MOORE STEPHENS
ACCOUNTANTS & ADVISORS

19 December 2012

Level 10, 530 Collins Street
Melbourne VIC 3000

T +61 (0)3 8635 1800
F +61 (0)3 8102 3400

www.moorestephens.com.au

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

Via email: transferpricing@treasury.gov.au

Dear Sir / Madam

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

We refer to the announcement made by The Hon David Bradbury, MP on 22 November 2012 and, in particular, to the exposure draft issued on the same date titled: “Tax Laws Amendment (Cross-Border Transfer Pricing) Bill 2013: Modernisation of transfer pricing rules” (the “Exposure Draft”).

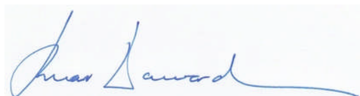
We submit herewith our comments and recommendations in response to the Exposure Draft. We also note that we have previously provided detailed submissions in response to the earlier announced reform of Australia’s transfer pricing legislation (and now enshrined as Subdivision 815-A of the Income Tax Assessment Act 1997).

Transfer pricing is viewed by multinational organizations as an area of substantive “risk” in the conduct of their business and an area that creates a substantial administrative burden with which they must deal; accordingly, we believe that a clear legislative framework in relation to the operation of our transfer pricing rules is imperative in dealing with the “risk’ and in limiting the administrative burden that taxpayers confront. The Exposure Draft, coupled with Subdivision 815-A, does little to assist taxpayers address both the “risk” and administrative burden to which we refer.

We appreciate the opportunity to respond to the Exposure Draft and attach our comments and recommendations that address a number of the more important issues that we believe the proposed legislation presents or fails to address satisfactorily.

We would welcome the opportunity to provide further input and to discuss our submission with you should further information or clarification of our comments be considered appropriate. In the meantime, should you have any queries please contact me Stuart Edwards on (03) 8635 1967 or Daren Yeoh on (03) 8635 1994.

Yours sincerely



Stuart Edwards
Associate Director

Daren Yeoh
Director

MOORE STEPHENS
MELBOURNE PTY LTD

APPENDIX 1

1.1 The administrative burden of reform

Clear guidance as to the transfer pricing obligations of taxpayers is critical to compliance with their obligations as good corporate citizens. We submit that the ongoing piecemeal approach to reform of Australia's transfer pricing laws imposes a significant, costly and so far as Subdivision 815-A of the Income Tax Assessment Act 1997 is concerned, a spurious administrative burden upon affected taxpayers.

The Exposure Draft provisions bear many similarities to the controversial Subdivision 815-A. It is a travesty of justice, however, that the Government failed to temper its enthusiasm for transfer pricing reform so as to introduce legislation (such as that now proposed) in one-fell swoop in lieu of the stop-gap measure adopted; that is the introduction of Subdivision 815-A which will have no life beyond the date of implementation of the Exposure Draft. Taxpayers must now comply with Division 13 of the Income Tax Assessment Act 1936 up until sometime in early 2013 unless their trade is with Treaty countries in which case, from 8 September 2012, they must also comply with Subdivision 815-A retrospectively from 1 July, 2004 afterwhich, they must comply with the proposed Exposure Draft from some yet-to-be-determined date in 2013.

The proposed legislation in conjunction with the burgeoning administrative obligations cast by the International Dealings Schedule (IDS) and, for some, the Reportable Tax Position Schedule (RTP), imposes a substantial documentation burden upon affected taxpayers.

One is left questioning: what level of regard the Government has had for the non-productive administrative burden cast upon affected taxpayers that must deal with multiple layers of complex legislation and ATO reporting obligations?

1.2 The penalty mischief

Transfer pricing is a very substantive "risk" area for taxpayers with cross-border transactions with related parties. The recently released Exposure Draft incorporates new and significant proposed legislative changes that will leave taxpayers searching for a solution to the potentially horrendous "penalty" provisions that apply in the case of the ATO successfully prosecuting a transfer pricing adjustment against a taxpayer.

Whilst we welcome the proposed 8 year time limit within which the ATO must issue a notice of assessment in relation to a transfer pricing adjustment (refer later comments) we submit that it is iniquitous that a taxpayer that prepares robust transfer pricing documentation, documentation which demonstrates the arm's length nature of their related party dealings, should face the prospect of any penalties whatsoever provided that documentation has been prepared in good faith on a contemporaneous basis in accordance with Exposure Draft requirements.

We submit that the Exposure Draft should include a provision that operates to negates penalties in respect of an adverse transfer pricing adjustment in like terms to that set down at paragraph 2.11 in Taxation Ruling TR 98/11 'Income tax: documentation and practical issues associated with setting and reviewing transfer pricing in international dealings', namely:

> **"Taxpayers who have in good faith followed the four steps outlined in Chapter 5 of this Ruling in the preparation of their returns and kept sufficient and relevant contemporaneous documentation to show compliance with the arm's length principle will not be subject to penalties...."**

We believe a provision along these lines should be enshrined in law and not be dependent upon the 'goodwill' of the ATO. We note that Taxation Ruling 98/16 'Income tax: international transfer pricing - penalty tax guidelines' paragraph 36, includes a similar statement to that within TR 98/11.

1.3 The reconstruction power

A substantive concern that we harbour with the Exposure Draft is the stated power to "substitute" actual conditions with "...arm's length conditions..." under the proposed Section 815-115 and Section 815-215. We have seen in the SNF case [and Roche Products case (in relation to the diagnostics division)] the ATO attempt to 'reconstruct' the taxpayers operating performance with scant regard for commercial realities. Any power to "substitute" or reconstruct should be limited to "exceptional" circumstances as is detailed in the OECD Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines). Whilst the OECD Guidelines form a critical basis for interpreting the proposed new legislation, the proposed legislation is far more explicit as to the ATO's power to reconstruct when compared with OECD Guidelines; accordingly, this divergence of view is unquestionably setting the scene for uncertainty and controversy in the years ahead.

In relation to this power to reconstruct the OECD Guidelines state:

> ***"In other than exceptional cases, the tax administration should not disregard the actual transactions or substitute other transactions for them. Restructuring of legitimate business transactions would be a wholly arbitrary exercise the inequity of which could be compounded by double taxation created where the other tax administration does not share the same views as to how the transaction should be structured."*** [OECD Guidelines, 2010, Para 1.64]

The OECD Guidelines outline "....two particular circumstances..." when recharacterisation of a transaction may be "...appropriate and legitimate..." and ***we strongly recommend that a limitation on the power to reconstruct be enshrined in the proposed new law.***

It is noteworthy that the OECD Guidelines acknowledge that there will be cases where it is not "...possible to apply the arm's length principle to arrive at a single ..."price" or "margin" ...that is the most reliable to establish whether the conditions of a transaction are arm's length."[OECD Guidelines Paragraph 3.55]. The OECD Guidelines proceed to point out that "....any point in the "range" could satisfy the arm's length principle. It follows that a power to reconstruct unless limited, as is the case in the OECD Guidelines, may simply present the ATO with an alternative proposition, arguably an equally valid outcome, to that achieved by the taxpayer and therein lies the basis for dispute.

1.4 Thin Capitalisation quagmire

Subdivision 815-B leaves taxpayers in little doubt that the ATO will have the 'power to reconstruct' the level of a taxpayer's debt, so as to calculate the arm's length interest rate to apply to actual debt; this is so notwithstanding taxpayers may comply with the thin capitalisation provisions of Division 820.

The Exposure Draft achieves this by stating that in working out the "rate" that is to apply to the actual quantum of debt interest one must do so "...as if the arm's length conditions had operated".

We acknowledge that this guidance confirms the ATO's stance previously set down in TR 2010/7 (titled: "Income tax: the interaction of Division 820 of the Income Tax Assessment Act 1997 and the transfer pricing provisions"); however, the practical application of the concept and determination of what is the arm's length "rate" will, no doubt, be fraught with controversy given the disparity of views that will exist as to what is the quantum of the 'arm's length' amount of debt'. As alluded to above, it is likely that there will be a "range" of potential debt levels that could reasonably be expected to 'present' in arm's length conditions. Accordingly, ***we recommend that a more pragmatic approach be adopted in the legislation, that being, unless and until a taxpayer's actual level of debt***

exceeds the amount allowed for in Division 820, the "rate" is to be determined by reference to the actual quantum of debt. In the alternative, we believe that Division 820 should be amended, as a policy measure, if what the Government is really trying to achieve is a reduced quantum of interest bearing debt borne by Australian taxpayers

1.5 OECD 'most appropriate method' approach

In identifying the "arm's length conditions", the Exposure Draft directs one to use the transfer pricing "...method, or the combination of methods, that is the most appropriate and reliable..." One is then directed to a number of "relevant factors" including the relative merits of each possible method and the functional profile of the taxpayer.

We believe the focus on the "most appropriate method" coupled with the direction to refer to OECD guidance is a positive step in potentially tempering the Taxation Office enthusiasm for use of the profit methods.

We say this as the OECD guidance makes clear the fact that where it is possible to apply one or other of the traditional transaction methods (the "comparable uncontrolled price method" or the "resale price" or "cost plus methods") in an equally reliable manner to the profit methods "...the traditional transaction method is preferable..." Accordingly, the profit methods, whilst unquestionably now having legislative "life" will only be the "most appropriate" method where they are more appropriate than the traditional transaction methods.

1.6 Arm's length principle for permanent establishments

We harbour some concerns with the Exposure Draft insofar as it deals with permanent establishments (PE) at Subdivision 815-C and refers to substituting the profits of a (PE) with **"arm's length profits"**. ***We recommend that the reference should be amended to a reference to the "arm's length outcome" or "arm's length result" of a PE.*** The terms "arm's length profits" (whilst defined to include a loss) may be seen to convey, in the mind of an overly enthusiastic ATO official, that a PE is expected to derive a profit.

1.7 Transfer pricing record keeping requirements

The reform of our transfer pricing rules should recognize that there are very significant documentation challenges that taxpayers (and the ATO) face in seeking to benchmark a company's operating performance.

As part of the Government's reform of Australia's transfer pricing rules we have previously submitted that any reform must consider the scarcity of independent Australian taxpayers against which a company may benchmark its profitability. We have also raised, as issues, the use of foreign companies as comparables and the fact we have grave concerns at the ATO use of private companies (where results are often materially distorted) and divisions of public companies (where allocation of costs and revenue may, equally, be materially distorted). In short, benchmarking the operating performance of a taxpayer against substantially similar companies to gauge the appropriateness of a taxpayer's operating performance presents a real challenge. Some recognition of this challenge and the range of results that are likely to flow from any such study should ideally be recognized in the legislation. ***We submit that this could perhaps be addressed by recognizing that a "range" of results may be the outcome of any documentation prepared by taxpayers and taxpayers are not to be penalised for taking a position within that 'range' that is reasonable in the circumstances.***

We welcome the absence of mandatory documentation requirements in the proposed legislation at Subdivision 815-D. Having said that, in the absence of taxpayers maintaining robust transfer pricing documentation they will face harsher penalties than would otherwise be the case. These penalties, not being deductible for taxation purposes, can present as a horrendous impost on taxpayers (and in this regard refer to point numbered 1.2 above wherein we recommend the 'negating' of penalties in certain circumstances).

We are also pleased to see that taxpayers that maintain robust and contemporaneous transfer pricing documentation "should" have a Reasonably Arguable Position (RAP) and legislative access to reduced base penalties in the event that an adverse transfer pricing adjustment is processed.

1.8 Time Limitations on transfer pricing adjustments

In the present environment of real time income tax reviews being conducted by the ATO and significantly greater taxpayer disclosure requirements in relation to transfer pricing matters (for example the IDS and RTP), it is very much appropriate that a time limit is imposed upon the Commissioner within which a notice of assessment should issue for an adverse transfer pricing adjustment. In this regard the proposed 8 year limitation is a significant improvement to the present situation and we welcome this proposal.

We note that we have previously submitted that, absent fraud on the part of a taxpayer, if the ATO has conducted a transfer pricing record review (or transfer pricing review by whatever name) then following any such review, absent adjustment and amended assessments issuing at that time, the ATO should be prevented from reopening that matter at any time in the future. Accordingly, we submit that a provision in this regard should be captured in the proposed legislation.