Senate Standing Committees on Economics
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Parliament House
Canberra ACT 2600
Australia

Sent via email: economics.sen@aph.gov.au

11 July 2012

Dear Sir

Tax Laws Amendment (Cross Border Transfer Pricing) Bill (No. 1) 2012

We are writing to comment on the Tax Laws Amendment (Cross Border Transfer Pricing) Bill (No. 1) 2012 which was introduced into Parliament by the Assistant Treasurer on 24 May 2012.

The Bill proposes to provide the Commissioner of Taxation (the Commissioner) a new power to impose tax on corporate taxpayers with retrospective effect from 2004. We appreciate the opportunity to make a submission on this Bill given that it raises a number of concerns for our clients and for the tax policy environment in Australia more broadly.

PwC is Australia's largest tax advisor and our clients include a large number of Australian and foreign owned multinationals who could be impacted by the proposed changes. We are writing to express our views on the proposed changes.

We consider the following aspects of the Bill in particular to be concerning:

1. There is no basis to justify introducing the proposed Subdivision 815-A retrospectively.
2. The proposed changes discriminate against taxpayers who deal with related parties in treaty countries and could breach non-discrimination articles in certain tax treaties.
3. The proposed changes appear designed to protect the position taken by the Commissioner in several ongoing transfer pricing audits. This is unfair for the taxpayers involved in those disputes, and could result in taxpayers being penalised for not complying with a law that did not exist at the time they entered into an arrangement. The proposed penalty relief provision for retrospective assessments does not go far enough to protect taxpayers from this situation arising.

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4. The proposed changes (particularly the retrospective application of the changes) will increase the complexity of doing business in Australia by creating a patchwork of different transfer pricing rules that could apply to a particular transaction depending upon whether or not a treaty applies, which treaty applies and which period the relevant transaction occurred.

In addition, we would specifically like to respond to the following aspects of the Second Reading Speeches in relation to the Bill:

1. The debate between the Hon Ed Husic MP, Government Whip, and the Hon Malcolm Turnbull MP, Shadow Minister for Communications and Broadband, in relation to the intended impact these proposed changes are to have on the technology sector in particular;

2. The claim made by the Hon Bernie Ripoll MP, Parliamentary Secretary to the Treasurer, that 'major accounting firms' have supported the Government's view that Australia's tax treaties provide a separate basis for making transfer pricing adjustments;

3. The comments made by the Hon David Bradbury MP, Assistant Treasurer, and the Hon Joe Hockey MP, Shadow Treasurer, with respect to the applicability of treaty mechanisms designed to relieve any double taxation that may arise as a result of these changes; and

4. The discussion by the Hon Scott Buchholz MP and Bert van Manen MP surrounding the decision of the Full Federal Court in *Commissioner of Taxation v SNF (Australia) Pty Ltd* [2011] FCAFC 74 (*SNF*).

We have provided a brief overview below of the reasons for our concerns and our specific responses to the Second Reading Speeches outlined above. We have also attached the following documents which provide further detail on these matters:

- PwC's Submission to Treasury dated 30 November 2011 in response to the 1 November 2011 Treasury Consultation Paper and the Assistant Treasurer's Media Release (the PwC Consultation Paper Submission)

- PwC's Supplementary Submission to Treasury dated 24 February 2012 redacted for confidential information (the PwC Supplementary Submission)

- PwC's Submission to Treasury dated 13 April 2012 in response to the Exposure Draft of Subdivision 815-A (the PwC ED Submission)

- An article published in the June 2012 edition of "The Tax Specialist" titled *The smoke and mirrors around the "stage one" transfer pricing reforms*.

Overview of PwC concerns

1. **No basis for retrospective application**

The Government's premise for introducing Subdivision 815-A retrospectively is that the new provisions will apply in the way that Parliament had always intended the tax treaties to operate. We acknowledge that the Explanatory Memorandum (EM) to the Bill has attempted to demonstrate this; however, the views represented in the EM are incomplete. We refer to the PwC Supplementary Submission, which explains in detail why the Government's views are not accurate.

It is a matter for the Courts to decide how the existing law applies. If the Courts interpret the law in a manner that Parliament finds to be inconsistent with its intentions, then any changes should only be made on a prospective basis. There is evidence available (as outlined in the PwC Supplementary Submission) which indicates that the Courts do not agree with the view that Australia's tax treaties provide a separate taxing power to the Commissioner.

In any case, regardless of Parliament's intention of how the existing law should operate, the changes proposed in the Bill go well beyond clarifying the existing law. Rather, the Bill will introduce a new law with retrospective application.

2. **Discrimination against tax treaty countries**

As the new law will only apply to dealings that are covered by a tax treaty, it will discriminate against major trading partners. Australian companies dealing with related parties in treaty countries may be worse off than those dealing with tax havens. Furthermore, the proposed law could breach non-discrimination articles in certain treaties (see the PwC ED Submission for further details).

3. **Prejudice against taxpayers involved in ongoing transfer pricing disputes**

There has been a lack of transparency about the underlying motivation for introducing the proposed new law retrospectively. According to the EM, the proposed changes are a "revenue protection measure" and therefore will have no financial impact.

However, this is inconsistent with statements by Treasury. For example, at the Senate Economics Legislation Committee Estimates Hearing on 30 May 2012, in response to a question on the impact on revenue of the new law from Senator Cormann, Tony McDonald (General Manager of the International Tax Treaties Division at the Department of the Treasury) stated:

> "... in the absence of those amendments. As I said, there are very different views in relation to that. The aggregate quantum of income that is in dispute in cases is in the billions."

Also illuminating were the comments made by Deputy Commissioner Mark Konza at a Large Business Advisory Group meeting on 1 June 2012, in which he indicated that the ATO has 40 transfer pricing audits in progress which may be impacted by Subdivision 815-A and that the proposed adjustments at stake are worth approximately $1.9 billion.

Introducing a new law which could be applied to disputes that are already in progress is unfair to taxpayers who have made genuine efforts to comply with the law as it stood at the time. This again illustrates that it is inappropriate to introduce the proposed changes retrospectively.

4. **Complexity of transfer pricing rules**

The proposed changes would create a complex patchwork of different transfer pricing rules that could apply in different situations, particularly if the proposed retrospective application is enacted. Different rules could apply to any given arrangement depending on:

- whether the arrangement is subject to a tax treaty
- whether the taxpayer's structure is a branch or a company
- which particular treaty (or treaties) applies
- which period the arrangement relates to (pre 2004, 2004 to 2012, or 2012 onwards). In addition, there is no explanation of how this patchwork will operate where an arrangement spans one or more period.

This increases complexity of doing business in Australia and will not enhance Australia's reputation as an attractive investment location. Disputes are likely to arise under these rules that will need to be resolved by the Courts or our treaty partners.

Specific Responses to Second Reading Speeches

1. **Impact of proposed changes on technology sector**

While a number of media reports in the weeks preceding the parliamentary debate and the speech made by Mr Husic have focused on the supposed impact these transfer pricing reforms will have on the technology industry, it is a misconception to believe that transfer pricing is at the core of, or even peripheral to, the issue of technology giants allegedly not paying their 'fair share' of tax. There is nothing in wording of the Bill or even in the Explanatory Memorandum that suggests that these reforms are in any way targeted at tackling technology companies.

2. Support for Government's view by major accounting firms

Mr Ripoll claimed that 'major accounting firms' have supported the Government's view that Australia's tax treaties provide a separate basis for making transfer pricing adjustment. We would like to point out that neither the key industry bodies (Institute of Chartered Accountants in Australia and CPA Australia) nor any of the 'Big 4' accounting firms – PwC, KPMG, Ernst & Young and Deloitte – agreed with this interpretation during the consultation process. While we cannot speak on behalf of all Big 4 accounting firms, PwC does not and has never agreed with this interpretation. While we may have provided advice to taxpayers in the past discussing a potential taxing power under a relevant treaty, this would have been in the context of mitigating tax risk given the Commissioner's public view that such a power exists, not our considered view of the law.

3. Applicability of treaty mechanisms to relieve double taxation

As we have stated throughout the consultation process and as alluded to by Mr Hockey, the Mutual Agreement Procedure (MAP) process provides a mechanism through which taxpayers, who face double taxation as a result of a transfer pricing adjustment, may seek relief. However, we cannot emphasise enough that relief through MAP is not an automatic entitlement, but instead a time consuming and expensive process that does not guarantee the elimination of double taxation.

In addition, we are perturbed and perplexed by the Government's decision not to alert our treaty partners to a decision to introduce a new retrospective tax. Rather, the Government has blindly assumed that our treaty partners will fund this retrospective new tax.

4. Alleged defects of Division 13 in the *SNF* decision

A common theme amongst the Second Reading Speeches is that this Bill is designed to make Australia's transfer pricing law more consistent with OECD guidance to overcome the alleged deficiencies of Division 13 in respect of companies, like the taxpayer in *SNF*, who post consecutive years of tax losses. However, the Full Federal Court held that the transactional based approach used by the taxpayer under Division 13 was at arm's length and, "if it mattered", the OECD Guidelines. That is, even if the Australia–France Double Taxation Treaty and the OECD Guidelines were applied, there is no guarantee that the outcome would have been different.

Conclusion

We recommend the Senate Economics Legislation Committee consider the concerns we have raised because, as the Bill currently stands, the proposed retrospective changes could have a number of undesirable consequences. The changes will increase the complexity of doing business in Australia, could reduce confidence from overseas investors and governments of treaty partners, and may negatively impact the way the Government's tax reform policy is perceived more broadly. We particularly recommend that the retrospective aspect of these proposed amendments be removed.

* * * *

We would be more than pleased to appear and explain our submission before the Senate Economics Legislation Committee.

Yours sincerely

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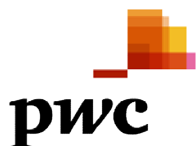

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For the attention of Mr Neil Motteram

30 November 2011

Dear Mr Motteram

Submission to Treasury

Income Tax: Cross border profit allocation: Review of Transfer pricing rules Consultation Paper 1 November 2011

PwC welcomes the opportunity to provide a submission to treasury in response to the Income Tax: Cross Border Profit Allocation Review of Transfer Pricing Rules Consultation Paper 1 November 2011.

We acknowledge the benefits of clarifying the operation of Australia's transfer pricing rules to ensure they better reflect global best practice and, in particular, latest Organisation for Economic Cooperation and Development (OECD) guidance. Modernising the transfer pricing rules may help to reduce some of the complexity involved in applying the arm's length principle and should be welcomed by multinational enterprises (MNEs) who are well versed in applying OECD guidance in their day to day transfer pricing. Having said this, transfer pricing is not an exact science and there will always be issues which are open to interpretation. Rewriting the transfer pricing rules to better incorporate OECD guidance will not provide a solution to all transfer pricing issues which are debated between taxpayers and the Australian Taxation Office (ATO).

We understand that Treasury is concerned that the existing law could lead to a substantial leakage of revenue. While we are not privy to the data underlying this proposition, we are aware that, in some circles, there is a view that the Division 13 rewrite is an overreaction to the Commissioner's loss in the SNF case.

In our view, the Commissioner's loss in SNF was not due to flaws in the existing law. Had the OECD guidelines been applied to the facts as they were presented to the Court, we are of the opinion that the result would have been the same. We also hold the view that if the case had been run differently applying the existing law, a different decision may have been reached. Having said this, given the uncertainty that exists, we consider it worthwhile to clarify prospectively the operation of Australia's transfer pricing rules.

It is important that the new law is drafted based on a principled approach and has the arm's length principle, as set out in OECD guidance, as the anchor point. It is important that Australia's transfer pricing rules do not go beyond what is included in relevant OECD guidance. While we understand that this is not the intention of Treasury and the Government, it will be important to ensure that any Australian interpretation on the OECD Guidance is consistent with the interpretation of our major treaty partners. Taking the Australian rules beyond OECD guidance would create further uncertainty for Australian taxpayers and would increase the risk of double taxation, not to mention imposing on Australian taxpayers additional compliance costs.

Profit attribution to permanent establishments (PEs)

The Consultation Paper states that the decision on the treatment of PEs will be treated as a separate policy question to those outlined in the Consultation Paper. We consider that the OECD's functionally separate entity approach should be adopted for profit attribution to PEs and should be incorporated into the proposed Division 13 rewrite. However, given the importance of this policy question, our detailed views are outlined in a separate submission.

Assistant Treasurer's media release

The Assistant Treasurer's media release announcing the review of the transfer pricing rules included a comment that the Government intends to make legislative amendments to 'clarify' that a taxing power exists under Australia's double tax treaties. It is proposed that the amendments will be effective from 1 July 2004. We understand the Government intends to implement these particular amendments without any public consultation process.

PwC has a number of concerns with this act of "clarification" and we have included comments on these in our submission. In brief, we are of the opinion that this is not a mere "clarification" but a retrospective change to the law. We do not consider retrospective changes of law to be good tax policy and consider that such changes have the potential to harm Australia's standing with foreign investors and our treaty partners.

Format of our submission

We have prepared our submission in the following sections:

1. Retrospective amendments on the application of treaties
2. Adequacy of the existing transfer pricing rules
3. Specific comments on the Consultation Paper
4. Other considerations.

We would be pleased to discuss the comments in our submission with you further.

Yours sincerely

Lyndon James	Ian Farmer
Partner	Managing Partner
Transfer Pricing, National Leader	Tax and Legal

1. Retrospective changes to treaty application

Observations and issues

- The question of whether treaties give rise to a taxing power is contentious. This is acknowledged in the Consultation Paper. The ATO has publicly and regularly[1] stated that treaties can create tax obligations that do not arise under domestic law. However, despite ample opportunities to do so, the ATO has chosen not to test this view in the Courts. On the other hand, taxpayers and the profession have held the view that treaties merely allocate taxing rights in accordance with internationally accepted practice.[2] It has been unnecessary for taxpayers to argue this point in the context of Article 9 because, as noted above, the Commissioner has chosen not to test his views in Court. However, in the context of treaty taxing powers more generally, the Commissioner has been unsuccessful in the Courts on a number of occasions.[3] In our view, it is clear that Article 9 does not provide the Commissioner with a right to impose tax.

- Parliament has specifically recognised the role and status of the domestic transfer pricing provisions and we do not believe it has in any way indicated that "the law should operate so that Australia's treaties are an alternative to our domestic law". References in the Press Release to amendments made to section 170 are tenuous at best and do not evidence that the intent of Parliament was that our treaties would operate to impose tax on residents of our tax treaty partners.

- We consider the "clarification" of the application of a taxing power under the treaties to be a retrospective law change which would be open to further legal challenge and would be negatively perceived by the business community. As mentioned above, a number of legal cases have specifically considered that DTAs limit the operation of existing domestic taxing provisions rather than providing a separate taxing power.

- The retrospective nature of the change may have the unintended, but real consequence of discriminating against taxpayers dealing with related entities in Treaty countries (viz our major trading partners). Put another way, a company established in the Cayman Islands gets a "better deal" than a resident of the USA, China or Japan. It seems very strange to us that Australia intends to impose higher taxes on our treaty partners.

- We also observe that none of our major trading partners seek to use Article 9 to impose additional taxes. Instead, and in line with international practice, they accept that domestic transfer pricing legislation (as restricted by Article 9) is the relevant taxing provision.

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[1] Refer *TR 2001/11 Income tax: international transfer pricing - operation of Australia's permanent establishment attribution rules* at para 2.3 and *TR 2001/13 Income tax: Interpreting Australia's Double Tax Agreements* para 32.
[2] Klaus Vogel, *Double Taxation Conventions* (3rd ed, 1997), referred to in the decision in *Chong* at para 19
[3] Refer *Undershaft (No 1) Limited v Commissioner of Taxation* [2009] FCA 41 at paras 44-45, *Chong v Commissioner of Taxation* [2000] FCA 635 at para 26, *GE Capital Finance Pty Ltd v Commissioner of Taxation [2007]* FCA 558 at para 29, *Roche Products Pty Limited and Commissioner of Taxation* [2008] AATA 639 and *Commissioner of Taxation v SNF (Australia) Pty Ltd* [2011] FCAFC 74.

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- It is widely accepted that retrospective legislation is justified in extremely limited circumstances such as to mitigate blatant tax avoidance. These circumstances do not exist in relation to the application of Division 13. There has been no suggestion that changes to Australia domestic transfer pricing rules are required to stop blatant tax avoidance. In any case, Australia's tax laws include a comprehensive general anti-avoidance provision which can deal with cases of tax avoidance.

- If the proposed changes were to go ahead they would effectively widen the Commissioner's powers retrospectively. The Commissioner could have greater ability to reallocate profits through reconstructing transactions. As far as we are aware, the boundaries of this power have not been tested in the courts. Accordingly, this could lead to a greater number of disputes that cannot be resolved between the Commissioner and taxpayers. Where these cases are referred to MAP for resolution, we are concerned that there may be an increased risk of double taxation, as the Competent Authorities of our treaty partners may not agree with the reconstruction proposed by the Commissioner.

- Legislating that the treaties allow the Commissioner a power to tax may in fact undermine other areas of Australia's domestic tax legislation where a policy decision has been made to adopt a taxing treatment more favourable than that under the treaty. For example, the thin capitalisation regime may be undermined if the Commissioner were to adopt a taxing position under the treaty that was in contradiction to the position allowable under domestic rules.

Recommendations

- Any changes to transfer pricing rules should apply prospectively.

- The issue of DTAs providing a taxing power should be clarified by the Courts.

- If the retrospective change is legislated, we recommend that the ATO issue a public ruling on how the ATO interprets its power under Article 9.

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2. Adequacy of existing rules

Observations and issues

- We are aware that there is a view that the existing drafting of Division 13 is inadequate and that the existing law is inconsistent with the OECD guidelines. While we are not necessarily of this view, we consider that seeking to align Australia's transfer pricing laws with OECD guidance will improve certainty for taxpayers.
- The ATO has made a significant effort to incorporate OECD guidance in its taxation rulings on transfer pricing. In practice, most taxpayers follow the guidance provided by the ATO and OECD in setting and reviewing their Australian transfer pricing policies. For most taxpayers, there would be no material difference in their position under the existing regime and a new law based on OECD guidelines.
- We are of the opinion that the recent decision in the SNF case was not necessarily due to differences between Division 13 and OECD guidelines. Had the Court been asked to decide on SNF applying the OECD guidelines to the same facts as they were presented by the taxpayer and Commissioner, it is uncertain that the result would have been any different.
- Furthermore, comments in the SNF decision provided a roadmap on how the Commissioner could ensure the OECD guidelines can be considered a relevant authority in future cases.
- It is important to note that the OECD guidelines are open to interpretation. Incorporating the guidelines into our law will not solve all transfer pricing problems

Recommendations

- Any proposed changes should be limited to clarifying that the arm's length principle should be interpreted in a way that is consistent with the OECD Guidance, limiting time for amendments and, if documentation rules are to be legislated, clear guidance on penalty remission.

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3. Responses to Consultation Paper proposals to general transfer pricing rules

3.1. Definition and interpretation of the arm's length principle

Observations and issues

- PwC supports Treasury's view that the arm's length principle should continue to underpin the domestic transfer pricing rules. PwC supports the broader policy principle of *prospectively* aligning the domestic definitions, including the arm's length principle, with globally accepted best practice such as the 2010 OECD guidelines and model taxation treaty.

- The arm's length principle can be open to interpretation. The definition of the arm's length principle in the Australian transfer pricing rules should not be different from or go beyond the OECD guidance.

- Based on the Consultation Paper, it appears that Treasury's interpretation of 'arm's length' is based on the 'outcome' of a transaction or group of transactions, rather than the arm's length 'price' of specific transactions. Our view is that the word "outcome" is interpreted by the ATO as a proxy for profit regardless of the pricing of the actual transaction. We consider this to be inconsistent with OECD guidance.

- Profit methods are a means to an end (the 'end' being identifying an arm's length price), and are not an end in themselves.

- The OECD Guidelines refer to the definition of arm's length principle in Article 9 of the model treaty. Article 9 specifically considers adjustments where *transactions* have been entered into between related parties on other than arm's length terms. The commentary on Article 9 goes on to state:

  "No re-writing of the accounts of associated enterprises is authorised if the transaction between such enterprises have taken place on normal open market commercial terms (on an arm's length basis)"

- OECD guidance makes it clear that the arm's length principle does not necessarily mean that profits will result. Parties dealing at arm's length can (and do) incur losses for commercial reasons. If the conditions of a transaction are arm's length, then the 'outcome' of that transaction must be arm's length, regardless of whether that outcome is a profit or loss.

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Recommendations

- The definition of the arm's length principle in our domestic law should not go beyond the definition in the OECD guidelines and model treaty and application of the arm's length principle does not mean losses cannot occur.

3.2. Comparability

Observations and issues

- The concept of comparability is critical in applying the arm's length principle. In order to apply the arm's length principle, it is necessary to identify suitably comparable transactions.
- In our view, the purpose of reviewing comparable transactions is to identify an arm's length *price*. This may be done *directly*, in the case of the CUP method, or *indirectly*, in the case of a gross profit or net profit based method.
- Paragraph 48 of the Consultation paper states "the internationally accepted approach to determining an arm's length outcome for dealings … requires that the economically relevant characteristics of the situations being compared are sufficiently comparable to arrive at a reliable an arm's length **outcome".** The emphasis on outcomes or profits does not accurately reflect OECD guidance.
- The OECD guidelines set out factors which are relevant when assessing comparability. In our view, the comparability factors in the OECD guidelines provide an adequate framework for assessing comparability.
- There is no need for Treasury to provide additional guidance on comparability issues over and above the OECD guidance. We submit the issue of interpreting the OECD Guidance should be left to a facts and circumstances analysis. If the Commissioner considers there is a need for guidance on the ATO approach to comparability over and beyond the guidance of the OECD, this is best done through a Taxation Ruling on the topic, rather than written into the legislation.
- The Consultation Paper requested input on the extent to which the taxpayer's circumstances are relevant in a comparability analysis, citing the Canadian transfer pricing legislation as an example. PwC submits that while the circumstances of the taxpayer should be considered, this should be limited to the five comparability factors in the OECD Guidelines. Comparable transactions should not be rejected on the basis that the circumstances of the parties are not identical.
- The Consultation Paper raises the question of whether specific guidance is required to ensure that a strict market valuation approach is not adopted in favour of an 'arm's length outcome'. The inference is that the decision in SNF somehow acknowledged that the outcome achieved was not arm's length. In fact, in that decision the Court accepted that the losses of the taxpayer were entirely due to commercial factors unrelated to the transfer pricing. In this regard, we submit that there is no need to legislate guidance as to the relevance of the

'circumstances of the taxpayer'. Again, the OECD adequately deals with the consensus view of its members on the comparability standards appropriate – any attempt to enshrine an additional standard will likely result in an inconsistency with the arm's length standard and increased risk of double taxation.

Recommendations

- The transfer pricing rules should not be overly prescriptive on comparability issues.
- The Australian rules should not include additional comparability requirements. There is no need to restate, qualify or otherwise constrain the factors as set out in the OECD guidelines. If further guidance is required, this should be addressed in a public Taxation Ruling.

3.3. Selection of methods

Observations and issues

- The 1995 version of the OECD guidelines emphasised a preference for the use of Transactional methods to test the arm's length nature of transactions. Profit based methods were considered methods of 'last resort'. Similarly, the existing wording in Division 13 of the ITAA 1936 has been interpreted by the courts in SNF to focus on the pricing of individual transactions.
- The 2010 OECD guidelines no longer refer to profit based methods as methods of 'last resort', and now encourage selection of the most appropriate method. Treasury has extended this observation to say that a profit based method should be used wherever it is the most appropriate method.[4] It should also be noted that the OECD Guidelines state that where a transactional method and profit method are equally reliable, the transactional method should be preferred[5].
- There is an undue focus on profit outcomes (and implicitly, profit based methods) in the Consultation Paper. This does not seem consistent with the wording of the 2010 OECD guidelines, or the spirit of the arm's length principle as discussed earlier. At heart, the arm's length principle is focused on identifying comparable transactions to determine an arm's length price for a particular transaction. Where comparable data is available at a transactional level, this will usually produce a more reliable measure of the arm's length price than a profit based analysis.
- In June 2011 the OECD released a Suggested Approach to Transfer Pricing Legislation. In Section 4 of that report they note that the arm's length remuneration of a controlled transaction should be determined by applying the most appropriate transfer pricing method having regard to:
    - The respective strengths and weaknesses of the approved methods
    - The appropriateness of an approved method in view of the functions undertaken, assets utilized and risks assumed

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[4] Consultation Paper, paragraph 56
[5] Para 2.3 of the OECD Guidelines 2010

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- The availability of reliable information needed to apply the selected method; and
- The degree of comparability between the controlled and uncontrolled transactions.

- PwC submits that the guidance on method selection in the Australian transfer pricing rules should not go beyond these criteria. If Treasury or more particularly the ATO feel that further commentary on method selection is necessary, this should be contained in Taxation Rulings so as not to constrain the ability of taxpayers to rely on the OECD Guidance directly.

Recommendations

- A 'most appropriate method' approach is suitable.
- There should be no bias for any one particular approach.
- There should be no requirement to use a profit based method to test the arm's length nature of the outcome where a transactional method has been selected as most appropriate.
- Legislation should reference OECD guidance rather than provide prescriptive rules on method selection.

3.4. Self executing rules

Observations and issues

- We support a move to applying the transfer pricing rules on a self assessment basis. In our experience, taxpayers usually make their best efforts to comply with the tax law, including the transfer pricing rules.
- Currently, the only mechanism by which non-arm's length prices can be amended to reduce income in Australia is if an adjustment is initiated by an overseas tax authority and a correlative adjustment is provided under the Mutual Agreement Procedure (MAP) process. If we are to move to a full self assessment regime for transfer pricing, consideration should be given to whether the law should enable taxpayers to adjust their income downwards to correct a non-arm's length price, provided there is a solid basis and appropriate evidence is available to support such an adjustment.

Recommendations

- Consideration should be given as to whether the self assessment rules should permit taxpayers to make transfer pricing adjustments in either direction to correct a non-arm's length price.

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3.5. Discretionary powers

Observations and issues

- We agree that retention of the wide discretionary power in Section 136AD(4) is inconsistent with self assessment and agree it should be limited to exceptional cases. The examples in the Consultation Paper are discussed below.

Insufficient data

A discretionary power based on inadequate data would be problematic for a number of reasons. These include:

- Perfect comparable data is rarely available in practice. It should be possible to identify arm's length prices based on the best comparable data available (even if this is the 'least worst' data). The Commissioner should have an obligation to seek to identify appropriate comparable data and should not be able to apply a discretionary power merely because such data is difficult to find. This is a common issue for transfer pricing globally. The analysis should be based on the most reliable and appropriate analysis and not allow a default to the Commissioner's averment position simply because there are no comparable dealings.

- A discretionary power based on insufficient data may encourage the ATO to adopt a standard of comparability which is so high that this power would be applied by the Commissioner frequently. We have seen in the courts (in *SNF* in particular) that the standard of comparability expected by the Commissioner can "set the bar at an unattainable height".

- The Commissioner has wide ranging power to access information held by taxpayers. In light of the powers held by the Commissioner, any discretionary power should be limited to only extreme situations where the taxpayer has withheld information or refused to cooperate with requests from the Commissioner.

Reconstruction

We anticipate several problems could arise with granting the Commissioner a power to 'reconstruct' transactions.

- The OECD Guidelines state that in all but exceptional cases, tax authorities should respect the actual transactions undertaken and should not disregard them or substitute other transactions for them.[6] The OECD Guidelines explain that restructuring legitimate business transactions is arbitrary and is more likely to lead to double tax. [7]

- OECD guidelines acknowledge MNEs may enter transactions that third parties may not. The guidelines state that "the mere fact that a transaction may not be found between independent parties does not mean that it is not arm's length".[8] A requirement for taxpayers to demonstrate that the structures of their transactions are similar to arrangements between independent parties would be onerous and would be likely to lead to non-arm's length outcomes. Tax authorities cannot and

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[6] OECD Guidelines, paragraph 1.64
[7] OECD Guidelines, paragraph 1.64
[8] OECD Guidelines, paragraph 1.11

should not dictate how MNEs structure their operations and should take care in assessing whether a transaction is "commercially realistic"

- The question of whether a transaction 'would have' occurred between independent parties is highly subjective and ignores the fact that MNEs may choose, for commercial reasons, to structure their businesses differently from independent parties.

- The exceptional circumstances contemplated in the OECD Guidelines are where either:

    - The economic substance of an arrangement differs from its legal form; or

    - The arrangements between related parties, when viewed in totality, differ from what would have been "adopted by independent enterprises behaving in a commercially rational manner ***and the actual structure practically impedes the tax administration from determining an appropriate transfer price"*** (emphasis added).

- The general anti-avoidance rules in Part IVA provide the Commissioner a broad power to challenge non-commercial arrangements which have been entered into for the purposes of tax avoidance.

Thin capitalisation and capital structures

- We note that the Consultation Paper includes the example of a loan to a thinly capitalised entity as a transaction that could potentially warrant reconstruction. We understand that a review of Australia's thin capitalisation rules is not within the scope of Treasury's review of the transfer pricing rules, and the only reason this example was included is because it is mentioned in the OECD Guidelines.

- The context for the inclusion of this example in the OECD Guidelines is that in some other countries, the transfer pricing rules operate to determine an arm's length amount of debt that an entity may borrow. In Australia, the thin capitalisation rules provide a specific safe harbour on the amount of debt in respect of which interest deductions may be claimed. We suggest removing this example in any further consultation over the proposed changes to the transfer pricing rules.

- The interaction of the transfer pricing rules with the thin capitalisation rules and debt-equity rules has been a contentious area of debate for several years. In 2010, the ATO issued a Taxation Ruling (TR 2010/7) which clarified that the transfer pricing rules should not override the thin capitalisation safe harbour.[9]

- The new law needs to explicitly confirm that the transfer pricing rules are not to be used as a 'back door' way to override the thin capitalisation safe harbour or Division 974 debt equity rules.

Recommendations

- A discretionary power for cases where there is insufficient data should be limited to situations where the taxpayer has intentionally withheld information. The

[9] See Example 4 in TR 2010/7

Commissioner already has significant formal powers to gather information and does not need additional discretionary powers to meet his needs.

- The Commissioner should not be given a discretionary power in situations where it is difficult to identify comparable dealings.
- If there is to be a discretionary power to reconstruct transactions, this should be limited to the exceptional circumstances contemplated in the OECD Guidelines.
- It should be made clear in the new law that the transfer pricing rules will not override the thin capitalisation rules in Division 820 in respect of determining an arm's length capital structure, nor will they override the rules in Division 974 which determine whether an instrument is considered debt or equity for tax purposes.
- We would welcome legislation that specifically confirms that the transfer pricing provisions should be applied to the actual transactions entered into.

3.6. Record keeping requirements

Observations and issues

- In light of the taxpayer's onus of proof under a self-assessment based system, we agree that it is appropriate for taxpayers to be required to maintain documents which demonstrate their compliance with the transfer pricing rules.
- A documentation requirement needs to be balanced with the risk involved and compliance costs to taxpayers.
  - We agree with the Consultation Paper suggestion that legislative documentation requirements should not be overly prescriptive. Taxpayers should be given discretion to apply the principles of 'prudent business management' to determine what documentation is appropriate based on the materiality of and potential risk associated with their transfer pricing arrangements.
  - We support the inclusion of a *de minimis* threshold within the documentation requirements. We agree that the value of related party dealings may be an appropriate criterion upon which to base the threshold. We recommend considering a threshold for entities, and a threshold for specific transactions. Consistency with the threshold in the International Dealings Schedule of the income tax return would be sensible.
  - If guidance will be provided on the 'minimum requirements' to be included in a taxpayer's transfer pricing documentation, these should not be overly prescriptive and should not go beyond the OECD Guidelines.
- In our opinion, the ATO's expectations of a taxpayer's documentation are too high. Taxpayers should not be measured against a set of 'ideal' documentation criteria. If a taxpayer has acted with due care and diligence in preparing its documentation, we consider that penalties should be reduced to nil.
- The law must be carefully drafted to ensure the documentation requirements do not force taxpayers to use a particular transfer pricing method. Taxpayers should select the most appropriate method for their transactions based on the various criteria we discussed above at section 3.3.

- The suggestion in the Consultation Paper that documentation should include an explanation of the profit outcomes may force taxpayers into applying some form of profit based method, even where they have comparable data available to apply a traditional transactional method. In our view, this would be beyond OECD Guidance. A requirement for a taxpayer's documentation to explain the profit outcomes will not be relevant in all cases.

Recommendations

- The documentation requirements should provide flexibility to taxpayers to determine what documentation is appropriate for their business and related party dealings having regard to the complexity and value of the transaction and perceived level of risk in the transactions.
- If the documentation rules require taxpayers to explain why the profit outcomes of their dealings are reasonable, care must be taken to ensure this does not force taxpayers to apply profit based transfer pricing methods.
- The proposed legislation should state that "contemporaneous documentation" means documentation that was in place prior to the lodging of the tax return.

3.7. Penalties

Observations and issues

- It is acknowledged by the ATO and transfer pricing practitioners that transfer pricing is rarely free from some doubt and differences of opinion. Therefore, Treasury's intention to reduce penalties is welcomed and encouraged.

- The Consultation Paper suggests that penalties should be reduced where 'taxpayers act with due care and diligence and make reasonable efforts to apply the arm's length principle'. We agree with this suggestion.

- We agree with the suggestion to reduce penalties to zero where the taxpayer 'has made good faith attempts, commensurate with the relative importance of the profit allocation issue in the context of the taxpayer's business, to determine an arm's length price and has maintained contemporaneous documentation.'

- It is reasonable to link the preparation of contemporaneous documentation to penalties for any tax shortfall resulting from a transfer pricing adjustment. For example, we understand that in the United States, where a taxpayer has prepared contemporaneous documentation that satisfies certain requirements, penalties on transfer pricing adjustments can be reduced to zero.

- The Consultation Paper's direct link to a prudent business management test is encouraged; however, more guidance will be required to clarify this matter further. In our experience, most taxpayers prepare documentation commensurate with their perceived level of risk, the complexity of the transactions and the relative value of the international related party transactions. However, this is subject to personal interpretation and therefore, taxpayers should not be penalised merely because an ATO officer believes more documentation should have been prepared. Further, the Commissioner should not rely on hindsight to make a judgment on whether a taxpayer's response, at the time of dealing with international related parties, was appropriate. Regard should be had to what a prudent business person would do at the time.

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- We understand and agree that more complex issues and transactions (e.g. transfer of intellectual property, cost sharing arrangements) would ordinarily require more detailed documentation than more routine and simpler transactions such as the sale or purchase of goods, or provision or receipt of services.

- The Consultation Paper contemplates penalising taxpayers who do not hold their documentation in Australia. We do not agree with this suggestion. Multinational companies often prepare documentation centrally to support the arm's length nature of transactions. In particular, it is more efficient for taxpayers to prepare documentation centrally from some transactions such as services provided by head office management teams. Provided the documentation relevant to Australian transactions, meets Australia's requirements, was in existence prior to lodgement of the tax return and is made available to the ATO upon request, there should be no penalty for storing the information offshore.

Recommendations

- We recommend that penalties for a shortfall arising from transfer pricing adjustment should be zero percent where taxpayers have made a genuine and reasonable attempt to comply with the transfer pricing rules having regard to the nature of the taxpayer's business (e.g. size, financial position, available resources etc), complexity of transfer pricing issues and value of the transactions subject to transfer pricing.

- Penalties should only apply where a taxpayer has:

  – Made no attempt to support its transfer pricing position,

  – Been reckless or intentionally disregarded the requirements, or

  – Obstructed the Commissioner in making his assessment.

  To the extent possible, where penalties are applied (i.e. above 0%), the regime for penalties should be consistent with other general tax matters resulting in shortfalls.

- The location where documentation is held should not be a driver for penalties. Regard should be had to whether the documentation meets Australia's requirements, supports an arm's length price, the taxpayer has transacted in accordance with the documentation and whether additional analyses in Australia would have resulted in a materially different price.

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3.8. Time limits for amendments

Observations and issues

- The Consultation Paper refers to two time limits; one for the initiation of a transfer pricing audit and the second for the making of an amended assessment. In our view, a time limit for amendment is more consistent with other areas of tax and is therefore preferable. There are strong arguments that the time limit for amendment should be reduced in line with the normal time limits for amendments, 4 years. The proposal to legislate transfer pricing documentation, the increased disclosure requirements of the International Dealings Schedule and the Reportable Tax Positions Schedule and the ATO's stated move to carry out risk reviews in "real time", would suggest that any time limit beyond 4 years is no longer required. At worse, time limits for amendments involving transfer pricing should be no more than the 6 year time limit for general anti-avoidance.

Recommendations

- We support the introduction of time limits for making transfer pricing adjustments and consider that a 4 year amendment limit is appropriate.

3.9. Treaty Issues

Observations and issues

- We note that the Consultation Paper states that domestic profit allocation rules could be redesigned to 'clearly act as the principal source of authority for profit allocation assessment' and that treaty provisions will only seek to 'limit any power contained in the domestic law'. In our view, this would be the correct approach and would be preferable to the Assistant Treasurer's suggestion that the law may be clarified to give treaties a taxing power.

- Attempting to apply a taxing power under the treaties would be open to legal challenge, even if the law is amended prospectively. It will also mean that our treaty countries are prejudiced in comparison to non-treaty countries. We do not consider that the wording variations between Australia's concluded treaties and the OECD model treaty are likely to have any material impact on the question of whether a particular transaction between associated enterprises has been conducted on an arm's length basis.

Recommendations

- The domestic transfer pricing rules should be formally recognised as the principal authority for the Commissioner to enforce Australia's transfer pricing rules. We do not support the notion of the treaties creating a taxing power.

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4. Other considerations

Observations and issues

We note that there are several other issues that may need to be considered in redrafting the transfer pricing rules. These include:

- If profit based methods are to be embedded in the law, consideration will need to be given to how a profit based transfer pricing analysis will be linked to assessable income and allowable deductions from a practical perspective.
- The interaction of the transfer pricing and customs rules should be considered. Tension has always existed between the transfer pricing and customs rules. Where an adjustment is made to the price of imported goods for tax purposes under the transfer pricing rules, there is no automatic adjustment to the customs value of the goods. Seeking an adjustment for customs purposes can be problematic because the timeframes within which adjustments can be made are shorter under the customs rules, and because customs rules focus on the value of specific import transactions. If changes to the transfer pricing rules promote the use of profit methods, this will only increase the number of instances in which the customs and transfer pricing rules are misaligned.
- Consideration should be given to clarifying the application of the transfer pricing provisions to equity instruments. The existing transfer pricing provisions are widely drafted and can arguably apply to an equity instrument such as a share. In the years since the introduction of Division 13, Australia has introduced debt equity provisions which allow certain equity instruments to be regarded as debt for tax purposes. These rules have limitations on the amount of 'interest' deductible which are similar in nature, but more prescriptive than the transfer pricing provisions. It is, in our view, unnecessary to have the transfer pricing provisions apply to such instruments and creates additional compliance burdens in ensuring the level of debt deductions is allowable under both sets of provisions. In our view, there is no need for the transfer pricing provisions to apply to equity instruments.

Recommendations

- Drafting of legislation will need to address the practical application of the transfer pricing rules in determining income and deductions.
- PwC submits that government should consider and address the customs implications of the new transfer pricing rules. We encourage dialogue between Treasury and the Department of Home Affairs in order to align transfer pricing legislation with Customs legislation.
- The new transfer pricing provisions should not apply to equity instruments.

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24 February 2012

Dear Neil,

RETROSPECTIVE TAX CHANGE PROPOSAL: Supplementary Submissions to Treasury

Income tax: cross border profit allocation: Review of transfer pricing rules - Consultation Paper 1 November 2011 ("Consultation Paper")

We refer to our earlier submissions[1], [redacted].

PwC welcomes the opportunity to provide supplementary submissions in respect of the proposed amendments canvassed by the Consultation Paper.

A key concern with respect to the proposed "clarification" of the operation of the Associated Enterprises Article ("**Article 9**") as the source of a separate assessment power is the retrospective operation of the proposed amendments. In particular, there is significant divergence between the views held by the Commissioner of Taxation ("**Commissioner**") [redacted] and views held by the tax profession and taxpayers, as evident from the submissions on this issue [redacted].

Purpose of our supplementary submissions

Given the divergent views on the operation of Article 9, the purpose of these supplementary submissions is to set out, in greater detail, the reasons why Article 9 in Australia's tax treaties **<u>does not and never has</u>**, in our view, provided the Commissioner with a separate source of assessment power and therefore any proposed "clarification" will result in retrospective legislation. ***<u>We believe it is essential that the position on this issue is accurately conveyed to the Treasurer and the Parliament. This is because,</u>*** [redacted] ***<u>we believe that any description of this amendment as "a mere clarification" would be misleading.</u>*** Therefore, the focus of this submission is on addressing the Commissioner's views [redacted] from a technical perspective.

[1] Dated 30 November 2011.

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The submissions herein also provide further reasons against the retrospective operation of the amendments, highlighting the inconsistent result with the Commissioner's position in MT 2008/2 and the fact that concerns in relation to the proposed amendments are likely to be brought to the attention of the Senate by the Senate Standing Committee for the Scrutiny of Bills ("**Senate Bills Committee**"). This submission does not consider the reasons why retrospective legislation is undesirable as this has been covered by other submissions.

Executive summary

There is extensive support for the position that Article 9 does not and never has provided the Commissioner with a separate assessment power. The view that such a power is contemplated by subsection 170(9B) is not supported by the principles of statutory interpretation, general international practice, parliamentary documents in relation to tax treaties or case law.

Given that the position that Article 9 provides a separate assessment power is not supportable, the proposed changes will not constitute a "clarification" of the law – but rather the clear enactment of retrospective new law. The proposed amendments are likely to attract the attention of the Senate Bills Committee which, we anticipate, will require justification for a retrospective change to the tax law which will affect a large number of taxpayers.

In light of the above, we submit that the proposed amendments should not operate retrospectively. However, if the Government decides to introduce retrospective tax legislation which will affect a large number of taxpayers, it is critical that protection is provided against any interest and penalties which might otherwise be imposed[2].

Format of our submissions

We have prepared our submission by reference to the following propositions:

1. The view that Article 9[3] provides a separate assessment power is not supported by principles of statutory interpretation and case law. This applies to both:
    - the Commissioner's original position relying on the operation of section 4 of the *International Tax Agreements Act 1953* (Cth) ("**Agreements Act**"); and
    - the Commissioner's more recently developed position which relies on the operation of subsection 170(9B) *Income Tax Assessment Act 1936* (Cth).
2. General international practice confirms that Article 9 does not, and is not designed to, impose tax.

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[2] Consistent with recent Government practice in relation to retrospective tax changes (refer *"CONSOLIDATION: CHANGES TO THE RESIDUAL TAX COST SETTING AND RIGHTS TO FUTURE INCOME RULES"*, Treasury (25 November 2011).

[3] We refer in this submission to Article 9 generally. However, it is recognised that the words of any particular treaty will need to be considered. For example, we have already stated very clearly our views in relation to the operation of Article 1(2) of Australia's tax treaty with the USA.

3. If Article 9 was intended by Parliament to operate in a way which differs from general international practice, this should be evident from parliamentary documents which relate to Australia's tax treaties. This is not the case.

4. Case law confirms that Australia's tax treaties (including Article 9) do not provide a separate assessment power, even if incorporated into the *Income Tax Assessment Act 1936* (Cth) and the *Income Tax Assessment Act 1997* (Cth) (collectively the "**Assessment Act**").

5. If the operation of Article 9 were to be tested in Court, the view provided by Justice Downes in *Roche Products Pty Limited and Commissioner of Taxation* [2008] AATA 639 *("**Roche**")* (i.e. that tax treaties do not confer a power on the Commissioner to assess) would prevail. The comments by Justice Middleton in *SNF (Australia) Pty Ltd v Commissioner of Taxation* [2010] FCA 635 ("***SNF***") need to be viewed in context.

6. The retrospective application of the amendments is inconsistent with the Commissioner's view that taxpayers may adopt an alternative treatment to that expressed in a ruling.

7. The Senate Bills Committee is likely to draw attention to the proposed amendments on the basis that they unduly trespass on personal rights and liberties.

In theses submissions we only consider whether Article 9 provides a separate power of assessment. However, the same arguments should in most circumstances apply to the Business Profits Article of Australia's tax treaties.

Unless specified otherwise, all legislative references are to the Assessment Act.

We would be pleased to discuss the comments in our submissions with you further.

Yours sincerely

Lyndon James	Peter Collins
Partner	Partner
Transfer Pricing, National Leader	International Tax Services, National Leader

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1. *The view that Article 9 provides a separate power is not supported by principles of statutory interpretation and case law*

Introduction

We acknowledge that the Commissioner has, for an extended period of time, voiced the view that treaty provisions (specifically Article 9) give rise to a separate assessment power. However, the reasons for the Commissioner's view are not supported under the principles of statutory interpretation and case law. This applies to both:

- the Commissioner's original position[4] in 2003 relying on the operation of section 4 of the Agreements Act; and
- the Commissioner's more recently developed position[5] in 2009 relying on the operation of subsection 170(9B).

Original position relying on the operation of section 4 of the Agreements Act

The original basis for the Commissioner's view relied on the effect of the incorporation of the Assessment Act into the Agreements Act. In particular, this view relied on the argument that the effect of section 4 of the Agreements Act was that the Act effectively "modified" the Assessment Act (e.g. refer paragraphs 39 and 46 of *GE Capital Finance Pty Ltd v Commissioner of Taxation* [6] ("***GE Capital***")).

However, this argument was dismissed in *GE Capital* where the Court relevantly held (at paragraph 40):

> *By the operation of s 4(1), the Agreements Act incorporates the Assessment Act subject to s 4(2). However, each Act retains its own identity and the imposition of the relevant tax is still imposed by and at the rates declared by the Income Tax (Dividends, Interest and Royalties Withholding Tax) Act 1974 (Cth) and the Income Tax Rates Act 1986 (Cth) by reference to the Assessment Act. The incorporation has the consequence, as a matter of a drafting technique, of incorporating the text of the Assessment Act into the Agreements Act*. (emphasis added by PwC)

For present purposes, the decision in *GE Capital* provides the following guidance on the interaction between the Agreements Act and the Assessment Act and consequently the validity of the view relying on the operation of section 4 of the Agreements Act:

a) income tax is imposed by the *Income Tax Act 1986* (Cth) ("**Tax Act**");

[4] First publicly stated in TR93/D40 dated 31 August 1993 (refer paragraphs 143-145). This became TR 94/14.
[5] First publicly stated in the "Merkel Advice" ("**Merkel 1**" dated 11 May 2009 and " **Merkel 2**" dated 23 June 2009) which was released to the public on 16 December 2009.
[6] (2007) 159 FCR 473

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b) the Assessment Act is incorporated into the Tax Act with the effect that the Tax Act is modified by the Assessment Act but retains its own identity (i.e. it is the Tax Act, as modified by the Assessment Act);

c) the consequence of a) and b) is that income tax is imposed under the Tax Act as modified by the Assessment Act;

d) in order for Article 9 to provide a separate assessment power, the Agreements Act would need to be ultimately incorporated into the Tax Act;

e) the Agreement Act is not incorporated into and therefore does not modify the Assessment Act. Rather, the Assessment Act is incorporated into the Agreements Act with the effect that the Agreement Act is modified by the Assessment Act but retains its own identity (i.e. it is the Agreement Act, as modified by the Assessment Act); and

f) as a result of e) there is an insufficient connection between the Tax Act and the Agreements Act in order for the provisions of the Agreements Act to impose tax. A sufficient connection could possibly exist if the Agreement Act was incorporated into the Assessment Act.

The fact that the view based on section 4 of the Agreements Act "does not work" is recognised in Merkel 1 (viz transfer pricing memorandum of advice dated 11 May 2009 by Ron Merkel QC) at paragraph 50. In the words of Merkel QC "…Middleton J concluded that the legislature failed to achieve that outcome…". This conclusion also appears to be acknowledged by the Commissioner given that, in contrast to TR 2001/13 (at paragraph 32), the subsequently issued TR 2010/7 (at paragraphs 40 to 41) does not refer to this position[7].

More recently developed position relying on subsection 170(9B)

The Commissioner's more recently developed position relies on a specific interpretation of subsection 170(9B) (as affected by subsections 170(9C) and 170(14) of the Assessment Act). By way of background, these subsections provide:

> *(9B) Subject to subsection (9C), nothing in this section prevents the amendment, at any time, of an assessment for the purpose of giving effect to a prescribed provision or a relevant provision.*
>
> *(9C) Subsection (9B) does not authorize the Commissioner, for the purpose of giving effect to a prescribed provision or a relevant provision, to amend an assessment made in relation to a taxpayer in relation to a year of income where:*
>
> > *(a) in a case where the purpose of the amendment is to give effect to the prescribed provision in relation to the supply or acquisition of property--the prescribed provision has been previously applied, in relation to that supply or acquisition, in making or amending an*

[7] The Commissioner has failed to directly publicly acknowledge the broader ramifications of *GE Capital* (refer Decision Impact Statement: *GE Capital Finance Pty Ltd (as trustee for the Highland Finance Unit Trust) v Commissioner of Taxation* dated 9 August 2007).

assessment in relation to the taxpayer in relation to the year of income; or

(b) in any other case--the prescribed provision or the relevant provision, as the case may be, has been previously applied, in relation to the same subject matter, in making or amending an assessment in relation to the taxpayer in relation to the year of income.

For the purposes of subsections 170(9B) and 170(9C), the term 'relevant provision' is defined in subsection 170(14):

*"**relevant provision**" means:*

(a) a provision of a double taxation agreement that attributes to a permanent establishment or to an enterprise the profits it might be expected to derive if it were independent and dealing at arm's length; or

The Commissioner's position relying on subsection 170(9B) is set out in Merkel 1, which provides:

- the effect of the definition of 'relevant provision' is that, by subsection 170(9B), the Commissioner, relevantly has the power to at any time amend an assessment for the purpose of giving effect to Article 9, being a relevant provision (paragraph 54);
- subsection 170(9C), in referring to a previous application of the associated enterprises article in making an assessment, demonstrates that the legislature has enacted sections 170(9B) and (9C) on the basis that the Commissioner may rely on either section 136AD or Article 9 (paragraph 59); and
- the existence of the power to amend an assessment in reliance on Article 9 implies that the Commissioner has a power to assess in reliance on the article (paragraph 59).

However, the view expressed in Merkel 1 is not supported by established principles of statutory interpretation, as it unnecessarily and inappropriately departs from the literal meaning and operation of the provisions.

The position also fails to recognise that the legislative intention noted in the Explanatory Memorandum to subsection 170(9B)[8] was affected by the erroneous assumption that section 4 of the Agreements Act was effective in incorporating the Agreements Act into the Assessment Act.

These points, including the impact on the Merkel Advice are discussed below.

[8] The Explanatory Memorandum to the *Income Tax Assessment Amendment Bill 1982*

How should subsection 170(9B) be interpreted?

Section 15AA of the *Acts Interpretation Act 1901* (Cth) provides that in interpreting a provision of an Act, the interpretation that would best achieve the purpose or object of the Act (whether or not that purpose or object is expressly stated in the Act) is to be preferred to each other interpretation.

Further guidance on the rules of statutory interpretation are relevantly set out in *Prebble v Commissioner of Taxation* [2003] FCAFC 165 ("***Prebble***") at paragraphs 24 to 25:

> *24* *It is well accepted that the task of statutory interpretation requires close attention to be paid to the language used by Parliament in the context in which that language appears, using the word 'context' in the broadest sense as including matters such as the mischief which Parliament intended to address, the object of the legislation and its legislative history: CIC Insurance Ltd v Bankstown Football Club Ltd (1997) 187 CLR 384 at 408. Further, resort should be had to context at the outset and not merely at a later stage when ambiguity might be thought to arise. The modern approach to statutory interpretation makes it clear, even without the statutory direction in s 15AA of the Acts Interpretation Act 1901 (Cth), that the Courts will give effect to the intention of Parliament as that is to be found in the legislation itself or where it may appear from extrinsic materials to which the Court may have recourse.*
>
> *25* *The Courts will depart from the literal meaning of a statutory provision where that literal meaning leads to absurdity or where it produces a result which is capricious or irrational. It will do so also where the literal meaning of the words used by Parliament do not conform with the legislative intention as ascertained from the statute itself: Cooper Brookes (Wollongong) Pty Ltd v Commissioner of Taxation (Cth) (1981) 147 CLR 297 at 321. It is true that subject to the above principles the language of the statute will generally be given its ordinary and grammatical reading, even where the result may, perhaps, be thought to be 'inconvenient'. Courts should not readily depart from the ordinary meaning of the words used where there is no ambiguity, for to do so might, as Gibbs CJ said in Cooper Brookes at 305, lead Judges to approach the task of interpretation by reference to their own ideas of justice or social policy. But ambiguity will often be present. It is here. And hence the search will be for that construction which will give effect to the real intention of the legislature so far as that can be gleaned from the legislation.*
> (emphasis added by PwC)

In light of the above, subsection 170(9B) and also subsections 170(9C) and (14) need to be interpreted in the broader context of sections 169, 170, 173, the decision in *GE Capital* on the effect of section 4 of the Agreements Act and subsection 170(11). In particular, the subsection needs to be interpreted in the context of the Commissioner's general power of assessment under section 169, as modified (limited) by section 170. This best achieves the purpose of the Assessment Act, which is essentially concerned with the calculation and collection of income tax.

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In this regard, the Commissioner's general power of assessment is set out in section 169, which provides as follows:

> ***169 Assessments on all persons liable to tax***
>
> *Where under this Act any person is liable to pay tax (including a nil liability), the Commissioner may make an assessment of the amount of such tax (or an assessment that no tax is payable).*

In simple terms, section 169 requires a person to be liable to tax under the Assessment Act in order for the Commissioner to have a power of assessment.

In contrast, section 170 does not specifically provide a broad power to amend an assessment. Rather, the section sets out, in detail, the circumstances where the Commissioner may or may not amend an assessment (e.g. specifying time limits and restrictions on amendment of assessments which have previously been amended). The section appears to both express and at the same time limit the Commissioner's power of assessment – in the context of amending an assessment. However, the section necessarily and naturally presupposes a power of assessment, which is located in section 169 and therefore should be interpreted in this context (i.e. that there must initially be a power of assessment).

This conclusion is consistent with the Commissioner's views in TR 2011/5, where, with respect to the relationship of an amended assessment to the original assessment, the Commissioner provides (at paragraphs 82 and 83):

> *82. From the discussions in these cases, it is apparent that an amended assessment does not cancel, revoke, extinguish or replace the original assessment. Rather, its role is to alter the original assessment by amending it in a particular or particulars, with a view to imposing a fresh liability, or at least, by adjusting the components or elements that went to determining the taxable income or tax payable amounts previously notified.*
>
> *83. It is clear from these authorities that at any given time, there is only one assessment in operation for a given income year, which fixes with certainty the taxpayer's taxable income (or that there is no taxable income) and the tax payable thereon (or that there is no tax payable). Thus, an amendment of an existing assessment is not a new assessment.* (emphasis added by PwC)

This conclusion is also supported by the words of subsections 170(9B) and (9C). These subsections are part of a number of provisions in section 170 which are couched in negative terms and provide that "nothing in this section prevents the amendment, at any time of an assessment for the purpose of giving effect to ...." (e.g. refer subsections (10), (10AA) and (11)).

The ordinary and literal reading of the words "nothing in this section prevents the amendment of an assessment" indicates that the Commissioner has a pre-existing power of amendment/assessment which exists outside of the relevant subsection. That is, the necessary and natural conclusion is that these subsections are aimed at preserving, rather than granting, the Commissioner a power of assessment which arises from the power of amended in subsection 170(1). However, as discussed above, this power of amendment presupposes a power of assessment under section 169 – the two are interlinked. This is confirmed by subsection 170(1) which requires a notice of

assessment to be issued before the power of amendment can be exercised. This connection is also confirmed by section 173, which provides:

> ***Amended assessment to be an assessment***
>
> *Except as otherwise provided every amended assessment shall be an assessment for all the purposes of this Act.*

The necessary and natural conclusion of the above is that where the Commissioner does not have a power to assess under section 169, he likewise should not have a power to amend an assessment. To say that where the Commissioner has a power to amend an assessment necessarily implies that he has a power to assess is to "put the cart before the horse".

In the present case, as highlighted by the decision in *GE Capital*, the Commissioner does not have a power to assess a taxpayer in accordance with Article 9 under section 169. This is on the basis that the Agreements Act (via modification of the Assessment Act) is not, ultimately, incorporated into the Tax Act.

The fact that the Commissioner is not empowered to assess a taxpayer under section 170 to increase their tax liability by giving effect to Article 9 is evident from the existence of subsection 170(11), which provides:

> *(11) Nothing in this section prevents the amendment, at any time, of an assessment to decrease the liability of a taxpayer for the purpose of giving effect to section 24 of the International Tax Agreements Act 1953.* (emphasis added by PwC)

Section 24 of the Agreements Act essentially provides for the Commissioner to provide relief from double taxation where a taxpayer is assessed by another jurisdiction in accordance with or consistent with the principles of Article 9. If the effect of subsection 170(9B) was, as proposed by the Commissioner and set out in the Merkel Advice, subsection 170(11) would not be necessary or would be couched in terms which would also allow the Commissioner to increase a taxpayer's liability.

Accordingly, subsection 170(9B) cannot be read to provide the Commissioner with a power of assessment which he would not otherwise have under section 169. In particular, on a literal reading of subsection 170(9B) this subsection is aimed at preserving, rather than granting, the Commissioner a power of assessment.

The source of the confusion – why subsections 170(9B) and (9C) are drafted the way they are

The confusion around the application and effect of subsections 170(9B) and (9C) arises from the erroneous assumption, which existed at the time that these subsections were introduced, that section 4 of the Agreements Act was effective in essentially incorporating the Agreements Act into the Assessment Act.

The perceived consequence of that assumption was that, in determining the tax liability of a taxpayer, the Commissioner was required to apply the provisions of the Agreements Act in priority to the provisions of the Assessment Act. Therefore, in making a transfer pricing adjustment, where both Division 13 and Article 9 applied, the Commissioner would be required to apply Article 9 as a result of the operation of

subsection 4(2) of the Agreements Act. This is evident from the following extract from the Explanatory Memorandum:

> *"In their practical effect, proposed sub-sections 170(9B) and (9C) will clarify the powers of the Commissioner to amend an assessment where a provision of a double taxation agreement that deals with profit shifting may be applicable. Sub-section 4(2) of the Income Tax (International Agreements) Act 1953 provides that the provisions of that Act are to have effect notwithstanding anything inconsistent with those provisions contained in the Principal Act. Technically, therefore, the provisions of a double taxation agreement that deal with profit shifting, either under a "business profits" article (e.g., Article 5 of the Australia/U.K. agreement), or an "associated enterprises" article (e.g., Article 7 of that agreement), may have to be applied instead of Division 13. Where the profit shifting provisions of a double taxation agreement are to apply in these circumstances, sub-sections 170(9B) and (9C) confer the same specific powers of amendment of an assessment as are to be provided in relation to revised Division 13."*[9] (emphasis added by PwC)

The effect of the above is that if subsection 4(2) does not operate as provided above as a result of the decision in *GE Capital*, then subsections 170(9B) and (9C) likewise will not apply. That is, the subsections only apply where the Commissioner is required to apply Article 9 in priority to Division 13. This interpretation is consistent with the last sentence in the above Explanatory Memorandum which confirms that the subsections will only operate where there is a power of assessment (as there is with Division 13).

Furthermore, absent the decision in *GE Capital*, there is strong evidence that Article 9 cannot be relied on as a separate assessment power. This is evident from international practice and case law (e.g. *Roche* and other cases which indicate that the articles of a tax treaty need to be interpreted in the context of the overall purpose of the treaty), as discussed below.

Therefore, in the words of Merkel 1 (at paragraph 50), although the legislature probably intended that subsection 170(9B) confer a power to amend an assessment in reliance on Article 9, it failed to achieve that outcome – as the basis for the assessment does not and never did exist.

Implications of the above for the conclusions in Merkel 1

In light of the above, the following response can be provided to the conclusions of Merkel 1:

Merkel 1 Advice	**Response**
"The effect of the definitions [of 'relevant provision'] is that, by s 170(9B)(subject to section s 170(9C)), the Commissioner, relevantly, has power to at any time amend an assessment ... for the purpose of giving effect to the Associated Enterprises Article, being a relevant provision" (para 54)	The ordinary meaning of the words in subsection 170(9B) is that they are aimed at preserving the Commissioner's power of amendment. That is, the section does not provide the Commissioner with a power to amend an assessment - which exists outside of the subsection.

[9] The Explanatory Memorandum to the *Income Tax Assessment Amendment Bill* 1982

	There is no ambiguity which necessitates the departure from the ordinary meaning of the words in the subsection (refer *Prebble* above). The conclusion that the subsection provides a power of assessment is to, using the words of Justice Middleton in *GE Capital* (at para 46) "... embark upon the task of impermissibly rewriting the [Act] to facilitate the result the [Commissioner] seeks".
"Put another way, the sub-section can be taken to have incorporated the associated enterprises article into the Assessment Act by empowering the Commissioner to amend an assessment in reliance upon that article" (para 55)	As the subsection does not empower the Commissioner to amend an assessment, the implication is not "necessary and natural". Refer above comments that the power of assessment arises under section 170(1) and by reference and in the context of section 169. Neither of those sections require or contemplate the incorporation of Article 9. Subsection 170(11) does not, for its effect, require the Commissioner to have a power to increase (rather than decrease) tax liability of a taxpayer.
"Subsection 170(9C), in referring to a previous application of s 136AC or the associated enterprises article in making an assessment, demonstrates that, at least from 1982, the legislature has enacted these provisions upon the basis that the Commissioner may rely upon either section 136AD or the associated enterprises article as separate sources of power to make an assessment" (para 59)	Subsections 170(9B) and (9C) were drafted on the erroneous assumption that section 4 of the Agreements Act was effective in essentially incorporating the Agreements Act into the Assessment Act and that Article 9 could be applied as a separate assessment power. However, where such power does not exist and therefore the initial power of assessment cannot be applied, subsection 170(9C) will not operate. This is consistent with the subsections generally being aimed at preserving rather than granting the Commissioner with a power of assessment.
"Conferral of a power to amend an assessment (which is an assessment) on a particular basis naturally and necessarily implies a power to assess on that basis, particularly where it has been concluded that the particular basis of for	As noted above, subsection 170(9B) does not confer a power to amend an assessment, but rather preserves the Commissioner's power. The implication is not necessary and does not arise. It is impermissible to embark

the amendment has been incorporated into the Assessment Act" (para 59) on a rewriting of the Act, as there is no ambiguity in the present case.

In light of the above, we submit that the Merkel Advice does not provide a cogent argument that Article 9 can be applied as a separate source of assessment power.

Conclusion

Neither of the positions on which the Commissioner has relied to support his view that Article 9 provides a separate assessment power is supportable under principles of statutory interpretation. Accordingly, any amendment to grant the Commissioner such power will go beyond merely "clarifying" the law and constitute retrospective legislation.

2. General international practice confirms that Article 9 does not and is not designed to impose tax

Introduction

[redacted] suggests that there is no principle under international law that tax treaties are to be applied in an exclusively reliving manner. In support of this conclusion [redacted] provides a number of examples – none of which relate to Article 9 and all of which relate to particular circumstances under local law. We submit that these exceptions confirm, rather than deny, the existence of the sword/shield principle, which is supported by general international practice.

The exception confirms the rule

We accept that there are instances where tax treaties have been applied in a way which extends source taxation. However these examples are limited and do not detract from the general principles which are set out in commentary and judicial decisions that tax treaties are effectively concerned with relieving double taxation. We do not propose to discuss these again, as they are contained in other submissions.

The existence of the exceptions (e.g. in France) supports the position that tax treaties generally operate in a reliving manner - *exceptio probat regulam in casibus non exceptis* (the exception confirms the rule in cases not excepted). For example, the fact that countries have 'reservations' in relation to the OECD Model Tax Convention, does not mean that there is no OECD standard for tax treaties.

Examples of how Article 9 is applied by other countries confirm that the article is not designed to impose tax

None of the examples provided [redacted], namely of France, Italy and the Netherlands directly relate to how Article 9 has been applied by those countries. Our analysis indicates that Italy, the Netherlands and France apply Article 9 in a way which limits, rather than extends taxation (refer below).

In terms of the specific examples [redacted], we note the following after having reviewed these examples in more detail:

- The article by Philippe Martin[10] in relation to France actually states that:

  > *"tax treaties do not normally give rise to grounds for domestic taxation"*
  >
  > *"in transfer pricing cases, treaty provisions following Article 9...may be used to restrict the scope of domestic transfer pricing provisions"*

[10] Martin, P. (2011) *France: Interaction between Tax Treaties and Domestic Law*, Bulletin for International Taxation, Vol. 65, No. 4/5

"In practical terms, subsidiarity means the FTA cannot rely on treaty provisions to tax a person. This protective effective is explicitly described in the Schneider case".

The article explains the introduction, in 1959, of so-called "stopgap" legislation which codifies that income attributed to France by tax treaties is taxable in France.

- The article by Alessio Persiani[11] in relation to Italy deals with a very specific example in relation to employment income of Italians. In discussing a decision of the Supreme Court, Persiani notes that *"..it is accepted that tax treaties do not impose tax"* and reference is made to another article [12]on this topic in the context of Canadian tax.

- The Article by Philip Baker[13] which makes reference to a decision in the Netherlands states that *"..the issue of whether a treaty...can impose a higher tax than might otherwise exit under domestic law. Different states have adopted different views on this point , though the majority appear to take the view that treaties only relieve from tax and not impose a higher charge than under domestic law."*

In summary, none of these examples [redacted] are persuasive.

We refer to volume 96a of the *Cahiers de droit fiscal international* (tax treatment cross-border business restructuring) ("**Cahiers**") which confirms general international practice that Article 9 is not applied in a way which provides a separate power of assessment. Relevant extracts are provided below. That Australia accepts this general international practice is confirmed by subsection 170(11) which preserves the Commissioner's power to amend an assessment to decrease the tax liability of a taxpayer to give effect to Article 9.

Extracts from Cahiers

Country	Extract from section 1.4 of the relevant country report	Page
Canada	*"... Canadian tax treaties generally override domestic law, since article 9 of Canadian tax treaties is not a charging provision but limits a contracting state's ability to impose tax..."*	180
Finland	*"Generally, as a tax treaty may only limit the competency of the tax authorities, interventions in business restructuring are not possible on the basis of tax treaties alone."*	314-315
Germany	*"Basically, according to §2 General Fiscal Code (Abgabenordnung) international treaties take precedence over national law once they have been*	357

[11] Persiani, A. (2010) *Foreign Employment Income in the Italian Tax Setting*, Bulletin for International Taxation, August/September 2010

[12] B.J. Arnold *The relationship between Tax Treaties and the Income Tax Act: Cherry Picking*, Canadian Tax Journal (1995), page 869

[13] Baker, P. *Double Tax Conventions and International Tax Law*, London, Sweet and Maxwell, 1994

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	adopted as regular German law. ... A German double taxation treaty copying article 9 of the OECD MC results in a barrier effect because deviations from article 9 OECD MC either have no effect or represent a treaty override. Another state will not accept an approach that has not been bilaterally agreed upon."	
Ireland	*"For Irish tax purposes the provisions of Ireland's DTAs take precedence over domestic law to the effect that they provide relief from taxation but they cannot impose any new taxation over and above the requirements of Irish domestic legislation."*	387
Italy	*"The relationship between domestic law and tax treaties is an issue that the Supreme Court (Corte di Cassazione) has tackled in a number of instances. Judges have affirmed in the past that a tax treaty could generate a tax claim that did not exist under domestic law.* *More recently the Supreme Court has followed a different approach, though with a reference to specific cases concerning the taxation of employment income ...* *As a result, the principles outlined by the Supreme Court recently, whereby Italy may tax even absent a domestic provision if the tax treaty so provides, appear in conflict with other precedents of the Court and have been criticised by some scholars."*	430
Netherlands	*"At the same time, (tax) treaties do not create taxation in the Netherlands. Article 9 model convention basically provides the right to the Netherlands (as contracting state) to make transfer pricing adjustments in cases of non-arm's length dealings. On the basis of article 8b CITA, the Netherlands basically effectuated this right."*	512
Sweden	*"The tax provisions of a tax treaty are applied only if they limit a tax liability in Sweden that would otherwise exist. Tax treaties can thus never provide Sweden with taxation rights that do not already exist under domestic Swedish tax law."*	683

More recently, PwC transfer pricing experts in UK, USA, Canada, Japan, New Zealand, France and China have confirmed that Article 9 does not provide a power to impose tax in those countries.

Conclusion

General international practice confirms that Article 9 is not intended to be applied in a way which imposes tax. Therefore, even if the article were incorporated into the Assessment Act, unless there was an express intention that the article is intended to provide a separate assessment power, it is unlikely that such a power could be implied.

3. If Article 9 was intended by Parliament to operate in a way which differs from general international practice, this should be evident from parliamentary documents which relate to Australia's tax treaties. This is not the case.

Introduction

In forming the view relying on subsection 170(9B), the Commissioner and the Merkel Advice rely on the relevant Explanatory Memorandum, as indicating a legislative intention that the subsection should enable the Commissioner to issue an assessment applying Article 9.

If tax treaties provide the Commissioner with a separate power of assessment under subsection 170(9B) then this should be evident from parliamentary documents relating to tax treaties. However, neither the explanatory memoranda, nor other parliamentary documents such as regulatory statements or national interest analyses in relation to tax treaties specifically refer to Article 9 as providing the Commissioner with a separate power of assessment.

This confirms that the legislature, in enacting tax treaties into law, do not have an intention that they will be applied in a way which provides the Commissioner with a separate power of assessment.

No clear intention in explanatory memoranda

The following extract from the Explanatory Memorandum to the 2003 United Kingdom Convention specifically recognises that in Australia's tax treaties, the profit allocation rules are concerned with the allocation of taxing rights (i.e. allocation of profits on an arm's length basis) which in turn are taxed under Australia's domestic transfer pricing rules:

> ***"What is the purpose of Australia's tax treaties?***
>
> *Australia's tax treaties are designed to:*
>
> - *prevent avoidance and evasion of taxes on various forms of income flows between the treaty partners by:*
>   - *providing for the allocation of profits between related parties on an arm's length basis;*
>   - *generally preserving the application of domestic law rules that are designed to address transfer pricing and other international avoidance practices; and*

- *providing for exchanges of information between the respective taxation authorities. (emphasis added)"*[14] (emphasis added by PwC)

We specifically draw attention to the second-last bullet point, which provides that Australia's tax treaties are designed to preserve the application of domestic transfer pricing rules.

In a similar way, nothing in the following paragraphs in the Explanatory Memorandum to the more recent Australia-Turkey Convention, which was signed in 2010, indicates that Article 9 is intended to operate in a way other than by "authorising" and "allowing" adjustments to profits under the domestic rules and in accordance with the article:

> ***"Reallocation of profits***
>
> *8.108 This Article deals with associated enterprises (such as parent and subsidiary companies and companies under common control). <u>It authorises the reallocation of profits</u> between related enterprises in Australia and Turkey <u>on an arm's length basis</u> where the commercial or financial arrangements between the enterprises differ from those that might be expected to operate or be made between unrelated enterprises dealing wholly independently with one another. [Article 9, paragraph 1]*
>
> *8.109 This Article would not generally authorise the rewriting of accounts of associated enterprises where it can be satisfactorily demonstrated that the transactions between such enterprises have taken place on normal, open market commercial terms. The term 'might reasonably be expected to operate' in paragraph 1 is included to conform to Australia's treaty practice and <u>allows adjustments</u> where it is not possible to determine the conditions that 'would have been made or occurred' between the associated enterprises.* [15]
>
> *8.110 <u>The broad scheme of Australia's domestic law provisions relating to international profit shifting arrangements under which profits are shifted out of Australia, whether by transfer pricing or other means, is to impose arm's length standards</u> in relation to international dealings. Where the Commissioner cannot ascertain the arm's length consideration, it is deemed to be such an amount as the Commissioner determines.*
>
> *8.111 <u>Each country has the right to apply its domestic law relating to the determination of the tax liability of a person</u> (for example, Australia's Division 13 of Part III of the ITAA 1936) to enterprises, including in cases where the available information is inadequate, <u>provided that such provisions are applied, so far as it is practicable to do so, consistently with the principles of the Article.</u> This is of particular relevance where there is no data available or the available data is not of sufficient quality to rely on the traditional transaction methods for the <u>attribution of arm's length profits</u>. This reflects Australia's reservation to Article 9 (Associated Enterprises) of the OECD Model. [Article 9, paragraph 2]"* (emphasis added by PwC)

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[14] Explanatory Memorandum to the *International Tax Agreements Amendment Bill 2003*
[15] Explanatory Memorandum to the *International Tax Agreements Amendment (No. 1) Bill 2011*, para 8.108 and 8.109

In particular, in both instances significant emphasis is placed on the "authorisation" of the reallocation of profits (indicating an entitlement to tax) and the operation of domestic law provisions.

Significance of the lack of evident intention in the explanatory memoranda

In the Full Federal Court decision *Commissioner of Taxation v SNF (Australia) Pty Ltd* [2011] FCAFC 74 ("***SNF FFC***"), the Court notes that tax treaties which are incorporated in their entirety into domestic legislation should be applied in a way which is consistent with their intended operation (at paragraph 119). As discussed above, Article 9 is not applied by other countries in a way which would grant a separate power of assessment (i.e. act as a charging provision). Rather, the article is applied as being merely concerned with ensuring that each contracting state applies its domestic transfer pricing rules in a way which is consistent with the arm's length method. Nothing in the explanatory memoranda nor other parliamentary documents indicates that the legislature intended to depart from this intention and provide the articles with a more extensive operation.

Furthermore, given the significance of such a departure from international norms, this intended operation should have been explicitly stated in parliamentary documents given that parliamentarians voting on this legislation are otherwise unlikely to be aware of the significance of this. Taxpayers, likewise, may be caught off-guard by such a departure from general international practice.

Conclusion

The absence of specific reference in parliamentary documents to Article 9 providing a separate power of assessment confirms the view that such a power was not specifically intended to be granted by the legislature in enacting the legislation.

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4. *Case law confirms that Australia's tax treaties (including Article 9) do not provide a separate assessment power, even if incorporated into the Assessment Act*

Introduction

In his press release dated 1 November 2011 (No. 145), the Assistant Treasurer provides that there is a *"... strong argument that tax treaty rules already operate independently of the domestic rules..."*[16] However, this view is inconsistent with court cases which have considered the application of tax treaties. In particular, case law:

- confirms that the purpose and effect of Australia's tax treaties is the allocation of taxing rights, which presupposes the existence of separate domestic taxing provisions;
- specifically provides that tax treaties do not provide a separate taxing power; and
- indicates that the mere fact that tax treaties are incorporated into Australian tax legislation does not transform their operation.

This is relevant as, even if the incorporation of the Agreements Act into the Assessment Act was effective or the subsection 170(9B) view was upheld by a Court, this would not "necessarily and naturally" result in Australia's tax treaties (including Article 9) operating independently and providing the Commissioner with a separate assessment power.

As follows are relevant extracts from these cases.

Case law confirms that the purpose and effect of Australia's tax treaties is the allocation of taxing rights, which presupposes the existence of separate domestic taxing provisions

The purpose and effect of tax treaties, as understood by Australian Courts, is summarised in the decision in *Undershaft (No 1) Limited v Commissioner of Taxation* [2009] FCA 41 ("***Undershaft***"), which provides at paras 44 to 45:

> *"A purpose of a DTA is to avoid the potential for the imposition of tax by both of the Contracting States on the same income. It is appropriate to say that the Contracting States achieve their objective by "allocating" as between themselves the right to bring to tax a particular item to one Contracting State while the other State agrees to abstain from doing so (Lamesa at 600, Chong v Commissioner of Taxation [2000] FCA 635; (2000) 101 FCR 134 at [24]-[27])."*

[16] The Hon Bill Shorten MP, *"Robust Transfer Pricing Rules for Multinationals"* (Media Release, 1 November 2011).

In a similar way, the presupposed existence of domestic taxing provisions is set out in the decision in *Chong v Commissioner of Taxation* [2000] FCA 635 ("***Chong***"), which provides at para 26:

> *"As a matter of principle it is appropriate to describe the purpose and effect of a double tax agreement, where there are two existing tax systems in two contracting states, as one where areas of taxation are allocated between the two contracting states. The allocation of taxing power in a double tax agreement is predicated on the existence of a sovereign right by a contracting state to impose taxation and the existence of taxation legislation. When one refers to an allocation of taxing power one is doing no more than saying that in an area where both contracting states have the right to impose taxation, and may have already imposed taxation, they have agreed that one contracting state, rather than the other or, as the case may be, both contracting states, shall have the right to impose taxation in that area. Whether one uses the language of allocation of power or the language of limitation of power, the result is the same; there is designated or agreed who shall have the right under the agreement to impose taxation in the particular area."* (emphasis added by PwC)

This is also highlighted in the decision in *GE Capital*, which provides at para 29:

> *"Certain forms of income are dealt with separately in the USA Double Tax Treaty. Interest is dealt with in Art 11, and business profits are dealt with in Art 7. In relation to each, the USA Double Tax Treaty is both prohibitive and permissive. Where it permits taxation by allocating the power to tax, the result will depend upon the provisions of the domestic legislation."* (emphasis added by PwC)

The above position is consistent with and reflected in other recent tax treaty court cases, including *Roche* and *SNF FFC*.

The above position is also consistent with internationally accepted views on how tax treaties operate. For example, the following extract from the preeminent text on tax treaties by Klaus Vogel, *Double Taxation Conventions* (3rd ed, 1997), referred to in the decision in *Chong* at para 19, provides:

> *"Tax treaty rules assume that both contracting States tax according to their own law; unlike the rules of private international law, therefore, treaty rules do not lead to the application of foreign law. Rather, treaty rules, to secure the avoidance of double taxation, limit the content of the tax law of both contracting States; in other words, the legal consequences derived from them alter domestic law, either by excluding application of provisions of domestic tax law where it otherwise would apply, or by obliging one or both States to allow a credit against their domestic tax for taxes paid in the other State."* (emphasis added by PwC)

Case law specifically provides that tax treaties do not provide a separate assessment power

A number of cases have specifically considered that tax treaties limit the operation of existing domestic taxing provisions rather than providing a separate assessment power. For example, the decision in *Undershaft*, referred to above, specifically provides at paragraphs 44 to 45:

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"A DTA does not give a Contracting State power to tax, or oblige it to tax an amount over which it is allocated the right to tax by the DTA. Rather, a DTA avoids the potential for double taxation by restricting one Contracting State's taxing power." (emphasis added by PwC)

In a similar way, the decision in *Roche Products* provides at para 191:

"In the result I do not need to decide the issue 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 of Australia, do not go past authorising legislation and do not confer power on the Commissioner to assess. They allocate taxing power between the treaty parties rather than conferring any power to assess on the assessing body. On this basis Division 13 should be seen as the relevant legislative enactment pursuant to the power allocated." (emphasis added by PwC)

Likewise, the decision in *GE Capital* provides at para 45:

"Section 3(11) operates to determine whether the beneficiary's share of the income may be taxed in Australia in accordance with the business profits article. Such a provision has effect notwithstanding the operation of the withholding tax provisions and s 128(B)(3)(h)(ii) as contended for by the applicant. In my view, s 3(11) facilitates the operation of the business profits article which is only enabling and does not impose any tax itself ... As I had said, s 3(11) does not impose any tax in itself, or in conjunction with Art 7, assuming it applies." (emphasis added by PwC)

The above cases, all decided in the last five years, confirm the view that Courts consider that tax treaties do not operate independently of domestic rules.

Case law indicates that the mere fact that tax treaties are incorporated into domestic tax provisions should not transform their operation

A number of cases recognise that the incorporation of tax treaties into domestic provisions should not affect their intended operation. For example, the decision in *GE Capital* provides at paragraph 44:

"The obvious purpose of s 4(2) is to ensure that the Agreements Act is to prevail, but only in respect of its field of operation and according to its provisions." (emphasis added by PwC)

In a similar way, the decision in *SNF* provides at paragraph 119 that tax treaties which are incorporated in their entirety into domestic legislation should be applied in a way which is consistent with their intended operation:

"In that last regard, it is crucial to observe that the whole text of each treaty has been given domestic effect. In cases where the exact text of a whole treaty has been given effect by domestic legislation it would be surprising if it were interpreted without keeping that fact in mind. It should be noted that these taxation treaties stand in a very different position to, for example, the Refugee Conventions whose text is not given the force of law. Where Parliament implements a treaty using its expressions and its provisions then

naturally enough one must begin with the words Parliament has used. <u>But where Parliament expressly decides to incorporate the whole text of a treaty in domestic law and makes it plain, as here, that it is doing so, then it is appropriate to construe the provisions in accordance with the ordinary principles governing the interpretation of treaties.</u> This is because the Parliament's use of the treaty shows its intention to fulfil its international obligations. This has been accepted by the High Court in respect of the double taxation treaties: Thiel v Federal Commissioner of Taxation [1990] HCA 37; (1990) 171 CLR 338." (emphasis added by PwC)

Conclusion

The effect of the above is that even if the incorporation of the Agreements Act into the Assessment Act or the incorporation of Article 9 into the Assessment Act were effective the same conclusion would be drawn. That is, tax treaties and the individual articles should be interpreted in a way which is consistent with the overall operation of the tax treaty – essentially to allocate taxing rights. An artificial dissection of the operation and effect of each article which results in a significantly different operation of the article from the remainder of the treaty (i.e. as a source of assessment power rather than allocation of taxing rights) is unauthorised and would not be supported by the Court if challenged.

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5. *If the operation of Article 9 were to be tested in Court, the view provided by Justice Downes in Roche (i.e. that tax treaties do not confer a power on the Commissioner to assess) would prevail. The comments by Justice Middleton in SNF need to be viewed in context*

Introduction

In support of their position, [redacted] the Commissioner refer to the following *obiter* comments by Justice Middleton in *SNF* (at paragraph 23):

> *"As the stand alone taxing power issue was raised in written submissions, I make the following very brief comment. I do see some force in the argument that by operation of s 170(9B) of the ITAA and the terms 'prescribed provision' and 'relevant provision' as defined in s 170(14) of the ITAA, there is a clear legislative intention (at least from the time of the introduction of s 170 (9B)) that the Commissioner may in amending an assessment, rely on either s 136AD or the relevant associated enterprises article, as conferring upon the Commissioner, as a separate power, a power to amend an assessment. I say this although there is no provision expressly stating that 'the relevant provision' (namely, the associated enterprises article) has been incorporated into the ITAA. However, it seems to me that the express words in the ITAA necessarily and naturally imply the required incorporation of the relevant associated enterprises article into the ITAA."* (emphasis added by PwC)

However, these comments need to be viewed in context.

The issue was not fully considered by the Court

We understand that in *SNF,* the separate assessment power issue was raised only briefly in written submissions and was not the subject of oral submissions by agreement of the parties. Therefore, it is unlikely that this issue was fully analysed by the Court.

The comments rely on the Merkel Advice

Justice Middleton's comments echo the Merkel Advice, especially in relation to the "necessary and natural implication" of the required incorporation. We submit that if the position set out in these submissions on the application and interpretation of subsection 170(9B) was put to the Court (i.e. that the view relying on subsection 170(9B) is unsupportable), this position would ultimately be upheld.

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The significance of the decision in Roche has not been recognised

In *Roche* both parties made extensive written and oral submissions on the issue of whether tax treaties provide a separate assessment power. In particular, the Commissioner's view relying on subsection 170(9B) was fully explained and considered by the Tribunal.[17] In this regard, having considered the subsection 170(9B) argument, Justice Downes provides at paragraph 191:

> *"In the result I do not need to decide the issue 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 of Australia, do not go past authorising legislation and do not confer power on the Commissioner to assess. They allocate taxing power between the treaty parties rather than conferring any power to assess on the assessing body. On this basis Division 13 should be seen as the relevant legislative enactment pursuant to the power allocated."* (emphasis added by PwC)

We also consider that applicant's submissions on the meaning and effect of the words "may be taxed" in Article 9 will resonate with a court. In particular, we draw attention to the following extract from the Applicant's Written Submissions (at paragraphs 59 to 61):

> *"The concluding phrase of Article 9, "may be included in the profits of that enterprise and taxed accordingly," extends to the "profits which … might have been expected to accrue" the power to impose tax on income, gains and profits conferred on Australia by Articles 6-8, 10-13 and 16-17. In each case, the expression "may be taxed" has the effect that Australia, as a contracting state, may without breach of its Treaty obligations enact a tax on the relevant class of income. As with each of the other Articles, the power given by Article 9 is one given to the legislature, not the Commissioner.*
>
> *None of these provisions confer on the Commissioner the power to make a "determination" that an amount be subjected to tax or included in taxable income. Notwithstanding that the Articles are given "force of law", they do not confer on the Commissioner a power to "determine" that tax be imposed on (for example) income from land (Art 6), dividends (Art 10) or directors' fees (Art 16). The Commissioner is not given any power to impose tax on these categories of income merely because the treaty states that they "may be taxed".*
>
> *If as the Respondent contends the phrase "may be … taxed" in Article 9 confers power to assess on the Commissioner, so also must it confer such a power where it appears elsewhere in the Treaty. But beyond saying that each of the various classes of income "may be taxed", the Treaty gives no guidance or limit: the supposed power would be entirely at large. An uncontrolled power to tax could not validly be enacted into Australian law. The implications of the Respondent's contention emphasise that it should be rejected."* (emphasis added by PwC)

[17] For example, refer Respondent's Outline of Argument at paragraph 44.

Conclusion

Given that the subsection 170(9B) argument was considered in *Roche* and that for the reasons set out above, the comments in the Merkel Advice are unlikely to be upheld by a Court, we consider that little persuasive value should be provided to Justice Middleton's comments.

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6. *The retrospective application of the amendments is inconsistent with the Commissioner's view that taxpayers may adopt an alternative treatment to that expressed in a ruling*

Introduction

We note [redacted] comments that the clarifying amendments do not represent a change of policy, as the Commissioner has expressed his view for an extended period of time. However, the mere fact that the Commissioner has expressed his view in a public ruling does not necessarily mean that alternative treatment to that suggested by the public ruling cannot form the basis of a reasonably arguable position – and therefore be adopted by taxpayers.

Taking an alternative view is recognised and "authorised" by the Commissioner

The Commissioner acknowledges in paragraph 46 to 48 of MT 2008/2 that a taxpayer may adopt an alternative view to that expressed in a taxation ruling and still be protected from shortfall penalties (on the basis that it has a reasonably arguable position):

> *"46. While a public ruling issued by the Commissioner under Division 358 is a relevant authority, the mere fact that a public ruling has issued does not necessarily mean that alternative treatments to that suggested by the public ruling cannot be reasonably arguable.*
>
> *47. In other words, entities should take particular note of the Commissioner's views on the correct operation of the law as expressed in a public ruling, but may adopt alternative treatments provided there are sound reasons for doing so.*
>
> *48. Where there are significant alternative views in relation to the interpretation or application of the law adopted in a public ruling, the ruling will usually acknowledge the existence of those alternative views. Alternative views expressed in public rulings are not necessarily equivalent to having a reasonably arguable position. However, the relevant authorities used to support the alternative view may assist the entity in formulating a reasonably arguable position."* (emphasis added byPwC)

The above is particularly relevant in the present circumstances as it is likely that a large number of taxpayers will have adopted the alternative view to that of the Commissioner. These taxpayers would ordinarily rely on MT 2008/2 to protect them against shortfall penalties of 25% to 75% - given the extensive authorities on the operation of Article 9.

Given the complexity of the law, retrospective amendment in favour of the Commissioner's view is unacceptable

Where the law is "clarified" to support the Commissioner's view, this will expose taxpayers who have adopted the alternative view (relying on MT 2008/2) to further tax liability and shortfall penalties. This is on the basis that taxpayers will no longer be able to say that they have a reasonably arguable position and in fact may be considered to have intentionally disregarded the law – attracting penalties of up to 75% of the shortfall tax amount.

This is an unacceptable result given the ambiguity and complexity around how the law applies, as recognised by the Commissioner, the Merkel Advice and case law. For example, Jim Killaly, Deputy Commissioner, in a speech given to the Tax Institute of Australia's Victorian State Convention in 2008 states:

> *"The constitutional and legislative standing of the Associated Enterprises Articles in Australia's treaties is <u>not free from doubt</u> and it seems clear that the debate around this issue could possibly continue until finally determined by the Courts<u>. For its part the Tax Office will continue to reflect on the issue.</u> In cases where Division 13 and the relevant Associated Enterprises Article apply it is unlikely that a Court will seek to resolve the point. It may be that the debate may have to be had in a case where the consideration for an acquisition or supply of property is not the source of the transfer pricing problem."*[18] (emphasis added by PwC)

Echoing the Commissioner's views, the Merkel Advice provides:

> *"The question of whether the associated enterprises articles provide the Commissioner with a separate source of power to assess independently of Divs 13 and 820 is <u>complex</u>."* (emphasis added by PwC)

In a similar way, although judicial consideration indicates that tax treaties (including Article 9 – as noted by *Roche*) cannot be applied to impose tax, the comments by Justice Middleton in *SNF* create added uncertainty.

This uncertainty is further highlighted by the 'tentative' and non-conclusive wording in TR 2010/7 (at paragraphs 39 to 42):

> ***"Tax treaties***
>
> *39. Provisions of Australia's tax treaties, notably the Business Profits Article and the Associated Enterprises Article, contemplate adjustments to profits to reflect the outcome that would be achieved if cross-border dealings had been conducted in accordance with the internationally accepted arm's length principle. Australia's tax treaties are included as schedules to the International Tax Agreements Act 1953 (the Agreements Act). All of Australia's treaties preserve the operation of subsection 136AD(4) of Division 13 provided the subsection is applied consistently with the principles in the*

[18] *Distinguishing between business driven and tax driven restructuring*, Jim Killaly, Deputy Commissioner, Large Business and International (Case Leadership), speech given to the Tax Institute of Australia's Victorian State Convention on 9 October 2008.

relevant treaty article. Depending on the facts and circumstances of the case the relevant treaty article may also apply according to its own terms without the assistance of subsection 136AD(4).

40. The Commissioner has long considered that an adjustment applying the arm's length principle to the pricing or profit allocation in respect of a taxpayer's international dealings is authorised on the basis of Australia's transfer pricing provisions in Division 13 and those related treaty provisions. This view had been questioned following the Administrative Appeals Tribunal decision In Re Roche Products Pty Ltd and the Federal Commissioner of Taxation.

41. Amendments made at the time of the introduction of Division 13 in 1982 appeared to signal an intention on the part of the Parliament that amended assessments could be made to give effect to 'a provision of a double taxation agreement that attributes to a permanent establishment or to an enterprise the profits it might be expected to derive if it were independent and dealing at arm's length' (see subsection 170(9B) of the ITAA 1936 and the definition of 'relevant provision' in subsection 170(14) of the ITAA 1936).

42. The proposition that there is a power to assess in reliance on the Associated Enterprises Articles in Australia's treaties received favourable comment, in obiter , from the Federal Court (Middleton J) in SNF (Australia) Pty Ltd v Commissioner of Taxation." (emphasis added by PwC)

Finally, the suggestion that the proposed amendment is a "clarification" is difficult to reconcile with the following statement by the Commissioner[19]:

"...the issue of whether there is a power to assess to give effect to the treaty provisions is likely to be of practical significance only if the Commissioner's view that Division 13 is as extensive as the treaty provisions in this respect is found to be wrong by the Courts".

Of course, given the Commissioner view about Division 13 has indeed been found to be wrong by the Courts, this proposed amendment is likely to be of "practical significance" to a large number and population of taxpayers.

Conclusion

Given that the Commissioner recognises that taxpayers may adopt alternative views to those in tax rulings and still be protected from penalties, any retrospective clarification which favours the Commissioner's view in circumstances where a reasonably arguable position can be formed on an alternative view is unacceptable. This is particularly relevant given that a retrospective change could expose taxpayers to significant shortfall penalties.

[19] Paragraph 27 of TR 2009/D6. This draft ruling became TR 2010/7. However, paragraph 27 of TR 2009/D6 is not included in TR 2010/7.

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7. The Senate Bills Committee is likely to draw attention to the proposed amendments on the basis that they unduly trespass on personal rights and liberties

Introduction

In Australia, one of the 'checks and balances' on retrospective legislation is the Senate Bills Committee. The Senate Bills Committee was established in 1981 and is responsible for reporting on clauses of bills introduced into the Senate and in respect of Acts of the Parliament which, among other things, "trespass unduly on personal rights and liberties".[20]

As a matter of practice, the Senate Bills Committee draws attention to any bill that seeks to have retrospective impact and comments adversely where such a bill has a detrimental effect on people.

The proposed amendments are likely to attract the attention of the Senate Bills Committee as they are retrospective and can be perceived to trespass unduly on personal rights and liberties - given that they will result in increased retrospective tax liability and exposure to penalties in circumstances where taxpayers have adopted positions which could be considered reasonably arguable under the existing law.

Particular concerns which are likely to be brought to the attention of the Senate by the Senate Bills Committee

The Senate Bills Committee is likely to recognise and raise the following concerns with the Senate with respect to the proposed amendments:

- in contrast to the general nature of Australian retrospective tax legislation which is aimed at rectifying technical deficiencies and not being detrimental to taxpayers, these amendments go beyond rectifying a technical deficiency and will have a significant and detrimental effect on numerous taxpayers. In particular:
  - the amendments mark a significant departure from the position accepted by taxpayers and the Courts on how the transfer pricing rules operate; and
  - the unlimited amendment period which applies to transfer pricing adjustments means that taxpayers could be subject to additional tax liability, penalties (possibly of 75%) and interest for the last seven years in circumstances where they have applied existing law.

[20] Andrew Palmer and Charles Sampford, *'Retrospective Legislation in Australia: looking back at the 1980s'* (1994) 22 *Federal Law Review* 217, 234 and footnote 68

- on the basis that they appear to arise as a result of the Commissioner losing two significant transfer pricing cases[21] and seek to address/overrule those decisions, the amendments appear (and are likely to be perceived by the Courts, taxpayers and the public) to usurp the role of the judiciary;

- the retrospective amendments are inconsistent with the principle of the income tax self-assessment regime as they will effectively overrule current law (albeit to some extent uncertain), which taxpayers have relied on during the proposed period of retrospectivity in complying with their income tax liabilities; and

- retrospectivity does not appear to be justified in the present case, as the amendments are not targeted at blatant tax avoidance and/or evasion (which would be the case where the expectations of taxpayers are neither rational nor legitimate)[22] or to rectify defects in the law which have created unintended consequences.[23]

Conclusion

While the Senate Bills Committee does not have the power to stop bills which trespass unduly on personal rights and liberties, it does have the power to bring its concerns with such bills to the attention of the Senate. This should be considered [redacted] as part of the consequences of the proposed amendments being retrospective.

* * * * *

[21] *Roche Products Pty Ltd V FC of T* [2008] AATA 639 and *Commissioner of Taxation v SNF (Australia) Pty Ltd* [2011] FCAFC 74
[22] Andrew Palmer and Charles Sampford, *'Retrospective Legislation in Australia: looking back at the 1980s'* (1994) 22 *Federal Law Review* 217, 259
[23] Ibid 237

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For the attention of Mr Neil Motteram

13 April 2012

Dear Mr Motteram

Exposure draft of treaty-equivalent cross border transfer pricing rules

We are writing to respond to the exposure draft (ED) and explanatory memorandum (EM) of the "treaty-equivalent cross border transfer pricing rules" released by the Assistant Treasurer on 16 March 2012.

In short, we disagree with the proposed changes. We consider the changes proposed in the ED to be a new retrospective law rather than a "clarification" of existing law. As we have outlined in our previous submissions, we consider retrospective law to be bad policy. Furthermore, we strongly believe that the proposed law creates complexity and uncertainty beyond what currently exists and therefore fails to meet its purported "clarification" objective in all aspects.

Our key concerns with the proposed changes are:

1. The ED will create a new retrospective taxing power for the Commissioner under domestic law. This is entirely different from Treasury's proposal to 'clarify' that the Commissioner holds a taxing power under Australia's tax treaties. There is no basis to justify making such a change on a retrospective basis.

2. The changes will discriminate against taxpayers who deal with related parties in treaty countries and could breach non-discrimination articles in certain treaties. As stated above, the proposed changes will create a new retrospective taxing power for the Commissioner, so we do

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not accept the view that this discrimination has always existed. Australia's treaty partners would normally expect the Australian law to provide preferential treatment to their residents over residents of non-treaty countries, not the reverse. The proposed changes are likely to result in an increased risk of unrelieved double taxation, particularly taking into account the retrospective nature of the amendments and the fact that no discussions with treaty partners took place before the proposed changes were announced.

3. If, as Treasury and the Commissioner have asserted, a taxing power already exists under Australia's treaties, then there should be no need for Subdivision 815-A to be introduced. The Commissioner has had ample opportunity to test this theory in court and has declined.

4. The proposed changes will further the divide that already exists between Australia's transfer pricing and customs rules. There is currently no coherent, efficient mechanism to ensure that taxpayers who are subject to transfer pricing adjustments to the price of imported goods for income tax purposes can adjust the customs value and duty payable on those goods. This, in effect, creates a form of domestic double tax, and also creates a substantial compliance cost for business. Failure to address this issue is likely to increase costs for all companies importing dutiable goods or materials into Australia. In particular, this could worsen conditions for the already struggling Australian manufacturing sector.

5. Branch profit attribution rules have been introduced in a piecemeal way. The current draft provisions will create asymmetrical treatment of inbound branches (ie Australian branches of foreign companies) and outbound branches (ie foreign branches of Australian companies). Carving out branches from the proposed changes altogether would not improve the situation because then there would be asymmetrical treatment of branches and companies. The current proposals will create a high likelihood of unrelieved double taxation for multinational groups conducting their Australian business through branch structures. This would increase costs in the banking sector, which would have broader implications for the Australian economy and consumers.

6. As currently drafted, Subdivision 815-A casts significant doubt on the framework and application of Australia's thin capitalisation regime. The draft provisions are open to different and conflicting interpretations.

We strongly believe that, far from providing clarification, the proposed changes will increase complexity and uncertainty for Australian taxpayers.

Our submission has been presented in the following format:

1. Reasons we object to the proposed changes
2. On a 'without prejudice' basis, comments on specific details within the ED and EM that require clarification or amendment if the Government decides to proceed with introducing the proposed changes.

We have included comments on the ED and EM because our impression, based on discussions with Government and Treasury, is that the Government has decided to introduce these rules despite strong reservations voiced by the profession and business bodies.

Making the proposed retrospective changes in haste could have a number of undesirable consequences for the complexity of doing business in Australia, confidence from overseas investors and governments of treaty partners, and the way the Government's tax reform policy is perceived more broadly. There will be different sets of rules that could apply depending on various factors such as the location of the transacting party and the relevant income year. Disputes are likely to arise under these rules that will need to be resolved by the Courts or our treaty partners.

Our view is that it does not make sense to rush these changes through Parliament now, particularly when the transfer pricing rules in Division 13 are also about to be rewritten with prospective effect. It would be far more efficient to introduce a one-off prospective change to Australia's transfer pricing rules that applies to everyone equally.

We would be pleased to discuss any aspect of our submission with you further.

Yours sincerely

Lyndon James
Partner
Transfer Pricing, National Leader

Peter Collins
Partner
International Tax Services, National Leader

Copy to:
The Hon David Bradbury MP, Assistant Treasurer
Mr Graeme Cuxson, Treasury

1. Reasons we disagree with the proposed changes

A. This is a new retrospective law, not clarification of existing law

In our previous submissions[1], we objected to:

a) Treasury's assertion that the treaties provide the Commissioner with a separate taxing power; and

b) Retrospective amendments to the law.

We continue to hold these objections, that is, we do not agree that the treaties provide the Commissioner with a taxing power and we do not support any retrospective amendments to the law. We have stated the reasons for our objections to these two principles in our previous submissions.

We had understood the intention of Treasury's proposed amendments was to 'clarify' that the treaties provide the Commissioner with a taxing power under the existing law. We submit that the ED goes beyond this by proposing to introduce a new taxing power under the domestic law that will apply retrospectively. In our opinion, even a retrospective 'clarification' of the law could not be justified, but this is more than a clarification and there is absolutely no basis to justify introducing new law that will apply retrospectively.

Below is a summary of the reasons why we consider the proposed changes to be new law and not a clarification.

1. Subdivision 815-A does not clarify that the treaties give rise to a separate power. The status of treaties as a power under which assessments can be made is exactly as it was before. This is recognised in the EM (refer table after paragraph 1.17). This question has not been resolved by Subdivision 815-A.

2. Subdivision 815-A is a new retrospective law that synthetically adopts language from the treaties into the domestic legislation with statutory rules for interpretation and qualifications on the interaction with thin capitalisation rules. This is not the same legislative outcome as allowing the treaties a direct taxing power. Subdivision 815-A is a domestic taxing power that will be subject to the domestic rules for statutory interpretation. The treaties are subject to a

[1] PwC's Submissions to Treasury dated 30 November 2011 (including PwC's general response (the PwC General Submission) and PwC's specific response in relation to permanent establishments (the PwC PE Submission)), and PwC's Supplementary Submission to Treasury dated 24 February 2012 (the PwC Supplementary Submission).

different set of rules for interpretation, which is acknowledged by the Commissioner himself in a specific taxation ruling on treaty interpretation.[2]

3. There are aspects of Subdivision 815-A which are entirely and indisputably new law. For example:

    a. Legislating rules for the interaction of treaties and the thin capitalisation provisions.

       The attempt to legislate the position in TR2010/7[3] back to 2004 cannot ever have been said to be the position under the treaty. It is in fact, an attempt to reconcile the treaty with Australia's thin capitalisation rules. If this is truly a 'clarification' of what Parliament intended in 2004 why did it take a further six years for the Commissioner to release TR2010/7?

    b. Legislating specific documents as relevant for interpretation of treaty articles.

       If the treaties had always provided a taxing power to the Commissioner, then we would expect that the relevant treaty articles would need to be interpreted having regard to the customary rules for interpretation of treaties, for which the primary authority is the Vienna Convention.[4] Prescribing specific documents as relevant for interpretation of certain treaty articles may produce a different outcome than the commonly accepted rules for treaty interpretation. In the SNF[5] decision in 2011, the Full Federal Court did not consider that there was sufficient evidence available to demonstrate that the OECD Transfer Pricing Guidelines (TPG)[6] were permissible materials for interpreting Article 9 of Australia's treaties. Based on this, we cannot see any basis for retrospectively prescribing in our domestic legislation that the OECD TPG are necessary for interpretation of Article 9 of the treaties. (We note that we do not object in principle to the use of the OECD TPG for interpretation of Article 9, but we are merely highlighting this as a further example that is clearly new law.)

As demonstrated above, the changes proposed in the ED are new law and therefore should not be introduced with retrospective effect.

B. The changes discriminate against treaty partner countries

The proposed changes will only apply to dealings with treaty partner countries. We understand that this concern has been raised in discussions with Treasury and that Treasury's response is that there has always been the potential for different treatment of dealings with treaty versus non-treaty

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[2] Taxation Ruling 2001/13: Income tax: Interpreting Australia's Double Tax Agreements
[3] Taxation Ruling 2010/7: Income tax: the interaction of Division 820 of the Income Tax Assessment Act 1997 and the transfer pricing provisions
[4] *Vienna Convention on the Law of Treaties*, 23 May 1969
[5] Commissioner of Taxation v SNF (Australia) Pty Ltd (2011), FCAFC 74
[6] OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations

countries under our existing law (if one accepts the view that the Commissioner has always held a taxing power under the treaties).

As explained above, the proposed changes are new law. It therefore cannot be said that the powers proposed under the new law have always been held by the Commissioner. Since the new law can only be applied in situations where an Australian entity is subject to a treaty, the proposed changes are clearly discriminatory against taxpayers dealing with treaty partner nations. It is highly unusual for a law to be introduced that will provide a worse outcome for investors from treaty partner countries than non-treaty partner countries. Normally, the opposite would be expected and investors from treaty partners would receive preferential treatment over investors from non-treaty countries.

The proposed changes arguably contravene the non-discrimination articles that are included in several treaties.[7] For example, Article 25(4) of the United Kingdom treaty states:

> *"Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned State in similar circumstances are or may be subjected."*

There is also a similar non-discrimination clause that requires Australian permanent establishments (PEs) of UK companies to be treated on an equal footing with Australian resident companies.

Historically, the Commissioner has held the view that application of the arm's length principle under Division 13 and the relevant treaty articles should produce the same outcomes. Treasury now believes that there will be circumstances in which Subdivision 815-A will produce a higher amount of Australian taxable income than would be the case under Division 13. This must be the case because if Division 13 would produce the same revenue outcome then there would be no need to introduce Subdivision 815-A. We are not privy to the specific circumstances that Treasury has in mind, but if it will produce a situation where a subsidiary or PE of a company resident in a treaty country will be treated less favourably than an Australian resident company would be treated under Division 13, this could breach a non-discrimination article (if the relevant treaty contains such an article).

The risk of unrelieved double taxation may increase, particularly if the ATO adopts an aggressive interpretation of OECD guidance in applying the new provisions, as the number of Mutual Agreement Procedure (MAP) claims for relief from double tax is likely to increase. If the Commissioner makes determinations under Subdivision 815-A by interpreting the OECD TPG in a manner that our treaty partners disagree with, taxpayers may be subject to double taxation. In MAP cases, treaty partners following the OECD TPG will expect the Australian Competent Authority to bear the burden of

[7] Non-discrimination articles are included in Australia's treaties with Chile, Finland, Germany (only in relation to dividends), Japan, New Zealand, Norway, South Africa, Turkey, the United Kingdom, and the United States

demonstrating that the Commissioner's adjustments are in accordance with the arm's length principle.[8]

We acknowledge that the risk of double taxation is present under the existing provisions and that the ATO may contend that the MAP process has traditionally worked effectively to relieve double taxation where it occurs. However, in our experience, the process can take years and there is no compulsion under Australia's treaties for the competent authorities to reach agreement. We are concerned that foreign jurisdictions will take a harder line in MAP negotiations with Australia in light of the introduction of retrospective legislation which is clearly intended to increase Australia's tax take beyond that available under Division 13. This is likely to further increase the time required for MAP negotiations and will increase the risk of unrelieved double taxation.

An increase in the number and complexity of MAP cases may require additional ATO resources to ensure that the caseload can be managed. The Government has not provided any indication that it will increase the resources available to the ATO following the introduction of the proposed changes. If no additional resources are provided, this will also prolong the timeframes for MAP negotiations.

We understand that the Government did not engage in any discussions with treaty partners about the proposed changes prior to releasing the ED. Implementing a new retrospective law which discriminates against treaty partners may have political and diplomatic implications for the Government, particularly given that no consultation with treaty partners took place prior to announcing the proposed changes.

C. There is no need for Subdivision 815-A

If, as Treasury and the Commissioner have asserted, the Commissioner holds a taxing power under Article 7 and Article 9 of the treaties, then there should be no need for Subdivision 815-A to be introduced.

We do not endorse the view that the Commissioner has a taxing power under the treaty nor do we agree that Parliament has indicated that it intends the treaties to operate in this way. However, putting the merits of each side of the debate aside, the treaties either do, or do not, provide the Commissioner with a taxing power.

If the Commissioner is correct in his view that he can impose tax under the treaties, then there is nothing to stop him from using this power. We are aware that the Commissioner has issued transfer pricing assessments to taxpayers in the past applying Article 9 of the treaties as an alternative to Division 13. While some of these cases have been disputed by taxpayers in the courts, the issue of whether assessments issued under a treaty were valid has not been considered.

[8] OECD TPG, paragraph 4.17

The Commissioner has had opportunities to test the taxing power of Article 9 in court himself, for example, he could have done so in the SNF case. Whenever the opportunity has arisen for the Commissioner, he has declined it.

If the Commissioner were to test the taxing power of Article 9 in court, he would find out whether his view is correct. If the courts agreed that a taxing power does exist under Article 9, this would show that the Commissioner was correct, and would mean that Subdivision 815-A is unnecessary. If the courts found that the Commissioner does not hold a taxing power under Article 9, then the basis for introducing Subdivision 815-A retrospectively would be undermined.

D. The changes will further the divide between transfer pricing and customs rules

There has always been tension between the transfer pricing and customs rules and the way in which those rules are administered. The customs rules focus primarily on the pricing of specific import transactions to determine the amount of duty payable. The ATO's administration of the transfer pricing rules often involves application of profit-based transfer pricing methods. Where the ATO applies profit-based methods to reduce the price of imported goods, obtaining a corresponding reduction in the import value for customs duty purposes is problematic.

The current transfer pricing rules under Division 13 at least require the Commissioner to pay heed to the consideration of specific transactions when making transfer pricing adjustments. The proposed changes could lead to a greater number of ATO transfer pricing adjustments determined using profit-based methods without being clearly traceable to specific transactions. This will make it more difficult for importers to obtain refunds of duty paid where the ATO has made an adjustment to reduce the import value of goods. Furthermore, where the Commissioner applies Subdivision 815-A retrospectively, time limits for seeking duty refunds (four years) are likely to have expired. This would create an additional form of double tax (i.e., additional Australian income tax on top of overpaid customs duty) or even triple tax (i.e., Australian income tax and foreign income tax on the same income and overpaid customs duty) for those taxpayers where MAP timeframes have also been exceeded.

Improvements are required to better align the legislative and administrative frameworks for customs and transfer pricing. Mechanisms need to be available to taxpayers to ensure that adjustments to the customs value of goods (and duty payable/refundable) can be made following ATO transfer pricing adjustments. This needs to be embedded in legislation and needs to be supported by a clear administrative process.

The customs and transfer pricing rules are contained in different Acts and are administered by different Government departments. The Government has the opportunity to take action to ensure that the two sets of rules and administrators do not create domestic double tax.

Failure to address this issue is likely to increase costs for all companies importing goods or materials into Australia. This could have a particularly severe impact on the Australian manufacturing sector

which is already experiencing difficulties competing against lower cost manufacturing locations overseas.

E. Branch profit attribution rules have been inadequately addressed

The proposed law as it stands will significantly increase the level of uncertainty for taxpayers with branch operations in Australia and the complexity of disputes. The law should be amended prospectively to make clear that taxpayers may adopt the Authorised OECD Approach (AOA) to attribution of profits to permanent establishments. We explained the reasons for this in detail in the PwC PE Submission to Treasury in November 2011. We have outlined below the specific concerns we continue to have based on the ED and EM as they have been drafted.

Inconsistent rules for branches versus companies and inbound versus outbound branches

Our understanding, based on the Consultation Paper and discussions with Treasury, was that the issue of updating of Australia's domestic attribution rules to reflect the AOA was to be separately considered. Accordingly, we were surprised to see the ED introduce the ability for the Commissioner to increase the taxable income of Australian branches of companies resident in treaty countries.

Based on the way the ED has been drafted, different profit attribution rules (and outcomes) could apply for:

- Inbound branches of foreign companies resident in treaty countries (potentially with different results under different treaties);
- Inbound branches of foreign companies resident in non-treaty countries;
- Subsidiaries of foreign companies resident in treaty countries;
- Subsidiaries of foreign companies resident in non-treaty countries;
- Outbound branches of Australian companies; and
- Outbound subsidiaries of Australian companies.

This will clearly create a complex series of rules which are difficult for taxpayers to understand and will create an uneven playing field for different types of taxpayers. The profit attribution rules for branches need to be reviewed on a comprehensive basis, not only for a small proportion of taxpayers. This should be done at the same time as the rewrite of Division 13 to ensure that all taxpayers are on an equal footing from an Australian transfer pricing perspective regardless of whether they are a company or branch, inbound or outbound investor, or dealing with a treaty or non-treaty country.

Need for clarity on adoption of Authorised OECD Approach

Consistent with our earlier submission, PwC is strongly of the view that Australia should amend its law to embrace the OECD consensus position on the attribution of profits to permanent establishments as soon as possible. The AOA is reflected in the OECD's Report on Attribution of Profits to Permanent Establishments – 2010 (the OECD PE Report). This report has been incorporated into Article 7 and its associated commentary of the 2010 OECD MTC.[9]

Australia has played a leading role in drafting and establishing this position and so should, as a matter of priority, seek to adopt this approach in its domestic legislation. Australia did not make any relevant reservations to the inclusion of the new Article 7 and commentary in the 2010 OECD MTC.

As you will be aware from earlier submissions[10] there is currently a great deal of uncertainty and confusion as to the extent to which Australia's existing tax law permits the adoption of the principles in the OECD PE Report. At present, this uncertainty is greatest in the financial services sector which traditionally operates cross border under branch structures. In particular, the official ATO view is that Australia's PE attribution rules operate on a 'relevant business activity' basis. Further, it is the ATO's view that Australia's transfer pricing rules and its treaties do not permit the recognition of notional dealings between parts of a PE and instead require a tracing and attribution of actual income and expenses of the entity.[11] For various reasons, set out in other submissions, such an approach is out of step with the AOA and is near impossible for complex financial services institutions in the modern financial services environment.[12]

The wording of s815-22(1)(b)(ii), which requires a PE's profits to be determined based on the profits the PE might be expected to make if it were a "separate and distinct" entity, may further exacerbate the uncertainty over how Article 7 should be interpreted. This wording appears to be aligned with the AOA, which would place it at odds with the Commissioner's views on interpretation of Article 7.

Unfortunately the ED falls well short of ensuring that Australia's domestic rules are consistent with the OECD consensus. Subsection 815-22(3) requires the business profits article of a relevant treaty to be interpreted so as to best achieve consistency with the 2010 OECD guidance on Article 7. This may be read as allowing the Commissioner to apply the AOA for the purpose of raising an assessment under Subdivision 815-A. This interpretation is not clear, however, as the requirement to achieve best consistency with the 2010 OECD MTC is qualified by the words *"to the extent the documents are relevant"* in s815-22(3). This casts at least some doubt as to whether the 2010 OECD MTC could be regarded as relevant to the interpretation of words emanating from a treaty concluded pre-2010.

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[9] The 2010 Commentary to Article 7 says at paragraph 9 *"The current version of the Article therefore reflects the approach developed in the Report and must be interpreted in light of the guidance contained in it."*

[10] Australian Bankers' Association Submission to Treasury, 2 December 2011 (the ABA Submission); Australian Financial Markets Association Submission to Treasury, 16 December 2011 (the AFMA Submission); PwC PE Submission.

[11] This is made clear in Taxation Rulings TR2001/11 (paragraph 1.15) and TR 2005/11 (paragraph 7). It is reiterated in an unclassified ATO report entitled Profit Allocation to Permanent Establishments of Banks dated 6 July 2011 (paragraph 8).

[12] Cross Border Dealings within a Single Entity, Tony Frost, Challis Taxation Discussion Group, 5 May 2010; ABA Submission; AFMA Submission; PwC PE Submission.

Paragraph 1.46 of the EM seems to add weight to the view that the 2010 OECD MTC would not be relevant for interpreting pre-2010 treaties, but it does not make the matter sufficiently clear.

We note that the Commissioner holds the view that the latest guidance of the OECD, reflected in the 2008 OECD MTC Commentary and the 2010 OECD MTC Article 7 and Commentary, is not relevant on the basis that Australia has not incorporated any of the new text of Article 7 into its treaties.[13] Many taxpayers dispute this view. The ED could be interpreted as providing one set of rules for the Commissioner and another set of rules for taxpayers. Such a result is unacceptable and will lead to excessive complexity and increased risk of unrelieved double taxation.

Complexity of transitional rules

The issue will be further complicated by the proposed transitional rules applying to years of income prior to the 2012-2013 income year. These rules will operate to ensure that a transfer pricing benefit is to be interpreted so as to best achieve consistency with the OECD MTC last published before the start of the income year. Accordingly, there will be different versions of OECD materials for different years. This is unnecessarily complex and will lead to greater confusion and costs for taxpayers in analysing and supporting their positions.

This issue does not only apply to PEs; the transitional rules for companies will also be complex due to changes that have been made in recent versions of the OECD TPG (in particular, there were significant changes in the 2010 version of the OECD TPG). We have commented further on this matter in Section 2 of our submission.

Interaction with other areas of tax law

There is no clear indication as to how the proposed rules will interact with other areas of the existing tax law applicable to PEs. For example, there is no clarity on how the proposed Subdivision 815-A will interact with Part IIIB of the Income Tax Assessment Act 1936. Nor is there any indication of the implication of an adjustment made under Subdivision 815-A where a foreign resident has an Australian permanent establishment that is also an Offshore Banking Unit.

Conclusion on branch issues

The introduction of a new set of rules, available to the Commissioner only, and applicable to inbound permanent establishments only, is both inequitable and ill considered.

Consistent with our earlier recommendation we would support a considered and comprehensive approach to amending Australia's transfer pricing provisions as they relate to permanent establishments to allow the full effect of the OECD latest guidance. However such an approach cannot be piecemeal and needs to consider the interaction with other relevant areas of the tax law. It should apply prospectively and both to inbound and outbound taxpayers.

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[13] Profit Allocation to Permanent Establishments of Banks –Appendix 3.

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This again illustrates that the proposed changes have not been properly thought through and should be put on hold until a more comprehensive review has been performed.

F. Increased complexity on interaction with thin capitalisation rules

The ED attempts to deal with the interaction between Subdivision 815-A and the thin capitalisation rules but, in our view, does so in an unsatisfactory way. The specific provisions included within the ED on the interaction with Division 820 are open to conflicting interpretations. Two possible interpretations (among others) are:

1. Subdivision 815-A could undermine the thin capitalisation safe harbour.

   Subdivision 815-A requires the Commissioner to consider whether an entity's "profits" are less than the profits that it would have accrued if it had been acting on an arm's length basis. Profits are defined as taxable income, which implies that the Commissioner should consider whether a taxpayer's post-interest profits are arm's length.

   This could lead to a situation where the Commissioner could apply Subdivision 815-A to reduce interest deductions that would otherwise be deductible (if the taxpayer's pre-interest profits were considered to be arm's length and interest deductions on debt within the safe harbour limit create a post-interest profit or loss that is below the Commissioner's expectations of an arm's length outcome).

   This would clearly undermine the policy intent of the thin capitalisation safe harbour.

2. Subdivision 815-A could give retrospective legislative effect to TR 2010/7.

   Subsections 815-22(4) and (5) appear to be aiming to embed the principles from TR 2010/7 within the law. We have several concerns over this approach:

   - TR2010/7 represents the Commissioner's view of how the law should be interpreted. There are no grounds for giving legal force to the Commissioner's interpretation of the law on a retrospective basis. As far as we are aware, there are no precedents for retrospectively changing the law to give force to a particular interpretation of the Commissioner.

   - Giving retrospective legal effect to the Commissioner's views would disadvantage taxpayers who have taken a different interpretation of the law.

   - We are not convinced that s815-22(4) and (5) will be effective in 'preserving' the interpretation taken by the Commissioner in TR2010/7. TR2010/7 requires the Commissioner to apply an arm's length interest rate to the actual amount of debt (provided the actual amount is within the safe harbour). Subsection 815-22(4) appears to intend to do this also, but as noted above, we are concerned that the other provisions within s815-22 could be interpreted in a way that would enable the Commissioner to place

additional limitations on the interest deductions a taxpayer would otherwise be entitled to claim.

Both of these interpretations have the potential to produce unfavourable outcomes for taxpayers and to some extent they contradict one another. A law that is open to multiple contradictory interpretations will create confusion and complexity for taxpayers, and will also create complexity for the Commissioner in administering the law. This further illustrates that the proposed changes will not achieve the objective of 'clarifying' the law and will, in fact, increase complexity and uncertainty.

2. Matters requiring clarification or amendment if Subdivision 815-A is introduced

We stress that we are unequivocally opposed to the changes proposed in the ED. However, if the Government decides to proceed with the retrospective changes and introduces Subdivision 815-A, there are many aspects of the draft ED and EM that require further clarification or amendment. This section sets out our specific comments on the ED and EM as they have been drafted.

A. Interaction with the thin capitalisation provisions

As noted above in Section 1 of our submission, we have a number of concerns about the way the ED proposes to deal with the interaction of Subdivision 815-A and Division 820. Below we have set out the specific amendments that we recommend to address the concerns we have on the interaction between Subdivision 815-A and Division 820 based on the current ED.

Recommendation 1: Subsection 815-22(5) should be removed from the ED. Example 1.4 should be removed from the EM. TR 2010/7 should remain in force to ensure that taxpayers who have relied upon the Commissioner's views in this ruling are not disadvantaged.

Subsections 815-22 (4) and (5) purport to have the combined effect of preserving the outcome of the Commissioner's position in TR 2010/7. In principle, the object appears to be to ensure that a transfer pricing adjustment can be made in respect of a debt interest and that the adjusted interest rate is applied to the actual value of the debt.

The EM confirms that these "additional rules" will apply and that these rules are "consistent with the current administrative approach provided in Taxation Ruling 2010/7".

We support the inclusion of s815-22(4) to ensure that Subdivision 815-A does not override Division 820 in determining the maximum amount of debt allowable for a taxpayer. We also support the use of OECD guidance to determine an arm's length rate of return on a taxpayer's debt, as would be the case under s815-22(4)(a). We note, however, that there is currently no specific guidance available in the OECD TPG or OECD MTC on how an arm's length rate of return on a debt instrument should be determined. As such, taxpayers and the Commissioner will need to interpret the OECD's general guidance on the arm's length principle to determine an arm's length interest rate.

Subsection 815-22(5) and Example 1.4 in the EM presuppose a particular interpretation of OECD guidance. They presuppose that the OECD guidance would allow the rate of return on a taxpayer's debt to be determined by reference to a notional 'arm's length amount of debt' in certain circumstances. It

is open to debate as to whether this interpretation is correct. We submit that taxpayers and the Commissioner should each interpret the relevant OECD guidance as they see fit, rather than prescribing a particular interpretation in the law. For this reason, we recommend removing s815-22(5) from the ED and Example 1.4 from the EM.

It is important to ensure that taxpayers will not be exposed to greater risk of transfer pricing adjustments to debt transactions under Subdivision 815-A than they would have been under the existing law and the Commissioner's guidance in TR 2010/7. Arguably, the treaties permit the recharacterisation of an amount of debt, above an arm's length amount, as equity. The consequence of this is that no deduction would be available on the excess debt. This was the substance of the view formed in legal advice to the Commissioner dated 23 June 2009[14] (Merkel's advice).

Having regard to similar facts to those in Example 1.4 of the draft EM, Merkel's advice concluded that Division 13 and the Treaty could be applied to arrive at a deduction of $25m (being 10% of $250m). The actual example in the EM allows for a deduction of $30m for example 1.4 (being 10% of $300m). The outcome in example 1.4 of the EM is broadly consistent with the outcome in the equivalent example of TR 2010/7 – however, in TR 2010/7 the Commissioner acknowledges he regards this is a concessionary position – refer paragraph 58:

> *"So as not to defeat the operation of Division 820, any arm's length rate of interest derived under any of the approaches discussed at paragraphs 54 to 57 of this Ruling should be applied to the actual amount of debt."*

In other words, this is a recognition from the Commissioner that he believes the treaty, and in particular Article 9, has the effect of permitting a result that effectively disallows deductions on debt beyond an arm's length amount.

The position adopted by the Commissioner under TR 2010/7 effectively puts an administrative constraint on how he will use the additional power he believes he has under the treaty (which in light of the Merkel advice he believes could result in lower interest deductions) to ensure that the intent of Division 820 is not defeated.

Through TR 2010/7, the Commissioner has effectively acknowledged and dealt with the potential inconsistency between a treaty based outcome and a combined Division 13/Division 820 outcome by administratively placing a restraint on his purported power to adjust under the treaty and/or power to adjust under Division 13. Given TR2010/7 applies both prospectively and retrospectively there is no need to formalise this position in the legislation through s815-22(5). TR 2010/7 should remain in force after the introduction of Subdivision 815-A to ensure that taxpayers who have relied upon the Commissioner's views in this ruling may continue to do so under Subdivision 815-A.

Recommendation 2: Amend s815-22 to ensure that "profits" for the purposes of s815-22(1)(a)(iii) is to be determined without regard to debt deductions, i.e. on a pre-interest basis.

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[14] Ron Merkel QC Supplementary advice 23 July 2010

pwc

The stated intention of s815-22 (4) and (5) is to preserve the effectiveness of the safe harbour provisions in Division 820 to allow debt deductions on debt interests up to the safe harbour amount.

Subsections 815 -22(4) and (5) purport to do this through setting principles for determining the amount of deductions. Subsection 815-30 (3) then requires the Commissioner to make a determination relating to the debt deductions of the entity if Division 820 applies to the entity.

However, the interaction between s815-22(4) and (5) and s815-22(1) to (3) is not explicit. Specifically, our concern is that there is nothing in the ED which would prevent the Commissioner from circumventing the limitation on his power in subsections (4) and (5) through the operation of s815-22(2) to calculate the transfer pricing benefit. This may give rise to situations where the Commissioner would 'claw back' any concession through adjustments to other amounts of assessable income or deductions. In short, s815-22(4) seems to be a rule which calculates the amount of a debt deduction, whereas s812-22(2) applies to the profit in totality.

Example

Take the same facts as in Example 1.4 of the draft EM.

Based on the facts and assumptions in that example, s815-22(1)(a) (iii) would potentially apply. There is an amount of profits (within the meaning of the article) which, but for the conditions mentioned in the article might have been expected to accrue to the entity, has by reason of those conditions, not so accrued. The amount of the profits (or transfer pricing benefit) in this instance is $20m, being the difference between the actual deductions of $45m and the amount of deductions that has been determined that would have been available at arm's length being 10% of 250m, or $25m.

S815-22(4) would also apply. Based on the analysis in example 1.4 of the draft EM the net impact of this is that the debt deductions of Ausco are reduced by $15m. This is on the basis that a debt deduction would be allowed on the actual amount of debt capital within the safe harbour being $300m.

It would appear, prima facie, that it would be open to the Commissioner to then issue two determinations under s815-30(1) and that these determinations would then be attributable to amounts of assessable income and deductions in s815-30(2) as the Commissioner determines.

Subsection 815-30(3) requires one of the determinations to relate to the debt deductions. Therefore the Commissioner may issue a determination that reduces debt deductions by $15m.

However there is nothing that appears to explicitly prevent the Commissioner from issuing a further determination to reduce other deductions or increase an amount of assessable income by $5m to arrive at a total adjustment of $20m.

The outcome is possible largely because the "profits" in s815-22 (1)(a)(iii) are not constrained to only consider pre-interest profits.

We do not believe such an outcome is consistent with the policy intent of 815-22(4) and (5) nor with Division 820 and TR2010/7.

In our view, this concern is not merely a theoretical possibility. Increasingly we are seeing examples in practice of where the Commissioner is taking positions which clearly undermine the intent of the thin capitalisation provisions.

If Subdivision 815-A is to be applied consistently with OECD guidance, then the provisions must have regard to OECD guidance for interpreting the meaning of "profits" in the context of Article 9. It is neither sufficient nor appropriate to refer to subsection 3(2) of the International Tax Agreements Act 1953, which defines profits as taxable income. It is insufficient because applying the arm's length principle is far more complex than merely reviewing whether taxable income is arm's length (indeed, it is hard to see how this could be possible), and it is inappropriate because it is a domestic provision and therefore may not be consistent with what was intended by the treaty partners.

The guidance in the OECD MTC and OECD TPG does not directly define "profits" in the context of Article 9. Instead, the OECD guidance requires the arm's length principle to be applied by selecting and applying an appropriate transfer pricing method for transactions that have been undertaken between the associated enterprises. The methods endorsed by the OECD test whether a transaction (or group of transactions) is arm's length by comparing the price, gross margin, or net operating margin of the transaction(s) to those derived in comparable independent dealings.

Traditionally, in transfer pricing practice, the application of transfer pricing methods and principles for non-financial dealings has been applied by taxpayers and tax authorities alike on a pre-interest basis (with the possible exception of financial services businesses). The OECD TPG explicitly support this approach in the guidance provided on the application of transactional profit methods.[15] In other words, the profit being considered and potentially adjusted is the profit of the taxpayer pre-interest and without regard to the capital structure. The capital structure itself was then dealt with through a combination of the transfer pricing and thin capitalisation provisions. Increasingly we are seeing examples where the Commissioner is blurring the distinction and arguing that the arm's length profit outcome in Australia should be on a post-interest basis. This position is not consistent with OECD guidance and undermines the integrity and policy intent of the thin capitalisation provisions.

B. Need to consider interaction with relevant provisions of the tax law

Recommendation 3: There is a need to limit the possibility that Subdivision 815-A could be used to override specific tax treatment of certain items of income or expenses on a transaction basis. The Commissioner should be required to apply s815-30(2) for all determinations made under Subdivision 815-A.

[15] OECD TPG paragraph 2.80

There are a number of areas of the tax law which operate on a transactional basis. That is, an important feature of the application of the taw law is being able to identify specific transactions that give rise to items of assessable income, allowable deductions and non-assessable non exempt income.

The existing transfer pricing provisions of Division 13 also operate on a transactional basis. Any adjustments made under Division 13 apply to effectively replace the actual consideration with arm's length consideration for specific transactions. The rest of the tax law then operates on the basis that the arm's length consideration is used for the specific transaction.

We are concerned that Subdivision 815-A will not require the identification of the transactions being adjusted. Subdivision 815-A appears to operate to increase taxable income, without regard to specific transactions and/or the specific tax treatment of those transactions. In particular, s815-30(1) permits the Commissioner to make a determination with the effect of increasing taxable income and/ or decreasing a tax loss or net capital losses. It is not clear that in making this adjustment specific items of income or expenditure are themselves to be adjusted (for other purposes of the tax law). Subsection 815-30(2) allows the Commissioner to attribute determinations to particular items of income or expense but does not require him to do so in all cases.

Some examples (by no means exhaustive) of areas where Subdivision 815-A has the potential to override domestic taxing provisions include:

- The debt /equity provisions (Division 974 of the ITAA 1997) which operate based on the terms and conditions of particular instruments;
- The Offshore Banking Unit regime which applies to tax certain qualifying income at a concessional tax rate; and
- The non resident reinsurance provisions (Division 15 of the ITAA 1936) which determine the tax treatment of insurance premiums and recoveries to and from non-residents.

In each of the above cases, an adjustment made under Subdivision 815-A has the potential to increase taxable income of the taxpayer but with no ability to determine the flow on consequences for other taxing provisions of the domestic legislation.

Allowing the Commissioner to make an amended assessment to a taxpayer's net taxable income without requiring him to attribute this to specific items of income or expense would be inconsistent with OECD guidance and would also have negative implications for consequential adjustments, customs duty and MAP negotiations. Subsection 815-30(2) and paragraph 1.56 of the EM should be amended to require the Commissioner to attribute determinations to specific items in all cases.

Failure to address this outcome will place taxpayers subject to Subdivision 815-A (ie, those that are subject to a treaty) at a disadvantage to those subject to Division 13 alone. As mentioned in Section 1, this could breach non-discrimination articles in certain treaties.

C. Interpretative material

Recommendation 4: All OECD transfer pricing and model tax convention materials approved by the OECD Council should be adopted as relevant for interpreting Australia's transfer pricing rules.

The ability for new interpretative material to be introduced by regulation under s815-25 is too broad. There is no apparent constraint on the type of material that can be regulated. For example, it appears possible that a Taxation Ruling could be prescribed by the regulations as relevant for interpreting Subdivision 815-A. While we accept that it is unlikely that this is the intent of the legislation, there remains the risk that new OECD material may be released that is inconsistent or in conflict with a position adopted by the Commissioner in a Taxation Ruling. This may lead to a potential for the Commissioner's view on the matter to be preferred over that of the consensus view of the OECD. Such a conflict could lead to confusion and uncertainty amongst the business community as to the stance Australia takes on transfer pricing. This would also be inconsistent with the policy intent of improving consistency with OECD guidance.[16]

There is a risk that Treasury may be perceived as picking and choosing which elements of OECD Guidance to accept and refuse. Sceptics may also be concerned that the ATO will attempt to influence Treasury's views on which OECD materials are relevant. This will create ongoing uncertainty which is unnecessary given Australia's role in the OECD. It will also work against Treasury's objective to achieve international consistency with our treaty partners. This will increase uncertainty for multinational enterprises operating in Australia and could increase the risk of double tax issues arising that cannot be resolved through the Mutual Agreement Procedure process.

There is a formal diplomatic process by which the Australian Government can express reservations on OECD documents. In the absence of formal reservations, all published OECD materials should be endorsed as relevant for interpreting Australia's transfer pricing rules and tax treaties.

Recommendation 5: Clearer guidance is required on the transitional rules for income years prior to 2012-13.

The ED and EM indicate that relevant documents for interpreting Subdivision 815-A will be the versions of the OECD MTC and OECD TPG that were published most recently prior to the beginning of the relevant income year. This will add complexity to the interpretation of Subdivision 815-A in the context of the historical income years to which it is proposed to apply.

In Section 1.E above we outlined the complexity that this would give rise to particularly for branches, where there have been significant recent developments in OECD guidance.

Other areas of OECD guidance have also developed significantly in recent years. The 2010 version of the OECD TPG included the following major changes:

[16] EM paragraph 1.12

- A significant overhaul of Chapters I to III (for the first time since the OECD TPG were published in 1995); and
- Addition of Chapter IX on the transfer pricing aspects of business restructuring.

The 2010 revision of the OECD TPG did not carry an express date of entry into force, so it is possible that other OECD members will have chosen to apply the 2010 version of the TPG to resolve controversies related to prior years, particularly in cases involving issues that have been more comprehensively addressed in the latest OECD guidance (such as business restructuring).

If the Government proceeds with implementing Subdivision 815-A retrospectively, further thought needs to be given as to how the various interpretative materials will be applied to prior income years, particularly where new OECD guidance has become available that covers issues not previously addressed (or not addressed to the same extent). This should also be considered for new OECD guidance that may be released in the future. The Australian view on how OECD materials should be applied to prior years should not be developed in isolation: the Government should consider the approach adopted by treaty partners when assessing whether to apply new OECD materials to interpret prior year issues.

D. Clarification is required on when Subdivision 815-A will apply

Recommendation 6: The Commissioner should not be given multiple assessing powers for transfer pricing.

The Commissioner should not be permitted to issue multiple determinations for the same amount under Division 13, Subdivision 815-A, and the relevant treaty directly. While s815-50 makes it clear that the Commissioner cannot bring an amount to tax under Subdivision 815-A and also under another provision of the Act, this does not restrict the Commissioner from choosing whichever provision he likes when making a transfer pricing adjustment. Historically, the Commissioner has issued assessments to taxpayers applying both Division 13 and the treaties. We consider this to be bad policy as it places an unfair burden on taxpayers to analyse the potential legal consequences of each.

If the options are left open to the Commissioner, as appears to be the case with the current draft, this would increase the legal burden on taxpayers. This could be particularly onerous for taxpayers engaged in dealings with related parties in several treaty partner countries, as those taxpayers may be required to consider the interpretation of multiple treaties. Given that the Commissioner holds the view that the outcomes should be the same whether he makes a transfer pricing adjustment under Division 13 or the treaties (as evidenced by historical assessments), and Treasury's view that the proposed changes are a clarification of the existing law, there should be no disadvantage in providing a clearer legislative framework on when each provision may (or may not) be applied.

Recommendation 7: The EM should be expanded to provide examples of when Subdivision 815-A will apply. In particular, this should clarify situations in which Subdivision 815-A may be applied on a retrospective basis. This guidance is required to ensure Parliament's policy intent is clear.

As we have repeatedly stated, we strongly disagree with implementing the proposed changes retrospectively to 2004. However, if the legislation is enacted with retrospective effect, we believe further guidance is required to clarify the policy intent of when it would be appropriate for the Commissioner to apply the law to prior income years. Given the potential severity of the retrospective changes, we consider that this should be considered by the Parliament and not merely dealt with in ATO administrative guidelines. We recommend expanding the EM to include examples of situations in which it may be appropriate to apply Subdivision 815-A on a retrospective basis. There should also be examples to clarify when it would *not* be appropriate to apply Subdivision 815-A on a retrospective basis (such as cases that the Commissioner has previously closed or walked away from).

Administrative guidance may also be required to ensure that ATO field officers enforce the law in a manner that is consistent with the policy intent of Parliament.

Recommendation 8: To the extent this is a clarification of existing law, there needs to be some mechanism to prevent the Commissioner from revisiting transfer pricing cases that have previously been closed.

Although we do not agree, Treasury's view and intent is that Subdivision 815-A is consistent with existing law. Therefore, we would expect that transfer pricing cases previously closed or set aside by the ATO would not now be reopened for further investigation. We recommend explicitly confirming this in the EM.

E. Arbitration clauses should be considered for future treaties to ensure the risk of double tax does not increase.

Recommendation 9: The Government should consider including a binding arbitration clause in the MAP article of any new treaties that are negotiated (or renegotiated) in the future.

The MAP article in the 2010 OECD MTC treaty includes a binding arbitration clause which enables taxpayers to request that a double tax dispute be submitted to arbitration if the competent authorities of the two treaty countries are unable to resolve the case. Arbitration clauses have already been introduced to some treaties by important trading partners such as the United States, Canada, Germany and Japan.

An arbitration clause would provide greater comfort to taxpayers that transfer pricing adjustments will not result in double tax.

We acknowledge this cannot be addressed within the scope of the current transfer pricing reforms, but we strongly encourage the Government to place this on the policy agenda for future treaty negotiations.

F. Taxpayers should not be subject to penalties for retrospective determinations made under Subdivision 815-A

Recommendation 10: No penalties or interest charges should apply where the Commissioner applies Subdivision 815-A to make determinations in respect of income years prior to enactment of the law.

Taxpayers recognise and understand that they may be penalised if they do not comply with the law. Subdivision 815-A is a new law with retrospective application. It would be unfair to penalise taxpayers for not complying with a law that did not exist at the time they entered into an arrangement. We therefore recommend that no penalties should be applied to Subdivision 815-A assessments made by the Commissioner for income years prior to enactment of the law.

The ATO has issued a practice statement on the administration of tax law that will apply retrospectively to the date of an announcement.[17] PSLA 2007/11 contemplates situations in which taxpayers face uncertainty when lodging tax returns between the date of the announcement and date of enactment of a law that will be effective from the announcement date. In these situations, the ATO indicates that taxpayers will not be subject to shortfall penalties or interest charges where they have lodged their tax returns based on the existing law.

PSLA 2007/11 does not contemplate situations in which legislative changes may be given retrospective effect to apply to income years prior to the date of an announcement. Clearly the proposed retrospective application date for Subdivision 815-A of 1 July 2004 is well before the date that the proposed changes were announced (1 November 2011). Since the Commissioner already provides a concession on penalties where retrospective legislative changes are backdated to the date of an announcement, we submit that this concession should also apply to all prior income years to enactment of Subdivision 815-A.

While this could potentially be managed through further ATO administrative guidance (such as an additional practice statement or an addendum to PSLA 2007/11), given the extraordinary nature of the retrospective changes proposed in this case we recommend that this issue should be considered by the Parliament. We recommend that the bill or EM that is submitted to Parliament should state that no penalties or interest will apply to assessments made by the Commissioner under Subdivision 815-A for income years prior to the date of enactment.

We note that in cases that the Commissioner considers penalties would be appropriate, it would still be open to him to issue determinations under Division 13.

G. Time limits should be placed on the number of years available for the Commissioner to make amendments under Subdivision 815-A

Recommendation 11: A time limit should be introduced on the period in which the Commissioner may apply Subdivision 815-A to issue amended assessments for prior income years.

[17] Practice Statement Law Administration (PS LA) 2007/11: Administrative treatment of taxpayers affected by announced but unenacted legislative measures which will apply retrospectively when enacted.

The ED does not place any time limit on when the Commissioner may make Subdivision 815-A determinations relating to prior income years, other than the start date of 1 July 2004. If no time limit is introduced, this could leave taxpayers facing uncertainty indefinitely over whether they may be exposed to amended assessments for 2004 onwards. We acknowledge that there is no time limit for amendments under the existing Division 13; however, Treasury has already indicated that a time limit may be included in the new prospective transfer pricing rules.

An indefinite time limit would be inconsistent with amendment periods for other areas of income tax and may be inconsistent with certain treaties. We recommend that a time limit should be introduced for Subdivision 815-A. Since a time limit is already being contemplated for the new prospective transfer pricing rules, this should be consistent with Treasury's policy intent. The amendment period for Subdivision 815-A should not exceed the time limits stated in any relevant treaty and should not exceed the time limit in the new prospective transfer pricing rules. As recommended in our previous submission, we consider a time limit of four years to be appropriate.

H. Amendments should be made to ensure that customs relief is available where an adjustment is made under Subdivision 815-A (or any other transfer pricing provision).

Under the present law there are significant difficulties in ensuring that transfer pricing adjustments can be reconciled to customs value. As explained previously in this submission, this risk is likely to increase under Subdivision 815-A. Treasury should work together with the Department of Home Affairs to achieve better alignment of the transfer pricing and customs rules from a legislative and administrative perspective.

As previously mentioned in Section 2.B above, s815-30(2) and paragraph 1.56 of the EM should also be amended to oblige the Commissioner to attribute determinations under s815-30(1) to specific items of income or expense.

G. Other areas of the ED and EM requiring clarification or amendment

Reference	Issue	Recommendation
s815-30(6) and s815-45(6)	These subsections state that failure by the Commissioner to provide a copy of a determination to a taxpayer does not affect the validity of the determination. We consider this to be unreasonable.	Remove s815-30(6) and s815-45(6)

Reference	Issue	Recommendation
s815-30(7)	Clarification is needed on whether determinations relating to dealings with different treaty countries may be included in the same document or separately. Given that a transfer pricing benefit under s815-22 must be determined by reference to a specific treaty, at a minimum we expect the Commissioner must provide separate determinations showing the amount relating to each country.	Clarify the format that determinations will take where the Commissioner makes determinations in respect of a taxpayer's dealings with more than one treaty country.
s815-45 and EM paragraphs 1.68 and 1.69	The draft provisions on consequential adjustments allow the Commissioner to make consequential adjustments, following a determination under s815-30, if the Commissioner is satisfied that such an adjustment would be "fair and reasonable" for the taxpayer and revenue. There is no need for the Commissioner to hold such a discretion in relation to consequential adjustments. Whether or not a consequential adjustment is required should be determined objectively based on the determinations made by the Commissioner and the collateral tax consequences that these will give rise to.	The draft provisions and EM should be revised to require the Commissioner to make consequential adjustments where a determination made under s815-30(1) if, based on the item(s) the determination is attributed to under s815-30(2), a consequential adjustment should objectively be made. For example, if a determination is made to reduce a taxpayer's royalty expense, a consequential adjustment should be made to withholding tax applied to the royalties without the need for the Commissioner to judge whether this is fair and reasonable to revenue.
EM paragraphs 1.8 to 1.10	The EM makes certain unsubstantiated references to Parliamentary intention, such as "repeatedly referenced its view", "publicly expressed consistently" and "last demonstrated its intention". As evident from the public submissions to Treasury, these statements are disputed by many members of the tax profession and taxpayers.	The EM should not make unsubstantiated statements of this nature without acknowledging that they are not free from doubt.

Reference	Issue	Recommendation
EM paragraphs 1.15, 1.35 and 1.36	The EM makes several references requiring the Commissioner to have regard to “relevant circumstances of the entity” when applying Subdivision 815-A. We consider this to be inconsistent with OECD guidance. Introducing concepts that are based on a particular interpretation of OECD guidance will reduce international consistency and increase the risk of double taxation that cannot be resolved through MAP.	Delete the words “having regard to the relevant circumstances of the entity” from paragraph 1.15. Delete the last sentence of paragraph 1.35 and the last sentence of paragraph 1.36.

The smoke and mirrors around the "stage one" transfer pricing reforms

by Peter Collins, FTIA, Partner, Lyndon James, ATIA, Partner, and Piotr Klank, Manager, PricewaterhouseCoopers

Abstract: Despite vocal and significant criticisms from the tax community, the government is proceeding with the introduction of new, retrospective (going back to 1 July 2004) "treaty equivalent transfer pricing rules". If the rules are enacted, taxpayers could face transfer pricing adjustments in respect of the last eight years, despite having complied with the law as it existed at the time the tax returns for those years were prepared. While the government claims that this is "clarification" of parliament's previously expressed intention, taxpayers and the broader tax community strongly disagree. This article covers the background to the new rules, both sides of the two key issues — "clarification" and the existence of "parliament's intention" — and provides a view on whether the retrospective operation of the new rules is justified. The article concludes with the authors' prediction on what is likely to happen next.

Introduction

Retrospective legislation has been labelled as "... unjust, undemocratic, unreliable and contrary to human rights, individual autonomy, the rule of law and the Constitution".[1] Some even claim that it is not law at all.[2] Professor Jim Corkery notes: "Retrospectivity is the handmaiden of incompetent or mischievous governments."[3]

The "evil" of retrospective legislation is recognised by the drafters of the Constitution of the United States who firmly believed that the power to create ex post facto laws was one of the hallmarks of tyranny.[4] This led to the incorporation of an ex post facto bar into the Constitution of the US, which specifically prohibits retrospective legislation.[5] A similar provision is included in the Constitution of Sweden — specifically in relation to taxation.[6]

The government does not appear to share this view. Despite vocal and significant criticisms from the tax community, it is proceeding with the introduction of new, retrospective (going back to 1 July 2004) "treaty equivalent transfer pricing rules" (new TP rules) into the domestic law. While the government claims that this is "clarification" of parliament's previously expressed intention,[7] taxpayers and the broader tax community strongly disagree.[8]

The consultation process around the new TP rules has been very limited when compared with other tax consultations and, even with confidential stakeholder involvement, the government has been unwilling to be transparent on the revenue impacts of the new TP rules.

To create greater awareness of the issues, this article takes the reader on a journey which covers the background to the new TP rules (including their implications and related concerns) and both sides of the two key issues — "clarification" and the existence of "parliament's intention" — and whether the retrospective operation of the new TP rules is justified. The article concludes with the authors' prediction on what is likely to happen next.

Background

An unexpected announcement

On 1 November 2011, the government announced that it will "... reform the transfer pricing rules in the income tax law and Australia's future tax treaties to bring them into line with international best practice, improving the integrity and efficiency of the tax system".[9]

The reforms were announced ostensibly as a result of the Commissioner of Taxation's loss in the transfer pricing case, *FCT v SNF (Australia) Pty Ltd*[10] (*SNF*). These changes (now referred to as "stage two" reforms) had been widely anticipated, but legislation has not yet been released.

In the same press release, the government unexpectedly announced that it will also "... address a related area of potential uncertainty" by introducing amendments to the law to "clarify" that transfer pricing rules in Australia's double tax treaties (DTAs) (relevantly, the Associated Enterprises Article (art 9)[11]) operate as an alternative to the existing transfer pricing rules in Div 13 of the *Income Tax Assessment Act 1936* (Cth) (ITAA36).

These changes (now referred to as "stage one" reforms) came as a surprise to everyone outside the Australian Taxation Office (ATO), the government and Treasury. Contrary to the position in the media release, the widely held view, supported by case law and international practice (discussed below), is that art 9 does not operate independently of Div 13. On this basis, retrospective operation of the new TP rules seemed entirely unjustified.

A confidential consultation process

As part of the 1 November 2011 announcement, the government called for "consultation" on the transfer pricing reforms.[12] The consultation process has involved Treasury arranging meetings with a limited number of stakeholders on 7 February and 4 April 2012 to explain the government's decision to introduce the new TP rules; participants remain subject to confidentiality undertakings.

The likely themes of the feedback provided to Treasury can be gleaned from the extensive submissions that have been made public. The vast majority of these echo the same message — art 9 does not operate independently of Div 13.[13] Other issues raised include that the proposed stage one reforms:

- will unfairly target and discriminate against Australia's DTA partners (including the US, China, Japan, Germany and Singapore) as the new TP rules will only apply to transactions

with DTA countries (counter-intuitively, transactions with "tax havens" will not be caught and will receive preferential treatment presumably until the stage two reforms are enacted);

- are in clear breach of art 1(2) of the US DTA, as they will result in the US DTA operating in a way which increases the tax liability above that which would arise if the DTA did not apply;[14] and
- will give rise to the risk of unrelieved double taxation (discussed below).

Introducing the new TP rules

On 16 March 2012, the government released for public consultation the exposure draft legislation (ED) which provides for a new Subdiv 815-A of the *Income Tax Assessment Act 1997* (Cth) (ITAA97).[15] It is fair to observe that concerns raised during the consultation process in relation to retrospectivity (as evident from the submissions made public) have been ignored by the government, as they are not reflected in the provisions of Subdiv 815-A.

In broad terms, Subdiv 815-A is intended to apply to an entity in circumstances where art 9 or a business profits article of a DTA applies to the entity and the entity gets a transfer pricing benefit.[16] It is clear that Subdiv 815-A can only apply if the transaction involves a resident of a DTA partner. Transactions with "tax havens" and non-DTA countries are not affected.

An associated entity will get a transfer pricing benefit where it is an Australian resident and the requirements of the relevant art 9 are met.[17] The amount of the benefit is determined by "... comparing the profits that have accrued to that entity with the profits that might have been expected to have accrued had it been independent and dealing wholly independently".[18]

When determining whether an entity gets a transfer pricing benefit and the amount of that benefit, Subdiv 815-A and the applicable art 9 (or a business profits article, if applicable) are required to be interpreted in a way which best achieves consistency with OECD guidance (ie the "OECD Model Tax Convention on Income and on Capital" (22 July 2010 edition) and the "Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations" (18 August 2010 edition) (TP Guidelines)).[19]

Where an entity gets a transfer pricing benefit, the Commissioner may make a determination to ensure that the entity is subject to tax in one or more income years in respect of that benefit.[20] The Commissioner may also make consequential adjustments (eg to reduce the amount of withholding tax on a oyalty, where a taxpayer's royalty expense has been adjusted).[21] In a similar way to Div 13 ITAA36, the new TP rules in Subdiv 815-A are not self-executing and require the Commissioner to make a determination.[22]

The new TP rules apply to all income years commencing after 30 June 2004.[23]

Concern with the new TP rules

The main concern with the retrospective operation of the new TP rules is that they may result, in certain circumstances, in a different outcome than that which would apply under Div 13 ITAA36.

In simple terms, this may arise as a consequence of the difference in the way that Div 13 and the new TP rules apply the arm's length principle. An example is the so-called "reconstruction power" recognised in the TP Guidelines which set out the circumstances where it may be appropriate to disregard the structure adopted by a taxpayer when entering into a controlled transaction:[24]

> "The first circumstance arises where the economic substance of a transaction differs from its form ... The second circumstance arises where, while the form and substance of the transaction are the same, the arrangements made in relation to the transaction, viewed in their totality, differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner and the actual structure practically impedes the tax administration from determining an appropriate transfer price."

This reconstruction power is also recognised in the transfer pricing memorandum of advice by Ron Merkel, QC, and Diana Harding dated 11 May 2009 (Merkel advice), released to the public by the Commissioner, which provides (at para 79):

> "The associated enterprises article is couched in terms that are broader than Div 13 and may in a given situation provide greater latitude for the Commissioner to *address the income tax consequences of non–arm's length dealings by reconstructing the relevant transaction to make it accord with the surrogate arm's length transaction.*" (emphasis added)

The question then becomes whether the Commissioner is likely to exercise this reconstructive power. Given the strong determination to introduce this controversial retrospective legislation rapidly[25] despite extensive objections, the authors' view is that the Commissioner will enthusiastically apply the new TP rules and this could result in taxpayers facing transfer pricing adjustments in respect of the last eight years, despite complying with the existing rules.

Furthermore, these taxpayers will face the risk of unrelieved double taxation — either through the expiry of relevant limitation periods in other jurisdictions or the failure of the "mutual agreement procedure" (MAP).

In particular, with respect to the MAP, since the government did not engage in any discussions with our DTA partners about the proposed retroactive changes prior to releasing the ED, these jurisdictions are likely to adopt a hardline approach to MAP claims. Consequently, affected taxpayers will face the risk of unrelieved double taxation, especially as the MAP process can take years to complete and there is no compulsion under Australia's DTAs for the competent authorities to reach agreement.

Treasury has refused to be transparent about the assumed impact of the new TP rules on taxpayers. This seems to be on the basis that the rules are being presented as protecting the budget, rather than raising new revenue. This "logic" is reflected in the government's *Mid-Year Economic and Fiscal Outlook 2011-12*[26] and the explanatory memorandum (EM) to the new TP rules.[27]

In the circumstances, it would seem likely that the ATO has indicated material shortfalls in budgeted revenue collections to the government and this has influenced the government's decision to retrospectively change the law. It is hoped that these changes are not connected with any particular disputes on foot with the ATO. It would be galling to discover that the ATO were advocating retrospective law changes in an endeavour to "protect" revenue based on controversial and long-held ATO views which have been found to be shaky by the courts.

Within this context, the question of whether the new TP rules represent a "clarification" of the current law becomes all the more important. If the new TP rules are indeed a "clarification", why are the rules necessary? If the new TP rules are not a "clarification", they should be represented for what they are: retrospective taxation. More transparency is required.

Why the new TP rules are not a "clarification"

Government position

The collective position of the Commissioner, Treasury and the government (government position) seems to be that art 9 *currently* provides the Commissioner with a separate source of power to make transfer pricing adjustments. This view has been expressed by the Commissioner previously, although the basis for this view changed following the decision in *GE Capital Finance Pty Ltd v FCT*[28] (*GE Capital*).

Original position relying on s 4 of the Agreements Act

Initially, the Commissioner relied on the operation of s 4 of the *International Tax Agreements Act 1953* (Cth) (Agreements Act), the rationale being:

- income tax is imposed by the *Income Tax Act 1986* (Cth) (Tax Act);
- the ITAA36 and the ITAA97 (collectively, the Assessment Act) are incorporated into the Tax Act with the effect that income tax is imposed by reference to the Assessment Act;
- s 4(1) of the Agreement Act incorporates the Assessment Act into the Agreements Act and thereby "modifies" the Assessment Act; and
- the "modified" Assessment Act is incorporated into the Tax Act, with the effect that there is a sufficient connection between DTAs (in the Agreements Act) and the imposition of tax under the Tax Act for art 9 in a DTA to provide a power to issue assessments.[29]

In this article, this is referred to as the "original position".

However, as recognised in the Merkel advice,[30] this position is ineffective as a result of the decision in *GE Capital* where the court relevantly held:[31]

> "By the operation of s 4(1), the Agreements Act incorporates the Assessment Act subject to s 4(2). *However, each Act retains its own identity* and the imposition of the relevant tax is still imposed by and at the rates declared by the Income Tax (Dividends, Interest and Royalties Withholding Tax) Act 1974 (Cth) and the Income Tax Rates Act 1986 (Cth) by reference to the Assessment Act. *The incorporation has the consequence, as a matter of a drafting technique, of incorporating the text of the Assessment Act into the Agreements Act*." (emphasis added)

For present purposes, the decision in *GE Capital* provides the following guidance on the interaction between the Agreements Act and the Assessment Act:

(1) the Agreements Act is not incorporated into and therefore does not modify the Assessment Act. Rather, the Assessment Act is incorporated into the Agreements Act with the effect that the Agreements Act is modified by the Assessment Act but retains its own identity (ie it is the Agreements Act, as modified by the Assessment Act); and

(2) as a result of (1) above, there is an insufficient connection between the Tax Act (under which income tax is imposed) and the Agreements Act in order for the provisions of the Agreements Act to impose tax. In the authors' opinion, a sufficient connection could possibly exist if the Agreements Act was incorporated into the Assessment Act.

The Commissioner appears to have since abandoned this position which is not directly referred to in TR 2010/7.[32] However, the importance of the basis for this position and relevance of it being ineffective will become apparent later, when we look at parliamentary intention.

Current position relying on s 170(9B) ITAA36

The government's more recently developed position[33] relies on a specific interpretation of s 170(9B) ITAA36 (as affected by s 170(9C) and (14)). In this article, this is referred to as the "s 170(9B) position".

By way of background, s 170(9B) and (9C) ITAA36 provide:[34]

> "(9B) Subject to subsection (9C), nothing in this section prevents the amendment, at any time, of an assessment for the purpose of giving effect to a prescribed provision or a relevant provision.
>
> (9C) Subsection (9B) does not authorize the Commissioner, for the purpose of giving effect to a prescribed provision or a relevant provision, to amend an assessment made in relation to a taxpayer in relation to a year of income where:
>
> (a) in a case where the purpose of the amendment is to give effect to the prescribed provision in relation to the supply or acquisition of property--the prescribed provision has been previously applied, in relation to that supply or acquisition, in making or amending an assessment in relation to the taxpayer in relation to the year of income; or
>
> (b) in any other case--the prescribed provision or the relevant provision, as the case may be, has been previously applied, in relation to the same subject matter, in making or amending an assessment in relation to the taxpayer in relation to the year of income."

A "prescribed provision" is s 136AD or 136AE ITAA36. A "relevant provision" is "… a provision of a double taxation agreement that attributes to a permanent establishment or to an enterprise the profits it might be expected to derive if it were independent and dealing at arm's length".

The s 170(9B) position is set out in the Merkel advice, which, in broad terms, provides:

- the effect of the definition of "relevant provision" is that, by s 170(9B), the Commissioner has the power to, at any time, amend an assessment for the purpose of giving effect to art 9, being a relevant provision;[35]
- s 170(9C), in referring to a previous application of the associated enterprises article in making an assessment, demonstrates that the legislature has enacted s 170(9B) and (9C) on the basis that the Commissioner may rely on either s 136AD or art 9;[36] and
- the existence of the power to amend an assessment in reliance on art 9 implies that the Commissioner has a power to assess in reliance on the article.[37]

Why the government position is incorrect

The authors submit that, although seemingly persuasive, the s 170(9B) position is not supported by the rules of statutory interpretation, as it unnecessarily departs from the literal meaning and operation of the provisions. It also fails to recognise that the legislative intention noted in the EM to s 170(9B)[38] was affected by the erroneous assumption that s 4 of the Agreements Act was effective in incorporating the Agreements Act into the Assessment Act. Furthermore, the position is inconsistent with parliamentary documents which relate to Australia's DTAs, case law and international practice.

Ordinary reading of s 170(9B) and (9C)

In *Prebble v FCT*,[39] the court relevantly provides:[40]

> "… the task of statutory interpretation requires close attention to be paid to the language used by Parliament in the context in which that language appears … *Courts should not readily depart from the ordinary meaning of the words used where there is no ambiguity*, for to do so might … lead Judges to approach the task of interpretation by

> reference to their own ideas of justice or social policy." (emphasis added)

In light of the above, s 170(9B) and (9C) need to be interpreted in the broader context of ss 169, 170, 173 ITAA36, the decision in *GE Capital*, and s 170(11) ITAA36. In particular, the subsections need to be interpreted in the context of the Commissioner's general power of assessment under s 169, as modified (limited) by s 170.

The Commissioner's general power of assessment is set out in s 169, which provides as follows:

> "**Assessments on all persons liable to tax**
> Where under this Act any person is liable to pay tax (including a nil liability), the Commissioner may make an assessment of the amount of such tax (or an assessment that no tax is payable)."

In simple terms, s 169 requires a person to be liable to tax under the Assessment Act in order for the Commissioner to have a power of assessment.

In contrast, s 170 does not specifically provide a broad power to amend an assessment. Rather, the section sets out, in detail, the circumstances where the Commissioner may or may not amend an assessment (eg specifying time limits and restrictions on amendment of assessments which have previously been amended). The section appears to both express and at the same time limit the Commissioner's power of assessment — in the context of amending an assessment. However, the section necessarily and naturally presupposes a power of assessment, which is located in s 169 and therefore should be interpreted in this context (ie that there must initially be a power of assessment).

This conclusion is consistent with the Commissioner's views in TR 2011/5, where, with respect to the relationship between an amended assessment and an original assessment, the Commissioner relevantly provides:[41]

> "... it is apparent that an amended assessment does not cancel, revoke, extinguish or replace the original assessment. Rather, its role is to alter the original assessment by amending it in a particular or particulars ... Thus, an amendment of an existing assessment is not a new assessment."

This conclusion is also supported by the words of s 170(9B) and (9C). These subsections are part of a number of provisions in s 170 which are couched in negative terms and provide that "nothing in this section prevents the amendment, at any time of an assessment for the purpose of giving effect to ...".[42]

The ordinary and literal reading of the words "nothing in this section prevents the amendment of an assessment" indicates that the Commissioner has a pre-existing power of amendment/assessment which exists outside of the relevant subsection. That is, the necessary and natural conclusion is that these subsections are aimed at preserving, rather than granting, the Commissioner a power of assessment which arises from the power of amendment in s 170(1). However, as discussed above, this power of amendment presupposes a power of assessment under s 169 — the two are interlinked. This is confirmed by s 170(1) which requires a notice of assessment to be issued before the power of amendment can be exercised. This connection is also confirmed by s 173, which provides:

> "**Amended assessment to be an assessment**
> Except as otherwise provided every amended assessment shall be an assessment for all the purposes of this Act."

The necessary and natural conclusion is that where the Commissioner does not have a power to assess under s 169, he likewise should not have a power to amend an assessment. To say that where the Commissioner has a power to amend an assessment necessarily implies that he has a power to assess is to "put the cart before the horse".

In the present case, as highlighted by the decision in *GE Capital*, the Commissioner does not have a power to assess a taxpayer in accordance with art 9 under s 169. This is on the basis that the Agreements Act (via modification of the Assessment Act) is not, ultimately, incorporated into the Tax Act.

The fact that the Commissioner is not empowered to assess a taxpayer under s 170 *to increase* their tax liability by giving effect to art 9 is evident from the existence of s 170(11), which provides:

> "Nothing in this section prevents the amendment, at any time, of an assessment *to decrease the liability of a taxpayer* for the purpose of giving effect to section 24 of the International Tax Agreements Act 1953." (emphasis added)

Section 24 of the Agreements Act essentially provides for the Commissioner to provide relief from double taxation where a taxpayer is assessed by another jurisdiction in accordance with or consistent with the principles of art 9. If the effect of s 170(9B) was as proposed by the Commissioner and set out in the Merkel advice, s 170(11) would not be necessary or would be couched in terms which would also allow the Commissioner to increase a taxpayer's liability.

> "… if the operation of art 9 were to be tested in court, comments by Downes J in *Roche* would prevail."

Accordingly, s 170(9B) cannot be read to provide the Commissioner with a power of assessment which he would not otherwise have under s 169. In particular, on a literal reading of s 170(9B), this subsection is aimed at preserving, rather than granting, the Commissioner a power of assessment.

The confusion regarding the effect of s 170(9B) and (9C) arises from the erroneous assumption, which existed at the time these subsections were introduced, that s 4 of the Agreements Act effectively incorporated the Agreements Act into the Assessment Act and that, consequently, art 9 needed to be applied in priority to Div 13 ITAA36 in some instances. This is reflected in the EM to s 170(9B) and (9C).[43] However, the EM is clear that the aim of the subsections was only to provide the Commissioner with a power, which it was perceived he had, as a result of s 4 of the Agreements Act. Where the Commissioner does not have this power, it is inappropriate to infer such a power.

The government position is incorrect even if s 170(9B) operates as contended

Even if the original position and/or the s 170(9B) positions were effective, case law, international practice and parliamentary documents strongly indicate that art 9 would nevertheless have to be

applied in a way which is consistent with the overall purpose of Australia's DTAs. That is, the Commissioner would still not be able to increase a taxpayer's liability by reference to art 9.

In particular, a number of cases recognise that the incorporation of DTAs into domestic provisions should not affect their intended operation. For example, in *GE Capital*:[44]

> "The obvious purpose of s 4(2) is to ensure that the Agreements Act is to prevail, *but only in respect of its field of operation* and according to its provisions." (emphasis added)

In a similar way, the court in *SNF* provides:[45]

> "But where Parliament expressly decides to incorporate the whole text of a treaty in domestic law and makes it plain, as here, that it is doing so, then it is appropriate to construe the provisions in accordance with the ordinary principles governing the interpretation of treaties."

Numerous cases indicate that the purpose of Australia's DTAs is the allocation of taxing rights and that DTAs do not provide a contracting state with a power to tax. For example, in *Undershaft (No 1) Ltd v FCT*,[46] the court provides:[47]

> "*A DTA does not give a Contracting State power to tax*, or oblige it to tax an amount over which it is allocated the right to tax by the DTA. Rather, a DTA avoids the potential for double taxation by restricting one Contracting State's taxing power." (emphasis added)

In a similar way, the decision in *Roche Products Pty Ltd and FCT*[48] (*Roche*) provides:[49]

> "... there is a lot to be said for the proposition that the treaties, even as enacted as part of the law of Australia, do not go past authorising legislation and do not confer power on the Commissioner to assess."

This is consistent with international practice. In particular, the authors understand that Canada, China, Finland, France, Germany, Ireland, Italy, Japan, Netherlands, New Zealand, Sweden, the United Kingdom and the US do not apply art 9 in a way which imposes tax.[50] This is also consistent with academic literature on point.[51]

The authors recognise that there are very specific and limited circumstances ("exceptions") where DTAs have been applied in a way which extends source taxation.[52] An example is the specific anti-avoidance "stopgap" legislation in France which codifies that income attributed to France by a DTA is taxable in France.[53] However, these "exceptions" are limited and do not detract from the general principles set out in commentary and judicial decisions. The existence of these "exceptions" in fact supports the position that tax treaties generally operate in a relieving manner — exceptio probat regulam in casibus non exceptis (the exception confirms the rule in cases not excepted). For example, the fact that countries have "reservations" in relation to the OECD Model Tax Convention, does not mean that there is no OECD standard for DTAs.

Consequently, if parliament intended to depart from international practice, this should be evident from parliamentary documents relating to DTAs. However, based on the authors' review, neither the EMs, nor other parliamentary documents such as regulatory statements or national interest analyses in relation to DTAs appear to specifically refer to art 9 as providing the Commissioner with a separate assessment power.[54]

This confirms that parliament, in enacting the DTAs into law, did not have an intention that they be applied in a way which provides the Commissioner with a separate power of assessment. Therefore, even if the Commissioner is entitled to amend an assessment to give effect to art 9, this power needs to be exercised in a way which is consistent with international practice.

What would happen if the government position were tested before the courts?

The authors consider that if the operation of art 9 were to be tested in court,[55] comments by Downes J in *Roche* would prevail. In particular, the authors understand from written submissions lodged with the Administrative Appeals Tribunal in *Roche* that both parties made extensive submissions on the issue of whether DTAs provide a separate assessment power and that the Commissioner's view relying on s 170(9B) was fully explained and considered by the Tribunal. In this regard, having considered the s 170(9B) position, Downes J stated:[56]

> "*... there is a lot to be said for the proposition that the treaties, even as enacted as part of the law of Australia, do not go past authorising legislation and do not confer power on the Commissioner to assess.* They allocate taxing power between the treaty parties rather than conferring any power to assess on the assessing body. On this basis Division 13 should be seen as the relevant legislative enactment pursuant to the power allocated." (emphasis added)

The authors recognise that in *SNF (Australia) Pty Ltd v FCT*[57] (the *SNF* decision at first instance), Middleton J indicated in obiter comments that there was some merit to the s 170(9B) position discussed above.[58] However, the authors understand that this issue was raised only briefly in written submissions and was not the subject of oral submissions by agreement of the parties. Hence, it is unlikely that this issue was fully analysed by the court. Furthermore, Middleton J's comments appear to echo the Merkel advice. Therefore, it is the authors' view that if the position set out in this article on the application and interpretation of s 170(9B) was put to the court (ie that the view relying on s 170(9B) is unsupportable), this position would ultimately be upheld.

Conclusion on "clarification"

It is clear that there is little support for the government's publicly stated position that the new TP rules "clarify" existing law. The description of the current law in the EM to Subdiv 815-A as allowing a transfer pricing adjustment to be made under either Div 13 or transfer pricing provisions of a DTA is inappropriate and misleading.

Parliament's intention – what intention?

Government position

The government has tried to justify the retrospective operation of the new TP rules on the basis that "... Parliament has indicated the law should apply this way on a number of occasions, most recently in 2003".[59]

The authors understand that the reference to 2003 is a reference to para 3.5 of the EM to the UK DTA, which provides:[60]

> "Subsections 170(9B) and (9C) of the ITAA 1936 deal with time limits for amending income tax assessments for the purpose of giving effect to a relevant provision. Paragraph (a) of the definition for relevant provision in subsection 170(14) defines relevant provision as paragraph (3) of Article 5 or paragraph (1) of Article 7 of the existing tax treaty with the United Kingdom (currently defined as United Kingdom agreement within subsection 170(14)), or a provision of any other tax treaty that corresponds with either of those paragraphs. *These paragraphs in Australia's tax treaties allow for adjustments to the profits of permanent establishments or associated enterprises on an arm's length basis.*" (emphasis added)

In addition, in the past, the Commissioner has also relied on the EM to Div 13 and s 170(9B),[61] which provides:[62]

> "In their practical effect, proposed sub-sections 170(9B) and (9C) will clarify the powers of the Commissioner to amend an assessment where a provision of a double taxation agreement that deals with profit shifting may be applicable. Sub-section 4(2) of the Income Tax (International Agreements) Act 1953 provides that the provisions of that Act are to have effect notwithstanding anything inconsistent with those provisions contained in the Principal Act. *Technically, therefore, the provisions of a double taxation agreement that deal with profit shifting, either under a 'business profits' article (e.g., Article 5 of the Australia/U.K. agreement), or an 'associated enterprises' article (e.g., Article 7 of that agreement), may have to be applied instead of Division 13.* Where the profit shifting provisions of a double taxation agreement are to apply in these circumstances, sub-sections 170(9B) and (9C) confer the same specific powers of amendment of an assessment as are to be provided in relation to revised Division 13." (emphasis added)

The position that art 9 provides a separate source of assessment power has also been raised by the Commissioner in a number of speeches (in 2008 and in 2009)[63] and rulings prior to 1 November 2011.[64] For example, in TR 2001/13, the Commissioner provides:[65]

> "In the same way, the ATO considers that the DTA Associated Enterprises Article (Article 9 in most of Australia's DTAs) could similarly apply to adjust profits of separate but related enterprises in cases where Division 13 of our domestic law is not relied on."

Why the government's position is incorrect

On face value, there would appear to be some merit in the position that, prior to 1 November 2011, the government has indicated that the law should apply in the contended way. However, this is not the case for a number of reasons.

Paragraph 3.5 of the EM to the UK DTA does not directly relate to the UK DTA. Rather, it relates to amendments to s 170(14), specifically the definition of the term "relevant provision", to reflect the replacement of the existing UK DTA text in the Agreements Act.

If the comments are intended to reflect parliament's intention that art 9 can be applied in a way which imposes tax, this should be noted in the section of the EM which deals with art 9 of the UK DTA — which is not the case. In particular, given that this would represent *significant* departure from international practice, such a reference would be expected. That is, taxpayers reading the EM to determine the implications of the DTA on their financial situation would expect this information to be highlighted, rather than having to read an obscure and dated EM to a specific amendment provision.

Furthermore, the EM to the UK DTA specifically recognises that in Australia's DTAs the profit allocation rules are concerned with the allocation of taxing rights (ie allocation of profits on an arm's length basis) which in turn are taxed under Australia's domestic transfer pricing rules. The EM provides:[66]

> "What is the purpose of Australia's tax treaties? Australia's tax treaties are designed to:
>
> - prevent avoidance and evasion of taxes on various forms of income flows between the treaty partners by:
>   - providing for the allocation of profits between related parties on an arm's length basis;
>   - *generally preserving the application of domestic law rules that are designed to address transfer pricing and other international avoidance practices ...*"
>
> (emphasis added)

This is also recognised at para 1.101, where the EM explains that art 9 "authorises the re-allocation of profits...", at para 1.104 where it explains that art 9 "specifically recognises the right of each country to apply its domestic law... (e.g. Australia's Division 13 of the ITAA 1936) ...", and also at para 4.6 where the EM provides "[t]ax treaties reduce or eliminate double taxation ... because treaty partners agree ... to limit taxing rights ...".

In a similar way, the comments in the EM to Div 13 and s 170(9B) merely set out parliament's intention that, where art 9 applies in priority to Div 13, s 170(9B) should empower the Commissioner to amend an assessment to give effect to the article. The comments are limited to s 170(9B) and do not express parliament's intention on how or when art 9 should be applied, being the critical issue. As noted above, case law and international practice indicate that art 9 should not be applied to impose tax.

The fact that art 9 is intended to operate in a way which relieves double taxation is confirmed by the EM to s 170(11) (discussed above), which provides:[67]

> "**Method of relieving double tax resulting from a transfer pricing adjustment**
>
> 1.160 Australia is obliged, under most of its international agreements (including tax treaties), to provide relief (to a resident company) from economic double taxation that arises as a result of a transfer pricing adjustment by a tax treaty partner country. *Relief from economic double taxation in these circumstances ('correlative relief') is usually provided in the rules on associated enterprises (generally Article 9 of Australia's tax treaties).*" (emphasis added)

While speeches and tax rulings raise the possibility of art 9 applying in the way that imposes tax, they also recognise the ambiguity and complexity around how the law applies and are generally tentative in nature. For example, Jim Killaly, Deputy Commissioner, in a speech given to The Tax Institute's Victorian State Convention in 2008 states:[68]

> "The constitutional and legislative standing of the Associated Enterprises Articles in Australia's treaties is *not free from doubt* and it seems clear that the debate around this issue could possibly continue until finally determined by the Courts. *For its part the Tax Office will continue to reflect on the issue.*" (emphasis added)

Contrary to the suggestion of this Deputy Commissioner, it now seems more likely that the issue will be finally resolved by parliament. It could be that the Commissioner reflected on the issue, particularly in light of case law referred to above, and concluded that a court was unlikely to support his controversial and long-standing publicly stated views.

The uncertainty is highlighted by the "tentative" wording in TR 2010/7:[69]

> "41. Amendments made at the time of the introduction of Division 13 in 1982 *appeared to signal* an intention on the part of the Parliament that amended assessments could be made to give effect to 'a provision of a double taxation agreement ...
>
> 42. The proposition that there is a power to assess in reliance on the Associated Enterprises Articles in Australia's treaties *received favourable comment, in obiter*, from the Federal Court (Middleton J) in SNF (Australia) Pty Ltd v Commissioner of Taxation." (emphasis added)

Furthermore, the Commissioner's views in speeches and rulings do not represent the law nor do they carry the same gravity as EMs. In particular, the Commissioner may change his views or such views may subsequently be determined to be incorrect (eg TR 2001/12 , which outlined the Commissioner's long-standing and controversial view about capital gains tax and DTAs, which was eventually withdrawn following Federal Court decisions on point[70]). The Commissioner acknowledges

in MT 2008/2 that a taxpayer may adopt an alternative view to that expressed in a taxation ruling and still be protected from shortfall penalties where it still has a reasonably arguable position.[71]

Conclusion on intention

There is little support for the view that parliament has clearly and effectively (or, at the very least, sufficiently) expressed the view that DTAs provide a separate source of assessment power. The references in EMs relied on by the government either do not support this position or have been taken out of context. If parliament had such an intention, it should be expressed in EMs to DTAs, which is not the case. Furthermore, the absence of clear intention by parliament is recognised by the Commissioner.

Is retrospective operation justified?

The intentions of the government seem honourable — it is merely trying to protect its tax revenue so that it can provide for the Australian community. However, from a taxpayer perspective, the ends do not justify the means. Referring to Subdiv 815-A as a "clarification" of the existing law is misleading — there is little support for the view that art 9 can apply to impose tax. In a similar way, references to "parliament's intention" are taken out of context and are inconsistent with statements by the Commissioner in rulings and speeches which recognise that the position is uncertain.

Cutting to the chase — the new TP rules are unjustified retrospective taxation. In addition, they unfairly only apply to countries "unlucky enough" to have entered into DTAs with Australia.

Next steps – the Senate Bills Committee

Despite extensive submissions, the government seems intent on retaining the retrospective operation of the new TP rules.

Unfortunately, in contrast to the US and Sweden, there is no prohibition in Australia against retrospective tax legislation and, in fact, this is not uncommon.[72] A recent example includes the proposed amendments to the rights to future income rules.[73] With this in mind, it becomes clear that claims by taxpayers that the new TP rules are "against the rule of law" and "usurp the role of the judiciary" are presently likely to fall on deaf ears.

Fortunately, there is a "check" on retrospective legislation in Australia, in the form of the Senate Bills Committee (Bills Committee). The Bills Committee, established in 1981, is responsible for reporting on clauses of Bills introduced into the Senate and in respect of Acts of the parliament that, among other things, "trespass unduly on personal rights and liberties".[74] As a matter of practice, the Bills Committee draws attention to any Bill that seeks to have retrospective impact and comments adversely where such a Bill has a detrimental effect on people.

The new TP rules are likely to attract the attention of the Bills Committee as they are retrospective and can be perceived to trespass unduly on personal rights and liberties, given that they will result in increased retrospective tax liability in circumstances where taxpayers have adopted positions which could be considered, at the very least, reasonably arguable under the existing law. In particular, the authors consider that the Bills Committee is likely to recognise and raise the following concerns with the Senate with respect to the proposed amendments:

- in contrast to the general nature of Australian retrospective tax legislation which is aimed at rectifying technical deficiencies and not being detrimental to taxpayers, these amendments go beyond rectifying a technical deficiency and will have a significant and detrimental effect on numerous taxpayers. In particular:
  - the amendments mark a significant departure from the position accepted by taxpayers and the courts on how the transfer pricing rules operate; and
  - the unlimited amendment period which applies to transfer pricing adjustments means that taxpayers could be subject to additional tax liability for the last eight years in circumstances where they have applied existing law;
- on the basis that they appear to arise as a result of the Commissioner losing two significant transfer pricing cases[75] and seek to retrospectively address issues raised by those decisions, the amendments appear to usurp the role of the judiciary;
- the retrospective amendments are inconsistent with the principle of the income tax self-assessment regime as they will effectively overrule current law (albeit to some extent uncertain), which taxpayers have relied on during the proposed period of retrospectivity in complying with their income tax liabilities; and
- retrospectivity does not appear to be justified in the present case, as the amendments are not targeted at blatant tax avoidance and/or evasion (which would be the case where the expectations of taxpayers are neither rational nor legitimate)[76] or to rectify defects in the law which have created unintended consequences.[77]

Unfortunately, whether the Senate responds to these concerns is a separate matter.

Conclusion

It is incontrovertible that the new TP rules are a retrospective new tax. They apply from 1 July 2004. There is very little support for the proposition that they "clarify" or "confirm" existing law or that parliament has expressed an intention that art 9 provides the Commissioner with a separate source of assessment power.

If the new TP rules are enacted, taxpayers could face transfer pricing adjustments in respect of the last eight years, despite having complied with the law as it existed at the time the tax returns for those years were prepared. They will also face the risk of unrelieved double taxation. Despite these significant consequences, the consultation process has left a lot to be desired and the lack of transparency around tax revenue apparently at stake has only heightened stakeholder concerns over the process.

In the end, it will be for parliament to decide whether to enact these controversial, retrospective and discriminatory new TP rules. However, the question must be asked — what precedents are the Commissioner, the government and Treasury setting with this behaviour?

Stop press

On 24 May 2012, the government introduced into parliament the Tax Laws Amendment (Cross-Border Transfer Pricing) Bill (No. 1) 2012, which, if passed, will insert Subdiv 815-A into the ITAA97. The Bill essentially reflects the ED in terms of how Subdiv 815-A will operate (eg identification of a transfer pricing benefit by reference to the application of art 9 in a DTA, reliance on OECD guidance, and the like). Unfortunately, like the ED, the Bill provides for the retrospective operation of Subdiv 815-A from 1 July 2004.

In the context of this article, a key difference between the Bill and the ED relates to the significantly more detailed context to the retrospective operation of Subdiv 815-A in the EM to the Bill. It would seem that the EM seeks to address some of the issues raised in submissions and this article — albeit from a government perspective and echoing earlier speeches by the Commissioner. In the authors' opinion, the overview in the EM should be viewed with a sceptical eye, as many of the statements are incomplete and in some instances inaccurate — as highlighted by this article.

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4 Jane Harris Aiken, "Ex post facto in the civil context: unbridled punishment" (1992-1993) 81 Ky LJ 323 at 324.

5 Constitution of the United States of America, art 1, s 10 ("No State shall ... pass any Bill of Attainder, ex post facto Law, or Law impairing the Obligation of Contracts ...").

6 Tim Jay, "Retro active tax legislation: a 'deaf leopard' and his spots" (2007) 17 *Revenue LJ* Article 10. See also Ch 2, art 10 of the Instrument of Government (Regeringsformen).

7 The Hon Bill Shorten, MP, "Robust transfer pricing rules for Multinationals", media release, 1 November 2011.

8 Refer to the submissions in relation to "Consultation paper — income tax: cross border profit allocation — review of transfer Pricing rules", available from the Australian Treasury website <http://archive.treasury.gov.au/contentitem.asp?ContentID=2305&NavID=> (accessed 27 April 2012). Also Damian Preshaw, "The associated enterprises articles in Australia's DTAs and Division 13" (2009) *Taxation in Australia* vol 44(5).

9 The Hon Bill Shorten, MP, "Robust transfer pricing rules for Multinationals", media release, 1 November 2011.

10 [2011] FCAFC 74.

11 The relevant transfer pricing rules are located in the business profits and the associated enterprises articles. However, for present purposes, only art 9 is addressed.

12 The Treasury, *Income tax: cross border profit allocation – Review of transfer pricing rules*, consultation paper.

13 Twenty-eight submissions (25 public and three confidential) were made in relation to the original proposals. These are available from the Australian Treasury website <http://archive.treasury.gov.au/contentitem.asp?ContentID=2305&NavID=> (accessed 27 April 2012).

14 Article 1(2) of the US DTA essentially provides that the treaty may not increase tax above the liability that would result under domestic law.

15 Exposure Draft Tax Laws Amendment (2012 Measures No.3) Bill 2012 (Cth): Cross-border transfer pricing (ED).

16 ED, s 815-20.

17 ED, s 815-22.

18 Explanatory memorandum (EM) to ED, para 1.15.

19 ED, s 815-25.

20 ED, s 815-30.

21 ED, s 815-45.

22 ED, s 815-30.

23 S 815-10 to be inserted into the *Income Tax (Transitional Provisions) Act 1997* (Cth).

24 TP Guidelines, para 1.65.

25 The rapid speed at which the stage one reforms have been converted into draft legislation intended for promulgation before 1 July 2012 can be contrasted with the pace at which all other recent tax changes (including the stage one transfer pricing reforms) have been legislated.

26 The Treasury, *Mid-year economic and fiscal outlook 2011-12*, refer Appendix A: Policy decisions taken since the 2011-12 Budget, at p 172.

27 EM to ED, para 1.10.

28 (2007) 159 FCR 473.

29 Refer Merkel advice at paras 44 to 50, and (2007) 159 FCR 473 at [39] and [46].

30 Merkel advice at para 50.

31 (2007) 159 FCR 473 at [40].

32 TR 2010/7 at paras 39 to 42.

33 Referred to in para 43(b) of the Commissioner's written submissions in *Roche* (respondent's outline of argument, no. NT7 and NT56-65 of 2005) and in *Distinguishing between business driven and tax driven restructuring*, Jim Killaly, Deputy Commissioner, Large business and international (case leadership), speech given to The Tax Institute's Victorian State Convention on 9 October 2008.

34 S 170(14).

35 Merkel advice at para 54.

36 Merkel advice at para 59.

37 Merkel advice at para 59.

38 EM to the Income Tax Assessment Amendment Bill 1982 (Cth).

39 [2003] FCAFC 165.

40 [2003] FCAFC 165 at [24] to [25].

41 TR 2011/5 at paras 82 and 83.

42 For example, refer s 170(10), (10AA) and (11).

43 EM to the Income Tax Assessment Amendment Bill 1982 (Cth), cl 21: Amendment of assessments.

44 [2009] FCA 41 at [44].

45 [2011] FCAFC 74 at [119].

46 [2009] FCA 41.

47 [2009] FCA 41 at [44] to [45].

48 [2008] AATA 639.

49 [2008] AATA 639 at [191].

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51 Klaus Vogel, "Double Taxation Conventions", 3rd ed, 1997, at p 20.

52 Netherlands — Philip Baker, "Double tax conventions and international tax law", (1994), London, Sweet and Maxwell, at p 7; France — Philippe Martin, "France: interaction between tax treaties and domestic law", (2011) *Bulletin for International Taxation*, vol 65, no. 4/5; Italy — Alessio Persiani, "Foreign employment income in the Italian tax setting", (2010) *Bulletin for International Taxation*, August/September 2010.

53 Philippe Martin, "France: interaction between tax treaties and domestic law", (2011) *Bulletin for International Taxation*, vol 65, no. 4/5.

54 The authors have considered such documents in relation to the UK, US and Turkish DTAs.

55 It has been noted in a number of submissions that the ATO has had ample opportunity to test its view on this point. It has chosen not to (for reasons that have not been articulated).

56 [2008] AATA 639 at [191].

57 [2010] FCA 635.

58 [2010] FCA 635 at [23].

59 The Hon Bill Shorten, MP, "Robust transfer pricing rules for multinationals", media release, 1 November 2011.

60 EM to the ED, para 1.10 and EM to the International Tax Agreements Amendment Bill 2003 (Cth), para 3.5.

61 *Distinguishing between business driven and tax driven restructuring*, Jim Killaly, Deputy Commissioner, Large business and international (case leadership), speech given to The Tax Institute's Victorian State Convention on 9 October 2008.

62 EM to the Income Tax Assessment Amendment Bill 1982 (Cth), cl 21: Amendment of assessments.

63 *Distinguishing between business driven and tax driven restructuring*, Jim Killaly, Deputy Commissioner, Large business and international (case leadership), speech given to The Tax Institute's Victorian State Convention on 9 October 2008, and *In the best interests of Australia*, speech by the Commissioner of Taxation, Michael D'Ascenzo, to the Corporate Tax Association Convention, Melbourne, 15 June 2009.

64 For example, TR 94/14 at paras 5 and 184 to 186; TR 2001/11 at para 2.3; and TR 2001/13 at para 33.

65 TR 2001/13 at para 33.

66 EM to the International Tax Agreements Amendment Bill 2003 (Cth).

67 EM to the Tax Laws Amendment (2007 Measures No. 4) Bill 2007, para 1.160.

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69 TR 2010/7 at paras 41 to 42.

70 Refer to TR 2001/12W.

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