SUBMISSION 8

Institute of Chartered Accountants Australia

22 February 2013

Committee Secretariat
Department of the House of Representatives
PO Box 6021
Parliament House
Canberra ACT 2600

Email: economics.reps@aph.gov.au

Dear Sir/Madam

Inquiry into the *Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013*

The Institute of Chartered Accountants Australia (the **Institute**) welcomes the opportunity to make a submission on *Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013* (**Bill**) and the explanatory material (**EM**) introduced into parliament on 13 February 2013. The Bill was then referred to the House of Representatives Standing Committee on Economics (**Committee**) for inquiry and report.

The Institute is the professional body for Chartered Accountants in Australia and members operating throughout the world. Representing more than 70,000 current and future professionals and business leaders, the Institute has a pivotal role in upholding financial integrity in society. Members strive to uphold the profession's commitment to ethics and quality in everything they do, alongside an unwavering dedication to act in the public interest.

We wish to provide comments on Schedule 2 to the Bill on *Modernisation of Australia's transfer pricing rules*.

The Institute's submission points include:

- Reconstruction of transactions – The Bill appears to provide for a broader application for the reconstruction of transactions than was intended by the Organisation for Economic Co-operation and Development (**OECD**) in the transfer pricing guidelines (**TPGs**). The Institute submits that the Bill should clearly place more defined restrictions on when the form of actual transactions should be disregarded.

- Thresholds for a reasonably arguable position and the imposition of penalties – It is the Institute's view that the Bill does not go anywhere near achieving the correct balance between compliance costs and the potential risk to revenue in the context of transfer pricing adjustments. The Institute submits that the monetary threshold of the scheme shortfall amount and for the imposition of penalties should be at least $5 million to achieve the right balance.

- Time limits for amending assessments – A compelling case has not been made as to why the Commissioner should be given a 7-year time limit for amending assessments. The Institute submits that the normal time limits for amending assessments under section 170 of the *Income Tax Assessment Act 1936* (**ITAA 1936**) should apply.

Customer Service Centre
1300 137 322

NSW
33 Erskine Street
Sydney NSW 2000

GPO Box 9985
Sydney NSW 2001

Phone 61 2 9290 1344
Fax 61 2 9262 1512

ACT
L10, 60 Marcus Clarke Street
Canberra ACT 2601

GPO Box 9985
Canberra ACT 2601

Phone 61 2 6122 6100
Fax 61 2 6122 6122

Qld
L32, 345 Queen Street,
Brisbane Qld 4000

GPO Box 9985
Brisbane Qld 4001

Phone 61 7 3233 6500
Fax 61 7 3233 6555

SA / NT
L29, 91 King William Street
Adelaide SA 5000

GPO Box 9985
Adelaide SA 5001

Phone 61 8 8113 5500
Fax 61 8 8231 1982

Vic / Tas
L3, 600 Bourke Street
Melbourne Vic 3000

GPO Box 9985
Melbourne Vic 3001

Phone 61 3 9641 7400
Fax 61 3 9670 3143

WA
L11, 2 Mill Street
Perth WA 6000

GPO Box 9985
Perth WA 6848

Phone 61 8 9420 0400
Fax 61 8 9321 5141

- Small and medium enterprises (**SMEs**) – The Institute considers that in a proper balancing of compliance costs against revenue risks, it is essential that some taxpayers are completely carved out of the transfer pricing rules. In any event, the Institute believes that penalties should not be imposed for any adjustment made under Subdivisions 815-B to 815-D on a SME taxpayer that has made reasonable efforts to comply with the legislation.

These and other issues are detailed in the attached appendix.

If you would like to discuss any aspect of this submission or require any further information, please do not hesitate to contact me on 02 9290 5609 at first instance. We would welcome the opportunity to discuss our concerns with the Committee in person.

Yours sincerely

Paul Stacey CA
Head of Tax Policy
Institute of Chartered Accountants Australia

Inquiry into the *Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013*

Schedule 2 – Modernisation of Australia's transfer pricing rules

This formal submission to the Committee follows our earlier submissions to Treasury of:

- 5 December 2011 in relation to Treasury's Consultation Paper, *Income Tax: Cross Border Profit Allocation – Review of Transfer Pricing Rules* released by the then Assistant Treasurer on 1 November 2011, and

- 20 December 2012 on the exposure draft legislation of *Tax Laws Amendments (Cross-Border Transfer Pricing) Bill* 2013 and explanatory memorandum of the proposed amendments to implement the second stage of the transfer pricing reforms. These were released by the Assistant Treasurer on 22 November 2012.

Although the Bill has benefitted from consultation, some of our concerns with the proposed provisions remain. These are discussed below.

1. Reconstruction of transactions

Our members are concerned that the Bill appears to provide for a broader application for the reconstruction of transactions than was intended by the OECD in the TPGs. This could lead to:

- an increased risk of double taxation
- increased uncertainty for taxpayers under a self assessment regime.

Whilst our members understand that the policy intent of Subdivision 815-B is to align Australia's domestic transfer pricing (**TP**) rules closely with the OECD TPGs, they are concerned that the drafting of the Bill and EM goes beyond the scope of the intent of the TPGs. Our members note that the proposed rules require taxpayers to substitute the arm's length conditions for the actual conditions (if the conditions in section 815-120(1)(c) are met) and that the term "conditions" is intended to be interpreted broadly.

In identifying the arm's length conditions, section 815-130 specifies a "basic rule" and "exceptions" that includes a focus on transactions inconsistent with the economic substance and transactions that would not have been entered into by independent parties.

Although this structure is more in line with the position of the OECD guidelines than the exposure draft, our members consider that the provisions taken together place an excessive and onerous burden on the taxpayer and go beyond the intent of the OECD TPGs. It is important to bear in mind that many parts of the OECD TPGs are directed at tax administrations to help them resolve double tax that can arise under Article 9 of the Model Tax Convention. It is arguable that the references to reconstruction in the OECD TPGs are an example of this, especially the commentary in paragraphs 1.64 and 1.65 of the OECD TPGs.

These paragraphs are clearly directed at tax administrations seeking to review transfer prices and make it clear that the review should be of the "actual transactions undertaken". They do not appear to be drafted with a view to be included in domestic legislation.

Some useful restrictions in relation to the application of the "exceptions" are provided in the EM, however these are limited in their scope and the legislation itself remains broad in its potential application. There is real concern at the present time amongst taxpayers and advisors that the ATO will consider that powers to reconstruct actual transactions extend beyond that envisaged in the OECD TPGs. In this respect, we also draw your attention to recent discussions with the ATO's Transfer Pricing Working Group (**TPWG**). The TPWG is a working group of the ATO's National Tax Liaison Group (NTLG) International Subgroup and was established in the latter half of 2012 to

consider potential administrative and interpretative matters arising in the context of the recently enacted Subdivision 815-A of the *Income Tax Assessment Act 1997* (**ITAA 1997**).

From the very first meeting of this new group, it became evident that there was a difference of understanding between the ATO representatives and external members of the TPWG as to what constituted circumstances under which the reconstruction of a controlled transaction should proceed as distinct from the re-pricing of a controlled transaction having regard to comparable uncontrolled transactions.

Discussions within the TPWG are continuing, however, this illustrates the need for the Bill to clearly place more defined restrictions on when the form of actual transactions should be disregarded. The absence of such a change in the Bill could increase the level of uncertainty to taxpayers and ATO auditors as to whether the ATO will seek to reconstruct actual transactions. Such uncertainty has the potential to heighten the risk of double taxation and increase the compliance burden on our members. This uncertainty will make Australia a less desirable location for capital investment.

Where reconstruction is considered necessary in line with the OECD TPGs, our members are of the view that the ability to reconstruct should only be relevant on determination by the Commissioner where the basis for the determination is clearly set out. The current drafting of the Bill requires taxpayers to self assess a reconstruction of a transaction which is an overly complex and unnecessary exercise.

2. Section 262A of the ITAA 1936

Taxpayers and public officers are potentially exposed to administrative penalties under section 288-25 of the *Taxation Administration Act 1953* (**TAA 1953**) and also to criminal penalties for failing to comply with section 262A (see PS LA 2005/2 (Penalty for failure to keep or retain records)). These administrative penalties are separate to and independent of any administrative penalties that might apply under Subdivision 284-B or 284-C of the TAA 1953.

According to paragraph 6.6 of the EM:

> "… It would be expected that to the extent that documents prepared in accordance with Subdivision 284-E relate to transactions or acts that would otherwise need to be recorded under section 262A, the documents prepared in accordance with Subdivision 284-E would satisfy the more general record keeping requirement under section 262A. **However where this is not the case, section 262A continues to apply in respect of any relevant transactions and acts." [Our emphasis]**

In other words, if documents are not prepared in accordance with Subdivision 284-E (which is open for the entity to do under that provision but it cannot have a reasonably arguable position in respect of that transaction(s)), it would seem that section 262A could still apply in regard to any relevant transactions or acts. The EM does not elaborate any further on what may be required to avoid this occurring.

This would seem to act against the objective of seeking to provide taxpayers with the flexibility to risk assess in regard to documentation requirements and administrative penalties under Subdivision 284-B or 284-C of the TAA 1953.

Therefore the Institute considers that the EM should provide clear guidance on what records taxpayers will need to maintain to avoid administrative penalties arising under section 288-25 of the TAA 1953 for failing to keep the records required by section 262A of the ITAA 1936.

3. Threshold for reasonably arguable position and the imposition of penalties

Administrative penalties will not apply in respect of Subdivisions 815-B or 815-C of the Bill where the scheme shortfall amount is equal to or less than an entity's reasonably arguable threshold.

The relevant thresholds proposed are those in subsection 284-90(3) in Schedule 1 to the TAA 1953, being the greater of:

- $10,000 or 1 per cent of income tax payable, or minerals resource rent tax (MRRT) payable by an entity for the income year; and
- $20,000 or 2 per cent of an entity's net income for an income year, where the entity is a trust or partnership.

The Institute submits that these "standard" thresholds for a reasonably arguable position and the imposition of penalties adopted in the Bill do not go anywhere near achieving the correct balance between compliance costs and the potential risk to revenue in the context of transfer pricing adjustments. This is particularly true for taxpayers in the SME segment.

Our view is that the monetary threshold of the scheme shortfall amount and for the imposition of penalties should be at least $5 million to achieve the right balance. (Please also refer to section 7 below for other SME segment comments).

4. Secondary adjustments

The Bill should clearly state that the scope of s815-115 is limited to the making of primary transfer pricing adjustments and does not extend to the making of secondary adjustments.

5. Permanent establishments (PEs)

Subdivision 815-C states that it applies the internationally accepted arm's length principle in the context of PEs. The Institute considers that it seems inconsistent to advocate a clear move to OECD guidance but to defer or avoid a similar move to accept OECD guidance on profit attribution (ie the 'functionally separate entity approach' rather than the 'relevant business activity approach').

The method of attributing profits to PEs is currently the subject of review by the Board of Taxation. Depending on the Board's findings and the government's response, proposed Subdivision 815-C could change significantly. Given that the Board's report is due at the end of April 2013, the Institute queries whether it might be appropriate to delay finalisation of Subdivision 815-C until after this time.

6. Time limits for amending assessments

A compelling case has not been made as to why the Commissioner should be given a 7-year time limit for amending assessments under sections 815-150 and 815-240 rather than applying the normal time limits for amending assessments under section 170 of the ITAA 1936.

In this respect, it is particularly important to note that subsection 170(7) of the ITAA 1936 provides the Commissioner with the ability to obtain additional time in which to complete an examination of a taxpayer's affairs.

On this basis:

- The normal time limits for amending assessments under section 170 of the ITAA 1936 should also apply in transfer pricing cases.
- To ensure consistency with the preceding recommendation, subsection 170(9B) of the ITAA 1936 should also be amended to limit the Commissioner's ability to issue amended assessments in reliance on:
  - Applying the business profits article or the associated enterprises article of a relevant DTA;
  - Division 13; and
  - Subdivision 815-A;

to the normal time limits for amending assessments under section 170 of the ITAA 1936 after the date of effect of the Bill.

7. SME segment concerns

In our view, in a proper balancing of compliance costs against revenue risks, it is essential that some taxpayers are completely carved out of the transfer pricing rules. This is on the basis that below a certain point it is just not cost effective or practical to impose transfer pricing guidelines. The UK has recognised this in its transfer pricing rules which provide that SMEs are exempt from the transfer pricing rules. An SME under this definition is one that has less than 250 employees and either:

- turnover of less than €50m; or
- assets with a balance sheet total of less than €43m.

We note that this approach of completely carving SME taxpayers out of the transfer pricing rules need not however, prevent the ATO from still being able to gather information to address any concerns it has around related party dealings by SMEs.

In any event, the Institute believes that penalties should not be imposed for any adjustment made under Subdivisions 815-B to 815-D on a SME taxpayer that has made reasonable efforts to comply with the legislation.

That is, it would be unfair in our view to impose transfer pricing penalties on any SME taxpayer that has made reasonable efforts to determine an arm's length price - notwithstanding that they may not have contemporaneous transfer pricing documentation.

For many SME taxpayers, putting together full contemporaneous transfer pricing documentation for every international transaction will simply be cost prohibitive - i.e. regardless of the potential penalties. However, if such taxpayers could prevent penalties by making reasonable efforts to determine an arm's length price, with a much lower compliance cost than that imposed by full transfer pricing documentation, then they would certainly be motivated to do so.

We note for completeness that the Canadian transfer pricing regime allows for a reduction in penalties where, inter alia, the taxpayer has made reasonable efforts to determine and use arm's length transfer prices.

As noted above, we also submit that there should be a de minimis exemption from penalties where a taxpayer's transactions with international related parties fall below a certain dollar threshold - this dollar threshold should ideally be more than $5 million but must, at very least, be no lower than $2 million in order to align with the threshold which must be met before taxpayers are required to complete and lodge an International Dealings Schedule as part of their tax returns.

8. Customs

The *Customs Act 1901* focuses on transactions whereas the Bill looks at overall profitability. Transfer pricing adjustments relating to some imported goods, particularly profit based transfer pricing adjustments, lead to a requirement to seek customs refunds which are administratively very difficult to obtain. Every effort should be made to take positive steps to address this issue.

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