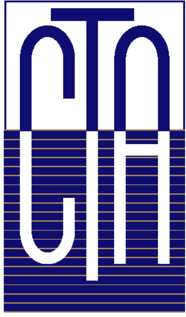

Response to Exposure Draft
Tax Laws Amendment (2012 Measures No.3)
Bill 2012: Cross-border transfer pricing

Corporate Tax Association of Australia Inc.

13 April 2012

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Exposure Draft – Tax Laws Amendment (2012 Measures No. 3) Bill 2012
Cross-border transfer pricing

In providing its comments on the above Exposure Draft, the Corporate Tax Association (CTA) wishes to reiterate its strong opposition to the retrospective nature of these proposed amendments. As we explained in our submission of 30 November 2011, these amendments will put new powers into the hands of the Commissioner and have the potential to severely disadvantage taxpayers who have applied the law in accordance with a consistent line of court decisions about the nature and operation of our tax treaties.

It is most disappointing that our objections (and those of other parties) have been met with not much more than the repeated assertion that the proposed new law merely 'clarifies' what was always the intention of the Parliament. Other than comments from senior ATO officials (who administer but don't make the law) there is scant evidence of any such intention. And even if there were, the court decisions referred to in our earlier submission suggest that any such intention was never in fact achieved. Taxpayers are entitled to rely on the law as it has been consistently interpreted by the courts over many years, and retrospective changes like this can only erode business confidence in Australia's revenue laws.

Moreover, there are serious doubts whether enshrining the OECD Transfer Pricing Guidelines and the OECD Model Treaty into the domestic law will result in any greater certainty for taxpayers or the ATO. India and other developing countries have recently rejected the OECD Guidelines, which they assert unduly reflect the interests of developed countries, and have advocated the development of separate UN Guidelines.

Outside of the competent authority process the US requires its administrators to follow US regulations and not the OECD Guidelines. And even where countries do follow the OECD Guidelines, they are not black letter law and are subject to a range of different interpretations. In our view, is must be likely that the proposed new law will lead to less rather than more certainty about transfer pricing outcomes.

Having said all that, we offer the following comments on the Exposure Draft in the spirit of helping to ensure the law gives effect to the government's announcements.

Profits based approach vs. underlying transactions

Following a number of consultation meetings, as well as previous submissions made, Treasury will be well aware of business concerns about the interaction between the transfer pricing rules and Customs valuation rules. In relation to imported goods, there is a tension between the two, in the sense that tax administrators would be concerned that the price goods imported from a foreign associate may be overvalued, while Customs officials would be concerned that those goods may be undervalued. Where the ATO rules that the imported goods were overvalued, the taxpayer should not then also be liable to import duty on the higher unadjusted amount.

To the extent that the new transfer pricing laws lead to an increase in income tax adjustments that are based on profits allocation methods, business is concerned that it will not always be clear to what extent any increase in taxable income is attributable to a downward adjustment in the price of goods supplied by a foreign associate. Any adjustment made could equally be attributable to something else (for example, the fee for prosecuting a long-term strategy of building market share mentioned in the ATO's Decision Impact Statement in respect of the *SNF* decision).

Aside from the Customs issue, many multinational enterprises have dealings with associates in a number of other jurisdictions. In order to avail themselves of correlative relief where appropriate, they will need to know which part of the transfer pricing benefit identified by the ATO relates to dealings with associates in which other treaty country or countries. The nature of any adjustment made may also have flow-on effects under the domestic tax laws, for instance in relation to withholding tax obligations or capital gains tax.

We note that draft secs 815-30(1) and (2) provide that the Commissioner *may* make a determination about the composition of a transfer pricing benefit he has identified (by indicating particular adjustments to assessable income or deductions, or capital gains or losses). In order to enable affected taxpayers to work through all the implications of a transfer pricing adjustment under the new provisions we would suggest that taxpayers be given a reviewable right to request a draft sec 815-30(2) determination (particularising the transfer pricing adjustment) in the same way that an entity can request a compensating adjustment in draft secs 815-45(4) and (8).

Better harmonising tax and Customs valuations

More broadly, we note that despite various efforts made over a number of years to achieve better alignment between income tax and Customs valuations in respect of the same imported goods, very little progress has so far been achieved. The CTA appreciates there is an inherent inconsistency between profits based and transactions base methods. Given that we are likely to see an increase in profits based transfer pricing adjustments if the draft legislation is passed, however, it is in our view imperative that a more effective mechanism be developed for harmonising the two where possible.

Thin Capitalisation

We support the inclusion of a provision that clarifies the way in which the thin capitalisation regime interacts with the transfer pricing rules – in particular draft sec 815-22(4)(b), which refers to applying the appropriate interest rate to the actual debt. However, there are references, in draft secs 815-22(4)(b) and (5) to the *value* of the debt interest. This may lead to confusion about what the provision is intended to achieve, and the word *value* might be replaced with *amount*.

We think that draft sec 815-22(5) is potentially misleading and should be deleted. The draft Div 815 is intended to insert the OECD Guidelines and the OECD Model Treaty into the domestic law. The OECD materials are what they are, and if the government's aim is for the Australian law to be aligned with OECD principles, that is all the legislation needs to say. Providing one view on the operation of the OECD principles (which is not accepted by many practitioners) risks having Australian law deviating from OECD principles and frustrating the stated policy intention of the government. For the same reason, Example 1.4 in the draft EM should be deleted.

Guidance Material

While we can appreciate the need for a degree of flexibility in the reference to guidance material (in draft sec 815-25), including through the use of regulations, we are concerned that draft sec 815-25(3) would enable regulations to specify "different documents or parts of documents for different circumstances". This provision would seem to open the door to elevating ATO documents as relevant documents in the context of the main operative provision of draft sec 815-22(3). That would be highly inappropriate in the CTA's view, given the highly contentious position at times adopted by the ATO in discussion papers (for example, the early version of the ATO's discussion paper on the interaction between the transfer pricing rules and the thin capitalisation rules).

Also, it is sometimes necessary and appropriate to refer to an entire document (or at least other relevant parts of a document) in order to see a particular part of it in its proper context. We appreciate that regulations may be disallowed by the Senate, but nevertheless it would be preferable if at least the explanatory material made it clear that this provision is not a licence for the revenue authority to introduce its own documents.

Validity of Determinations

Draft secs 815-30(6) and 815-45 (6) provide that determinations about transfer pricing benefits and consequential adjustments will be valid notwithstanding the Commissioner's failure to give the relevant entity a copy of the determination. It is hard to understand how a taxpayer would go about discharging the onus of proving that the amended assessment is excessive in such circumstances. Surely the taxpayer should not be put to an unfair disadvantage because of a failure by the Commissioner to act appropriately in administering the law.

Time limits for amendments

We understand the UK has six year statute of limitations from the end of the tax year. That would mean that compensating adjustments under a MAP process would not be available earlier than 2006, which could result in double taxation in respect of earlier years.

While we remain strongly of the view that the new law should be totally prospective in its application, if the government is determined to press ahead with retrospective changes, the ATO should have a period of no more than four years from the start date of the new law in which to raise retrospective amendments. The ATO should also set out in detail how it proposed to conduct MAP proceedings once the new law comes into effect.

Penalties

The legislation should provide taxpayers with explicit protection from penalties where they have acted on the basis that the Treaties do not confer a separate head of taxing power. Taxpayers who have made a genuine effort to price transactions actually entered into using, for example, the four step process set out in TR 98/11 should not be subject to administrative penalties where the Tax Office makes a transfer pricing adjustment based on a profits allocation method or recharacterises transactions actually entered into.

Impact of the new law

It is clear from government announcements that the draft law has been developed to overcome the Federal Court's decision in *SNF.* We would like to see the EM explain how the outcome of that case would have been different under the OECD Guidelines. The evidence as summarised by the Full Court suggests the taxpayer's poor profit performance over a period of many years was due to a variety of factors other than the prices paid for goods acquired from foreign associates (in fact, the Australian taxpayer was charged less for its supplies than independent third parties).

We think it is highly likely that even under the draft new law a court would have held that the transactions actually entered into were sufficiently comparable to those the foreign associate entered into with third parties, and hence that a profits based method of determining the arm's length price would not have been appropriate. If the government has a contrary view, setting that out in the EM will give taxpayers and the courts a better understanding of the new law.

Other concerns

There was a discussion at the 4th April 2012 consultation meeting about the impact of the global financial crisis on some related party loans. While the OECD Guidelines make it clear that in general actual transactions entered into need to be respected and revenue authorities should only recharacterise actual transactions in exceptional circumstances, we are concerned that the ATO may seek to recharacterise certain related party debt transactions that were implemented during the GFC.

For a period from late 2008 the global banking system came under severe pressure, with the outcome that many banks virtually stopped lending – particularly to business. At that time there were a number of cases where businesses that were inherently profitable were unable to obtain bank finance at any price. Some of them were able to raise equity capital from investors while others received government support. In the case of some wholly owned Australian subsidiaries of global firms, bank funding was replaced or supplemented by related party debt. All of these interventions were carried out for sound commercial reasons and in many cases enabled those businesses to survive and continue to provide employment for many people.

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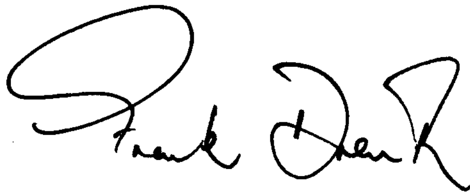
We think it would be beyond anything envisaged under the OECD Guidelines for a revenue authority to argue that parties acting at arm's length would not have entered into the relevant loan transaction at all and therefore the actual debt transaction should be recharacterised as quasi equity. To be fair, we haven't heard about the ATO pursuing this kind of argument as yet, but there is a concern they may not rule it out under the new law.

Yours sincerely,



(Frank Drenth)

Executive Director
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