SUBMISSION 13

THE TAX INSTITUTE

22 February 2013

Mr Stephen Boyd
Committee Secretary
Standing Committee on Economics
PO Box 6021
Parliament House
CANBERRA ACT 2600

By email: economics.reps@aph.gov.au

Dear Mr Boyd

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

The Tax Institute thanks the House of Representatives Standing Committee on Economics (the "**Committee**") for this opportunity to make a submission in relation to the *Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013* (the "**Bill**").

Our submission below is set out in two parts, relating to:

- **Part 1:** Schedule 1 of the Bill which seeks to amend Part IVA of the *Income Tax Assessment Act 1936* ("**Part IVA**" or "**the income tax general anti-avoidance rule**"); and

- **Part 2:** Schedule 2 which seeks to modernise Australia's transfer pricing rules via introduction of Subdivisions 815-B, 815-C and 815-D into the *Income Tax Assessment Act 1997* and Subdivision 284-E into Schedule 1 to the *Taxation Administration Act 1953* ("**TAA 1953**").

SUMMARY

Income Tax General Anti Avoidance Rule

The Tax Institute supports the maintenance of a robust general income tax anti avoidance rule within the tax system to ensure that tax is levied fairly, consistently and according to the policy intention of the relevant tax laws.

However, the amendments in the Bill are an unnecessary overreaction to recent Court cases and not required to maintain the integrity of the system.

Furthermore, we are concerned that the Bill as drafted will bestow excessively wide powers on the Commissioner to levy tax on the basis of an unreasonable alternative postulate. Such an unconstrained power will result in an inappropriate erosion of taxpayer rights and create potential for undesirable behavioural changes.

Our submission contains a number of recommended amendments for the Committee's consideration.

Transfer Pricing

The Tax Institute is supportive of the Government's efforts to ensure an equitable return on Australian operations is taxed in Australia by updating our current transfer pricing laws.

However, we are concerned that the Bill as currently drafted will:

- bestow unnecessarily wide powers on the Commissioner leading to taxpayer uncertainty;
- impose excessively high documentation requirements, especially on small to medium enterprises; and
- unnecessarily broaden the scope for penalties to apply.

Our submission contains a number of recommendations for the Committee's consideration.

PART 1: CHANGES TO THE INCOME TAX GENERAL ANTI-AVOIDANCE RULE

No need for amendments

The changes in Schedule 1 of the Bill seek to amend Part IVA with the aim of ensuring that the Act "continues to counter schemes that comply with the technical requirements of the tax law but which, when viewed objectively, are conducted in a particular way mainly to avoid tax."[1]

The Tax Institute supports the maintenance of a robust general income tax anti avoidance rule within the tax system to ensure that tax is levied fairly, consistently and according to the policy intention of the relevant tax laws. Widespread faith in the integrity of our tax laws is essential to securing taxpayer trust and voluntary compliance.

Nevertheless, it is our view that the existing income tax general anti-avoidance laws already fulfil this function. The Courts have applied the current rules appropriately to find that a tax benefit exists in only those cases where the taxpayer's actions have resulted in a loss to revenue. Recent cases have not resulted in the effectiveness of Part IVA being compromised and as such the amendments in the Bill are an unnecessary overreaction.

[1] Second Reading Speech, *Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013*, House of Representatives, Assistant Treasurer, the Hon. David Bradbury MP

This is because the repeated assertion in Government media releases and the Explanatory Memorandum to the Bill that the ability to successfully posit a “do nothing” alternative postulate would allow the “tax advantage” obtained from a scheme to function as a shield against the application of Part IVA is misguided and incorrect.

The circumstances that lead to this alternative postulate being successfully put in the *RCI case*[2] were reasonably unique. As such, the capacity to successfully put such a defence in other situations is very limited under current laws. The perceived resulting integrity risk is, in our view, based on an incorrect reading of the case.

At any rate, a “do nothing” alternative postulate does not come into play if the Commissioner is able to posit another reasonable alternative postulate that involved doing something. This integrity protection mechanism already exists under the current law.

As such, we do not anticipate that the *RCI case* will open a floodgate of taxpayers that can successfully rely on this argument at law. Any concerns that the case may result in an increase in taxpayer risk appetite via more taxpayers seeking to rely on the “do nothing” alternative postulate are better addressed via rigorous administration rather than legislative change.

With any such major changes in tax law, much effort and expense is typically required to be invested over the subsequent years to define and determine the legal effect and commercial impact of the change/s. In this case, all such efforts by the Australian Taxation Office, taxpayers and the Courts will represent a waste of resources, as no amendments to Part IVA are necessary to protect the integrity of the tax system.

In light of the above, we would be keen to explore the Government’s quantification of revenue protected as a result of these amendments ($1 billion), as noted in the Assistant Treasurer’s media release no. 010 dated 13 February 2013.

Recommendation 1

In recognition of the lack of necessity of changes to the current Part IVA, the Committee should recommend that Schedule 1 of the Bill be removed.

Problems with the Bill

Should the Committee not proceed with recommendation 1, our comments on and recommended changes to the Bill are as follows.

Broadly, Part IVA applies where a taxpayer enters into a *scheme* for the *sole or dominant purpose* of obtaining a *tax benefit*. Where Part IVA applies, the Commissioner may cancel the tax benefit.

In our view, the two safeguards in Part IVA (the tax benefit and purpose tests) were intentionally inserted by the legislature to ensure an appropriate balance in the current structure between the competing concerns of tackling tax avoidance and limiting the power to do so to an appropriate range of circumstances.

2 *RCI Pty Limited v Commissioner of Taxation* [2011] FCAFC 104

In applying the second safeguard, the tax benefit test, a tax benefit should not result unless a taxpayer's tax avoidance conduct has adversely affected the revenue i.e. the taxpayer has paid less tax than would or might reasonably be expected to be the case had the scheme not been entered into.

Annihilation provision

The Bill appears to bestow a wide and unrestricted power on the Commissioner with respect to the use of the annihilation provision in section 177CB(2).

Although the Explanatory Memorandum indicates that this provision will typically be used "where the scheme in question does not produce any material non-tax results or consequences for the taxpayer"[3] there is no such restriction on a wider use of this provision in the legislation itself.

If this power were applied broadly, the Commissioner could annihilate a 'scheme' in a way that produces an unreasonable basis on which the tax benefit is calculated without any capacity for taxpayer challenge.

Construction of alternative postulate

Under the current Part IVA, the Commissioner may put any reasonable alternative postulate as the basis for calculating the tax benefit. This test of course prevents other tax avoidance schemes from constituting a reasonable alternative postulate and as such protects the integrity of the tax system in a relatively unobtrusive fashion.

In contrast, the Bill seeks to amend the tax benefit test to allow the positing of all alternative postulates that are reasonable only once tax consequences are disregarded[4]. Such an amendment is inappropriate and unnecessary.

Under this assumption, the "tax benefit" will not necessarily correctly quantify the loss to revenue as the taxpayer may not reasonably be expected to have engaged in the posited course of conduct once this commercially unrealistic assumption is removed. This is because taxpayers legitimately take tax into account when considering business decisions. Significantly, taxpayers often legitimately evaluate commercially different alternatives on a post-tax basis.

Due to ambiguous drafting of section 177CB, it is unclear whether the alternative postulate is required to be reasonable in all of the facts and circumstances.

Concerns regarding lack of reasonableness requirement

This issue is of concern for two reasons:

- It significantly diminishes the second safeguard in Part IVA (the tax benefit test) and therefore disturbs the inherent balance in the current Part IVA between tackling tax avoidance and allowing taxpayers a reasonable right to challenge the Commissioner's assessment – an essential right in a self-assessment system to guard against the imposition of arbitrary assessments. The potential for adverse behavioral changes in the form of heightened taxpayer risk, negative effects on business sentiment and a greater taxpayer tendency not to

[3] Paragraph 1.82 of the Explanatory Memorandum to the Bill
[4] Sections 177CB(3) and (4)

challenge excessively high tax assessments is high, undesirable and unnecessary.

- Where Part IVA does apply, the Commissioner should only be permitted to reverse the ill-gotten gains of the taxpayer. Instead, the proposed amendment appears to confer a much wider power on the Commissioner to cancel any tax advantage obtained via the scheme, whether inappropriately or not. That is, the Commissioner may posit a commercially unrealistic set of circumstances following an annihilation of the scheme or construction of the alternative postulate (such as for example, a scenario involving double taxation of the same economic gain) and levy additional tax on that basis without any capacity for taxpayer challenge at Court.

The uncertainty caused by the ambiguous drafting in the Bill is also undesirable. Greater clarity with respect to whether an unreasonable alternative postulate is allowable under section 177CB(4) would greatly assist taxpayers in managing their tax risk.

It is our view that the Bill should be clarified to ensure that:

- Regard is required to be had to the substance of the scheme and the results or consequences produced for the taxpayer when applying the annihilation provision in section 177CB(2); and

- The Commissioner cannot put an unreasonable alternative postulate without any capacity for taxpayer challenge.

While we do not suggest that the Commissioner would seek to abuse such powers, the possibility will incite undesirable behavioral change, is inconsistent with the goal of taxpayer certainty and represents the rule of administration rather than the rule of law.

Such wide powers are also unnecessary to achieve the Government's stated policy intention of foreclosing on the "do nothing" alternative postulate, protecting the integrity of the tax system and tackling tax avoidance, as these objectives can be achieved by an appropriate limitation on the broad "disregard tax" assumption.

<u>Recommendation 2</u>

Should the Committee not proceed with recommendation 1, we recommend that the Bill be amended to restrict the capacity to apply the annihilation provision and require any alternative postulate to be "reasonable" *after* the disregard tax assumption has been applied. Such amendments should not pose any further integrity risks as compared to the Bill as:

- Insofar as the Commissioner's alternative postulate is considered to be reasonable, the taxpayer has no further right of reply. That is, the Commissioner's ability to apply Part IVA should not be restricted in any way that is counter to the Government's objectives via such an amendment.

- A Court would not consider another tax avoidance scheme to be reasonable in these circumstances.

- Any concern that such an amendment would pose an integrity risk by allowing taxpayers to argue that the Commissioner's alternative postulate is unreasonable due to its tax cost is unfounded.

  To the extent that a taxpayer has appropriately taken the tax cost of the substance of the scheme into account in a decision making process, Part IVA should not be applicable i.e. the success of such an argument should not pose an integrity risk.

  To the extent that a taxpayer has sought to engage in blatant, artificial or contrived behavior in order to secure a tax advantage, a Court would not find an alternative postulate which comprises of correctly applying the tax laws to the substance of the scheme to be unreasonable exclusively because of the resulting tax cost.

- The recommended restriction of the annihilation provision is in accordance with the provision's intended use, as set out in the Explanatory Memorandum to the Bill (paragraph 1.82).

The amendments required to effect recommendation 2 are set out below for the Committee's consideration.

Section 177CB(2) should be amended so that regard must be had to the factors in section 177CB(4)(a) (i.e. substance of the scheme and non-tax results or consequences produced) before the section can be applied.

Extract from section 177CB, marked up for suggested amendments.

(3) 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 an alternative postulate ~~that is a reasonable alternative~~ to entering into or carrying out the scheme.

(4) In constructing an alternative postulate ~~determining~~ for the purposes of subsection (3) ~~whether a postulate is such a reasonable alternative~~:

(a) have particular regard to:

(i) the substance of the scheme; and
(ii) any result or consequence for the taxpayer that is or would be achieved by the scheme (other than a result in relation to the operation of this Act); but

(b) disregard any result in relation to the operation of this Act that would be achieved by the postulate for any person (whether or not a party to the scheme).

(5)Notwithstanding subsection (4), an alternative postulate to entering into or carrying out the scheme under subsection (3) must be reasonable.

PART 2: MODERNISING AUSTRALIA'S TRANSFER PRICING RULES

As noted in the Assistant Treasurer's media release no. 010 on introduction of the Bill (13 February 2013), "[t]ransfer pricing rules are critical to the integrity of the tax system. They seek to ensure that an appropriate return for the contribution of Australian operations of a multinational group is taxable in Australia for the benefit of the broader community."

The Tax Institute is supportive of the Government's efforts to ensure an equitable return on Australian operations is taxed in Australia by updating our current transfer pricing laws.

The transfer pricing rules modernisation project will, if implemented appropriately, yield benefits for the revenue authority and taxpayers alike. A closer alignment of Australia's transfer pricing rules with the 2010 OECD Transfer Pricing Guidelines ("**OECD guidelines**")[5] should ensure that multi-national enterprises ("**MNEs**") are broadly taxed in line with mutually agreed principles via a cohesive and co-ordinated international approach to transfer pricing.

The anticipated benefits of this policy objective are plentiful – lower compliance costs for MNEs due to standardised rules across jurisdictions and more appropriate tax collections for revenue authorities.

Nevertheless, we are concerned that the Bill as currently drafted will not yield many of the lauded simplicity and certainty benefits and will increase the compliance burden especially and disproportionately on small to medium enterprises.

Furthermore, many of these additional costs do not yield any commensurate benefit for the revenue. That is, the Bill may be amended to address these concerns without compromising the integrity of the proposed transfer pricing rules or any other part of the tax system. Our concerns and recommended changes to the Bill are set out in further detail below.

Reconstruction powers

The Bill, as currently drafted allows the Commissioner to tax MNEs on the basis of a situational construction rather than the actual dealings in a range of situations, including:

- where taxpayers dealing at arm's length would not have entered into the actual dealings; and

- where the form of the actual dealings is inconsistent with the substance of the dealings.

In these circumstances, the Commissioner may disregard the form of the actual dealings and/or reconstruct the actual transaction and then levy tax on the basis of an arm's length alternative in *all* cases where a taxpayer obtains a transfer pricing benefit.

In sharp contrast, under the OECD guidelines, transactions may only be reconstructed in *'exceptional'* circumstances (paragraphs 1.64 and 1.65 of the OECD guidelines).

[5] As noted in the Assistant Treasurer's media release no. 010, dated 13 February 2013.

The powers created by the Bill are unnecessarily broad to achieve the relevant policy objectives. Furthermore, the wide scope of potential application of this power will create difficulties for taxpayers in self-assessing the likelihood that the power will be exercised. The resulting uncertainty is unnecessary and will prove costly to implement.

Such wide powers are also out of sync with international best practice as expressed in the OECD guidelines. This is an unfortunate and unnecessary deviation and will undermine the policy intention of closer alignment, as set out above.

The section intended to achieve closer alignment with the OECD guidelines (section 815-135) is an inadequate safeguard against the broad scope of the reconstruction power for the following reasons:

- The OECD guidelines (paragraph 1.65) refer to two circumstances in which it is appropriate for a revenue authority to disregard the actual transactions. However, even these circumstances represent only basic conditions in which a reconstruction power may be considered. In order for a revenue authority to legitimately apply a reconstruction power, it is also necessary that the case in relation to which use of a reconstruction power is being considered is itself exceptional.

- The OECD guidelines (paragraph 1.65) do not provide any clarity around what might constitute 'exceptional' cases, leaving such matters to be determined under the domestic tax law of each country. This is understandable given the consensus nature of the OECD guidelines. This also provides an as yet unutilised opportunity to Australian law makers to define what should constitute "exceptional" circumstances for the purposes of our domestic laws; and

- The text of paragraph 1.65 of the OECD guidelines is consistently permissive rather than mandatory in nature. This can be contrasted with subsections 815-130(2)-(4) which, as noted above, require the arm's length conditions to replace the actual conditions in *all* cases where a taxpayer obtains a transfer pricing benefit. A permissive guideline offers no reliable protection against the text of Australian law.

Subsections 815-130(2)-(4) as currently drafted are not consistent with paragraphs 1.64 and 1.65 of the OECD guidelines and therefore are not in keeping with the Government's policy objective of aligning Australia's transfer pricing rules with international best practice as expressed in the OECD guidelines.

As set out below, we recommend that this power be more appropriately restricted (in line with OECD guidelines) in order to lessen uncertainty and compliance costs for taxpayers. Furthermore, establishing appropriate boundaries for the exercise of such a power will not result in any integrity concerns of note.

While we do not intend to suggest that the Commissioner would seek to abuse such a broad power, a lack of further guidance/restriction on the use of this power will result in uncertainty, confusion and undesirable behavioural changes in the form of negative business sentiment and increase in tax risk.

Recommendation 1

The Committee should recommend that subsections 815-130(2)-(4) be amended to ensure that they apply only in exceptional cases, consistent with paragraphs 1.64 and 1.65 of the OECD guidelines.

Annihilation provision

The annihilation provision in subsection 815-130(4) seeks to calculate the transfer pricing benefit by disregarding the actual arrangement between the parties. As currently drafted, there is no limitation on when this provision may be utilised.

Such a provision is likely to result in harsh or potentially oppressive outcomes if the Commissioner seeks to annihilate an actual arrangement that involved real activities being undertaken by the Australian taxpayer. This situation may arise where, for example, a MNE engages in transactions that independent enterprises would not have undertaken, but which are nevertheless commercially rational and/or arm's length transactions. Such a situation is recognised in the OECD guidelines (paragraphs 1.11, 1.67 and 9.172).

Disregarding transactions where real activities are undertaken in Australia is also inconsistent with the Objects clause (paragraph 815-105(1)(a)) and the Government's policy intention i.e. to ensure that an appropriate return for the contribution of Australian operations of a multinational group is taxable in Australia for the benefit of the broader community. See also paragraph 3.1 of the Explanatory Memorandum.

Recommendation 2

The Committee should recommend that subsection 815-130(4) be amended to enable real activities undertaken by Australian taxpayers to be taken into account in determining whether a taxpayer has obtained a transfer pricing benefit.

Transactions entered into before date of effect of the Bill

While the Bill purports to only apply on a prospective basis, it is unclear whether transactions entered into prior to the date of commencement of Schedule 2 can also be reconstructed under subsections 815-130(2)-(4). This situation is likely to arise as many dealings entered into by MNEs span over several income years, and the tax effect of a particular transaction may also span several income years.

If transactions entered into prior to the date of effect of the Bill are able to be reconstructed under Subdivision 815-B, the Bill will in effect have retrospective application to transactions entered into potentially years before the relevant date of effect. Such a retrospective application is inappropriate as the reconstruction power in subsections 815-130(2)-(4) is significantly broader than current transfer pricing laws, and taxpayers could not have had any awareness of the breadth of this power at the time of entering into such dealings.

<u>Recommendation 3</u>

The Committee should recommend that the Bill be amended so that the reconstruction powers in subsections 815-130(2)-(4) are not able to be applied retrospectively to transactions entered into prior to the date of effect of the Bill.

Record keeping and penalty requirements

The record keeping and penalty requirements imposed by the Bill as currently drafted are unnecessarily onerous to achieve their policy objective and offer little incentive for voluntary compliance.

The policy intention as set out in the Explanatory Memorandum is that "an entity only maintain and prepare documentation in respect of those conditions that are both material and relevant to the application of Subdivision 815-B and 815-C to them." (paragraphs 6.25 and 6.26).

While such guidance in the Explanatory Memorandum is welcomed, as the High Court has recently reiterated, the task of statutory construction must begin with a consideration of the statutory text itself considered in its context. Legislative history and extrinsic materials cannot displace the meaning of the statutory text[6].

The actual text of the Bill does not allow any scope for taxpayers or the Commissioner to consider the materiality or relevance of conditions for purposes of determining the records that need to be kept in order to have a reasonably arguable position.

As such, the Bill currently creates an obligation to maintain and prepare documentation for *all* conditions that are relevant to the transfer pricing rules, no matter how significant or material in order to achieve protection from penalties. Such an obligation will be particularly onerous for small to medium enterprises operating internationally.

<u>Recommendation 4</u>

The Committee should recommend that:

- Subsections 284-250 and/or 284-255 of Schedule 1 to the TAA 1953 be amended to allow the materiality and relevance of conditions to be taken into account in determining whether sufficient documentation has been maintained in order to have a reasonably arguable position; and

- Greater discretion be provided to the Commissioner to determine penalties in accordance with degrees of compliance with the documentation requirements.

[6] *Alcan (NT) Alumina Pty Ltd v Commissioner of Territory Revenue* [2009] HCA 41 at paragraph 47; *Commissioner of Taxation v Consolidated Media Holdings* Ltd [2012] HCA 55 at paragraph 39). Also, Section 15AB of the *Acts Interpretation Act 1901* (use of extrinsic material) does not assist where the meaning of the statutory text is clear on its face.

De minimus penalty thresholds

The *de minimis* thresholds of $10,000 and $20,000 in proposed section 284-165 of the TAA 1953 are far too low to achieve their intended purpose. These thresholds will not carve out most enterprises operating in the small to medium enterprise market as intended, as the international operations of these entities typically exceed the proposed thresholds.

Recommendation 5

The *de minimis* thresholds should be raised to $5,000,000 in order to achieve their intended effect.

Interaction between transfer pricing rules and customs duty rules

The Bill does not address the interaction between the transfer pricing rules and customs duty rules. Transfer pricing adjustments involving the importation of goods can cause customs duty problems because a separate adjustment then needs to be sought to the customs value of the goods. This is particularly problematic where a transfer pricing adjustment results from the use of a profit method.

Recommendation 6

The Committee should recommend that a whole-of-government approach be instituted with the aim of creating a simple legislative mechanism by which taxpayers can obtain refunds of any overpaid customs duty following the making of a transfer pricing adjustment by the Australian Taxation Office.

Amendment period

There is no discernible reason why the amendment period for transfer pricing adjustments should not align with the standard amendment period (typically 4 years). This is especially the case due to increased information sharing between tax jurisdictions, greater reliance on fast electronic transmission of information and increasing reliance on pre-lodgment information gathering by revenue authorities.

Furthermore, should the standard amendment period prove insufficient, the Commissioner may obtain additional time in which to complete an examination of a taxpayer's affairs under subsection 170(7) of the ITAA1936.

The 7-year time limit for amending assessments in the Bill (paragraphs 815-150(1)(a) and 815-240(a)) is unnecessarily long and should be reduced to the standard amendment period.

<u>Recommendation 7</u>

The Committee should recommend that the normal time limits for amending assessments under section 170 of the ITAA1936 should also apply in transfer pricing cases.

* * * * *

If you would like to discuss this matter, please contact me or The Tax Institute's Tax Counsel, Deepti Paton, on 02 8223 0044.

Yours sincerely

Steve Westaway
President