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EY Submission on Treasury paper "Cross-border profit allocation - review of transfer pricing rules"

Dear All

We appreciate the opportunity to comment on issues related to the timing of implementation of the OECD recommendations, guidance that may be required from the ATO on the uptake of these recommendations relating to the BEPS action items 8-10 agreed to by the G20 ("the recommendations"), as well as any unintended consequences that may need to be addressed. However, before addressing these issues, it is important to set out the context in which we provide our comments.

Transfer pricing rules clearly play an important part in ensuring Australia receives an appropriate share of tax from multinational firms. Adopting the new OECD guidance may well ensure that Australia continues to have best practice transfer pricing rules to help ensure that multinationals adhere to the arm's length principle when attributing profits in connection with their international related party arrangements. However, it is also important that these rules are applied appropriately and consistently by revenue authorities to ensure that multinationals are not subject to double taxation or excessive administrative burden. Double taxation clearly needs to be avoided from an overall fairness perspective but also to minimize the resulting negative impact on global investment.

Therefore we are concerned that if Australia adopts the recommendations before these have been adopted by other G20 countries, notably Australia's key trading partners, this will magnify the risk of tax controversy and double taxation in relation to transfer pricing issues involving Australian transactions.

Getting the balance right in setting and implementing the rules is now more important than ever given the increased interaction of tax-related requirements and obtaining approvals for foreign investments into Australia. The need for a balanced approach has been heightened by the Federal Treasurer's recent introduction of additional tax-related requirements on Foreign Investment Review Board (FIRB) approvals for multinational entities' foreign investment into Australia. These include the prospect of Advance Pricing Agreements and other tax sign-offs, which magnifies even further the need for Australia to be "in the pack" on the adoption of the 2015 OECD recommendations.

We appreciate that the public sentiment puts immense pressure on both Treasury and the ATO to be seen doing everything in their power to protect Australia's tax base. But public sentiment is strong also on securing Australia's future by being "open for business", attracting investment and driving innovation due to well understood link to employment opportunities, job security and prosperity. The implementation and application of the transfer pricing rules (and other tax rules) must have regard to both. This does not mean a relaxed approach to applying the rules for foreign investors, but it does require a fair, consistent and timely application of those rules.

Our responses to your specific consultation questions outlined in the Attachment can be encapsulated in the following considerations:

- Delay incorporation of the recommendations set out in the 2015 OECD report until complete and formal OECD guidelines have been issued.
- Defer the "1 July 2016 start date" to ensure a greater consensus and agreement between Australia and its major trading partners.
- Incorporate the guidance by regulation as an appropriate and efficient alternative to legislative amendment. If incorporated by regulation, it would be helpful to clarify the interaction between the OECD Guidelines, the wording of section 815-130 and the parliamentary intent in relation to the reconstruction of related party transactions.
- Establish an Independent Review Panel that specifically focuses on the application of the reconstructive powers in the Australian transfer pricing provisions and the OECD guidance on reconstruction to ensure their consistent and appropriate use.

We would be pleased to discuss any of our comments with you, and continue to participate in the consultation process around these important measures.

Please contact Paul Balkus on (02) 9248 4952 or Jean-Paul Donga on (03) 9288 8065 if you would like to discuss any of the issues outline in the Attachment.

Yours sincerely

Paul Balkus
Partner, International Tax – Transfer Pricing

Attachment

Attachment: EY's response to the Consultation Questions

The responses in this attachment address the specific questions in the consultation paper issued on 11 February 2016 which seeks stakeholder views on adopting the new OECD guidance in the context of the Australian tax system, particularly in addressing issues related to the timing of implementation of the recommendations, guidance that may be required from the ATO on the uptake of the recommendations, or any unintended consequences that might need to be addressed.

Question 1:	Would there be any significant unintended consequences for Australia if these recommendations are incorporated as relevant guidance for the purposes of applying Division 815 of the ITAA 1997?

Australia's transfer pricing legislation specifies that it is to be interpreted 'as best to achieve consistency' with the OECD's Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations as last updated in 2010. Therefore, at a high level there should not be any significant unintended consequences for Australia if these recommendations are incorporated into existing transfer pricing guidelines.

However, we note that the OECD guidance and recommendations are not yet complete. In particular, the clarification and strengthening of the guidance on transactional profit splits is not yet ready for inclusion in the Transfer Pricing Guidance. Together with the development of useful illustrations of the situations in which transactional profits splits can reliably be applied and how they can be applied to produce arm's length outcomes this is an important piece in the puzzle to make the rules work in practice. Draft guidance is to be developed by WP6 during 2016 and expected to be finalised in the first half of 2017.

It has always been the objective that the changes made to the OECD guidelines should be applied holistically (i.e. the various aspects of transfer pricing need to be considered in their totality and not in isolation). It has also been the stated objective that changes to the guidelines should be universally adopted.

Therefore we are concerned that if Australia adopts the recommendations before these have been adopted by other G20 countries, notably Australia's key trading partners. Early adoption will magnify the risk of tax controversy and double taxation in relation to transfer pricing issues involving Australian transactions and create an excessive administrative burden on taxpayers.

On 22 February 2016 the Federal Treasurer introduced additional tax-related requirements on Foreign Investment Review Board (FIRB) approvals for multinational entities' foreign investment into Australia. We note that these include for perceived higher risk transactions the prospect of Advance Pricing Agreements and other transfer pricing adjustments, which magnifies even further the need for Australia to be "in the pack" on adoption of the recommendations but not to be a front-runner.

Therefore it may be prudent to delay incorporation of the recommendations set out in the 2015 OECD report until complete and formal OECD guidelines have been issued. This would avoid any potential inconsistencies that could arise between what is currently being recommended and what is ultimately included in the final OECD guidelines and help to ensure the guidelines have also been adopted by other G20 countries..

Question 2: Are there any significant challenges with commencing the new Guidance for income years starting on or after 1 July 2016?

The Government is proposing to amend Australia's domestic transfer pricing law to incorporate recent recommendations with probable application to income years starting on or after 1 July 2016. To incorporate the OECD changes into domestic transfer pricing law, it will be necessary to either amend section 815-135(2)(a) or prescribe a document by regulation.

Australia's rules are deliberately drafted in a way to allow the incorporation of the latest Transfer Pricing Guidance with relative ease whilst preserving parliamentary scrutiny safeguards. We would expect the changes to have bipartisan support.

Other countries may not be able to implement the changes as quickly as Australia or may not have the political will to act immediately. In particular, there are major economies such as the USA and China that have not adopted the current OECD guidelines given their reluctance to delegate or undermine their local taxing powers. This could result in different rules being applied by tax authorities, which can potentially result in double taxation.

We reiterate our concern that if Australia adopts the recommendations before these have been adopted by other G20 countries, notably Australia's key trading partners, this will magnify the risk of tax controversy and double taxation in relation to transfer pricing issues involving Australian transactions.

Clearly such a result is not in the best long term interest of Australia. As such, the need for global coordination on implementation dates is paramount.

Therefore, in may be prudent to defer the "1 July 2016 start date" to align timing and ensure a greater consensus and agreement between Australia and its major trading partners.

Question 3: It is envisaged in section 815-135 of the ITAA 1997 that documents to be relied upon in applying Australia's transfer pricing rules can be prescribed by way of regulation. Are there any reasons why regulation (as opposed to legislative amendment) is not the appropriate method for incorporating the recommendations contained within the 2015 OECD report

The OECD changes can be incorporated into domestic transfer pricing law either by amending section 815-135(2)(a) or prescribing a document, such as the 2015 OECD Report by regulation. We see no reason to prevent the use of regulation to implement the recommendations.

Incorporation by regulation is appropriate and efficient. If incorporated by regulation it would be helpful to clarify the interaction between the OECD Guidelines, the wording of section 815-130 and the parliamentary intent in relation to the reconstruction of related party transactions.

Question 4: What new ATO guidance / explanatory materials do you think the ATO will need to prepare (and what existing ATO guidance / explanatory materials will need to be updated) if the changes by the 2015 OECD Report are adopted?

In addition to new specific and general anti-avoidance rules and principal purpose tests in treaties, Australia has also modernized its transfer pricing rules to combat perceived abuses by some multinationals.

The legislative changes to the transfer pricing provisions give the ATO significant power in determining the appropriate attribution of profit of multinational companies and give significant responsibility to ATO resources as to how and under what circumstances these broader powers should be applied.. A specific example of these broader powers under the transfer pricing rules is the ATO's ability to reconstruct taxpayer transactions. Under OECD guidelines, tax administrations may appropriately disregard transactions when the exceptional circumstances of commercial irrationality apply. Arguably, these reconstruction powers are broader under Australian transfer pricing rules. However, in either case, it is important to avoid the inappropriate application of these reconstruction provisions in ways that do not align with the OECD's "exceptional circumstances" threshold.

Australia does not benefit from the inappropriate application of these broader powers or the delays that the use of such powers can create when taxpayers are subject to ATO compliance related activities. The inappropriate application of these rules may result in double taxation which in turn could have a negative impact on foreign investment into Australia.

Therefore, it is recommended that an Independent Review Panel be established that specifically focuses on the appropriate application of these reconstructive powers. It should be noted that the Panel should not deal with pricing of transactions, but should focus solely on objectively assessing the nature of the commercial financial arrangements between related party with a view to whether it is appropriate to modify, disregard or maintain what has actually occurred between the parties. The creation of this panel should ensure consistency, avoid uncertainty and maintain confidence of companies in the integrity of the Australian taxation system. This should in turn help maintain Australia's reputation as a fair and reasonable country that is truly "open for business".