Tax
10 Shelley Street
Sydney NSW 2000

P O Box H67
Australia Square 1213
Australia

ABN: 51 194 660 183
Telephone: +61 2 9335 7000
Facsimile: +61 2 9335 7001
DX: 1056 Sydney
www.kpmg.com.au

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

Our ref KPMG submission on Phase 2 ED

Contact Anthony Seve
(02) 9335 8728

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Dear Sir/Madam,

Exposure Draft of Tax Laws Amendment (Cross-Border Transfer Pricing) Bill 2013: Modernisation of transfer pricing rules

We appreciate the opportunity to comment on the Exposure Draft of *Tax Laws Amendment (Cross-Border Transfer Pricing) Bill 2013: Modernisation of transfer pricing rules* (the ED) and accompanying draft Explanatory Memorandum (the EM) which were released on 22 November 2012.

KPMG has played a significant role in drafting submissions both for the Institute of Chartered Accountants in Australia and The Tax Institute and supports the issues raised in these submissions.

Our intention in providing this submission is to highlight our key areas of concern and also key concerns raised with us by our clients.

Introduction

Following consultation held with Treasury on 7 December 2012, we understand the Government's underlying policy objectives with respect to the ED can be broadly expressed in the following terms:

- To align Australia's transfer pricing rules with international best practice as expressed in the 2010 OECD Transfer Pricing Guidelines;
- To maintain the 'single entity' approach with respect to the attribution of profits to permanent establishment (PEs);
- To give legislative effect to the current administrative practices set out in ATO transfer pricing rulings in relation to record keeping and penalties (in particular TR 98/11 and TR 98/16); and

- To ensure that the rules are "sufficiently robust to protect the Australian tax base – but they also need to be balanced so as not to overreach or impose transaction costs which may inhibit Australian's international competitiveness[1]".

We base the key comments outlined in our submission on this understanding. Unless otherwise indicated, all section references are to sections of the ED.

Key areas of concern

We are concerned that the ED could be seen not to strike an appropriate balance between protecting the revenue and the additional compliance burden and uncertainty that will arise for taxpayers if the ED is enacted in its current form. In this respect, we urge Treasury to undertake further consultation with relevant stakeholders with a view to achieving a more appropriate balance between these competing objectives.

Our key areas of concern with the ED and accompanying draft EM having regard to the Government's underlying policy objectives and also more generally are:

- The ED is not in alignment with the 2010 OECD Transfer Pricing Guidelines in a number of key respects, including:
  - Under section 815-115(2), the arm's length conditions replace the actual conditions in all cases where a taxpayer obtains a transfer pricing benefit and does not therefore limit the potential for the ATO to reconstruct transactions only in 'exceptional circumstances', contrary to paragraph 1.64 of the 2010 OECD Transfer Pricing Guidelines;
  - Subdivision 815-D has not been drafted having regard to prudent business management principles as recommended in paragraphs 5.4 and 5.28 of the 2010 OECD Transfer Pricing Guidelines;
- The ED is not consistent with the current administrative practices of the ATO as set out in TR 2011/1 (application of the transfer pricing provisions to business restructuring by multinational enterprises) in a key respect. Where it applies, subsection 815-125(7) requires the arm's length conditions to be identified as if what was actually done by the parties had not been done. By contrast, paragraphs 19 (Step 3, sixth dot point) and 41 of TR 2011/1 state that where an examination shows that the pricing of the business restructuring arrangement does not make commercial sense, the Commissioner would in the first instance seek to make a pricing adjustment by reference to the arrangement as entered into by the parties;
- It is not clear in the ED how the proposed new provisions will interact with Division 13 and Subdivision 815-A. The ED states that Division 13 will be repealed. The draft EM states that Subdivision 815-A will have no operation from the date of application of the new provisions. Our main concern in this regard is that it is not clear what taxing provision will

[1] Statement from 1 November 2011 Consultation Paper.

operate (if Division 13 is repealed and given Subdivision 815-A is only applicable to treaty cases) in non-treaty cases relating to arrangements entered into prior to application of the new provisions;

- The ED is not consistent with the current administrative practices of the ATO as set out in ATO transfer pricing rulings in relation to record keeping and penalties in a number of key respects:
  - Subdivision 815-D has not been drafted having regard to prudent business management principles as endorsed by the ATO in paragraphs 1.5-1.10 of TR 98/11;
  - Subdivision 815-D does not distinguish between the quantum, proportion or complexity of a taxpayer's cross-border dealings contrary to the ATO's current administrative approach set out in, in particular, paragraph 1.9 of TR 98/11;
  - Subdivision 815-D has been drafted on the basis that *all* of the requirements set out in subsections 815-305(2)-(5) must be satisfied to enable a taxpayer to potentially have a reasonably arguable position (RAP) and thereby have administrative penalties reduced to 10%. This approach:
    - is contrary to the ATO's current administrative approach set out in paragraphs 36 and 39 of TR 98/16 under which taxpayers with transfer pricing documentation rated as being at least medium-to-high quality generally have administrative penalties reduced to *nil* in the event of a transfer pricing adjustment;
    - does not leave any meaningful scope for the ATO to remit penalties under section 298-20 of the *Taxation Agreements Act 1953* (TAA 1953) to a rate less than 10%; and
    - does not encourage voluntary compliance;
  - Subdivision 815-D has not been drafted having regard to reducing documentation requirements for small businesses contrary to the approach taken in Chapter 6 of TR 98/11;
  - Subdivision 815-D requires taxpayers to prepare records that satisfy *all* of the requirements set out in subsection 815-305(2)-(5) for *each* year of income to enable a taxpayer to potentially have a RAP contrary to the ATO's current administrative approach set out in the Four Step Process described in TR 98/11 (in particular Step 4);
- The term 'economic substance' used in subsection 815-125(5) to (7), has not been defined in the ED. The context in which the term 'economic substance' is used seems to indicate that it is intended to go beyond considering the "economic substance" of a single transaction, compared to the legal form of the transaction, to potentially considering the totality of the arrangements between the parties although this is not clear;
- The ED does not clearly define or differentiate key terms used in the drafting of Subdivision 815-B, in particular key sections 815-115, 815-120 and 815-125, nor have a single consistent meaning for each term on each occasion in which it is used in these provisions. For example, the term '*conditions*' does not appear to have a consistent meaning on each

occasion in which it is used in these provisions. Further, the ED does not sufficiently differentiate between the terms '*conditions*' and '*circumstances*' used in these provisions;

- Under subsection 815-115(2), the arm's length conditions are deemed to replace the actual conditions where a taxpayer obtains a transfer pricing benefit. The drafting of subsection 815-115(2) is potentially broad enough to also require taxpayers to make secondary adjustments[2] consistent with arm's length conditions. The ED should clearly state that the scope of section 815-115 is limited to the making of primary transfer pricing adjustments and does not extend to the making of secondary adjustments;
- Clearer guidance is needed as to what records taxpayers will need to maintain to avoid administrative penalties arising under section 288-25 of the TAA 1953 for failing to keep the records required by section 262A of the *Income Tax Assessment Act 1936* (ITAA 1936);
- The *de minimis* thresholds of $10,000 and $20,000 in proposed section 284-165 of the TAA 1953 are relatively ineffective in the context of the ATO's administration of Australia's transfer pricing rules and should be raised to $5,000,000;
- The ED does not clearly indicate how proposed Subdivisions 815-B and Subdivisions 815-C interact with a number of other key areas of the income tax laws (eg the capital gains and loss provisions in Parts 3-1 to 3-3 of the *Income Tax Assessment Act 1997* (ITAA 1997) which contain their own market value substitution rules including in the event of non-arm's length dealings between parties[3] and the debt/equity rules in Division 974 of the ITAA 1997 which apply an economic substance rather than legal form approach in determining whether an interest is a debt interest or an equity interest for tax purposes) and could result in increased uncertainty and additional compliance costs for taxpayers;
- A compelling case has not been made as to why the Commissioner should be given an 8-year time limit for amending assessments under sections 815-145(1) and 815-235 rather than applying the normal time limits for amending assessments under section 170 of the ITAA 1936. In this respect, it is particularly important to note that subsection 170(7) of the ITAA 1936 provides the Commissioner with the ability to obtain additional time in which to complete an examination of a taxpayer's affairs; and
- The ED does not address the interaction between the transfer pricing rules and customs duty rules. Transfer pricing adjustments involving the importation of goods, particularly adjustments resulting from the use of profit methods, can cause customs duty problems, because a separate adjustment needs to be sought from Customs in order to obtain a refund of any overpaid customs duty. Obtaining such customs duty adjustments is not straightforward. A whole-of-government approach is needed with the aim of creating a

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[2] A secondary adjustment can broadly be described as an adjustment arising from a secondary constructive transaction that can be triggered by a primary transfer pricing adjustment made under Article 7 or 9 of a DTA, or under domestic law anti-transfer pricing measures (paragraph 35 of TR 2007/1).

[3] Section 116-30 in relation to capital proceeds and section 112-20 in relation to cost base.

simple legislative mechanism by which taxpayers can obtain refunds of any overpaid customs duty following the making of a transfer pricing adjustment by the ATO.

In light of the above, we urge Treasury to undertake further detailed consultation with a view to addressing the above concerns.

Yours sincerely

Anthony Seve
Partner

Damian Preshaw
Director