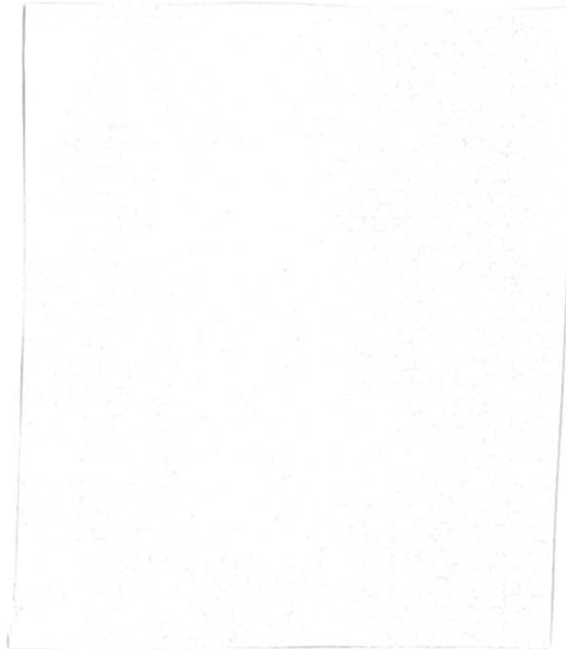

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13 April 2012

The Manager
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Dear Sir/Madam

Submission on: Exposure Draft Tax Laws Amendment (2012 Measures No. 3) Bill 2012 Cross- Border Transfer Pricing

The Federal Chamber of Automotive Industries (FCAI) is the peak industry organisation representing the automotive industry in Australia. FCAI's membership comprises the three domestic passenger motor vehicle manufacturers and all major international brands which import and market passenger, light commercial and four wheel drive vehicles, and motor cycles in Australia.

As the automotive industry is a significant importer and exporter of goods and services in Australia, it will therefore be directly impacted by the proposed changes to the transfer pricing rules, not only for income tax purposes but also for customs duty purposes.

As the FCAI has already provided detailed comments in our submission dated 30 November 2011 in relation to the Consultation paper – Income Tax Cross Border Profit Allocation – Review of Transfer Pricing Rules, (copy enclosed) - we advise that those comments also form part of our current submission.

Within this context the FCAI appreciates the opportunity to participate in the consultation process and accordingly provide the following comments on the ***Exposure Draft*** which was issued on 16 March 2012 in addition to those raised in the Consultation document :

Operative provisions

Section 815-10 Object

As stated in the Exposure Draft the object of Subdivision 815-A is to ensure that ***"profits"*** are appropriately brought to tax in Australia , consistent with the arm's length principle. The objects clause fails to link the concept of dealing at arms length with either a specific person or persons, or a specific transaction or transactions. As there is no link to an underlying transaction or specific activity, the concern is that the term "profits", used in this context, may be construed very broadly to include a consideration of overall profitability, and to permit the imposition of additional income tax without reference to any specific dealing or dealings of the taxpayer.

As mentioned in our earlier submission, whilst it is generally understood that it is good tax policy to legislate to ensure that international related party dealings result in an "arm's length outcome", it is difficult to understand how such an outcome will be achieved by concentrating on "overall profitability" and in particular the overall profitability of the Australian operations. Unrelated parties dealing at "arm's length" have no regard for the overall profitability of the party with which they are buying and selling.

Section 815-22 When an entity gets a transfer pricing benefit and Section 815-30 Commissioner may ensure transfer pricing benefit is taxed

In keeping with the Objects clause, section 815-22 refers to "an amount of profit" that an entity might have accrued as being a "transfer pricing benefit." Also in keeping with the Objects clause, section 815-30 authorises the Commissioner to ensure such a "transfer pricing benefit" is subject to tax by simply making a determination to increase the taxable income of an entity in one or more income years. There is no link to an underlying transaction. There is no requirement that the Commissioner identify an actual taxable dealing or transaction as giving rise to the increase in taxable income. While sub-section 815-30(2) permits the Commissioner to do this at the Commissioner's discretion, there is no requirement that this occur before a tax assessment is made.

Reference is made to the UK Transfer Pricing legislation[1], which we understand has been a source of reference for the Exposure Draft; the UK Transfer Pricing rules refer to "transactions" or "series of transactions". In our submission, this is the correct and preferred approach.

It is submitted that both section 815-22 and 815-30 are inconsistent with the general structure of the Income Tax Assessment Acts, which do not impose income tax on a taxpayer's net "profit" – but rather, impose tax on taxable income calculated under the Acts as arising from individual amounts of assessable income and allowable deductions, as derived or incurred from specific transactions and dealings.

It is further submitted that both sections are also inconsistent with section 3(2) of the International Tax Agreements Act 1953, and, in particular, the interpretation of that provision advanced by the Commissioner, and accepted by the Full Federal Court, in *Russell v CT*

[1] Taxation (International and other Provisions) Act 2010 UK Chapter 1 Basic Transfer - Pricing Rule at Section 147 and Chapter2 Key Interpretive Provisions at section 150

[2011] FCAFC 10. As the Commissioner submitted, and as that case makes clear, a reference to profits of an enterprise in a treaty is to be construed as meaning those profits which are, according to the meaning of the Income Tax Assessment Acts, taxable income in the hands of an identifiable taxpayer. It follows that, before a transfer pricing adjustment can be made under the associated enterprises article, there must first be an identification of an actual transaction of an actual taxpayer which would otherwise give rise to taxable income within the meaning of the Income Tax Assessment Acts. The associated enterprises article cannot be used to manufacture taxable income where there is no specific underlying transaction of an actual taxpayer to which the taxable income can be attributed.

Thus the proposed amendments go far beyond "clarifying" the previous operation of the transfer pricing rules. They provide the Commissioner a new, unprecedented, power to impose additional income tax by direct determination, without any requirement to bring the adjustment to tax liabilities within the specific assessing provisions of the Income Tax Assessment Acts.

Section 815-25 Cross Border transfer pricing guidance

Both subsection 1(c) and (3) are problematic in that they provide no guidance as to what additional documents will be used by the Commissioner for the purposes of achieving interpretive consistency in the application of the Division. Whilst it creates maximum flexibility for the Commissioner, it will create uncertainty for taxpayers in understanding and complying with the law.

Section 815-30 Commissioner may ensure transfer pricing benefit is taxed

Whilst this section empowers the Commissioner to make a determination giving effect to a transfer pricing adjustment, it does not require him to provide a copy of the determination to the taxpayer. Therefore, the situation could arise whereby an FCAI member receives a transfer pricing adjustment to overall taxable income with no underlying explanation as to how the adjustment was calculated and whether it related to a particular transaction, or amount of assessable income or deduction. This will create uncertainty for our members and make it very difficult to object, litigate or obtain a Customs Duty refund if applicable.
This will also have potential double tax implications for FCAI members considering a MAP process as they will have insufficient information.

Principles Based Legislation

As the Exposure Draft has been draft according to "principles based legislation" reference is made to a University of Oxford research paper by Judith Freedman [2] as follows:

"It raises fundamental questions about the interpretation of legislation, the separation of powers as between the legislature, the courts and the administration, and the level of detailed guidance required to satisfy basic requirements of the rule of law".

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[2] University of Oxford Legal Research Paper Series paper No 26/2011 April 2011 - " Improving (Not Perfecting) Tax Legislation; Rules and Principles Revisited by Judith Freedman Reprinted from British Tax Review Issue 6, 2010 Sweet & Maxwell at page 718.

Whilst "principles based legislation" has advantages and is much easier to comprehend, unless it provides clear detailed guidance it will lead to greater uncertainty for taxpayers. As written, the Exposure draft provides the Commissioner with far greater discretion to amend taxable income without the obligation to provide taxpayers with background supporting details, or to link the adjustment to specific transactions or dealings. It will be very difficult for a taxpayer to mount a legal challenge in a Court of law due to this uncertainty, or for the judiciary to interpret the law as placing any limit on the Commissioner's discretion to impose additional income tax as he or she sees fit. Provisions which have the practical effect of making the exercise of taxing power immune to judicial oversight are not consistent with the rule of law.

Interaction between Transfer Pricing Rules and Customs Valuation Rules

As you will be aware, FCAI members are subject not only to the provisions of the Income tax Assessment Acts of 1936 (as amended) and 1997, but also the Customs Act 1901 "Customs Act" in respect of the importation of motor vehicles, light commercial vehicles and motor cycles.

Under the Customs Act, customs duty is levied on a transaction by transaction basis. There is no reference in the Customs Act to overall profitability of the Australian operations as is proposed under the Exposure Draft.

It is unreasonable to place FCAI members in the invidious position of defending transfer prices in respect of the same motor vehicle under two very different valuation rules. Whilst it should be acknowledged that this inconsistency of approach to the Valuation rules has been the subject of much international debate, under the existing Division 13 of the Income Tax Assessment Act the focus is on "transactions". This focus will change completely under the new rules envisaged in the Exposure Draft.

This inconsistency in approach may have adverse ramifications for FCAI members. Whilst we refer to our earlier submission which provides further details, it is important to reiterate that a whole of government approach is required in drafting revenue laws in Australia.

Retrospective Legislation

As stated in our earlier submission, we do not believe it is good tax policy to empower the Commissioner of Taxation to apply the new rules retrospectively to 2004. Members have complied with tax legislation in accordance with the tax laws as enacted at the time. Applying the proposed changes retrospectively may result in some members being placed in unfavourable tax positions through no fault of their own. In practice, revenue officials in the foreign jurisdiction may not agree to amend prior year assessments or those assessments may be out of time for amendment. This will result in double taxation without treaty relief. In addition, Customs officials may not agree to provide duty refunds due to either time limits for refunds expiring or technical valuation methodology reasons.

In Summary

We accordingly request that the Treasury consider our concerns and the potential ramifications for our members, not only from an income tax perspective, but also in relation

to Customs Duty. This is particularly relevant as both Income Tax and Customs are ultimately the responsibility of the Federal Treasurer and the Treasury. As mentioned in our earlier submission, the government has previously committed to a whole of government approach to legislation.

Yours faithfully

Ian Chalmers
Chief Executive