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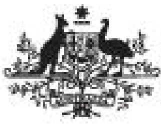

Australian Government
Australian Taxation Office

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In the best interests of Australia

Opening Speech by the Commissioner Michael D'Ascenzo
Corporate Tax Association Convention
Melbourne, 15 June 2009

The one thing most economists agree about the current global economic crisis is that the path ahead is uncertain.

As tax administrators we would like to make that path as safely navigable as possible for taxpayers.

Australia has escaped the technical definition of a recession - two consecutive quarters of negative GDP growth - but as the Prime Minister said, we are not out of the woods yet[1].

The global picture is of synchronised global recession in all the major markets of Northern America, Europe and Japan. Governments have found themselves in the unusual position of owning large parcels of banks and auto makers.

In Australia, the latest National Accounts show positive growth - albeit small - but amidst positive signs there is an outlook of lower business investment due to declining demand, worsening terms of trade, and rising unemployment.[2]

In short, Treasury's forecast is for the economy to contract by 0.5 per cent in 2009-10 and grow by just 2.25 per cent in 2010-11. The unemployment rate is forecast to rise to 8.5 per cent.

Large corporates remain significant contributors to overall tax revenues. In 2007-08, large corporates with a turnover of $250 million or more, paid 61.4 per cent of all company tax, or $37.9 billion. In Treasury's forward estimates, this is likely to reduce in line with Budget forecasts. However, they are expected to increase on an upward trend in 2010-2011. The extra funds provided to the ATO by Government are about ensuring that large companies (and wealthy Australians) continue to meet their tax obligations as the economy recovers.[3]

Given the significance of large companies to our economy, they continue to command our attention. Recently we undertook a program of visiting some large companies to assess the business impact of the crisis. By invitation, we visited 77 large corporates. Many companies said they were happy for an opportunity to explain how the change in economic conditions was affecting their business and tax performance.

The findings of this program will not surprise you. Earnings are on a downward trend for the coming year, and most businesses are expecting the cost of funds to increase.

This, in turn, will affect their ability to refinance or to finance new projects.

However, the general view was that the situation is better than in the Northern Hemisphere.

Employment growth expectations of many of the companies visited were limited, but there are still some - nine per cent - looking to expand their labour force.

Shedding staff remained the usual restructuring route, although a number of companies are adopting alternative methods to reduce labour costs without losing skilled employees.

This was a well learned lesson following the nineties recession, and will be important as current markets recover.

Many companies visited were also actively examining their GST payments with a particular focus on house-keeping to ensure input tax credits are claimed in the first available period.

Generally, companies expect that their overall income tax payments in 2009 are unlikely to exceed those in 2008. There was a slightly higher likelihood of wash-up payments in 2009, though the value of these is not expected to be as significant as in previous years. A significant number, however, have not varied their instalment rate to reflect tax expectations.

We are encouraging businesses with short term cash flow difficulties to vary their instalment rate downwards in line with their likely end of year tax performance. They can be confident that shortfall penalties will not be imposed if reasonable steps are taken to get the variation right.

Generally for a variation to be reasonable the taxpayer is expected to have based their calculation on the best available information and on the basis that best reflects the likely tax outcome at the time.

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If a taxpayer were queried in relation to a variation, we would look to see if there was a logic or method behind the calculation. This would include a calculation of likely tax payable and a comparison to instalments already paid.

The ATO will give fair latitude as to what is reasonable, given the current uncertain economic climate, particularly where the taxpayer has a good compliance record.

The value of certainty

The volatile economic climate revealed in our program of corporate visits places a new premium on the value of certainty - that is, knowing what to expect or the risks involved in terms of a company's tax position and the likely subsequent impact on cash flows.

For some time now we have outlined a platform for an enhanced relationship with large businesses based on core elements such as good corporate governance and full and frank dialogue on tax risks and issues. In addition, the private ruling system exists to provide the highest levels of certainty.

A new service and improved support for large businesses

Since then we have had the opportunity to listen to taxpayers about what would be helpful to them. In response, we are pleased to announce that the ATO is building upon existing personalised client management arrangements for our largest taxpayers as well as exploring ways to improve our services for all large businesses.

Lead Relationship Manager

We will be introducing a new role of Lead Relationship Manager for our largest companies, particularly those that have shown a genuine desire to work collaboratively with us.

The Lead Relationship Manager will be a single primary point of contact to help coordinate and streamline your dealings with us (and vice versa).

Lead Relationship Managers will be sufficiently senior, with the necessary client service skills, industry knowledge and experience required to give you the service you are seeking.

They will coordinate a company's interactions with us, fast track critical issues and seek ways to remove irritants. Lead Relationship Managers will also facilitate access to specialists and technical support.

In short, they will provide the 'cut through' to achieve more timely resolutions of tax issues.

Let me give you an example. A company may have a number of matters under review across several tax categories, and be required to provide a range of information and meet multiple deadlines.

The Lead Relationship Manager will coordinate contact from our end, consulting with businesses to set timeframes and priorities. The aim is that they will help reduce compliance burdens on large companies.

Of course, the relationship must work both ways and be grounded in trust and co-operation.

Like Annual Compliance Arrangements, the Lead Relationship Manager service will offer high levels of support to our largest taxpayers. But it will not offer the wider benefits of entering into an ACA, such as likely relief from traditional audits and concessions around penalties and general interest charges. The relationship manager is more about coordinating our interaction with you rather than 'signing-off' on your annual tax risks.

We plan to initially work with a handful of Australia's largest companies to help us co-design and pilot the new service.

We will also be working with the Large Business Advisory Group to establish guiding principles and mutual expectations around the new role.

Feedback from the pilot and wider consultation will be taken into account to fine tune the service and its eligibility criteria before offering it to other large taxpayers in 2010.

Let me assure you that other large business taxpayers will not be left behind. We are also exploring how we can improve the operational support we offer them on a day-to-day basis.

We do this through our large business phone service and client managers. Our aim is to resolve potential irritants in transactions earlier, be more responsive to your concerns, and create better escalation processes when things do not go as planned. We look forward to working with you to build a better service across a number of fronts.

Large business tax compliance booklet

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We are also refreshing the *Large Business and Tax Compliance* publication which was last reviewed in 2006.

A lot has happened since. The ATO has introduced a number of new products and approaches to enhance how we work with large business on tax risk management.

The Large Business Advisory Group tells us that the booklet is a valuable resource. We will work with this group to refine the next edition (which we may make web-based to better allow regular updates).

Update on other developments

Large Business Advisory Group

The new measures I have outlined will build on the momentum we have created through a number of initiatives designed to improve two-way communication and to provide large businesses with greater certainty in their tax affairs.

Creation of the Large Business Advisory Group (LBAG) was one of these initiatives. It is the peak forum through which large business can work with us to identify improvements in our processes to reduce compliance costs. It also provides another avenue to raise technical issues where further guidance (or public rulings) would provide greater certainty.[4]

For example, I met with members at the Group's first meeting last November. The range of issues discussed included the best ways to identify and address risks before they escalate, and finding ideas for administrative fixes to simple or small issues. If there are areas of uncertainty there are plenty of avenues to raise these with us (or Treasury where they relate to tax policy or unintended outcomes of existing legislation).

In this context, I would like to highlight the new Tax Issues Entry System which provides a channel for raising minor policy issues or possible legislative change. [5]

Annual Compliance Arrangements

In the last 12 months we also introduced Annual Compliance Arrangements. These are designed to minimise tax surprises for large businesses and provide them with timely and practical certainty.[6]

Importantly for business, the arrangements are providing greater assurance because transactions can be reviewed and ticked off as they happen - real time practical certainty.

So far, two income tax ACAs have been finalised in the financial sector. One GST Annual Compliance Arrangement has also been signed and two other taxpayers have completed the entry process and are close to signing.

We have also signed memorandums of understanding with three others that plan to move to GST ACAs in the next financial year.

Companies involved in the ACA process have provided very positive feedback. They are telling us that the arrangements have improved their relationship with us. Experience has also shown that there can be significant bottom line savings stemming from their Annual Compliance Arrangements. However, to work effectively there has to be a whole-hearted commitment to the spirit of the agreement and good corporate governance processes in place.

Interpretive assistance

Priority private rulings

Twelve months ago I made a commitment to expand our priority rulings process to include class rulings. We have now issued a new practice statement covering the expanded priority ruling service. This is a timely adjunct to our other initiatives.

We are using priority rulings to handle requests for advice from large business. For example, we recently responded to a request from a large taxpayer in the financial sector relating to an urgent capital raising transaction. By liaising closely we were able to issue the advice within several weeks.

The feedback from large corporates seeking advice is also positive. Many have high levels of satisfaction with the service (even from some who received a negative response).[7]

Early engagement is a strong feature of the process. This has shown to be very effective in helping taxpayers manage their tax risk with significant transactions. However, as I have explained previously,[8] it is important that there be full and true disclosure of all relevant facts associated with a private ruling request. If not, the private ruling will not give the certainty which is sought.

We are currently investigating transactions in the financial sector where the full facts may not have been made available, in order to check whether there have been any misrepresentations or omissions of material facts. If that proves to be the case, we will apply the full suite of remedial action available to the Commonwealth.

Again, I encourage companies to ensure that they practise good corporate governance that takes into account tax risks. In particular, please pay attention to transactions that have a tax effect which is at variance with commercial outcomes, or which include elements of transfer pricing which are overly engineered (for example, using swap transactions) or which involve any degree of collusion.

I understand that our responsiveness is critical when fast business decisions need to be made, particularly in the current climate. But it is difficult to be responsive when we don't know all the facts. Moreover it is dangerous for you when that happens.

Managed investment trusts

Another way to promote certainty is to start talking to us early, raising issues right at the beginning when you are uncertain how the law applies. Ultimately, a taxpayer's civic responsibility is to comply with the law (which speaks from its date of effect). For tax professionals your responsibility is to advise on the law in accordance with your codes of conduct.

To give you an example, the Budget announced a new measure allowing Australian managed investment trusts, except those that are taxed like companies, to make an irrevocable election to apply the capital gains tax regime as their primary code for taxing certain disposals of assets.

We have received some criticism of the way we have handled this issue, although the industry is supportive of the Government's response. There is a view that, in identifying a risk, and moving to make clear our view of the law, we have somehow made a u-turn.

Those who were not party to the initial consultations with key industry associations have also criticised us for not consulting with them about developing a draft tax determination.

The problem with this criticism is that, wherever there is uncertainty about the application of tax laws, taxpayers can seek advice from us by requesting a ruling and where the uncertainty is widespread, representative bodies should seek a public ruling (or raise possible law changes with Treasury).

It seems that, despite uncertainty on whether their dealings should be treated as revenue or capital account (not a new distinction in the law), there was a general reluctance by managed investment funds to seek guidance on the way the law applied to their particular circumstances.

For some time we have been raising our concerns about the way industry has handled the issue through formal discussions, speeches, letters and presentations to key industry bodies.

For example, in March 2003 and June 2004, the ATO discussed the issue with members of the Investment and Financial Services Association (IFSA) who attended our tax update sessions as part of their 'Key Issues Presentations'. Transcripts of these discussions were then circulated to the wider IFSA membership. In September 2004, compliance reminder letters were also issued to IFSA for circulation among its members (including advisory firms) outlining fund manager responsibilities under self-assessment to correctly determine the character of gains and losses on sale of investment assets in accordance with established general law principles and their particular facts and circumstances.

We have also formally raised our concerns with a number of specific fund managers following compliance risk reviews of the operations of some managed investment funds.[9] We have also been auditing a number of funds.

The issue illustrates the importance of working with us (or Treasury) when the application of the law is unclear. It also raises questions about the quality of some of the independent advice and audit sign off, and of the robustness of the governance processes, of some of the managed investment trusts.

Depending on the terms of the proposed legislation, these questions may no longer have to be answered.

Interaction of the Transfer Pricing and Thin Capitalisation rules

I want to turn now to the current debate about the interaction between the transfer pricing and the thin capitalisation rules following the release of TD2007/D20 and the discussion paper on intra-group finance guarantees and loans.

After receiving feedback on the issues raised in the discussion paper, we sought legal advice and have been consulting with Treasury about the intended policy relating to the interaction of the transfer pricing and thin capitalisation rules. We are currently awaiting some further advice from counsel.

We recently provided a practical 'rule of thumb' approach to deal with any uncertainty, pending further guidance by the

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ATO.[10] That approach was for taxpayers to adopt the usual interest rate paid by the ultimate parent company and apply it to the existing amount of related party debt (provided of course that that amount does not exceed the safe harbour amount allowed under the thin capitalisation rules).

I want to outline today in more detail our broad approach in this difficult area to provide greater certainty to taxpayers and their advisers. We plan to finalise the draft tax determination and provide further guidance as soon as practicable. We will continue to work with the CTA and other representative bodies in finalising our position.

I cannot emphasise enough that the application of these provisions is very much fact driven and that particular cases need to be considered in the context of market practice and appropriate benchmarks that allow the commerciality of the tested transactions to be correctly assessed.

In draft determination TD2007/D20, the ATO expressed the view that the existence of a safe harbour debt amount in the thin capitalisation rules in Division 820 does not prevent the Commissioner from determining an appropriate arm's length cost for the debt funding under the transfer pricing provisions in Division 13 of the 1936 Act, or the relevant provisions of Australia's tax treaties.

The terms of Division 820 (and in particular paragraph 820-40(1)(b)) require that the thin capitalisation rules apply after the transfer pricing rules (and other rules for determining tax deductibility such as section 8-1) have been applied. However, the Explanatory Memorandum introducing Division 820 at paragraph 11.11, makes clear that a safe harbour approach was intended so as to provide 'sufficient protection of the Australian tax base … while simultaneously minimising compliance costs'. In clarifying this conundrum we have sought advice from Treasury.

In the discussion paper, the ATO explored the scope of the application of the transfer pricing rules where the rate of interest (or guarantee fee) is above an arm's length amount, in circumstances where the level of debt is within the safe harbour in the thin capitalisation rules. We were seeing some indicators, both in terms of the overall trend in debt funding and in some audit cases, that raised concerns that some taxpayers may be claiming excessive amounts (and at the highest risk level, grossly excessive amounts) of interest expense and guarantee fees.

In relation to the interest expense, there is nothing explicit in the law which says that the application of the transfer pricing rules is different depending on whether or not a taxpayer's level of debt is within the thin capitalisation safe harbour. However, we appreciate that there is an inconsistency with one of the objectives of the thin capitalisation rules - that of reducing compliance costs - and the application of the transfer pricing rules. As outlined above, we have been seeking Treasury's advice as to the policy intent to inform our conclusions on the proper application of the law to the facts of particular cases.

We also appreciate that the terms of Division 13 (but not necessarily the transfer pricing provisions in Australia's tax treaties) and the independent entity principle more generally, suggest that regard should be paid to the actual capital of the borrowing entity rather than some reconstructed amount. But in any event, the market interest charge is not only linked to the level of capital but may take into account a range of other considerations.

For example, market practice shows that the credit standing of a borrower will depend on a range of factors, not just the capital structure of the borrower. Asset levels, realisable value of assets, strength of cashflow, capacity to absorb losses, probability of default, extent of recourse (including the possibility of wider recourse and additional financial support) will all be relevant.

Also, in some cases, there may be evidence that the market notches up the credit rating of a subsidiary because of its affiliation with its parent or as a member of the group. However, all this depends on the facts of the case, and a realistic and commercial appreciation of the market place.

Also, depending on the facts, grossly excessive interest charges may be subject to disallowance under section 8-1 or Part IVA (which may apply to the underlying capital structure in cases that are blatant and contrived).

As we move towards deciding our position we are taking into account the practical issues that have been raised with us, including costs of compliance. However, we will continue to challenge interest charges that are grossly excessive having regard to all the facts.

Power to assess under the Treaties

An issue raised in feedback on the discussion paper is whether the treaty articles can be relied on as a separate source of assessing power independently of Division 13. We have long held the view that the treaties do provide a separate power to assess. This view has been questioned in some decisions. For example, in the Roche case, Downes J stated in obiter:

> In the result I do not need to decide the issue (of whether the treaties in question conferred a power to assess) although I note that there is a lot to be said for the proposition that the treaties, even as enacted as part of the law

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of Australia, do not go past authorising legislation and do not confer power on the Commissioner to assess.

See also *McDermott Industries (Aust) Pty Ltd v Commissioner of Taxation (2005)* 142 FCR 134 at [2]; *Commissioner of Taxation v Lamesa Holdings BV (1997)* 77 FCR 597 at 600-1; *Chong v Commissioner of Taxation (2000)* 101 FCR 134 at [26]; *GE Capital Finance Pty Ltd v Federal Commissioner of Taxation (2007)* 159 FCR 473 at [36], [37]. In the most recent case on this issue *Undershaft (No 1) Limited v Commissioner of Taxation (2009)* FCA 41 (3 February 2009) [45], [46], Lindgren J cited, inter alia, *Chong* and reiterated that the double tax treaty does not give the contracting State a power to tax, or oblige it to tax but, rather, avoids the potential for double taxation by restricting one contracting State's taxing power.

However, in these cases the Administrative Appeals Tribunal and the Federal Court have focused on the *International Agreements Act* and have not had to fully consider the power to assess in accordance with the treaty provisions under the provisions of the *Income Tax Assessment Act*, and in particular the amendments made at the time of the introduction of Division 13 in 1982. These amendments provide for a separate source of power to amend an assessment in reliance upon the associated enterprises article. For example, refer to sections 170(9B) and (9C) and the accompanying explanatory memorandum at Clauses 19 and 21-23, and also to the associated amendments to the penalty provisions [ss226 (2B) - (2F)] and also the later enacted s225 (and refer also to the explanatory memorandum to the 1984 penalty provisions). We have also received recent legal advice which supports the view that the treaties as incorporated into the *Income Assessment Act* provides a separate taxing power.

However, in the light of comments by the Administrative Appeals Tribunal and the Federal Court, we have raised this issue with Treasury with a view to considering whether a law change is needed to remove any doubts about the intended policy or the current operation of the law.

Good governance

Good corporate governance is important at all times in the business cycle, but it is vital in an economic downturn.

This together with increasing cooperation amongst revenue authorities, were clear trends emerging from the recent OECD forum on tax administration[11].

This increasing focus on corporate governance and the risk management systems of large companies is hardly surprising given that the major international finance sector collapses of the past year could be attributed in part to a loosening of internal controls and the acceptance of increasingly risky business.

Conclusion

Certainty, they tell us, is an emotion. It is one that has divided thinkers for centuries. John Stuart Mill, the 19th century philosopher, seemed to sum it up when he said;

'There is no such thing as absolute certainty, but there is assurance sufficient for the purpose of human life.'

That is the aim of the measures outlined today, including the introduction of the Lead Relationship Manager service, and of the cooperative compliance approach we have touted for some time now. However, practical certainty will rest largely with how you play out your civic responsibilities.

Footnotes

[1] Prime Minister Kevin Rudd and Treasurer Wayne Swan **Joint Press Conference, 3 June 2009.**

[2] Treasurer Wayne Swan, **Media Release No .076, *National Accounts - March Quarter 2009***, 3 June 2009.

[3] Then Assistant Treasurer Chris Bowen, **Media Release No .047, *ATO Strategic Compliance Package***, 12 May 2009.

[4] As well as ATO industry forums, representation through industry bodies and the National Tax Liaison Group and its sub-committees (including the NTLG Public Rulings Steering Group), large business has regular contact with the ATO through the Corporate Tax Association.

[5] The Tax Issues Entry Systems (TIES) was launched by the Assistant Treasurer in November 2008. TIES is jointly managed by the ATO and Treasury. It provides a single entry point for tax professionals and the community to raise minor policy issues relating to the care and maintenance of the tax and superannuation systems. See also Michael D'Ascenzo, Commissioner of Taxation, ***From the Commissioner's desk - we live in interesting times***, 'Public Practice Muster', National Institute of Accountants Public Practice Symposium, Sydney, 21 May 2009.

[6] There has also been overseas interest in our ACA model from other tax administrators.

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[7] The results from Client Feedback Questionnaires (CFQs) on interpretive advice over the 2008/2009 financial year are as follows: 98% of returned CFQs are above the benchmark of 70%, with 36 out of 45 questionnaires showing a 100% satisfaction rating.

[8] Michael D'Ascenzo, Commissioner of Taxation, ***Spirit of Engagement***, G100 function, 28 May 2008.

[9] Note also public ruling, **TR 2005/23** on listed investment companies dealing with the same issue in relation to the capital and revenue distinction.

[10] Jim Killaly, Deputy Commissioner of Taxation, ***Assisting compliance and managing tax risks in the large market: understanding ATO approaches and perspectives***, Fifth Annual Corporate Tax Forum, Sydney, 18 May 2009.

[11] See **Paris Communiqué, Fifth Meeting of the OECD Forum on Tax Administration,** 29 May 2009. At the FTA, Australia presented a report on four studies covering transparent tax compliance by banks, engagement with high net worth individuals, corporate governance and tax risk management and compliance management of large businesses.

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