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Modernisation of the Transfer Pricing Rules

The Corporate Tax Association welcomes this opportunity to comment on the Exposure Draft (ED) and accompanying Explanatory Memorandum (EM) which set out the proposed amendments to Australia's transfer pricing rules.

As announced by the Hon Bill Shorten MP on 1 November 2011, the purpose of the proposed amendments is to modernise the transfer pricing rules contained in Australia's domestic law by ensuring that they better align with the international standards set out by the Organisation for Economic Co-operation and Development (OECD). On this point we acknowledge and appreciate Treasury's comments at the transfer pricing meeting on Friday 7 December that the proposed amendments as set out in the ED are aligned with Minister Shorten's announcement in that they are intended to do nothing more than ensure that the outcomes under Australia's transfer pricing rules are the same as those that would arise if one went directly to the OECD's Transfer Pricing Guidelines (the Guidelines).

It is with these points in mind that we make the following comments.

Insertion of the OECD Guidelines into the domestic law

The following is an extract from the CTA's submission dated 30 November 2011 on the Consultation Paper entitled Income tax: cross border profit allocation – review of the transfer pricing rules (1 November 2011):

> "The CTA would not see anything objectionable in principle about giving consideration to importing the OECD Guidelines into the Australian law**, provided what is reflected in our laws are the OECD Guidelines and not some modified version that reflects the ATO's (or Treasury's) views about what they should say**."

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Sec 815-125 of the ED explicitly focuses on concepts that Treasury considers important, most notably the meaning of 'arms-length conditions' and the relevance of economic substance. This approach places undue emphasis on Treasury's interpretation of the Guidelines, rather than on the Guidelines themselves.

The dangers associated with this approach are clearly illustrated by sec 815-125(5) to (8), which appear to leap straight in to allowing the ATO to reconstruct a transaction actually entered into where it believes that independent entities dealing wholly independently with one another would not have entered into such a transaction. Under the OECD Guidelines, reconstruction of transactions by tax authorities is only allowable in exceptional circumstances and only after a thorough examination and application of recognised transfer pricing methodologies to determine what parties dealing with other at arms-length would have done. The absence of the 'exceptional circumstances' requirement from the ED has the effect of playing down the importance of applying the reconstruction powers as a last resort. This is exactly the kind of outcome that the CTA was referring to in its earlier submission on this point.

What should be reflected in our domestic law are the Guidelines as they stand, subject to sec 815-130. Any attempt to unpack the Guidelines as done in sec 815-125 will be susceptible to the problems outlined above and as such will go beyond the stated policy intent of reflecting the OECD guidelines in the domestic law.

On sec 815-130, subsection (1) states that Sub-division 815-B is to be interpreted as to best achieve consistency with the OECD commentary (except where the contrary intention appears). These words in brackets need to be removed for the following reasons:

- The words in themselves suggest that there is a contrary intention (which there may well be when you look at sec 815-125 and its misalignment with the Guidelines as set out above).
- The words may be relied upon by the ATO to exclude parts of the Guidelines that do not suit the particular circumstances of the case.
- The provision already provides for the exclusion of OECD Guidance where appropriate via Regulations (subsec 815-130 (30 and (4)).

The 'Exceptional Circumstances' Test

In addition to the comments above, we note that the reference in the Guidelines to 'exceptional circumstances' when considering the limited circumstances in which reconstruction should apply is recognised and adopted in the EM accompanying Sub-division 815-A. We also note paragraph 18 of Taxation Ruling TR 2011/1 (application of the transfer pricing provisions to business restructuring by multinational enterprises):

> "However, in the **exceptional case** where it is not possible or practicable to achieve an arm's length outcome in this way, the ATO considers that it may apply the transfer pricing provisions to adjust the consideration receivable or payable by the taxpayer

> by reference to an agreement that might reasonably be expected between independent parties dealing at arm's length in comparable circumstances."[1]

Recognition of the limited or exceptional circumstances in which reconstruction should apply should be reflected in the proposed Sub-division 815-B, as it is in the EM to Sub-division 815-A and TR 2011/1.

Amendment of Assessments

Under sec 815-145 the ED proposes an amendment period of eight years for transfer pricing adjustments. Although we recognise that transfer pricing reviews can be complex and time consuming, the same can be said about many other areas of the tax law. There are also a number of other reasons why the time limit for making transfer pricing adjustments should be aligned with the general four year period:

- The ATO's current practice of carrying out risk reviews in real time;
- The introduction of the International Dealings Schedule;
- The introduction of the Reportable Tax Positions (RTP) Schedule;
- The ATO's Pre Compliance Review product; and
- The Commissioner's power to extend time periods beyond the prescribed time where an investigation has commenced but is not yet completed.

These factors strongly indicate that the time limit for transfer pricing adjustments should be aligned with the general law.

Record Keeping Requirements

We understand that Treasury has indicated that the objective of the proposed record keeping requirements was to legislate the ATO's current administrative practices around penalties and documentation for transfer pricing.

The record keeping requirements as set out in Sub-division 815-D impose a statutory regime that is far more onerous and adverse to taxpayers than the current regime. Under the current regime, where documents are rated medium to high by the ATO, where the taxpayer has been open and transparent in its dealings with the ATO, the Commissioner may remit penalties to nil. The proposed rules, which state that **all** requirements and conditions must be met in order for taxpayers to be able to establish a reasonably arguable position, sets a much higher bar.

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[1] The reference in paragraph 18 of TR 2011/1 to "in this way" is reference to determining the arm's length consideration by applying the most appropriate arm's length pricing method using available reliable data relating to an agreement between independent parties dealing at arm's length for a comparable transaction in comparable circumstances.

On documentation, the proposed requirement that taxpayers keep records that adhere to sec 815-305 before the time by which it lodges its tax return is ambitious to say the least. The reality is that the majority of large corporates simply don't have the resources to meet the stated requirements, particularly those set out in subsec 815-305(4). For those few that might be able to comply with sec 815-305 in its entirety, it would come at an enormous and disproportionate cost. We understand that the ATO has in the past adopted a reasonably flexible approach to documentation, particularly in circumstances where there is no material change to the transaction from year to year. Assuming our understanding of Treasury's intention as outlined above is correct, the proposed statutory rules need to be wound back considerably if they are to resemble the ATO's current administrative practices. In the context of the ATO's current administrative practices, a carve out for documentation requirements for APA participants should also be considered.

Taxation Ruling TR 1999/1

Also on record keeping, we note that many multinationals currently rely on the administrative practices for 'non-core' services outlined in paragraphs 75 to 102 of TR 1999/1. In particular, where an Australian entity acquires or supplies services that are not integral to the profit-earning activities of the group, it does not need to apply the accepted arms-length methodologies in order to establish an arm's length price for the non-core services. Rather, it can rely on the arm's length transfer prices as specified by the Commissioner in TR 1999/1 (e.g. cost + 7.5%).

It is not clear from the ED or the EM whether taxpayers will be entitled to rely on this administrative practice going forward. We are concerned that the removal of this administrative practice will result in a substantial increase in compliance costs for taxpayers in respect to low value/low risk internal services. In order to reduce this risk and provide taxpayers with greater certainty, we propose that the administrative practices currently provided for in paragraphs 75 to 102 of TR 1999/1 be incorporated into the ED in some form. These administrative practices could be incorporated through the inclusion of statutory safe harbours in respect of non-core services. These statutory safe harbours should operate to deem the arm's length conditions of an arrangement to be the same as the actual conditions of the arrangement, where the pricing for the arrangement is within a specified range.

De Minimis Thresholds

The compliance costs associated with mandatory record keeping for transfer pricing purposes are significant and transfer pricing reviews are usually a very costly and time consuming exercise for both the taxpayer and the ATO. On this basis, any annual statutory de minimis threshold should be set at a level that carves out related party cross border dealings that involve transactions that do not pose a material threat to the revenue. The proposed de Minimis thresholds in sec 284-165, which relate to penalties and therefore assume all taxpayers with related party cross border dealings have already run the gauntlet, do not address the need for a legitimate transfer pricing carve out.

In our view, the de minimis threshold for the transfer pricing rules should be set at $10m in related party cross-border dealings before taxpayers become liable for transfer pricing adjustments (or examinations). A true de minimis exemption should also incorporate a test which relieves the documentation requirements where a single transaction is not material – perhaps using a similar threshold to the RTP schedule.

As stated in our earlier submission, ATO and business resources should not be applied to chasing down non-material amounts of potential revenue.

Customs issues

Sub-division 815-A encourages the Commissioner to particularise a transfer pricing adjustment so that a taxpayer can apply it to income or deductions as appropriate. This requirement should be reflected in the proposed Sub-division 815-B, particularly given that the Customs valuation arrangements are very much transactions based. Where a taxpayer is required to adopt the profit allocation method, every effort should be made to translate that into a pricing adjustment for the actual transactions entered into to ensure consistency between the transfer pricing and Customs outcomes.

Please feel free to give me a call should you wish to discuss any aspect of this submission further.

Yours sincerely,

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