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

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

Dear Sir/Madam

Thank you for the opportunity to make a submission to the inquiry.

Our comments in this submission reflect those areas we feel require urgent attention, as well as suggestions for their resolution. This submission is not an exhaustive list of the issues that the proposed legislation raises; rather it highlights the key areas where there may be some scope for change.

In particular, our submission focuses on the following areas of concern:

- determination of a transfer pricing benefit;
- application of the reconstruction rules;
- adjustments to taxable income arising from a transfer pricing benefit; and
- operation of the penalty regime.

Our suggested solutions recognise the practicalities of demonstrating arm's length pricing in the context of modern business models, and allow for a practical resolution of current deficiencies within the legislation.

If you have any comments or questions regarding any of the matters discussed in our submission, please do not hesitate to contact either of the undersigned. If it would facilitate your review of this important issue, we would be happy to discuss such matters in person.

Yours Sincerely

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Copy: The Hon. David Bradbury MP, Assistant Treasurer

Determination of a transfer pricing benefit

Issue: *The requirement that a transfer pricing benefit is determined having regard to the "conditions that operate between the entity and another entity" is potentially problematic for taxpayers that have highly integrated businesses with related party transactions involving a number of entities within the global multinational group. These taxpayers could be unfairly impacted as adjustments would be required to be made on an entity by entity basis. More specifically, given that the proposed legislation only operates to increase the taxable income of an Australian resident company, this entity by entity approach to the determination of a transfer pricing benefit would create situations where the ATO could make a transfer pricing adjustment with respect to a specific related party transaction that does not take into account other transactions between other foreign entities which could mitigate the need to make such adjustment.*

Explanation: Section 815-120 states that an entity gets a transfer pricing benefit from conditions that operate between the entity and another entity in connection with their commercial or financial relations.

The direct implication of this is that the legislation does not allow for any netting off of transactions with different related parties, with the result that a taxpayer would only adjust the dealings with those parties where they get a transfer pricing benefit. The taxpayer would therefore be required to identify whether there is a transfer pricing benefit for the conditions between it and each of its affiliates separately.

Consider a situation where a distributor purchases goods from a number of affiliates, for which some lines of goods are very profitable and some are not. It is from time to time not uncommon for a distributor in this situation to consider the integrated business, accepting that some dealings will be undertaken at a loss. This is an arrangement that is commonly seen in businesses where a portfolio of goods is being purchased at a range of margins, some of which result in a profit, and some of which result in a loss.

Instead of being able to aggregate the dealings, which would be expected for independent parties, the distributor would have to analyse the conditions that exist between it and every entity with which it has dealings, in order to identify whether a transfer pricing benefit has been received. The distributor would then need to replace the conditions that result in a transfer pricing benefit with arm's length conditions.

Division 13 of the Income Tax Assessment Act ("Division 13") was interpreted by the ATO in a series of existing Rulings. Under these Rulings the ATO recognised that transactions involving a range of entities could and should be aggregated in appropriate circumstances. These Rulings are administratively binding on the ATO and were facilitated by the fact that the application of Division 13 was only triggered in instances where the Commissioner exercises his discretion to do so.

The requirement to make adjustments on an entity by entity basis under 815-B could result in the ATO adjusting for a specific transaction between two entities, without considering the commerciality of the taxpayer's business as a whole or the arm's length nature of integrated related party transactions. Further, a strict requirement to test for a transfer pricing benefit on an entity by entity basis may be inconsistent with the correct application of the most appropriate method. For example, the correct application of a Transactional Net Margin Method or a Profit Split may require the aggregation of transactions with numerous affiliated entities operating in various countries.

Allowing the consideration of transactions more holistically is also consistent with our trading partners. For example the decision of the Supreme Court of Canada in *GlaxoSmithKline*[1] emphasised that all of the circumstances of the Canadian taxpayer relevant to the price must be considered (in this instance, the existence of a licence agreement with a UK affiliate was deemed to be relevant to the purchase of goods from a Swiss affiliate).

[1] Her Majesty the Queen v GlaxoSmithKline Inc 2012 SCC 52

Suggested resolution: Section 815-120 should be redrafted to take into consideration the integrated commercial activities of taxpayers, and allow sufficient recourse to an aggregation of transactions where it is appropriate having regarding to the commercial context of a taxpayer's overall business.

Application of the reconstruction rules

Issue: *The legislation does not specifically incorporate the OECD requirements that set out the circumstances under which it is appropriate to reconstruct a transaction. Instead it relies on a broad definition of "conditions that operate" that could provide a transfer pricing benefit, and the omission of a key OECD caveat over the reconstruction of the economic substance.*

The combination of these definitions and omission provides the ATO with broader powers to reconstruct a related party arrangement than was intended under the OECD guidelines. The omission of the OECD requirements around reconstruction from the face of the legislation is likely to be interpreted by the courts as a deliberate departure from the words of the OECD Guidelines notwithstanding any comments in the Explanatory Memorandum, and therefore make the reconstruction rules easier to apply than is intended by the OECD Guidelines.

Explanation: The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations ("OECD Guidelines")[2] include an important caveat to the application of the reconstruction provisions. The OECD Guidelines require tax administrations to accept the economic substance of the arrangements between entities unless there is an exceptional reason not to do so. More specifically, in determining whether it is appropriate *to reconstruct* the transactions of an entity, paragraph 1.65 of the OECD Guidelines includes an additional requirement to section 815-130 - that "the actual structure practically impedes the tax administration from determining an appropriate transfer price".

This additional requirement is an important limitation on a revenue authority's power to reconstruct transactions in situations where such a reconstruction is not appropriate. It is particularly important in the context of business restructures, where the OECD Guidelines state the following:

> *If a more profitable structure could have been adopted, but the economic substance of the taxpayer's structure does not differ from its form* ***and the structure is not commercially irrational such that it would practically impede a tax administration from determining an appropriate transfer price, it is not disregarded.***[3] (Emphasis added)

Further, the OECD Guidelines state:

> *...If an appropriate transfer price...can be arrived at in the circumstances of the case,* ***irrespective of the fact that the transaction or arrangement may not be found between independent enterprises and that the tax administration might have doubts as to the commercial rationality of the taxpayer entering into the transaction or arrangement****, the transaction or arrangement would not be disregarded under the second circumstance in paragraph 1.65.*[4] (Emphasis added)

Finally, the OECD Guidelines state:

> *The difference between restructuring the controlled transaction under review which, as stated above, generally is inappropriate, and using alternatively structured transactions as comparable*

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[2] Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, as approved by the Council of the Organisation for Economic Cooperation and Development and last amended on 22 July 2010.
[3] Ibid at paragraph 9.60
[4] Ibid at paragraph 9.180

> *uncontrolled transactions is demonstrated in the following example. Suppose a manufacturer sells goods to a controlled distributor located in another country and the distributor accepts all currency risk associated with the transactions. Suppose further that similar transactions between independent manufacturers and distributors are structured differently in that the manufacturer, and not the distributor, bears all currency risk. In such a case,* ***the tax administration should not disregard the controlled taxpayer's purported assignment of risk unless there is good reason to doubt the economic substance of the controlled distributor's assumption of the currency risk***[5]*. ...* (Emphasis added)

The omission of the specific language of the OECD Guidelines around reconstruction and the inclusion of a broad definition around "conditions that operate" have the following implications:

- Inappropriately allow the reconstruction of a taxpayer's arrangement in situations where such reconstruction would not have occurred under the OECD Guidelines;
- Negatively impact a taxpayer's ability to avoid double tax through Australia's treaty network by allowing a potential departure from the OECD Guidelines around reconstruction.

Suggested resolution: the additional requirement set out by the OECD Guidelines, that the actual structure practically impedes the tax administration from determining an appropriate transfer price, should be included within the legislation in section 815-130 in identifying "arm's length conditions".

Adjustments to taxable income arising from a transfer pricing benefit

Issue: *The provisions do not require the ATO to identify individual transaction amounts with a sufficient level of granularity to ensure relief under the MAP articles of Australia's double tax agreements and address the impact on other areas, such as the ability to claim Customs duty or withholding tax refunds.*

Explanation: Unlike Subdivision 815-A, the operative provision of Subdivision 815-B does not require the identification of individual amounts of income or expense when making a transfer pricing adjustment.

The Subdivision applies for purposes of "working out" the amount of an entity's taxable income, loss of a particular sort, tax offsets or withholding tax. The Explanatory Memorandum, at paragraph 3.16, states the following:

> *Subdivision 815-B does not contain an explicit rule requiring individual amounts to be specified. A rule of this kind is not necessary because under Subdivision 815-B an entity is required to* work out *its taxable income, loss of a particular sort, tax offsets or withholding tax payable...*

This would mean that, for example, in working out an entity's taxable income, you look to that entity's assessable income and allowable deductions. The legislation would not require any consideration beyond this point.

Suggested resolution: Similar to Subdivision 815-A, section 815-115 should include a requirement that any adjustments made (including adjustments made at the net profit level) be related back to the transaction level. This will enable taxpayers to identify and address potential double taxation as well as other impacted areas, such as Customs.

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[5] Ibid at paragraph 1.69

Operation of the penalty regime

Issue: *There is insufficient clarity on what is expected of taxpayers in preparing their transfer pricing documentation for purposes of obtaining a RAP and avoiding potential penalties for adjustments to taxable income in connection with a transfer pricing benefit.*

Explanation: The documentation requirements are linked to the penalty regime; however there is insufficient clarity on the expectations placed on taxpayers in preparing their documentation to avoid or mitigate such penalties.

In particular, the legislation is unclear as to what will be expected from taxpayers in order to establish a reasonably arguable position ("RAP"). Previously, TR98/11 was clear in setting out the expectations placed on taxpayers in preparing documentation of a sufficiently high quality, in order to avoid punitive penalties. The Explanatory Memorandum contains some information on what should be included in documentation, but needs to go further. In this regard, there should be some degree of flexibility to consider the merits of the documentation and the ability to support a RAP that is not solely based on the timing of the preparation of such documentation. Further, Section 284-255 is drafted in terms of "records kept by an entity", and does not specify which entity bears the responsibility for preparing documentation. This raises the question of whether it is sufficient for documentation to be prepared somewhere within a global organisation, or whether it needs to be prepared and or maintained by the Australian entity.

Finally, the relationship between taking reasonable care and having a reasonably arguable position should be clarified. Subdivisions 284-B and 284-C of the Taxation Administration Act 1953 apply independently, and as such may give rise to two separate penalties. The proposed rules do not contain any clarification on the relationship between establishing a RAP, and having taken reasonable care. As such, significant uncertainty arises, as the preparation of documentation by a taxpayer (thereby establishing a RAP for the purposes of scheme penalties) does not appear to impact upon whether a taxpayer has taken reasonable care (and therefore is exempt from penalties relating to statements).

Suggested resolution: The Explanatory Memorandum needs to include additional information on precisely what is expected from taxpayers in preparing their documentation. Specifically, the EM should include additional detail about:

- What is considered contemporaneous documentation?
- Who is able to prepare documentation for transfer pricing purposes?
- What is required to be covered in the documentation in order to establish a RAP?
- What the relationship is between a RAP and reasonable care?