14 July 2012

The Secretary
Senate Standing Committees on Economics
PO Box 6100
Parliament House
Canberra ACT 2600

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

Inquiry into the Tax Laws Amendment (Cross Border Transfer Pricing) Bill (No. 1) 2012

Dear Senate Committee,

AVCAL welcomes the opportunity to make a submission to the inquiry in the proposed amendments introduced in Tax Laws Amendment (Cross Border Transfer Pricing) Bills (No. 1) 2012 ("the Bill").

AVCAL is particularly concerned about the following aspects of the proposed amendments:

- the retrospective nature of the proposed amendments;
- the lack of a transitional period; and
- the lack of a mandated requirement to process compensating adjustments for withholding taxes where relevant outflows attracting withholding taxes have been denied as deductions under the rules.

It would appear to us that the introduction of this retrospective legislation is a backward step in the Government's stated intention of providing more clarity and certainty for the funds management industry. The introduction of this law may act to increase existing investor anxieties about sovereign risk inherent in Australia's tax system.

AVCAL's Recommendations

1. AVCAL submits that the Senate Committee should not support the introduction of the Bill as it is currently drafted. Any legislative change should be introduced to apply prospectively with sufficiently robust transitional rules that allow time for taxpayers to comply going forward without penalising current positions.

2. If the rules are to be introduced with retrospective application, there should also be a sufficient transitional period for taxpayers to allow time for taxpayers to comply without penalising current positions. In this respect, AVCAL believes that the provisions should only apply retrospectively (if at all) to allow the Commissioner to use the rules as a 'shield' to protect already collected revenue as opposed to a 'sword' to be used to challenge prior positions adopted by taxpayers.

3. If withholding tax is being levied on a cash flow that is denied as a deduction, the provisions should be amended such that a compensating adjustment must be made to reduce the withholding tax rather than leaving the matter as a discretionary power of the Commissioner.

1. Retrospective tax change

AVCAL strongly opposes the retrospective nature of these amendments, particularly where the amendments have been introduced without a sufficient transition period, for the following reasons:

- We believe that the references to statements of the Australian Tax Office ("ATO") of how it thinks the law should operate is not a sufficient justification for back dating the law to a time when the ATO first announced how it thought the existing legislative provisions ought to have been interpreted.

  It is not unusual for a revenue office to have a different view about how particular provisions should be interpreted when compared to the view adopted by taxpayers properly advised. Retrospectively adopting a revenue office's interpretation

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usurps Parliament's role as the body responsible for determining applicable laws; and of the court's role of arbitrating disputes as to the law's application to given facts.

- Secondly, in our view, the law should not apply in a manner which results in different tax outcomes depending on whether a particular taxpayer's international dealings are with foreign affiliated entities which are a resident of a country with which Australia has concluded a double tax treaty. Such an approach is discriminatory.

  AVCAL understands that further amendments are to be introduced to address this bias. However the announcements made indicate that those amendments are to have prospective operation, in contrast to the currently proposed amendment which will be retrospective.

- Thirdly, we note that retrospective legislation by its nature undermines business confidence, and as such is bad policy other than in the most exceptional cases. The retrospective nature of the proposed amendments is another example of why international investors now perceive investment in Australia to have greater sovereign risk than previously. Once investors' attitudes in this regard have been formed, it is, in our assessment, difficult to reverse. A stand by the Senate against legislative amendment with retrospective application in this instance will be a strong signal towards rectifying this worrying development.

The explanatory memorandum ("EM") to the Bill seeks to justify the retrospectivity of the legislation by seeking to establish evidence of Parliament intent. AVCAL sees no evidence of this and notes that there is a long line of judicial precedents to the contrary where the courts have consistently held that tax treaties allocate taxing rights rather than providing an avenue for increasing revenue collection (i.e. *FC of T v Lamesa Holdings BV* 1997 ATC 4752; *Chong v FC of T* 2000 ATC 4315; *McDermott Industries (Aust) Pty Ltd v FC of T* 2005 ATC 4398; *Virgin Holdings SA v FC of T* 2008 ATC 20-051; *Undershaft No 1 LTD v FC of T; Undershaft No 2 BV v FC of T* 2009 ATC 20-091; *FC of T v SNF (Australia) Pty Ltd* 2011 ATC 20-265).

In this regard, AVCAL submits that there is no basis for using Australia's tax treaties to extend taxing rights. The EM at paragraphs 1.33 *et seq.* cite France, the Netherlands and Italy as countries which have applied tax treaties to extend their domestic taxation rights. It is interesting to note that the EM is silent on the countries that <u>do not adopt</u> this approach, including Australia's major trading partners China, Canada, Japan, New Zealand, the US and the United Kingdom.

The EM goes further by including as justification that "the Commissioner of Taxation has long held and publicly expressed a view that the treaty transfer pricing rules, as enacted, provide an alternate basis to Division 13 for transfer pricing adjustments." As indicated above, AVCAL disputes this as being sufficient justification for retrospective legislation that is likely to have a significant impact on the business community. Perceivably, the comments in the EM imply that the ATO is the arbiter of tax law. The Commissioner's interpretation of the legislation is not the law nor does is it necessarily a correct representation of the law.

The EM also states that the proposed measure has no revenue impact as it is merely intended to be a revenue protection measure. It is difficult to understand the justification for such a statement given the extremely limited responses made to Senator Cameron's questions on this particular point in the Senate Economics Legislation Committee meeting held in Canberra on 30 May 2012 and the subsequent comments that Mr Mark Konza (Deputy Commissioner) made in Canberra on 1 June 2012 to the Large Business Advisory Group that the proposed Subdivision 815-A could affect a significant number of current tax audits and preserve $1.9 billion of taxes.

These are inadequate grounds for the Treasury and the ATO to seek to justify legislation that not only is retrospective to 2004, but also grants a separate and unrestricted taxing power to the Commissioner, which on the face of the draft legislation, seems to be a power that the Commissioner can exercise without accountability. It would appear misguided to AVCAL if the Government is prepared to accept this without full and detailed consideration of the impact on the broader business community.

If the Government genuinely intends that the provisions apply in a protective manner, the legislation should specifically contemplate that the expanded jurisdiction given to the Commissioner apply only to prevent taxpayers from seeking to reduce their Australian tax base from that actually reported here. In other words, we recommend that if the provisions are to be retrospective, they should only be so to enable the Commissioner to apply a 'shield' to maintain revenue already collected. The provisions should not apply retrospectively so as to provide the Commissioner with a 'sword' which would allow the Commissioner to retrospectively amend the assessments of taxpayers that have filed returns consistently with the laws as they applied when those returns were actually filed.

Need for transitional period and mandatory compensating adjustments

The proposed amendments will raise transitional issues for taxpayers. AVCAL's constituents foresee that the introduction of these rules will impact upon acquisitions and divestments since 2004.

For instance, proposed subdivision 815-A allows the Commissioner to adjust the interest rate on a loan that is compliant with the thin capitalisation rules. It is maintained that the introduction of this ability is predicated on aligning the Commissioner's current administrative approach in Taxation Ruling TR 2010/7 (refer to EM paragraph 1.105). However, the existence of the amending retrospective legislation highlights that the amendments do not align transactions negotiated and implemented as far back as 2004 with the tax law that then applied.

The proposed approach noted in the EM gives the Commissioner the ability to reconstruct transactions in determining what, in his opinion, is the arm's length price (i.e. the interest rate) for a loan. As a result, the Commissioner is to have the power to disregard transactions that are actually in place, notwithstanding that they were negotiated under laws then validly governing the transaction.

Further, the methodology places a significant and unreasonable burden of proof on taxpayers. It also translates into uncertainty in positions adopted in and pricing used for leveraged buyouts and divestments since 2004. Purchasers and vendors are now potentially subject to the Commissioner's discretion without recourse under sale and purchase agreements which (unsurprisingly) would have been calibrated to the laws existing when the relevant contracts were consummated. In AVCAL's view, this is inappropriate.

Further, it is not unusual in structured financing projects, including those in which the infrastructure, property and private equity sectors participate, to involve capital structures that are "locked in" for a lengthy investment period. In AVCAL's assessment, it is not fair for taxpayers who find themselves in circumstances where it is impractical or legally impossible to vary existing capital structures, to be subjected to the amendments. Fairness dictates that a grandfathering or transitional mechanism be contemplated in the amendments to protect taxpayers in this position.

Compensating adjustments

Proposed Division 815 contemplates that the Commissioner be given a discretion to reduce the quantum of withholding tax that has been imposed on an outflow from Australia (eg. Interest withholding tax) if it is concluded that the quantum of the outflow was excessive having regard to the transfer pricing principles contemplated in the Division.

In this regard, we note that the Commissioner 'may' make such a determination in respect of withholding taxes (see for example, paragraph 815-35(4)(d)), if it believes it is fair and reasonable such adjustment be made.

If the legislation is to be retrospective, and or without appropriate transitional relief, AVCAL has the strong view that the legislation should be drafted to compel the Commissioner to make compensating adjustments where deductions for outflows are denied on which withholding tax has been collected.

If the law is to be so significantly changed, AVCAL strongly recommends that a transitional period is introduced with grandfathering rules that cover prior transactions before the date of the introduction of the Bill into Parliament.

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We would welcome any opportunity to discuss our views with you in further detail. Please do not hesitate to contact me on or Ian Scott of Ernst & Young (AVCAL's adviser on this matter) on

Yours sincerely

Dr Katherine Woodthorpe
Chief Executive, AVCAL