The Institute of Chartered Accountants in Australia

13 July 2012

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

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

Dear Sir/Madam

Submission to inquiry on Tax Laws Amendment (Cross-Border Transfer Pricing) Bill (No. 1) 2012

The Institute of Chartered Accountants in Australia (the Institute) welcomes the opportunity to provide a submission to the Senate Standing Committee on Economics (the Committee) on its inquiry into the *Tax Laws Amendment (Cross-Border Transfer Pricing) Bill (No. 1) 2012 (the Bill)*.

Specifically, the Institute wishes to make comments on three aspects of the Bill. These can be summarised as follows:

- The proposed retrospective amendment to the law is being proposed in circumstances where it cannot be justified on either a policy or revenue integrity basis. (Our comments are in Part A of this submission).
- Despite our concerns with the proposal, if the government decides to proceed with the retrospective amendment of the law, it is critically important that the level of power to be exercised by the Commissioner under the treaties be clearly defined and understood. We do not believe that the amendments in the Bill achieve this. (Our comments are in Part B of this submission).
- In a proper balancing of compliance costs against revenue risks, it is essential that some small to medium enterprise (SME) taxpayers are completely carved out of the transfer pricing rules, (Our comments are in Part C of this submission).

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
- 17 April 2012 on the exposure draft legislation and explanatory memorandum of the proposed amendments to implement the first stage of the transfer pricing reforms. These were released by the Assistant Treasurer on 16 March 2012.

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Our views in this submission are consistent with the views expressed in those earlier submissions but have been updated in some respects for changes made during the development of this Bill.

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
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The Institute of Chartered Accountants in Australia

PART A - RETROSPECTIVE AMENDMENT

1. General – retrospective changes are highly undesirable

The Institute remains concerned that yet another retrospective amendment to the tax law is being proposed. This Bill follows recent changes in relation to other high profile examples such as amendment of the tax consolidation regime rights to future income rules, as well as amendments to the Petroleum Resources Rent Tax regime which date back over 20 years.

It has been a long-standing practice of the legislature that retrospective tax laws will only be passed in exceptional circumstances where the integrity of the tax system would be fundamentally jeopardised if not for the introduction of back-dated taxation laws. Recent reviews into the policy-making processes surrounding the development of taxation law in Australia have supported the conclusion that tax measures introduced by the government should generally operate on a prospective basis only.

Where retrospective tax laws have been contemplated, it has been broadly accepted that such situations would be limited only to instances where taxpayers were either not adversely impacted (i.e. neither worse off nor better off), or were in fact, favourably impacted.

Paragraph 3.21 of the 2008 report of the Tax Design Review Panel does acknowledge that in rare cases, retrospective tax laws may be appropriate where the changes 'rectify technical deficiencies from the date of the original legislation or where there is a serious risk to the revenue'.

A signal of the importance of freedom from retrospective laws has been held to be so critical to the basic rights of individuals and corporations that the constitutions of both the United States and Sweden have explicitly prohibited such a practice. Whilst Australia's constitution does not expressly prohibit the making of retrospective laws, the generally accepted practice of parliament has been to only exercise those powers sparingly, often only in extreme and exceptional circumstances.

From a practical perspective, businesses that have fulfilled their tax obligations and complied with the law as it existed are now being asked to go back and re-assess their positions in light of the new version of the old law. Needing to do so causes significant frustration, imposes considerable administrative costs, and in some cases may lead to an obligation to pay more tax than paid previously if appropriate safe-guards are not put in place. These problems are amplified by the impact on the perception of Australia in the international marketplace as a stable environment in which to do business.

The Institute considers that retrospective amendments are undesirable and can only be justified in exceptional circumstances.

2. Specific issues with the proposed tax treaty retrospective change

Proposed amendments are not a mere clarification of the law

In the Media Release of 1 November 2011, the then Assistant Treasurer stated that the law will be amended to "clarify that transfer pricing rules in our tax treaties operate as an alternative to the rules currently in the domestic law". The change is to have effect from 1 July 2004. The announcement also includes the statement that "recent court decisions suggest our existing transfer pricing rules may be interpreted in a way that is out-of-kilter with international norms".

We agree that the decision in *SNF (Australia) Pty Ltd v Commissioner of Taxation* [2011] FCAFC 74 ("SNF") indicated that some changes to Division 13 of the *Income Tax Assessment Act 1936* (ITAA 1936), may be appropriate. However, the decision in *SNF* is not relevant to the issue of whether the Associated Enterprise Articles of the Double Tax Agreements (DTAs or treaties) give rise to a separate power to amend assessments.

The Institute is not persuaded by the reasons given to justify the retrospective change to 1 July 2004 in the Explanatory Memorandum (EM) to the Bill (paragraphs 1.16 -1.38).

If the Associated Enterprise Articles of the DTAs operate to provide a separate taxing power, we submit that there is no need to retrospectively amend the law. If the Associated Enterprise Articles do not operate to provide a separate taxing power, the proposed amendment in the Bill would not be a mere clarification. Irrespective of whether there was any parliamentary indication that the DTAs operate as an alternative to Division 13 of the ITAA 1936, the effect of the proposed amendment could be that a taxpayer that fully complied with the law as then enacted will be retrospectively exposed to tax. We consider that any amendment that has this effect is inequitable.

Despite the arguments set out in the EM, the Institute is of the view that, outside the context of resolving a double tax issue, there is considerable doubt over whether the ATO has the power to raise an assessment under a DTA that increases the tax payable position of a taxpayer.

As acknowledged in paragraph 1.35 of the EM, this view is supported by statements in various judicial decisions, even though in obiter, that tax treaties do not confer power to the Commissioner to assess (e.g. Downes J in *Roche Products Pty Ltd v FC of T* [2008] AATA 639).

In *SNF*, the Commissioner had the opportunity to have the Full Federal Court declare the law on the operation of the arm's length rule in a DTA. For whatever reason, the Commissioner chose not to have the Federal Court declare the law. Had the Commissioner not abandoned the DTA argument during the course of the SNF proceedings, there would be no need to legislatively clarify the existing operation of the law or, in the alternative, any retrospective amendments would unambiguously alter the existing operation of the law. It is clear that taxpayers may, potentially, be retrospectively and adversely affected by the proposed "clarification", which is a consequence of the Commissioner's decision to not pursue his argument in *SNF*.

Commissioner's analysis of the law is not a substitute for correct application of the law

We do not accept the position given in paragraph 1.36 of the EM. The Commissioner's analysis of the law, no matter how considered or long held, cannot substitute for the correct application of the law. In the absence of judicial precedent, taxpayers were entitled to take a position that is contrary to the Commissioner's view of the operation of the arm's length provisions of the DTAs and expect to have the right to challenge any assessment to confirm the position taken. Any retrospective amendment will take away a taxpayer's ability to challenge the Commissioner's view of the law. We consider this a breach of the rule of law.

No information provided on revenue claimed to be at risk

Given that this measure might provide the Commissioner with a power that might not presently exist, the measure cannot properly be described as having no financial impact. We submit that the Treasury should provide its estimates of the revenue that it considers is at risk.

Worse position where transactions are with DTA associated enterprises

The Institute is concerned that if the retrospective measures in the Bill are enacted, they will only apply to taxpayers who transact with associated enterprises in countries that have a DTA with Australia. Taxpayers who transact with associated enterprises in non-tax treaty countries will only be subject to current transfer pricing adjustments based on Division 13 of the ITAA 1936. In other words, affected taxpayers dealing with associated enterprises in DTA countries will be worse off, having to contend with both Division 13 of the ITAA 1936 and the proposed retrospective measures in this Bill. The Institute considers that this discriminatory.

Potential unresolved double tax and MAP implications

Paragraphs 1.47 to 1.50 of the EM provide comment on Mutual Agreement Procedure (MAP). The Institute considers this to be an oversimplification of the practicalities involved.

Notwithstanding the MAP mechanism, the Institute is of the view that there is the potential for significant unresolved double tax to be brought into existence for which positive resolution would be unlikely. This in turn would have a negative impact on the profile of Australia as an OECD member country and raise issues of sovereign risk for prospective future investment decisions.

To illustrate this point, it should be understood that Australian taxpayers who have lodged tax returns for the years commencing 1 July 2004 and onwards have a settled tax paid position in Australia, and the overseas related party entity transacting with the Australian taxpayer has a settled tax paid position in its jurisdiction. In a vast majority of cases, the tax returns lodged in relation to the related party transactions provide a symmetry of tax outcome (i.e., of the total profit earned on a transaction, tax will be paid on a portion in one jurisdiction and for the remaining portion in another). By implementing the retrospective treaty powers and raising assessments retrospectively, the ATO would necessarily bring into existence a situation where additional tax would become payable in Australia on transactions for which tax has already been paid in another jurisdiction. Thus a position of double tax would be brought into existence.

Where tax arises in this way under a treaty, the counterparties to the treaty have the power under MAP to attempt to relieve the burden of double tax. Although Australia currently has a good record of resolving MAP issues, this record has been forged in an environment where taxpayers have had the opportunity to follow largely stable and well understood ATO policies in a self-assessment environment. It is considered likely however, where there is a substantial retrospective change in the implementation of OECD powers of the type proposed in the Bill through the increased treaty powers, that counterparty OECD treaty partners would be much less inclined to find a solution that involves reducing their taxing outcome in order to allow Australia to increase its taxing profile. If this was to occur, at best taxpayers would be drawn into protracted and expensive MAP processes and it is submitted that there would be an increased likelihood that taxpayers would find themselves in a situation of unresolved double tax.

Conclusion

The Institute can only conclude that the case for a retrospective amendment cannot be justified.

PART B – CONSTRAINTS ON COMMISSIONER'S POWERS

Despite our concerns with the proposal, if the government decides to proceed with the retrospective amendment of the law, it is critically important that the level of power to be exercised by the Commissioner of Taxation under the treaties be clearly defined and understood. We do not believe that the Bill achieves this and set out our concerns below.

Reconstruction of transactions

The Institute has significant concerns in relation to the potential new retrospective reconstruction power which is claimed to be available to the Commissioner under the Bill.

With respect to the reconstruction of controlled transactions, 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 limiting application, the Institute notes the additional cautionary words in the OECD Transfer Pricing Guidelines[2]:

[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.

> "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."

It is the view of the Institute that, in effect, OECD guidance limits any potential reconstruction powers to the most exceptional of circumstances such that these powers would be largely inoperative. Even if it is accepted that this power does have some practical application (which is very unlikely), this power would be further restricted by a number of key administrative issues. In the Institute's 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 notion of what independent parties would or would not do if acting in a commercially rational manner.

The Institute recommendations are:

- Given the limited practical application of this power and for the sake of clarity, reconstruction power should be excluded from Subdivision 815-A in totality.
- To the extent that reconstruction power is not excluded in totality, Subdivision 815-A should not be modified by way of partial amendments in relation to this matter. This will ensure that the existing law is not inadvertently altered in favour of the ATO rather than being properly clarified (in line with the stated objectives of Treasury).
- The Commissioner's ability to amend assessments on a prospective basis in reliance on a new reconstruction power should be strictly limited.

PART C -- DE MINMIS THRESHOLD NEEDED FOR SMALL TO MEDIUM ENTERPRISES (SMEs)

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 small and medium enterprises are exempt from the transfer pricing rules. A small or medium enterprise 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.

This test is undertaken taking into account the whole of the group of which the UK enterprise is a member. Therefore a large multinational group with the resources to comply with transfer pricing legislation would not be carved out of the rules even if its local subsidiary was a relatively small operation.

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.

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[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.