplain,

Review of Tax Arrangements applying to Permanent Establishments

The Tax Institute is pleased to have the opportunity to make a submission to the Board of Taxation (**Board**) in relation to the *Review of Tax Arrangements applying to Permanent Establishments* Discussion Paper (**Discussion Paper**).

Summary

Our submission below addresses some of the issues raised in the Discussion Paper. In particular, we note that due consideration should be given to the impact (both intended and unintended (ie consequential)) of the functional separate entity treatment on both the branch and head office and equal attention should be paid to the tax implications for both inbound and outbound activities if this approach is adopted by Australia.

We have addressed in detail the issues raised in Chapters 2 to 5 of the Discussion Paper and in broader terms the issues raised in Chapters 6 and 7. We have not provided any response in respect of the issues raised in Chapter 8.

For our views on how rules affecting permanent establishments should interact with the transfer pricing rules, please refer to our submission to Treasury on the *Tax Laws Amendment (Cross-Border Transfer Pricing) Bill 2013: Modernisation of Transfer Pricing Rules* Exposure Draft.

Discussion

Currently in Australia, a “relevant business activity” approach is used to allocate income between the head office and the “branch” (permanent establishment) according to the functions performed by the different entities. An arm’s length methodology is also applied for the purpose of working out the amount of profit that is taxable in the country where the branch is located. The OECD approach for recognising the permanent establishment as a “functionally separate entity” (**FSE**) encapsulated in the new Model Article 7 involves recognising internal transactions between the head office and branch for the purpose of determining the profit to be taxed in the country where the branch is located by treating the branch as a “separate entity” from the head office.

We have structured our response to follow the questions as numbered throughout Chapters 2 to 5. However, in respect of the issues raised in Chapters 6 and 7, we consider the issues raised on a broad basis.

1. Overall Policy Objectives and Principles for Assessment of the Functionally Separate Entity Approach

Q 2.1 – Issues/Questions

Reasons for using a permanent establishment

The reasons an organisation entering a new country to start up operations may use a permanent establishment rather than a subsidiary are many and varied and include the following:

- the commercial ease and flexibility a permanent establishment structure offers in the start-up phase of a business;

- as the size and permanence of an organisation’s operation in a particular location is usually unknown, use of a permanent establishment structure provides the flexibility for the operation to start small and then grow and eventually be converted to another more formal legal structure (e.g. subsidiary) as and if required;

- depending on the industry in which an organisation operates, it may be preferable to establish a permanent establishment rather than a separate legal entity to operate in a particular location (e.g .the banking and insurance industries);

- a business that undertakes a specific project or utilises a mobile asset (e.g. drilling rig, surveying vessel, aircraft etc) in a specific location for a relatively short period of time may use a permanent establishment structure to take advantage of undertaking the project or using the asset globally without the requirement to establish a local presence (i.e. subsidiary) each time and transfer/dispose of assets.

Types of Activities

The types of activities ordinarily undertaken by a permanent establishment will vary depending on the industry in which the organisation operates. Service providers to the resources industries, for example, can provide services such as engineering, procurement, installation and construction of a particular item (e.g. a pipeline, processing plant, LNG train, etc) at a particular location that are ordinarily handed over to the client on a “turnkey” basis. A majority of the work will occur overseas with the last phase of the work occurring in Australia, giving the item the relevant connection to Australia. It is not unusual for such service providers to operate in Australia through a permanent establishment.

An organisation may also be a global services provider that has a principal contractor in Australia. For commercial reasons, in these types of arrangements, the principal contractor sub-contracts with the various entities within the global organisation that provide different services (e.g. a UK-based engineering entity provides engineering services, the global employment entity provides labour, head office supplies management support services, etc). The Australian principal contractor could be a permanent establishment in this case. This is especially the case where the relevant contract is the first for the business in Australia. We observe generally that where this kind of contractor subsequently establishes a permanent presence in Australia (e.g. an office, operations, etc), that presence will usually be established through the incorporation of an Australian subsidiary.

Another example of typical activities that lead to the establishment of a permanent establishment is the “beachhead” type of operations often used in the funds management industry where the entity enters a particular jurisdiction initially on a temporary basis. This type of operation is undertaken especially where the organisation has a particular or unique expertise and wants to establish some kind of client-facing operation within a particular jurisdiction to facilitate service delivery and support to its clients and potential in that jurisdiction and does not yet want to establish a more permanent “structure”. Typically, this will involve the entity sending 2 to 3 employees to the jurisdiction and often this is enough of a “presence” to be regarded as a permanent establishment.

Further, typically a foreign fund manager may wish to have an employee operate in a particular time zone without establishing a representative office or other structure that would give rise to a permanent establishment (e.g. typically the employee may be employed by a US company and sent to live in Australia to operate in the “Asia Pacific” time zone and would work out of their home rather than an office). This structure is not ordinarily regarded as a permanent establishment.

As noted in the Discussion Paper, other kinds of businesses, such as banking and insurance entities, establish permanent establishments. This allows the organisation to maintain the assets used to support the business of all its branches in any location and does not require the organisation to have to locate assets in the same locations as all its branches. It also allows those assets to be available to support transactions of and claims made against all branches, rather than the "support" given to the branch being limited by the assets only located in the same jurisdiction as the branch, (which is a limitation that does arise in the case of a separate legal entity such as a subsidiary).

Size/extent of use of permanent establishments vs subsidiaries

We note that this kind of information is recorded in the International Dealings Schedule (which replaces Schedule 25A) lodged by entities that have permanent establishments which we suggest ought to be able to be obtained from the Australian Taxation Office.

We note, however, that in the last decade, there has been a surge (in both number and scale) of foreign entities which have recently entered Australia to do business here that have historically not looked to operating in Australia, particularly in relation to the resources services industries.

2. The Authorised OECD Approach

Q 4.1 Issues/Questions

Other countries likely to adopt the new Article 7

Based on evidence noted in the Discussion Paper, certain key trading partners of Australia and the larger OECD member countries are looking to eventually adopt the new Article 7 into their bilateral treaties. Given the length of time it takes to negotiate new treaties with treaty partners and update them to adopt the new Article 7 (or a variant of it), Australia may end up in the "minority" if it does not look to consider adopting the new Article 7 into newly negotiated or renegotiated treaties.

Even though some of Australia's key trading partners, such as China and India, have expressly reserved their position on adopting the new Article 7[1], if they decide to not adopt the new Article 7, Australia does not necessarily want to be left behind simply by following suit of those particular trading partners. Rather, Australia should focus on who it mainly trades with and the nature of that trade (e.g. goods, services, source of capital investment) as this is relevant to also determining whether Australia should adopt the functionally separate entity approach for taxing permanent establishments.

Capital exporting countries appear to be favouring the adoption of the FSE approach, however, Australia is still a capital importer. Australia has significant trade relations with the United States and the United Kingdom, two major economies who, as the Board notes[2], are among several jurisdictions who are likely to adopt the new Article 7 into their newly negotiated treaties.

[1] Paragraph 4.33 of the Discussion Paper
[2] Paragraph 4.35 of the Discussion Paper

It may be the case that, rather than being able to adopt or reject the new Article 7 on a universal basis into all of Australia's treaties, whether new Article 7 is adopted or not will be determined according to the position held of the particular treaty partner with whom Australia is negotiating/renegotiating its treaty. This will give Australia an approach that is consistent with the particular treaty partner, that would be beneficial in both the negotiation process and afterwards once the treaty is settled. Taking this flexible approach will ensure that, unless it is determined that Australia should be opposed to adopting the new Article 7 (which is a view not held by The Tax Institute), Australia is not left behind and is free to include or not include new Article 7 in newly negotiated treaties.

Reasons other than the UN's reasons why countries may not adopt the new Article 7

It is The Tax Institute's view that proper and due consideration should be given to whether Australia should adopt new Article 7 rather than just seeking out reasons for not adopting it. There are arguments for adopting the FSE approach, such as:

- Australia has to date followed a hybrid type of approach to FSE treatment such that often, this type of treatment is already applied in relation to some aspects of taxing permanent establishments; and

- The interpretation contained in *Taxation Ruling TR 2001/11 Income Tax: International Transfer Pricing – Operation of Australia's permanent establishment attribution rules* of how profits are attributed to permanent establishments under Australia's double tax treaties is broadly consistent with the FSE approach (though this type of approach is not formally adopted in law as yet).

There are also reasons against adopting the FSE approach, such as:

- While appreciating the benefits of adopting the FSE approach, caution needs to be exercised to ensure it does not give rise to unintended consequences.

  For example (as discussed at paragraph 4.28 of the Discussion Paper), the potential for the creation of taxable gains or losses on the internal 'disposal' of assets between a head office and the permanent establishment upon a change in use or location. Such gains could arise under the depreciation provisions of the tax law as well as CGT K7.[3] In the case of CGT Event K7, this would build on what is already arguably an inappropriate outcome of the provision.[4]

[3] Refer section 104-520 of the *Income Tax Assessment Act 1997* (**ITAA 1997**).
[4] Being that the CGT Event applies equably to depreciable assets used for business purposes outside of Australia in the same manner as private use (as both do not give rise to the gaining or producing of Australian assessable income).

It is our view that the FSE approach should not give rise to such consequences where there has been no actual or underlying disposal.

- In our view, the FSE approach should not also give rise to withholding taxes (e.g. royalty and interest withholding tax) on internal transactions, e.g. lease charges or interest.

  Australian tax law already allows for the imposition of such withholding tax where the royalty or interest payable is paid by the foreign company but attributable to its Australian permanent establishment.[5] That is, Australia already has taxing rights over the actual amounts of interest and royalties paid or incurred by the taxpayer that are attributable to Australia.

- The FSE approach could also result in an inappropriate mark-up for services provided between the head office and the PE or give rise to a charge for services or functions being imposed on the PE because it is regarded as "functionally separate". If the PE is small relative to the rest of the group (e.g. there are 100 people in Australia out of a total of 20,000 people employed by a multinational corporation) and is treated as functionally separate, how should the PE work out the "charge" for services from the head office? Is the charge for services to be quantified by the amount of services actually consumed or required to be consumed or is it based on amount of services the PE would have been taken to have consumed if it is regarded as functionally separate?

- How certain structures (like the "beachhead" structure or the single employee working in a particular jurisdiction out of their home) may be treated under the FSE approach and whether adoption of the FSE approach may result in "worse" rather than "better" treatment for these types of entities. For example, how will these types of entities be regarded under the FSE approach? Is it appropriate to apply the FSE approach? Could adoption of the FSE approach impose transfer pricing obligations on these types of entities that are not currently imposed on these entities and therefore an additional cost burden in some circumstances where it doesn't need to? The ATO has always taken a "practical approach" with regard to these types of structures[6], but the question then arises whether this practical approach will be retained or indeed whether the ATO will even be able to retain it if the FSE approach is adopted..

Other innovations in Australia's international taxation policy, such as the amendments to the transfer pricing rules currently underway, are moving towards aligning with international best practice following OECD guidelines.

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[5] For example, see section 128B(2)(b)(ii) of the *Income Tax Assessment Act* 1936 (**ITAA 1936**) for interest.

[6] See, for example, "International transfer pricing - a simplified approach to documentation and risk assessment for small to medium businesses" at http://www.ato.gov.au/taxprofessionals/content.aspx?menuid=0&doc=/content/48756.htm&page=1&H1

In our view, the benefits for adopting the OECD approach far outweigh the reasons for not adopting this approach. Further, adopting (as much as possible) the FSE approach is consistent with other changes occurring in Australia's international taxation policy.

3. Adopting the Authorised OECD Approach in Australia

Q 5.1 Issues/Questions

The Tax Institute regards the OECD's approach in the form of FSE treatment for permanent establishments as fundamentally superior to the current treatment of permanent establishments applied in Australia. Adoption of this approach is likely to provide better outcomes than the current position provides. We refer to the specific issues raised by the Board separately below.

Implications for domestic tax law and tax treaty policy of Australia adopting the OECD approach

The FSE approach applies best to permanent establishments with active businesses, but for a variety of reasons (including those discussed above) it is not necessarily an appropriate treatment for deemed permanent establishments (such as one which arises through a lease of (in the case of Australia's tax treaties, substantial) equipment) because of the focus on the "functions" of the permanent establishment and risks assumed (a deemed permanent establishment does not necessarily have any "functions" or assume any risks). Where such functions or risks exist in Australia, our view is that both the current and proposed transfer provisions already ensure appropriate Australian tax recognition of those activities.

In our view, Australia needs to ensure that, with any new approach to the treatment of permanent establishments, it factors in protection of, and the ability to access, Australia's natural resource reserves as well as the ability to access scarce capital resources and services (e.g. drilling rigs, specialist vessels, engineering and consulting services etc) commonly operated by multinational business through permanent establishments.

Consideration also needs to be given to the possible impact of the FSE approach on an entity established under a trust since the trust structure is used so prolifically in Australia.

In this regard, carve outs will be needed from the OECD approach to permanent establishments if adopted into Australian domestic law. However, the focus of the current exercise by the Board should be squarely on getting the approach right that best suits the majority of permanent establishments subject to Australian domestic tax law (factoring in the nature of activities typically undertaken by permanent establishments inbound and outbound) while bearing in mind the need for these exceptions, rather than having the need for these exceptions (or special cases) dominating the process of determining whether this approach should be adopted.

Adoption of approach on a treaty by treaty basis or uniformly in Australian domestic law

Based on our comments contained at Part 2 above, The Tax Institute supports the adoption of the OECD approach on a treaty by treaty basis. We note that it will take a substantial amount of time for Australia to renegotiate its entire treaty network (comprised of 45 treaties), however renegotiation of Article 7 need only be undertaken at the time each treaty is renegotiated and the new Article 7 could be brought into negotiations with new treaty partners with whom Australia does not have a pre-existing treaty.

This may result in differing treatment of permanent establishments depending on which treaty the taxation of the permanent establishment is subject to, however it will allow for consistency of treatment with specific treaty partners. As there are already differences between the same Articles employed across Australia's treaty network[7] adopting this approach should not result in a situation much different to one to which we are accustomed. Though these differences may be minor, the differences between the two types or Article 7's will be well-understood and accounted for.

Principles to follow in amending domestic income tax law if the OECD approach was to be adopted into Australian domestic law

In making amendments to the Australian domestic law should the decision be made to adopt the FSE approach, due regard should be given to the following:

- Ensure the adoption of the FSE approach does not give rise to taxable gains or losses where no actual transactions or disposals have taken place;

- Ensure the imposition of withholding taxes on 'internal' transactions (between head office and PE) does not impose an unintended economic cost on the business by, for example, such a transaction being disregarded in the home country of the taxpayer, such that no credit or offset is available in that jurisdiction for any Australian withholding tax; and

- Consider whether it may be necessary to amend the transfer pricing laws (Division 13 of the ITAA 1936 or Division 815 of the ITAA 1997) to accommodate this change should it occur.

Special rules for capital allocation to branch operations if OECD approach is adopted?

There is some guidance in OECD Report[8] regarding allocating capital to the PE under the FSE approach. To ensure consistency is obtained between countries that adopt the

[7] For example, see the significant variation in Australia's tax treaties around the requirements for a deemed permanent establishment arising in respect of substantial equipment.
[8] *2010 Report on the Attribution of Profits to Permanent Establishments* OECD (22 July 2010)

FSE approach for the purpose of taxing branches, The Tax Institute recommends following the OECD guidelines.

If the OECD guidelines for capital allocation are going to be followed, The Tax Institute queries whether a similar approach should also be taken in respect of allocating capital to subsidiaries. Should the approach that applies to allocating capital to subsidiaries be changed to follow the approach that may be adopted for PEs if Australia adopts the FSE approach? If so, this may require examination of the CFC and FAF rules (once introduced or perhaps during their design phase) to ensure that there is a consistent approach to allocating capital for both subsidiaries and branches/PEs. The Tax Institute suggests that Australia should adopt a similar approach for the allocation of capital for PEs and subsidiaries.

Impact on current tax practices of adopting the authorised OECD approach

Should Australia adopt the FSE approach, Australian entities will need to examine their existing transfer pricing methodologies currently in place and consider whether their current policies are appropriate and consistent or inconsistent with the FSE approach.

This may or may not require these entities to make changes. However, there are potential flow-on consequences if the FSE approach is adopted in some treaties and not others where entities may have to have several transfer pricing methodologies in place to align with FSE treatment for some PEs and different treatment for other PEs. This could potentially create undue administrative burdens on entities with PEs in many jurisdictions that have varying approaches as to how PEs are to be regarded.

Also, the creation of taxable gains or losses on the ‘disposal’ of scarce tangible mobile assets upon a change in use or location as a consequence of adopting the FSE approach will provide a major disincentive to multinational business allocating those assets to Australia as compared to other jurisdictions.

Q 5.2 Issues/Questions

Impact on inbound and outbound activities of multinational corporations

Attention needs to be paid to the treatment of both inbound and outbound transactions where under the FSE approach ideally treatment of both types of transactions should be symmetrical or, if symmetry cannot be attained, then treatment that is close to giving symmetrical treatment should be applied. There could be a whole variety of flow-on consequences where proper attention is not given to the tax implications for both inbound and outbound transactions.

Particular issues for deemed permanent establishments and special purpose/project permanent establishments

For the reasons discussed above, it is difficult to regard a deemed permanent establishment as functionally separate from the main entity. It is therefore (at a minimum) difficult to determine this type of permanent establishment's tax liabilities under the FSE approach. As noted above, a carve-out may be required to deal with this special type of permanent establishment.

These types of permanent establishments arise most commonly in the resources services industry where globally mobile assets of significant value are leased into or operated in Australia.

Issues arising include to whom the tangible asset should be attributed and to whom the risks associated with the operation of the equipment being operated should be attributed.

Substantial equipment is often leased by its owner on a fixed price or "no risk" (at least to the lessor) basis (i.e. by way of a bareboat lease or dry charter (depending on the industry)) and the lessor derives a fixed and risk-free income stream.

The risk associated with the utilisation/performance of the equipment under such passive lease arrangements is then passed on to the lessee.

In this regard, it is important to note that a deemed permanent establishment of this nature does not generally arise in other jurisdictions, nor are equipment lease payments generally regarded as payments of royalties as they are in Australia.

Therefore, under a FSE approach, royalty withholding tax could apply to equipment lease payments "paid" by an Australian permanent establishment to its head office**.** In addition, if the permanent establishment has "borrowed" funds from its head office to acquire the equipment, the question arises whether the interest might also be subject to withholding tax in Australia if FSE treatment is applied to the branch.

If appropriate changes are not made to the Australian tax law, withholding tax may be imposed on interest or royalty payments made by the head office to third parties which are attributable to the Australian permanent establishment (as discussed above).

4. Adopting the Authorised OECD Approach – Specific Kinds of Entities and Administration, Compliance and Revenue Impacts

The points made above can be applied to the specific kinds of entities and particular issues raised in Chapters 6 and 7 of the Discussion Paper. In broad terms, these points are:

- There is potential for "tension" to apply between the treatment of certain activities or certain entities for tax purposes in one (a "foreign") jurisdiction differs to the treatment in another (the "home") jurisdiction and whether competitive neutrality between the two jurisdictions can arise.

- A “principles-based” approach should be taken to amending the Australian domestic tax law if the FSE approach is chosen to be adopted domestically both in respect of the general laws to apply and any specific laws to apply to specific kinds of entities.

- The Discussion Paper focuses on the “branch” (the PE), but due regard needs to also be given to the impact on the head office if the FSE is to be adopted both as it applies to specific kinds of entities in specific industries that may require a specific set of rules (such as banking and finance and insurance) and as it applies more broadly to entities in other industries that are subject to the general rules.

If you would like to discuss any of the above, please contact either me or Tax Counsel, Stephanie Caredes, on 02 8223 0011.

Yours sincerely

Ken Schurgott
President