CORPORATE TAX
ASSOCIATION
of Australia Incorporated

5 April 2013

The Secretary
Senate Economics Legislation Committee
PO Box 6100
Parliament House
Canberra ACT 2600

By e-mail economics.sen@aph.gov.au

Submission on
Tax Laws Amendment (Cross-Border Transfer Pricing) Bill (No. 1) 2013

The Corporate Tax Association (CTA), which represents the taxation interests of about 120 of Australia's largest companies, welcomes this opportunity to offer comments on the Tax Laws Amendment (Cross-Border Transfer Pricing) Bill (No. 1) 2013 (the Bill) as referred to the Senate Economics Legislation Committee on 14 March 2013.

We have attached for the Committee's information and consideration copies of:

- the CTA's 20 December 2012 submission on the transfer pricing Exposure Draft;
- the CTA's December 2012 submission on the General Anti-Avoidance Rules Exposure Draft; and
- the CTA's 22 February 2013 submission to the House Economics Committee on the above Bill.

The House Economics Committee presented its report on the Bill on 12 March 2013. While the concerns raised by various stakeholders (including the CTA) were duly acknowledged and considered in the majority report, it was most disappointing that not a single change to the actual legislation was recommended by the Committee.

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While the CTA respects the right of the Parliament to amend the taxation laws as it sees fit, we remain as concerned about various aspects of the proposed changes to both the General Anti-Avoidance Rules and the transfer pricing regime as we were when we wrote to the House Economics Committee in February.

The proposed changes to the General Anti-Avoidance Rules represent an over-reaction to the Commissioner of Taxation's lack of success in a couple of court cases that actually have quite limited application. The inclusion of an "ignore tax" presumption in the proposed new law will actually prove quite difficult for taxpayers, the Tax Office and the courts to come to grips with. It will create unnecessary uncertainty and is not actually needed to remedy the perceived mischief.

On the proposed transfer pricing changes, from reading the majority report we cannot see how adopting our suggestions would in any way thwart the purpose or underlying policy objective of the proposed changes, which is to incorporate the OECD Transfer Pricing Guidelines into the domestic law. In our view, our suggested changes remain necessary and if adopted would result in the Bill achieving its stated aim of aligning the transfer pricing rules with the international standards set out by the OECD.

We trust that our submission will be considered on a nonpartisan basis and on its merits.

We would be pleased to provide further information or clarification for the Committee, should that be required.

Yours sincerely,

(Frank Drenth)

Executive Director

CORPORATE TAX ASSOCIATION
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20 December 2012

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Modernisation of the Transfer Pricing Rules

The Corporate Tax Association welcomes this opportunity to comment on the Exposure Draft (ED) and accompanying Explanatory Memorandum (EM) which set out the proposed amendments to Australia's transfer pricing rules.

As announced by the Hon Bill Shorten MP on 1 November 2011, the purpose of the proposed amendments is to modernise the transfer pricing rules contained in Australia's domestic law by ensuring that they better align with the international standards set out by the Organisation for Economic Co-operation and Development (OECD). On this point we acknowledge and appreciate Treasury's comments at the transfer pricing meeting on Friday 7 December that the proposed amendments as set out in the ED are aligned with Minister Shorten's announcement in that they are intended to do nothing more than ensure that the outcomes under Australia's transfer pricing rules are the same as those that would arise if one went directly to the OECD's Transfer Pricing Guidelines (the Guidelines).

It is with these points in mind that we make the following comments.

Insertion of the OECD Guidelines into the domestic law

The following is an extract from the CTA's submission dated 30 November 2011 on the Consultation Paper entitled Income tax: cross border profit allocation – review of the transfer pricing rules (1 November 2011):

> "The CTA would not see anything objectionable in principle about giving consideration to importing the OECD Guidelines into the Australian law**, provided what is reflected in our laws are the OECD Guidelines and not some modified version that reflects the ATO's (or Treasury's) views about what they should say**."

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Sec 815-125 of the ED explicitly focuses on concepts that Treasury considers important, most notably the meaning of ‘arms-length conditions’ and the relevance of economic substance. This approach places undue emphasis on Treasury’s interpretation of the Guidelines, rather than on the Guidelines themselves.

The dangers associated with this approach are clearly illustrated by sec 815-125(5) to (8), which appear to leap straight in to allowing the ATO to reconstruct a transaction actually entered into where it believes that independent entities dealing wholly independently with one another would not have entered into such a transaction. Under the OECD Guidelines, reconstruction of transactions by tax authorities is only allowable in exceptional circumstances and only after a thorough examination and application of recognised transfer pricing methodologies to determine what parties dealing with other at arms-length would have done. The absence of the ‘exceptional circumstances’ requirement from the ED has the effect of playing down the importance of applying the reconstruction powers as a last resort. This is exactly the kind of outcome that the CTA was referring to in its earlier submission on this point.

What should be reflected in our domestic law are the Guidelines as they stand, subject to sec 815-130. Any attempt to unpack the Guidelines as done in sec 815-125 will be susceptible to the problems outlined above and as such will go beyond the stated policy intent of reflecting the OECD guidelines in the domestic law.

On sec 815-130, subsection (1) states that Sub-division 815-B is to be interpreted as to best achieve consistency with the OECD commentary (except where the contrary intention appears). These words in brackets need to be removed for the following reasons:

- The words in themselves suggest that there is a contrary intention (which there may well be when you look at sec 815-125 and its misalignment with the Guidelines as set out above).
- The words may be relied upon by the ATO to exclude parts of the Guidelines that do not suit the particular circumstances of the case.
- The provision already provides for the exclusion of OECD Guidance where appropriate via Regulations (subsec 815-130 (30 and (4)).

The ‘Exceptional Circumstances’ Test

In addition to the comments above, we note that the reference in the Guidelines to ‘exceptional circumstances’ when considering the limited circumstances in which reconstruction should apply is recognised and adopted in the EM accompanying Sub-division 815-A. We also note paragraph 18 of Taxation Ruling TR 2011/1 (application of the transfer pricing provisions to business restructuring by multinational enterprises):

> “However, in the **exceptional case** where it is not possible or practicable to achieve an arm's length outcome in this way, the ATO considers that it may apply the transfer pricing provisions to adjust the consideration receivable or payable by the taxpayer

> by reference to an agreement that might reasonably be expected between independent parties dealing at arm's length in comparable circumstances."[1]

Recognition of the limited or exceptional circumstances in which reconstruction should apply should be reflected in the proposed Sub-division 815-B, as it is in the EM to Sub-division 815-A and TR 2011/1.

Amendment of Assessments

Under sec 815-145 the ED proposes an amendment period of eight years for transfer pricing adjustments. Although we recognise that transfer pricing reviews can be complex and time consuming, the same can be said about many other areas of the tax law. There are also a number of other reasons why the time limit for making transfer pricing adjustments should be aligned with the general four year period:

- The ATO's current practice of carrying out risk reviews in real time;
- The introduction of the International Dealings Schedule;
- The introduction of the Reportable Tax Positions (RTP) Schedule;
- The ATO's Pre Compliance Review product; and
- The Commissioner's power to extend time periods beyond the prescribed time where an investigation has commenced but is not yet completed.

These factors strongly indicate that the time limit for transfer pricing adjustments should be aligned with the general law.

Record Keeping Requirements

We understand that Treasury has indicated that the objective of the proposed record keeping requirements was to legislate the ATO's current administrative practices around penalties and documentation for transfer pricing.

The record keeping requirements as set out in Sub-division 815-D impose a statutory regime that is far more onerous and adverse to taxpayers than the current regime. Under the current regime, where documents are rated medium to high by the ATO, where the taxpayer has been open and transparent in its dealings with the ATO, the Commissioner may remit penalties to nil. The proposed rules, which state that **all** requirements and conditions must be met in order for taxpayers to be able to establish a reasonably arguable position, sets a much higher bar.

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[1] The reference in paragraph 18 of TR 2011/1 to "in this way" is reference to determining the arm's length consideration by applying the most appropriate arm's length pricing method using available reliable data relating to an agreement between independent parties dealing at arm's length for a comparable transaction in comparable circumstances.

On documentation, the proposed requirement that taxpayers keep records that adhere to sec 815-305 before the time by which it lodges its tax return is ambitious to say the least. The reality is that the majority of large corporates simply don't have the resources to meet the stated requirements, particularly those set out in subsec 815-305(4). For those few that might be able to comply with sec 815-305 in its entirety, it would come at an enormous and disproportionate cost. We understand that the ATO has in the past adopted a reasonably flexible approach to documentation, particularly in circumstances where there is no material change to the transaction from year to year. Assuming our understanding of Treasury's intention as outlined above is correct, the proposed statutory rules need to be wound back considerably if they are to resemble the ATO's current administrative practices. In the context of the ATO's current administrative practices, a carve out for documentation requirements for APA participants should also be considered.

Taxation Ruling TR 1999/1

Also on record keeping, we note that many multinationals currently rely on the administrative practices for 'non-core' services outlined in paragraphs 75 to 102 of TR 1999/1. In particular, where an Australian entity acquires or supplies services that are not integral to the profit-earning activities of the group, it does not need to apply the accepted arms-length methodologies in order to establish an arm's length price for the non-core services. Rather, it can rely on the arm's length transfer prices as specified by the Commissioner in TR 1999/1 (e.g. cost + 7.5%).

It is not clear from the ED or the EM whether taxpayers will be entitled to rely on this administrative practice going forward. We are concerned that the removal of this administrative practice will result in a substantial increase in compliance costs for taxpayers in respect to low value/low risk internal services. In order to reduce this risk and provide taxpayers with greater certainty, we propose that the administrative practices currently provided for in paragraphs 75 to 102 of TR 1999/1 be incorporated into the ED in some form. These administrative practices could be incorporated through the inclusion of statutory safe harbours in respect of non-core services. These statutory safe harbours should operate to deem the arm's length conditions of an arrangement to be the same as the actual conditions of the arrangement, where the pricing for the arrangement is within a specified range.

De Minimis Thresholds

The compliance costs associated with mandatory record keeping for transfer pricing purposes are significant and transfer pricing reviews are usually a very costly and time consuming exercise for both the taxpayer and the ATO. On this basis, any annual statutory de minimis threshold should be set at a level that carves out related party cross border dealings that involve transactions that do not pose a material threat to the revenue. The proposed de Minimis thresholds in sec 284-165, which relate to penalties and therefore assume all taxpayers with related party cross border dealings have already run the gauntlet, do not address the need for a legitimate transfer pricing carve out.

In our view, the de minimis threshold for the transfer pricing rules should be set at $10m in related party cross-border dealings before taxpayers become liable for transfer pricing adjustments (or examinations). A true de minimis exemption should also incorporate a test which relieves the documentation requirements where a single transaction is not material – perhaps using a similar threshold to the RTP schedule.

As stated in our earlier submission, ATO and business resources should not be applied to chasing down non-material amounts of potential revenue.

Customs issues

Sub-division 815-A encourages the Commissioner to particularise a transfer pricing adjustment so that a taxpayer can apply it to income or deductions as appropriate. This requirement should be reflected in the proposed Sub-division 815-B, particularly given that the Customs valuation arrangements are very much transactions based. Where a taxpayer is required to adopt the profit allocation method, every effort should be made to translate that into a pricing adjustment for the actual transactions entered into to ensure consistency between the transfer pricing and Customs outcomes.

Please feel free to give me a call should you wish to discuss any aspect of this submission further.

Yours sincerely,

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Corporate Tax Association

CORPORATE TAX
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Submission

Exposure Draft

Tax Laws Amendment (2013 Measures No. 1) Bill 2013: General anti-avoidance rules

Corporate Tax Association

December 2012

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The Corporate Tax Association is pleased to provide the following comments in relation to the recent Exposure Draft for *Tax Laws Amendment (2013 Measures No. 1) Bill: General anti-avoidance rules*.

By way of background and context, we reiterate that the CTA is of the view that the courts have for the most part been getting Part IVA right, and we remain unconvinced about the need for major change. Nevertheless, we do accept that the government has made a decision to make certain limited changes as announced by former Minister Arbib on 1 March 2012, and we are committed to contributing to the law design process in a constructive way so as to give effect to those announced policy changes.

However, we are firmly of the view that the Exposure Draft is not the right approach – it exceeds the scope of the government's announcement in some respects and creates unnecessary uncertainty by making sweeping changes to the architecture of Part IVA. We note also the reassurances given by Assistant Treasurer David Bradbury on two separate occasions (CCH Tax Manager forums in September and October 2012) that the amendments will be limited to the matters covered by the 1 March 2012 announcement.

SUMMARY COMMENTS

- The proposed amendments seek to target the "do nothing" and "steps within a scheme" outcomes. In our view four pages of proposed amendments (accompanied by 24 pages of explanatory memoranda) is excessive, and by drafting multiple amendments to sections of Part IVA runs a strong risk of removing the relative certainty of case law precedent of the operation of Part IVA. Further, the uncertainty likely to arise from the current proposed amendments has been described as a "barrister's picnic". Rather, the changes to Part IVA should be kept to a minimum to solely address the two targeted areas.

- We support the inclusion of an Objects clause. However the Objects clause should include a statement that Part IVA is intended to target "tax avoidance arrangements that are blatant, artificial or contrived" – refer the 1981 Explanatory Memorandum that introduced Part IVA, and para 1.10 of the proposed Explanatory Memorandum.

- The assumption that tax was disregarded by the relevant persons is unnecessary and would give the Commissioner the power to make determinations that impose maximum tax.

- The assumption that the relevant persons would have sought to achieve the same non-tax effects as the scheme is appropriate, but should be expressed in more general language.

- The law should clarify that there may be more than a single alternative postulate.

- The explanatory material should refrain from arguing for a single holistic enquiry into the alternative postulate. This is a highly theoretical construct that is not supported by any case law and there is simply no need to depart from the tried and proven three step approach of identifying the scheme and the tax benefit before moving on to purpose. Nothing useful (to taxpayers or the Commissioner) comes from conflating tax benefit with purpose, as is done in draft sec 177CB(2).

ANALYSIS

The principal part of the new law is draft sec 177CB, which modifies the way in which a tax benefit in connection with a scheme is determined under sec 177C. It does this in two ways. Firstly it assumes, in draft para 177CB(1)(a), that in relation to the alternative postulate under sec 177C that each person would have acted or refrained from acting without having any regard to tax. Secondly, draft para 177CB(1)(b) assumes that persons would have sought to achieve the same "non-tax effects" as the scheme achieves.

The "disregard tax" assumption

We consider the first assumption risks giving the Commissioner the power to assess taxpayers on the basis of "maximum tax" – that is to say, an amount of tax than most fair minded people would regard as being excessive. This is perhaps best illustrated by way of a simple example:

Say a taxpayer is considering selling an asset to an unrelated third party to realise a profit of $100. After obtaining tax advice, the transaction is structured in such a way as to trigger a tax liability of only $5. The structure adopted involves a number of artificial steps which, when considered objectively, can only be explained by the taxpayer's desire to minimise his tax liability.

The Commissioner determines there is a scheme for the purposes of Part IVA and assesses the taxpayer on an alternative postulate that results in a tax liability of $60. There are no legal or commercial impediments to the Commissioner's alternative postulate – the acquirer would have been indifferent and it does not breach any statutory or regulatory rules.

The taxpayer in this case might wish to argue that the Commissioner's alternative postulate is not one that he would reasonably have contemplated. Rather than pay 60 per cent of the realised gain in tax, he would instead have retained the asset and obtained a return from it. Under draft sec 177CB(1)(a), however, he would be prevented from making that argument because he is assumed to be indifferent to tax.

It has been suggested in the course of the consultation process that proceeding on the basis of an unreasonable or excessive alternative postulate would make the Commissioner less likely to succeed on purpose under the factors that have to be weighed up under sec 177D. It is far from clear why this would necessarily be so. Were such a scenario to be litigated, a court would be in the position of having to compare the scheme that was actually entered into (which was one that clearly involved avoidance) with the Commissioner's alternative postulate that is protected by statute.

The reality is that business and individuals operate in an after-tax world, and from a practical and corporate governance perspective, it would be highly problematical to ask board members to put their minds to what the company would have done in the highly artificial world where tax is assumed not to matter. Tax always matters to some degree, and the High Court has made it clear in *Hart's* case that some tax planning is permissible without triggering the application of Part IVA.

The government should also note that Part IVA lay largely idle for the first few decades of its existence, and it has not been until relatively recently that the Commissioner has sought to apply the GAAR in a number of cases that taxpayers and advisers would previously have thought were beyond the scope of these provisions. It would be very negative for business (and ultimately for levels of future investment) if this attempt to overcome what the Government has been advised is a technical problem around the alternative postulate resulted in a major shift in the overall balance of a provision that most tax specialists consider has been working quite well.

While we do not suggest the Commissioner would deliberately abuse the power to maximize tax in an unreasonable way, it would be wrong to make such an outcome even theoretically possible. Importantly, we consider the objectives expressed in the 1 March 2012 announcement can be achieved without this statutory assumption, although not with para 177CB(1)(b) in its current form.

Para 177CB(1)(b) creates unwarranted uncertainty

It is clear from the consultation process, the draft legislation and the explanatory material that the aim of this draft provision is to foreclose on both the "do nothing" argument and the "do something materially different" argument. The former is clearly covered by the 1 March 2012 announcement, although the latter is not, strictly speaking:

> "For example, they could have entered into another scheme that also avoided tax, deferred their arrangements indefinitely or done nothing at all. Such an outcome can potentially undermine the overall effectiveness of Part IVA and so the Government will act to ensure such arguments will no longer be successful."

We see little point in engaging in unproductive hair splitting over the language used in the announcement, and we accept that preventing taxpayers from arguing they would have done something else entirely is not inconsistent with the stated aim of preventing them from arguing they would have done nothing at all or deferred the arrangement indefinitely.

We don't regard the concerns about taxpayers arguing they would have done something that would itself have been susceptible to Part IVA (e.g. selling the asset in the above example using different steps and resulting in a tax liability of $6 instead of $5) as being soundly based. We are not aware of all the cases that come before the ATO's GAAR Panel, but there are no reported cases of litigation where such an argument has ever been advanced. If it were, we would expect the Courts would not seriously entertain them under the existing law.

The CTA's main concern centers on the uncertainty which would potentially be created by the language used to give effect to a principle that seems clear enough from the policy announcement. Taxpayers, the Commissioner and eventually the Courts would need to put their mind to when something achieved by a scheme is a "non-tax effect", which is defined in draft sec 177CB(3) by what it isn't – something relating to the taxpayer's liability to tax or something that is incidental to that.

The difficulty here is that many acts, steps, and transactions can have both a tax effect and a non-tax effect and the risk is that the complexity around Part IVA will shift from the alternative postulate being "at large" to an uncertain analysis of non-tax effects. The extent of the proposed change in language is likely to create unnecessary uncertainty for both taxpayers and the ATO for many years to come.

As a matter of detail, we believe that the wording of the definition of "non-tax effect" is too vague, centering on a taxpayer's "liability to tax or withholding tax". This definition could potentially include the likes of tax offsets (such as for Film Tax Offsets) which themselves cannot constitute a "tax benefit" under sec 177C. The definition of "non-tax effect", if thought to be necessary at all, should only reference effects other than those that could potentially give rise to a tax benefit under sec 177C(1)(a), (b), (ba), (bb) or (bc).

Part IVA appears to be working well enough in relation to purpose, and whatever is currently wrong about the alternative postulate does not, in our view, warrant the sort of upheaval that would result from the introduction of new and uncertain language. Instead, we offer the following suggestions about the path that should be followed.

Draft a "do something" assumption

While there may be some who have understandable reservations about the use of principle based drafting in most areas of the tax law, having seen the Exposure Draft we consider that a case could be made for its application in conveying the idea that in framing the alternative postulate, the broader commercial (or family) dealing that the taxpayer actually entered into would still have happened. For example, if the scheme identified by the Commissioner is part of a broader commercial arrangement, the essence of which was the disposal of an asset to a third party, the alternative postulate would assume that the taxpayer would have disposed of the asset to the third party in some other way. We are confident that the Courts would in the large majority of cases reach the right decision about what broader transaction or event would have happened in some other way.

We don't profess to have any special skills in drafting tax legislation and won't try to suggest an appropriate form of words in this submission. However, we hope this part of the submission adequately describes the approach we would prefer the legislation to take. It may be useful for the explanatory material to include examples to illustrate the way such a provision is expected to apply. The CTA would be pleased to assist with developing such examples if required.

More than one Alternative Postulate

Consideration should also be given to including a provision which makes it clear that in some situations there may be more than one alternative postulate, and that the Commissioner is not required to identify the most reasonably likely alternative postulate. There is a view that *RCI* may suggest otherwise.

We agree that where there is a range of possible alternative ways of achieving a particular commercial or family outcome, it would be unduly onerous to require the Commissioner to identify the one reasonable possibility among many other reasonable ones that is the most likely (perhaps sometimes by only a narrow margin). From a policy perspective it should be sufficient that the alternative postulate identified by the Commissioner is reasonable in all respects (other than for the "do something" assumption).

Steps within a scheme

It isn't entirely clear why it was considered necessary to include the "steps within a broader commercial scheme" point in the 1 March 2012 announcement.

> "The Government amendments will confirm that Part IVA always intended to apply to commercial arrangements which have been implemented in a particular way to avoid tax. This also includes steps within broader commercial arrangements."

There are many who think this argument was settled as far back as *Spotless*, and certainly since *Hart*. We acknowledge there was some debate in *RCI* about whether the dividend that was paid out of the revaluation reserve was part of the broader restructuring of the James Hardie group; however we do not think much turned on that in the final analysis. We note that the draft objects clause 177AA refers to steps within or towards other schemes, and have no objection to this clarification being included.

The "disregard tax" assumption is not needed

While it might seem counterintuitive to suggest this assumption is not needed, we advance this argument in the context of the concerns we have already expressed about the Commissioner potentially being empowered to raise assessments that are unreasonable and excessive.

But even putting those concerns to one side, it is submitted that an appropriately worded “do something” assumption (using high level principles), combined with the suggested clarification about the potential for there being more than one alternative postulate, should effectively overcome the “at large” concerns about the alternative postulate and foreclose on the “do nothing” (or “do something else”) argument.

If there is a statutory assumption that the underlying transaction of which the scheme is a part would have occurred in one way or another and the Commissioner identifies an alternative postulate that is reasonable in all other respects (including its tax cost), it would not be open to the taxpayer to argue that he would adopted some other course of action that involves a tax outcome that is more advantageous to him.

Again using the example of the disposal of an asset to a third party for a $100 gain, if the Commissioner’s alternative postulate resulted in a tax cost of $30 in the case of a corporate taxpayer (or, say, $28 or $32), and there are no non-tax factors the taxpayer can point to that would stand in the way of the Commissioner’s alternative postulate, then we are confident that a Court would regard that as being reasonable. On the other hand, if the Commissioner over-reaches, and identifies an alternative postulate that is unreasonable (say, involving a tax cost of $60 by paying tax twice on the one gain) then his determination should not be allowed to stand as a matter of good public policy. If that raises issues about his powers to amend to give effect to an alternative postulate that is reasonable, then that should be addressed as a separate matter.

We appreciate there could well be some instances where it might be impossible on the facts to identify any alternative course of action other than what the taxpayer actually did. We don’t expect that would be a common outcome, but it is one that might be an inevitable consequence on insisting on a “do something” rule. It may just be something the Courts would have to deal with if and when it occurs.

Start date

Finally, we applaud the government’s decision regarding the later start date for any new law. However, should the Exposure Draft that was released on 16 November 2012 be amended substantially (as we suggest it should be), then consideration should be given to having a later date of effect.

Next steps

Rather than rush to meet some self-imposed deadline, we would also recommend having at least one further iteration of the public consultation process. It is important to get these amendments right and, in our view that means keeping any changes to a minimum. The debate around these changes has thus far been highly legalistic, which is perhaps inevitable. However, such an approach poses the risk that some of the more practical issues may not be fully explored. The CTA would be pleased to facilitate input from experienced corporate tax practitioners to assist in identifying and addressing such issues.

Thank you for the opportunity to comment, and also for the roundtable process that the writer participated in.

(Frank Drenth)

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Corporate Tax Association

CORPORATE TAX
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22 February 2013

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Submission on
Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013

The Corporate Tax Association (CTA), which represents the taxation interests of about 120 of Australia's largest companies, welcomes this opportunity to offer some comments on the Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013 (the Bill) as referred to the House Economics Committee on Economics on 15 February 2013.

We have attached for the Committee's information copies of the CTA's December 2012 submissions on the earlier exposure drafts for the anti-avoidance measures and the transfer pricing changes respectively.

We maintain that both the proposed changes to transfer pricing and the anti-avoidance measures represent an over-reaction to the Taxation Office losing particular court decisions. In our view, these losses were not caused by deficiencies in the legislation, but rather by the Taxation Office's case selection and its approach to running the cases in litigation.

Transfer Pricing

In relation to the proposed transfer pricing changes, a number of the issues raised in our submission have been addressed in part in the current Bill and associated Explanatory Memorandum.

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However, we remain concerned about a number of significant aspects:

- The scope of the Commissioner's power to reconstruct actual transactions appears to be very broad and to go beyond what is contemplated by the OECD Guidelines. Heavy reliance is placed on the Explanatory Memoranda and guidance material to read down the words in the Bill so as to align the Bill to OECD principles. However, the Courts have recently down played the role of Explanatory Memoranda in statutory interpretation, and there is a significant risk that the Commissioner will use this power routinely in circumstances other than the "exceptional circumstances" the OECD contemplates.

- In particular, proposed sec 815-130(4), which deals with instances where independent entities dealing with each other at arm's length would not have entered into any transactions with each other at all, has no equivalent rule in the OECD Guidelines. It is not entirely clear what this provision is attempting to achieve but if, as we have been assured, the aim of Schedule 2 of the Bill is no more than to import the OECD Guidelines into the Australian domestic law, then it should not include provisions that are not to be found in the OECD Guidelines.

- The documentation requirements are still quite onerous. The standard and scope of the documentation required to meet the requirements of the Bill is very high. Given the significant adverse consequences of having documentation that does not meet these strict requirements, the time frame allowed for document preparation is extremely limited and should be extended.

- The seven year time limit for amendments is too long. It should be four years, the same as other tax matters, some of which can be at least as complex as transfer pricing matters.

- There should be a statutory materiality threshold of $10 million before the transfer pricing rules may be applied.

- Finally, the Bill (as did the earlier draft) fails to deal effectively with the direct conflict between Customs Duty and the transfer pricing valuation rules, which presents an ongoing dilemma for Australian importers. In making a transfer pricing adjustment the Commissioner should be required to set out precisely how the adjustment impacts on individual transactions.

Broadly speaking, we consider that importing the OECD transfer pricing Guidelines into the domestic law on a prospective basis is something that business should be able to adjust to. However, we are concerned that the Bill has not successfully executed this policy objective. In our view, the Bill should be tested further before it is passed to ensure that it is both robust and workable, and will stand the test of time.

The General Anti-avoidance Rules

The CTA acknowledges the need for a robust and effective General Anti-Avoidance Rule to protect the revenue in circumstances where the specific tax rules may be open to abuse. However, we have consistently maintained that the proposed changes represent an over-reaction to the Taxation Office losing a number of court decisions that have quite limited application. In addition, they appear to go beyond the scope of the then Assistant Treasurer's policy announcement in March 2012.

The business community remains concerned that the amended legislation could be administered in a way that would create unexpected tax liabilities in relation to genuine commercial transactions containing no element of contrivance or artificiality. The uncertainty that would persist until judicial determination of a number of the new concepts introduced would constrain commercial activity and adversely affect everyday business decision-making.

The amended Bill does represent an improvement over the earlier draft in the way in which it forecloses on the "do nothing" argument (i.e. where some taxpayers have successfully argued that without the offending tax benefit they would not have proceeded with the relevant transaction at all). However, the use of the test 'a reasonable alternative' in proposed sec 177CB(3) introduces a degree of uncertainty for taxpayers in assessing alternative postulates as 'a reasonable alternative' may not always be the most likely alternative.

Proposed sec 177CB(4) qualifies whether a postulate is a reasonable alternative to the scheme identified by the Commissioner. We think that the qualifications in proposed sec 177CB(4)(a)(i) and (ii), which require that the alternative postulate should as far as possible align with the substance of the scheme and its results and consequences, are sufficient in themselves to foreclose on the sorts of arguments that were put in the relevant cases. For example, if the underlying transaction in the scheme involved the disposal of an asset to a third party, the alternative postulate would be expected to do likewise and it would not be open to a taxpayer to argue that he would have retained the asset absent the scheme.

But the Bill goes further and in proposed sec 177CB(4)(b) also sets up a “disregard tax” presumption. While such a rule might have some intuitive appeal, it is in fact unnecessary to overcome the “do nothing” argument – the “substance of the scheme” and “result or consequence of the scheme” rules already have that effect.

There is a risk that a “disregard tax” rule could potentially be open to abuse by the Commissioner, as it could empower him to construct an alternative postulate that involves what is clearly an excessive amount of tax – for example by taxing the same economic gain twice. It has been suggested in the consultation process that such an outcome would be unlikely as the Commissioner would still have to be successful on the “purpose test” in sec 177D. However, it is far from clear how the purpose test would displace a statutory assumption that tax should be disregarded or how the courts would interpret such a rule.

Giving the Commissioner the extraordinary power to raise “maximum tax” assessments is in the CTA’s view quite unnecessary to deal with whatever mischief has been caused by a small number of court cases that are largely confined to their own facts. It also far exceeds the scope of the 1 March government announcement.

The proposed amendments could severely impact a taxpayer’s ability to restructure their affairs for legitimate business reasons. Below are two examples of relatively typical transactions within corporate groups which could potentially be impacted by the proposed changes.

> ***Example 1***
> *Company A, the head entity of a consolidated group, owns 100% of the shares in Company B. The Company A tax consolidated group has carried forward capital losses, but does not have any carry forward revenue losses.*
>
> *Company B owns two businesses and the majority of the assets of Company B consist of depreciable plant and equipment. Company B agrees to sell one of its businesses to a third party. Company A sets up Company C, also a 100% owned subsidiary of Company A. Company B transfers the assets that the group wishes to retain to Company C. Company A then sells Company B, realising a capital gain.*
>
> *Is the restructure of the consolidated group’s assets prior to the sale a scheme to which the revised Part IVA would apply? What about the decision to sell the shares in Company A rather than the underlying assets (assuming the purchaser was indifferent)?*

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Example 2
Aust Co owns 100% of the issued shares of Foreign Co, a company resident in the UK. Foreign Co has historically been profitable and has a history of paying annual dividends to Aust Co. A third party offers to acquire Foreign Co from Aust Co. Prior to the execution of the transaction, Foreign Co pays a dividend to Aust Co equal to its retained profits. The consideration payable by the third party acquirer is reduced by an amount equal to the dividend paid. The dividend is exempt in the hands of Aust Co pursuant to Sec 23AJ. The sale of Foreign Co by Aust Co results in a taxable capital gain in the hands of Aust Co.

Is the exempt pre-completion dividend a scheme to which the revised Part IVA would apply?

We also believe there is a technical deficiency in the drafting of proposed sec 177C(1)(g). In its interaction with proposed sec 177C(1)(bc), it appears to define the tax benefit in a withholding tax scenario as being the gross amount on which tax would be withheld, rather than the quantum of the withholding tax benefit itself.

We would be pleased to provide further information or clarification for the Committee, should that be required.

Yours sincerely,

(Frank Drenth)

Executive Director