Ref: DH/CMB/aw

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21 December 2012

Manager
International Tax Integrity Unit
Corporate and International Tax Division
The Treasury
Langton Crescent
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By email: transferpricing@treasury.gov.au

Dear Sir/Ms

MODERNISATION OF THE TRANSFER PRICING RULES

Thank you for the opportunity to make a submission on the Exposure Draft legislation ("ED") and explanatory memorandum ("EM") issued on 22 November 2012.

Pitcher Partners is 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 - which we refer to as "the middle market" in this submission.

General comments

We are concerned by the fact that the approach proposed in the ED and the EM does not adequately address the high compliance costs for transfer pricing compliance and documentation in the middle market.

To ensure that the compliance cost of these measures does not exceed the perceived revenue risk we believe that the following must 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;
- a threshold amount of related party debt below which taxpayers do not have to concern themselves with determining arm's length debt amounts; and
- no penalties where reasonable efforts have been made to transact at an arm's length price - even if documentation has not been prepared contemporaneously.

Consultation Process

In our view the potential compliance costs of introducing the approach proposed in the ED and the EM means that it should not be applied to the middle market in the same way that it is applied to large taxpayers.

The consultation process needs to consider that when the balance between revenue integrity and compliance costs is properly taken into account what might be suitable to require from a large business taxpayer could be totally unsuitable for a middle market taxpayer.

This consultation should not be done at a high level - it needs to be practically focused, based on 'real life' case studies and it must specifically consider the compliance costs for middle market taxpayers.

Additional comments

Additional details regarding our general comments can be found in Appendix 1.

Appendix 2 sets out some specific concerns that we have about the drafting of the ED.

Appendix 3 contains some statistics on the importance (and difficulties) of small business.

Further information

Please contact the writer on 03 8610 5401 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

DENISE HONEY
Executive Director

Encl: Appendices

Appendix 1 - Additional details regarding our general comments

We are greatly concerned by the fact that the approach proposed in the ED and the EM does not adequately address the high compliance costs for transfer pricing compliance and documentation in 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.

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 a taxpayer in the middle market can comply with:

- the arm's length pricing mechanisms; and
- documentation,

required by the ATO 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.

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;

- a threshold amount of related party debt below which taxpayers do not have to concern themselves with determining arm's length rates; and

- no penalties where reasonable efforts have been made to transact at an arm's length price - even if 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.

De Minimis Threshold

We would like to emphasise 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[1] 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

A further way to reduce compliance costs without placing the revenue at risk would be to introduce appropriately designed and implemented safe harbour transfer pricing methodologies for common transactions. Given the high level of expense associated with transfer pricing compliance we submit that it is essential that such safe harbours are incorporated into the administrative approach taken by the ATO in implementing the transfer pricing rules.

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.

At the very least, SMEs/other taxpayers should have the certainty of knowing that they will not be exposed to any amendments if the amounts they are charging/receiving are within the safe harbours.

We believe that safe harbours would be relatively easy to implement by having the new Transfer Pricing rules specifically authorise the ATO to issue Practice Statements having regard to certain factors.

For example, the legislation could authorise the ATO to issue a Practice Statement setting out the parameters for the safe harbours by:

- 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.

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

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 Practice Statement as follows:

- 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.

Provided the safe harbours are designed in a way that allows them to be easily understood and applied, we believe that taxpayers in the middle market are likely to choose the applicable safe harbour rather than doing their own detailed transfer pricing analysis.

As mentioned above, we believe that such safe harbours would not only have the dual benefit of keeping compliance costs relatively modest and limiting revenue risk but may well, in fact, increase revenue due to better compliance from the middle market with respect to transfer pricing.

In this regard, we note that (like a number of other countries) 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 and penalties

The proposed de minimis rule in subdivision 815-D is totally inadequate.

We submit that there should:

1. be an exemption from penalties where a taxpayer's transactions with international related parties fall below a certain dollar threshold - this dollar threshold should, at very least, be $2 million to align with the threshold which must be met before taxpayers are required to complete and lodge an International Dealings Schedule ("IDS"); and
2. a fundamental rethink as to what actually needs to be documented by taxpayers from a transfer pricing perspective - especially taxpayers with limited resources such as those in the middle market.

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.

In other words, we submit that provided a taxpayer can show that the price they are charging / paying for goods and services is within an acceptable arm's length band it should not matter that they:

- do not actually have the written agreements in place that arm's length parties would use;
- cannot provide contemporaneous (or sometimes even any) evidence that they negotiated the relevant price in the same manner that arm's length parties would have done; and/or
- do not have anything more than the most rudimentary evidence (for example, a spread-sheet) to show how they arrived at the relevant price.

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.

Appendix 2 - Some specific concerns that we have about the drafting of the ED

Self-assessment

We note that the proposed Subdivisions 815-B and 815-C will require taxpayers to assess their own transfer pricing arrangements to determine whether they comply with the new rules. As currently drafted however, the proposed provisions only authorise increases in tax outcomes and not decreases to reflect arm's length outcomes.

We submit that the legislation should be redrafted to allow a taxpayer to downward assess a tax liability where that reflects arm's length outcomes.

Characterisation of adjustments

We note that the proposed Subdivision 815-B does not contain an equivalent to section 815-30(2) of Subdivision 815-A, which requires the ATO to attribute an adjustment to a particular income or expense amount.

We submit that a similar provision to section 815-30(2) needs to be inserted into the proposed Subdivision 815-B.

Reconstruction

Paragraphs 1.64 to 1.68 of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010 state that the reconstruction of transactions should only occur in 'exceptional' cases - i.e. it should not be used as a general rule.

We note however, that whilst it is clear that paragraphs (5) to (8) of the proposed subsection 815-125 authorise the ATO to reconstruct or re-characterise transactions, this power is not similarly constrained to being used only in 'exceptional' cases.

As we are concerned that the ATO will seek to use the proposed section 815-125 to reconstruct or re-characterise actual arrangements in cases or circumstances that are outside those contemplated by the OECD Guidelines, we recommend that paragraphs (5) to (8) of the proposed subsection 815-125 Section 815-125 be deleted.

Modification of thin capitalisation / threshold amount of related party debt

The proposed section 815-135 contains specific provisions dealing with the interaction of the transfer pricing and thin capitalisation rules. Whilst the intention of this provision is to maintain the position outlined by the ATO in TR 2010/7, we highlight that this provision will place an onerous obligation on middle market taxpayers to determine the amount of debt that would have been borrowed at arm's length in order to identify an arm's length interest rate to apply to the debt.

We submit that there should be a threshold amount of related party debt below which taxpayers do not have to concern themselves with determining arm's length rates. For example, $250,000 of debt deductions on related party debt might be a minimum threshold below which taxpayers do not have to concern themselves with determining arm's length debt.

This is something that would already be considered as part of the thin capitalisation calculations and thus should not impose a high compliance burden. Revenue risk below this level would certainly be minimal.

Amendment of assessments

Whilst we welcome the change from the current unlimited time period for amendments to give effect to Division 13, we submit that the proposed 8 year time limit for amending assessments is too long.

We believe that the general 4 year time limit in section 170 of the 1936 Tax Act is far more appropriate - i.e. given the introduction of self-assessment, and the proposed contemporaneous documentation requirements under the new provisions, there is no longer a case for different time limits for transfer pricing and other tax amendments.

Appendix 3 - Understanding the importance and difficulties of small business

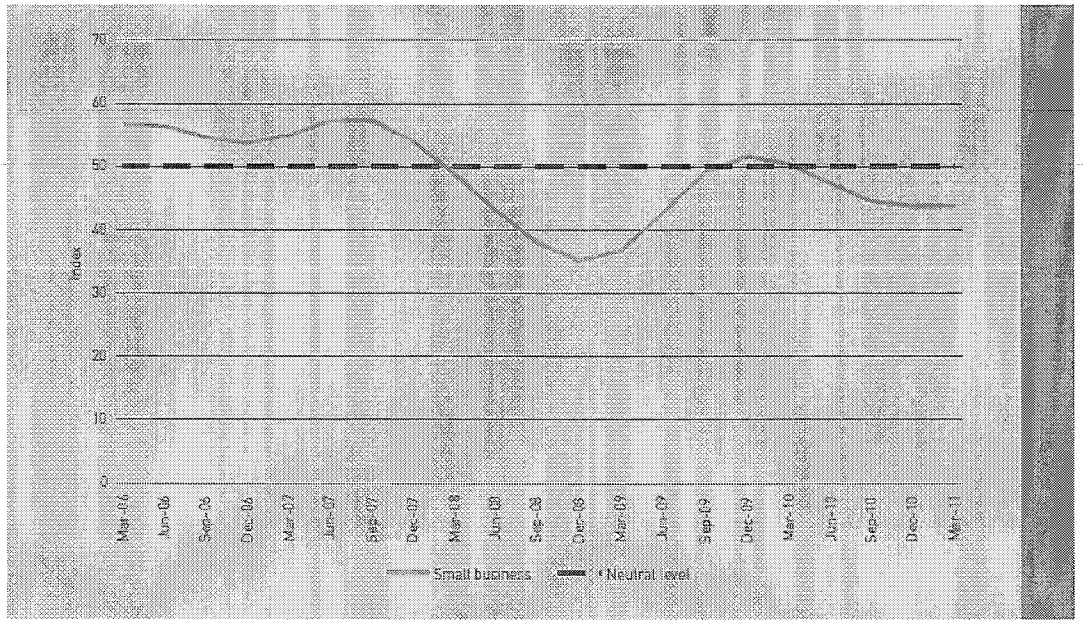
Small businesses make a significant contribution to the Australian economy, accounting for almost half of industry employment (47.2%) and contributing over a third of industry value added in 2009-10 (35.3).[2]

Some of the major industries that small business contribute to in Australia include agriculture (82.9%) and services (40.0%), two very large segments of our economy. In particular, with respect to services, small business plays a very significant role in a number of key segments in our economy, including:

- accommodation and food services (43.4%);
- construction (55.5%);
- professional, scientific and technical services (74.1%);
- real estate services (74.1%); and
- healthcare and social assistance services (41.8%).[3]

The previous paragraphs highlight the importance of small business on our economy and the importance it plays for many of our major industries. Many of these industries are significant and growing industries that are (effectively) supported predominantly by small business operators, being businesses having a turnover of less than $2 million and employees of less than 5. The financial and labour capital resources available to such business are obviously quite restricted.

That coupled with the overall conditions for small business need to be taken into account. Since the GFC, these conditions have been steadily declining for small business. Statistically, "business condition" indices typically look at a collective index of measures including labour conditions, profits, sales, input costs and selling prices. The following ACCI Small Business survey shows a steady decline in conditions for small business.



Data source: ACCI Small Business survey, Thomson Reuters EcoWin

[2] The Department of Innovation Industry, Science and Research "Key Statistics – Australian Small Business", 31 October 2011, page 3.
[3] ibid, page 5.

These statistics demonstrate the difficulties that small business face, which takes into account some of the significant increases in regulation that have occurred for small business over the last few years. There has also been a significant gap that has emerged as between small business conditions and large business conditions.[4]

Number of small business taxpayers

Australia has almost three million micro enterprise taxpayers according to the ATO (which defines micro enterprises as businesses with an annual turnover of under $2 million or superannuation funds with less than $2 million in assets).

These taxpayers employ one in five Australian workers and account for more than a quarter of tax revenue collected, including approximately $14 billion in pay as you go ("PAYG") withholding tax for their employees.

Mostly operating as sole traders or family businesses, micro enterprises rely on around 29,000 registered tax agents and BAS agents to help manage their tax affairs - with around 90% of micro enterprise returns and 50% of activity statements lodged through agents.

According to the ATO there are also around 183,000 businesses in Australia with an annual turnover of between $2 million and $250 million - which the ATO classify as SMEs.

General tax compliance burdens (already) faced by small business

In September this year the Institute of Chartered Accountants in Australia issued a media release stating that the:

> *... cost of tax compliance has more than doubled for small businesses, according to new research conducted by tax professionals and academics across Australia.*
>
> *The rise and rise of tax compliance costs for the small business sector in Australia, is the first installment of a three-year research project into the viability of Australia's tax system.*
>
> *The Institute of Chartered Accountants' tax counsel, Paul Stacey, says it costs small businesses an average of $32,389 a year to comply with the multitude of state and federal taxes in Australia.*
>
> *"For small businesses, the cost of tax compliance has more than doubled over the last 17 years. On average, it costs small businesses $11,950 just to collect GST, bringing to light the question of whether they are acting as unpaid tax collectors for the government. In addition, small businesses are spending four times as many hours per year complying with tax obligations as they did 17 years ago." he says. ...*
>
> *"The tax compliance burden placed on small businesses has serious impacts on their long-term sustainability, particularly when the cost and time required for compliance is still growing. The federal and state governments need to address this issue in order to ensure the tax system can meet Australia's social and economic needs in the future," he says.*
>
> *Small businesses indicated that to ease the compliance burden, new measures*

[4] ACCI Small Business Survey, Commonwealth Bank-ACCI Business Expectations Survey, Thomson Reuters EcoWin.

needed to be simple.

"Rather than complicating compliance with anti-avoidance rules, small businesses indicated they would simply like a lower tax rate," Mr Stacey says.