AFMA

21 December 2012

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

Email: transferpricing@treasury.gov.au

Dear Sir/Madam

**Modernisation of Transfer Pricing Rules – Exposure Draft**

The Australian Financial Markets Association (AFMA) represents the interests of over 130 participants in Australia's wholesale banking and financial markets. Our members include domestic and foreign banks, securities companies, treasury corporations, traders across a wide range of markets and industry service providers.

AFMA acknowledges the importance of appropriate and globally consistent transfer pricing rules to facilitate multi-national trade while protecting the integrity of Australia's tax system. We think it is important that companies with international operations pay their fair share of tax on the profits they make in Australia.

The policy context for the proposed law change extends well beyond the short and long term tax revenue objectives. In particular, these measures will form an important part of the regulatory fabric governing the international capital flows that support Australia's productivity and economic development, as well as our engagement with the Asian Century.

Transfer pricing rules should be certain, transparent and strike a balance in protecting Australian tax revenue and facilitating international business.

## 1. The Economic Context for Transfer Pricing Reform

Australia typically runs a significant current account balance of payments deficit of about 3% of GDP, so our ongoing economic development depends in part on capital investment from overseas. Moreover, because our economy has a strong focus on international commerce, both inward and outward capital flows contribute significantly to our economic development. For instance, the total inward stock of direct investment in Australia was $494 billion in 2010, while direct investment from Australia to other countries was $377 billion.[1]

The Gillard Government noted, in the Asian Century White Paper, that "(B)usiness tax reform is a long-term agenda and our efforts must be mindful of the need to ensure Australia remains an attractive destination for globally mobile capital.[2]" Accordingly, it is imperative that Australia's transfer pricing rules, enshrined in both the domestic law and Australia's network of Double Taxation Treaties, are consistent with global norms and impose compliance obligations that are consistent with the risks that the rules seek to address.

It is important that Australia makes the right policy choices to foster economic development, promote competition in banking and respond to the challenge of lifting our productivity. Transfer pricing rules will apply to a substantial volume of economic business conducted in Australia and by Australian companies overseas. The design and execution of tax policy is a highly relevant consideration in this context. A well-founded set of transfer pricing rules will support Australia's international trade and investment, whereas an incomplete or poorly constructed set of rules could harm our economy and stymie Australia's ability to capitalise in the Asian Century.

## 2. Interaction with Part IIIB

There are currently 48 foreign owned banks in Australia, of which 40 are branches and 8 are subsidiaries[3]. The *Banking Act* 1959 requires that a foreign bank's retail banking business must be conducted in a locally incorporated subsidiary. The preference for branch operations to conduct wholesale banking reflects a steady trend away from bank and non-bank financial institution subsidiaries since the foreign bank branch regime was introduced in 1993, which has occurred for commercial and regulatory reasons.

Part IIIB of the *Income Tax Assessment Act* 1936 (**the 1936 Act**) applies separate entity treatment to foreign bank branches (and to branches of foreign financial entities) in Australia for key intra-entity transactions. This is the strongest feature of Part IIIB for foreign banks and tax administrators, as it provides tax certainty for funding and certain other intra-bank transactions and the application of arm's length rates to those transactions.

AFMA's members are concerned about the risk that the provisions of the Exposure Draft could be applied in a way that would in effect set aside or undermine the operation of Part IIIB by allowing the ATO to instead rely on the proposed transfer pricing rules. There are no policy grounds to leave open the risk that a retrograde step of this nature might be taken. To the contrary, the evidence is that the separate entity provisions in Part IIIB have operated in the way intended by Parliament and the application of the Exposure Draft would only serve to increase tax uncertainty for foreign bank branches.

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[1] See ABS, Cat. No. 53520, reported in Business Council of Australia, Assessing Australia's Trade and Investment with Asia.

[2] "Australia in the Asian Century" White Paper, October 2012, p150

[3] See http://www.apra.gov.au/adi/Pages/adilist.aspx

It is vital that the role of Part IIIB as the primary taxation code for foreign bank branches is left undisturbed by the proposed legislation. We recommend that in order to close off the risk of a different outcome, the legislation should be amended to include an explicit carve-out for entities that are taxed under Part IIIB. This would preserve the policy principles that applied when foreign banks opened, or transferred their business to, a permanent establishment and confirm the assurance given to them that this would apply to them on an ongoing basis. This would involve no cost and no risk to tax revenue but it would maintain the certainty and efficiency of the tax system for foreign bank branches, which is especially important at a time when their businesses are under significant pressure in adjusting to the post-GFC environment.

**3. Ability to Reconstruct Under the Proposed Legislation**

The proposed Subdivisions 815-B and 815-C of the *Income Tax Assessment Act* 1997 (**the 1997 Act**) require that where a transfer pricing benefit arises, the actual conditions under which the benefit arose are substituted with the "arm's length conditions." The arm's length conditions are defined as being "the conditions that might be expected to operate between independent entities dealing wholly independently with one another in comparable circumstances."

AFMA is concerned that the ability of the Commissioner to substitute the actual conditions with arm's length conditions, (that is, effectively reconstruct the transaction) is inconsistent with the 2010 OECD Transfer Pricing guidelines. These guidelines effectively restrict the revenue authorities from reconstructing a transaction apart from in exceptional circumstances, such as:

(i) The legal form of the transaction differs from its economic substance; or
(ii) The arrangements entered into, when viewed in totality, are different to what one would expect to find at arm's length and, importantly, the actual structure adopted practically impedes the setting of an arm's price.

This means that, to the extent that an arm's length price is able to be determined based on the actual conditions, then the structure of the transaction should be respected and not substituted with arm's length conditions that may imply an alternate structure.

We understand that the intention of Treasury is to ensure that the Commissioner's powers of reconstruction under the proposed legislation are no broader than those set out in the OECD guidelines; however the wording of the Exposure Draft and the Draft Explanatory Memorandum may be read as extending the Commissioner's powers of reconstruction. Accordingly, AFMA recommends that the Exposure Draft and/or Explanatory Memorandum explicitly states that the reconstruction powers are limited to, and are to be interpreted in accordance with, the 2010 OECD Transfer Pricing guidelines.

**4. Application to Permanent Establishments – Subdivision 815-C**

Proposed Subdivision 815-C addresses the transfer pricing rules in respect of permanent establishments. Section 815-201, in setting out the application of the Subdivision, states that it “applies the internationally accepted arm’s length principle in the context of permanent establishments.”

Subdivision 815-C is drafted in a way that reflects the current approach to the taxation of permanent establishments that is incorporated into Australia’s network of Double Taxation Treaties, namely the relevant business activity approach. Under this approach, the income and expenditure of the entire entity is allocated to the permanent establishment as if the permanent establishment were a separate entity. However, this approach differs to that included in the 2010 OECD Transfer Pricing guidelines, being the functionally separate entity approach, which permits recognition of transactions between permanent establishments and head office/other permanent establishments for transfer pricing purposes.

AFMA is aware of, and indeed has lodged a submission to, the current review being undertaken by the Board of Taxation regarding the taxation arrangements of permanent establishments. The terms of reference for this review are to “examine and report on the advantages and disadvantages of Australia adopting the OECD functionally separate entity approach to the determination of profits attributable to a permanent establishment.” AFMA’s submission to the Board of Taxation endorsed the adoption of the functionally separate entity principle. It may be that the Board of Taxation concludes that there are significant advantages associated with the adoption of the functionally separate entity principle and the Australian Treasury accepts that the functionally separate entity principle should be enshrined in both the domestic law and the network of Double Taxation Treaties.

The current drafting of Subdivision 815-C undermines the stated policy objective of the proposed transfer pricing legislation. The stated objective of the proposed legislation, as set out in the Draft Explanatory Memorandum, is to ensure that the new rules “better align with the internationally consistent transfer pricing approaches set out by the…OECD.” However, in respect of Subdivision 815-C, proposed Section 815-230(2)(a) provides that the Subdivision is to be interpreted to achieve consistency with the OECD Model Tax Convention “to the extent that document extracts the text of Article 7 and its Commentary as they read before 22 July 2010.” In other words, the drafting of Subdivision 815-C abrogates the extent to which the provisions are internationally consistent by not incorporating the latest version of the OECD guidelines with respect to permanent establishments.

It is therefore submitted that the drafting and enactment of Subdivision 815-C occur subsequent to the Australian Treasury receiving the report from the Board of Taxation to ascertain whether the drafting of Subdivision 815-C should be amended to reflect the adoption of the functionally separate entity principle.

## 5. Record Keeping Requirements

Proposed 815-D sets out the record keeping requirements with respect to arrangements between entities (Subdivision 815-B) and within entities (Subdivision 815-C).

### *5.1 Linking Documentation to Reasonably Arguable Positions*

Section 815-305(1) provides that an entity “may” keep records that meet the requirements of the Subdivision. While the requirements are voluntary, the note to the section states that where no records are kept, the relevant entity cannot have a “reasonably arguable position.” Hence, such an entity is exposed to higher administrative penalties even if the position adopted was, in fact, reasonably arguable.

In AFMA's view, the linkage of documentation to a reasonably arguable position represents a shift in the administration of transfer pricing rules. Taxation Rulings TR 98/11 and TR 98/16 evidence that under the current approach, there is a linkage between documentation and the remission of penalties for any tax shortfall. As per TR 98/11, "(t)he existence of adequate contemporaneous documentation is an indicator that the efforts of a taxpayer are such that penalties should be remitted in the event of a transfer pricing adjustment." This is regardless of whether the documentation evidences a position that is reasonably arguable or not. AFMA posed the question during the Treasury consultation as to whether adherence to TR 98/11 and providing medium to high quality transfer pricing documentation would mean that the taxpayer had a reasonably arguable position, and the view from both Treasury and the Australian Taxation Office was that there was no necessary link between the two concepts (i.e. a taxpayer could hold medium to high quality documentation and not have a reasonably arguable position).

In light of the apparent policy shift under the proposed Subdivision 815-D, AFMA requests that Treasury clarify the applicability of TR 98/11 and TR 98/16 under the proposed Subdivision 815-D to provide taxpayers with sufficient certainty as to the application of penalties under the new transfer pricing rules.

### *5.2 Documentation Requirements*

The proposed Sections 815-305(4) require that the records kept by taxpayers identify "all conditions" operating in the income year that meet the cross-border requirement. This may be read as imposing a requirement on taxpayers to document every single condition regardless as to relevance and materiality to the transfer pricing methodology adopted. Given that adequate documentation is now linked to the ability of a taxpayer to have a reasonably arguable position, a literal reading of proposed Section 815-305(4) could result in a taxpayer not having a reasonably arguable position where an immaterial or irrelevant condition is not documented.

Accordingly, AFMA requests that proposed Subdivision 815-D be amended to clarify that there is no requirement for taxpayers to document irrelevant/immaterial conditions in order to comply with the record-keeping requirements.

### *5.3 Alignment to OECD Documentation Standards*

Many AFMA members operate in a considerable number of jurisdictions and adopt and apply transfer pricing policies that aim to be consistent globally. In this light, Subdivision 815-D should include an explicit statement that, in interpreting the documentation requirements imposed on taxpayers, regard should be had to the 2010 OECD Transfer Pricing guidelines such that documentation that would be acceptable under the guidelines would also result in a reasonably arguable position.

## 6. De Minimus Threshold

We submit that the de minimus threshold for the application of the penalty provisions (currently set at greater of $10,000 or 1% of tax payable for entities) should be benchmarked against the transfer pricing regimes of other OECD countries. For example, AFMA understand that the comparable regime in the United States results in penalties only where the shortfall amount is greater than USD $5 million or 10% of gross receipts. AFMA acknowledges the view from the Australian Treasury that there are differences in the regimes that result in different penalty structures; however at a macro level the proposed thresholds are well below those imposed by other OECD jurisdictions.

## 7. Time Limits

AFMA welcomes the introduction of a time limit for the amendment of assessments, with the current proposal being eight years from the date of on which the Commissioner gives notice of the assessment to the taxpayer. However, we note that the eight year period is effectively double the normal period for amendment of assessments. While we acknowledge the general complexity and onerous nature of transfer pricing enquiries, thereby justifying a time period in excess of the standard, we believe that a time period of six years would assist in providing taxpayers the requisite certainty and align more favourably with record-keeping requirements.

## 8. Concluding Comments

Thank you for the opportunity to comment on the proposed Exposure Draft and the accompanying Draft Explanatory Memorandum.

Yours sincerely

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