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19 December 2012

The Manager
International Tax and Integrity Unit
The Treasury
Langton Crescent
PARKES ACT 2600

Submission on Modernisation of Transfer Pricing Rules: Exposure Draft of Tax Laws Amendment (Cross Border Transfer Pricing) Bill 2013

Dear Sir / Madam

We appreciate the opportunity to submit our views and observations in relation to the Exposure Draft of Tax Laws Amendment (Cross-Border Transfer Pricing) Bill 2013: Modernisation of transfer pricing rules.

Our detailed comments are set out in Attachment 1 to this letter, and the recommendations from our detailed comments are listed in Attachment 2. An executive summary of our comments is set out below.

The suggested changes that we propose are extensive.

We would be pleased to discuss our submission with Treasury and the ATO, to assist in your understanding and the proper drafting of the relevant amendments.

To schedule a meeting, or if you have any comments or questions about matters contained in our response, please do not hesitate to contact either of the undersigned.

Yours sincerely

Pp

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Attachment 1

1. General Operation

1.1 Positive policy and design aspect

We recognise that the Exposure Draft ('ED') contains a number of positive elements important to the efficiency and integrity of Australia's transfer pricing regime.

- The arm's length principle is the most valid and appropriate fundamental basis for determining tax outcomes between entities dealing across borders on a non-independent basis. It has been the subject of strong technical debate over many decades, and this has refined the application of the principle and developed a common understanding of its strengths and limitations. We recognise that it can produce answers that are not free of argument, and the application of the arm's length principle varies to a degree in practical application from country to country. However, it remains the only framework of concepts and language likely to achieve a workable consensus from Revenue Authorities and multinational enterprises.

- The establishment of an interpretive nexus between transfer pricing rules and the OECD Guidelines better supports the intent of the Australian transfer pricing rules and their consistency with international standards.

- The establishment of a legal basis for the use of profit methods in Australian transfer pricing supports the balanced selection of the most appropriate method. As a consequence, multinational enterprises can now rely upon these commonly used methods as part of their compliance with Australian transfer pricing rules, while the overall integrity of the regime is maintained.

- The introduction of time limits for amendments better aligns the transfer pricing rules with the general operation of the taxation system, and provides additional certainty.

1.2 Disruption to current practice

The stated objective of the ED is to ensure Australia's transfer pricing rules better align with internationally consistent transfer pricing approaches set out by the OECD. This is said to reduce uncertainty and the risk of double taxation, and minimise compliance and administration costs.

In reality, the ED achieves none of these things.

The ED takes concepts and a framework intended to be applied as guidance - with all of its ambiguities, complexities, and contradictions - and inserts these directly into a legislative instrument. The OECD Guidelines are intended to be a reflection of the extent of international consensus, expressed as broad guidance.

All of the certainty, or at least common understanding of convention, that has been built up over decades in relation to the use of the OECD Guidelines is lost as the rigour of Australian legal interpretation and rules are now to be applied to the specific words, and the broader collection of concepts. At its simplest, the ED requires a court to determine what the relevant economic substance of a situation is for the purpose of determining whether there is a material difference between a condition and an alternative condition for the purpose of selecting the most appropriate method to use to determine a notional taxable income.

The multiple layers of judgement required to do this do not efficiently lend themselves to a legislative mechanism.

The ATO have conveyed the view that the ED represents 'business as usual'. It is true that the ED provides the ATO with a stronger position to prosecute its existing views on the application of the arm's length principle to controversial cases involving financing, losses, and business restructures. In this sense the ED represents 'business as the ATO have interpreted it'. However, the real danger is that the piecemeal translation of aspects of the OECD Guidelines into law opens up such a wide range of new issues that actual certainty is greatly diminished.

The additional complexity and lack of certainty introduced by the ED will not improve the efficiency of the system. Both taxpayers and the ATO will struggle to practically apply the ED with certainty. Further, it is unlikely that the ED will assist in resolving potential cases of double taxation any more effectively than the existing rules.

In a survey of 450 corporate tax professionals, which we conducted 3 weeks ago, approximately 70 per cent of the respondents indicated that they believe the ED would lead to increased disputes with the ATO in relation to transfer pricing.

Recommendation: If the ultimate Bill largely reflects the ED, the EM will need to be significantly expanded to give direction to the practical interpretation and application of the OECD language and concepts dropped into Australian law.

1.3 Clarity required on intended deviation from OECD Guidelines

While the ED requires the interpretation of the new rules so as best to achieve consistency with the OECD Guidelines, it includes the caveat "(except where the contrary intention appears)" (s815-130(1)).

This is a crucial caveat and adds great uncertainty. Potentially, to the extent there is any difference that can be found between OECD Guidelines and the expression of law, this reflects a contrary intention.

It is not clear from the EM where these contrary intentions are intended to be. For example, it is not clear whether the provisions of s815-125(5) to (8) should be read down to accord with paragraph 1.65 of the OECD Guidelines, or should be taken instead to be an appearance of a contrary intention.

It should not be open to the ATO to cherry pick the elements where the OECD Guidelines are to be ignored. This is necessary as a matter of good governance of the tax system, and crucial given the objective of achieving international alignment.

Recommendation: s815-130(1) should be far clearer about how to identify the relevant contrary intention. The law, explained by the EM, should state clearly where there is a Parliamentary intent to diverge Australian rules from OECD Guidelines.

1.4 Recognition of a range of outcomes

It is inherent in the arm's length principle under OECD Guidelines that there is generally not a single arm's length outcome, but a range of equally valid arm's length outcomes. The recognition of a range of arm's length outcomes is accepted in Taxation Rulings, and reflected in the general approach currently adopted by the ATO.

The premise of the ED is however that a taxpayer or the ATO can compare the taxable income under actual conditions with a notional taxable income under arm's length conditions. This 'silver bullet'

determination of a single taxable income outcome under arm's length conditions is inconsistent with the arm's length principle under the international consensus reflected in the OECD Guidelines.

To provide certainty for taxpayers, and align with international transfer pricing approaches, the EM should properly recognise the implications of there being a range of valid arm's length taxable income outcomes.

Recommendation: The EM should:

a) include recognition of the arm's length range and its impact on determining taxable income, etc. under arm's length conditions

b) state that the ATO's ability to subsequently amend an assessment is limited to situations where the taxpayer's determination of taxable income does not assume arm's length conditions, and

c) state that it is not open to the ATO to amend an assessment merely because it can identify a higher taxable income under alternative arm's length conditions to the arm's length conditions identified and used by the taxpayer in determining their taxable income

1.5 Scope of ED beyond transfer pricing

The ED requires the substitution of arm's length conditions for the purposes of working out an entity's taxable income, etc. (s815-115). Paragraphs 2.92 – 2.95 of the draft EM indicate that after the arm's length conditions are determined, the entity must consider the effect on any elements or questions that would be considered in determining an entity's tax position. The draft EM provides an example of the question of source. However, the draft EM does not clarify whether this requires taxpayers to literally consider every issue again, including for example whether hypothesised dealings and relationships are revenue or capital, covered by specific rules within legislation, may involve elections to be made, etc.

As the ED is intended to modernise transfer pricing rules, it would not seem consistent or practical to require an entity to recast its entire income tax position based on the dealings hypothesised under arm's length conditions.

Recommendation: The EM should state clearly that the adjustment required under s815-115 is limited to the pricing of actual or hypothesised dealings.

1.6 Multiple year analysis

The ED defines a transfer pricing benefit in relation to an income year (s815-120). The object clause (s815-105) refers more broadly to the amount brought to tax in Australia.

The OECD Guidelines at paragraphs 3.75 to 3.79 support the view that transfer pricing analysis can more usefully be conducted on a multi-year basis, recognising that the outcomes for an enterprise can fluctuate from year to year and over the life of a business cycle.

It is very important that the law and the EM make it clear that a taxpayer's outcomes may fluctuate from year to year, and the application of the most appropriate method to determine the arm's length conditions may have regard to a multi-year analysis. This enables a taxpayer to test that its relevant actual conditions match arm's length conditions in a manner consistent with OECD Guidelines.

In our recent experience, there have been a number of cases where the ATO has stated it is bound by the precedents of Roche and SNF to apply a range to each individual year, with resulting adjustments proposed, notwithstanding on a multiple year average the taxpayer fits within the range. Accordingly, we note this is a real, rather than theoretical issue.

Recommendation:

a) the law should specify, at minimum in a note, that a multiple year analysis of the taxpayers' conditions may be appropriate

b) the EM should state clearly that there is no Parliamentary intent to diverge Australian rules from OECD Guidelines in relation to the use of multiple year analysis in the process of determining the precise transfer pricing benefit in respect of a year

1.7 Identification of particular transactions

The ED places an obligation on taxpayers, and the opportunity for the ATO, to make a lump sum adjustment to taxable income, etc. Unlike Subdivision 815-A, the ED contains no provision to necessarily determine the particular income or deduction, etc. to which to attribute the adjustment. The identification of particular items of income or deductions is important in instigating and resolving the likely double taxation that will flow from the adjustment, and in dealing with other tax issues.

The absence of any obligation on the ATO to, in so far as possible, identify particular items of income or deductions is inconsistent with decades of practice, Subdivision 815-A, and accepted international approaches.

Recommendation: The ED must have provisions analogous to s815-30(2) and (3) enabling the taxpayer, and requiring the ATO, to determine which particular items income or deduction, etc. should be adjusted.

1.8 Administrative practice in relation to non-core services

Many multinationals currently rely on the ATO administrative practice for 'non-core' services, and de minimis cases, that is set out in paragraphs 75 to 102 of TR 1999/1. Under the administrative practice, an Australian entity can rely on the method specified by the Commissioner in TR 1999/1, which is broadly cost + 7.5%, as providing a realistic outcome without needing to further apply the arm's length methodologies.

This administrative practice provides an efficient approach that does not undermine the integrity of the overall rules, and has been positively regarded since its release.

Recommendation: The ED should be amended to include the administrative practice set out in TR 1991/1 for 'non-core' services and de minimis cases, in a similar manner to the modification for thin capitalisation in s815-135.

1.9 Period for amendment of assessments

The ED (section 815-145) enables the amendment of assessments up to an 8 year limit from the notice of assessment. Given the intention stated in the EM to modernise and align the transfer pricing rules, the period for amendment should logically be consistent with the limit upon ordinary assessments.

Recommendation: The ED should be redrafted to delete s815-145(1) so as to adopt a consistent approach to the time generally available for the amendment of assessments.

1.10 Impact of self assessment on ATO resources

We believe the transition of transfer pricing rules into the self assessment environment will lead to a significant increase in the demands on ATO resources.

The following factors will increase uncertainty and the resources required by taxpayers to comply with the transfer pricing rules on a self assessment basis. As a result these drivers will also cause taxpayers to explore other forms of risk management.

1.10.1 Open ended scope of conditions relevant for self assessment

Under Division 13, the Commissioner must make a determination before an adjustment takes effect. As part of this process the taxpayer has an opportunity to present its case and review the ATO's position before any adjustment is made. This generally enables the taxpayer and ATO to narrow the focus to key areas of difference between the parties in relation to judgement or assumptions. The concept of 'conditions' under the ED is almost literally anything. Under the self executing provisions of the ED, there is no interactive process and taxpayers will be forced to consider all conditions in depth in order to demonstrate their taxable income is correct – not just those aspects that do ultimately end up in contention.

1.10.2 The requirements to obtain a RAP are onerous

As discussed below, the requirements that need to be met in order to have the possibility of obtaining a RAP are comprehensive and go beyond the current practice of reasonable taxpayers.

1.10.3 The need to substitute or reconstruct actual circumstances when filing a return

The extent of the substitution of terms, transactions and even economic substance make it difficult to define the limits to the extent of analysis required to support a self assessed position.

Further, in our experience, the extent of the reconstruction required or permitted under the ED goes well beyond the approach typically taken in practice by Revenue Authorities in other countries. The requirement under the ED for taxpayers to self assess adjustments based on hypothesised dealings, as well the wide scope open to the ATO to do the same, will lead to increased difficulty in resolving MAP cases.

Given the increased uncertainty arising from multiple aspects of the ED. we expect that more taxpayers will want to use additional steps to obtain sufficient certainty. The main alternatives are likely to be to:

- seek advance pricing arrangements ('APAs') for certainty
- explore the use of private binding rulings ('PBRs') as a real time mechanism to obtain certainty
- resort to mutual agreement procedures ('MAP') in order to avoid double taxation

We expect significantly more MAP cases than currently arise. The OECD updated its Commentary on Article 25 in 2008 (as part of the wider OECD project on dispute resolution) and one of the changes was an expansion of the view regarding the conditions under which a taxpayer is able to seek MAP.

Paragraph 14 of the OECD Commentary on Article 25 discusses what would constitute an action of a contracting state and cites the example of the filing of a tax return under a self assessment system as being 'an action of a contracting state', where the requirement of self assessment would give rise to taxation not in accordance with the treaty. There is nothing to indicate that Australia (or the ATO) does

not agree with this view. We anticipate the number of MAP requests will increase greatly as a result of Subdivision 815-B, i.e. as taxpayers begin to make upwards adjustments to their taxable income as required under 815-B, and then seek relief through international processes.

Consequently, the ED will place additional stress on the ATO's ability to competently administer the transfer pricing law. This comes on top of what has been a diminution in recent times of the capability of the ATO to resource economists and transfer pricing specialists in case work. We are concerned that the ATO does not have the resources to manage a major increase in case numbers.

Recommendation: If the ultimate Bill largely reflects the ED, the ATO is unlikely to be ready for the impact of the ED and will in any event require extra resources with appropriate specialist experience in relation to transfer pricing, economics and MAP cases. The issue needs to be discussed in greater depth and assurances given to taxpayers that the ATO will support and work with taxpayers on their Competent Authority requests.

2. Reconstruction

The ED requires the substitution of the arm's length conditions for the actual conditions where there is a transfer pricing benefit. As the meaning of arm's length conditions is open ended and includes net profits and the division of profits, it seems to include (inter alia) every understanding, dealing, term, transaction, organisation, strategy and financial outcome. Under the ED, any of these that are not arm's length will require the substitution of the relevant understanding, dealing, term, transaction, organisation, strategy or financial outcome.

This is far more complicated and uncertain a process than contemplated by taxpayers currently in considering the possible operation of Division 13. Because of the scope of the automatic substitution of terms and transactions for the purpose of determining taxable income, etc. there is significant potential for the ED to increase the frequency and difficulty of controversy cases and MAP cases.

However, where the arm's length conditions are predicated on the same economic substance as the actual conditions, there is at least some point of commonality in addressing issues so as to resolve the case with the ATO and/or in Court, or under a MAP.

2.1 Substitution of a different economic substance

In addition to the general overarching substitution of arm's length conditions described above, the ED includes additional provisions dealing with the relevance of economic substance (s815-125(5) to (8)).

These provisions are difficult to understand, and cause confusion. They appear to require the taxpayer (and enable the ATO) to consider determining the arm's length conditions predicated on an economic substance that differs from the actual economic substance.

However, there is no apparent limit on the degree to which the hypothetical economic substance should or could differ from the actual economic substance. In the context of self assessment, this is an extremely impractical obligation for taxpayers to satisfy. Ultimately it will also be problematic for the ATO when forced to justify its positions in a Court or in MAP.

Recommendation: These provisions should be deleted. They create uncertainty and are redundant given the general overarching substitution mechanism and the use of OECD guidance in interpreting the Subdivision. Further, their inclusion opens up significant potential for uncertain ATO application, divergent from international consensus based on the OECD Guidelines.

Recommendation: In the event that the provisions are not deleted, they should be rewritten to make their effect clearer. As discussed below, the language in paragraph 1.65 of the OECD Guidelines should provide the model. Otherwise the issue of 'contrary intention' referred to above will arise.

2.2 Exceptional circumstances as a necessary limit

It is clear that s815-125(5) to (7) mean that the economic substance assumed for the purpose of the arm's length conditions does not have to be the actual economic substance that exists.

The OECD Guidelines deal with substitution of economic substance in one section, paragraphs 1.64 and 1.65.

The Guidelines state that other than in exceptional circumstances, the tax administration should not disregard the actual transaction or substitute transactions.

Paragraph 1.65 gives only two examples of where an actual transaction may be ignored. The first deals with a situation where the legal form differs from the economic substance. This situation is effectively provided for under the overarching substitution of arm's length conditions for actual conditions discussed above. The second example is where the arrangements differ from those that would have been adopted in a commercially rational manner, and the actual structure practically impedes the tax administration from determining an appropriate transfer price.

However s815-125(5) to (7) have no limitation.

Recommendation: As recommended above, s815-125(5) to (7) should be deleted, and reliance placed upon the OECD Guidelines. In the event that the provisions are not deleted, they should be rewritten to adopt the OECD language and make their effect contingent on it being otherwise impractical to determine an appropriate transfer price. The EM should also make it clear that the intended use of such a provision would be limited to exceptional circumstances.

2.3 Impact of reconstruction on future income years

The practical difficulties in relation to the reconstruction of transactions or business structures are compounded when considering future years beyond the event that gave rise to the transaction or business model which becomes the subject of reconstruction.

For how many years into the future is it necessary to maintain the fiction of the reconstructed transaction for the purpose of determining taxable income? If you have to reconsider existing transactions and business models for the purpose of applying the ED in an income year, how far into the past do taxpayers have to analyse the consistency of the conditions with the arm's length principle?

Recommendation: As recommended above, s815-125(5) to (7) should be deleted, and reliance placed upon the OECD Guidelines. In the event that the provisions are not deleted, they should be rewritten to adopt the OECD language and make their effect contingent on it being otherwise impractical to determine an appropriate transfer price.

3. Permanent Establishments

There is currently a review by The Board of Taxation of the tax arrangements applying to PEs, which may lead to changes in the law in relation to determining the taxable profits of PEs. There is potentially an unreasonable imposition here on taxpayers who have to deal with two significant changes of law in a short period of time. Taxpayers in industries such as banking, where there may be a network of branches within a multinational, may face an extreme compliance burden in managing two rounds of change.

PEs are particularly important in certain industries such as financial services and construction, both of which are, in turn, important to the Australian economy.

Although they are not the most common business structure, PEs are crucial to multinational trade, and will be of increasing importance given the compositional change in multinational trade towards services and financial products.

It is important for Australia to have a workable approach towards the taxation of PEs that is consistent with international practice. Division 13 contains provisions in s136AE that are important to attribute profit to PEs in a manner that is both practical and consistent with international standards. In particular, s136AE(7) provides that in working out the source of income and expenses, this should be done on the basis that the PE is treated as a separate independent entity.

The separate entity hypothesis forms the basis for the international standard on the allocation of profit to PEs. It is consistent with our tax treaties, and consistent with transfer pricing approaches generally that emphasise the substance of situations rather than the minutia of transactional detail.

In our experience, the ATO has at times asserted that there is a conflict between the separate entity approach and the need to allocate income and expenses to determine the taxable profit of the PE. In such cases the ATO has taken the view that individual income and expense items need to be traced through the accounts. This frustrates the purpose of s136AE(7), which is to use the separate entity hypothesis by analogy to allocate aggregated income, expenses or profits in a way that best reflects the arm's length principle.

The draft EM states that Division 13 is to be repealed when the ED is enacted. In the absence of s136AE, there would be no legislative recognition of the separate entity approach as a mechanism to allocate income and expenses.

The ED includes Subdivision 815-C, which maintains the use of the separate entity analogy for the purpose of determining the profit of a PE. Further, it does so in testing the overall profit rather than individual transactions. This approach of looking to the overall profit, where income and expenses are allocated in broad sense rather than in minutia, is also consistent with the design of the ED that looks at the impact of conditions on an holistic basis.

Recommendation: The EM must include clear direction that 815-C operates so that:

- there is no conflict between the allocation of income and expenses and the separate entity analogy – the separate entity analogy is the basis for allocating income and expenses, and
- it applies to test the overall profit rather than individual items of income and expense

Recommendation: In light of the prospect of further change in the near future arising from the Board of Taxation Review, consideration should also be given to the deferral of the application of 815-C for industries that may be significantly affected. There is precedent for this in the deferral of the second

tranche of Taxation of Financial Arrangement ("TOFA") reform for banks. The second tranche, which introduced Division 775 (on foreign currency gains or losses), specifically excluded its operation from the banking industry on the basis that the third and fourth tranches (which was subsequently introduced in Division 230) was intended to be a comprehensive taxation regime primarily utilised by the banking industry. It is noted that upon the introduction of Division 230, the operation of Division 775 (though having only residual operation) was then switched on for the banks, reflecting the finalisation of the review process on the taxation of these affected financial instruments.

4. Transfer Pricing Records

The ED contains prescriptive record keeping requirements that have to be met in order for a taxpayer to have the possibility of having a RAP.

Of note is that the records must:

- identify all the actual conditions and arm's length conditions (or activities and circumstances in the case of a PE), and
- set out the amount by which the taxable income, etc. differs under the arm's length conditions (s815-305(4))

4.1 Conditions covered by a RAP

The requirements in s815-305 and s815-310 create an 'all or nothing' paradigm for transfer pricing documentation. This is unreasonable and inconsistent with international transfer pricing standards.

Most complex multinationals prepare documentation based around categories of transactions, reflecting their perception of local compliance requirements, likely sensitivity from the perspective of local Revenue Authorities, and risk of adjustment.

The premise that most taxpayers currently document all their conditions in relation to all their transactions is incorrect. Taxpayers do not start with a top down consideration of all the conditions (particularly where the concept of 'conditions' is open ended). Instead, it is a risk based approach based on reasonable endeavours.

What is needed is the ability to have a RAP in relation to the key conditions, without covering all conditions. The RAP should operate in relation to, or to the extent that, it identifies particular conditions. In the absence of this, 815-D will be a significant disincentive for taxpayers to prepare transfer pricing documentation for the purpose of supporting a RAP.

Recommendation: Proposed s284-180 of the Tax Administration Act should be redrafted to enable a taxpayer to have a RAP:

- in relation to differences in taxable income, etc. that arise from conditions identified in the RAP, and
- where the RAP explains the treatment of 815-B or 815-C as applying in a particular way

4.2 Identification of the amount

Taken on the face of the draft legislation, it seems impossible to satisfy the record keeping requirements necessary to have a RAP.

Sections 815-305(4)(c) and 815-310(4)(c) require that the records set out the amount, if any, by which taxable income, etc. would be different if the arm's length conditions had operated. Logically, if a RAP is relevant, it is because an adjustment has been made by the ATO as a result of the taxpayer not identifying and self assessing the negation of a transfer pricing benefit. If the opportunity to have a RAP has any value, it must be possible to satisfy it having made a reasonable attempt, notwithstanding an alternative view is ultimately upheld. Alternative views may well be reasonable (or at least have involved reasonable care) given that the set of conditions that need to be covered is extremely wide and open ended. This is particularly important in relation to transfer pricing where, as discussed above, the concept of a range of equally valid outcomes is internationally accepted.

Recommendation: Proposed s284-180 of the Tax Administration Act should be redrafted to enable a taxpayer to have a RAP notwithstanding a failure to identify the amount by which taxable income, etc. would be different if the arm's length conditions had operated.

5. Penalties

5.1 De minimis thresholds

The de minimis thresholds provide important protection for taxpayers that are substantively complying with the law. However, the thresholds are unreasonably low at the levels set out in the ED, particularly for small to medium sized enterprises.

In our experience we have rarely, if ever, seen the ATO seek to make an adjustment that would make the proposed de minimis thresholds relevant.

For a large, diverse multinational, 1% of income tax payable may be significant. However, the threshold in the ED of the greater of $10,000 or 1% of income tax payable (TAA s284-165) effectively means that small to medium enterprises with income tax payable of slightly more than $1 million will be subject to penalties in relation to very small adjustments.

Recommendation: Proposed s284-165 of the Tax Administration Act should be redrafted to provide for a threshold of the greater of $100,000 or 1% of income tax payable.

5.2 Interaction with general penalty provisions

With the transition to a self assessment regime, the interaction of the transfer pricing rules with the general penalty mitigation framework is of increased importance.

The reasonable care requirement relates to the penalties that can be imposed where a shortfall arises as a result of a statement that is false or misleading. The extent of the penalty depends on whether the shortfall results from intentional disregard of the law, recklessness, or failure to take reasonable care.

It is important to understand how Parliament intends that taxpayers would satisfy the reasonable care requirement under the ED.

It is unclear whether reasonable care can be established where a taxpayer has made a genuine attempt to consider relevant conditions, notwithstanding a failure to identify relevant conditions or the amount by which taxable income, etc. differs under arm's length conditions.

Recommendation: The EM must clarify that a genuine attempt to consider the conditions can be reasonable care, notwithstanding a failure to identify relevant conditions or the amount by which taxable income, etc. differs under arm's length conditions.

Attachment 2

Recommendations for our detailed comments

1. General Operation

1.1 Positive policy and design aspect

Not applicable.

1.2 Disruption to current practice

Recommendation: If the ultimate Bill largely reflects the ED, the EM will need to be significantly expanded to give direction to the practical interpretation and application of the OECD language and concepts dropped into Australian law.

1.3 Clarity required on intended deviation from OECD Guidelines

Recommendation: s815-130(1) should be far clearer about how to identify the relevant contrary intention. The law, explained by the EM should state clearly where there is a Parliamentary intent to diverge Australian rules from OECD Guidelines.

1.4 Recognition of a range of outcomes

Recommendation: The EM should:

a) include recognition of the arm's length range and its impact on determining taxable income, etc. under arm's length conditions

b) state that the ATO's ability to subsequently amend an assessment is limited to situations where the taxpayer's determination of taxable income does not assume arm's length conditions, and

c) state that it is not open to the ATO to amend an assessment merely because it can identify a higher taxable income under alternative arm's length conditions to the arm's length conditions identified and used by the taxpayer in determining their taxable income

1.5 Scope of ED beyond transfer pricing

Recommendation: The EM should state clearly that the adjustment required under s815-115 is limited to the pricing of actual or hypothesised dealings.

1.6 Multiple year analysis

Recommendation:

a) the law should specify, at minimum in a note, that a multiple year analysis of the taxpayer's conditions may be appropriate

b) the EM should state clearly that there is no Parliamentary intent to diverge Australian

rules from OECD Guidelines in relation to the use of multiple year analysis in the process of determining the precise transfer pricing benefit in respect of a year

1.7 Identification of particular transactions

Recommendation: The ED must have provisions analogous to s815-30(2) and (3) enabling the taxpayer, and requiring the ATO, to determine which particular items income or deduction, etc. should be adjusted.

1.8 Administrative practice in relation to non-core services

Recommendation: The ED should be amended to include the administrative practice set out in TR 1991/1 for 'non-core' services and de minimis cases, in a similar manner to the modification for thin capitalisation in section 815-135.

1.9 Period for amendment of assessments

Recommendation: The ED should be redrafted to delete s815-145(1) so as to adopt a consistent approach to the time generally available for the amendment of assessments.

1.10 Impact of self assessment on ATO resources

Recommendation: If the ultimate Bill largely reflects the ED, the ATO is unlikely to be ready for the impact of the ED and will in any event require extra resources with appropriate specialist experience in relation to transfer pricing, economics and MAP cases. The issue needs to be discussed in greater depth and assurances given to taxpayers that the ATO will support and work with taxpayers on their Competent Authority requests.

2. Reconstruction

2.1 Substitution of a different economic substance

Recommendation: These provisions should be deleted. They create uncertainty and are redundant given the general overarching substitution mechanism and the use of OECD guidance in interpreting the Subdivision. Further, their inclusion opens up significant potential for uncertain ATO application, divergent from international consensus based on the OECD Guidelines.

Recommendation: In the event that the provisions are not deleted, they should be rewritten to make their effect clearer. The language in paragraph 1.65 of the OECD Guidelines should provide the model. Otherwise the issue of 'contrary intention' referred to above will arise.

2.2 Exceptional circumstances as a necessary limit

Recommendation: As recommended above, s815-125(5) to (7) should be deleted, and reliance placed upon the OECD Guidelines. In the event that the provisions are not deleted, they should be rewritten to adopt the OECD language and make their effect contingent on it being otherwise impractical to determine an appropriate transfer price. The EM should also make it clear that the intended use of such a provision would be limited to exceptional circumstances.

2.3 Impact of reconstruction on future income years

Recommendation: As recommended above, s815-125(5) to (7) should be deleted, and reliance placed upon the OECD Guidelines. In the event that the provisions are not deleted, they should be rewritten to adopt the OECD language and make their effect contingent on it being otherwise impractical to determine an appropriate transfer price.

3. Permanent Establishments

Recommendation: The EM must include clear direction that 815-C operates so that:

- there is no conflict between the allocation of income and expenses and the separate entity analogy – the separate entity analogy is the basis for allocating income and expenses, and
- it applies to test the overall profit rather than individual items of income and expense

Recommendation: In light of the prospect of further change in the near future arising from the Board of Taxation Review, consideration should also be given to the deferral of the application of 815-C for industries that may be significantly affected. There is precedent for this in the deferral of the second tranche of Taxation of Financial Arrangement ("TOFA") reform for banks. The second tranche, which introduced Division 775 (on foreign currency gains or losses), specifically excluded its operation from the banking industry on the basis that the third and fourth tranches (which was subsequently introduced in Division 230) was intended to be a comprehensive taxation regime primarily utilised by the banking industry. It is noted that upon the introduction of Division 230, the operation of Division 775 (though having only residual operation) was then switched on for the banks, reflecting the finalisation of the review process on the taxation of these affected financial instruments.

4. Transfer Pricing Records

4.1 Conditions covered by a RAP

Recommendation: Proposed s284-180 of the Tax Administration Act should be redrafted to enable a taxpayer to have a RAP:

- in relation to differences in taxable income, etc. that arise from conditions identified in the RAP, and
- where the RAP explains the treatment of 815-B or 815-C as applying in a particular way

4.2 Identification of the amount

Recommendation: Proposed s284-180 of the Tax Administration Act should be redrafted to enable a taxpayer to have a RAP notwithstanding a failure to identify the amount by which taxable income, etc. would be different if the arm's length conditions had operated.

5. Penalties

5.1 De minimis thresholds

Recommendation: Proposed s284-165 of the Tax Administration Act should be redrafted to provide for a threshold of the greater of $100,000 or 1% of income tax payable.

5.2 Interaction with general penalty provisions

Recommendation: The EM must clarify that a genuine attempt to consider the conditions can be reasonable care, notwithstanding a failure to identify relevant conditions or the amount by which taxable income, etc. differs under arm's length conditions.