Grant Thornton

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Dear Sir/Madam

SUBMISSION: EXPOSURE DRAFT – TAX LAWS AMENDMENT (CROSS-BORDER TRANSFER PRICING) BILL 2013: MODERNISATION OF TRANSFER PRICING RULES

Grant Thornton Australia Limited ("Grant Thornton Australia") appreciates the opportunity to provide comments to The Treasury on the Exposure Draft inserts for Tax Laws Amendment (Cross-Border Transfer Pricing) Bill 2013: Modernisation of transfer pricing rules ("Phase 2 Transfer Pricing Exposure Draft"), dated 22 November 2012.

Grant Thornton Australia's response reflects our position as leading advisers to multinational enterprises and entities undertaking related party cross-border transactions. We welcome the opportunity to be involved in the legislative change process and provide the following comments in the spirit of cooperation and transparency. Based on our observation, Grant Thornton Australia appreciates the following in Phase 2 Transfer Pricing Exposure Draft:

- the alignment of Phase 2 Transfer Pricing Exposure Draft with the Organisation for Economic Cooperation and Development ("OECD") Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations ("OECD Guidelines");
- the inclusion of the "amendment of assessment" in sections 815-145 and 815-235, ITAA 1997; and
- the proposal of thresholds for administrative penalties arising from arm's length principle (section 284-165, Taxation Administration Act 1953 ("TAA 1953")).

In particular, Grant Thornton welcomes the following aspects of Phase 2 Transfer Pricing Exposure Draft.

Section 815-140, ITAA 1997 outlines the availability of consequential adjustments, granting the Commissioner the power to make a determination on the consequential adjustment amount for the "disadvantaged entity". Grant Thornton Australia welcomes the proposed inclusion of "consequential adjustments" in subdivision 815-B, ITAA 1997. We believe the proposed legislation will clarify the dispute resolution process for Australian taxpayers going forward.

Sections 815-145 and 815-235, ITAA 1997 propose limiting the amendment of an assessment to eight (8) years after the day on which Commissioner gives notice of assessment to taxpayer. Grant Thornton Australia supports the above time limitation on the amendment of assessment. In addition, we also welcome the proposal of the non-applicability of the abovementioned time limits with regards to "consequential adjustments" (section 815-145(2), ITAA 1997).

On the other hand, Grant Thornton Australia provides comments on the following areas of concern identified in Phase 2 Transfer Pricing Exposure Draft:

- the application of the text of Article 7 and its Commentary as they read in the Model Tax Convention on Income and on Capital and its Commentaries as adopted by the Council of the OECD ("Model Tax Convention"), before 22 July 2010;
- the application of subdivision 815-B, ITAA 1997 to uncontrolled entities and tax residents of non-tax treaty countries;
- the reconstruction powers introduced in sections 815-115(1), 815-125(7), 815-215(1) and 815-225(3), ITAA 1997 of Phase 2 Transfer Pricing Exposure Draft;
- the allowance for the use of "a combination of methods" to identify the arm's length conditions (section 815-125(2), ITAA 1997);
- the implications of not maintaining contemporaneous transfer pricing documentation, which place a heavy compliance burden on taxpayers; and
- no definition as to the "regulations" incorporated in sections 815-130 and 815-230.

Overall, Grant Thornton Australia found that certain aspects of the proposed legislation require the provision of further details or clarifications. We have highlighted below the key comments that we considered to be relevant in the modernisation of the transfer pricing rules for the considerations of the Treasury.

Alignment to OECD guidelines

Grant Thornton Australia welcomes the alignment of Phase 2 Transfer Pricing Exposure Draft with the OECD Guidelines. In particular, we appreciate the alignment of subdivision 815-B to the arm's length conditions and the comparability of circumstances as outlined in the OECD Guidelines.

However, we have reservations relating to section 815-230(2), ITAA 1997, with respect to the application of the text of Article 7 and its commentary as they read in the Model Tax Convention, before 22 July 2010. In our view, as a member country of the OECD, the legislation should incorporate guidance that reflects the latest view of the OECD in support of the alignment of tax related issues within the organisation.

Application of OECD guidelines

Section 815-120(3), ITAA 1997 of Phase 2 Transfer Pricing Exposure Draft outlines the instances where the actual conditions meet the cross-border requirement. In particular, paragraph 3(a) indicates that actual conditions meet the cross-border requirement where "the other entity" is non-Australian resident; non-resident trust estate for the purposes of Division 6 of Part III of the Income Tax Assessment Act 1936 ("ITAA 1936); and not a partnership in which all partners are directly or indirectly Australian residents or resident trust estates.

Based on the above, Grant Thornton Australia observed the broad coverage of the types of overseas entities incorporated within Phase 2 Transfer Pricing Exposure Draft extending the scope of the application of subdivision 815-B to taxpayers engaging in business with uncontrolled non-Australian entities. Grant Thornton Australia considers that the broad definition of "the other entity" will require taxpayers to prepare records on cross-border conditions with regards to its dealings with uncontrolled entities in order to establish an arguable position in the context of subdivisions 815-B or 815-C, ITAA 1997. In our view, this requirement is burdensome.

In addition, we note that the broad definition of "the other entity" has implications for entities that carry on business with "other entities" located in an area not covered by an international tax sharing treaty by applying conditions consistent with the Model Tax Convention as last amended on 22 July 2010 and the OECD Guidelines. This will bring, as a consequence, significant potential double taxation implications with no opportunity for tax relief. This would place taxpayers dealing with jurisdictions that have not signed an international treaty with Australia at a disadvantage.

In light of the above, clarification and specific guidance may need to be included as part of the draft legislation on the applicability of the OECD Guidelines and the Model Tax Convention as guidance material for business carried on by taxpayers with uncontrolled overseas entities and entities resident of non-tax treaty countries. In our view, the clarification is necessary following the intention of the proposed legislation to repeal Division 13, ITAA 1936.

Reconstruction powers

Phase 2 Transfer Pricing Exposure Draft contains provisions that allow actual transactions to be disregarded in certain circumstances (sections 815-115(1) and 815-125(7)). Grant Thornton Australia considers that such reconstruction powers go far beyond the "exceptional circumstances" described in the OECD Guidelines (para. 1.64 and 1.65). Hence, this proposed legislation is in conflict with the OECD Guidelines, which are to be the basis for interpreting Phase 2 Transfer Pricing Exposure Draft and later, the new legislation.

In our opinion, the application of this section will create substantial confusion and controversy in its implementation. In addition, this section may be redundant since the Commissioner already has access to general anti-avoidance rules in Part IVA of Income Tax Assessment Act, 1936.

Combination of methods

Section 815-215(2), ITAA 1997 of the Phase 2 Transfer Pricing Exposure Draft allows for the use of "a combination of methods" to identify the arm's length conditions that operate between entities that meet the cross-border requirement.

In this regard, we note that paragraph 2.11 of the OECD Guidelines outlines that "the arm's length principle does not require the application of more than one method for a given transaction (or set of transactions that are appropriately aggregated following the standard described at paragraph 3.9)".

In addition, the OECD Guidelines indicate that generally, it will be possible to select one (1) method to provide the best estimation of the arm's length price. Accordingly, in our view, the incorporation of the use of a combination of methods to identify arm's length conditions contradicts with guidance provided as part of the OECD Guidelines.

Further, in our opinion, the application of more than one (1) method to identify arm's length conditions may result in different outcomes, creating confusion as to the appropriate arm's length result. As a result, further analysis and adjustments of the comparable data used in the application of methods may be required. This situation would impose significant burden for taxpayers.

Record keeping requirements and penalty

Section 815-305, ITAA 1997 of Phase 2 Transfer Pricing Exposure Draft sets out optional record keeping requirements about arm's length principle for cross-border conditions between entities. In addition, Section 815-305(1), ITAA 1997 includes that an entity that does not keep records would be treated as not having a reasonable arguable position and makes reference to section 284-180 in Schedule 1 of the TAA 1953.

Grant Thornton Australia notes that the above implication will place a heavy compliance burden on taxpayers, especially for the small and medium enterprises ("SME") involved in cross-border transactions. We believe that a threshold for record keeping requirements should be included in Phase 2 Transfer Pricing Exposure Draft, below which a taxpayer should not be required to prepare and/or maintain documentation. This situation would for taxpayers to alleviate this burden on SME's.

In our view, clarification with respect to the effect of subdivision 284-CA of the TAA 1953 in relation to the treatment of an entity as not having a reasonable arguable position, needs to be provided. Alternatively, specific reference to the interaction of subdivision 815-B, 815-C or 815-D of the ITAA 1997 with section 284-15 – When a matter is reasonably arguable ITAA 1997, TAA 1953 and the penalty regime outlined in section 284-145, TAA 1953, may need to be included as part of subdivision 284-CA of TAA 1953.

Definition of "regulations"

Section 815-130 and section 815-230, ITAA 1997 of the Phase 2 Transfer Pricing Exposure Draft makes reference to "regulations". Grant Thornton Australia notes that no definition as to the "regulations" was provided in the Phase 2 Transfer Pricing Exposure Draft. As such, we believe that further clarification on the "regulations" that will serve as guidance for section 815-130 and section 815-230 of ITAA 1997 needs to be provided.

In addition, we note that in our view, these regulations need to be made publicly available prior to the reforms being introduced into Parliament.

We believe that the highlighted issues require clarification prior the legislative reforms are discussed at the parliamentary level. In our view, any uncertainty created by the proposed legislation may jeopardise future investment by multinational companies in Australia. On the other hand, complex transfer pricing regime may result in increased compliance burdens and uncertainty to existing taxpayers, hence threatening the sustainable future development of the Australian economy in the context of its global interactions.

Should you have any queries in relation to these matters, please do not hesitate to contact me on 03 8663 6200 or Jason Casas on 03 8663 6433.

Yours sincerely,
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