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The Manager
International Tax Integrity Unit
The Treasury
Langton Crescent
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13 April 2012

Dear Sir

Re: Comments on Exposure Draft legislation on cross-border transfer pricing

Deloitte welcomes the opportunity to comment on the Exposure Draft of *Tax Laws Amendment (2012 Measures No.3) Bill 2012: Cross-border transfer pricing*.

1. Introduction

We refer to our comments dated 30 November 2011 on the proposal to amend the transfer pricing rules as set out in the Consultation Paper *"Income tax: cross border profit allocation - review of transfer pricing rules"* and the Assistant Treasurer's associated Media Release of 1 November 2011.

We reiterate our previous comments that legislative amendments to retrospectively allow the Commissioner to raise transfer pricing adjustments on treaty law as an alternative to domestic law raises very serious issues of fairness and arbitrariness in the application of Australian international tax laws. For reasons previously stated, we do not consider these amendments necessary, appropriate or fair to taxpayers, and maintain our view that they should not be made. If the Government nevertheless decides to pursue these amendments, we consider that the issues we have previously raised, as well as those discussed below, should be taken into account in ensuring the amendments are as appropriate, fair and consistent as possible with the existing law.

2. Linking adjustments to transactions

In our view, the current drafting of Subdivision 815-A does not appropriately require that an adjustment under it be linked to an item of assessable income, deduction or capital gain/loss in respect of a particular transaction or transactions.

Subsection 815-30(1) authorises the Commissioner to make determinations to subject a transfer pricing benefit to tax by increasing an entity's taxable income, decreasing its tax loss, or decreasing its net capital losses. According to paragraph 1.53 of the Explanatory Memorandum to the legislation, a determination under subsection 815-30(1) only contemplates an overall adjustment to an entity's taxable income, tax loss or net capital losses, and this determination does not impact on how the entity is treated by other areas of the tax law because the determination does not apply to individual items of the entity's assessable income, particular deductions or particular capital gains/losses. Subsection 815-30(2) provides for the making of a further determination attributing the adjustment under 815-30(1) to a particular

amount of assessable income, deductible expenditure or capital gain/loss. However, there is no requirement to make a determination under 815-30(2) except in respect of an entity's debt deductions where Division 820 applies. Thus, 815-30 gives the Commissioner a general discretion to make an adjustment to taxable income without being required to specify what particular item of income, expenditure or capital gain/loss is affected.

The potential problems this can cause for an affected taxpayer can best be illustrated by an example. Say the taxpayer has various categories of cross-border dealings, including trading stock purchases, with numerous related parties resident in numerous offshore jurisdictions. The ATO conducts an audit and makes an adjustment under s.815-30 applying a transactional net margin method on a whole of entity basis. The issues raised for the taxpayer by its lack of knowledge of the basis for the adjustment, if the Commissioner in this case does not make determinations under s.815-30(2) attributing the adjustment to particular items, include:

- The extent to which the adjustment is referrable to an applicable Associated Enterprises Article for purposes of s.815-22 and knowing whether the adjustment relates to a "transfer pricing benefit" as defined for Subdivision 815-A, so that the Commissioner has authority to make the adjustment under that provision ;
- The extent to which the adjustment is referrable to an applicable Associated Enterprises Article for purposes of requesting correlative relief or Mutual Agreement Procedure under that treaty;
- The extent of the effect of the adjustment, if any, on the treatment of deductions for trading stock under other provisions of the Act;
- The extent of the effect of the adjustment, if any, on the valuation of the trading stock purchases for other purposes, eg. customs duties payable.

In our view the Commissioner should be required in all cases to identify and characterise what specific item is being adjusted so as to link that adjustment to the other provisions of the Act. We recommend that s.815-30(2) be amended to require that the Commissioner make determinations in all cases attributing the adjustment under 815-30(1) to a particular amount of assessable income, deduction or capital gain/loss.

Requiring the Commissioner to identify the particular item(s) to which the profits that are subject to a s.815-30 adjustment are attributable would accord with subsection 815-22. Subsection 815-22 essentially defines "transfer pricing benefit" as an amount of profits within the meaning of the applicable treaty article, interpreted so as to best achieve consistency with the OECD Model Tax Convention and the OECD Transfer Pricing Guidelines. Both the Commentary to Article 9 of the OECD Model Tax Convention and the Transfer Pricing Guidelines make clear that the amount of "profits" to which Article 9 applies is determined by reference to transactions. Thus, for instance, paragraph 1 of the Commentary to Article 9 states:

"This Article deals with adjustments to profits that may be made for tax purposes where transactions have been entered into between associated enterprises (parent and subsidiary companies and companies under common control) on other than arm's length terms."

In accordance with this, the Guidelines recognise five arm's length pricing methods to be used in applying Article 9, with these methods categorised as "traditional transaction methods" and "transactional profit methods". Under the Guidelines, the comparability analysis prescribed for applying those methods is performed at the level of individual transactions or an appropriate level of aggregation of transactions. The Commentary and the Guidelines do not contemplate the arm's length principle under Article 9 being applied to adjust profits in a way that does not attribute that adjustment to particular transactions between the associated enterprises. Accordingly, we do not see how the Commissioner can satisfy s.815-22(3) and hence make a valid adjustment under s.815-30 unless he determines the transfer pricing benefit by reference to the profits in respect of a particular transaction or transactions.

3. Interaction with thin capitalisation provisions

We note that the Assistant Treasurer's Media Release announcing the retrospective amendments made no mention of them addressing interaction with the thin capitalisation provisions (Division 820 ITAA 1997). This issue is arguably outside the scope of the amendments required to give effect to the Government's announced objective of clarifying the law as regards the treaties providing a separate assessment power to Division 13. On this basis we can understand why some might argue for paragraphs (4) and (5) of s.815-22 to be excluded from the legislation.

However, we do support retention of a provision in Subdivision 815-A that explicitly confirms that it interacts with Division 820 in the same way as Division 13 and treaty Article 9; that is, as stated in TR 2010/7, an arm's length interest rate as determined under Division 13, Article 9 or Subdivision 815-A is applied to the entity's actual amount of debt. As regards how an arm's length interest rate is determined, the provision can appropriately refer to the need for consistency with the OECD Guidelines. In our view it is unnecessary and inappropriate for the provision to go any further. Paragraph (5) of s.815-22 should be deleted. The OECD Guidelines do not explicitly state that in applying the arm's length principle to a loan between associated enterprises the rate of interest can appropriately be determined using a debt amount that is less than the actual debt amount. Paragraph (5) of s.815-22 purports to legislate an ATO view in TR 2010/7 which is controversial and arguable at best, and which is merely an interpretation of what is in the OECD Guidelines. Example 1.4 at paragraph 1.41 of the Draft Explanatory Memorandum to Subdivision 815-A is similarly objectionable and should also be deleted.

4. Permanent establishments

We note that the effect of ss. 815-22(3) and 815-25 is that a transfer pricing benefit for an Australian PE is determined consistent with the OECD Model Tax Convention, whose Commentary on Article 7 (Business Profits) as from 2008 incorporates conclusions from the OECD *Report on Attribution of Profits to Permanent Establishments*. We suggest that the relevant section of the Draft Explanatory Memorandum (paragraphs 1.29 to 1.34) be expanded to explicitly recognise that the authorised OECD approach under that Report is relevant, to the extent that it is incorporated into the OECD Commentary on Article 7, in interpreting Subdivision 815-A and the Business Profits Article of Australia's tax treaties.

5. Record keeping requirements

Subdivision 815-A does not address any record keeping requirements in respect of that provision. Whether a taxpayer has contemporaneous documentation evidencing its best efforts to comply with the arm's length principle is a factor relevant to the level of penalties imposable where Division 13 or treaty Article 9 applies (see TR 98/11). A similar approach should be taken where Subdivision 815-A applies. Where Subdivision 815-A applies retrospectively, it would obviously not be possible for a taxpayer to have contemporaneous documentation addressing the application of that provision. Accordingly, we recommend that Subdivision 815-A explicitly recognise that contemporaneous documentation prepared for Division 13 or treaty Article 9 purposes be treated as contemporaneously prepared for Subdivision 815-A purposes.

6. Penalties

We believe that the issue of penalties imposable on an adjustment applying Subdivision 815-A should be explicitly addressed in the legislative amendments introducing that provision. This might be addressed in Subdivision 815-A itself and/or in amendments to section 284-145 of the Taxation Administration Act 1953 (TAA).

We understand that the Commissioner accepts that the question of whether treaty Article 9 is a separate head of power for raising amended assessments to make transfer pricing adjustments is a matter on which there are real and rational differences of opinion between the view expressed by the Commissioner and the contrary view. This is the basis for the Government view that the legislative amendments to introduce Subdivision 815-A are needed to "clarify that transfer pricing rules in our tax treaties operate as an alternative to the rules currently in our domestic law" (as per the Assistant Treasurer's Media Release of 1/11/2011). In other words, there would be no need to clarify the law through these legislative amendments if there weren't uncertainty because of differing reasonably held views. Accordingly, we understand that in practice the Commissioner currently accepts that a taxpayer has a reasonably arguable position (RAP) that Article 9 is not a separate head of power.

Section 284-145 of the TAA prescribes the same penalty rates where Division 13 or Article 9 applies. However, given the above, we understand that the Commissioner accepts that a taxpayer has a RAP in respect of the application of Article 9 for s.284-145 purposes. This should appropriately also be the case in respect of the retrospective application of Subdivision 815-A, and we recommend that this be explicitly recognised in the amending legislation.

Deloitte will be pleased to provide representatives to meet with treasury to further discuss our views and/or participate in consultation forums.

Yours sincerely

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Director
Deloitte Touche Tohmatsu