Law Council
OF AUSTRALIA
Business Law Section

12 April 2013

The Secretary
Senate Economics Legislation Committee
PO Box 6100
Parliament House
CANBERRA ACT 2600

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

Dear Sir / Madam

SENATE ECONOMICS LEGISLATION COMMITTEE

INQUIRY INTO THE TAX LAWS AMENDMENT (COUNTERING TAX AVOIDANCE AND MULTINATIONAL PROFIT SHIFTING) BILL 2013

1. This submission made by the Tax Committee of the Business Law Section of the Law Council of Australia (**Committee**) concerns the "modernization of transfer pricing rules" in Schedule 2 to the Bill.

2. The Committee has lodged a separate submission in relation to other aspects of the Bill.

3. The Committee welcomes the opportunity to make submissions in relation to the Bill.

4. Enclosed with this submission is a copy of the Committee's submission to Treasury dated 17 December 2012 in relation to the Exposure Draft of the proposed transfer pricing amendments, to which reference is made below.

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Endorsement of adoption of arm's length principle

5. The Committee endorses the move to adopt the arm's length principle as the basis for establishing prices for international related party transactions.

Suggested improvements to the Bill

6. The Committee however has a number of concerns in relation to the Bill.

Reconstruction Power

7. The Committee does not support conferral of a reconstruction power on the Commissioner. Reconstruction of transactions is an arbitrary exercise liable to result in double taxation. The Committee considers that in certain cases it may be necessary to go beyond the contractual terms and examine the functions, assets and risks to identify the substance of the transaction. However, that should be no warrant for substituting an allegedly more commercially realistic arrangement for that agreed by the parties. See further paragraph 6-9 of the enclosed submission.

8. The House Standing Committee on Economics recorded in its Advisory Report on the Bill (**House Advisory Report**) (see para 2.90 on page 51) that Treasury submitted that: *"[T]he ability to reconstruct dealings or arrangements under the proposed rules is entirely consistent with the OECD guidelines, which only permit reconstruction in 'exceptional circumstances'.*" Nowhere, however, is the phrase "exceptional circumstances" (or an analogous phrase) found in the Bill. The omission of this phrase is not explicable by reference to applying the OECD Transfer Pricing Guidelines to the "Australian context" (see House Advisory Report, para 2.96; c.f. 2.99). The House Committee is mistaken in its conclusion that the proposed amendments are consistent with the Transfer Pricing Guidelines in this regard (House Advisory Report, para 2.97).

Arm's length principle and the OECD Guidelines

9. Both the legislation and the explanatory memorandum ought reflect that the OECD Guidelines emphasize that when considering the arm's length conditions

the focus is transaction pricing. . Note 1 to s815-115(1) suggests that price is but one of the many potentially relevant "conditions".

10. The requirement in s815-135 that "arm's length conditions" be identified "so as best to achieve consistency with the documents covered by the section" highlights two problems: (1) what is the status of the Guidelines – are they an interpretative guide or effectively incorporated into domestic legislation, and (2) if the latter, it is undesirable that unelected tax administrators of foreign jurisdictions, or other unknown people or bodies, effectively dictate the operation of Australian domestic tax law.

11. The House Advisory Report concludes that (at para 2.96): *"While it is clear that the OECD TPGs are currently the best thinking on transfer pricing, the provision for guidance material also allows for reference to other material as international developments are made in relation to transfer pricing methodologies*."

12. That conclusion glosses over the uncertainty concerning the status of the guidelines. Further, it assumes that unelected tax administrators of foreign jurisdictions , or other unknown people or bodies, are the source of the "best thinking" on transfer pricing in the *Australian* context. Finally, *best practice* promulgation of legislation requires material by reference to which legislation is to be interpreted to be available to the legislature at the time of enacting the legislation rather than (as is contemplated by the Bill) material produced after enactment of the legislation given a quasi-legislative effect by way of promulgation of regulations. It is an abrogation of the legislative function to permit critical interpretative text to be prescribed by regulation. It may expose (rightly or wrongly) the Executive to accusations of unfair discrimination. It is an undesirable development.

13. See generally paragraph 5 of the enclosed submission.

Onus of Proof in Reviews and Appeals

14. The information imbalance in the Commissioner's favour distinguishes transfer pricing matters from other tax matters and warrants a reversal (or at least a re-

balancing) of the onus of proof (see paragraphs 10-13 of the enclosed submission). For example, once the Commissioner determines (rightly or wrongly) that independent entities "would" have entered into other commercial arrangements (see s815-130(3)(a)-(b)), the onus will fall on the taxpayer to prove otherwise. Information about the arrangements of comparable taxpayers will be readily available to the Commissioner – but not the taxpayer. It follows that the policy grounds for taxpayers generally bearing the burden of proof in taxation matters are not applicable in the transfer pricing context. The suggestion that "would" in s815-130(3) imposes a higher standard of proof on the Commissioner in forming the relevant view is not to the point (c.f. EM, para 3.102). Unfortunately the House Advisory Report does not address this issue.

Documentation obligations

15. The Committee agrees with the approach of tying base document obligations to the level of penalties. However, the Committee strongly disagrees that base document obligations should be a pre-condition to demonstrating a reasonably arguable position. The assessment of whether a taxpayer has a "RAP" is an objective inquiry that ought not be pre-judged by reference to the level of documentation: see paragraphs 18-19 of the enclosed submission.

16. A more sensible *de minimis* exclusion for penalties than $10,000 or 1% of tax payable ought be included. Contrary to the suggestions otherwise in the Explanatory Memorandum (e.g. EM, para 6.26) and the conclusion expressed in the House Advisory Report (para 2.126), such a low threshold *effectively* makes the documentary obligations mandatory in all cases: see paragraphs 15-16 of the enclosed submission. Moreover, the *intention* that an entity only need maintain documentary records of "material" matters (EM, paras 6.25-6.26) is not reflected in the text of s284-255. It is no answer that the Commissioner has a broad discretion to remit penalties (c.f. House Advisory Report, para 2.127). It is poor public policy to impose unwarranted penalties on taxpayers on the assumption that the penalties *might* be remitted *after* the taxpayer has been put to the expense and inconvenience of paying the penalty and then seeking remission of the penalty, including the costs associated with seeking professional advice in respect of remission.

17. The documentation obligations may result in taxpayers routinely waiving client legal privilege in order to substantiate a RAP. This may have adverse public policy consequences, such as a practice developing of less comprehensive written advice being provided to taxpayers. See paragraphs 20-22 of the enclosed submission. This unwelcome development is not addressed in the House Advisory Report.

Yours faithfully,

Frank O'Loughlin

Law Council
OF AUSTRALIA

Professor (Emeritus) Sally Walker
Secretary-General

17 December 2012

The Manager
International Tax and Integrity Unit
The Treasury
Langton Crescent
PARKES ACT 2600

Via email: transferpricing@treasury.gov.au

Attention: Ms Lisa Clifton and Ms Kristen Baker

Dear Ms Clifton and Ms Baker

Modernisation of Transfer Pricing Rules: Exposure Draft of Tax Laws Amendment (Cross Border Transfer Pricing) Bill 2013 (Stage Two TP Reforms)

The Taxation Committee of the Business Law Section of the Law Council of Australia (the Committee) welcomes the opportunity to provide comments and submissions in relation to the proposed Stage Two Transfer Pricing (TP) Reforms. This follows on from the Committee's submissions in relation to previous consultations, including its letter of 30 November 2011 regarding Treasury's original consultation paper on the TP reforms (Consultation Paper Response) and its submissions to Treasury of 13 April 2012 (Stage One Submission) and the Senate Economics Legislation Committee of 11 July 2012 (Senate Submission) in relation to Subdivision 815-A of the *Income Tax Assessment Act 1997* ('ITA Act 1997') (collectively, the 'previous Committee submissions').

Outline of submission

1. In this submission, the Committee:

   - provides some introductory observations in relation to the proposed Stage Two TP Reforms and the consultation process;

   - comments on the arm's length principle and the manner in which the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines) are used in the proposed reforms;

   - expresses its concerns with respect to the power for the Commissioner of Taxation (the Commissioner) to reconstruct transactions having regard to their economic substance;

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- suggests that fairness would require that the reforms be accompanied by a reversal of the onus of proof where the Commissioner wishes to make an adjustment to the amounts self-assessed by a taxpayer; and

- submits that, given the new, effectively mandatory, documentation requirements, there is a need to introduce a real *de minimis* threshold to mitigate the compliance costs for taxpayers and ensure that such costs are reasonably proportionate to the revenue likely to be raised from the measures. The Committee has also suggested a number of other changes to make the operation of the regime clearer and more consistent with general tax principles.

Introductory comments

2. The Committee observes that the proposed Stage Two TP Reforms are intended to replace Division 13 of the *Income Tax Assessment Act 1936* (ITA Act 1936) and supersede Subdivision 815-A of the ITA Act 1997 as the domestic transfer pricing regime for income years commencing on or after the date of Royal Assent. Accordingly, it is critical that the new regime be considered carefully to ensure that it works effectively so that Australia gets its 'fair share' of tax from the activities of multinationals, but in doing so does not inappropriately deter investment in Australia or impede expansion of Australian businesses offshore.

3. In this regard, the Committee is concerned that, despite the delay in releasing an exposure draft of the Stage Two TP Reforms, only a short period of one month leading into Christmas has been allowed for consultation. This limits the opportunity for reflection on the measures which might better inform their design and avoid the kinds of issues which have arisen in relation to the operation of Division 13.

4. The Committee urges the Treasury to consider releasing a second exposure draft for further consultation as early as possible in 2013 to allow for the introduction of the rules in the Autumn sittings of Parliament.

Arm's length principle and the use of OECD Guidelines

5. As indicated in the previous Committee submissions, the Committee endorses the move to expressly adopt the arm's length principle as the basis for establishing prices for international related party transactions. However, the Committee has the following concerns regarding the manner in which this is done in the proposed Stage Two TP Reforms:

   (a) Proposed Subdivision 815-B focuses on the arm's length conditions of a transaction. This does, of course, reflect the words used in associated enterprises articles of Australia's Double Taxation Agreements (DTAs). However, the broad and potentially ambiguous words are given content through the OECD Guidelines. Importantly, the OECD Guidelines emphasise that the focus remains on pricing the relevant transactions undertaken by the parties (see, for example, paragraph 1.64 of the OECD Guidelines). As indicated in section 4 of the Committee's Stage One Submission, this should be reflected in the explanatory memorandum (the current draft of which mostly avoids any reference to transactions), if not in the legislation itself.

(b) Section 815-130 requires that the provisions be interpreted 'consistently' with the OECD Guidelines. As a general observation, this drafting technique creates some ambiguity about what 'consistently' means, particularly where the terms used in our domestic legislation differ from those used in the OECD Guidelines. If it is simply intended to suggest that the OECD Guidelines are a legitimate aid to construction, then it ought to be reflected in the language of the provision. If it is intended to convey that the OECD Guidelines are effectively incorporated into our legislation, then the Committee has real concerns about the impact on the sovereignty of the Australian Parliament given that the OECD Guidelines are developed by an unelected group of tax administrators from a limited number of (OECD member) countries.

(c) The Committee also has concerns about the powers contained in section 815-130(2)(b), (3) and (4) to select parts of the OECD Guidelines and other materials to use, and other parts to ignore. This could, in an extreme example, be used to discriminate against a certain class of taxpayer, and creates a lacuna as to the interpretation to be applied where the OECD Guidelines include commentary which is ignored.

Reconstruction of transactions

6. The potential for the Commissioner to 'reconstruct' all or part of a transaction seems to be embodied in the references in section 815-125(5) to the 'economic substance' of a transaction. Thus, in the explanatory material to the exposure draft, the following comment is made:

> *'2.87 If it were the case that independent entities would not have dealt with one another in the way that the two entities did, the transfer pricing question can extend to identifying what would have instead been done by entities dealing wholly independently with one another in comparable circumstances, and the arm's length conditions that would have arisen from those dealings. In* ***substituting*** *actual dealings or arrangements, a necessary precondition is that independent entities would not have done what was actually done given the options that are realistically available to them - it is not of itself sufficient to propose that independent entities would have done something else.'* (Emphasis added)

7. The Committee is extremely concerned with an attempt to give the Commissioner power to reconstruct all or part of a transaction. As observed in the OECD Guidelines, any attempt at reconstruction is necessarily an arbitrary exercise which is prone to result in double taxation where the other jurisdiction involved respects the form of the transactions entered into by the parties (at paragraph 1.64).

8. In the Committee's view, the references to 'economic substance' should mean no more than that it is necessary to identify the real transaction entered into by the parties, which may in some cases require an examination of functions, assets and risks beyond the pure contractual terms. However, where the contractual terms reflect the allocation of functions, assets and risks between the parties, there should be no warrant for substituting some other, allegedly more commercially realistic, arrangement.

9. To the extent that these arguments are not accepted, and there will be a power to reconstruct transactions, the Committee considers this should be subject to a determination being made by the Commissioner where 'exceptional circumstances' exist as set out in paragraph 1.64 of the OECD Guidelines, and that the legislation should set out criteria to be considered by the Commissioner in exercising what is otherwise an unbridled and potentially arbitrary power. This will obviate the risk of inadvertently expanding (or contracting) the scope of the power in circumstances where there is no international consensus as to when and, if so, how such a power applies.

Reversal of onus of proof

10. In the previous Committee submissions, the Committee has indicated the need for a reversal of the onus of proof to reflect the shift in the 'information balance' between the Commissioner and taxpayers brought about by the move away from traditional transaction methods to profit methods. By that the Committee means that the Commissioner has access to information on profits across the full taxpayer pool, whereas taxpayers are limited to information from their related parties and what can be gleaned from commercial databases.

11. This issue is even more critical in the self-assessment environment contemplated by the proposed Stage Two TP Reforms than it was in relation to Subdivision 815-A. The Committee considers that, provided a taxpayer has documentation to reasonably support its chosen methodology, the onus should shift to the Commissioner to prove that the methodology is not, in fact, the most appropriate method (see also paragraph 37 of the Committee's Consultation Paper Response). This aligns with the comments in the OECD Guidelines (at paragraph 2.11) that it should not be necessary for taxpayers to apply multiple methods, which would otherwise create a significant burden for taxpayers.

12. Further, in the event the Commissioner makes adjustments, it should be incumbent on him to identify the specific items of income or deductions which are the subject of adjustment, as is the case in section 815-30(2).

13. In the alternative, as indicated in section 3 of our Stage One Submission, an alternative to reversing the onus of proof would be to remove the presumption in appeals under Part IVC of the *Taxation Administration Act 1953* (TAA) to the Administrative Appeals Tribunal or the Federal Court in respect of Division 815 that the Commissioner of Taxation's decision is correct.

Documentation obligations

14. The Committee agrees with the approach of incorporating base documentation requirements into the legislation (proposed ss.815-305 and 815-310) and tying these to the level of penalties. However, the Committee has a number of concerns with the manner in which this is currently proposed to occur, as follows:

    De minimis exception

15. The only exception to penalties, and hence to the documentation requirements, is where the relevant adjustment is less than (the higher of) $10,000 or 1% of tax payable (proposed s.284-165(1) of the TAA). This will effectively make the documentation mandatory (notwithstanding the suggestions to the contrary at paragraph 1.24 of the explanatory material to the exposure draft), even where the cost of maintaining documentation is disproportionate to the likely revenue to be raised.

16. The Committee believes that there should be a more sensible *de minimis* exclusion that is tied to the value or significance of the dealing in the context of the taxpayer's business.

Transitional relief

17. The Committee notes that, for those taxpayers with extensive intercompany dealings, it will be a significant task to review and update their existing documentation and, where necessary, create new documentation to ensure compliance with the requirements in proposed Subdivision 815-D. Accordingly, the Committee recommends that a transitional provision be included in the proposed provisions enabling an entity to have up to six months after the date on which the relevant entity lodges its income tax return for the income year first occurring after the commencement of Subdivision 815-B, to prepare the records in accordance with proposed Subdivision 815-D.

Reasonably arguable position

18. The Committee also has concerns that the effect of proposed sections 815-305(1) and 815-310(1) is that the absence of a Reasonable Arguable Position (RAP) hinges conclusively on the non-fulfilment of the base documentation requirements. The assessment of whether a RAP exists is an objective one.[1] Accordingly, while the Committee has no objection to the level of penalties being higher if appropriate documentation is not in place, this should not be by way of deeming there to be no RAP.

19. In this regard, the Committee considers it more appropriate to tie the documentation to the question of whether reasonable care has been taken or, alternatively, the remission of penalties, rather than whether or not a RAP exists. Further, guidance should be provided as to:

    a. the impact of immaterial errors or omissions in the relevant documentation on the application of the penalty; and

    b. the interaction of the relevant provision with the Commissioner's guidelines on remission in Taxation Ruling TR 98/16.

Privilege/Accountants' Concession

20. The Committee is concerned that the documentation requirements may implicitly incorporate a requirement to provide the documentation to the Commissioner and result in the abrogation or waiver of client legal privilege or the accountants'

[1] Refer, for example, to *Walstern v Commissioner of Taxation* (2003) 138 FCR 1.

concession. It is reasonable to expect that, under the documentation obligations, records kept by taxpayers will include discussion of alternate methodologies to the approach taken. If it is the case that taxpayers will waive privilege (or any entitlement to the concession) upon the submission of documentation, the proposed documentation and disclosure requirements, which are mandatory in substance, will invariably put taxpayers at a significant disadvantage in tax disputes. Further, this may also lead to advisers providing less comprehensive written advice than is otherwise desirable.

21. Under paragraphs 9.10 to 9.14 of Taxation Ruling TR 98/11, the current requirement for documentation does not abrogate or override privilege or the concession. This should also be reflected in the explanatory material for the proposed legislation.

22. Further, while the failure to hand over the documentation to the Commissioner where privilege or the concession applies might lead to him imposing the higher rate of penalty, the Committee considers that a Court or the Tribunal should still have the ability to subsequently determine that appropriate documentation was in place to justify the lower rate of penalty**.**

The Committee trusts these comments are of assistance. Please do not hesitate to contact Teresa Dyson, the Committee Chair, or Reynah Tang, the Committee's representative in relation to the Treasury consultation meetings, on should you require any further information.

This submission has been lodged by the authority delegated by Directors to the Secretary General, but does not necessarily reflect the personal views of each Director of the Law Council of Australia.

Yours sincerely

Professor Sally Walker
Secretary-General

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12 April 2013

Dear Sir/Madam

Senate Economics Legislation Committee
Enquiry into the Tax Laws Amendment (Countering Tax Avoidance and Multi-National Profit Shifting) Bill 2013 - Amendments to Part IVA Income Tax Assessment Act 1936

1. This submission on behalf of the Tax Committee of the Business Law Section of the Law Council of Australia (**Committee**) is concerned with the provisions of the Bill relating to the proposed amendments to Part IVA of the *Income Tax Assessment Act 1936* (see Schedule 1 to the Bill). The Committee has lodged a separate submission in relation to other aspects of the Bill.

2. The Committee welcomes the opportunity to make submissions in relation to the Bill.

3. **Enclosed** with this submission is a copy of the Committee's submission to the Standing Committee on Economics of the House of Representatives in relation to this same topic, to which reference is made below. The Committee will not reiterate in this submission the substantive submissions which were made to the House Committee. We would recommend that the Senate Committee revisit the submissions therein.

4. We largely confine our comments below to the matters arising from the Advisory Report on the Bill delivered by the Senate Committee (**House Advisory Report)**.

5. The principal concern of the Committee is that Parliament recognise that the amendments to Part IVA proposed by the Bill will fundamentally change the operation of Part IVA, contrary to what is said in the Explanatory Memorandum (**EM**) to the Bill (at paragraphs 1.71 and 1.134). (See further paragraphs 7 to 13 of the enclosed submission).

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Prior Consultation by Government

6. The House Advisory Report recorded (see paragraphs 1.10 to 1.14) that there was a consultative process undertaken by Government. The Committee commends the Government for seeking the views of stakeholders in relation to the proposed changes to Part IVA. However, notwithstanding the consultation the Bill adopts an approach that in many respects, as explained elsewhere in this submission, the Committee does not agree with. In the Committee's view it is inappropriate to refer explicitly to the consultation in the EM as it tends to imply that the Bill and the EM are in a form approved of by those parties involved in the consultation. Moreover, the references to the consultation processes in explanatory material may limit or preclude any reliance on that material at all. In this regard, where complex legislation 9which Part IVA undoubtedly is) has been enacted after significant consultation and negotiation with the private sector, it is a mistake to assume the existence of a clear policy objective: the proper approach, in such a case, is to construe the legislation "*solely by reference to its text*". See *Stevens* v *Kabushiki Kaisha Sony Computer Entertainment* (2005) 224 CLR 193 at 203 [32] to [34] per Gleeson CJ and Gummow, Hayne and Heydon JJ; at [126] per McHugh J.

Response to Court Decisions

7. In the Committee's view the current proposals are an overreaction to the Commissioner's losses in several recent cases (refer enclosed submission at page 4, and House Advisory Report at paragraphs 2.6 to 2.27). We agree with the position adopted in the Coalition Members Dissenting Report set out at page 62 of the House Advisory Report.

8. In the Committee's opinion poor case selection has resulted from the ATO seeking to use Part IVA in inappropriate situations. It has become increasingly apparent in recent years that the ATO tends to seek to apply Part IVA routinely to significant dollar value complex commercial arrangements. This tendency has been observed by learned commentators (e.g. refer Professor Graeme Cooper, "The Part IVA Deluge", TIA May 2011, at page 4, and Justice Logan, "Mission Accomplished - A Perspective on Part IVA", TIA 2012 at page 12).

9. Put another way, Part IVA has ceased to be a "measure of the last resort".

10. The tendency to broaden the ambit of the application of Part IVA means that it is applied to factual situations where, it is submitted, Part IVA was never intended to operate. This has led to the ultimate consequence that courts have found adversely to the Commissioner on factual matters and cases have been lost. This does not point to a significant or fundamental defect with the legislation itself. (Part IVA has, of course, been successfully applied by the Commissioner in many cases over many years).

11. The Committee believes that if the Government is motivated by a concern with the "do nothing" counterfactual, then that could have been addressed in a more

straightforward way by a minimalist and clear legislative amendment. The Bill goes far further than necessary to address the "do nothing" counterfactual. In doing so, it introduces considerable and unnecessary uncertainty into how Part IVA will be applied by the Courts in the future. In our submission, the language used in the amendments is unclear. Further to this, the very fact that the law as to identification of tax benefit and how tax benefit is viewed is the context of the dominant purpose inquiry, means that the continued application of precedent developed over the last two decades is uncertain. We believe this uncertainty is unnecessary and avoidable (see further paragraph 14 of the enclosed submission

12. The Committee reiterates the recommendation at paragraph 6 of the enclosed submission. That is, if it is to continue to be the government's policy is to exclude a consideration of tax costs from the identification of the reasonable alternative possibilities, the Bill should be amended to require that, while excluding a consideration of tax costs, the reasonable alternatives must be otherwise economically or commercially feasible.

13. The Committee finds it curious that the EM does not address in any detail precisely how Part IVA in its changed form would result in any different outcome to the cases which have motivated the amendments. Perhaps doing so would assist in clarifying both the mischief that is of concern and the particular scope and operation of the proposed rules.

14. The Committee welcomes the opportunity to speak to this and the earlier submission concerning the Bill. To facilitate further dialogue please contact Mark Friezer, the Committee Chair, from Clayton Utz on or me on .

Yours faithfully

Frank O'Loughlin

Law Council
OF AUSTRALIA
Business Law Section

22 February 2013

Committee Secretary
Standing Committee on Economics
House of Representatives
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Dear Sir,

Tax Laws Amendment (Countering Tax Avoidance and Multi-National Profit Shifting) Bill 2013 – Schedule 1 – Amendments to Part IVA Income Tax Assessment Act 1936

1. This submission of the Tax Committee of the Business Law Section of the Law Council of Australia (**Committee**) concerns the provisions of the Bill relating to the "General Anti-Avoidance Rules" (see Schedule 1 to the Bill). The Committee has lodged a separate submission in relation to other aspects of the Bill.

2. The Committee welcomes the opportunity to make submissions in relation to the Bill.

Executive Summary

3. The Explanatory Memorandum to the Bill states at paragraphs 1.4, 1.31 and 1.133 that losses in recent cases have shed light on weaknesses in Part IVA. The Committee does not accept that this is necessarily so. The results in those cases may be due either to poor case selection or case management by the ATO,[1] or attempts in litigation to try to make Part IVA extend to situations to which it was not intended to apply.

[1]Logan J ' Mission Accomplished? – A Perspective on Part IVA of the Income Tax Assessment Act 1936' (Paper presented at The Tax Institute 2012 Queensland Corporate Tax Retreat, Hyatt Regency Gold Coast, 6 September 2012). Ibid page 12 (referring also to a report by the Inspector-General of Taxation, 'Review of the

4. Be that as it may be, the government's policy has been to address the perceived weaknesses thought to be exposed by those cases. However, the concern of the Committee is that Parliament recognise that in doing so the Bill is not changing the application of Part IVA, within the original policy setting. The Bill would fundamentally change the operation of Part IVA as it would tax people by reference to things they did not do, and, importantly, would never have done.

5. The consequences of the Bill will be to create great uncertainty, additional compliance costs, conflict with other legal responsibilities of taxpayers and further, adversely differentiate our tax regime from those of other countries.

Recommendation

6. While the government's policy is to exclude a consideration of tax costs from the identification of the reasonable alternative possibilities, the Committee submits that the Bill should be amended to require that, while excluding a consideration of tax costs, the reasonable alternatives must be otherwise economically or commercially feasible.

The Bill changes the legislative policy underlying Part IVA

7. The Bill will change fundamentally the policy approach to tax anti-avoidance law followed in this country for the last 30 years. the comments made at paragraphs 1.71 and 1.134 of the Explanatory Memorandum to the Bill to the effect that the proposed amendments do not change any legislative policy do not reconcile with two significant changes in policy which result from the Bill which are discussed below.

8. The policy evident from the current words of Part IVA is to determine if a transaction produces an avoidance of tax by an objective test of comparing what the taxpayer did, which resulted in less or no tax, with the one reasonable alternative they may prove, by a forensic analysis of evidence, that they would have done (importantly, not might or could have done) in the alternative.

9. This is not an easy burden for a taxpayer to discharge. Indeed, the ATO has won cases on Part IVA because the taxpayer could not pass this test. Currently, the field is heavily slanted to the ATO by the applicable burden of proof rules. This requirement to compare what was done with the proven alternative course of action reflects a policy that if you did not have a tax liability from what you did do, and you would not have had a tax liability if you had instead done the one reasonable alternative (proven by the taxpayer), then there is no tax mischief – that is, there is no tax avoided.

Australian Taxation Office's Use of Early and Alternative Dispute Resolution', especially the section, "ATO Management of Tax Litigation", paras 6.17 to 6.32: http://www.igt.gov.au/content/reports/ATO_alternative_dispute_resolution/ADR_Report_Consolidated.pdf).

10. The first policy change reflected in the Bill is that no longer will the comparison be with the one alternative which the taxpayer proves would have happened, but with any reasonable alternative possibility which could have occurred. The Bill does not require these alternative possibilities (in relation to the 'reconstruction approach') to be economically or commercially feasible.

11. Because of that, and because the Bill proposes that those hypothetical possibilities are to be based on an assumption which excludes the tax costs of alternatives, the possibilities included in the ambit of the new law will include possibilities which would never have occurred.

12. The second policy change reflected in the Bill is explained in paragraphs 1.56 to 1.59 of the Explanatory Memorandum. That is, the present requirement that a tax benefit be obtained in connection with a scheme before a determination is made of dominant purpose, will be replaced with a single unified enquiry into whether or not the taxpayer's dominant purpose in entering the scheme was obtaining a tax benefit.

13. This also reveals a logical difficulty in the operation of the proposed amendments. That is, it is difficult to conceptualise the 'single inquiry' explained at paragraph 1.58 of the Explanatory Memorandum as to whether or not someone has a dominant purpose of obtaining a tax benefit, without articulating first what that tax benefit is.

Consequences of the Change in Approach

14. The change in approach to the application of Part IVA will have a number of detrimental consequences, as outlined below:

(a) *Increased uncertainty*

The consequence of legislating this Bill will be to create significant difficulties, for ordinary taxpayers, small businesses and large corporations (both Australian and foreign) in understanding their tax obligations. They will be required to assess their tax obligations by reference to the tax which would have been paid if they had done something that in reality they would never have done.
Further, the significant body of case law which has developed over the last 20 years - where courts have developed the interpretation of Part IVA in response to a variety of commercial circumstances would, if the Bill is enacted in its current form, be largely otiose. The lack of applicable precedent means courts will need to "start from scratch". Again this leads to an environment of increased uncertainty.
Because it would create this uncertainty, this Bill breaches a basic principle of the rule of law – that every citizen should be able to know what the tax law is and how it applies to them.

(b) *Increased compliance costs*

Legislating the Bill, with its inherent uncertainty of operation discussed above, will increase compliance costs for taxpayers.

(c) *Creating conflicting legal responsibilities for directors and trustees*

This Bill will require taxpayers (such as company directors and trustees) who have a duty (under the *Corporations Act 2001* (Cth) or trust principles), to consider tax costs in deciding how to act for the benefit of others, assess the acceptability of transactions by reference to one or more hypothetical alternative transactions while ignoring tax costs. In other words they need to hypothesise alternative transactions as viable which, if they were pursued, would cause or give rise to breaches of duty.

(d) *Australia will be out of step with other developed countries' tax regimes*

This Bill will move Australia's tax law even further out of step with the tax laws of our major trading partners and capital providers. Part IVA is already far stronger than tax general anti-avoidance rules in other developed countries - USA, Canada, UK - let alone the dynamic economies of China, India, Singapore, Japan and the Asia Pacific. For example, in Canada, a society and economy similar to ours, its anti-avoidance rules ('GAAR') have a business purpose exception, and a requirement that they only apply in cases where the transaction involves a use or mis-use of the tax laws.

(e) *Increased sovereign risk*

The uncertainty and difficulty of the application of this Bill, and its retrospective effect, will add to the sovereign risk for foreign investors of dealing with Australia.

Retrospective Operation

15. The Bill is substantially different in its terms from the draft Bill released for consultation on 16 November 2012 (for example, there is a substantive change in approach to the operation of the amended law; and new drafting around the annihilation approach and the reconstruction approach are not contained in the consultation draft of 16 November 2012). It is inappropriate for the amendments contained in this Bill to have retrospective effect from 16 November 2012, as the legislative amendments now introduced are significantly different, so that taxpayers could not have known the proposed legislative landscape at that time.

Conclusion

The ATO is concerned that it has lost some recent cases on Part IVA. This does not signal a design flaw in Part IVA. In the 1990's the ATO lost the first case on Part IVA to reach the High Court of Australia[2]. The ATO overcame that loss and over 30 years has found Part IVA to be effective. Part IVA has achieved its purpose[3]. An administrator of a statute losing cases occasionally is a healthy sign that the administrator is identifying where the boundaries of the statute lie.

Further contact

[2] *Commissioner of Taxation v Peabody* (1994) 181 CLR 359.
[3] Ibid, note 1.

The Chair of the Committee (Mark Friezer at Partner at Clayton Utz in Sydney) would be happy to speak to the foregoing should it be thought to be helpful.

Yours faithfully

Frank O'Loughlin
Section Chairman