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13 April 2012

Dear Sir/Madam

EXPOSURE DRAFT - STAGE ONE TRANSFER PRICING REFORMS

BDO welcomes the opportunity to provide submissions on the matters addressed in the Exposure Draft of the T*ax Laws Amendment (2012 Measures No. 3) Bill 2012: Cross-border transfer pricing* (Exposure Draft) and accompanying *Explanatory Material* made available by Treasury on 16 March 2012.

While our submissions on a number of the issues raised by the Exposure Draft and Explanatory Material are attached as an Appendix, we wish to emphasise the following very serious points which are elaborated upon in our submissions:

- There is no justification for making the changes to Australia's taxation laws which are proposed under the Exposure Draft retrospective, such that they will apply for income years beginning on or after 1 July 2004. Such retrospective application:
  - contravenes the tax policy criterion of equity
  - contravenes the jurisprudential principle of cognoscibility which dictates that in a democratic society those to whom laws apply should be capable of knowing those laws at the time of such application
  - contravenes recommendations of the Tax Design Review Panel

- contravenes Senate Standing Order 24(1)(a)
- will be seen as an example of sovereign risk and bad faith by the governments of trading partners and multinationals doing business in Australia; and
- is justified, in the Explanatory Material, on specious grounds.

- The proposed changes are significant in nature and not a mere clarification of the existing law, as they are represented in the Treasury Consultation Paper: *"Income Tax: Cross Border Profit Allocation-Review of Transfer Pricing Rules"*, (the Consultation Paper) released for public consultation on 1 November 2011.

- In light of the significance of the changes, the time allowed for, and quality of, consultation undertaken in respect of the proposed changes has been inadequate. In particular, there appears to have been little meaningful response, in the drafting of the Exposure Draft, to the real concerns raised by interested parties (including BDO) in submissions made in response to the release of the Consultation Paper.

Should you have any questions, or wish to discuss any of the comments made in the submissions, please do not hesitate to contact me on (07) 3173 5428.

Yours sincerely

Matthew Wallace
National Tax Counsel

APPENDIX

This document sets out the submissions of BDO in relation the matters addressed in the Exposure Draft of the T*ax Laws Amendment (2012 Measures No. 3) Bill 2012: Cross-border transfer pricing* (Exposure Draft) and accompanying *Explanatory Material* made available by Treasury on 16 March 2012.

References to:

- the ITAA 1936, are to the *Income Tax Assessment 1936*
- the ITAA 1997, are to the Income Tax Assessment Act 1997
- the Agreements Act are to the International Tax Agreements Act 1953, and
- DTAs are to the double tax agreements forming schedules to the Agreements Act.

We have, in these submissions, focused on our concerns about the retrospective operation of the amendments proposed under the Exposure Draft. We addressed other design aspects of the measures proposed in our submissions to Treasury dated 30 November 2011 (Previous Submissions) in response to the Treasury Consultation Paper: *"Income Tax: Cross Border Profit Allocation-Review of Transfer Pricing Rules"*, (the Consultation Paper) released for public consultation on 1 November 2011. These Submissions should be read in conjunction with our Previous Submission.

The retrospective operation of the proposed changes is unjustified and is unacceptable

We note, with grave concern, the retrospective application of the proposed amendments. To this end Item 11 of the Exposure Draft provides for an amendment to the *Income Tax (Transitional Provisions) Act 1997* by the insertion of section 815-10. This proposed provision states,

"Subdivision 815-A of the Income Tax Assessment Act 1997 applies to income years beginning on or after 1 July 2004."

Such an extraordinary outcome was justified in the Consultation Paper, in part, on the basis of a mischaracterisation of the changes as a mere "clarification" of the existing law. The inaccuracy of such characterisation was addressed, at length, in our Previous Submissions.

The primary justification asserted for the retrospective operation of the proposed changes is based on representations in the Explanatory Materials:

- At paragraph 1.8 that *"Over time the Parliament has repeatedly referenced its view that the specific transfer pricing related articles as incorporated into Australia's domestic law provide alternative and independent transfer pricing liability provisions to those contained in Division 13"*

- At paragraph 1.10 that "*While this view has been publically expressed consistently since the commencement of Division 13 in 1982, these amendments will apply to income years commencing on or after 1 July 2004. The 2004 income year commenced immediately after the Parliament last demonstrated its intention that the law should operate in this way in the International Tax Agreements Act 2003 and its associated explanatory materials"*

Principles of equity and cognoscibility

The tax policy criterion of fairness or equity and the jurisprudential principle of cognoscibility would both dictate that, in a civilised and democratic society, tax laws should not, except in the most exceptional of circumstances, operate or apply retrospectively. To thus impose an unexpected taxation burden on the correctly advised, being those who have complied with the taxation laws as provided by parliament in the then applicable taxation legislation, is at odds with all principles governing such a society.

We believe that the inappropriateness of such retrospective application is eloquently addressed in the following passage from Professor Mark Cooray

> *"Laws should apply prospectively and not retrospectively. A person should never be made to suffer in law (criminal or civil) for an act which was not unlawful when he committed it. Retrospective legislation destroys the certainty of law, is arbitrary and is vindictive (being invariably directed against identifiable persons or groups). Such laws undermine many characteristics of the rule of law."*[1]

Tax Design Review Panel

On 8 February 2008, the then Assistant Treasurer and Minister for Competition Policy and Consumer Affairs, announced the appointment of a Tax Design Review Panel to examine how to reduce delays in the enactment of tax legislation and improve the quality of tax law changes. Such Tax Design Review Panel comprised representatives of the advisory profession, the Department of the Prime Minister and Cabinet, the Treasury, the Australian Taxation Office and the Office of Parliamentary Counsel.

The Tax Design Review Panel in its report *Better Tax Design and Implementation* (dated 30 April 2008 and released by the Assistant Treasurer on 22 August 2008), provided a strong recommendation against retrospective legislation. Specifically, Recommendation 3 of that Report states[2]:

> *"Recommendation 3:* ***Changes should be prospective*** *and introduced within 12 months*
>
> *The* ***Government should ensure that announced changes generally apply prospectively (ie, from a date following enactment of the legislation)****. The Government should aim to introduce legislation for such measures within 12 months of announcement"* (emphasis added)

The Report further states, at paragraph 2.4, that:

> *"Retrospective changes that increase the liability of taxpayers were strongly opposed."*

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[1] Professor LJM Cooray, *The Australian Achievement: From Bondage to Freedom* The Australian Achievement Project, 1988 at page 91.

[2] http://www.treasury.gov.au/documents/1342/PDF/tax_design_review_panel_report.pdf at page 4.

We refer to the Press Release by the Assistant Treasurer dated 22 August 2008 in which he stated that the Government accepted in principle all of the recommendations in the report and made particular reference to the content of Recommendation 3.

We request that the Government stands by its commitment to support the recommendations of this Panel and ensure that the proposed changes contained in the Exposure Draft apply prospectively, that is, "… from a date following enactment of the legislation."

Senate Standing Orders

We bring to your attention Senate Standing Order 24 (1)(a) which states[3],

> *At the commencement of each Parliament, a Standing Committee for the Scrutiny of Bills shall be appointed to report, in respect of the clauses of bills introduced into the Senate, and in respect of Acts of the Parliament, whether such bills or Acts, by express words or otherwise:*
> *(i) trespass unduly on personal rights and liberties;*
> *(ii) make rights, liberties or obligations unduly dependent upon insufficiently defined administrative powers;*
> *(iii) make rights, liberties or obligations unduly dependent upon non reviewable decisions;*
> *(iv) inappropriately delegate legislative powers; or*
> *(v) insufficiently subject the exercise of legislative power to parliamentary scrutiny.*

We submit that the retrospective nature of the proposed legislation would offend against Standing Order 24(1)(a)(i).

Parliament's statements of intention

As noted above, paragraph 1.18 of the Explanatory Material justifies the retrospective application of the proposed measures, in part, on the assertion that:

"Over time the Parliament has repeatedly referenced its view that the specific transfer pricing related articles as incorporated into Australia's domestic law provide alternative and independent transfer pricing liability provisions to those contained in Division 13"

It is trite law that Parliament expresses its legislative intention in the words of the legislation which it passes into law. With such an understanding in mind, the above assertion is revealed as misleading. We were unable to locate any legislation passed by Parliament that disclosed any clear intention to accord the "associated enterprises" articles of Australia's DTAs such a status. It is apparent that the Australian Taxation Office and its legal counsel came to similar conclusions in respect of the appeal before a single judge of the Federal Court in *SNF (Australia) Pty Ltd v FCT* [2010] FCA 635 and the subsequent appeal to the Full Federal Court in *FCT v SNF (Australia) Pty Ltd* [2011] FCAFC 74 where the Commissioner conceded that if he "*could not succeed ... under Div 13, he could not otherwise succeed under the relevant DTA*" (see paragraph 21 of the judgment in the first mentioned case). The

[3] http://www.aph.gov.au/binaries/senate/pubs/standing_orders/b00.pdf

unwillingness to test this "theory" before the courts when given an ample opportunity in the *SNF case* litigation provides eloquent evidence about the lack of faith in its efficacy.

We directed particular scrutiny towards the provisions of the *International Agreements Act 2003 (IAA 2003),* as it is relied upon as setting the commencement date for the proposed retrospective provisions on the basis that within that Act "*Parliament last demonstrated its intention that the law should operate in this way*". (It is perhaps, noteworthy, as an aside that, notwithstanding the passing into law by Parliament of numerous DTAs since the enactment of IAA 2003, the authors of the Explanatory Material could find no later justification for the asserted, separate DTA based power).

The IAA 2003 passed into Australian law:

- a new DTA between Australia and the United Kingdom (the UK DTA)
- notes exchanged between the Australian and the United Kingdom governments (the UK Notes) in respect of the operation and interpretation the UK DTA;
- a DTA between Australia and Mexico (the Mexico DTA); and
- a Protocol to the Mexico DTA in respect of its operation and interpretation (the Mexico Protocol).

Nowhere in the IAA 2003 (including the UK DTA, the UK Notes, the Mexico DTA and the Mexico Protocol) is there evidence of any clear intention that the associated enterprises articles of the relevant DTAs should give the Commissioner a separate and additional transfer pricing power to that contained in Division 13 of Part III of the ITAA 1936. This is to be contrasted with, for example, Article 21 of the UK DTA and Article 22 of the Mexico DTA, which, in dealing with source of income, deem amounts to be so sourced "*for the purposes of the laws of Australia relating to its tax*", in the former, and "*for the purposes of the law of* ... {the relevant] *Contracting State relating to its tax*", in the latter.

Turning to the Explanatory Memorandum in respect of IAA 2003; even if there were a clear indication, therein, of an intention that the relevant associated enterprises articles of the UK DTA and the Mexico DTA had operation beyond that circumscribed by the operation of such DTAs, this would not be a sufficient justification for the retrospective operation of the measures proposed in the Exposure Draft. The status of such an Explanatory Memorandum is defined and circumscribed by s15AB of the *Acts Interpretation Act 1901,* and would, in addition, be restricted, in its limited application, to the provisions of the IAA 2003. However, the point is moot. There is no clear or unambiguous statement in such Explanatory Memorandum that the applicable associated enterprises articles should have operation outside the bounds of the operation of the applicable DTAs. Indeed, all references to the operation of such articles can more appropriately be construed as relating to an operation, so restricted.

Incorrect interpretations, no matter how oft repeated, are still misinterpretations

We note, with concern, that part of the purported justification for the retrospective nature of the changes proposed under the Exposure Draft is the assertion in the Explanatory Materials that the view, to be legislated, "*has been publically expressed consistently since the commencement of Division 13 in 1982*". Although not elaborated upon in the Explanatory Materials, we have assumed that this is a reference to the public statements of the Australian Taxation Office (ATO) in rulings and otherwise. At

no time have the statements of the ATO been a source of law in Australia. Indeed, the fallibility of the ATO in adopting points of view about the application of Australia's DTAs and the law giving them operation is illustrated in the outcomes in the following cases:

- In *Thiel v FCT* (1990) 171 CLR 338 the High Court of Australia rejected an argument by the ATO that an "enterprise" for the purposes of applying the business profits article of Australia's DTAs, and in that particular case, the DTA between Australia and Switzerland, required repeated, systematic behaviour analogous to the carrying on of a business.

- In *FCT v Lamesa Holdings BV* 97 ATC 4752 the Full Court of the Federal Court of Australia rejected an argument by the ATO that a reference to a "direct interest in land" in the "Alienation of property" articles in Australia's DTAs, and in that particular case, the DTA between the Netherlands and Australia, could extend to interests in other entities which, in turn, held interests in land.

- In *McDermott Industries (Aust) Pty Ltd v FCT* [2005] FCAFC 67 the Full Court of the Federal Court of Australia rejected an argument that in order for the use of substantial equipment to constitute a permanent establishment under the applicable Permanent Establishment Article in the DTA between Singapore and Australia, it had to be more than a "passive use".

- In *GE Capital Finance Pty Ltd (as Trustee for the Highland Finance Unit Trust) v FCT* [2007] FCA 558, the Federal Court of Australia rejected an argument by the ATO that interpretational rules in the International Agreements Act for determining when a resident of a treaty partner had a permanent establishment in Australia for the purposes of applying a DTA, applied for the purposes of determining whether such an entity had a permanent establishment in Australia when applying the withholding tax provisions in Division 11A of Part III of the ITAA 1936.

- In *Virgin Holdings SA v FCT* [2008] FCA 1503, the Federal Court of Australia rejected an argument by the ATO that, for the purposes of applying the Taxes Covered Article of Australia's DTAs, and in that particular case, the DTA between Switzerland and Australia, the capital gains tax provisions of Australia's income tax laws were not a part of the "Australian income tax" referred to therein. In that case the court also rejected erroneous interpretations of the business profits article and alienation of property article put forward by the ATO.

- In *Undershaft No.1 Ltd v FCT* and *Undershaft No. 2 BV v FCT* [2009] FCA 41 the Federal Court of Australia rejected similar erroneous arguments, in respect of relevant articles of the DTAs between the United Kingdom and Australia and between the Netherlands and Australia, to those previously rejected by that same court in the *Virgin Holdings case*.

We note, in addition, that there have been many "publicly expressed views" that, in the absence of express authority to the contrary, DTAs can only operate to limit taxing rights and do not operate to confer taxing rights. This was most relevantly and clearly articulated in the judgment of the Federal

Court of Australia in *Undershaft No.1 Ltd v FCT* and *Undershaft No. 2 BV v FCT* [2009] FCA 41 which provides (at paragraph 46):

> "*A DTA does not give a Contracting State power to tax, or oblige it to tax an amount over which it is allocated the right to tax by the DTA. Rather, a DTA avoids the potential for double taxation by restricting one Contracting State's power to tax*".

This issue is addressed further in our Previous Submissions.

We further note that the only legislative response to the ATO losses before the courts, addressed above, was the enactment of s3A of the *Agreements Act* in response to the outcome in the *Lamesa* case. This amendment was, appropriately, **prospective** in operation.

Sovereign risk and bad faith

Properly advised residents of trading partners and, indeed, Australian residents who have multinational operations, have, in good faith, complied with the law as it stood, since 2004. The retrospective amendment of such law, such as to render such correctly advised taxpayers non-compliant, must be seen by such taxpayers and the governments of the countries in which they operate or are resident, as an act of bad faith on the part of the Australian government. As such, there will also be an increase in the perception of sovereign risk in doing business in Australia.