wts TAX LEGAL CONSULTING

By email

Division Head
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The Treasury
Langton Crescent
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Email: beps@treasury.gov.au

25 February 2016

Dear Sir/Madam,

Submission: Cross-border profit allocation - review of transfer pricing rules

We welcome the opportunity to provide our comments in response to the consultation questions raised in the treasury consultation paper titled "Income Tax: cross-border profit allocation - review of transfer pricing rules" released on 16 February 2016.

WTS Australia is a member firm of WTS Alliance, a global network of specialist tax, legal and consulting firms in over 100 countries. We provide tax and advisory services for multinational, listed public companies and major internationally active medium sized companies.

Please find our submission attached in Appendix A.

If you have any questions regarding our submission, please contact Sharon Arasu-Koh or myself on 03 9939 4488.

Yours sincerely

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Appendix A
Cross-border profit allocation - review of transfer pricing rules
WTS Australia Submission

We set out below our comments in relation to each of the consultation questions raised.

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?

1.1 The consultation paper is recommending that changes be made to the Australian transfer pricing rules in Division 815 to bring the 2015 OECD Report recommendations (**2015 guidance**), expected to be released sometime this year within these rules.

1.2 We believe that this of itself is not controversial, since the current rules already require compliance with the 2010 OECD guidelines. However, we wish to highlight areas of concern relating to the following proposed changes.

1.3 ***"Control of risk" requirement***

1.4 Division 815 requires the taxpayer to assess its transfer pricing positions having regard to substance and value creation over the form of the transactions, which makes it broadly in line with the recommendations in the OECD action plans. However, the OECD recommendations as they stand focus largely on capturing and valuing risk, but only where that risk is capable of being controlled by the taxpayer and that control is demonstrated.

1.5 We suggest that there are two primary issues with this approach when it comes to the assessing arm's length principle and outcomes:

(1) The focus on risk might be considered a change to the nature of the "functional analysis" process for determining the degree of comparability, by increasing the importance of risk and decreasing the importance of the actual functions performed and assets employed, which goes against commonly accepted transfer pricing practices (albeit an unintended consequence).

(2) The level of control to satisfy these requirements - does a taxpayer look at who makes the decisions on a daily basis vs who signs-off on the decision? Which function would be considered to be exercising control?"

1.6 Should the 2015 guidance be applied as it stands, there is a risk that entities performing functions that are necessary and, arguably, significant in driving overall value may not receive an appropriate or commensurate return if the control of risk cannot be demonstrated.

1.7 In some cases, the increased importance of being able to control risk could result in a change in the weighting of elements in a functional analysis exercise away from functions performed/assets employed towards risks assumed and, accordingly, a change in the value of contributions made by Australian taxpayer entities. This could also have an adverse effect on revenue.

1.8 While it is accepted that the OECD's recommendations are targeting transactions which artificially separate the "in substance" control of risk from the contractual allocation of risk, the way the guidelines are drafted imply that contractual allocations are only respected (and therefore priced) where the party assuming the risk is not only able to control the risk but also has the financial capacity to assume the risk (with other factors, including functions actually performed, carrying less weight). This may prove difficult to demonstrate when related entities may also be required to be a party to contractual arrangements jointly and severally.

1.9 Group financing entities

1.10 The control of risk requirement could have consequences for group financing entities that are typically established to secure liquidity and optimise funding and interest outcomes for group members. Under the 2015 guidance, such entities would be entitled to no more than a risk-free return, even though they arguably perform a significant function in providing and managing working capital and investment requirements for a region/business division, which in turn drives profit outcomes for those businesses.

1.11 Ability to use ex-post outcomes to evaluate ex-ante pricing arrangements in hard to value intangibles

1.12 The OECD recommendations suggest that tax administrations may use hindsight when evaluating taxpayer transfer pricing positions, which would have been made at the time of the transaction, and the onus would be on the taxpayer to defend the assumptions relied upon.

1.13 Giving the ATO the ability to use hindsight to evaluate ex-ante pricing arrangements is unfair and could lead to tax adjustments that are not based on the commercial reality of pricing a transaction contemporaneously, being inconsistent with the requirement that transfer prices are evaluated and documented contemporaneously. The mismatch of information being relied upon to evaluate the same transaction (in such cases, likely to be weighed in favour of the Commissioner) could result in tax adjustments that do not reflect the actual and arm's length conditions that existed at the time of the transaction.

1.14 Cost contribution arrangements (CCA)

1.15 The 2015 guidance suggests requiring contributions to a CCA to be measured at value rather than at cost (the current position). Although there would be an exception for pre-existing intangible assets, there is some concern about needing to value on-going payments at market value instead of cost (when, realistically, third-party examples of CCAs, for example in the biotech/pharma industries measure contributions at cost).

1.16 For example, in the case of CCAs for the joint development of intangible assets, depending on the stage of development, we query how the ongoing future benefits to the participants would be valued (prior to commercialisation) and how using an arbitrary measure of "value" is more consistent with the arm's length principle than valuing contributions on a cost basis (which is measurable and transparent).

1.17 In our view, a key risk area with the proposed changes to CCAs is the contribution of pre-existing intangible assets at cost for which a market value may be readily ascertainable (or, at least, not subject to so many variables so as to render a valuation artificial and not in accordance with the arms' length principle).

1.18 If this measure is to be incorporated in Division 815, we would recommend that it is limited in application to the transfer of pre-existing intangible assets (for CCAs relating to development). For CCA's relating to the provision of services (i.e. current and ongoing benefits) we would suggest that existing CCAs are grandfathered, to limit impacts to existing CCA arrangements.

1.19 As one of the purposes of BEPS is to prevent the artificial avoidance of tax by shifting intangibles at less than market value, we recommend that consideration be given to implementing a threshold value for CCAs, to ensure these arrangements achieve the BEPS intended outcome while still remaining commercially viable tools.

1.20 As an aside, we note that CCAs are generally based on costs (hence the term "cost" in the title) so the proposed change to "value" is a significant change in both concept and terminology.

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

2.1 We believe there are significant challenges with commencing the new Guidance for income years starting on or after 1 July 2016 as the change in position with respect to control of risk is a major change that has far reaching consequences for a range of taxpayers (including those for whom the separation of holding and development of intellectual property has been structured for commercial reasons other than tax efficiencies and for whom these changes may result in unintended and/or artificial profit allocations, i.e. that exact problem the Guidelines were designed to counter).

2.2 A start date of 1 July 2016 gives taxpayers insufficient time to review their existing contractual obligations and (a) evaluate if a change in contractual obligations is necessary and commercially practical and, if so (b) to implement any necessary changes. Overarching this is the potential need for an entity to review its profit allocations (even where functions performed have not changed) if the entity assuming the risk is unable to demonstrate independent financial capacity to do so (which hasn't been required previously).

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.

3.1 We believe the changes to Australia's transfer pricing rules should be addressed by way of regulation, to allow for adoption of some of the Guidelines (noting our concerns above) and also to allow for changes to OECD positions (given the Guidelines have not yet been released at this stage and further work is likely to be done in the area of measuring and valuing intangibles).

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?

4.1 In our view, new ATO guidance/explanatory materials would need to be prepared to address the following:

- What factors will indicate financial capacity to assume risk? Does the entity have to demonstrate that it may independently assume the risk (e.g. without financial guarantees, etc.) or would the presence of financial support (implied or explicit) be viewed as a negative factor?
- What factors are relevant for assessing control of risk, particularly in the context of decentralised business functions or joint control of risk?
- Valuation concepts/shortcuts that may be applied for CCAs.
- Pre-existing arrangements and administrative concessions.