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13 April 2012

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

By e-mail: transferpricing@treasury.gov.au

Dear Sir/Ms

Exposure Draft - Stage One Transfer Pricing Reforms ("the Exposure Draft")

Pitcher Partners comprises 5 independent firms operating in Adelaide, Brisbane, Melbourne, Perth and Sydney. Collectively we would be regarded as one of the largest accounting associations outside the Big Four. Our specialisation is advising smaller public companies, large family businesses and small to medium enterprises ("SMEs") - which we refer to as "the middle market" in this submission. Thus, our main focus in writing this submission is on the implications of the proposals in the Exposure Draft for the middle market.

General comments

Our key concerns with the proposed provisions in the Exposure Draft are that:

- they are retrospective - in our view retrospective legislation is not appropriate except in the most extreme of circumstances;
- they will effectively double the compliance burden for taxpayers that are dealing with related parties resident in a country that has a double tax treaty with Australia - this is on the basis that taxpayers will now need to analyse their transfer pricing under two different Australian transfer pricing regimes;
- uncertainty will be created by the fact that the ATO now has the power to not only question the pricing of transactions that took place but to 'recreate' the transactions themselves; and

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- these amendments were not accompanied by any of the other measures previously announced by the Government that might have helped to 'soften their blow' (such as limiting the period over which the ATO can make transfer pricing adjustments).

We are particularly concerned by the fact that the Exposure Draft does not adequately address the high compliance costs for transfer pricing compliance and documentation in the middle market.

Therefore, in order to ensure the fairness of these measures we believe that the following must also be implemented:

- a meaningful de minimis threshold below which the transfer pricing rules do not apply - this is in line with systems in countries such as the United Kingdom;
- safe harbours for the most common international related party transactions - again this is consistent with many of our trading partners; and
- no penalties where reasonable efforts have been made to transact at an arm's length price - even if full documentation has not been prepared contemporaneously.

We believe that the implementation of the proposals above would represent an appropriate balancing of revenue risk with the compliance cost burden on middle market taxpayers.

Specific comments

Some additional comments together with a more detailed discussion on the points raised above are set out in the attached Appendix.

Further information

We believe that the issues raised in this submission are of critical importance to the middle market and we would appreciate a meeting with Treasury to discuss these issues further.

Please contact the writer on 03 8610 5503 if you would like more information on, or clarification of, any of the issues raised in this submission or to organise a meeting to discuss this further.

Yours faithfully
PITCHER PARTNERS ADVISORS PROPRIETARY LIMITED

THEO SAKELL
Executive Director

Encl: Appendix

APPENDIX: SPECIFIC COMMENTS ON THE EXPOSURE DRAFT - STAGE ONE TRANSFER PRICING REFORMS ("THE EXPOSURE DRAFT")

We have had the benefit of reading the ICAA's submission in draft and we concur with the comments made in that submission.

However, our focus in making this submission is on the compliance burden faced by taxpayers in the middle market. The specific comments in this Appendix are therefore focused on the issues that we believe to be of particular relevance to middle market taxpayers.

Compliance Problems

We are greatly concerned by the fact that the proposed Subdivision 815-A in the Exposure Draft - especially when coupled with the new International Dealings Schedule ("IDS") that the ATO plans to roll out to predominantly middle market taxpayers this year - does not adequately address the high costs for transfer pricing compliance that will be imposed on the middle market.

We note that transfer pricing compliance is far more than a matter of merely documenting transactions - it is actually having the resources to analyse and correctly apply a law in the first place.

As we pointed out in our submission on the earlier Consultation Paper - Income tax: cross border profit allocation - Review of transfer pricing rules ("the Consultation Paper"), transfer pricing is a highly specialised area which requires access to skills and information that the vast majority of middle market taxpayers simply do not internally possess.

The only way that middle market taxpayers can comply with both the transfer pricing and documentation requirements under the current law is to engage an external firm to perform this work. Due to the nature of the work, such services are generally very expensive.

For taxpayers with hundreds of millions of dollars of international related party transactions we can see that the potential revenue risk may justify the imposition of such compliance costs. However, for middle market taxpayers with international related party transactions in the hundreds of thousands of dollars the cost benefit analysis is quite different.

If the Exposure Draft is legislated in its current form, the middle market will (somehow) have to find the resources to follow three different transfer pricing regimes (of which two are Australian, Division 13 and the proposed Subdivision 815-A, and the third is the associated enterprises article in our tax treaties).

Larger taxpayers may have the resources to deal with all of these requirements but taxpayers in the middle market do not - they are struggling to cope with the existing law as it is and imposing new requirements on top of

the existing law is just going to lead to even more non-compliance by middle market taxpayers.

In short, making provisions that are already complicated even more complicated will not work for taxpayers who do not have the resources to spend thousands of dollars implementing information systems and paying accountants/economists etc. to analyse legislation and information for them.

Accordingly, whilst we understand that the ATO and Treasury:

- believe some middle market taxpayers may still be engaging in 'Wickenby' style transactions (for want of a better description);
- have concerns around related party dealings by taxpayers in the middle market; and
- think that an education process is needed for the middle market regarding compliance with Division 13, controlled foreign company and thin capitalisation issues,

there must be a better way to deal with these concerns than asking middle market taxpayers to comply with the new IDS and the proposed Subdivision 815-A.[1]

We submit that if 'Wickenby' style transactions and concerns around related party dealings are indeed the issues that the ATO and Treasury believe them to be for middle market taxpayers, then a better targeted measure for the middle market would be more appropriate - leaving larger taxpayers, who have the resources to do so, as the only ones to have to meet the compliance requirements of the proposed Subdivision 815-A and the new IDS.

For example, we believe that a far simpler (and much better focused) approach would be to just add the following questions to the body of the company, individual, partnership and trust tax returns and require all taxpayers to answer them:

(1) Have you made advances and/or loans to a foreign related party?
(2) Have you received advances and/or loans from a foreign related party?
(3) Have you provided goods and/or services to a foreign related party?
(4) Have you received goods and/or services from a foreign related party?
(5) If you answered 'Yes' to any of the above questions, have you taken reasonable care (i.e. made reasonable efforts and sought appropriate advice) to ensure that all of the relevant transactions are priced on arm's length terms?

[1] We also, in fact, question whether the proposed Subdivision 815-A and the new IDS will actually address the above issues. That is, while the new IDS will certainly provide the ATO with a large amount of data it will still only be information as to the value of related party services or loans - which is exactly what the current Schedule 25A does but with far less questions. In addition, we note that requiring middle market taxpayers to comply with the proposed Subdivision 815-A is not what we would regard as an 'education process' regarding the transfer pricing rules.

(6) If you answered 'Yes' to any of the above questions and you are a large taxpayer (i.e. have a turnover of more than $250m per year) have you complied with Subdivision 815-A and completed the International Dealings Schedule?

We note that if a taxpayer answers 'No' to any (or all) of the questions about advances, loans, goods and services and it is subsequently found (by, for example, the analysis of data collected by Austrac) that they have actually entered into such transactions, then the taxpayer will have made a false or misleading statement and will be exposed to penalties.

Similarly, if a taxpayer answers 'Yes' to any (or all) of the questions about advances, loans, goods and services and 'Yes' to the question about taking reasonable care, then they will be exposed to penalties if they have not actually taken reasonable care.

If the above more targeted approach is unacceptable to achieve the level of disclosure regarding 'Wickenby' style transactions and related party dealings by middle market taxpayers that the ATO and Treasury are seeking then, in order to ensure that the compliance burden of these measures does not fall on taxpayers who do not have the resources to meet them, we believe that the following should be implemented:

- a meaningful de minimis threshold below which the transfer pricing rules do not apply - this is in line with systems in countries such as the United Kingdom;
- safe harbours for the most common international related party transactions - again this is consistent with many of our trading partners; and
- no penalties where reasonable efforts have been made to transact at an arm's length price - even if full documentation has not been prepared contemporaneously.

We believe that the implementation of the proposals above would represent an appropriate balancing of revenue risk with the compliance cost burden on middle market taxpayers.

We discuss each of these elements in more detail below.

<u>De Minimis Threshold</u>

We would like to emphasise again a point that we made in our submission on the earlier Consultation Paper, namely, that in a proper balancing of compliance costs against revenue risks it is essential that some taxpayers are completely carved out of the transfer pricing rules.

That is, below a certain point it is just not cost effective or practical to impose transfer pricing guidelines. The UK has recognised this in its transfer pricing

rules which provide that small and medium enterprises[2] are exempt from the transfer pricing rules. A small or medium enterprise for this purpose is one that has less than 250 employees and either:

- turnover of less than €50m; or
- assets with a balance sheet total of less than €43m.

This test is undertaken taking into account the whole of the group of which the UK enterprise is a member. Therefore, a large multinational group with the resources to comply with transfer pricing legislation would not be carved out of the rules even if its local subsidiary was a relatively small operation.

Safe Harbours

As we highlighted in our submission on the Consultation Paper, a further way to reduce compliance costs without placing the revenue at risk would be to implement safe harbour transfer pricing methodologies for common transactions. Given the high level of expense associated with transfer pricing compliance we believe that it is essential that such safe harbours are incorporated into the new transfer pricing rules - especially if, contrary to our strongly held views, the ATO is granted the power to make retrospective amendments going back to the 2004/5 tax year.

That is, if the ATO does (contrary to our submission) get the power to 'go back in time' then SMEs/other taxpayers should at least have the certainty of knowing that they will not be exposed to any retrospective amendments if the amounts they are charging/receiving are within the safe harbours.

In other words, if the ATO can go back to the 2004/5 tax year then there should also be safe harbours going back to that tax year.

We believe that this would be very easy to legislate. We would propose that the legislation allow the introduction of safe harbours via regulation. The legislation could set out the parameters for this regulation making power. We would see this as being:

- defining a series of transaction classes;
- specifying an approved transfer pricing methodology for each transaction class; and
- setting out an approved range within the approved transfer pricing methodology for each class.

Examples of this type of approach can be found in the service trust guide issued by the ATO. Another example is non-core administration services (a matter considered to a limited extent in TR 1999/1) which could be set out in a table in the legislation as follows:

[2] As defined in the Annex to European Commission recommendation 2003/361/EC of 6 May 2003.

- Class: Non-core administration services (with an appropriate definition)
  - methodology - cost plus; and
  - approved range - mark up of between 5% - 7.5%.

Other examples of common transactions are as follows:

- Group finance services;
- Group management services;
- On-charging of personnel;
- Unsecured loans in AUD;
- Fully secured loans in AUD;
- Provision of a guarantee;
- Sale of manufactured goods; and
- Sale of raw materials.

We believe that taxpayers in the middle market would be likely to choose the applicable safe harbour rather than seek to do their own detailed transfer pricing analysis in most instances. This would have the dual benefit of keeping compliance costs relatively modest and limiting revenue risk. In fact, it may well increase revenue on the basis of increased compliance from the middle market with respect to transfer pricing.

The United States and New Zealand already have safe harbours for some transactions to ensure transactions are on an arm's length basis, as discussed above. Therefore, the utilisation of safe harbours would be in line with international standards.

Documentation - No Penalties if Reasonable Efforts made

While we understand the importance of motivating taxpayers to comply with legislation, we believe that it would be unfair to impose transfer pricing penalties on taxpayers who have made reasonable efforts to determine an arm's length price - notwithstanding that they may not have contemporaneous transfer pricing documentation.

For many middle market taxpayers, putting together full contemporaneous transfer pricing documentation for every international transaction will simply be cost prohibitive - i.e. regardless of the potential penalties. However, if such taxpayers could prevent penalties by making reasonable efforts to determine an arm's length price, with a much lower compliance cost than that imposed by full transfer pricing documentation, then they would certainly be motivated to do so.

We note for completeness that the Canadian transfer pricing regime allows for a reduction in penalties where, inter alia, the taxpayer has made reasonable efforts to determine and use arm's length transfer prices.

Technical issues with the Exposure Draft

Interaction of the Australian domestic law with OECD guidelines

As other commentators have pointed out,[3] the proposed changes in the Exposure Draft will effectively hand over the power to make law in relation to Australian transfer pricing matters "to an unelected OECD working party of administrators, with the officers of the Australian Taxation Office as … [the Australian Parliament's] only diplomatic representatives."[4]

We also note that the language used in subsection 815-22(3) of the Exposure Draft to incorporate the OECD guidelines into Australian domestic law is far from precise. For example, how will a taxpayer (especially one in the middle market with limited resources) be able to determine:

1. if its interpretation of Subdivision 815-A and the business profits or associated enterprises of a tax treaty best achieves consistency with the OECD guidelines; and/or
2. if the OECD guidelines are actually relevant, in whole or in part, to their situation in the first place?

In short, whilst the phrases "best achieve consistency" and "to the extent the documents are relevant" in the current subsection 815-22(3) of the Exposure Draft may well provide flexibility to accommodate any differences in the text of an Australian tax treaty with its equivalent OECD Model provision, they:

- create a great degree of uncertainty for both taxpayers and the ATO; and
- highlight the need for bright line tests/safe harbours to be introduced to enable middle market taxpayers to know, in a self-assessment environment, that they are actually complying with the law.

Interaction of the thin capitalisation and transfer pricing rules

The following example is an edited version of Examples 1.1 and 1.4 in the EM:

Aust Co is an Australian resident subsidiary company of For Co - which is resident in a country with which Australian has a tax treaty. Aust Co has a 'safe harbour debt amount' under the current thin capitalisation rules of $A375 million. Aust Co has borrowed $A300 million from For Co at an interest rate of 15% - leading to $A45 million being paid in interest each income year.

Based on information available to it however, the ATO determines that the closest arm's length scenario at which a loan might reasonably be expected to exist between independent parties dealing wholly independently with one

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[3] See, for example, the paper prepared by Paul McNab, Pete Calleja and Colin Little of PwC entitled 'Trends and Developments in Transfer Pricing Case Law in Australia: A Paradigm Shift' for the 27th National Convention of the Tax Institute in March this year.
[4] Ibid.

another is a loan of $250 million at 10% - provided a further $50 million of equity is raised.

To quote from the EM (emphasis added):

> *In this case, a reduced value for the debt interest, being an arm's length value, should be used to determine the amount of transfer pricing benefit Aust Co has received, since that best ensures consistency with the relevant OECD guidance. The fact that Aust Co's debt amount is less than its safe harbour debt amount for [the purposes of the thin capitalisation rules in] Division 820 ... is not relevant to determining the amount of the transfer pricing benefit.*
>
> *This information is used to work out the amount of Aust Co's transfer pricing benefit ($A15 million), by applying the 10% interest rate to the actual debt amount of Aust Co ($A300 million), and comparing this to Aust Co's actual debt deductions of $A45 million.*

Whilst the proposed law will provide legislative backing for the stance taken by the ATO in TR 2010/7, the above example also demonstrates:

1. how the interaction between the thin capitalisation rules and transfer pricing rules can create highly adverse results for taxpayers; and
2. the fact that taxpayers will not only have to find the resources to ascertain the thin capitalisation safe harbours but also find the resources to do an arm's length analysis as well.

We suspect that a number of taxpayers in the middle market will not have been following TR 2010/7 and, as highlighted above, doubt that many taxpayers in the middle market will have the resources to not only ascertain the thin capitalisation safe harbours but to do an arm's length analysis as well.

In light therefore, of the limited resources available to middle market taxpayers we submit that only large taxpayers (as defined by the ATO each year) should be expected to do an arm's length analysis - leaving middle market taxpayers with the safe harbour of only having to comply with the thin capitalisation rules.

Reconstructing an arrangement

The following example is an edited version of a Case Study in TR 2011/1 - which is the ATO's ruling on Business Restructuring:

SubCo is a wholly owned subsidiary of a foreign parent company. It operates a product manufacturing plant in Australia and has the following rights and responsibilities under its existing business arrangements:

- SubCo is responsible for arranging the purchase of all raw materials;
- SubCo has sole ownership interest and risk in all raw materials, work-in-process and finished goods inventories;
- SubCo owns or licenses all intangible property rights (for example, patents, trademarks and copyrights) in respect of the products;

- SubCo controls what is produced, when and in what quantity; and
- SubCo sells the products to associated distributors.

The foreign parent company decides to restructure the group's product manufacturing activity by centralising it in a group company resident outside Australia ("ForCo") - with ForCo taking over the vast majority of the functions, assets and risks of SubCo.

The ATO will have the power under the Exposure Draft to:

(a) conclude that independent parties dealing at arm's length in comparable circumstances would not be expected to have entered into the business restructuring arrangement as actually agreed; and
(b) determine the taxation position of SubCo under the agreement(s) that the ATO believes might reasonably be expected between independent parties dealing at arm's length in comparable circumstances.

These broad powers, whilst arguably providing no more than legislative support for the ATO's stance in TR 2011/1, have the potential to create a great deal of uncertainty for taxpayers.

For example, if there is an outright sale of property (such as patents and trademarks) and the ATO concludes that independent parties would not have entered into the same agreement as SubCo and ForCo did for this transfer, what agreement(s) will the ATO substitute? Will the ATO use a licensing agreement rather than an outright sale or still use a transfer but with a 'kicker' to deal with the case where the property turns out to be extremely valuable within (say) 18 months of its sale?

Once again, in light of the limited resources available to middle market taxpayers we submit that the middle market should only be exposed to the uncertainties posed by the ATO having the power to reconstruct a transaction in exceptional circumstances - i.e. in cases where it is clear that the dominant purpose of an arrangement is to avoid tax.

In other words, middle market taxpayers should have the safe harbour of knowing that the ATO will only be able to use its reconstruction powers in 'abusive' cases that have clearly not been entered into in the course of ordinary commercial or family dealings.

As Deputy Chief Tax Counsel Peter Walmsley noted in a paper he delivered to the Tax Institute entitled 'Tax avoidance and succession planning: Pt IVA and ordinary family dealings',[5] for family reasons an arrangement by a middle market taxpayer (especially a succession plan) will often not look like "an arm's length sale and we realistically expect that steps will be taken, within limits, to make it tax effective."

[5] The Tax Specialist, Volume 14 No. 2, October 2010.

We believe therefore, that the ATO should only be able to reconstruct a cross-border transaction entered into by a middle market taxpayer under Subdivision 815-A if it would have sought to use Part IVA against that transaction in a purely Australian domestic setting.

The ATO should not be allowed to use the reconstruction powers granted to it by Subdivision 815-A against middle market taxpayers in an unfettered manner - i.e. those reconstruction powers must not be allowed to effectively become Part IVA without any limitations.