THE TAX INSTITUTE

11 July 2012

Mr Tim Bryant
Secretary
Senate Standing Committees on Economics
PO Box 6100
Parliament House
Canberra ACT 2600
Australia

By email: economics.sen@aph.gov.au

Dear Mr Bryant

INQUIRY INTO TAX LAWS AMENDMENT (CROSS-BORDER TRANSFER PRICING) BILL (NO.1) 2012

The Tax Institute is pleased to make a submission to the Senate Economics Legislation Committee (the "**Committee**") in relation to *Tax Laws Amendment (Cross-Border Transfer Pricing) Bill (No.1) 2012* (the "**Bill**").

Our comments below relate to both the application date of the Bill as well as the substance of the proposed reforms, and as such have been set out in the following sections in order to ensure ease of reference:

Section 1: General comments in relation to the application date of the Bill (1 July 2004).

Section 2: General comments in relation to the policy underpinning the Bill.

Section 3: Specific comments in relation to the Bill and related Explanatory Memorandum.

Section 4: Recommendations.

SECTION 1: APPLICATION DATE OF THE BILL

As consistently noted in our submissions on the then Assistant Treasurer's media release of 1 November 2011 in relation to this measure (attached as Appendix A) as well as on the Exposure Draft and supporting draft Explanatory Material released by Treasury in relation to this measure (attached as Appendix B), The Tax Institute has grave concerns as to the appropriateness of retrospective legislation to effect this announced change.

It is our strongest view 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 including an explanation of the anticipated impact on revenue.

Retrospective legislation that may be disadvantageous to taxpayers is inappropriate for a number of reasons, including:

- Retrospective changes in tax law that alter a taxpayer's tax liability are likely to disturb the substance of bargains struck between taxpayers who have made every effort to comply with the prevailing law as at the time the agreement was entered into;

- Retrospective changes in tax law that result in taxpayers being issued with amended assessments that rely upon the retrospective law changes expose taxpayers to penalties in circumstances where taxpayers could not possibly have taken steps at the earlier time to mitigate the potential for penalties to be imposed;

- The taxpayer's tax expense and current tax liability/assets as disclosed in financial accounts may be rendered incorrect due to the retrospective change, resulting in adverse implications for investors and capital markets that have relied on the financial statements;

- Retrospective amendments to change tax liability and therefore a taxpayer's tax profile can materially impact the financial viability of investment decisions and the pricing of those decisions; and

- A retrospective amendment with an application date of more than 8 years before the date of enactment, especially without clear reasons for the retrospectivity will exacerbate persistent concerns in the international community of the increased 'policy risk' of investing in Australia.

In addition to the above general comments, retrospective application is particularly inappropriate in the context of this change as:

- There is no justification for the use of the 1 July 2004 application date as the Bill effects a change in law rather than a mere clarification;

- The Commissioner's powers under Sub-division 815-A may be considerably broader than under Division 13; and

- The Bill could potentially result in a significant additional tax burden.

The 1 July 2004 application date

On 1 November 2011, the then Assistant Treasurer announced that the Government would be introducing amendments to address an area of potential uncertainty: whether tax treaties provide a power to make transfer pricing adjustments **independently** of the transfer pricing rules in the *Income Tax Assessment Act 1936* **("ITAA 1936")**. The media release went on to say that the government would be introducing amendments to clarify that transfer pricing rules in our tax treaties operate **as an alternative** to the rules currently in the domestic law.

Independent vs. Separate Power

In this regard, we note that the rights conferred on taxpayers differ significantly depending on whether any such power is **independent** or **separate**.

A **separate** power may be constrained so as to limit tax liability to the amount which might arise under another taxing power (for example, Division 13) and may be necessary to address situations where application of the tax treaty power resulted in a more favourable outcome for a taxpayer. This is because 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.

In contrast, an **independent**, unconstrained power would be much broader and would significantly widen the tools and methods available to the Australian Taxation Office ("**ATO**") to establish and calculate transfer pricing adjustments (and therefore tax liability).

Government justification for application date

The Government's justification for the application date of the proposed amendments is wholly without basis. The Explanatory Memorandum elaborates as follows:

> *"(t)he Parliament has indicated the law should operate in this way on a number of occasions, most recently in 2003. Therefore, the clarifications will apply to income years commencing on or after 1 July 2004 in treaty cases."*

This does not justify retrospective application. Parliament may have ambiguously referenced a view over time that tax treaties provide a **separate** basis for making transfer pricing adjustments. However, there is no unequivocal support for the assertion made in the Government's media release that tax treaties provide a power to make transfer pricing adjustments **independently** of the transfer pricing rules in the *ITAA 1936.*

Effect of retrospective application date on taxpayers

We note that an alternate view was reasonably open to adoption by taxpayers throughout the retrospective period of application. That is, taxpayers could reasonably have (and many in fact did) taken the alternative view that while tax treaties may provide a **separate** basis for making transfer pricing adjustments, treaty provisions do not (without the amendments in the Bill) provide an unconstrained, **independent** power to make such adjustments.

Such an alternative view was open to taxpayers as a result of conflicting views expressed by Parliament over time, as well as lack of clear judicial authority on:

- Whether or not treaty provisions constitute an alternative basis for transfer pricing adjustments;

- If so, whether the alternative basis constitutes a separate but constrained basis so that tax liability is limited to a maximum of the taxpayer's liability under Division 13; or

- Otherwise, whether the alternative basis constitutes an independent, unconstrained power.

Taxpayers that have reasonably adopted this alternative view will be significantly disadvantaged by the retrospective nature of the Bill (as described in further detail below).

According to our members, a significant number of taxpayers have adopted an alternative view to that stated in the Assistant Treasurer's media release of 1 November 2011, and will be required now to undertake transfer pricing analysis again under the new Sub-division 815-A once introduced, significantly increasing the compliance burden placed on these taxpayers.

Conflicting views expressed by Parliament

An example of conflicting views expressed by Parliament on this issue is as follows. Underpinning the retrospective application of the amendments proposed in the Bill is the following statement from the Explanatory Memorandum:

> "1.22 Since 1982, the income tax law has made specific provision for transfer pricing amendments based on treaty rules. The Parliament not only assumed that the treaty transfer pricing rules could be applied to increase a taxpayer's liability, but intended this outcome be both facilitated and clarified through further amendments to the income tax laws (notably through the enactment of section 170 and former section 226 of the ITAA 1936)." (underlining added)

We note that contrary to this assertion, Parliament was very clearly of the view that taxpayers could get a more favourable outcome under tax treaties than under domestic law when the issue was directly considered by Parliament in 1994 at the time Part IIIB (Foreign Bank Branches) was introduced into the *Income Tax Assessment Act 1936*. Notably, Part IIIB clearly contemplates that taxpayers could get a more favourable outcome under an applicable Double Tax Agreement ("**DTA**") than under Part IIIB, and therefore allows taxpayers to elect out of Part IIIB (and by inference into the relevant DTA).

Of particular relevance in the context of the retrospective application of the Bill is paragraph 5.4 of the Supplementary Explanatory Memorandum to Government Proposed Amendments to *Taxation Laws Amendment Bill (No.3) 1994:*

> "5.4 The new Part assists a foreign bank in calculating the taxable income from its Australian branch by identifying certain amounts of income and expenditure that are properly to be regarded as attributable to the branch. If, however, a DTA is applicable in relation to the bank and if in relation to the calculation of the taxable income of the bank for a particular year of income the outcome for the bank would be more favourable under the DTA than if the Part taken overall applied, then the bank will be free to choose that the new Part not apply in respect of the calculation of its taxable income for that year." (underlining added)

We also draw attention to the following reports of the Joint Standing Committee on Treaties in the context of whether Australia's tax treaties are intended to impose greater obligations on Australian taxpayers than exists under domestic tax law:

> **Report No.25** (dated 21 September 1999) Re: South African DTA: Paragraph 6.14 includes the following statement with respect to obligations imposed by the treaty: "In general, it does not impose any greater obligations on residents of Australia than Australia's domestic law would otherwise require."

Report No.28 (dated 23 November 1999) Re: Argentina DTA: Paragraph 5.13 states the following with respect to obligations imposed by the treaty: "The proposed Agreement does not impose any greater obligations on Australian residents than are imposed by existing domestic tax laws."

Report No.37 (dated 28 November 2000) Re: Russian DTA: The National Interest Analysis (Appendix B of the report) includes the following statement with respect to obligations imposed by the treaty: "In general, the Agreement does not impose any greater obligations on residents of Australia than Australia's domestic tax laws would otherwise require."

The statement in paragraph 1.22 of the Explanatory Memorandum to the Bill that tax treaties can not only increase a taxpayer's liability but that such an outcome was intended by Parliament is also not consistent with the above views expressed by the Joint Standing Committee on Treaties.

Commissioner's powers under Sub-division 815-A may be considerably broader than under Division 13

We remain particularly concerned at the potential for the Commissioner to raise amended assessments in reliance upon a retrospective power that is far broader than currently exists under Division 13.

Such a power would allow the Commissioner to commence new audits with reliance being placed on the wider powers that will be provided by Subdivision 815-A rather than on the Commissioner's long held view that there should be no fundamental difference between Division 13 and the Associated Enterprises Articles of Australia's DTAs (discussed at length in our submission in response to the Consultation Paper, attached at appendix A).

Specifically we draw the Committee's attention to the following areas where the scope of Sub-division 815-A, which is based on the scope of the transfer pricing articles contained in Australia's tax treaties, is broader than the scope of Division 13:

- A wider range of methods can be used
- Thin capitalisation issues can be addressed
- Reconstruction of transactions between related parties is permitted

Paragraph 1.41 of the Explanatory Memorandum states: "It is likely that Australia's tax treaties provide access to a greater range of transfer pricing methodologies and may permit the Commissioner to better question whether the arrangements made by multinational enterprises would have been made by independent parties."

Australia has introduced separate rules contained in Division 820 to address thin capitalisation rather than do so through Division 13. As discussed in more detail later in this submission, many taxpayers arranged their tax affairs on the basis that the safe harbour limits in Division 820 operated as a true safe harbour, contrary to the approach ultimately developed by the ATO in TR 2010/7.

That is, according to our members, a significant number of taxpayers have adopted an alternative view whereby gearing levels were kept below the safe harbour limits in Division 820 and then any related party debt was priced on the basis of the actual amount of

debt the taxpayer had and not on the basis of a notional 'arm's length' amount of debt as required by TR 2010/7 in certain cases.

Taxpayers that have reasonably adopted this alternative view will be significantly disadvantaged by the retrospective nature of the Bill as the Bill seeks to give legislative backing to the approach expressed in TR 2010/7.

We also remain particularly concerned at the potential for the Commissioner to raise amended assessments in reliance upon a retrospective reconstruction power that does not currently exist under Division 13. The OECD's Transfer Pricing Guidelines state that the reconstruction of transactions between related parties is permitted in two exceptional circumstances:

- Where the economic substance of a transaction differs from its legal form; and

- Where arrangements made in relation to a controlled transaction differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner.

This is a key area of concern as it goes to the very heart of taxpayers' concerns that the Bill is not simply clarifying the law but is proposing to provide the Commissioner with additional taxing powers that do not currently exist under Division 13.

The Bill could result in a significant additional tax burden

Paragraph 1.8 of the Explanatory Memorandum states that "There is no financial impact from these amendments as they protect the existing revenue base". This statement does not accord with our members' view of the likely revenue impact of the Bill on taxpayers.

As discussed in the previous section, there are a number of areas where the scope of proposed sub-division 815-A is broader than the scope of Division 13. Consequently, given the potential for the Commissioner to raise amended assessments in reliance upon a retrospective power that is broader than currently exists under Division 13, the financial impact of the Bill will only be nil **if** the transfer pricing rules in Australia's tax treaties provide a separate **and independent** power to Division 13. Appendix D provides a flowchart to illustrate this.

As noted above, the courts have not directly considered this issue, a point noted in paragraph 1.35 of the Explanatory Memorandum, and views differ on what the answer might be under existing law.

Specifically we draw the Committee's attention to the following:

- Paragraph 1.15 of the Explanatory Memorandum acknowledges the possibility that these amendments may extend the current law. For example, paragraph 1.41 of the Explanatory Memorandum states: "It is likely that Australia's tax treaties provide access to a greater range of transfer pricing methodologies and may permit the Commissioner to better question whether the arrangements made by multinational enterprises would have been made by independent parties.";

- As noted above, a significant number of taxpayers have adopted an alternative view to that stated in the Assistant Treasurer's media release and are therefore potentially

exposed to retrospective amended assessments under the new Sub-division 815-A once introduced;

- As noted above, a significant number of taxpayers have adopted an alternative approach to that expressed in TR 2010/7 in relation to the pricing of related party debt and are therefore potentially exposed to retrospective amended assessments under the new Sub-division 815-A once introduced; and

- The potential for the Commissioner to raise amended assessments in reliance upon a retrospective reconstruction power that is far broader than currently exists under Division 13 means that potentially significant additional revenue could be collected.

Taken together, the above factors indicate that the Bill could result in a significant additional tax burden for taxpayers

As such, we recommend that Treasury make publicly available further information on the inputs and underlying bases of calculation that have resulted in this estimation that there is no financial impact from these amendments.

Summary

Certainty in relation to the operation of tax laws is in the best interests of taxpayers, the ATO and the broader economy. As such, The Tax Institute does not consider retrospective application of these amendments to be appropriate.

The Tax Institute strongly recommends that the Bill be amended so that the application date of the amendments is either the date of Royal Assent or if appropriate the date of the relevant announcement of the measure (1 November 2011).

Further, The Tax Institute strongly recommends that the Explanatory Memorandum to the Bill be revised to more accurately reflect differing views in the tax community and judiciary on this issue. In particular, the Explanatory Memorandum to the Bill should be revised to acknowledge that in 1994 Parliament had considered and had accepted that DTAs could provide taxpayers with more favourable outcomes than under the domestic law alone and that differing views have been held within the tax community and judiciary from 1 July 2004 to the present day as to whether the existing law (prior to the introduction of the Bill) confers an independent and unconstrained power on the Commissioner to make transfer pricing adjustments.

SECTION 2: POLICY UNDERPINNING THE BILL

The policy underpinning the Bill is outlined in the Explanatory Memorandum to the Bill. In our view, this policy contains significant flaws of understanding of the current and proposed laws and is at odds with the principles underpinning our tax laws and the basis on which Australia enters into DTAs.

Scope of Sub-division 815-A vs Division 13

It is indicated at paragraph 1.40 of the Explanatory Memorandum that underpinning the Bill is the assumption that both the ATO and taxpayers had been applying the law as though the tax treaty transfer pricing rules were always an alternative, independent and unconstrained set of transfer pricing liability provisions. As noted above, this view is incorrect insofar as

according to our members, many taxpayers have taken an alternative view for a substantial period of time.

Furthermore, as noted at paragraph 1.41 of the Explanatory Memorandum, "It is likely that Australia's tax treaties provide access to a greater range of transfer pricing methodologies and may permit the Commissioner to better question whether the arrangements made by multinational enterprises would have been made by independent parties."

As a result, most taxpayers that engage in related-party dealings with international parties that are resident in tax treaty partner countries will be required to undertake separate transfer pricing analyses in order to ensure that the taxpayer is not in breach of either Sub-division 815-A or Division 13.

This compliance obligation is particularly onerous in the context of income years already passed, in relation to which taxpayers had undertaken analysis to determine whether the requirements of Division 13 were satisfied, but will now need to consider the potential application of the new Sub-division 815-A. Furthermore, this compliance obligation is particularly onerous in a transfer pricing context due to the lack of limited amendment periods.

To the extent that "[a]ny increased Australian taxation will generally be capable of being offset to some extent by compensating reductions in foreign taxation through mutual agreement procedures …" (paragraph 1.42 of the Explanatory Memorandum), we note that the mutual agreement procedure is expensive and time consuming to engage in, is not guaranteed to yield a fair result, and does not at any rate apply to penalties and interest (i.e. the procedure can only resolve issues of double taxation related to the primary tax liability).

As such, taxpayers that have legitimately and reasonably taken an alternative view to that expressed by the ATO in the absence of unequivocal guidance from either Parliament or the Courts will be subject to significant, additional compliance cost in determining their liability under the new Sub-division 815-A and may have to subsequently engage in costly negotiation with treaty partners via the mutual agreement procedure in order to secure a fair result in respect of periods past.

Discrimination against treaty countries

The new Sub-division 815-A creates greater compliance obligations and therefore discriminates against taxpayers that trade with related parties resident in countries with which Australia has a tax treaty. For example, the proposed amendments have the potential to lead to tax outcomes whereby taxpayers who transact with associated enterprises in non-tax treaty countries (e.g. Bermuda, Caymans) will only be subject to transfer pricing adjustments based on Division 13, whereas taxpayers who transact with associated enterprises in tax treaty countries (e.g. United States, United Kingdom, Japan) could be subject to transfer pricing adjustments under any of three sets of provisions (as outlined above).

Such an outcome is counter-intuitive as the impact of the retrospective and reconstruction power aspects of the Bill will only affect taxpayers who transact with associated enterprises in tax treaty countries.

As such, The Tax Institute recommends that the Bill be referred to the Joint Standing Committee on Treaties to consider whether it is in the national interest for countries with which Australia has entered into a tax treaty to be more adversely affected than countries where Australia has not entered into a tax treaty.

Discrimination between different types of taxpayer

The new Sub-division 815-A will create different rules for companies and permanent establishments ("**PEs**"). Furthermore, the rules for PEs will be different depending on whether the PE is an inbound branch of a treaty country (with potential variations from treaty to treaty), an inbound branch of a non-treaty country, or an outbound branch of an Australian company.

Further to the above we note that the Assistant Treasurer announced on 24 May 2012 that the Board of Taxation has been directed to "investigate the impacts of Australia adopting the Authorised OECD Approach in respect of the attribution of profits to permanent establishments".

As such, we recommend that the policy underpinning the Bill be re-examined in light of the comments made above, and, at the very least, the Explanatory Memorandum be revised to reflect differing views within the tax community in relation to the nature of these amendments as well as the law as it stands prior to the amendments.

SECTION 3: SPECIFIC COMMENTS IN RELATION TO THE BILL AND RELATED EXPLANATORY MEMORANDUM

Penalties

The Tax Institute broadly supports the manner in which penalties may be applied under the Bill in respect of past periods where the taxpayer's primary tax liability is greater under Sub-division 815-A than would have been the case under Division 13.

However, we note that the Bill as currently drafted allows for penalties to be limited to the extent that the amount under Sub-division 815-A is greater only where the penalty is levied under Sub-division 284-C of Schedule 1 to the *Tax Administration Act 1953* (ITAA 1953). Notably, the same treatment does not apply to penalties levied under Sub-division 284-B of the same Act.

The ATO has set out the view in PS LA 2008/18 that penalties under Sub-divisions 284-B and 284-C can be levied independently of each other. In broad terms, penalties under Sub-division 284-B of Schedule 1 to the ITAA 1953 can be imposed in two situations: where a taxpayer makes a false or misleading statement which has resulted in a lower amount of tax being paid; and where a taxpayer does not have a reasonably arguable position that an income tax law applies in a particular way and a lower amount of tax has been paid than would be the case if the taxpayer had applied the law correctly.

We recommend that the Bill be expanded to also cover Sub-division 284-B in respect of the application of penalties to past periods.

Thin capitalisation interaction

It appears to us that proposed subsection 815-25(2) seeks to give legislative effect to the ATO's position in TR 2010/7 with respect to the interaction between the thin capitalisation rules in Division 820 and the transfer pricing rules (see paragraph 1.105 of the Explanatory Memorandum). More particularly, and of more concern, the retrospective application of subdivision 815-A to years of income commencing on or after 1 July 2004 will have the effect of giving legislative backing to an interpretative approach which the ATO had not finally developed until TR 2010/7 was issued on 27 October 2010, i.e. more than 6 years after 1 July 2004.

The approach ultimately developed by the ATO in TR 2010/7 does not enjoy widespread taxpayer support. On the contrary, the views expressed by the ATO in TR 2010/7 are controversial and in this respect, we refer to the Joint Submission by The Tax Institute, The Institute of Chartered Accountants in Australia, CPA Australia, Institute of Public Accountants and Taxpayers Australia on *Draft Taxation Ruling TR 2009/D6* dated 16 February 2010 (a copy of which is attached at Appendix C).

In this regard, it is our view that the intent of proposed section 815-25 does not reflect the current law. Instead, these subsections merely seek to reflect the ATO's interpretation of the law. As such, legislating this position does not constitute a "mere clarification", but represents a retrospective change in the tax law that should be consulted on in greater detail.

Many taxpayers have adopted an alternative view to that expressed in TR 2010/7

Throughout the retrospective period of application (and also for many years before), many taxpayers arranged their tax affairs on the basis that the safe harbour limits in Division 820 operated as a true safe harbour, contrary to the approach ultimately developed by the ATO in TR 2010/7.

That is, according to our members, a significant number of taxpayers have adopted an alternative view whereby gearing levels were kept below the safe harbour limits in Division 820 and then any related party debt was priced, having regard to ATO guidance available at the time (eg TR 92/11), on the basis of the actual amount of debt the taxpayer had and not on the basis of a notional 'arm's length' amount of debt.

In this respect, we draw particular attention to the following extract from TD 2007/D20 which the ATO issued on 28 November 2007 (TD 2007/D20 being the original predecessor of TR 2010/7):

> "*Alternative view 2*
>
> 32. A second alternative view that has been expressed is that the capitalisation or gearing ratio required for the purpose of applying the arm's length principle under the transfer pricing provisions should be calculated by reference to the thin capitalisation rules in Division 820. That is, because there is no Division 820 excess debt then the actual capitalisation or gearing must be used for the purpose of applying the transfer pricing provisions to determine the arm's length price of the costs."

Notwithstanding that the ATO does not agree with this view and did not include it in TR 2010/7, it is nevertheless significant that the ATO was prepared to acknowledge that this alternative view had sufficient merit that it should be included in TD 2007/D20.

Taxpayers that have reasonably adopted this alternative view will be significantly disadvantaged by the retrospective nature of the Bill.

Paragraph 1.108 of the Explanatory Memorandum is not consistent with section 815-25(2)(b)

Without resiling in any way from the above, The Tax Institute also notes that the first sentence of the second dot point of paragraph 1.108 of the Explanatory Memorandum is not consistent with section 815-25(2)(b).

The inconsistency arises because the first sentence of the second dot point of paragraph 1.108 of the Explanatory Memorandum states that "the arm's length rate is applied to the entity's actual amount of debt", however, section 815-25(2)(b) states that "(the arm's length rate is applied) to the debt interest the entity actually issued." Section 815-

25(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 Explanatory Memorandum 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 Explanatory Memorandum be amended to ensure consistency with section 815-25(2)(b) and to avoid the potential for confusion.

SECTION 4: RECOMMENDATIONS

We urge the Committee to recommend that:

- The Bill be amended so that the application date of the amendments is either the date of Royal Assent or if appropriate the date of the relevant announcement of the measure (1 November 2011) i.e. a recommendation of rejection of the retrospective nature of the amendments;

- Treasury makes publicly available further information on the inputs and underlying bases of calculation that have resulted in this estimation of revenue impact;

- The Explanatory Memorandum to the Bill be revised to acknowledge that in 1994 Parliament had considered and had accepted that DTAs could provide taxpayers with more favourable outcomes than under the domestic law alone and that differing views have been held within the tax community since 1 July 2004 to the present day as to whether the existing law (prior to the introduction of the Bill) confers an independent and unconstrained power on the Commissioner to make transfer pricing adjustments;

- The Bill be referred to the Joint Standing Committee on Treaties to consider whether it is in the national interest for countries with which Australia has entered into a tax treaty to be more adversely affected than countries where Australia has not entered into a tax treaty;

- The policy underpinning the Bill be re-examined in light of our comments above;

- The Bill be amended so that penalties under subdivision 284-B of *Schedule 1 to the* ITAA 1953 are excluded from applying before the date of Royal Assent in the same way as penalties under subdivision 284-C of *Schedule 1 of the* (ITAA 1953) have been excluded;

- The first sentence of the second dot point of paragraph 1.108 of the Explanatory Memorandum be amended to ensure consistency with section 815-25(2)(b); and

- Further consultation be undertaken in respect of these amendments.

* * * *

Should you have any queries with respect to any of the matters raised above, please do not hesitate to contact Senior Tax Counsel, Robert Jeremenko, on

Yours sincerely

Ken Schurgott
President

Appendix A

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

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 in the first instance.

Yours sincerely

Peter Murray
President

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

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

Submission of The Tax Institute on

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

and

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

Date: 8 December 2011

Interpretation

In this submission:

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

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

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

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

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

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

ATO means the Australian Taxation Office;

Commissioner means the Commissioner of Taxation;

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

CWI means "commensurate-with-income";

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

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

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

DTA means double tax agreement;

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

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

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

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

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

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

TAA means the *Taxation Administration Act 1953*; and

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

Principles underpinning tax law amendments

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

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

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

Retrospective legislation

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

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

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

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

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

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

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

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

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

Parliamentary procedures to safeguard against retrospective legislation

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

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

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

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

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

Trend towards retrospectivity

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

The Tax Institute's recommendations

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

The Tax Institute's recommendations

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

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

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

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

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

31. A DTA-based power accommodates:

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

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

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

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

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

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

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

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

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

Reconstruction of transactions

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

The Tax Institute's recommendations

Reconstruction of transactions

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

Addressing thin capitalisation issues independently of domestic thin capitalisation rules

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

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

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

Imposing taxation on the basis of applying a CWI mechanism

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

The Tax Institute's recommendations

Imposing taxation on the basis of applying a CWI mechanism

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

The Tax Institute's recommendations

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

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

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

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

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

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

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

The Tax Institute's recommendations

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Part Three - Submissions on the Consultation Paper

Adoption of OECD Guidelines and selection of methods

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

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

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

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

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

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

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

60. The Consultation Paper seems to suggest that the definition of the arm's length principle in Article 9 of the OECD Model DTA and in the OECD Guidelines is based on the outcomes or profit allocations arising from a group of transactions, as opposed to the arm's length 'price' of specific transactions. We do not believe this is a correct interpretation of the OECD Guidelines, which are principally about arm's length pricing. 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

[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.

Appendix B

THE TAX INSTITUTE

16 April 2012

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: EXPOSURE DRAFT "STAGE ONE TRANSFER PRICING REFORMS"

The Tax Institute welcomes the opportunity to make this submission to Treasury in response to the Exposure Draft and supporting Explanatory Material intended to effect Stage One of the transfer pricing reforms announced by the then Assistant Treasurer on 1 November 2011 (the "**press release**").

We have set out our comments at Appendix A in five separate sections, as follows:

- Section 1: Our comments on the policy underpinning the proposed reforms;
- Section 2: Our general comments on the Exposure Draft (on the presumption that the Exposure Draft legislation is intended to effect the policy as set out in the press release);
- Section 3: Our general comments on the Explanatory Material (on the presumption that the Exposure Draft legislation to which the Explanatory Material relates is intended to effect the policy as set out in the press release);
- Section 4: Our concerns in relation to the interaction between the transfer pricing rules and the thin capitalisation rules under the Exposure Draft and Explanatory Material; and
- Section 5: Our comments on other significant issues of note.

We understand that many of the issues raised in this submission will be the subject of ongoing consultation during the legislative drafting process. 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 me or our Senior Tax Counsel, Robert Jeremenko on or The Tax Institute's Tax Counsel, Deepti Paton on

Yours sincerely

Ken Schurgott
President

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

CC: The Hon David Bradbury MP, Assistant Treasurer and Minister Assisting for Deregulation

APPENDIX A

SECTION 1: Comments on the policy underpinning the proposed reforms

Retrospectivity

As noted in our submission in response to the Consultation Paper preceding the release of the Exposure Draft, The Tax Institute has grave concerns as to the appropriateness of retrospective legislation to effect this announced change.

It is our strongest view 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 including an explanation of the anticipated impact on revenue.

Retrospective legislation that may be disadvantageous to taxpayers is in our view inappropriate for a number of reasons, including:

- Retrospective changes in tax law that alter a taxpayer's tax liability are likely to disturb the substance of bargains struck between taxpayers who have made every effort to comply with the prevailing law as at the time the agreement was entered into;

- Retrospective changes in tax law that result in taxpayers being issued with amended assessments that rely upon the retrospective law changes expose taxpayers to penalties in circumstances where taxpayers could not possibly have taken steps at the earlier time to mitigate the potential for penalties to be imposed;

- The taxpayer's tax expense and current tax liability/assets as disclosed in financial accounts may be rendered incorrect due to the retrospective change, resulting in adverse implications for investors and capital markets that have relied on the financial statements;

- Retrospective amendments to change tax liability and therefore a taxpayer's tax profile can materially impact the financial viability of investment decisions and the pricing of those decisions; and

- A retrospective amendment with an application date of more than 7 years before the date of enactment, especially without clear reasons for the retrospectivity will exacerbate persistent concerns in the international community of the increased 'policy risk' of investing in Australia.

We urge the Government to reconsider the circumstances in which retrospective legislation is appropriate in light of the comments 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. At the very least, we urge the Government to put a stronger case to the tax community to support the use of retrospective legislation in this circumstance.

Powers afforded to the Commissioner under proposed Division 815 vs. the current Division 13

As noted in the Explanatory Material at paragraph 1.9 "Whether the treaty transfer pricing rules could give rise to a different arm's length outcome than that arrived at through an application of Division 13 is unclear."

In this regard, and as discussed in our submission in response to the Consultation Paper (attached as appendix B to this submission), we again submit that a treaty-based power will be much broader than the rules contained in Division 13 of Part III of the *Income Tax Assessment Act 1936* ("**ITAA1936**") as it accommodates a reconstruction mechanism which is clearly far broader than currently exists in Division 13.

Due to the lack of clarity in relation to the scope of operation of the new rules and the limited number of comparable international jurisdictions that apply treaty provisions in the fashion proposed under the new Division 815, it is clearly open for the conclusion to be drawn that the scope of the new Division 815 is intended to have a wider ambit of operation than the current Division 13.

As a result, most taxpayers that engage in related-party dealings with international parties that are resident in tax treaty partner countries will be required to undertake separate transfer pricing analyses in order to ensure that the taxpayer is not in breach of either Division 815 or Division 13.

This compliance obligation is particularly onerous in the context of income years already passed, in relation to which taxpayers had undertaken analysis to determine whether the requirements of Division 13 were satisfied, but will now need to consider the potential application of the new Division 815.

In this regard, the presumption underpinning the proposed changes, that both the Australian Taxation Office ("**ATO**") and taxpayers had been applying the law as though the tax treaty transfer pricing rules were always an alternative, independent and unconstrained set of transfer pricing liability provisions continues, to be incorrect (see following section).

This is because while Parliament may have referenced a somewhat similar but ambiguous view over time, the press release of 1 November 2011 was the first instance in which such a view was specifically expressed in such terms. In addition, judicial authority on this 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 ITAA1936, *Income Tax Assessment Act 1997* ("**ITAA1997**") or the *International Tax Agreements Act 1953* (together the "**Tax Acts"**) as those Acts interact.

According to our members, a significant number of taxpayers have adopted this alternative view, and will be required now to undertake transfer pricing analysis again under the new Division 815 once introduced.

Whether the specific transfer pricing related articles in Australia's Double Tax Agreements provide alternative and independent transfer pricing liability provisions to Division 13

Paragraph 1.8 of the Explanatory Material states that "Over time the Parliament has repeatedly referenced its view that the specific transfer pricing related articles as incorporated into Australia's domestic law provide alternative and independent transfer pricing liability provisions to those contained in Division 13". As discussed in our submission in response to the Consultation Paper (attached as appendix B to this submission), we strongly disagree with this view. We will not repeat here the various arguments raised in our previous submission, nevertheless, we do wish to draw the Government's attention to the following additional material, which in our view, is particularly relevant to this issue.

Part IIIB (Australian branches of foreign banks) of the ITAA 1936 (Part IIIB) was introduced into the tax laws in 1994 and clearly contemplates that taxpayers could get a more favourable outcome under an applicable Double Tax Agreement ("**DTA**") than under Part IIIB (subsection 160ZZVB(2)). Paragraph 5.4 of the Supplementary Explanatory Memorandum to Government

Proposed Amendments to *Taxation Laws Amendment Bill (No.3) 1994* clearly shows that such an outcome constituted the underlying rationale for providing taxpayers with the ability to elect that Part IIIB should not apply to them. This position has been accepted by the ATO for many years (paragraph 2 of TD 2002/28).

As Division 13 is clearly intended to apply to matters dealt with in Part IIIB (albeit via section 136AD rather than by section 136AE in certain situations – see subsection 160ZZW(5)), the proposition stated in paragraph 1.8 of the Explanatory Material that "Over time the Parliament has repeatedly referenced its view that the specific transfer pricing related articles as incorporated into Australia's domestic law provide alternative and independent transfer pricing liability provisions to those contained in Division 13" is incompatible with the view expressed by Parliament in 1994 at the time Part IIIB was introduced into the tax laws.

This follows because, if the transfer pricing related articles in Australia's DTAs provide alternative and independent transfer pricing liability provisions to Division 13, there would have been no point in allowing taxpayers to elect out of Part IIIB because the Commissioner could still apply Division 13 (as an alternative and independent transfer pricing liability provision to the transfer pricing articles in Australia's DTAs) irrespective of the fact that a taxpayer could get a more favourable outcome under an applicable DTA.

In light of the above, we urge the Government to reconsider the view expressed in paragraph 1.8 of the Explanatory Material.

At the very least, we request the Government to amend paragraph 1.8 of the Explanatory Material to refer to the broadly-held contrary view held in Australia (that Australian tax treaties do not under the current law constitute an alternative, independent and unconstrained power to make transfer pricing adjustments) in order to provide the Courts with appropriate guidance when interpreting the application of the new Division 815 in years to come.

Discrimination against treaty countries

The new Division 815 creates greater compliance obligations and therefore discriminates against taxpayers that trade with related parties resident in countries with which Australia has a tax treaty.

Discrimination between different types of taxpayer

The new Division 815 will create different rules for companies and permanent establishments ("**PEs**"). Furthermore, the rules for PEs will be different depending on whether the PE is an inbound branch of a treaty country (with potential variations from treaty to treaty), an inbound branch of a non-treaty country, or an outbound branch of an Australian company.

Transfer pricing adjustments and customs duty interaction

The new Division 815 creates greater capacity for transfer pricing adjustments for which there will not necessarily be any corresponding relief from customs duty (because customs rules focus on values for individual import transactions).

In this respect, recommendations contained in the report of the *Review of Business Taxation* ("**Ralph Review**") appear to have been overlooked. In particular, we note that the Ralph Review recommended (Recommendation 22.16) that legislative changes should be developed to provide rules to link transfer pricing for customs and income tax purposes.

SECTION 2: General comments on the Exposure Draft

Objects clause – proposed section 815-10

The objects clause should also include a statement to the effect that the operation of Subdivision 815-A is not intended to override the safe harbour limits in Division 820 of the ITAA1997.

Whether an entity gets a transfer pricing benefit for purposes of section 815-22 – retrospective reconstruction power

We are particularly concerned at the potential for the Commissioner to raise amended assessments in reliance upon a retrospective reconstruction power that is far broader than currently exists under Division 13. As mentioned elsewhere in this submission, we are also concerned at the potential for the Commissioner to impose penalties on taxpayers in such cases.

Further, we are concerned that the Commissioner would use a retrospective reconstruction power to commence new audits with reliance being placed on the wider powers that will be provided by Subdivision 815-A rather than on the Commissioner's long held view that there should be no fundamental difference between Division 13 and the Associated Enterprises Articles of Australia's DTAs (discussed at length in our submission in response to the Consultation Paper, attached at appendix B).

This is a key area of concern as it goes to the very heart of taxpayers' concerns that the Exposure Draft is not simply clarifying the law but is proposing to provide the Commissioner with additional taxing powers that do not currently exist under Division 13.

With respect to the reconstruction of transactions between related parties, the OECD's Transfer Pricing Guidelines state that this should only occur in two exceptional circumstances[1]:

- Where the economic substance of a transaction differs from its legal form; and
- Where arrangements made in relation to a controlled transaction differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner.

In terms of what constitutes exceptional circumstances, we note the additional cautionary words in the OECD Transfer Pricing Guidelines[2]:

> *"In other than exceptional cases, the tax administration should not disregard the actual transactions or substitute other transactions for them. Restructuring of legitimate business transactions would be a wholly arbitrary exercise the inequity of which could be compounded by double taxation created where the other tax administration does not share the same views as to how the transaction should be structured."*

In our view, the Commissioner should not be able to raise an amended assessment in reliance on a reconstruction power, retrospective or otherwise, that is not soundly based on evidence of what third parties actually do or do not do in the same or similar circumstances. That is, the Commissioner should not be able to issue amended assessments in reliance on a reconstruction power that is simply based on some perceived notion of what independent parties would or would not do if acting in a commercially rational manner.

[1] Paragraph 1.37 of the OECD Transfer Pricing Guidelines as they existed before amendments made in the 2010 OECD Transfer Pricing Guidelines, paragraph 1.65 of the 2010 OECD Transfer Pricing Guidelines.
[2] Paragraph 1.36 of the OECD Transfer Pricing Guidelines as they existed before the amendments made in the 2010 OECD Transfer Pricing Guidelines, paragraph 1.64 of the 2010 OECD Transfer Pricing Guidelines

Proposed section 815-22 should be modified to make it clear that the Commissioner is not permitted to raise amended assessments in reliance on a retrospective reconstruction power.

The Commissioner's ability to amend assessments on a prospective basis in reliance on a reconstruction power should be strictly limited, for example, by:

- Only being applicable to transactions entered into on or after the date on which the relevant Bill is introduced to the House of Representatives;
- Setting out clearly the types of transactions and circumstances in which a reconstruction power could be applied (i.e., the exceptional circumstances in which a reconstruction power might be applied consistently with the OECD Transfer Pricing Guidelines);
- Introducing clear and objective criteria, all of which must be satisfied, before a reconstruction power could be applied;
- Requiring that application of reconstruction power is to be soundly based on evidence of what third parties actually do or do not do in the same or similar circumstances;
- Allowing for merits review by the Administrative Appeals Tribunal of any determination made by the Commissioner to apply a reconstruction power; and
- Placing the onus of proof on the Commissioner rather than the taxpayer in litigation under Part IVC of the *Taxation Administration Act 1953* to show what the reconstructed (counterfactual) transaction would be.

Section 815-30(1) determinations

Under proposed section 815-30, the Commissioner is not required to provide any detail as to the adjustments to assessable income or deductions that will result in the taxpayer's taxable income having changed (i.e. the Commissioner is only required to a make a determination under section 815-30(1) but is not also required to make a determination under section 815-30(2) that would provide such detail). As a result, the flow on effects of, for example and in particular, net adjustments to taxable income, including how the adjustment will relate to other aspects of the Tax Acts may be unclear.

One consequence of such an approach is that taxpayers could be left in the invidious position of not being able to determine whether they should, and if so how they might challenge an amended assessment. That is, taxpayers should be told the taxable facts upon which any amended assessment has been based.

It is also not consistent with principles of good tax policy development or good tax administration for taxpayers to be left in the dark in relation to how their tax liabilities have been determined. In this respect, we draw attention to the following remarks of the Commissioner of Taxation delivered in a speech on 2 April 2012[3]:

> *"To achieve this vision we are committed to working with taxpayers, their intermediaries and the wider community to move from a 'game of hide and seek' to one of mutual transparency." (emphasis added)*

Further, the effect of the Commissioner only making a subsection 815-30(1) determination could also have the following adverse consequences for taxpayers:

[3] *'Mitigating Risk', speech by the Commissioner of Taxation Michael D'Ascenzo to the 10th International Tax Administration Conference (ATAX), Sydney, 2 April 2012.*

- Lead to amounts being included in net adjustments to a taxpayer's taxable income that do not constitute assessable income;

- Lead to increased difficulties in taxpayers seeking refunds of overpaid customs duty (because customs rules focus on values for individual import transactions);

- Requiring taxpayers to give written requests to the Commissioner in order to establish their entitlement to consequential adjustments under section 815-45;

- Lead to taxpayers not knowing whether a transfer pricing benefit brought to tax under section 815-30(1) might not also be subject to tax based on the application of Division 13, notwithstanding section 815-50; and

- Impact a multinational enterprise's ability to obtain a corresponding adjustment under Article 9(2) or the mutual agreement procedure article of a relevant tax treaty. More particularly, such an approach is not consistent with the spirit of the OECD TP Guidelines which places the burden of demonstrating that a primary transfer pricing adjustment is justified both in principle and as regards the amount on the country that has proposed the primary transfer pricing adjustment (paragraph 4.17).

There may be a need to clarify that the definition of "transfer pricing benefit" does not unintentionally erode the MAP process and the ability to have contrary adjustments (in favour of the taxpayer) in general.

The connection between "profit" (in tax treaties) and "taxable income" in the exposure draft should be drawn in a way that ensures that exempt / non-assessable income is not unintentionally 'picked up' and taxed through the new Subdivision.

The Commissioner should be required (and not merely permitted) to provide taxpayers with the level of detail contained in proposed section 815-30(2), and in that context should be required to:

- Provide the relevant taxpayer with sufficient detail to evaluate how the relevant amount or amounts referred to in sections 815-30(1)(a) to (c) as the case may be have been ascertained for purposes of the determination (as well as the determinations' flow-on effects with respect to other parts of the Tax Acts); and

- Specify the amount or amounts referred to in sections 815-30(1)(a) to (c) as the case may be which relate to particular international tax agreements in cases where more than one international tax agreements is applicable.

- While it is our preferred approach that the Commissioner should be required to provide taxpayers with the level of detail contained in proposed section 815-30(2), an alternative approach would be to provide taxpayers with the ability to request the Commissioner to provide them with the requisite level of detail together with the ability to object in the manner set out in Part IVC of the *Taxation Administration Act 1953* where the taxpayer is dissatisfied with the Commissioner's decision. Such an approach would enable taxpayers to obtain sufficient details in relation to how the relevant amount or amounts referred to in sections 815-30(1)(a) to (c) as the case have been ascertained to enable them to determine whether they should, and if so how they might challenge an amended assessment. The correctness or otherwise of the amended assessment could then be challenged in the usual manner under Part IVC of the *Taxation Administration Act 1953.*

Net adjustments to taxable income arising as a result of a section 815-30(1)(a) determination do not sit comfortably with other areas of the Tax Acts

The following examples illustrate potential problematic outcomes where net adjustments to taxable income arise as a result of a section 815-30(1)(a) determination being made:

- Taxpayers may not be able to claim carry-forward losses that are available to them under section 36-17 of ITAA 1997. Given that subsection 36-17(2) is based on assessable income and allowable deductions, no mechanism has been provided by which carry-forward losses available to a taxpayer can be offset against an additional amount of taxable income that has been determined under subsection 815-30(1)(a) for a particular year of income.

- How does exempt income interact with determinations under the proposed section 815-30? For example, will exempt income (such as dividends exempt under section 23AJ of the ITAA1936) be able to give rise to an increase in taxable income under Section 815-30 effectively unwinding the tax treatment afforded to this income under domestic laws?

The relevance of the debt/equity rules in Division 974 of the ITAA1997 to Subdivision 815-A except in relation to the application of the thin capitalisation provisions in Division 820 of the ITAA1997 is unclear.

SECTION 3: General comments on the Explanatory Material

- Paragraph 1.10 of the Explanatory Material should also appropriately refer to situations where the revenue of other jurisdictions is compromised i.e. income is over-reported in Australia in order to constitute a fair and balanced description of the policy underpinning the amendments.

- Paragraph 1.32 of the Explanatory Material should be rewritten to make it more consistent with the position set out in the Commentary to the Business Profits Article of the OECD Model DTC in relation to internal payments of interest made by different parts of a financial enterprise to each other on advances (see paragraphs 19 and 20 of the 2005 Model DTC and paragraphs 41, 42 and 49 of the 2008 Model DTC).

SECTION 4: Interaction of transfer pricing and thin capitalisation rules

It appears to us that proposed subsections 815-22(4) and (5) seek to give legislative effect to the ATO's position in TR 2010/7 with respect to the interaction between the thin capitalisation rules in Division 820 and the transfer pricing rules (see paragraph 1.39 of the Explanatory Materials). More particularly, and of more concern, the retrospective application of subdivision 815-A to years of income commencing on or after 1 July 2004 will have the effect of giving legislative backing to an interpretative approach which the ATO had not finally developed until TR 2010/7 was issued on 27 October 2010, i.e. more than 6 years after 1 July 2004.

As a preliminary point, we wish to have it noted that the approach ultimately developed by the ATO in TR 2010/7 does not enjoy widespread taxpayer support. On the contrary, the views expressed by the ATO in TR 2010/7 are controversial and in this respect, we refer to the Joint Submission by The Tax Institute, The Institute of Chartered Accountants in Australia, CPA Australia, Institute of Public Accountants and Taxpayers Australia on *Draft Taxation Ruling TR 2009/D6* dated 16 February 2010 (a copy of which is attached at appendix C).

In this regard, it is our view that the intent of proposed subsections 815-22(4) and (5) as set out in the Explanatory Material does not reflect the current law. Instead, these subsections merely seek to reflect the ATO's interpretation of the law. As such, legislating this position does not

constitute a “mere clarification”, but represents a retrospective change in the tax law that should be consulted on.

Notwithstanding the above, the following comments are provided on our understanding that it is nevertheless the Government’s intention to give legislative effect to the approach ultimately developed by the ATO in TR 2010/7. In this respect, we have a number of concerns that the drafting of the relevant subsections does not necessarily achieve the desired policy intent as articulated in TR 2010/7. For example:

- Proposed section 815-22(4)(a) uses the term “rate of return for the debt interest”. While the “rate of return” for a simple loan might conceivably be regarded as the interest rate set out in the applicable loan agreement, although this is not without doubt, it is far less clear as to what the expression “rate of return” means with respect to more complex financial instruments such as zero coupon bonds, convertible notes, swaps, redeemable preference shares, etc. It is also unclear what the expression “rate of return” means in cases where financial instruments are originally issued at a discount or premium to their face value;

- Proposed section 815-22(4)(b) states that the “rate of return is to be applied to the actual value of the debt interest”. However, it is far from clear as to how these words are to be interpreted. For example:

    - How is the “actual value” of a debt interest to be determined? Is this to be based on market value, fair market value, face value or arm’s length value?

    - When is the “actual value” of a debt interest to be determined? Is this to be determined at the time of issue of the debt interest, in each year of income, at some other time?

- Similar questions to those in the preceding dot point arise in relation to proposed section 815-22(5) and its use of the term “reduced value”.

- We also note at this point that proposed sections 815-22(4) and 815-22(5) respectively include the words “so as to best achieve the consistency mentioned in subsection (3)” and “if that best achieves the consistency mentioned in subsection (3)” (i.e. with the documents covered by proposed section 815-25). In this respect, it is worth noting that the OECD Transfer Pricing Guidelines do not include any detailed guidance on how an arm’s length consideration might be determined with respect to a financial instrument (e.g. a loan). The 1979 OECD Transfer Pricing Guidelines did include a chapter on loans (Chapter V) but neither the 1995 OECD Transfer Pricing Guidelines nor any later version includes such specific guidance.

- The interaction between proposed subsections 815-22(4) and (5) and proposed subsections 815-22(1) to (3) is unclear. “Profits” for the purposes of s815-22(1) are currently equated to taxable income (see Note following section 815-22(1)). However, taxable income is determined on post-interest profits. Based on the current drafting, the potential exists for the Commissioner to override any concession made to a taxpayer under proposed subsections 815-22(4) and (5) by adjusting other items of income or expense where the taxpayer’s post-interest profits fall below the Commissioner’s expectations of the profits that would have accrued if the taxpayer had been dealing at arm’s length.

We also have a number of concerns that the drafting of the relevant Explanatory Material is not consistent with the Exposure Draft or with TR 2010/7 in a number of important respects. For example:

- Paragraph 1.40 (first dot point, second sentence) of the Explanatory Material states that "The normal application of this Subdivision would require consideration of the conditions operating between the Australian entity and its foreign associates, and a comparison of the profits which would have accrued to the entity had it been wholly independent." By comparison, TR 2010/7 only goes so far as to state that "it is necessary to take account of whether the outcome makes commercial sense in all of the circumstances of the case" (paragraph 50). There is no requirement in TR 2010/7 for "a comparison of the profits which would have accrued to the entity had it been wholly independent" to be made;

- Paragraphs 1.39 and 1.40 of the Explanatory Material refer to "the arm's length cost of debt capital" in a number of places. Debt capital is defined in s995-1 of the ITAA 1997 as meaning any debt interests issued by the entity that are still on issue at a particular point in time. The definition of debt capital does not therefore distinguish between debt interests issued to related parties and debt interests issued to independent parties. *Prima facie*, debt interests issued to independent parties will be undertaken on an arm's length basis. Paragraph 1.40 is contrary to the position taken in TR 2010/7 which is that transfer pricing provisions can apply to debt funding that is provided on a non-arm's length basis, for example, where debt interests issued to related parties have not been priced on an arm's length basis; and

- Paragraphs 1.39 and 1.40 of the Explanatory Material state that "the arm's length cost of debt capital is applied to the entity's actual amount of debt" in a number of places. This seems to require the calculation of an average (arm's length) cost for all of a taxpayer's debt interests. Such an approach is not consistent with proposed subsections 815-22(4)(a) and 815-22(4)(b) which clearly require that the relevant rate of return is in respect of a particular debt interest. A requirement to calculate an average (arm's length) cost for all of a taxpayer's debt interests is also likely to be problematic where an entity has more than one debt interest on issue in any year of income.

SECTION 5: Other significant issues of note

Regulation making power contained in proposed section 815-25(1)(c)

Neither proposed subsection 815-25(1)(c) nor the corresponding Explanatory Material (in paragraphs 1.47-1.48) provide any guidance as to the type of documents that might be prescribed by regulation in order to work out whether an entity gets a transfer pricing benefit for purposes of proposed subsection 815-22(3).

Using documents issued by the OECD as a guide, these can be broadly divided into three categories:

- **Tier 1 documents:** documents which have been specifically adopted by the OECD Council including the making of specific recommendations to OECD member countries in accordance with Article 5(b) of the Convention on the OECD of 14 December 1960. Broadly speaking, such documents represent an international consensus (or at least a consensus amongst OECD member countries). Examples of such documents include the OECD Model DTC, the OECD Transfer Pricing Guidelines and the 2008 and 2010 Attribution of Profits to Permanent Establishments reports.

- **Tier 2 documents:** documents which have not been specifically adopted by the OECD Council but have been prepared by the OECD's Committee on Fiscal Affairs. While there is clearly a level of consensus amongst OECD member countries in relation to the views expressed in these documents, the OECD Council has not adopted them and has made no recommendations to OECD member countries in relation to them. Examples of such documents include the 1987 Thin Capitalisation Report (No.2 in Issues in

International Taxation series) and the 2002 Attribution of Income to Permanent Establishments Report (No.5 in Issues in International Taxation series).

- **Tier 3 documents:** documents which have been published under the responsibility of the Secretary-General of the OECD and which clearly state that the views expressed therein are not necessarily those of the OECD and its members. An example of such a document is The Taxation of Employee Stock Options (Tax Policy Study No. 11) 2004.

In our view, it is only Tier 1 (OECD) documents and other documents that follow a similar process of adoption and recommendation by an international organisation such as the United Nations that should be within contemplation as documents that could be prescribed by regulation for purposes of working out whether an entity gets a transfer pricing benefit.

Proposed section 815-25 should provide greater clarity as to the type of documents that might appropriately be prescribed by regulation in order to work out whether an entity gets a transfer pricing benefit. Alternatively, greater guidance should be included in the Explanatory Material as to the type of documents that are within reasonable contemplation of being used, and also of not being used, for purposes of working out whether an entity gets a transfer pricing benefit.

Penalties

The Exposure Draft is silent in relation to the matter of administrative penalties that can be imposed on taxpayers under Division 284 of the *Taxation Administration Act 1953 (Division 284) where the Commissioner issues* an amended assessment in reliance upon Subdivision 815-A.

The Exposure Draft should make it clear that administrative penalties under Division 284 cannot be imposed on taxpayers following the issuing of an amended assessment in reliance upon Subdivision 815-A of an amount greater than the amount that might reasonably have been expected to have been imposed if, notwithstanding section 815-50, the Commissioner had issued an amended assessment in reliance upon Division 13.

Consequential adjustments

In our view, proposed subsection 815-45(1)(d) gives the Commissioner discretionary powers that are too broad for the efficient operation of the transfer pricing laws. As such, we recommend that the Exposure Draft be amended so that if the conditions in paragraphs (b) and (c) are met, then the Commissioner should be required to make the relevant consequential adjustments i.e. such amendments should not be discretionary.

Moreover, the Explanatory Material at paragraph 1.69 notes that the discretion must be exercised with reference to the points of view of both the taxpayer and the revenue. As a result, even in circumstances where an adjustment is fair and reasonable and warranted on technical grounds, the Commissioner may, following the guidance in the Explanatory Material, allow considerations of quantum and impact on revenue to affect the exercise of his discretion. We recommend that this paragraph be rewritten so that the Commissioner is required to consider the merits of the relevant adjustment only in applying the discretion.

Appendix C

JOINT SUBMISSION BY

The Institute of Chartered Accountants in Australia, The Taxation Institute of Australia, CPA Australia, National Institute of Accountants and Taxpayers Australia

Draft Taxation Ruling TR 2009/D6

Income tax: the interaction of Division 820 of the Income Tax Assessment Act 1997 and the transfer pricing provisions in relation to costs that may become debt deductions, for example, interest and guarantee fees

Date: 16 February 2010

The Professional Bodies welcome the opportunity to comment on the draft Tax Ruling TR 2009/D6 (the draft Ruling) released by the Australian Taxation Office (ATO) on 16 December 2009. Our representations have been compiled based on discussions and feedback from various members.

We would be pleased to discuss any aspect of our submission in more detail by way of a meeting or a teleconference. In this regard, please do not hesitate to contact the Tax Administrator at the Institute of Chartered Accountants on (02) 9290 5751 in the first instance.

Our comments are divided into two parts. The first part (General Comments) raises some fundamental concerns that the Professional Bodies continue to have with the approach taken in the draft Ruling. The second part (Specific Comments) provides comments on specific paragraphs of the draft Ruling. The comments in the second part should not be misconstrued as in any way diminishing the significance of the fundamental concerns raised in the first part.

GENERAL COMMENTS

The Professional Bodies appreciate the ATO's continued endeavours to clarify the interaction of Australia's thin capitalisation rules, as set out in Division 820 of the *Income Tax Assessment Act 1997* (ITAA 1997), with the transfer pricing rules contained in Division 13 of Part III of the *Income Tax Assessment Act 1936* (ITAA 1936) and the relevant provisions of Australia's tax treaties (ie the Business Profits Article and the Associated Enterprises Article).

The Professional Bodies also welcome the ATO's decision to withdraw TD 2007/D20 and to reissue it as a draft ruling and the ATO's decision to release the legal advice it obtained from Ron Merkel QC and Diana Harding. Such steps facilitate further and meaningful consultation with interested parties.

Nevertheless, the Professional Bodies continue to have fundamental concerns with the approach proposed in the draft Ruling at the following levels:

- Policy;
- Proposed retrospective application;
- Technical / interpretative; and
- The additional compliance cost burden is disproportionate to the revenue at risk.

We also have a number of other general concerns. We address each of these concerns below.

1. Policy considerations

1.1 Policy objective underlying the introduction of the thin capitalisation safe harbour rules

At the outset and of overarching importance in relation to the approach proposed in the draft Ruling is the issue of whether the proposed approach is consistent with the policy underlying the introduction of the thin capitalisation provisions and in particular the safe harbour rules.

There is nothing in the draft Ruling or in the legal advice obtained by the Commissioner that alters the view of the Professional Bodies that it was Parliament's intention when introducing the thin capitalisation rules in Division 820 in 2001 (which replaced the thin capitalisation rules contained in Division 16F of the ITAA 1936) to provide the rules by which capital structure issues would be determined for the entities to which they apply for purposes of the Act[1].

The Professional Bodies acknowledge that the primary purpose of Division 820 is to ensure that multinational entities do not allocate an excessive amount of debt to their Australian operations (see for example, paragraphs 1.18, 2.8, 11.6 and 11.11 of the EM). However, in order to give effect to this policy objective, paragraphs 11.11 and 11.35 of the EM also make it clear that the safe harbour approach is to be the rule of general application in relation to whether the Australian operations of a multinational entity are sufficiently capitalised because of the need to reduce the compliance cost burden that would otherwise arise if an arm's length test was to be required. Paragraph 11.11 is such an important paragraph in this respect that we reproduce it in full below and highlight the text that clearly supports this view:

> "11.11 The objective of the thin capitalisation regime is to ensure that multinational entities do not allocate an excessive amount of debt to their Australian operations. This is to prevent multinational entities taking advantage of the differential tax treatment of debt and equity in order to minimise their Australian tax. **The most appropriate method of assessing whether in fact the Australian operations of a multinational entity are sufficiently capitalised is by the application of an arm's length test.** Such a test requires the analysis of the assets, liabilities and cash flow of the Australian operations of the entity to ascertain if the level of debt of the operation is in fact commercially justifiable for an independent entity. **After significant consultation with industry representatives, it was recognised that the application of this test may be quite onerous leading to an increase in compliance costs. To reduce the compliance burden, a safe harbour approach was adopted as the rule of general application. The safe harbour allows sufficient protection of the Australian tax base to be provided whilst simultaneously minimising compliance costs.**" (emphasis added)

The approach proposed in the draft Ruling, which will generally require taxpayers to determine an arm's length amount of debt for purposes of the transfer pricing provisions, is therefore inconsistent with the clearly stated policy objective to minimise compliance costs as stated in paragraph 11.11 of the EM.

In the opinion of the Professional Bodies, the policy and interpretative issues being considered by the ATO provide an excellent example of the situation described in speeches by Second Commissioners of Taxation in recent years where the underlying policy is either not able to be reflected in the ATO's interpretation of the law, or where the ATO's interpretation of the law produces anomalies or unintended consequences. In such cases,

---

[1] That is not to say that Division 13 and the relevant provisions of Australia's tax treaties (in particular the Associated Enterprises Article) cannot be used to determine an arm's length interest rate on a cross-border related party loan (see for example, paragraph 1.78 of the Explanatory Memorandum to New Business Tax System (Thin Capitalisation) Bill 2001 (the EM)) but rather that the mechanism by which the arm's length interest rate is determined under the transfer pricing provisions would be based on the actual amount of debt that a taxpayer has.

the ATO has indicated that it would advise Government, presumably with the intention of seeking a legislative fix[2].

Recommendation: The ATO should approach Government for a legislative fix with the view to achieving the original policy objectives of the safe harbour rules within the thin capitalisation provisions which were introduced to minimise compliance costs.

1.2 Divergence from standard transfer pricing approaches and tax treaty implications

We are concerned that determination of an arm's length amount of debt for purposes of application of the transfer pricing provisions as proposed in the draft Ruling rather than applying the transfer pricing provisions on the basis of the actual debt that a taxpayer has diverges from accepted practice in the interpretation of the arm's length principle as set out in the Organisation for Economic Co-operation and Development's *'Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations'* (OECD Guidelines). In particular, we refer to paragraph 1.36 which states that *'in other than exceptional circumstances, tax administrations should not disregard the actual transactions or substitute other transactions for them'*. In our view, it is difficult to argue that exceptional circumstances exist when Australia has a comprehensive thin capitalisation regime in Division 820.

1.3 Increased likelihood of double taxation

The proposed approach requiring determination of an arm's length amount of debt, which is a notional rather than actual amount, may be problematic from the perspective of the tax authority in the jurisdiction of the related party lender. For example, if an arm's length rate of interest has been determined for a loan from an international related party to an Australian taxpayer but the ATO uses a notional arm's length amount of debt to reduce that rate of interest to an alternative 'arm's length rate', it appears possible that Mutual Agreement Procedures (MAP) may be more easily frustrated and could give rise to greater incidences of double taxation where the other taxation authority does not recognise an adjustment determined on the basis of notional transactions.

2. Proposed retrospective application

Paragraph 17 of the draft Ruling indicates that the ATO intends to apply the approach described in the draft Ruling retrospectively as well as prospectively.

As a consequence, many taxpayers will face the risk of potential transfer pricing adjustments and the imposition of interest and GIC irrespective of the fact that:

- The capital structure of their Australian subsidiaries may have been determined on the basis of satisfying the safe harbour rules within the thin capitalisation provisions; and
- Related party debt may have been priced in good faith having regard to standard transfer pricing approaches and ATO guidance provided nearly 20 years ago in TR 92/11.

Retrospective application of the approach outlined in the draft Ruling would be harsh and unreasonable, especially given there is no time limitation imposed on the ATO for amendment for Division 13 adjustments. TD 2007/D20, the June 2008 discussion paper and now TR 2009/D6 represent the first occasion on which the ATO has expressed the view that concepts such as the arm's length amount of debt for the borrower and the effect, if any, of parental

---

[2] See '*The role and implications of litigation in tax administration*' by Bruce Quigley, Second Commissioner of Taxation (Law) to Australian Petroleum Production & Exploration Association Annual Conference, Hobart, 22 November 2007 and '*A unique taxation partnership for the benefit of the Australian community*', speech to ATO/AGS/Counsel Workshop by Michael D'Ascenzo, Second Commissioner and Chief Tax Counsel and Steve Martin, Senior Tax Counsel, Australian Taxation Office, 3 April 2004.

affiliation should be taken into account for purposes of determining an arm's length interest rate on a cross-border related party loan. Taxpayers and ATO auditors alike have been determining the arm's length interest rate on related party loans based on the Australian company's actual capital structure and in light of ATO guidance contained in TR 92/11 for more than nearly 20 years.

In addition, irrespective of any legal remedies taxpayers may have available to them (discussed below), it has been the long-standing practice of the ATO to regard views expressed in taxation rulings as administratively binding on the ATO (eg TR 92/1, TR 2006/10 and more recently PS LA 2008/3). The approach proposed in the draft Ruling represents a significant change to the views expressed in Part E of TR 92/11 which addresses the manner in which the ATO will calculate arm's length interest.

TR 92/11 explains the circumstances in which Division 13 may be applied to impute interest income or deny deductions for excessive interest expense. Specific guidance on the factors to be taken into account in determining arm's length consideration in relation to an international related party loan is provided in paragraph 83 of TR 92/11 (as noted in paragraph 29 of the draft Ruling). However, the draft Ruling makes material changes to the guidance provided in paragraph 83 of TR 92/11 by extending the factors to be taken into account to include an arm's length amount of debt (paragraphs 6 and 12) or an arm's length debt amount (footnote 6) for the borrower and the effect, if any, of parental affiliation which is briefly mentioned in paragraph 32 of the draft Ruling (ie implicit credit support or 'notching' as it is described in the June 2008 discussion paper). In contrast, TR 92/11 does not refer explicitly or implicitly to concepts such as arm's length amount of debt or to parental affiliation.

In a self assessment environment, taxpayers who have in good faith attempted to comply with their transfer pricing obligations, and in particular where such compliance has had regard to existing ATO rulings and guidance and the conduct of the ATO in undertaking its compliance activities over many years, should be administratively protected from retrospective application of material changes in how the ATO interprets the transfer pricing rules and/or how the arm's length principle as expressed within those rules is applied by the ATO.

Further, following the review into various aspects of the self assessment system undertaken by Treasury[3], amendments were made to the *Taxation Administration Act 1953* in 2005 with effect from 1 January 2006 to provide taxpayers with enhanced statutory rights in cases where:

- ATO rulings provide inconsistent treatment with respect to the same matter (ss357-75(1) of Schedule 1 to the *Taxation Administration Act 1953*); and
- The ATO changes a general administrative practice which is less favourable to a taxpayer (ss358-10(2) of Schedule 1 to the *Taxation Administration Act 1953*).

As a result, taxpayers are now legally entitled to rely on the ATO view stated in TR 92/11 and ATO administrative practice in respect of related party loans already entered into until such time as the view stated in that ruling is withdrawn or changed and changes in ATO administrative practice is clarified to assist reasonable taxpayer compliance. Taxpayers should not be forced into litigation by the ATO simply to protect rights given to them by Parliament following a detailed review into the operation of Australia's self assessment system.

We also note that the Inspector-General of Taxation is examining the interaction of the transfer pricing rules and the thin capitalisation rules as part of his "U-turn" review.

Recommendation: Without prejudice to any other comment in this submission, the approach outlined in the draft Ruling should only be applied on a prospective basis, from the date of finalisation of the draft Ruling.

[3] Report on Aspects of Income Tax Self Assessment, Treasury 2004

3. Technical / interpretative

3.1 Whether the Associated Enterprises Article of Australia's tax treaties provide the Commissioner with a separate head of taxing power to that provided in Division 13

Notwithstanding the views expressed in paragraph 27 of the draft Ruling, the question of whether the Associated Enterprises Article of an applicable tax treaty (in particular) provides the Commissioner with a separate head of taxing power to that provided in section 136AD of Division 13 raises important issues for both the draft Ruling and more generally.

As mentioned at the beginning of these comments, the Professional Bodies welcome the release by the ATO of a copy of the legal advice it obtained on the interaction between Division 820 and the transfer pricing provisions in Division 13 and the Associated Enterprises Articles of Australia's tax treaties. The Professional Bodies have reviewed the legal advice closely. While there is agreement 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 tax treaty, the Professional Bodies note that counsel's opinion did not address the issue of whether the grant of power is constrained or unconstrained. That is, neither the draft Ruling nor the legal advice obtained by the ATO provides 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 tax treaty 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 had been applied.

In particular, reference is made to a recent article published in the November 2009 issue of Taxation in Australia titled '*The associated enterprises articles in Australia's DTAs and Division 13*' by Damian Preshaw (copy attached). 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 tax treaty in certain circumstances. However, and importantly, after examining the Explanatory Memorandum to *Income Tax Assessment Amendment Bill 1982* (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).

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 *International Tax Agreements Act 1953*.

The significance of the conclusion reached in the above article is that the issue of whether the Commissioner's view that section 136AD is as extensive as the associated enterprises articles of Australia's tax treaties (as mentioned in the last sentence of paragraph 27 of the draft Ruling) assumes far greater importance. This issue is addressed in sections 3.2 and 3.3 below.

Recommendation: The draft Ruling should address the issue of whether the grant of power to amend assessments in reliance upon the Associated Enterprises Article of an applicable tax treaty given to the Commissioner under subsection 170(9B) of the ITAA 1936 is constrained or unconstrained (in the sense of whether it can be used to produce a result where a taxpayer could be assessed on a higher amount of tax than would otherwise be payable if section 136AD had been applied).

3.2 Determining the scope of Division 13 (in particular section 136AD)

The scope of Division 13 is a critically important interpretative issue. More particularly, questions arise as to whether the scope of Division 13 (and in particular section 136AD) is broad enough to: (1) address the matter of whether a taxpayer's capital structure is arm's length or not; and (2) enable the use of a notional arm's length amount of debt for purposes of determining the arm's length interest rate on a cross-border related party loan.

We note that the legal advice obtained by the ATO addresses the scope of Division 13 by asking the question whether the operation of Division 13 has been altered by the later enactment of Division 820. However, in the opinion of the Professional Bodies, this is not the correct starting point for purposes of addressing the issue of the scope of Division 13. This is because establishing the scope of Division 13 needs to have regard to the following matters which pre-dated the introduction of Division 820 before regard can be given to the question of whether the operation of Division 13 has been altered by the later enactment of Division 820:

- What was the intended scope of Division 13 at the time of its introduction in 1982?
- Was the scope of Division 13 affected by the later enactment of Division 16F?

In considering the scope of Division 13 at the time of its introduction in 1982, it is critically important to have regard to the following facts. First, that there is nothing in the Division 13 EM to suggest it was Parliament's intention that the transfer pricing rules in Division 13 were: (1) broad enough to address the matter of whether a taxpayer's capital structure was arm's length or not; and (2) able to use a notional arm's length amount of debt for purposes of determining the arm's length interest rate on a cross-border related party loan.

Second, it is equally important to have regard to the fact that both before and after the introduction of Division 13, questions regarding the capital structure of foreign companies investing in Australia were administered by the Foreign Investment Review Board (FIRB) under the *Foreign Acquisitions and Takeovers Act 1975* and not under the income tax laws.

In considering whether the scope of Division 13 was affected by the enactment of Division 16F in 1987, it is relevant to first have regard to Press Release No.37 dated 30 April 1987 of the then Treasurer, Mr Keating, titled "*Thin Capitalisation and Corporate Restructures*" in which it is 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."

It is clear from the press release that the then government did not consider the scope of Division 13 to be broad enough to address the matter of whether a taxpayer's capital structure is arm's length or not. It is also reasonable to conclude from the press release that the then government did not consider the scope of Division 13 to be broad enough to enable a notional arm's length amount of debt to be used for purposes of determining the arm's length interest rate on a cross-border related party loan (i.e. there would have been no need to introduce the thin capitalisation rules in Division 16F into the ITAA 1936).

Later in 1987, the thin capitalisation rules in Division 16F were introduced into the income tax laws by *Taxation Laws Amendment Bill (no.4) 1987* (TLAB 4 (1987)). Both the Second Reading Speech and the Explanatory Memorandum to TLAB 4 (1987) provide further support to the views expressed in the previous paragraph.

It is also worthy of note that at the time of introduction of Division 16F into the ITAA 1936 and when Division 16F was repealed at the time of introduction of Division 820 in 2001, no amendments were made to Division 13.

It seems clear that, if the approach proposed in the draft Ruling had been applied by the ATO prior to the introduction of Division 820, there would have been little or no purpose served by its introduction[4].

To summarise, in the view of the Professional Bodies, the scope of Division 13 was not intended by Parliament to address capital structure issues. As a consequence, the question of whether Division 13 enables the ATO to use a notional arm's length amount of debt for purposes of determining the arm's length interest rate on a cross-border related party loan is, in our view, moot.

Recommendation: The draft Ruling should address the scope of Division 13 having regard to the following:

- **The intended scope of Division 13 at the time of its introduction in 1982 (and in the context of the administration of capital structure issues by FIRB at that time);**
- **Whether the scope of Division 13 was affected by the enactment of Division 16F and Division 820 into the ITAA 1936.**

3.3 Whether ss136AD(4) enables the Commissioner to have regard to a notional arm's length amount of debt rather than the actual amount of debt that a taxpayer has

Without in any way resiling from the view expressed in the previous section that the scope of Division 13 was not intended by Parliament to address capital structure issues, this section addresses whether the scope of subsection 136AD(4) might nevertheless enable the ATO to have regard to a notional arm's length amount of debt rather than the actual amount of debt that a taxpayer has for purposes of determining the arm's length interest rate on a cross-border related party loan.

Paragraphs 34-36 of the draft Ruling expresses the ATO's view in relation to the interpretation of subsection 136AD(4). It is stated in paragraph 36 that "it is open to the Commissioner, in determining the arm's length consideration, to have regard to the level of debt that the borrowing entity would be able to borrow in an arm's length dealing".

As mentioned in various submissions on the June 2008 discussion paper, it is the view of the Professional Bodies that the ATO is reading more into the scope provided to the Commissioner by ss136AD(4) than actually exists.

While ss136AD(4) is drafted broadly, the Professional Bodies do not agree that it should be interpreted as broadly as described in paragraphs 34-36 of the draft Ruling. In our view, ss136AD(4) needs to be interpreted having regard to how it interacts with ss136AD(1)-(3) (see paragraph 331 of TR 94/14) and having regard to, amongst other things, the definition of arm's length consideration in paragraph 136AA(3)(d). Subsection 136AD(3) and paragraph 136AA(3)(d) are predicated on there being an acquisition of particular property and determination of the consideration that independent parties might reasonably have expected to give in respect of the particular acquisition. In light of this, it is our view that ss136AD(4) should not be applied to deem an arm's length consideration based on a different acquisition of property, for example, a notional arm's length amount of debt.

Accordingly, it is our view that the power granted to the Commissioner under ss136AD(4), where it is being used in conjunction with ss136AD(3), is limited to determining the consideration that independent parties might reasonably have expected to give in respect of the acquisition of the property actually acquired and not in respect of some different property.

---

[4] The only significant area of operation left for Division 820 would have been in the area of outward investment from Australia.

Further, the drafting of paragraph 36 gives the strong impression that where the Commissioner forms the view that the information and evidence used by a taxpayer is not sufficient to justify the approach adopted such that the Commissioner may then need to undertake his own analysis, that the Commissioner will completely disregard the information and evidence used by a taxpayer. In the view of the Professional Bodies, it would be inappropriate in applying subsection 136AD(4) for the Commissioner to completely disregard the information and evidence used by a taxpayer particularly where such information and evidence was based on the best available third party information. In such cases, the question should be one of the weight to be given to such information and evidence when compared with any alternative approach including the use of a notional arm's length amount of debt as proposed in the last sentence of paragraph 36.

Recommendations: (1) The draft Ruling should include an alternative view (based on the comments in sections 3.2 and 3.3) that the scope of Division13 is not as wide as described in paragraphs 34-36 of the draft Ruling;

(2) The Professional Bodies request the Commissioner to clarify the application of subsection 136AD(4) and in particular to confirm that where the information and evidence used by a taxpayer is based on the best available third party information that the Commissioner will not completely disregard this information when applying subsection 136AD(4).

4. The additional compliance cost burden is disproportionate to the revenue at risk

In addition to our concerns associated with policy, technical / interpretative issues and retrospectivity, the Professional Bodies are particularly concerned about the additional compliance cost burden to be imposed on taxpayers. These compliance costs will affect all taxpayers, large and small, and would be additional to existing compliance costs associated with applying the guidance in TR 92/11.

To put this into context, we provide the following example:

> Consider a AUD50M related party loan that was priced at LIBOR plus 400bps based on a capital structure that is close to the safe harbour limits in the thin capitalisation rules but which would have been priced at LIBOR plus 200bps based on an arm's length amount of debt. Such a situation represents a very small risk to the revenue as a consequence of non-arm's length pricing. A 200bps adjustment on a AUD50M principal amount would result in a reduction in the annual interest tax deduction of AUD1M. Given the current company tax rate of 30%, this would equate to a reduction in tax revenue of just AUD300,000 per annum prior to any reduction due to overpaid interest withholding tax. After adjusting for the overpaid interest withholding tax on the AUD1M (assumed to be at 10%), the net effect on the Australian revenue base is only AUD200,000 per annum for the period of the loan.

For many taxpayers the compliance costs associated with giving effect to the approach described in the draft Ruling is likely to represent a significant part of any additional tax revenue that might be collected.

In our view, such an outcome cannot be regarded as consistent with the prudent business management principle described in paragraph 1.6 of TR 98/11 and paragraph 5.4 of the OECD Guidelines. Neither is it consistent with principles of good tax administration as the costs of compliance are disproportionate to any risk to the revenue.

Having regard to the example above, possible solutions might include the introduction of appropriately targeted administrative practices such as, for example, not applying the approaches in the draft Ruling where related party loans or related guarantees are made with reference to a principal that does not exceed a specific amount in aggregate.

The Professional Bodies also note for reference that New Zealand's Internal Revenue Department has developed administrative practices that grades cross-border related party loans in accordance with their size and related tax risk to mitigate compliance costs.

The Professional Bodies would welcome the opportunity to discuss with the ATO how appropriate administrative practices could be developed that would balance the risk to the revenue with the compliance cost burden.

Recommendation: Notwithstanding the fundamental policy and interpretative concerns the Professional Bodies nevertheless strongly urge the ATO to develop an appropriate administrative practice or practices in this area to mitigate the potentially large taxpayer compliance costs.

5. Other concerns

5.1 Determining the arm's length amount of debt

Notwithstanding the above concerns with the draft Ruling, the Professional Bodies urge the ATO to issue a further tax ruling addressing how the arm's length amount of debt should be determined. At the NTLG Transfer Pricing Sub-group meeting held on 1 December 2009, the ATO flagged that it was considering whether to issue such a ruling, however, the most recent update of the ATO's rulings program (dated 14 January 2010) did not indicate that the ATO had committed to issuing such a ruling. We further request that the draft Ruling not be finalised until such guidance has been issued.

5.2 Clarification regarding the application of the provisions to guarantee fees

Based on the title of the draft Ruling, it appears that the ATO intends the approach described in the draft Ruling to apply to guarantee fees paid to international related parties. However, the only occurrence of the words "guarantee", "guarantees" or "guarantor" in the draft Ruling, apart from the title, are in paragraphs 29 (in an extract from TR 92/11), paragraph 30 (in the context of discussing creditworthiness) and in paragraph 50 (in a discussion on an alternative view).

In the Professional Bodies' view, the draft Ruling should include at the very least a worked example describing how the approach described in the draft Ruling would apply to guarantee fees (consistent with the title of the draft Ruling).

SPECIFIC COMMENTS

6. Re: What this Ruling is about

Paragraphs 1-2

Having regard to the intended scope of the draft Ruling as described in paragraphs 1 and 2, the Professional Bodies wish to draw particular attention to the following:

- The views expressed in paragraphs 6 and 7 of the draft Ruling are inconsistent with TR 2001/11 (in particular, paragraphs 3.41-3.45) which is not based on determining an arm's length interest rate but attributes a portion of the entity's actual interest expense paid to third party lenders to a permanent establishment;
- The views expressed in the draft Ruling conflict with the views expressed in TR 2005/11 (in particular, paragraphs 10, 34 and 40) which clearly state that where an ADI passes the relevant safe harbour test in Division 820, that Australia's PE attribution rules will not be used to adjust the gearing even if the level of equity capital of the bank's Australian operations is less than an arm's length amount (paragraphs

10 and 40) and that debt deductions will not be disallowed where the bank's Australian operations has at least the minimum amount of ADI equity capital (paragraph 34); and

- The scope of the draft Ruling is far broader than the scope of the June 2008 discussion paper which restricted application of the views expressed therein to dealings between separate legal entities and excluded dealings between parts of a single legal entity (see paragraphs 1 and 12 of the June 2008 discussion paper).

7. Re: Ruling

Paragraphs 4-5

The Professional Bodies request the ATO to provide greater clarity with respect to the types of arrangements to which the draft Ruling is intended to apply. This is because the first line of paragraph 4 limits the application of the views expressed in the draft Ruling to situations where an entity has excess debt (as defined in footnote 3) for purposes of Division 820. The first sentence of paragraph 5 is to similar effect. This is also consistent with the approach adopted in TD 2007/D20. However, paragraph 40 of the draft Ruling indicates that Division 820 can operate to reduce the amount otherwise deductible as the arm's length consideration after the application of Division 13 and the factual scenario discussed in Example 1 relates to a case where there is excess debt. Both these situations fall outside the scope of the draft Ruling.

Examples (paragraphs 9-16)

The Professional Bodies request that Example 1 be redrafted or deleted as it addresses a situation that falls outside of the situations ruled on in paragraphs 4 and 5. That is, paragraphs 4 and 5 only apply to situations where there is not excess debt, however, the example generally and the last sentence of paragraph 12 specifically shows that the situation discussed in the example relates to a case where there is excess debt.

The Professional Bodies request that the draft Ruling include an example illustrating the guidance provided in paragraphs 28-36 in the case where Aus Co is not able to borrow the whole amount of related party debt and the ATO considers that the interest rate paid by Aus Co is more than the arm's length consideration. In our view, Example 2 simply illustrates the position addressed in Part E of TR 92/11 and the view expressed in paragraph 1.78 of the EM to Div 820 and is therefore of limited value.

8. Re: Appendix 1 - Explanation

8.1 Working out arm's length consideration in relation to debt funding

Paragraph 30

In the view of the Professional Bodies, this paragraph should be reviewed for the following reasons:

- Expected loss (EL), loss given default (LGD) and exposure at default (EAD) are not concepts that directly relate to the creditworthiness of a borrower but are concepts that assist in determining how much regulatory capital or economic capital may need to be maintained by a lender with respect to a particular counterparty and in some cases may assist in the pricing of debt. EL, LGD and EAD do not directly concern the capacity of a borrower to obtain debt funding; and
- TR 92/11 does not directly or indirectly refer to EL, LGD and EAD.

Paragraph 31

The reference in the first line to paragraph 136AA(3)(c) should be a reference to paragraph 136AA(3)(d).

8.2 Thin capitalisation provisions in Division 820

Paragraph 40

See comments on paragraphs 4-5.

9. Re: Appendix 2 – Alternative views

The Professional Bodies request that Alternative view 2 from TD 2007/D20 (ie paragraphs 32-33) should be included in this section of the draft Ruling as it represents the critical issue in the context of the policy and interpretative issues arising out of the draft Ruling as discussed in our General Comments.

10. References

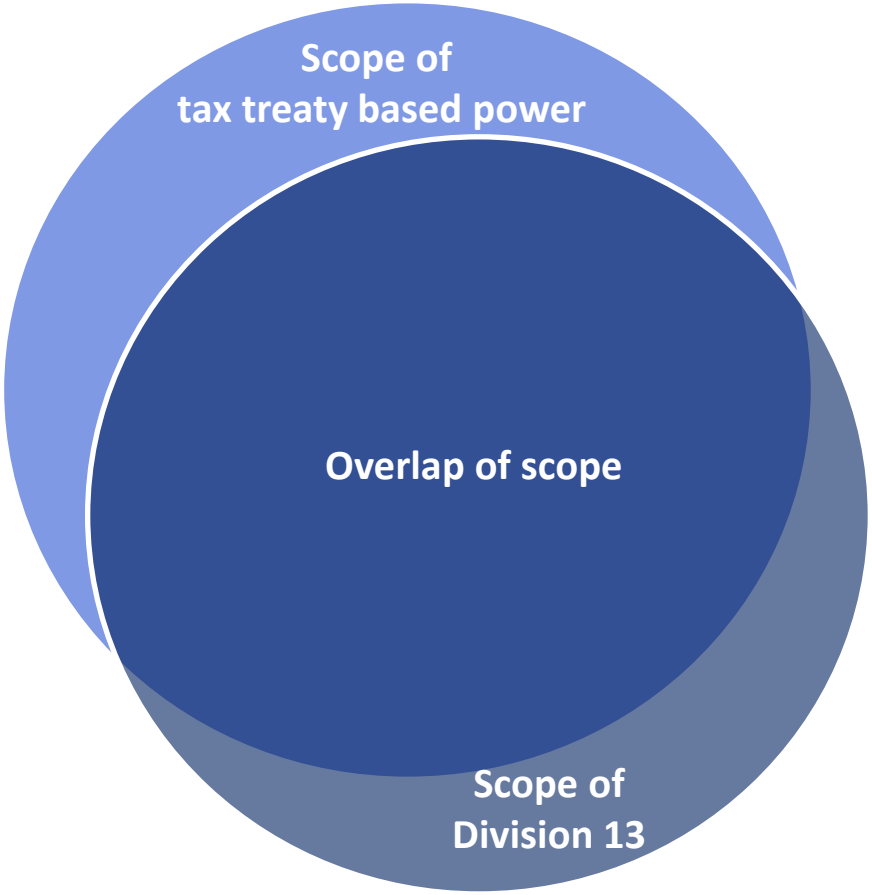
Related Rulings/Determinations

The Professional Bodies request that a reference to TR 2005/11 be included.

***

Appendix D

The scope of a tax treaty based power is not the same as the scope of Division 13



- Scope of tax treaty based power is broader than scope of Division 13 as allows:
  - A wider range of methods to be used
  - Reconstruction of transactions
  - Thin capitalisation issues to be addressed
- Scope of Division 13 is broader than scope of tax treaty based power:
  - Can apply to non-arm's length dealings between independent enterprises

Is the potential revenue impact of the Bill likely to be nil?