Australian Government

The Treasury

House of Representatives Economics Committee
PO Box 6100
Parliament House
Canberra ACT 2600
Australia

Dear Mr Boyd

SUBJECT - Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013

As requested, please find attached Treasury's submission answering specific questions posed by the Committee on the *Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013* in your letter dated 27 February 2013 to the Secretary of the Treasury.

Schedule 1 of the Bill contains amendments to the income tax general anti-avoidance rule. The income tax general anti-avoidance rule seeks to counter artificial or contrived arrangements that, objectively viewed, have been entered into with the sole or dominant purpose of avoiding tax. Schedule 2 contains amendments to modernise Australia's transfer pricing rules. Australia's transfer pricing rules seek to ensure an appropriate return for the contribution made by Australian operations.

We would be happy to provide any further information that is required by the Committee.

Yours sincerely

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Schedule 1 (The general anti-avoidance rule)

Court decisions in relation to Part IVA of the Income Tax Assessment Act 1936

Issue: It has been asserted that the amendments are an over-reaction to the Tax Office losing some recent cases.

Key Points:

- The amendments are necessary to ensure the ongoing effective operation of the general anti avoidance rule known as Part IVA.
- The amendments are a measured response to exposed weaknesses in the operation of the 'tax benefit' concept, not a reaction to whether the Commissioner won or lost a particular case.
- The amendments protect significant amounts of revenue that would otherwise be at risk.

This Bill amends the general anti-avoidance rule known as Part IVA to ensure its effective operation in countering arrangements that, objectively viewed, have been carried out with a relevant tax avoidance purpose.

The amendments are a measured response to weaknesses that have been exposed in the existing law and are necessary to protect significant amounts of revenue that would otherwise be at risk.

The amendments are wholly directed at addressing problems with the tax benefit test (section 177C) and do not amend the substance of the purpose test (section 177D), which is the main means by which Part IVA distinguishes between legitimate tax planning and impermissible tax avoidance.

The revealed weaknesses in the existing law are examined in detail at paragraphs 1.31 to 1.59 of the Explanatory Memorandum.

The Explanatory Memorandum

Issue: It has been asserted that the Explanatory Memorandum does not provide guidance on when an annihilation approach under subsection 177CB(2) will apply rather than a reconstruction approach under subsection 177CB(3). It is also claimed that the Explanatory Memorandum uses inconsistent language to describe what would constitute a reasonable alternative to a scheme.

Key Points:

- The Explanatory Memorandum explains that the 'annihilation' and 'reconstruction' approaches (subsections 177CB(2) and (3)) operate as alternative bases for identifying tax benefits.
- The Explanatory Memorandum is consistent in the way it explains when a postulate might be considered a reasonable alternative to a scheme.

Annihilation versus reconstruction

The Explanatory Memorandum makes it clear that the annihilation approach under subsection 177CB(2) and the reconstruction approach under subsection 177CB(3) are intended to operate as alternative bases for identifying tax benefits (see paragraphs 1.74 – 1.76). The Commissioner is entitled to rely on either limb. This will typically depend on the facts of the case.

It is important to note that, under either approach, a tax benefit that the Commissioner purports to cancel must be a tax benefit that exists as a matter of objective fact — it cannot depend upon the Commissioner's opinion or satisfaction that there is a tax benefit.

Moreover, the tax benefit must, viewed objectively, be obtained by a taxpayer in connection with a scheme that was entered into or carried out with the required tax avoidance purpose.

Put differently, 'tax benefit' is just one concept that must be considered in deciding whether Part IVA applies (see paragraphs 1.18 to 1.23 of the Explanatory Memorandum). The concepts of 'scheme' and 'purpose' also have important parts to play. Part IVA must be read as a whole.

For that reason, an annihilation approach is an effective way to identify a tax benefit where the scheme in question does not produce any material non-tax results for the taxpayer, whereas a reconstruction approach is effective in relation to a scheme that achieves substantive non-tax results. In the latter case, simply annihilating the scheme would be inconsistent with the non-tax results objectively sought for the taxpayer by the participants in the scheme.

Consistency on the question of reasonable alternative postulates

At paragraph 1.102, the Explanatory Memorandum explains that, under the reconstruction approach in subsection 177CB(3), the role of an alternative postulate is to provide a meaningful comparison between the tax consequences of the scheme and the tax consequences of 'an alternative that is reasonably capable of achieving for the taxpayer *substantially the same* non-tax results and consequences as those achieved by the scheme'.

At paragraph 1.110, the Explanatory Memorandum explains that, for a postulate to constitute a reasonable alternative to a scheme it would be expected to 'achieve for the taxpayer non-tax results and consequences that are *comparable* to those achieved by the scheme itself'.

There is no conflict between the language of paragraphs 1.102 and 1.110. To say that a thing should be ‘comparable’ to something else is to suggest that it should be ‘similar to’, ‘equivalent to’ or ‘analogous to’. To say that something should be ‘substantially the same’ as something else has broadly the same meaning.

Alternative postulates

Issue: Concerns have been expressed that the reconstruction approach in subsection 177CB(3) could generate excessive tax benefits because, in determining whether a postulate is a reasonable alternative to a scheme, subsection 177CB(4) requires particular consideration be given to the substance and effect of the scheme and expressly prevents consideration being given to any tax consequences of the postulate.

Key Points:

- The amendments give effect to the policy underlying Part IVA, which is to expose the substance and reality of what has been achieved for the taxpayer to the ordinary operation of the taxation laws.

Generally

Part IVA operates to counter artificial or contrived arrangements that, objectively viewed, have been entered into with the sole or dominant purpose of avoiding tax. To achieve this, Part IVA must be capable of exposing the substance or reality of what it is that has been achieved for the taxpayer (tax aside) to the ordinary operation of the taxation laws.

Consistent with this, the focus of the reconstruction approach should be on identifying whether or not there is a reasonable substitute for the scheme. It is not conducive to the effective operation of Part IVA to inquire into whether taxpayers would have pursued an entirely different course of action had they not participated in the scheme.

As the Explanatory Memorandum explains, a tax advantage cannot meaningfully be linked to a scheme by comparing the tax consequences of that scheme to the tax consequences that would have flowed if the parties had chosen to pursue some different objective.

Disregarding tax

Having identified a substitute for the scheme, it would undermine the operation of Part IVA to permit the tax consequences of that substitute to be a reason for concluding that the substitute is unreasonable. To do so would be to allow the very tax advantage that Part IVA is seeking to identify and measure to function as a shield against its operation.

The fact that a taxpayer would not have entered into a transaction if it had known in advance that it would be subject to tax should be no answer to Part IVA. To accept such a proposition would be to accept that there are situations in which it is reasonable for a taxpayer to avoid the ordinary operation of the taxation law on the substance or reality of what they have actually done. Applying Part IVA will not lead to more income tax being payable than results from that ordinary operation.

Furthermore, the Commissioner has the power under existing subsection 177F(3) to provide compensating adjustments where it ‘is fair and reasonable’ to do so.

Other technical issues

Issue: Concern has been expressed that the reconstruction approach in subsection 177CB(3) could introduce uncertainty because ‘a reasonable alternative’ may not always be ‘the most likely alternative’. Concern is also expressed that there is a technical deficiency in the interaction between proposed paragraph 177C(1)(g) and proposed paragraph 177C(1)(bc).

Key Points:

- The amendments reflect the existing requirements in Part IVA about the reasonableness of alternative postulates.
- Proposed paragraph 177C(1)(g), concerning withholding tax benefits, is a consequential amendment. The amendment is consistent with existing section 177CA of the 1936 Act.

Most likely alternative postulate

Subsection 177CB(3) builds on existing subsection 177C(1), which itself tests the reasonableness of alternative postulates. Specifically, each of the relevant paragraphs of subsection 177C(1) includes a test as to whether a particular tax effect ‘might reasonably be expected’ to have occurred ‘if the scheme had not been entered into or carried out’.

Proposed subsection 177CB(3) specifies that ’a decision that a tax effect might reasonably be expected to have occurred if the scheme had not been entered into or carried out must be based on a postulate that is a reasonable alternative to entering into or carrying out the scheme’. As such, the amendments will introduce no greater uncertainty than currently exists in Part IVA.

Withholding tax benefits

As the Explanatory Memorandum indicates, proposed paragraph 177C(1)(g) is a consequential amendment designed to bring the avoidance of withholding tax within the same list as the other tax benefits set out in section 177C. This ensures that the amendments concerning alternative postulates apply with equal force to withholding tax benefits.

Proposed paragraphs 177C(1)(bc) and 177C(1)(g) replace, and are consistent with, existing section 177CA of the 1936 Act, which provides that a taxpayer who avoids paying withholding tax on an amount on which it would have, or could reasonably be expected to have, paid withholding tax is taken to have obtained a tax benefit equal to the amount on which withholding tax is avoided.

In a similar way, where Part IVA applies to an amount of assessable income, the cancelled tax benefit is the amount of assessable income, not the tax payable on that assessable income. (The amount of tax payable on that assessable income could then be reduced by other factors such as losses.)

Schedule 2 (Modernisation of the transfer pricing rules)

Consistency with the OECD Guidelines

Issue: It has been claimed that the Bill is not consistent with the OECD Guidelines.

Key Points:

- One aspect of the Government's stated policy intent in relation to these amendments has been to align with international best practice as set out by the OECD.
- This alignment has been achieved through drawing heavily on the language of the relevant treaty provisions and the Guidelines in the construction of the provisions themselves.
- To strengthen the alignment of the rules with the OECD guidelines further, a direct legal pathway is created requiring that the central concept of 'arm's length conditions' is determined consistently with the OECD guidelines.

How is effect given to the Government's stated policy intent?

Part of the clear policy intent of the Government in relation to these amendments is to better align the rules with international best practice as currently set out by the OECD (see paragraph 3.2 of the Explanatory Memorandum). This was also stated in the description of the reforms published in the 2011-12 Mid-Year Economic and Fiscal Outlook.

In addition to using language drawn from the relevant treaty articles and the OECD guidelines, a specific legal pathway is provided to require regard to be had to the OECD material for interpretive purposes. The provision requires that the identification of arm's length conditions be undertaken in a way that best ensures consistency with prescribed materials, currently the OECD guidelines.

The guidance provision is a mechanism that a number of countries have introduced in various forms into their legislation or subordinate rules to assist in the interpretation of what are frequently complex cross-jurisdictional issues. Paragraphs 3.22-3.29 of the Explanatory Memorandum explain the rationale for the guidance provision.

The Explanatory Memorandum explains that the provisions are constructed to provide a mechanism to prescribe interpretive materials (or remove them, for example, if they cease to represent international best practice or are overtaken by more relevant alternative materials). The provision of a regulation making power ensures the Australian Parliament will always retain control over what materials are referred to in the laws of Australia. A full explanation of how this is achieved in set out in paragraphs 3.30 to 3.36.

Reconstruction

Issue: It has been claimed that the Bill is inconsistent with the OECD Guidelines is so far as it allows transactions to be disregarded and/or substituted. Further, it has been contended that application of the Bill in this regard is broader than that contemplated under the guidelines.

Key Points:

- The application and effect of the proposed rules related to reconstruction are clearly based on the language used in the OECD guidelines.
- The Bill also contains a guidance provision that requires the relevant rules to be interpreted consistently with the OECD guidelines.
- In the event that alternative interpretations could be taken to the rules, the interpretation that is most consistent with the OECD guidelines must be taken.
- To reinforce the alignment of the rules with the OECD guidelines, direct references to the relevant areas of the guidelines are made in the Explanatory Memorandum.

At the heart of the OECD material is the concept of the arm's length principle. The internationally accepted articulation of this principle is in paragraph 1 of Article 9 of the OECD Model Tax Convention on Income and Capital and is replicated in all of Australia's treaties. This reference is replicated in the Explanatory Memorandum at 2.19 and the OECD guidelines at paragraph 1.6.

The non-recognition and substitution (commonly referred to as 'reconstruction') of actual dealings or arrangements is one way of achieving an arm's length outcome consistent with the arm's length principle. Reconstruction is a key feature of all modern transfer pricing regimes and the OECD guidelines make clear provision for the ability to reconstruct transactions in determining an arm's length outcome.

The Bill does not introduce a broad reconstruction power. Rather, the ability to reconstruct dealings or arrangements under the proposed rules is entirely consistent with the OECD guidelines, which only permit reconstruction in 'exceptional circumstances'. Examples of 'exceptional circumstances' are described by the OECD as instances where:

- the economic substance of the arrangements does not match the legal form; and
- where the arrangements, viewed in their totality, differ from those which would have been entered into by independent enterprises acting in a commercially rational manner.

The proposed rules relating to reconstruction draw directly upon the language used in the OECD guidelines and are set out under the heading 'Exceptions'. The operation of these rules, as well as their relationship with the OECD guidelines, is described in detail at paragraphs 3.92 to 3.106 of the Explanatory Memorandum.

The explicit provision that requires the identification of 'arm's length conditions' to be done consistently with the OECD guidelines applies to the exceptions. As such, where there are a number of possible interpretations of the reconstruction rules, the interpretation that is the most consistent with the OECD guidelines must be applied.

Some submissions have suggested that subsection 815-130(4) is inconsistent with the exceptional circumstances described by the OECD guidelines. These submissions contend that the OECD guidelines only contemplate non-recognition of arrangements where other arrangements are substituted in their place.

The OECD guidelines discuss the process for substituting certain arrangements. However, the clear focus of the arm's length principle is on determining what independent entities would have done in the place of the parties. As such, if independent entities simply would not have entered into any arrangements at all, non-recognition (and substitution with *no* arrangements) is entirely consistent with the OECD guidelines.

It is important to note that this rule only has application where it can be demonstrated that independent entities would not have done anything. This imposes a high threshold because in any instance where an alternative set of arrangements or dealings can be postulated, subsection 815-130(4) cannot apply.

The operation of subsection 815-130(4) is explained in detail at paragraphs 3.104 to 3.106 of the Explanatory Memorandum.

Time limits for the Commissioner of Taxation to amend assessments

Issue: It has been claimed that the case for introducing a seven year time limit, rather than a four year time limit, has not been made out.

Key Points:

- Under the current transfer pricing rules, the Commissioner has an unlimited period to make a transfer pricing adjustment. Introducing a seven year time limit provides more certainty for taxpayers.
- A four year time limit would not provide the Commissioner with adequate time to conduct transfer pricing audits.
- The introduction of a seven year time limit strikes an appropriate balance between maintaining the integrity of the rules and providing taxpayers with certainty.

The proposed seven year amendment period strikes an appropriate balance between providing taxpayers with certainty and the Commissioner with the necessary time to conduct transfer pricing audits.

Subsection 170(9B) of the *Income Tax Assessment Act 1936* currently provides the Commissioner of Taxation with an *unlimited* period in which to make a transfer pricing adjustment under either Division 13 or the transfer pricing articles contained in an international agreement.

The introduction of a time limit for making transfer pricing adjustments provides greater certainty for taxpayers. However, the length of any time limit must balance this certainty with an adequate amount of time to conduct the necessary audit activity required to make an adjustment.

Although the general amendment period for making adjustments is usually four years, there are a number of reasons why a longer period is required in the case of transfer pricing adjustments.

Significantly:

- Transfer pricing audits are typically highly complex in nature and often require substantial time and resources in order to be properly conducted.
- In contrast to many audits that consider individual income years, transfer pricing audits often require the examination of dealings that take place over a number of income years. The general amendment period does not provide sufficient time to conduct multi-period analysis.
- The ATO has advised that obtaining the information required to conduct transfer pricing audits is typically more difficult and time consuming than for other matters. This issue is exacerbated by the cross-jurisdictional nature of transfer pricing because the ability to acquire information can be impeded by resource constraints of tax administrations in other jurisdictions.
  - Currently it can take a number of years to obtain relevant information from some jurisdictions.

Record keeping requirements in relation to a ‘reasonably arguable’ position

Issue: It has been claimed that linking the keeping of records to the ability to demonstrate a ‘reasonably arguable’ position imposes an inappropriate compliance burden on taxpayers.

Key Points:

- The preparation of transfer pricing documentation is not mandatory.
- Taxpayers are free to risk-assess their cross-border dealings and prepare documentation only in respect of matters they consider to be at risk of a transfer pricing adjustment by the Commissioner.
- Failure to prepare transfer pricing documentation in no way prevents the Commissioner from exercising a general discretion to remit penalties.

Rather than imposing mandatory record keeping requirements in relation to all cross-border dealings (which would impose significant compliance obligations), the proposed rules link the preparation of transfer pricing documentation to the ability to claim a reasonably arguable position.

Establishing a reasonably arguable position can reduce administrative penalties that are imposed in relation to certain adjustments made by the Commissioner. A failure to prepare documentation for a matter to which a transfer pricing adjustment relates will mean that the relevant taxpayer cannot claim a reasonably arguable position for that matter.

This approach provides an incentive for taxpayers to evaluate their cross-border dealings and prepare documentation in respect of matters that they consider to be at risk of transfer pricing adjustments. Allowing taxpayers to determine which matters, if any, should be documented provides appropriate flexibility for smaller taxpayers and taxpayers with low-risk dealings to self-assess whether transfer pricing documentation is needed to support their cross-border dealings.

The Commissioner continues to have a broad discretion to remit penalties where taxpayers have not prepared documentation, or to further remit administrative penalties below the levels prescribed under the penalty rules, where it is considered appropriate to do so.

Under current administrative practice, the Commissioner will generally reduce administrative penalties where a taxpayer has prepared documentation in accordance with ATO guidance contained in Tax Ruling 98/16. The proposed record keeping rules, including the nature of the documentation, are consistent with the approach taken in that ruling and therefore should be familiar to taxpayers.

Specific *de minimis* rules are also included to exempt transfer pricing adjustments under certain thresholds from administrative penalties. These thresholds provide additional protection to smaller taxpayers. The transfer pricing thresholds are directly linked to the general thresholds under the law, ensuring that they will be automatically updated by any changes to the general thresholds.