Institute of Chartered Accountants Australia

12 April 2013

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

Email: economics.sen@aph.gov.au

Dear Sir/Madam

Inquiry into the *Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013*

The Institute of Chartered Accountants Australia (the **Institute**) welcomes the opportunity to make a submission on *Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013* (**Bill**) and the explanatory material (**EM**) introduced into parliament on 13 February 2013. The Bill has passed through the House of Representatives and is now with the Senate Standing Committee on Economics (**Committee**) for inquiry and report.

The Institute is the professional body for Chartered Accountants in Australia and members operating throughout the world. Representing more than 70,000 current and future professionals and business leaders, the Institute has a pivotal role in upholding financial integrity in society. Members strive to uphold the profession's commitment to ethics and quality in everything they do, alongside an unwavering dedication to act in the public interest.

We wish to provide comments on both Schedule 1 and Schedule 2 to the Bill which covers the amendments to the general anti-avoidance rules and the modernisation of the transfer pricing rules.

Schedule 1 - Countering tax avoidance

Our key concern with the proposed amendments to Part IVA of the *Income Tax Assessment Act 1936* (**ITAA 1936**) in Schedule 1 is the constraining of the formulation of a reasonable alternative postulate in determining whether there is a tax benefit under section 177C of the ITAA 1936 (**Tax Benefit test**). Eliminating the 'Do Nothing' defence and disregarding the normal taxpayers' commercial consideration of the income tax consequences of arrangements, will unduly restrict the Part IVA enquiry, eliminating genuine commercial considerations and costs which should appropriately be considered by both the ATO and courts alike before applying the general anti-avoidance rule.

Under the existing Part IVA, there are already sufficient restraints on the operation of the Tax Benefit test. That is, an alternative postulate can only be considered if it is a 'reasonable expectation' of what might have occurred, absent the scheme. Notably, Justice Edmonds in *Macquarie Bank Limited v Commissioner of Taxation*[1] (**the Mongoose case**) has suggested that the 'Do Nothing' defence in *RCI Pty Limited v Commissioner of*

Customer Service Centre
1300 137 322

NSW
33 Erskine Street
Sydney NSW 2000

GPO Box 9985
Sydney NSW 2001

Phone 61 2 9290 1344
Fax 61 2 9262 1512

ACT
L10, 60 Marcus Clarke Street
Canberra ACT 2601

GPO Box 9985
Canberra ACT 2601

Phone 61 2 6122 6100
Fax 61 2 6122 6122

Qld
L32, 345 Queen Street
Brisbane Qld 4000

GPO Box 9985
Brisbane Qld 4001

Phone 61 7 3233 6500
Fax 61 7 3233 6555

SA / NT
L29, 91 King William Street
Adelaide SA 5000

GPO Box 9985
Adelaide SA 5001

Phone 61 8 8113 5500
Fax 61 8 8231 1982

Vic / Tas
L3, 600 Bourke Street
Melbourne Vic 3000

GPO Box 9985
Melbourne Vic 3001

Phone 61 3 9641 7400
Fax 61 3 9670 3143

WA
L11, 2 Mill Street
Perth WA 6000

GPO Box 9985
Perth WA 6848

Phone 61 8 9420 0400
Fax 61 8 9321 5141

[1] [2011] FCA 1076

Taxation[2] (**RCI**); would only be reasonable in the context of internal and voluntary transactions.

Schedule 2 - Modernisation of Australia's transfer pricing rules.

The Institute's submission points include:

- Reconstruction of transactions – The Bill appears to provide for a broader application for the reconstruction of transactions than was intended by the Organisation for Economic Co-operation and Development (**OECD**) in the transfer pricing guidelines (**TPGs**). The Institute submits that the Bill should clearly place more defined restrictions on when the form of actual transactions should be disregarded.

- Thresholds for a reasonably arguable position and the imposition of penalties – It is the Institute's view that the Bill does not go anywhere near achieving the correct balance between compliance costs and the potential risk to revenue in the context of transfer pricing adjustments. The Institute submits that the monetary threshold before the scheme shortfall amount and penalties can be imposed should be at least $5 million to achieve the right balance.

- Time limits for amending assessments – A compelling case has not been made as to why the Commissioner should be given a 7-year time limit for amending assessments. The Institute submits that the normal time limits for amending assessments under section 170 of the ITAA 1936 should apply.

- Small and medium enterprises (**SMEs**) – The Institute considers that in a proper balancing of compliance costs against revenue risks, it is essential that some taxpayers are completely carved out of the transfer pricing rules. In any event, the Institute believes that penalties should not be imposed for any adjustment made under Subdivisions 815-B to 815-D on a SME taxpayer that has made reasonable efforts to comply with the legislation

These and other issues are detailed in the attached appendix.

If you would like to discuss any aspect of this submission or require any further information, please do not hesitate to contact me on at first instance. We would welcome the opportunity to discuss our concerns with the Committee in person.

Yours sincerely

Paul Stacey CA
Head of Tax Policy
Institute of Chartered Accountants Australia

[2] [2011] FCAFC 104, [129]-[130].

Appendix

Inquiry into the *Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013*

Schedule 1 – Countering tax avoidance

We observe that the proposed Bill seeks to:

- restrict the operation of the Tax Benefit test in the section 177C of the ITAA 1936; and
- change the operation of Part IVA, as a result of the Commissioner of Taxation's (**the Commissioner**) recent defeats in the Federal Courts[3], by attempting to move the fulcrum of Part IVA to the Dominant Purpose test (i.e. whether there is the dominant purpose of enabling the relevant taxpayer(s) to obtain a tax benefit in connection with the scheme).

The Bill makes it clear there are now two separate and distinct limbs under Part IVA which may give rise to a Tax Benefit - i.e. where the taxpayer obtains a favourable tax effect (a lesser amount being included in assessable income or a greater deduction being available, etc) and such an effect either *would not* (**First Limb**) or *might reasonably be expected not* (**Second Limb**) to have occurred if the scheme had not been entered into or carried out.

We make no comment in relation to the proposed operation of the First Limb under the Bill. However, we make the following submissions and observations on the Bill as it concerns changes to the operation of the Second Limb.

The changes to the Second Limb seek to do the following:

1. eliminate the 'Do Nothing' defence which was successfully argued by the taxpayer in the Full Federal Court decision in RCI;
2. place constraints around the range of matters which can be considered in the alternative postulate enquiry under the Tax Benefit test by placing statutory restrictions on what can be considered; and
3. eliminate tax as a consideration under that test.

We are concerned whether any change to the legislative framework of Part IVA is needed as it has served both the Commissioner and taxpayers well over the past 30 years in eliminating Tax Benefits, which have arisen under blatant, artificial and contrived arrangements.

The proposed changes under the Bill are an example of bad cases making bad law. The recent defeats for the Commissioner in the Federal Court have not been as a result of any legislative defect in the existing Part IVA, but rather the outcome of cases selected by the Commissioner, which each ultimately turned on the application of Part IVA to evidence presented by both parties on particular facts and circumstances.

The proposed changes under the Bill may unduly restrict the Part IVA enquiry, eliminating genuine commercial considerations and costs which should appropriately be considered by both the ATO and the courts alike, before applying the general anti-avoidance rule.

In considering the proposed changes, the context of the policy behind the existing regime should be emphasised. The explanatory memorandum accompanying Part IVA explained that Part IVA was:

---

[3] *Commissioner of Taxation v Futuris* (2012) 205 FCR 274; *RCI Pty Ltd v Commissioner of Taxation* [2011] FCAFC 104; *Commissioner of Taxation v AXA Asia Pacific Holdings Ltd* (2010) 189 FCR 204; and *Commissioner of Taxation v Trail Brothers Steel and Plastics Pty Ltd* (2010) 186 FCR 410.

> designed to.....provide an effective general measure against those tax avoidance arrangements that — inexact though the words may be in legal terms — **are blatant, artificial or contrived'** (see explanatory memorandum, Income Tax Laws Amendment Bill (No 2) 1981).

The recent defeats by the Commissioner in the Federal Courts do not indicate any defect in Part IVA achieving this policy intent.

This point is illustrated by the respective Full Federal Court decisions of *British American Tobacco Australia Services Ltd v Commissioner of Taxation* (**BAT**)[4] and *AXA Asia Pacific Holdings Ltd* (**Axa**)[5]. Each of these cases involved an examination of the tax consequences associated with and potential application of Part IVA to internal movement of assets made by the respective Taxpayers, prior to the external sale of those assets.

In BAT, a decision which was favourable to the Commissioner, the court looked at the available evidence and concluded that the manner in which the transaction was undertaken and the transfer of assets to another entity was *explicable only by taxation consequences: s 177D(b)(I)"* [6]

By contrast, the court in Axa concluded, based upon the objective facts and commercial evidence presented, that the Commissioner's alternative postulate 'was not sufficiently reliable for it to be regarded as reasonable'[7].

These judgments highlight that there is no defect in Part IVA but rather that the courts' decisions in each instance turned upon evidence presented about the commerciality or otherwise of each step of the arrangements. These outcomes are consistent with an anti-avoidance regime intended to only apply to blatant, artificial and contrived arrangements.

Similarly in the RCI proceedings, it was noted by Gummow J during the course of the special leave hearing that the transactions under review were the 'sort of international structure, *which is not a contrived structure* for this purpose'[8].

The outcome of the RCI decision was once again consistent with the original policy intent of Part IVA.

We can see no justification for the parliament in expanding the operation of Part IVA from blatant and contrived to impact upon genuine and commercial transactions.

We can also see no policy justification for a blanket prohibition on the 'Do Nothing' defence and the normal consideration by taxpayers of the income tax consequences of arrangements, particularly those that concern voluntary and internal corporate reorganisations.

Under the existing Part IVA, there are already sufficient restraints on the operation of the Tax Benefit test. That is, an alternative postulate can only be considered if it is a 'reasonable expectation' of what might have occurred, absent the scheme.

This point was highlighted by Edmonds J in the first instance Federal Court decision in the Mongoose case where he suggested that the 'Do Nothing' defence in RCI would only be reasonable in the context of internal and voluntary transactions.

We can see no policy justification in undermining the fabric of Part IVA to overcome a limited class of cases. We can also see no reason in unduly restricting the Tax Benefit test and requiring taxpayers, in undertaking a voluntary and internal restructure of its organisation, in arranging its

---

[4] (2010) 189 FCR 151
[5] (2010) 189 FCR 204
[6] *British American Tobacco Australia Services Ltd v Commissioner of Taxation* (2010) 189 FCR 151 - paragraphs 51 to 53 affirming the trial judge's comments.
[7] AXA Asia Pacific Holdings Ltd (2010) 189 FCR 204 at paragraph 141-143
[8] *Commissioner of Taxation v RCI Pty Limited* [2012] HCATrans 6

affairs in such a way that attracts the highest tax costs, which has been acknowledged by the High Court as an ordinary costs of business[9].

Apart from the elimination of the 'Do Nothing' defence we can also see no policy justification for unduly restricting the Tax Benefit test by requiring an alternative postulate to have the same substance and result as the scheme identified.

In structuring their affairs, taxpayers may have regard to a broad range of potential arrangements and alternatives which each may differ slightly in terms of substance and outcome. Placing artificial constraints on the Tax Benefit test may limit a court's ability to look at a range of genuine concerns, pressures and opportunities experienced by taxpayers in the real world.

As a matter of good policy Part IVA should properly consider all relevant commercial considerations including 'Do Nothing' and tax considerations, providing those considerations are a reasonable alternative to the scheme implemented.

Finally, we note that restricting the Tax Benefit test and concentrating on the Dominant Purpose test will not necessarily result in any changes to outcomes of the court decisions which have been expressed to be of concern to the Treasury.

For example, whilst the High Court denied the Commissioner special leave to appeal the RCI decision in relation to the Tax Benefit test taking tax outcomes into consideration, it also made the observation that even if special leave had been granted, that the Commissioner would not have succeeded on Dominant Purpose."[10] Justice Gummow rejected the Commissioner's arguments on Dominant Purpose not being satisfied that the Full Court had erred in the application of the respective criterion.

Schedule 2 – Modernisation of Australia's transfer pricing rules

This formal submission to the Committee follows our earlier submissions to Treasury of:

- 5 December 2011 in relation to Treasury's Consultation Paper, *Income Tax: Cross Border Profit Allocation – Review of Transfer Pricing Rules* released by the then Assistant Treasurer on 1 November 2011, and

- 20 December 2012 on the exposure draft legislation of *Tax Laws Amendments (Cross-Border Transfer Pricing) Bill* 2013 and explanatory memorandum of the proposed amendments to implement the second stage of the transfer pricing reforms. These were released by the Assistant Treasurer on 22 November 2012.

Although the Bill has benefitted from consultation, some of our concerns with the proposed provisions remain. These were previously raised in a submission dated 22 February 2013 to the House of Representatives Standing Committee on Economics for its inquiry into the Bill and are reproduced below.

1. Reconstruction of transactions

Our members are concerned that the Bill appears to provide for a broader application for the reconstruction of transactions than was intended by the OECD in the TPGs. This could lead to:

- an increased risk of double taxation
- increased uncertainty for taxpayers under a self assessment regime.

Whilst our members understand that the policy intent of Subdivision 815-B is to align Australia's domestic transfer pricing (**TP**) rules closely with the OECD TPGs, they are concerned that the

[9] *Hart v Federal Commissioner of Taxation* (2002) 217 CLR 216 at 227
[10] *Commissioner of Taxation v RCI Pty Limited* [2012] HCATrans 29.

drafting of the Bill and EM goes beyond the scope of the intent of the TPGs. Our members note that the proposed rules require taxpayers to substitute the arm's length conditions for the actual conditions (if the conditions in section 815-120(1)(c) are met) and that the term "conditions" is intended to be interpreted broadly.

In identifying the arm's length conditions, section 815-130 specifies a "basic rule" and "exceptions" that includes a focus on transactions inconsistent with the economic substance and transactions that would not have been entered into by independent parties.

Although this structure is more in line with the position of the OECD guidelines than the exposure draft, our members consider that the provisions taken together place an excessive and onerous burden on the taxpayer and go beyond the intent of the OECD TPGs. It is important to bear in mind that many parts of the OECD TPGs are directed at tax administrations to help them resolve double tax that can arise under Article 9 of the Model Tax Convention. It is arguable that the references to reconstruction in the OECD TPGs are an example of this, especially the commentary in paragraphs 1.64 and 1.65 of the OECD TPGs.

These paragraphs are clearly directed at tax administrations seeking to review transfer prices and make it clear that the review should be of the "actual transactions undertaken". They do not appear to be drafted with a view to be included in domestic legislation.

Some useful restrictions in relation to the application of the "exceptions" are provided in the EM, however these are limited in their scope and the legislation itself remains broad in its potential application. There is real concern at the present time amongst taxpayers and advisors that the ATO will consider that powers to reconstruct actual transactions extend beyond that envisaged in the OECD TPGs. In this respect, we also draw your attention to recent discussions with the ATO's Transfer Pricing Working Group (**TPWG**). The TPWG is a working group of the ATO's National Tax Liaison Group (NTLG) International Subgroup and was established in the latter half of 2012 to consider potential administrative and interpretative matters arising in the context of the recently enacted Subdivision 815-A of the *Income Tax Assessment Act 1997* (**ITAA 1997**).

From the very first meeting of this new group, it became evident that there was a difference of understanding between the ATO representatives and external members of the TPWG as to what constituted circumstances under which the reconstruction of a controlled transaction should proceed as distinct from the re-pricing of a controlled transaction having regard to comparable uncontrolled transactions.

Discussions within the TPWG are continuing, however, this illustrates the need for the Bill to clearly place more defined restrictions on when the form of actual transactions should be disregarded. The absence of such a change in the Bill could increase the level of uncertainty to taxpayers and ATO auditors as to whether the ATO will seek to reconstruct actual transactions. Such uncertainty has the potential to heighten the risk of double taxation and increase the compliance burden on our members. This uncertainty will make Australia a less desirable location for capital investment.

Where reconstruction is considered necessary in line with the OECD TPGs, our members are of the view that the ability to reconstruct should only be relevant on determination by the Commissioner where the basis for the determination is clearly set out. The current drafting of the Bill requires taxpayers to self assess a reconstruction of a transaction which is an overly complex and unnecessary exercise.

2. Section 262A of the ITAA 1936

Taxpayers and public officers are potentially exposed to administrative penalties under section 288-25 of the *Taxation Administration Act 1953* (**TAA 1953**) and also to criminal penalties for failing to comply with section 262A (see PS LA 2005/2 (Penalty for failure to keep or retain records)). These administrative penalties are separate to and independent of any administrative penalties that might apply under Subdivision 284-B or 284-C of the TAA 1953.

According to paragraph 6.6 of the EM:

> "... It would be expected that to the extent that documents prepared in accordance with Subdivision 284-E relate to transactions or acts that would otherwise need to be recorded under section 262A, the documents prepared in accordance with Subdivision 284-E would satisfy the more general record keeping requirement under section 262A. **However where this is not the case, section 262A continues to apply in respect of any relevant transactions and acts." [Our emphasis]**

In other words, if documents are not prepared in accordance with Subdivision 284-E (which is open for the entity to do under that provision but it cannot have a reasonably arguable position in respect of that transaction(s)), it would seem that section 262A could still apply in regard to any relevant transactions or acts. The EM does not elaborate any further on what may be required to avoid this occurring.

This would seem to act against the objective of seeking to provide taxpayers with the flexibility to risk assess in regard to documentation requirements and administrative penalties under Subdivision 284-B or 284-C of the TAA 1953.

Therefore the Institute considers that the EM should provide clear guidance on what records taxpayers will need to maintain to avoid administrative penalties arising under section 288-25 of the TAA 1953 for failing to keep the records required by section 262A of the ITAA 1936.

3. Threshold for reasonably arguable position and the imposition of penalties

Administrative penalties will not apply in respect of Subdivisions 815-B or 815-C of the Bill where the scheme shortfall amount is equal to or less than an entity's reasonably arguable threshold.

The relevant thresholds proposed are those in subsection 284-90(3) in Schedule 1 to the TAA 1953, being the greater of:

- $10,000 or 1 per cent of income tax payable, or minerals resource rent tax (MRRT) payable by an entity for the income year; and
- $20,000 or 2 per cent of an entity's net income for an income year, where the entity is a trust or partnership.

The Institute submits that these "standard" thresholds for a reasonably arguable position and the imposition of penalties adopted in the Bill do not go anywhere near achieving the correct balance between compliance costs and the potential risk to revenue in the context of transfer pricing adjustments. This is particularly true for taxpayers in the SME segment.

Our view is that the monetary threshold of the scheme shortfall amount and for the imposition of penalties should be at least $5 million to achieve the right balance. (Please also refer to section 7 below for other SME segment comments).

4. Secondary adjustments

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

5. Permanent establishments (PEs)

Subdivision 815-C states that it applies the internationally accepted arm's length principle in the context of PEs. The Institute considers that it seems inconsistent to advocate a clear move to OECD guidance but to defer or avoid a similar move to accept OECD guidance on profit attribution (ie the 'functionally separate entity approach' rather than the 'relevant business activity approach').

The method of attributing profits to PEs is currently the subject of review by the Board of Taxation. Depending on the Board's findings and the government's response, proposed Subdivision 815-C

could change significantly. Given that the Board's report is due at the end of April 2013, the Institute queries whether it might be appropriate to delay finalisation of Subdivision 815-C until after this time.

6. Time limits for amending assessments

A compelling case has not been made as to why the Commissioner should be given a 7-year time limit for amending assessments under sections 815-150 and 815-240 rather than applying the normal time limits for amending assessments under section 170 of the ITAA 1936.

In this respect, it is particularly important to note that subsection 170(7) of the ITAA 1936 provides the Commissioner with the ability to obtain additional time in which to complete an examination of a taxpayer's affairs.

On this basis:

- The normal time limits for amending assessments under section 170 of the ITAA 1936 should also apply in transfer pricing cases.
- To ensure consistency with the preceding recommendation, subsection 170(9B) of the ITAA 1936 should also be amended to limit the Commissioner's ability to issue amended assessments in reliance on:
  - Applying the business profits article or the associated enterprises article of a relevant DTA;
  - Division 13; and
  - Subdivision 815-A;

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

7. SME segment concerns

In our view, in a proper balancing of compliance costs against revenue risks, it is essential that some taxpayers are completely carved out of the transfer pricing rules. This is on the basis that below a certain point it is just not cost effective or practical to impose transfer pricing guidelines. The UK has recognised this in its transfer pricing rules which provide that SMEs are exempt from the transfer pricing rules. An SME under this definition is one that has less than 250 employees and either:

- turnover of less than €50m; or
- assets with a balance sheet total of less than €43m.

We note that this approach of completely carving SME taxpayers out of the transfer pricing rules need not however, prevent the ATO from still being able to gather information to address any concerns it has around related party dealings by SMEs.

In any event, the Institute believes that penalties should not be imposed for any adjustment made under Subdivisions 815-B to 815-D on a SME taxpayer that has made reasonable efforts to comply with the legislation.

That is, it would be unfair in our view to impose transfer pricing penalties on any SME taxpayer that has made reasonable efforts to determine an arm's length price - notwithstanding that they may not have contemporaneous transfer pricing documentation.

For many SME taxpayers, putting together full contemporaneous transfer pricing documentation for every international transaction will simply be cost prohibitive - i.e. regardless of the potential penalties. However, if such taxpayers could prevent penalties by making reasonable efforts to determine an arm's length price, with a much lower compliance cost than that imposed by full transfer pricing documentation, then they would certainly be motivated to do so.

We note for completeness that the Canadian transfer pricing regime allows for a reduction in penalties where, inter alia, the taxpayer has made reasonable efforts to determine and use arm's length transfer prices.

As noted above, we also submit that there should be a de minimis exemption from penalties where a taxpayer's transactions with international related parties fall below a certain dollar threshold - this dollar threshold should ideally be more than $5 million but must, at very least, be no lower than $2 million in order to align with the threshold which must be met before taxpayers are required to complete and lodge an International Dealings Schedule as part of their tax returns.

8. Customs

The *Customs Act 1901* focuses on transactions whereas the Bill looks at overall profitability. Transfer pricing adjustments relating to some imported goods, particularly profit based transfer pricing adjustments, lead to a requirement to seek customs refunds which are administratively very difficult to obtain. Every effort should be made to take positive steps to address this issue.

* * * *