Deloitte Tax Services Pty Ltd
ACN 092 223 240

Grosvenor Place
225 George Street
Sydney NSW 2000
PO Box N250 Grosvenor Place
Sydney NSW 1220 Australia

Tel: +61 2 9322 7000
Fax: +61 (02) 9322 7001
www.deloitte.com.au

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

10 July 2012

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

Deloitte welcomes the opportunity to participate in the Committee inquiry into this proposed legislation.

In the first instance, we refer to, and reiterate, comments previously submitted as part of the consultation process on the legislation:

- Our comments dated 13 April 2012 on the Exposure draft of *Tax Laws Amendment (2012 Measures No. 3) Bill 2012: Cross-border transfer pricing* (attached at Appendix A);
- Section 2 of our comments dated 30 November 2011 on the proposal to amend the transfer pricing rules as set out in the Consultation Paper *"Income tax: cross border profit allocation - review of transfer pricing rules"* and the Assistant Treasurer's associated Media Release of 1 November 2011 (attached at Appendix B).

We strongly reiterate our view that it is neither appropriate, nor necessary, nor fair to taxpayers for these legislative amendments to be made retrospectively, particularly given:

- There is no clear evidence of a legislative intent that the transfer pricing rules in Australia's tax treaties can apply independently of the rules in Division 13 of the *Income Tax Assessment Act 1936*;
- The validity of any long-held view of the Commissioner of Taxation as to the existence of that intent should appropriately be determined by litigation and not retrospectively supported by legislation;
- There is no clear evidence that there is a significant risk to the revenue if the transfer pricing rules in Australia's tax treaties do not apply independently of the rules in Division 13;
- Any short term revenue gains from making the amendments retrospective are likely to be more than offset by changes in transfer pricing policies adopted by Australian taxpayers in response to the legislation and longer term revenue losses through damage done to Australia's reputation for fair dealing in international trade and investment by legislating retrospectively;
- A key component of the new legislation relates to the interaction of the transfer pricing rules with the thin capitalisation rules, and effectively legislates a position on which the Commissioner only provided his formal view in 2010. The thin capitalisation rules are particularly important for inward investors seeking certainty on the tax treatment of forms of foreign direct investment into Australia, and backdated changes in this area will be particularly damaging to Australia's reputation as an investment destination.

Further, having regard to the above points, we recommend that as part of its inquiry the Committee puts the following questions to Government:

- If, as stated, the Government is only seeking to clarify the operation of the current law, why would it risk damaging Australia's reputation in the international marketplace by doing so in the proposed retrospective manner?
- What is the basis for the Government's belief that there is a significant risk to the revenue if the transfer pricing rules in Australia's tax treaties do not apply independently of the rules in Division 13?
- If the Commissioner holds the view that the transfer pricing rules in Australia's tax treaties would have produced a decision in his favour in the SNF Australia case, why did he choose not to argue the application of those rules in that case?
- How does the decision in the SNF Australia case cause a risk to the revenue from taxpayers seeking credit amendments that needs to be addressed by retrospective legislation?
- Has Government considered the potentially significant compliance cost for taxpayers to review eight years of transfer pricing positions taken over the period back to 1 July 2004?
- Why is it appropriate or in Australia's best interests to discriminate against taxpayers that transact with associated enterprises in tax treaty countries, being many of Australia's major trading partners, by legislating potentially less favourable transfer pricing rules for these cross border dealings?

We urge the Committee to recommend withdrawal of the legislation altogether or alternatively to recommend that it only have prospective effect.

Yours sincerely,

Fiona Craig
Australia National Leader – Transfer Pricing
Partner, Deloitte

Appendix A

Deloitte.

Deloitte Tax Services Pty Ltd
ACN 092 223 240

Grosvenor Place
225 George Street
Sydney NSW 2000
PO Box N250 Grosvenor Place
Sydney NSW 1220 Australia

Tel: +61 2 9322 7000
Fax: +61 (02) 9322 7001
www.deloitte.com.au

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

13 April 2012

Dear Sir

Re: Comments on Exposure Draft legislation on cross-border transfer pricing

Deloitte welcomes the opportunity to comment on the Exposure Draft of *Tax Laws Amendment (2012 Measures No.3) Bill 2012: Cross-border transfer pricing.*

1. Introduction

We refer to our comments dated 30 November 2011 on the proposal to amend the transfer pricing rules as set out in the Consultation Paper *"Income tax: cross border profit allocation - review of transfer pricing rules"* and the Assistant Treasurer's associated Media Release of 1 November 2011.

We reiterate our previous comments that legislative amendments to retrospectively allow the Commissioner to raise transfer pricing adjustments on treaty law as an alternative to domestic law raises very serious issues of fairness and arbitrariness in the application of Australian international tax laws. For reasons previously stated, we do not consider these amendments necessary, appropriate or fair to taxpayers, and maintain our view that they should not be made. If the Government nevertheless decides to pursue these amendments, we consider that the issues we have previously raised, as well as those discussed below, should be taken into account in ensuring the amendments are as appropriate, fair and consistent as possible with the existing law.

2. Linking adjustments to transactions

In our view, the current drafting of Subdivision 815-A does not appropriately require that an adjustment under it be linked to an item of assessable income, deduction or capital gain/loss in respect of a particular transaction or transactions.

Subsection 815-30(1) authorises the Commissioner to make determinations to subject a transfer pricing benefit to tax by increasing an entity's taxable income, decreasing its tax loss, or decreasing its net capital losses. According to paragraph 1.53 of the Explanatory Memorandum to the legislation, a determination under subsection 815-30(1) only contemplates an overall adjustment to an entity's taxable income, tax loss or net capital losses, and this determination does not impact on how the entity is treated by other areas of the tax law because the determination does not apply to individual items of the entity's assessable income, particular deductions or particular capital gains/losses. Subsection 815-30(2) provides for the making of a further determination attributing the adjustment under 815-30(1) to a particular amount of assessable income, deductible expenditure or capital gain/loss. However, there is no requirement to make a determination under 815-30(2) except in respect of an entity's debt deductions where Division 820 applies. Thus, 815-30 gives the Commissioner a general discretion to make an adjustment to taxable income without being required to specify what particular item of income, expenditure or capital gain/loss is affected.

The potential problems this can cause for an affected taxpayer can best be illustrated by an example. Say the taxpayer has various categories of cross-border dealings, including trading stock purchases, with numerous related parties resident in numerous offshore jurisdictions. The ATO conducts an audit and makes an adjustment under s.815-30 applying a transactional net margin method on a whole of entity basis. The issues raised for the taxpayer by its lack of knowledge of the basis for the adjustment, if the Commissioner in this case does not make determinations under s.815-30(2) attributing the adjustment to particular items, include:

- The extent to which the adjustment is referrable to an applicable Associated Enterprises Article for purposes of s.815-22 and knowing whether the adjustment relates to a "transfer pricing benefit" as defined for Subdivision 815-A, so that the Commissioner has authority to make the adjustment under that provision ;
- The extent to which the adjustment is referrable to an applicable Associated Enterprises Article for purposes of requesting correlative relief or Mutual Agreement Procedure under that treaty;
- The extent of the effect of the adjustment, if any, on the treatment of deductions for trading stock under other provisions of the Act;
- The extent of the effect of the adjustment, if any, on the valuation of the trading stock purchases for other purposes, eg. customs duties payable.

In our view the Commissioner should be required in all cases to identify and characterise what specific item is being adjusted so as to link that adjustment to the other provisions of the Act. We recommend that s.815-30(2) be amended to require that the Commissioner make determinations in all cases attributing the adjustment under 815-30(1) to a particular amount of assessable income, deduction or capital gain/loss.

Requiring the Commissioner to identify the particular item(s) to which the profits that are subject to a s.815-30 adjustment are attributable would accord with subsection 815-22. Subsection 815-22 essentially defines "transfer pricing benefit" as an amount of profits within the meaning of the applicable treaty article, interpreted so as to best achieve consistency with the OECD Model Tax Convention and the OECD Transfer Pricing Guidelines. Both the Commentary to Article 9 of the OECD Model Tax Convention and the Transfer Pricing Guidelines make clear that the amount of "profits" to which Article 9 applies is determined by reference to transactions. Thus, for instance, paragraph 1 of the Commentary to Article 9 states:

"This Article deals with adjustments to profits that may be made for tax purposes where transactions have been entered into between associated enterprises (parent and subsidiary companies and companies under common control) on other than arm's length terms."

In accordance with this, the Guidelines recognise five arm's length pricing methods to be used in applying Article 9, with these methods categorised as "traditional transaction methods" and "transactional profit methods". Under the Guidelines, the comparability analysis prescribed for applying those methods is performed at the level of individual transactions or an appropriate level of aggregation of transactions. The Commentary and the Guidelines do not contemplate the arm's length principle under Article 9 being applied to adjust profits in a way that does not attribute that adjustment to particular transactions between the associated enterprises. Accordingly, we do not see how the Commissioner can satisfy s.815-22(3) and hence make a valid adjustment under s.815-30 unless he determines the transfer pricing benefit by reference to the profits in respect of a particular transaction or transactions.

3. Interaction with thin capitalisation provisions

We note that the Assistant Treasurer's Media Release announcing the retrospective amendments made no mention of them addressing interaction with the thin capitalisation provisions (Division 820 ITAA 1997). This issue is arguably outside the scope of the amendments required to give effect to the Government's announced objective of clarifying the law as regards the treaties providing a separate assessment power to Division 13. On this basis we can understand why some might argue for paragraphs (4) and (5) of s.815-22 to be excluded from the legislation.

However, we do support retention of a provision in Subdivision 815-A that explicitly confirms that it interacts with Division 820 in the same way as Division 13 and treaty Article 9; that is, as stated in TR 2010/7, an arm's length interest rate as determined under Division 13, Article 9 or Subdivision 815-A is applied to the entity's actual amount of debt. As regards how an arm's length interest rate is determined, the provision can appropriately refer to the need for consistency with the OECD Guidelines. In our view it is unnecessary and inappropriate for the provision to go any further. Paragraph (5) of s.815-22 should be deleted. The OECD Guidelines do not explicitly state that in applying the arm's length principle to a loan between associated enterprises the rate of interest can appropriately be determined using a debt amount that is less than the actual debt amount. Paragraph (5) of s.815-22 purports to legislate an ATO view in TR 2010/7 which is controversial and arguable at best, and which is merely an interpretation of what is in the OECD Guidelines. Example 1.4 at paragraph 1.41 of the Draft Explanatory Memorandum to Subdivision 815-A is similarly objectionable and should also be deleted.

4. Permanent establishments

We note that the effect of ss. 815-22(3) and 815-25 is that a transfer pricing benefit for an Australian PE is determined consistent with the OECD Model Tax Convention, whose Commentary on Article 7 (Business Profits) as from 2008 incorporates conclusions from the OECD *Report on Attribution of Profits to Permanent Establishments*. We suggest that the relevant section of the Draft Explanatory Memorandum (paragraphs 1.29 to 1.34) be expanded to explicitly recognise that the authorised OECD approach under that Report is relevant, to the extent that it is incorporated into the OECD Commentary on Article 7, in interpreting Subdivision 815-A and the Business Profits Article of Australia's tax treaties.

5. Record keeping requirements

Subdivision 815-A does not address any record keeping requirements in respect of that provision. Whether a taxpayer has contemporaneous documentation evidencing its best efforts to comply with the arm's length principle is a factor relevant to the level of penalties imposable where Division 13 or treaty Article 9 applies (see TR 98/11). A similar approach should be taken where Subdivision 815-A applies. Where Subdivision 815-A applies retrospectively, it would obviously not be possible for a taxpayer to have contemporaneous documentation addressing the application of that provision. Accordingly, we recommend that Subdivision 815-A explicitly recognise that contemporaneous documentation prepared for Division 13 or treaty Article 9 purposes be treated as contemporaneously prepared for Subdivision 815-A purposes.

6. Penalties

We believe that the issue of penalties imposable on an adjustment applying Subdivision 815-A should be explicitly addressed in the legislative amendments introducing that provision. This might be addressed in Subdivision 815-A itself and/or in amendments to section 284-145 of the Taxation Administration Act 1953 (TAA).

We understand that the Commissioner accepts that the question of whether treaty Article 9 is a separate head of power for raising amended assessments to make transfer pricing adjustments is a matter on which there are real and rational differences of opinion between the view expressed by the Commissioner and the contrary view. This is the basis for the Government view that the legislative amendments to introduce Subdivision 815-A are needed to "clarify that transfer pricing rules in our tax treaties operate as an alternative to the rules currently in our domestic law" (as per the Assistant Treasurer's Media Release of 1/11/2011). In other words, there would be no need to clarify the law through these legislative amendments if there weren't uncertainty because of differing reasonably held views. Accordingly, we understand that in practice the Commissioner currently accepts that a taxpayer has a reasonably arguable position (RAP) that Article 9 is not a separate head of power.

Section 284-145 of the TAA prescribes the same penalty rates where Division 13 or Article 9 applies. However, given the above, we understand that the Commissioner accepts that a taxpayer has a RAP in respect of the application of Article 9 for s.284-145 purposes. This should appropriately also be the case in respect of the retrospective application of Subdivision 815-A, and we recommend that this be explicitly recognised in the amending legislation.

Deloitte will be pleased to provide representatives to meet with treasury to further discuss our views and/or participate in consultation forums.

Yours sincerely

Fiona Craig
Australian National Leader – Transfer Pricing
Director
Deloitte Touche Tohmatsu

Appendix B

Deloitte.

Deloitte Touche Tohmatsu Ltd
ACN 092 223 240

Grosvenor Place
225 George Street
Sydney NSW 2000
PO Box N250 Grosvenor Place
Sydney NSW 1220 Australia

Tel: +61 (0) 2 9322 7000
Fax: +61 (0) 9255 8659
www.deloitte.com.au

The Principal Adviser
International Tax and Treaties Division
The Treasury
Langton Crescent
PARKES ACT 2600

30 November 2011

Dear Sir

Re: Australian Government Treasury Review of Transfer Pricing Rules - Deloitte Comments

Deloitte welcomes the opportunity to comment on the proposal to amend the transfer pricing rules as set out in the Consultation Paper *"Income tax: cross border profit allocation - review of transfer pricing rules"* and the associated press release of 1 November 2011 made by the Assistant Treasurer the Hon Bill Shorten MP.

1. Introduction

We generally welcome the review by the Government of Australia's transfer pricing rules, which pre-date a significant amount of work over the past 25 years at Organisation for Economic Cooperation and Development (OECD) level on transfer pricing. Notwithstanding guidance provided by the Australian Taxation Office (ATO) in the form of many taxation rulings that provide its interpretation of the transfer pricing rules and its view that the rules can be interpreted as essentially aligned to the OECD Transfer Pricing Guidelines, there remains uncertainty as to their practical application, as evidenced in recent court decisions. For this reason, we welcome the review, although as set out below, we are cautious of changes that are not fully considered and developed through proper consultation with taxpayers and advisors. Given this, and potential interactions of the transfer pricing provisions with other provisions in the law, we are concerned that the timetable proposed for the introduction of legislation as outlined by Treasury in discussions is too ambitious and recommend that a longer consultation period be applied. We also recommend that the changes to the permanent establishment profit attribution rules be developed in tandem with the changes to the transfer pricing rules for separate legal entities.

As a general proposition we agree that the current domestic transfer pricing rules embodied within Division 13 have been read to reflect a traditional "market value" approach to transfer pricing, which is not always aligned with current international thinking found in the OECD Guidelines and the domestic rules of Australia's major trading partners. As a result, the possibility of unintended double taxation arising from transfer pricing adjustments is increased, and as noted above, some uncertainty exists in the applicability of OECD guidance to transfer pricing arrangements involving Australian taxpayers.

The proposal to better align our domestic rules with the wider international community must improve certainty for multi-national groups, both domestic and foreign, and their advisors and reduce the possibility of double taxation.

We also agree that, consistent with the tax laws generally, taxpayers should self-assess their transfer prices and profits and there will need to be consequential amendments to existing Commissioner discretions, record keeping requirements and time limits for amendments.

While accepting Treasury's request for comment on broad principles, we believe that, as with most legislative change, the devil is in the detail and the Consultation Paper and associated proposals raise areas of concern for taxpayers and advisors. Set out below are our comments on the proposed retrospective application of the treaty rules (Section 2), the proposed changes to the transfer pricing rules for separate entities (Sections 3 to 12) and considerations specific to permanent establishments (Section 13).

2. Retrospective application of treaty rules

Although not a matter on which consultation was sought, the announcement by the Minister that he intends to introduce law to retrospectively allow the Commissioner to raise transfer pricing adjustments on treaty law as an alternative to domestic law raises very serious issues of fairness and arbitrariness in the application of Australian international tax laws. Indeed, the introduction of such law would create the absurd situation whereby non-treaty transactions will potentially be treated more favourably than transactions involving Australia's major trading partners.

The claim that Parliament has always intended this to be the case is not a justification for specific targeting of certain existing audit cases which, according to Treasury, the ATO appears to be of the view might otherwise fail based on the decisions in Roche and SNF. The validity of this legal position has been in dispute for years and the Commissioner has had ample opportunity in Roche and SNF to test his interpretation of the law. Only in SNF at first instance did the Court provide obiter in favour of the Commissioner. The Full Court on Appeal did not address the matter. The passing of retrospective law is not the approach to international tax law expected from a sophisticated trading nation and does considerable damage to Australia's reputation for fair dealing in international trade and taxation.

A further reason offered by Treasury for the Government's decision to retrospectively amend the law is the prevention of taxpayers making credit amendments to reduce taxable profit following the SNF decision. We are of the view that this concern is unfounded, both in practice and as a matter of law. In relation to audit cases and APAs that have been previously settled or agreed with the ATO, we note that there would be practical (and possibly legal) impediments to reopening these cases.

In relation to other cases, there are legal impediments to taxpayers effecting credit amendments under Division 13. The legislative purpose behind Division 13 is to ensure Australia can counter non-arm's length transfer pricing or international profit shifting arrangements in order to protect Australian tax revenue. One of the pre-conditions to the application of Division 13 is that the Commissioner must determine that the relevant sub-sections apply, i.e., it is a discretionary provision. The Explanatory Memorandum (EM) to Division 13 makes it clear that the provisions are anti-profit shifting provisions intended to apply where there is a shifting of taxable income from Australia. In addition, the EM makes it clear that the intention behind the granting of the Commissioner's discretion to apply Division 13 is to have regard to whether the use of non-arm's length prices has resulted in a shifting of taxable income from Australia.

Against this background, taxpayers have no basis to amend their tax returns to decrease their taxable income under Division 13, and it is difficult to see how the Commissioner could exercise his discretion to apply Division 13 in these circumstances, and it is unlikely that he would feel so inclined. We strongly recommend that any revenue estimates established to support the retrospective amendments be re-considered in light of the fact that the claims regarding levels of anticipated credit amendments appear unfounded.

As discussed above, retrospective amendments to law also raise issues of fairness. In the current proposals, the ATO will arguably have a power it currently does not have under existing law. The issue of fairness is paramount as, once the law is amended, the ATO's power to go back and reopen old cases (or start new ones given the absence of time limitations) is unfettered and the power may well be abused.

Retrospective amendments to Australian tax law have on occasion been made to correct inequalities in the existing income tax legislation. However, the proposal to retrospectively amend domestic law in relation to the application of the treaty rules for transfer pricing matters is not an example of this and should be clearly distinguished.

3. Revised transfer pricing rules for separate entities

We agree that the decision in SNF in particular has cast doubt on the ATO's view that the existing rules are essentially aligned to the OECD Guidelines and in particular the comparability factors set out in those Guidelines. Recent judges' opinions have applied the rules in a way more associated with a market valuation approach, as they do not take into account the circumstances of the taxpayer, or broader comparability factors. This approach is at odds with the international approach found in the OECD Transfer Pricing Guidelines and most of Australia's trading partners' domestic rules (although we note that the Full Federal Court in SNF did in fact base its assessment of the reliability of SNF's CUP evidence on the OECD comparability factors). We also agree that the decision in SNF, by not endorsing direct resort to the OECD Guidelines in interpreting the transfer pricing rules, raises considerable uncertainty for taxpayers and advisors.

The policy objective of basing transfer pricing on the functional analysis and broadly reflecting the parties' economic contributions is well understood and accepted by multi-national enterprises and professionals in the field. Accordingly, the proposal of mandating the use of the OECD Guidelines in tax legislation is supported. However, we do not agree with the view (refer paragraphs 12 and 23 of the Consultation Paper) that the current Division 13's transactional approach to the arm's length principle and its focus on pricing transactions is "in contrast to treaty rules".

The Consultation Paper appears to be based on the incorrect premise that the Associated Enterprises Article simply focuses on profit outcomes. In practice, the application of the treaty rules calls for a transactional approach. The arm's length pricing methods used in applying the treaty rules under the OECD Guidelines are all, except in limited prescribed circumstances, intended to be applied on a transactional basis. For this reason, the methods are referred to in the Guidelines as the "traditional transaction methods" and the "transactional profit methods". The transactional profit methods are in turn called the "transactional net margin method" and the "transactional profit split method". There is no authority under the Guidelines in applying the treaty rules to simply default to a highly aggregated approach of determining an arm's length profit outcome for a taxpayer with cross-border related party transactions. Any new domestic rules drafted so as to permit such an approach would not accord with the treaty rules as interpreted under the Guidelines.

4. Design of the rules

We support the proposal that the new rules reflect high level principles supported by reference to the OECD Guidelines and should not be overly prescriptive.

5. Self assessment

As taxpayers will need to self-assess under the proposed new rules, accordingly, the Commissioner's discretions should be removed altogether. In order to self assess, taxpayers need to be able to rely on the guidance found in the Guidelines.

The intention to retain the existing feature of Division 13 of extending the rules to dealings with unrelated parties is difficult to reconcile with a self assessment environment. Dealings with unrelated parties are at arm's length by definition, unless there is the existence of collusion or concealment e.g. bearer share entities. Such cases are more readily appropriate for general anti-avoidance rules than transfer pricing rules, particularly in a self assessment environment.

The anti-avoidance measure currently in Division 13 provided by the definition of an international agreement, designed to attack back-to-back arrangements or collusion with unrelated entities, is not suitable in a self assessment environment. As a matter of general design, with the advent of self assessment the new rules should dispense with the anti-avoidance aspects of Division 13 and instead seek to apply the OECD Guidelines to the issue of transfer pricing. Any anti-abuse rules which extend beyond those found in the OECD Guidelines should be dealt with under the existing anti-avoidance provisions in the domestic law. In addition, it seems to us to be consistent with this approach to allow the arm's length principle to apply whether or not there is a detriment to the Australian revenue. The new rules should focus exclusively on taxpayers being able to self assess their arm's length position with some certainty provided by the Guidelines.

We note that in practice the transactional profit methods are commonly selected by taxpayers as the most appropriate method for taxpayers and that taxpayers must be able to self assess the price of transactions or transactional profits as appropriate.

6. Discretions

As indicated above, the retention of Commissioner's discretions in the new rules would be inconsistent with self-assessment. We therefore agree with eliminating the current broad discretion in s.136AD(4), but do not agree with the appropriateness of retaining discretions for cases involving insufficient information or reconstruction.

Regarding reconstruction, paragraphs 1.64 to 1.69 of the 2010 OECD Guidelines provide for non-recognition of the actual transactions undertaken in exceptional circumstances. Given the proposal to include these guidelines in the new rules (as per paragraph 32.5 of the Consultation Paper), there is no need for any additional Commissioner's discretion to deal with this. These paragraphs of the Guidelines also sufficiently address reconstruction in relation to debt/equity issues and business restructures. Specifically, Chapter IX of the 2010 Guidelines provides considerable guidance on how these paragraphs apply in a business restructure context. It is difficult to understand what further discretion is seen as being required.

Between them, the OECD Guidelines and Division 820 protect the revenue against any debt related transfer pricing arrangements. The Guidelines allow the re-characterisation of debt to equity in appropriate cases, and Division 820 places a limit on the level of debt funding of Australian business. There is no need for any further Commissioner's discretion in relation to debt funding.

The need for a discretion where there is an insufficiency of information is to be addressed by the need for mandatory transfer pricing documentation in a self assessment environment. If a problem of insufficient information still exists in isolated cases that can be addressed through existing formal powers and ultimately section 167. Any further specific discretion for transfer pricing issues is unwarranted.

In our view, it is not generally appropriate for a tax authority to determine, by discretion, whether business decisions are commercially realistic or indicative of commercially rational behaviour. Again, paragraphs 1.64 to 1.69 of the OECD Guidelines address the exceptional circumstances where this may be appropriate.

7. UK legislation/OECD suggested legislation

Both the UK legislation and the OECD suggested legislation are useful guides to any new law in Australia. Potentially, the OECD suggested legislation is preferred. The UK legislation attempts to use transfer pricing rules to deal with abuse better dealt with under our existing anti-avoidance rules. This is because the UK does not have a general anti-avoidance rule. We agree that contrary to the UK, incorporation of the both the OECD Model Tax Convention (MTC) and the Guidelines in the new rules is preferred. We understand that the UK, in its recent rewrite of its transfer pricing legislation, considered similar retrospective amendments but decided, in principle, that retrospective amendments are generally not good law.

8. Comparability factors

We agree the OECD suggested legislation is a suitable model for ensuring comparability requirements are met.

9. Record keeping requirements

The explicit requirement to maintain contemporaneous transfer pricing documentation in Australia is consistent with self assessment and the Ralph Review and is supported for the reasons given in the Consultation Paper. However, the compliance burden on taxpayers relating to the requirements of transfer pricing documentation should not increase as a result of any changes to the domestic law, consistent with our comments at section 3 above.

The failure to keep appropriate transfer pricing documentation as evidence of the self assessment of the arm’s length principle in the law would be evidence of not using reasonable care as suggested.

As suggested, the question of proportionality of transfer pricing risk for particular taxpayers requires a de minimis rule. The threshold for documentation requirements should be more generous than the existing administrative rule. The nature of transfer pricing, its relative imprecision and the costs and complexity of compliance mean that only significant international dealings where any adjustment justifies the costs to all parties should exceed the threshold.

10. Penalties

A penalty regime for transfer pricing documentation is in accordance with the Ralph Review. In accordance with Ralph, any penalty regime should recognise the reasonable efforts made to apply the arm’s length principle. Under the existing Division 284 Tax Administration Act, penalties are still imposed in cases where documentation has been prepared in good faith but the ATO disagrees with the approach.

Where taxpayers self assess their transfer prices/profits in accordance with the OECD Guidelines and maintain contemporaneous documentation, no transfer pricing documentation penalties should apply.

11. Time limits

We agree that time limits for transfer pricing adjustments must be introduced. We understand that the eight year limit was based to some extent at least on ATO risk assessment and external data base requirements at the time of the 2007 review. We believe that, given the introduction of self-assessment and contemporaneous documentation requirements under the new rules, along with expanded disclosure requirements in the International Dealings Schedule and the Reportable Tax Position Schedule, there is no longer a case for different time limits for transfer pricing and other tax adjustments. Accordingly, we consider that the general time limits in section 170 should apply to transfer pricing adjustments.

12. Should treaty rules provide a separate authority for assessments?

This issue has been debated ever since the introduction of the existing rules. In supporting transfer pricing adjustments in practice, the ATO makes Division 13 determinations, on legal advice, on a belts and braces theory, covering ss.136AD(1), (2) or (3), s.136AD(4) and in the alternative applies the relevant treaty article.

The Commissioner has had ample opportunity to have the Courts decide the issue for transfer pricing and has declined. If the domestic rules are designed to encompass the OECD MTC and Guidelines, it appears prima facie unnecessary to legislate for the treaty rules to provide a separate authority for assessments. We have already made strong objection to the Minister's decision to retrospectively legislate to provide treaty authority under the existing law.

Furthermore, the stated policy rationale for having treaties is to avoid double taxation and to prevent fiscal evasion. The proposed amendment to give treaties a separate taxing power is not needed for either of these purposes.

13. Permanent establishment profit attribution issues

The OECD invested considerable effort in the work on the attribution of profits to PEs precisely because of the inconsistent treatment by OECD member countries, notwithstanding years of effort to reconcile issues under the MTC on Article 7. The inconsistency of interpretation of the profit attribution rules led to great uncertainty and numerous instances of double taxation. The OECD considered this issue in depth for many years before coming to the existing position. Very few countries (specifically, New Zealand and the Slovak Republic) have not endorsed the approach.

There is an inherent inconsistency within Article 7 in applying the arm's length independent enterprise test within a single legal entity. It is not useful in solving this problem to resort to the obvious legal reality that an entity cannot transact with itself.

The new Article 7 and the functionally separate entity approach to attributing profits has, or will be adopted by most OECD member countries and already has been included in new and re-negotiated US treaties. As a practical matter, the existing position in Australia is already causing concerns, particularly in the financial sector.

We consider it imperative that Australia keep in step with the countries that have sophisticated financial sectors as otherwise there is a risk of creating unnecessary tax hurdles for the industry. The new OECD authorised approach ('AOA') benefits the source country, particularly those countries with an active financial industry with foreign bank presence.

The existing official ATO interpretation of Article 7 using the 2008 Commentary recognises that internal dealings, such as swaps and other derivatives between parts of the same legal entity, should be recognised as being analogous to transactions and accepted where they represent an arm's length attribution of actual third party income or expense. However, the ATO's own Taxation Rulings do not seem to be understood or accepted by those who maintain that such transactions cannot be recognised because an entity cannot legally transact with itself. This is causing considerable distress to taxpayers attempting to achieve arm's length attributions of profit.

The major difference between the new OECD Article7 and Commentary is that notional income and expenses can be recognised e.g. the payment of a royalty to the "economic" owner, which is barred by the 2008 Commentary. The new approach does not treat a PE the same as a subsidiary and specifically recognises the economic differences such as the efficiency of capital. Accordingly PEs have the same creditworthiness as the rest of the legal entity and no attempt is made to determine an independent credit rating.

We note that in practice the AOA should give similar profit attribution outcomes to the approach under Australia's current PE profit attribution rules. For instance, TR 2005/11 on the application of the current Division 13 and treaty Article 7 to bank inter-branch funds transfers gives similar outcomes for attribution of interest income and expense as under the AOA. We believe that the AOA, properly applied, should not in practice result in the attribution of significantly increased expenses or reduced income to an Australian PE relative to under Australia's current PE profit attribution rules. On this basis, we would expect that there should not be significant revenue consequences of adopting the AOA.

We recommend that the changes to the PE profit attribution rules be developed in tandem with the proposed changes to the transfer pricing rules for separate legal entities.

Deloitte will be pleased to provide representatives to meet with Treasury to discuss further our views and/or participate in discussion forums.

Yours sincerely

Fiona Craig

Australia National Leader – Transfer Pricing

Partner, Deloitte

Paul Riley

Asia Pacific Leader – Transfer Pricing

Partner, Deloitte