Law Council
OF AUSTRALIA

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The Treasury
Langton Crescent
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Dear Mr McDonald

Exposure draft of *Tax Laws Amendment (2012 Measures No. 3) Bill 2012*

Thank you for the opportunity to provide comments, observations and submissions in relation to the exposure draft of the *Tax Laws Amendment (2012 Measures No. 3) Bill 2012: Cross-border transfer pricing* (**Exposure Draft**).

The Taxation Committee of the Business Law Section of the Law Council of Australia (**the Committee**) recognises the difficult policy and legislative considerations in this area and that equity and fairness considerations are difficult to balance in the circumstances. The Committee values the opportunity to contribute to the legislative process.

The Committee sets out its comments below addressing particular aspects of concern. In each instance the Committee proposes an alternative which it considers best balances the competing public interests involved.

1. Executive Summary

1.1 The Committee rejects the suggestion that there has been any clear expression of Parliamentary intention that the associated enterprises articles of Australia's double taxation agreements (**DTAs**) were to operate as an independent taxing power. Nor has Parliament previously indicated an intention to fundamentally alter the principles to be applied in interpreting the provisions of the DTAs conferring the taxing power. The Committee strongly considers the policy underlying the amendments is inappropriate and that the legislative amendments should only operate prospectively rather than retrospectively. Further, to the extent the amendments continue to be retrospective, there should be protections for taxpayers against any penalties or interest which would not have arisen but for the amendments.

1.2 In light of the increased powers of the Australian Taxation Office (**ATO**) to resort to profit allocation methods under the proposed amendments, and the ATO's greater access to comparative data of taxpayers in Australia, the Committee considers that the ATO should bear the burden of proof to show the taxpayer's pricing is not consistent with the arm's length principle. In the alternative, and as

a minimum to ensure fairness, there should be no presumption in relation to appeals to the AAT or the Federal Court that the Commissioner of Taxation's decision in respect of Division 815 is correct.

1.3 The Committee's concerns regarding the retrospective nature of the amendments are exacerbated by the proposed unlimited period for making adjustments under the new powers. There should be a short amendment period of two or, at most, four years from the introduction of the measures for the Commissioner to make adjustments, subject to the general power to seek an extension of time.

1.4 Consistent with the OECD's suggested approach to transfer pricing legislation, the Committee considers the operative rule should explicitly refer to *transactions* between international related parties having an arm's length price, rather than referring to the allocation of profits between parties.

1.5 Irrespective of the arguments in favour of making the 'treaty taxing power' retrospective, it is clear that there has been no articulation by the Parliament of an intention that the power could be applied to determine the pricing of debt, otherwise than based on the actual level of debt, particularly where the level of debt is within the range explicitly allowed for thin capitalisation purposes. Accordingly, there is no justification for the proposed provisions governing the interaction of the 'treaty taxing power' with the thin capitalisation rules to require a "reduced value" for debt that equates with some notion of its arm's length value.

2. Retrospective Laws

2.1 *The dangers of retrospective laws*

The Committee strongly considers that any legislative amendments should have prospective and not retrospective operation. Retrospective laws:

- are contrary to the rule of law;
- engender business uncertainty; and
- create adverse perceptions of sovereign risk in relation to Australian taxation laws generally.

A retrospective law undermines the rule of law, because it:

- cannot itself guide action; and
- undercuts the integrity of existing and prospective rules, since it puts them under the threat of retrospective change.[1]

As acknowledged by former Labor Senator Peter Cook (then Deputy Leader of the Opposition in the Senate), even where there is clear avoidance behaviour, it still may not be appropriate to apply any legislative fix retrospectively.[2] Here, there is not even a suggestion of avoidance behaviour.[3]

2.2 *No justification for backdating the amendment*

The Committee is concerned that paragraph 1.10 of the Draft EM seeks to justify the retrospective operation of the amendment from 1 July 2004 on a spurious basis.

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[1] Lon Fuller, *The Morality of Law*, Yale University Press (1964), 39.
[2] *Senate Hansard*, 16 August 2000, p16440.
[3] See paragraph 1.13 of the draft explanatory memorandum accompanying the Exposure Draft (**Draft EM**).

The purported basis for electing this particular date is that Parliament spoke to this issue in 2003, and that the current amendment is a ‘clarification’ of prior intention. The Draft EM cites the *International Tax Agreements Amendment Act 2003* (Cth) and its explanatory materials as Parliament’s most recent demonstration of its intention that DTAs provide alternative and independent transfer pricing liability provisions to those contained in Division 13 of the *Income Tax Assessment Act 1936* (**ITAA 1936**).

The Committee strongly disagrees that the 2003 amendment or its explanatory materials gave any signal – explicitly or implicitly – that the transfer pricing rules would operate as suggested. Furthermore, no further attempt at ‘clarification’ has been made by Parliament in the eight years since this time despite the issue being questioned by the courts on a number of occasions.[4] For these reasons it is plainly inappropriate to select this date and, if the provisions remain retrospective, the Draft EM (particularly paragraphs 1.8 to 1.10) should be modified to make it clear to Parliament that this is the case.

2.3 <u>*Not a clarification, but the introduction of a significant change in the law*</u>

In any case, on a proper interpretation, the retrospective amendments cannot be regarded as merely ‘clarifying’ that DTAs are a separate and independent source of the Commissioner’s power to issue and amend assessments.

This is because they introduce a new test for interpretation which requires the taxpayer and the Court to read the relevant provisions in the DTAs “so as to best achieve consistency with the documents covered by section 815-25”.[5]

For the years of retrospective application, the ‘documents’ are the Model Tax Convention (including commentary) and the Transfer Pricing Guidelines last published by the OECD prior to the relevant income year.[6]

The High Court has repeatedly recognised that the well established purposive approach to the interpretation of federal legislation is different to an approach requiring that a statute be interpreted to “best achieve” a specified purpose.[7] Different approaches to the interpretation of legislation can of course lead to very different results.[8] This point is illustrated by the Full Federal Court’s decision in *FCT v SNF (Australia) Pty Ltd.*[9]

In that case, the Court considered the role of the OECD Guidelines and the Model Tax Convention in interpreting the provision giving effect to the *associated enterprise article* in Australian domestic law. Relevantly, in that case no evidence was adduced that it was the practice in any of the relevant jurisdictions (Australia, China, France and the United States) to apply the OECD Guidelines to circumstances in which the *associated enterprise article* may apply. Consequently, the Court described the Commissioner’s submission

[4] See, for example, *GE Capital Finance Pty Ltd v Commissioner of Taxation* [2007] FCA 558, 36 per Middleton J, *Roche Products Pty Ltd v Commissioner of Taxation*, 2008 ATC 10-036, 191 per Justice Downes (President AAT), *Undershaft (No 1) Limited v Commissioner of Taxation* [2009] FCA 41, 45-46 per Lingren J.
[5] See proposed s 815-22(3) of the Exposure Draft.
[6] See clause 11 of the Exposure Draft.
[7] *Lacey v Attorney-General of Queensland* (2011) 242 CLR 573, [46] (per French CJ, Gummow Hayne, Crennan, Kiefel and Bell JJ); *Chugg v Pacific Dunlop Ltd* (1990) 170 CLR 249 at 262 (per Dawson, Toohey and Gaudron JJ).
[8] See, for example, the different outcomes that Deane J considered would flow from different approaches to the construction of s260 of the *Income Tax Assessment Act 1936* (Cth) in *FCT v Gulland* (1985) 160 CLR 55 at 94.
[9] (2011) 193 FCR 149.

that resort could be had to the OECD Guidelines in interpreting the provision as "legally unsound",[10] and concluded that:

> *"The guidelines .. are not a legitimate aid to the construction of the double taxation treaties."*

The concept of consistency with the OECD Guidelines was explicitly rejected by the Court. To the extent that evidence was able to be adduced of the application of the OCED Guidelines in other jurisdictions, the Court stated that reference may have been made to the OECD Guidelines to "throw light" on the meaning of the domestic legislation,[11] rather than a construction being preferred because it was consistent with the OECD Guidelines.

The proposed requirement to interpret the *business profits article* and the *associated enterprise article* to "best achieve consistency with" the OECD Guidelines and the Model Tax Convention will effect a fundamental change to the manner in which the provisions would otherwise be interpreted.[12]

It follows that the application of proposed Division 815 to income years prior to the year commencing 1 July 2013 is not a 'clarification' of existing law. It is an unannounced and unanticipated regime with retrospective application. It has the evident purpose of imposing an additional tax burden on taxpayers.

Arguments about whether Parliament had previously indicated its intention that DTAs be a separate and independent source of taxing power are irrelevant. The proposed provision is fundamentally different to any provision which might be said to have been foreshadowed.

2.4 *Retrospective legislation should only be used in extraordinary circumstances*

The Committee accepts that retrospective application of tax legislation is not entirely antithetical to good tax policy. Each case must be considered on its merits. The classic case in which it might be said that retrospective application of an impost on taxpayers may be appropriate is where taxpayers exploit loopholes in the tax law and thereby legally avoid tax.

The fundamental flaws in the policy argument for retrospective application of Division 815 are threefold.

- First, taxpayers have been subject to an existing regime for the entire period of the proposed retrospective application[13] – if Treasury is correct that DTAs are an independent source of taxing power.
- Second, there is no suggestion that retrospective application of Division 815 is intended to close any loophole in Division 13 of the ITAA 1936 being exploited by taxpayers.
- Third, no "references" (let alone clear and unambiguous public statements) have previously been made putting taxpayers on notice of Parliament's intention to introduce this particular regime.

It follows that good tax policy compels the conclusion that Labor Senator Peter Cook's *classical* argument against retrospectivity, as cited above, must prevail.[14] This is

[10] *FCT v SNF (Australia) Pty Ltd* (2011) 193 FCR 149, [107].
[11] *FCT v SNF (Australia) Pty Ltd* (2011) 193 FCR 149, [118].
[12] See n7 above.
[13] That is, under Division 13 of the ITAA 1936.

particularly so given that the use of the DTAs as a taxing power has not been the subject of any final judicial decision and is a matter in contention in disputes that are or will be before the courts in future.

The *unfairness* of the proposed legislation is exacerbated by the decision to apply it to the previous eight income years. Labor Senator Nick Sherry described "two years retrospectivity" of an amendment to GST legislation, designed to close a loophole capable of being exploited to the detriment of revenue, as "very significant indeed".[15] By that measure, eight years retrospectivity that does not involve closing a loophole must be *extraordinarily* significant.

2.5 <u>*No basis for penalties or interest*</u>

If, contrary to the Committee's views above, retrospective legislation is proposed to be introduced, it is even more extraordinary for a taxpayer to be subject to penalties or interest for breaching a provision it cannot have anticipated.

At a bare minimum, the extraordinary impact of the proposed measures should be ameliorated by providing protection against penalties and interest in circumstances where Division 13 of the ITAA 1936 would not have operated to permit the relevant adjustment.

It has been suggested in consultation discussions that the provisions already operate to limit penalties to the lower of the shortfall under Division 13 of the ITAA 1936 or by reason of a provision of a DTA.[16] Even if this is the case, as proposed Division 815 introduces a new taxing power (for the reasons outlined above), the penalty provisions should be expressly limited to shortfalls that would otherwise arise under Division 13.

3. Burden of Proof

The Committee is concerned that the Exposure Draft significantly increases the Commissioner's power – for example, allowing increased reliance on profit-based methods, which pose significant difficulties for taxpayers who do not have access to the same level of comparative data as is available to the ATO – yet taxpayers retain the burden of proof.

In many jurisdictions, the tax administration bears the burden of proof to show that the taxpayer's pricing is not consistent with the arm's length principle.

The OECD Guidelines indicate that the allocation of the burden should be decided after an assessment of the fairness of the features of the jurisdiction's tax system. In making such an assessment, the OECD Guidelines suggest that it is necessary to consider penalties, examination practices, administrative appeals processes, rules regarding payment of interest with respect to tax assessments and refunds, whether proposed tax deficiencies must be paid before protesting an adjustment, the statute of limitations, and *the extent to which rules are made known in advance*.[17]

The amendment provided for in the current Exposure Draft gives the Commissioner an independent and additional taxing power, on top of the powers provided for in Division 13 of the ITAA 1936.

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[14] Refer comments of former Labor Senator Peter Cook (the Deputy Leader of the Opposition in the Senate), *Senate Hansard*, 16 August 2000, p16440.
[15] *Senate Hansard,* 16 August 2000, p16431; see also the speech of Dr Carmen Lawrence MP (Labor, Fremantle) on 8 August 2001 concerning the "worrying" retrospective application of changes to R&D concessions: *House of Representatives Hansard*, 8 August 2001, p29390.
[16] Presumably under s284-145(2) of the *Taxation Administration Act 1953* (**TAA**).
[17] *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, 2010, 18.

The burden of compliance with both Division 13 and potential new powers derived from a combination of the new amendment and the DTAs will be significant for the taxpayer. Furthermore, the rules have not been made known in advance, and will apply with nearly a decade of retrospectivity.

To achieve the 'international consistency' which the Draft EM advocates in justification of the amendment,[18] and considering the level of complexity that will exist under the proposed regime, the Committee considers that the burden of proof should properly lie with the ATO.

In the alternative, and as a minimum to ensure fairness, there should be no presumption in appeals under Part IVC of the TAA to the AAT or the Federal Court in respect of Division 815 that the Commissioner of Taxation's decision is correct.[19]

That is, the taxpayer should bear no legal or evidential onus to prove that the assessment is excessive.

For example, the issue in an AAT proceeding would simply be whether the Tribunal standing in the shoes of the decision maker would make the same decision, which is the position that would prevail but for section 14ZZK of the TAA.[20] This could be achieved by inserting a provision to the following effect: "Section 14ZZK of the Taxation Administrative Act 1953 (Cth) does not apply to an application to the Administrative Appeals Tribunal pursuant to section 14ZZ(a)(i) of the Taxation Administrative Act 1953 (Cth) for review of a decision."

Appropriate amendments could similarly be made in relation to provisions dealing with appeals to the Federal Court.

Time Limits

The proposed legislation amends sections 170(9B) and (9C) of the ITAA 1936, giving the ATO an unlimited period to make adjustments. It is unclear why it is necessary to allow the Commissioner an unlimited amendment period, which only exacerbates the concerns about the retrospective nature of the legislation.

As the Committee noted in its earlier submission, the Commissioner is already equipped with:

(a) the existing disclosure obligations imposed through the requirement to file a Schedule 25A and/or an International Dealings Schedule with their tax returns; and

(b) the power to seek an extension of time under section 170(7) of the ITAA 1936.

These provisions give the Commissioner more than adequate resources to identify transfer pricing issues and make amendments within a normal four year period, or longer with the available extension. The Committee notes that the Commissioner appears to have never approached the Federal Court under section 170(7).

The Committee again submits that, in view of the existing power under section 170(7) and the significant number of DTAs and Tax Information Exchange Agreements, arguments

[18] Paragraph 1.10 of the Draft EM.
[19] See ss 14ZZK and 14ZZO of the TAA.
[20] See *McDonald v Director General of Social Security* (1984) 1 FCR 354, 357-359 (Woodward J), 366 (Northrop J); *SZBEL v MIMIA* (2006) 228 CLR 152, [40] (Gleeson CJ, Kirby, Hayne, Callinan and Heydon JJ); *Optimise Group v FCT* (2010) 119 ALD 585; [2010] AATA 782, [40].

about hindrance, lack of co-operation and the difficulties associated with information exchange fall away.

Accordingly, the Committee proposes a short period of two, or at most, four years for the Commissioner to make adjustments from the time the measures are introduced.

4. Characterisation of Arm's Length Test – Profits or Transactions

The proposed legislation characterises the arm's length test as applicable to the allocation of profits generally, rather than being confined to the profits resulting from specific *transactions*.[21]

The Committee considers that any profits-based methods must be explicitly confined to the assessment of transactions.

Any legislative reform that proposes assessment on a more general allocation of profits based on an entity's taxable income is not consistent with effective, equitable and transparent tax administration. The Commissioner's broad coercive information gathering powers and ability to obtain information pursuant to agreements with tax authorities in other jurisdictions means that taxpayers are at a significant disadvantage in obtaining potentially relevant information. In particular, in many cases taxpayers will not be in a position to obtain comparative data of other taxpayers' taxable income. Indeed, taxpayers are often unable to obtain taxable income data from their own related parties overseas.

The Committee supports amendments that ensure that transactional profit methods (i.e. the transaction net margin method and profit split) are available, provided this is to determine an arm's length price for *transactions* only.

Further, there should be no discretion to apply a transfer pricing method in a way that allows the Commissioner to reconstruct transactions or to tax an enterprise on profits that it does not earn merely on the basis that the group overall is in a profitable position where this does not otherwise reflect the adoption of an arm's length pricing for transactions which have occurred between those parties. This is consistent with the OECD Guidelines.[22]

The OECD suggested approach to transfer pricing legislation, released in June 2011, is consistent with the Committee's proposed approach. In paragraph 1 of section 1 it provides:

> "The amount of taxable profits derived by an enterprise that engages in one or more *commercial or financial transactions* with an associated enterprise shall be consistent with the arm's length principle if *the conditions of those transactions* do not differ from conditions that would have applied between independent enterprises in *comparable transaction*s carried out under comparable circumstances" (emphasis added).

In the Committee's view, this rule makes it appropriately clear that application of the arm's length principle is not an open-ended exercise of dividing global profits among associated enterprises, but rather an exercise focused on the profits referable to the commercial or financial transactions that the relevant taxpayer has entered with its associated enterprises.

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[21] For example, see proposed section 815-10 ('Object') and section 815-22(1)(a)(iii) ('When an entity gets a *transfer pricing benefit*').
[22] 2010 OECD Guidelines, 2.7.

Similarly section 147(1)(a) of the *Taxation (International and Other Provisions) Act 2010* (UK) refers to a transaction or a series of transactions as part of the basic preconditions for operation of the UK provisions. While section 150 goes on to define "transaction" and "series of transactions" broadly, it does not support an allocation of overall profits, as the focus remains on the relevant transaction(s) under consideration. By contrast the Exposure Draft seems to studiously avoid any references to transactions.

6. Interaction with Thin Capitalisation Rules

The Committee understands that provisions dealing with the interaction of the thin capitalisation and the proposed new transfer pricing rules have been inserted as a result of the desire of a number of taxpayers for certainty that the proposed new transfer pricing rules do not operate to "override" the thin capitalisation rules, but rather are restricted in their operation to the pricing of the debt in place.

In this regard, that purpose is achieved by the inclusion of section 815-22(4) and examples 1.1 to 1.3 in the Draft EM. It is not necessary and, in the Committee's view indeed inappropriate, to include section 815-22(5) and example 1.4 in the Draft EM providing that a reduced value of debt may be used in some (unspecified) extraordinary circumstances.

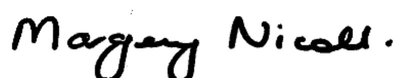
That change was neither requested by taxpayers nor mooted by the Assistant Treasurer in his press release of 1 November 2011, and was not contemplated by the 2003 amendment referred to in the Draft EM. Indeed the ATO's view on this point was not even publicly known until 2008 or 2009 and not finally outlined and confirmed until the issue by the ATO of Taxation Ruling 2010/7 on 27 October 2010.

The Committee considers the arguments outlined above regarding the potential injustice of retrospective legislation apply with even greater force with regard to section 815-22(5).

Further Contact

The Committee trusts these comments are of assistance. Please do not hesitate to contact Mr Reynah Tang, a member of the Committee, on (03) 9672 3535 should you require any further information.

Yours sincerely,



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