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For the attention of Mr Neil Motteram

13 April 2012

Dear Mr Motteram

Exposure draft of treaty-equivalent cross border transfer pricing rules

We are writing to respond to the exposure draft (ED) and explanatory memorandum (EM) of the "treaty-equivalent cross border transfer pricing rules" released by the Assistant Treasurer on 16 March 2012.

In short, we disagree with the proposed changes. We consider the changes proposed in the ED to be a new retrospective law rather than a "clarification" of existing law. As we have outlined in our previous submissions, we consider retrospective law to be bad policy. Furthermore, we strongly believe that the proposed law creates complexity and uncertainty beyond what currently exists and therefore fails to meet its purported "clarification" objective in all aspects.

Our key concerns with the proposed changes are:

1. The ED will create a new retrospective taxing power for the Commissioner under domestic law. This is entirely different from Treasury's proposal to 'clarify' that the Commissioner holds a taxing power under Australia's tax treaties. There is no basis to justify making such a change on a retrospective basis.

2. The changes will discriminate against taxpayers who deal with related parties in treaty countries and could breach non-discrimination articles in certain treaties. As stated above, the proposed changes will create a new retrospective taxing power for the Commissioner, so we do

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not accept the view that this discrimination has always existed. Australia's treaty partners would normally expect the Australian law to provide preferential treatment to their residents over residents of non-treaty countries, not the reverse. The proposed changes are likely to result in an increased risk of unrelieved double taxation, particularly taking into account the retrospective nature of the amendments and the fact that no discussions with treaty partners took place before the proposed changes were announced.

3. If, as Treasury and the Commissioner have asserted, a taxing power already exists under Australia's treaties, then there should be no need for Subdivision 815-A to be introduced. The Commissioner has had ample opportunity to test this theory in court and has declined.

4. The proposed changes will further the divide that already exists between Australia's transfer pricing and customs rules. There is currently no coherent, efficient mechanism to ensure that taxpayers who are subject to transfer pricing adjustments to the price of imported goods for income tax purposes can adjust the customs value and duty payable on those goods. This, in effect, creates a form of domestic double tax, and also creates a substantial compliance cost for business. Failure to address this issue is likely to increase costs for all companies importing dutiable goods or materials into Australia. In particular, this could worsen conditions for the already struggling Australian manufacturing sector.

5. Branch profit attribution rules have been introduced in a piecemeal way. The current draft provisions will create asymmetrical treatment of inbound branches (ie Australian branches of foreign companies) and outbound branches (ie foreign branches of Australian companies). Carving out branches from the proposed changes altogether would not improve the situation because then there would be asymmetrical treatment of branches and companies. The current proposals will create a high likelihood of unrelieved double taxation for multinational groups conducting their Australian business through branch structures. This would increase costs in the banking sector, which would have broader implications for the Australian economy and consumers.

6. As currently drafted, Subdivision 815-A casts significant doubt on the framework and application of Australia's thin capitalisation regime. The draft provisions are open to different and conflicting interpretations.

We strongly believe that, far from providing clarification, the proposed changes will increase complexity and uncertainty for Australian taxpayers.

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Our submission has been presented in the following format:

1. Reasons we object to the proposed changes
2. On a 'without prejudice' basis, comments on specific details within the ED and EM that require clarification or amendment if the Government decides to proceed with introducing the proposed changes.

We have included comments on the ED and EM because our impression, based on discussions with Government and Treasury, is that the Government has decided to introduce these rules despite strong reservations voiced by the profession and business bodies.

Making the proposed retrospective changes in haste could have a number of undesirable consequences for the complexity of doing business in Australia, confidence from overseas investors and governments of treaty partners, and the way the Government's tax reform policy is perceived more broadly. There will be different sets of rules that could apply depending on various factors such as the location of the transacting party and the relevant income year. Disputes are likely to arise under these rules that will need to be resolved by the Courts or our treaty partners.

Our view is that it does not make sense to rush these changes through Parliament now, particularly when the transfer pricing rules in Division 13 are also about to be rewritten with prospective effect. It would be far more efficient to introduce a one-off prospective change to Australia's transfer pricing rules that applies to everyone equally.

We would be pleased to discuss any aspect of our submission with you further.

Yours sincerely

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Copy to:
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1. Reasons we disagree with the proposed changes

A. This is a new retrospective law, not clarification of existing law

In our previous submissions[1], we objected to:

a) Treasury's assertion that the treaties provide the Commissioner with a separate taxing power; and

b) Retrospective amendments to the law.

We continue to hold these objections, that is, we do not agree that the treaties provide the Commissioner with a taxing power and we do not support any retrospective amendments to the law. We have stated the reasons for our objections to these two principles in our previous submissions.

We had understood the intention of Treasury's proposed amendments was to 'clarify' that the treaties provide the Commissioner with a taxing power under the existing law. We submit that the ED goes beyond this by proposing to introduce a new taxing power under the domestic law that will apply retrospectively. In our opinion, even a retrospective 'clarification' of the law could not be justified, but this is more than a clarification and there is absolutely no basis to justify introducing new law that will apply retrospectively.

Below is a summary of the reasons why we consider the proposed changes to be new law and not a clarification.

1. Subdivision 815-A does not clarify that the treaties give rise to a separate power. The status of treaties as a power under which assessments can be made is exactly as it was before. This is recognised in the EM (refer table after paragraph 1.17). This question has not been resolved by Subdivision 815-A.

2. Subdivision 815-A is a new retrospective law that synthetically adopts language from the treaties into the domestic legislation with statutory rules for interpretation and qualifications on the interaction with thin capitalisation rules. This is not the same legislative outcome as allowing the treaties a direct taxing power. Subdivision 815-A is a domestic taxing power that will be subject to the domestic rules for statutory interpretation. The treaties are subject to a

[1] PwC's Submissions to Treasury dated 30 November 2011 (including PwC's general response (the PwC General Submission) and PwC's specific response in relation to permanent establishments (the PwC PE Submission)), and PwC's Supplementary Submission to Treasury dated 24 February 2012 (the PwC Supplementary Submission).

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different set of rules for interpretation, which is acknowledged by the Commissioner himself in a specific taxation ruling on treaty interpretation.[2]

3. There are aspects of Subdivision 815-A which are entirely and indisputably new law. For example:

   a. Legislating rules for the interaction of treaties and the thin capitalisation provisions.

      The attempt to legislate the position in TR2010/7[3] back to 2004 cannot ever have been said to be the position under the treaty. It is in fact, an attempt to reconcile the treaty with Australia's thin capitalisation rules. If this is truly a 'clarification' of what Parliament intended in 2004 why did it take a further six years for the Commissioner to release TR2010/7?

   b. Legislating specific documents as relevant for interpretation of treaty articles.

      If the treaties had always provided a taxing power to the Commissioner, then we would expect that the relevant treaty articles would need to be interpreted having regard to the customary rules for interpretation of treaties, for which the primary authority is the Vienna Convention.[4] Prescribing specific documents as relevant for interpretation of certain treaty articles may produce a different outcome than the commonly accepted rules for treaty interpretation. In the SNF[5] decision in 2011, the Full Federal Court did not consider that there was sufficient evidence available to demonstrate that the OECD Transfer Pricing Guidelines (TPG)[6] were permissible materials for interpreting Article 9 of Australia's treaties. Based on this, we cannot see any basis for retrospectively prescribing in our domestic legislation that the OECD TPG are necessary for interpretation of Article 9 of the treaties. (We note that we do not object in principle to the use of the OECD TPG for interpretation of Article 9, but we are merely highlighting this as a further example that is clearly new law.)

As demonstrated above, the changes proposed in the ED are new law and therefore should not be introduced with retrospective effect.

B. The changes discriminate against treaty partner countries

The proposed changes will only apply to dealings with treaty partner countries. We understand that this concern has been raised in discussions with Treasury and that Treasury's response is that there has always been the potential for different treatment of dealings with treaty versus non-treaty

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[2] Taxation Ruling 2001/13: Income tax: Interpreting Australia's Double Tax Agreements
[3] Taxation Ruling 2010/7: Income tax: the interaction of Division 820 of the Income Tax Assessment Act 1997 and the transfer pricing provisions
[4] *Vienna Convention on the Law of Treaties*, 23 May 1969
[5] Commissioner of Taxation v SNF (Australia) Pty Ltd (2011), FCAFC 74
[6] OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations

countries under our existing law (if one accepts the view that the Commissioner has always held a taxing power under the treaties).

As explained above, the proposed changes are new law. It therefore cannot be said that the powers proposed under the new law have always been held by the Commissioner. Since the new law can only be applied in situations where an Australian entity is subject to a treaty, the proposed changes are clearly discriminatory against taxpayers dealing with treaty partner nations. It is highly unusual for a law to be introduced that will provide a worse outcome for investors from treaty partner countries than non-treaty partner countries. Normally, the opposite would be expected and investors from treaty partners would receive preferential treatment over investors from non-treaty countries.

The proposed changes arguably contravene the non-discrimination articles that are included in several treaties.[7] For example, Article 25(4) of the United Kingdom treaty states:

> *"Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned State in similar circumstances are or may be subjected."*

There is also a similar non-discrimination clause that requires Australian permanent establishments (PEs) of UK companies to be treated on an equal footing with Australian resident companies.

Historically, the Commissioner has held the view that application of the arm's length principle under Division 13 and the relevant treaty articles should produce the same outcomes. Treasury now believes that there will be circumstances in which Subdivision 815-A will produce a higher amount of Australian taxable income than would be the case under Division 13. This must be the case because if Division 13 would produce the same revenue outcome then there would be no need to introduce Subdivision 815-A. We are not privy to the specific circumstances that Treasury has in mind, but if it will produce a situation where a subsidiary or PE of a company resident in a treaty country will be treated less favourably than an Australian resident company would be treated under Division 13, this could breach a non-discrimination article (if the relevant treaty contains such an article).

The risk of unrelieved double taxation may increase, particularly if the ATO adopts an aggressive interpretation of OECD guidance in applying the new provisions, as the number of Mutual Agreement Procedure (MAP) claims for relief from double tax is likely to increase. If the Commissioner makes determinations under Subdivision 815-A by interpreting the OECD TPG in a manner that our treaty partners disagree with, taxpayers may be subject to double taxation. In MAP cases, treaty partners following the OECD TPG will expect the Australian Competent Authority to bear the burden of

[7] Non-discrimination articles are included in Australia's treaties with Chile, Finland, Germany (only in relation to dividends), Japan, New Zealand, Norway, South Africa, Turkey, the United Kingdom, and the United States

demonstrating that the Commissioner's adjustments are in accordance with the arm's length principle.[8]

We acknowledge that the risk of double taxation is present under the existing provisions and that the ATO may contend that the MAP process has traditionally worked effectively to relieve double taxation where it occurs. However, in our experience, the process can take years and there is no compulsion under Australia's treaties for the competent authorities to reach agreement. We are concerned that foreign jurisdictions will take a harder line in MAP negotiations with Australia in light of the introduction of retrospective legislation which is clearly intended to increase Australia's tax take beyond that available under Division 13. This is likely to further increase the time required for MAP negotiations and will increase the risk of unrelieved double taxation.

An increase in the number and complexity of MAP cases may require additional ATO resources to ensure that the caseload can be managed. The Government has not provided any indication that it will increase the resources available to the ATO following the introduction of the proposed changes. If no additional resources are provided, this will also prolong the timeframes for MAP negotiations.

We understand that the Government did not engage in any discussions with treaty partners about the proposed changes prior to releasing the ED. Implementing a new retrospective law which discriminates against treaty partners may have political and diplomatic implications for the Government, particularly given that no consultation with treaty partners took place prior to announcing the proposed changes.

C. There is no need for Subdivision 815-A

If, as Treasury and the Commissioner have asserted, the Commissioner holds a taxing power under Article 7 and Article 9 of the treaties, then there should be no need for Subdivision 815-A to be introduced.

We do not endorse the view that the Commissioner has a taxing power under the treaty nor do we agree that Parliament has indicated that it intends the treaties to operate in this way. However, putting the merits of each side of the debate aside, the treaties either do, or do not, provide the Commissioner with a taxing power.

If the Commissioner is correct in his view that he can impose tax under the treaties, then there is nothing to stop him from using this power. We are aware that the Commissioner has issued transfer pricing assessments to taxpayers in the past applying Article 9 of the treaties as an alternative to Division 13. While some of these cases have been disputed by taxpayers in the courts, the issue of whether assessments issued under a treaty were valid has not been considered.

[8] OECD TPG, paragraph 4.17

The Commissioner has had opportunities to test the taxing power of Article 9 in court himself, for example, he could have done so in the SNF case. Whenever the opportunity has arisen for the Commissioner, he has declined it.

If the Commissioner were to test the taxing power of Article 9 in court, he would find out whether his view is correct. If the courts agreed that a taxing power does exist under Article 9, this would show that the Commissioner was correct, and would mean that Subdivision 815-A is unnecessary. If the courts found that the Commissioner does not hold a taxing power under Article 9, then the basis for introducing Subdivision 815-A retrospectively would be undermined.

D. The changes will further the divide between transfer pricing and customs rules

There has always been tension between the transfer pricing and customs rules and the way in which those rules are administered. The customs rules focus primarily on the pricing of specific import transactions to determine the amount of duty payable. The ATO's administration of the transfer pricing rules often involves application of profit-based transfer pricing methods. Where the ATO applies profit-based methods to reduce the price of imported goods, obtaining a corresponding reduction in the import value for customs duty purposes is problematic.

The current transfer pricing rules under Division 13 at least require the Commissioner to pay heed to the consideration of specific transactions when making transfer pricing adjustments. The proposed changes could lead to a greater number of ATO transfer pricing adjustments determined using profit-based methods without being clearly traceable to specific transactions. This will make it more difficult for importers to obtain refunds of duty paid where the ATO has made an adjustment to reduce the import value of goods. Furthermore, where the Commissioner applies Subdivision 815-A retrospectively, time limits for seeking duty refunds (four years) are likely to have expired. This would create an additional form of double tax (i.e., additional Australian income tax on top of overpaid customs duty) or even triple tax (i.e., Australian income tax and foreign income tax on the same income and overpaid customs duty) for those taxpayers where MAP timeframes have also been exceeded.

Improvements are required to better align the legislative and administrative frameworks for customs and transfer pricing. Mechanisms need to be available to taxpayers to ensure that adjustments to the customs value of goods (and duty payable/refundable) can be made following ATO transfer pricing adjustments. This needs to be embedded in legislation and needs to be supported by a clear administrative process.

The customs and transfer pricing rules are contained in different Acts and are administered by different Government departments. The Government has the opportunity to take action to ensure that the two sets of rules and administrators do not create domestic double tax.

Failure to address this issue is likely to increase costs for all companies importing goods or materials into Australia. This could have a particularly severe impact on the Australian manufacturing sector

which is already experiencing difficulties competing against lower cost manufacturing locations overseas.

E. Branch profit attribution rules have been inadequately addressed

The proposed law as it stands will significantly increase the level of uncertainty for taxpayers with branch operations in Australia and the complexity of disputes. The law should be amended prospectively to make clear that taxpayers may adopt the Authorised OECD Approach (AOA) to attribution of profits to permanent establishments. We explained the reasons for this in detail in the PwC PE Submission to Treasury in November 2011. We have outlined below the specific concerns we continue to have based on the ED and EM as they have been drafted.

Inconsistent rules for branches versus companies and inbound versus outbound branches

Our understanding, based on the Consultation Paper and discussions with Treasury, was that the issue of updating of Australia's domestic attribution rules to reflect the AOA was to be separately considered. Accordingly, we were surprised to see the ED introduce the ability for the Commissioner to increase the taxable income of Australian branches of companies resident in treaty countries.

Based on the way the ED has been drafted, different profit attribution rules (and outcomes) could apply for:

- Inbound branches of foreign companies resident in treaty countries (potentially with different results under different treaties);
- Inbound branches of foreign companies resident in non-treaty countries;
- Subsidiaries of foreign companies resident in treaty countries;
- Subsidiaries of foreign companies resident in non-treaty countries;
- Outbound branches of Australian companies; and
- Outbound subsidiaries of Australian companies.

This will clearly create a complex series of rules which are difficult for taxpayers to understand and will create an uneven playing field for different types of taxpayers. The profit attribution rules for branches need to be reviewed on a comprehensive basis, not only for a small proportion of taxpayers. This should be done at the same time as the rewrite of Division 13 to ensure that all taxpayers are on an equal footing from an Australian transfer pricing perspective regardless of whether they are a company or branch, inbound or outbound investor, or dealing with a treaty or non-treaty country.

Need for clarity on adoption of Authorised OECD Approach

Consistent with our earlier submission, PwC is strongly of the view that Australia should amend its law to embrace the OECD consensus position on the attribution of profits to permanent establishments as soon as possible. The AOA is reflected in the OECD's Report on Attribution of Profits to Permanent Establishments – 2010 (the OECD PE Report). This report has been incorporated into Article 7 and its associated commentary of the 2010 OECD MTC.[9]

Australia has played a leading role in drafting and establishing this position and so should, as a matter of priority, seek to adopt this approach in its domestic legislation. Australia did not make any relevant reservations to the inclusion of the new Article 7 and commentary in the 2010 OECD MTC.

As you will be aware from earlier submissions[10] there is currently a great deal of uncertainty and confusion as to the extent to which Australia's existing tax law permits the adoption of the principles in the OECD PE Report. At present, this uncertainty is greatest in the financial services sector which traditionally operates cross border under branch structures. In particular, the official ATO view is that Australia's PE attribution rules operate on a 'relevant business activity' basis. Further, it is the ATO's view that Australia's transfer pricing rules and its treaties do not permit the recognition of notional dealings between parts of a PE and instead require a tracing and attribution of actual income and expenses of the entity.[11] For various reasons, set out in other submissions, such an approach is out of step with the AOA and is near impossible for complex financial services institutions in the modern financial services environment.[12]

The wording of s815-22(1)(b)(ii), which requires a PE's profits to be determined based on the profits the PE might be expected to make if it were a "separate and distinct" entity, may further exacerbate the uncertainty over how Article 7 should be interpreted. This wording appears to be aligned with the AOA, which would place it at odds with the Commissioner's views on interpretation of Article 7.

Unfortunately the ED falls well short of ensuring that Australia's domestic rules are consistent with the OECD consensus. Subsection 815-22(3) requires the business profits article of a relevant treaty to be interpreted so as to best achieve consistency with the 2010 OECD guidance on Article 7. This may be read as allowing the Commissioner to apply the AOA for the purpose of raising an assessment under Subdivision 815-A. This interpretation is not clear, however, as the requirement to achieve best consistency with the 2010 OECD MTC is qualified by the words *"to the extent the documents are relevant"* in s815-22(3). This casts at least some doubt as to whether the 2010 OECD MTC could be regarded as relevant to the interpretation of words emanating from a treaty concluded pre-2010.

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[9]The 2010 Commentary to Article 7 says at paragraph 9 *"The current version of the Article therefore reflects the approach developed in the Report and must be interpreted in light of the guidance contained in it."*
[10] Australian Bankers' Association Submission to Treasury, 2 December 2011 (the ABA Submission); Australian Financial Markets Association Submission to Treasury, 16 December 2011 (the AFMA Submission); PwC PE Submission.
[11] This is made clear in Taxation Rulings TR2001/11 (paragraph 1.15) and TR 2005/11 (paragraph 7). It is reiterated in an unclassified ATO report entitled Profit Allocation to Permanent Establishments of Banks dated 6 July 2011 (paragraph 8).
[12] Cross Border Dealings within a Single Entity, Tony Frost, Challis Taxation Discussion Group, 5 May 2010; ABA Submission; AFMA Submission; PwC PE Submission.

Paragraph 1.46 of the EM seems to add weight to the view that the 2010 OECD MTC would not be relevant for interpreting pre-2010 treaties, but it does not make the matter sufficiently clear.

We note that the Commissioner holds the view that the latest guidance of the OECD, reflected in the 2008 OECD MTC Commentary and the 2010 OECD MTC Article 7 and Commentary, is not relevant on the basis that Australia has not incorporated any of the new text of Article 7 into its treaties.[13] Many taxpayers dispute this view. The ED could be interpreted as providing one set of rules for the Commissioner and another set of rules for taxpayers. Such a result is unacceptable and will lead to excessive complexity and increased risk of unrelieved double taxation.

Complexity of transitional rules

The issue will be further complicated by the proposed transitional rules applying to years of income prior to the 2012-2013 income year. These rules will operate to ensure that a transfer pricing benefit is to be interpreted so as to best achieve consistency with the OECD MTC last published before the start of the income year. Accordingly, there will be different versions of OECD materials for different years. This is unnecessarily complex and will lead to greater confusion and costs for taxpayers in analysing and supporting their positions.

This issue does not only apply to PEs; the transitional rules for companies will also be complex due to changes that have been made in recent versions of the OECD TPG (in particular, there were significant changes in the 2010 version of the OECD TPG). We have commented further on this matter in Section 2 of our submission.

Interaction with other areas of tax law

There is no clear indication as to how the proposed rules will interact with other areas of the existing tax law applicable to PEs. For example, there is no clarity on how the proposed Subdivision 815-A will interact with Part IIIB of the Income Tax Assessment Act 1936. Nor is there any indication of the implication of an adjustment made under Subdivision 815-A where a foreign resident has an Australian permanent establishment that is also an Offshore Banking Unit.

Conclusion on branch issues

The introduction of a new set of rules, available to the Commissioner only, and applicable to inbound permanent establishments only, is both inequitable and ill considered.

Consistent with our earlier recommendation we would support a considered and comprehensive approach to amending Australia's transfer pricing provisions as they relate to permanent establishments to allow the full effect of the OECD latest guidance. However such an approach cannot be piecemeal and needs to consider the interaction with other relevant areas of the tax law. It should apply prospectively and both to inbound and outbound taxpayers.

[13] Profit Allocation to Permanent Establishments of Banks –Appendix 3.

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This again illustrates that the proposed changes have not been properly thought through and should be put on hold until a more comprehensive review has been performed.

F. Increased complexity on interaction with thin capitalisation rules

The ED attempts to deal with the interaction between Subdivision 815-A and the thin capitalisation rules but, in our view, does so in an unsatisfactory way. The specific provisions included within the ED on the interaction with Division 820 are open to conflicting interpretations. Two possible interpretations (among others) are:

1. Subdivision 815-A could undermine the thin capitalisation safe harbour.

   Subdivision 815-A requires the Commissioner to consider whether an entity's "profits" are less than the profits that it would have accrued if it had been acting on an arm's length basis. Profits are defined as taxable income, which implies that the Commissioner should consider whether a taxpayer's post-interest profits are arm's length.

   This could lead to a situation where the Commissioner could apply Subdivision 815-A to reduce interest deductions that would otherwise be deductible (if the taxpayer's pre-interest profits were considered to be arm's length and interest deductions on debt within the safe harbour limit create a post-interest profit or loss that is below the Commissioner's expectations of an arm's length outcome).

   This would clearly undermine the policy intent of the thin capitalisation safe harbour.

2. Subdivision 815-A could give retrospective legislative effect to TR 2010/7.

   Subsections 815-22(4) and (5) appear to be aiming to embed the principles from TR 2010/7 within the law. We have several concerns over this approach:

   - TR2010/7 represents the Commissioner's view of how the law should be interpreted. There are no grounds for giving legal force to the Commissioner's interpretation of the law on a retrospective basis. As far as we are aware, there are no precedents for retrospectively changing the law to give force to a particular interpretation of the Commissioner.

   - Giving retrospective legal effect to the Commissioner's views would disadvantage taxpayers who have taken a different interpretation of the law.

   - We are not convinced that s815-22(4) and (5) will be effective in 'preserving' the interpretation taken by the Commissioner in TR2010/7. TR2010/7 requires the Commissioner to apply an arm's length interest rate to the actual amount of debt (provided the actual amount is within the safe harbour). Subsection 815-22(4) appears to intend to do this also, but as noted above, we are concerned that the other provisions within s815-22 could be interpreted in a way that would enable the Commissioner to place

additional limitations on the interest deductions a taxpayer would otherwise be entitled to claim.

Both of these interpretations have the potential to produce unfavourable outcomes for taxpayers and to some extent they contradict one another. A law that is open to multiple contradictory interpretations will create confusion and complexity for taxpayers, and will also create complexity for the Commissioner in administering the law. This further illustrates that the proposed changes will not achieve the objective of 'clarifying' the law and will, in fact, increase complexity and uncertainty.

2. Matters requiring clarification or amendment if Subdivision 815-A is introduced

We stress that we are unequivocally opposed to the changes proposed in the ED. However, if the Government decides to proceed with the retrospective changes and introduces Subdivision 815-A, there are many aspects of the draft ED and EM that require further clarification or amendment. This section sets out our specific comments on the ED and EM as they have been drafted.

A. Interaction with the thin capitalisation provisions

As noted above in Section 1 of our submission, we have a number of concerns about the way the ED proposes to deal with the interaction of Subdivision 815-A and Division 820. Below we have set out the specific amendments that we recommend to address the concerns we have on the interaction between Subdivision 815-A and Division 820 based on the current ED.

Recommendation 1: Subsection 815-22(5) should be removed from the ED. Example 1.4 should be removed from the EM. TR 2010/7 should remain in force to ensure that taxpayers who have relied upon the Commissioner's views in this ruling are not disadvantaged.

Subsections 815-22 (4) and (5) purport to have the combined effect of preserving the outcome of the Commissioner's position in TR 2010/7. In principle, the object appears to be to ensure that a transfer pricing adjustment can be made in respect of a debt interest and that the adjusted interest rate is applied to the actual value of the debt.

The EM confirms that these "additional rules" will apply and that these rules are "consistent with the current administrative approach provided in Taxation Ruling 2010/7".

We support the inclusion of s815-22(4) to ensure that Subdivision 815-A does not override Division 820 in determining the maximum amount of debt allowable for a taxpayer. We also support the use of OECD guidance to determine an arm's length rate of return on a taxpayer's debt, as would be the case under s815-22(4)(a). We note, however, that there is currently no specific guidance available in the OECD TPG or OECD MTC on how an arm's length rate of return on a debt instrument should be determined. As such, taxpayers and the Commissioner will need to interpret the OECD's general guidance on the arm's length principle to determine an arm's length interest rate.

Subsection 815-22(5) and Example 1.4 in the EM presuppose a particular interpretation of OECD guidance. They presuppose that the OECD guidance would allow the rate of return on a taxpayer's debt to be determined by reference to a notional 'arm's length amount of debt' in certain circumstances. It

is open to debate as to whether this interpretation is correct. We submit that taxpayers and the Commissioner should each interpret the relevant OECD guidance as they see fit, rather than prescribing a particular interpretation in the law. For this reason, we recommend removing s815-22(5) from the ED and Example 1.4 from the EM.

It is important to ensure that taxpayers will not be exposed to greater risk of transfer pricing adjustments to debt transactions under Subdivision 815-A than they would have been under the existing law and the Commissioner's guidance in TR 2010/7. Arguably, the treaties permit the recharacterisation of an amount of debt, above an arm's length amount, as equity. The consequence of this is that no deduction would be available on the excess debt. This was the substance of the view formed in legal advice to the Commissioner dated 23 June 2009[14] (Merkel's advice).

Having regard to similar facts to those in Example 1.4 of the draft EM, Merkel's advice concluded that Division 13 and the Treaty could be applied to arrive at a deduction of $25m (being 10% of $250m). The actual example in the EM allows for a deduction of $30m for example 1.4 (being 10% of $300m). The outcome in example 1.4 of the EM is broadly consistent with the outcome in the equivalent example of TR 2010/7 – however, in TR 2010/7 the Commissioner acknowledges he regards this is a concessionary position – refer paragraph 58:

> *"So as not to defeat the operation of Division 820, any arm's length rate of interest derived under any of the approaches discussed at paragraphs 54 to 57 of this Ruling should be applied to the actual amount of debt."*

In other words, this is a recognition from the Commissioner that he believes the treaty, and in particular Article 9, has the effect of permitting a result that effectively disallows deductions on debt beyond an arm's length amount.

The position adopted by the Commissioner under TR 2010/7 effectively puts an administrative constraint on how he will use the additional power he believes he has under the treaty (which in light of the Merkel advice he believes could result in lower interest deductions) to ensure that the intent of Division 820 is not defeated.

Through TR 2010/7, the Commissioner has effectively acknowledged and dealt with the potential inconsistency between a treaty based outcome and a combined Division 13/Division 820 outcome by administratively placing a restraint on his purported power to adjust under the treaty and/or power to adjust under Division 13. Given TR2010/7 applies both prospectively and retrospectively there is no need to formalise this position in the legislation through s815-22(5). TR 2010/7 should remain in force after the introduction of Subdivision 815-A to ensure that taxpayers who have relied upon the Commissioner's views in this ruling may continue to do so under Subdivision 815-A.

Recommendation 2: Amend s815-22 to ensure that "profits" for the purposes of s815-22(1)(a)(iii) is to be determined without regard to debt deductions, i.e. on a pre-interest basis.

[14] Ron Merkel QC Supplementary advice 23 July 2010

The stated intention of s815-22 (4) and (5) is to preserve the effectiveness of the safe harbour provisions in Division 820 to allow debt deductions on debt interests up to the safe harbour amount.

Subsections 815 -22(4) and (5) purport to do this through setting principles for determining the amount of deductions. Subsection 815-30 (3) then requires the Commissioner to make a determination relating to the debt deductions of the entity if Division 820 applies to the entity.

However, the interaction between s815-22(4) and (5) and s815-22(1) to (3) is not explicit. Specifically, our concern is that there is nothing in the ED which would prevent the Commissioner from circumventing the limitation on his power in subsections (4) and (5) through the operation of s815-22(2) to calculate the transfer pricing benefit. This may give rise to situations where the Commissioner would 'claw back' any concession through adjustments to other amounts of assessable income or deductions. In short, s815-22(4) seems to be a rule which calculates the amount of a debt deduction, whereas s812-22(2) applies to the profit in totality.

Example

Take the same facts as in Example 1.4 of the draft EM.

Based on the facts and assumptions in that example, s815-22(1)(a) (iii) would potentially apply. There is an amount of profits (within the meaning of the article) which, but for the conditions mentioned in the article might have been expected to accrue to the entity, has by reason of those conditions, not so accrued. The amount of the profits (or transfer pricing benefit) in this instance is $20m, being the difference between the actual deductions of $45m and the amount of deductions that has been determined that would have been available at arm's length being 10% of 250m, or $25m.

S815-22(4) would also apply. Based on the analysis in example 1.4 of the draft EM the net impact of this is that the debt deductions of Ausco are reduced by $15m. This is on the basis that a debt deduction would be allowed on the actual amount of debt capital within the safe harbour being $300m.

It would appear, prima facie, that it would be open to the Commissioner to then issue two determinations under s815-30(1) and that these determinations would then be attributable to amounts of assessable income and deductions in s815-30(2) as the Commissioner determines.

Subsection 815-30(3) requires one of the determinations to relate to the debt deductions. Therefore the Commissioner may issue a determination that reduces debt deductions by $15m.

However there is nothing that appears to explicitly prevent the Commissioner from issuing a further determination to reduce other deductions or increase an amount of assessable income by $5m to arrive at a total adjustment of $20m.

The outcome is possible largely because the "profits" in s815-22 (1)(a)(iii) are not constrained to only consider pre-interest profits.

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We do not believe such an outcome is consistent with the policy intent of 815-22(4) and (5) nor with Division 820 and TR2010/7.

In our view, this concern is not merely a theoretical possibility. Increasingly we are seeing examples in practice of where the Commissioner is taking positions which clearly undermine the intent of the thin capitalisation provisions.

If Subdivision 815-A is to be applied consistently with OECD guidance, then the provisions must have regard to OECD guidance for interpreting the meaning of "profits" in the context of Article 9. It is neither sufficient nor appropriate to refer to subsection 3(2) of the International Tax Agreements Act 1953, which defines profits as taxable income. It is insufficient because applying the arm's length principle is far more complex than merely reviewing whether taxable income is arm's length (indeed, it is hard to see how this could be possible), and it is inappropriate because it is a domestic provision and therefore may not be consistent with what was intended by the treaty partners.

The guidance in the OECD MTC and OECD TPG does not directly define "profits" in the context of Article 9. Instead, the OECD guidance requires the arm's length principle to be applied by selecting and applying an appropriate transfer pricing method for transactions that have been undertaken between the associated enterprises. The methods endorsed by the OECD test whether a transaction (or group of transactions) is arm's length by comparing the price, gross margin, or net operating margin of the transaction(s) to those derived in comparable independent dealings.

Traditionally, in transfer pricing practice, the application of transfer pricing methods and principles for non-financial dealings has been applied by taxpayers and tax authorities alike on a pre-interest basis (with the possible exception of financial services businesses). The OECD TPG explicitly support this approach in the guidance provided on the application of transactional profit methods.[15] In other words, the profit being considered and potentially adjusted is the profit of the taxpayer pre-interest and without regard to the capital structure. The capital structure itself was then dealt with through a combination of the transfer pricing and thin capitalisation provisions. Increasingly we are seeing examples where the Commissioner is blurring the distinction and arguing that the arm's length profit outcome in Australia should be on a post-interest basis. This position is not consistent with OECD guidance and undermines the integrity and policy intent of the thin capitalisation provisions.

B. Need to consider interaction with relevant provisions of the tax law

Recommendation 3: There is a need to limit the possibility that Subdivision 815-A could be used to override specific tax treatment of certain items of income or expenses on a transaction basis. The Commissioner should be required to apply s815-30(2) for all determinations made under Subdivision 815-A.

[15] OECD TPG paragraph 2.80

There are a number of areas of the tax law which operate on a transactional basis. That is, an important feature of the application of the taw law is being able to identify specific transactions that give rise to items of assessable income, allowable deductions and non-assessable non exempt income.

The existing transfer pricing provisions of Division 13 also operate on a transactional basis. Any adjustments made under Division 13 apply to effectively replace the actual consideration with arm's length consideration for specific transactions. The rest of the tax law then operates on the basis that the arm's length consideration is used for the specific transaction.

We are concerned that Subdivision 815-A will not require the identification of the transactions being adjusted. Subdivision 815-A appears to operate to increase taxable income, without regard to specific transactions and/or the specific tax treatment of those transactions. In particular, s815-30(1) permits the Commissioner to make a determination with the effect of increasing taxable income and/ or decreasing a tax loss or net capital losses. It is not clear that in making this adjustment specific items of income or expenditure are themselves to be adjusted (for other purposes of the tax law). Subsection 815-30(2) allows the Commissioner to attribute determinations to particular items of income or expense but does not require him to do so in all cases.

Some examples (by no means exhaustive) of areas where Subdivision 815-A has the potential to override domestic taxing provisions include:

- The debt /equity provisions (Division 974 of the ITAA 1997) which operate based on the terms and conditions of particular instruments;
- The Offshore Banking Unit regime which applies to tax certain qualifying income at a concessional tax rate; and
- The non resident reinsurance provisions (Division 15 of the ITAA 1936) which determine the tax treatment of insurance premiums and recoveries to and from non-residents.

In each of the above cases, an adjustment made under Subdivision 815-A has the potential to increase taxable income of the taxpayer but with no ability to determine the flow on consequences for other taxing provisions of the domestic legislation.

Allowing the Commissioner to make an amended assessment to a taxpayer's net taxable income without requiring him to attribute this to specific items of income or expense would be inconsistent with OECD guidance and would also have negative implications for consequential adjustments, customs duty and MAP negotiations. Subsection 815-30(2) and paragraph 1.56 of the EM should be amended to require the Commissioner to attribute determinations to specific items in all cases.

Failure to address this outcome will place taxpayers subject to Subdivision 815-A (ie, those that are subject to a treaty) at a disadvantage to those subject to Division 13 alone. As mentioned in Section 1, this could breach non-discrimination articles in certain treaties.

C. Interpretative material

Recommendation 4: All OECD transfer pricing and model tax convention materials approved by the OECD Council should be adopted as relevant for interpreting Australia's transfer pricing rules.

The ability for new interpretative material to be introduced by regulation under s815-25 is too broad. There is no apparent constraint on the type of material that can be regulated. For example, it appears possible that a Taxation Ruling could be prescribed by the regulations as relevant for interpreting Subdivision 815-A. While we accept that it is unlikely that this is the intent of the legislation, there remains the risk that new OECD material may be released that is inconsistent or in conflict with a position adopted by the Commissioner in a Taxation Ruling. This may lead to a potential for the Commissioner's view on the matter to be preferred over that of the consensus view of the OECD. Such a conflict could lead to confusion and uncertainty amongst the business community as to the stance Australia takes on transfer pricing. This would also be inconsistent with the policy intent of improving consistency with OECD guidance.[16]

There is a risk that Treasury may be perceived as picking and choosing which elements of OECD Guidance to accept and refuse. Sceptics may also be concerned that the ATO will attempt to influence Treasury's views on which OECD materials are relevant. This will create ongoing uncertainty which is unnecessary given Australia's role in the OECD. It will also work against Treasury's objective to achieve international consistency with our treaty partners. This will increase uncertainty for multinational enterprises operating in Australia and could increase the risk of double tax issues arising that cannot be resolved through the Mutual Agreement Procedure process.

There is a formal diplomatic process by which the Australian Government can express reservations on OECD documents. In the absence of formal reservations, all published OECD materials should be endorsed as relevant for interpreting Australia's transfer pricing rules and tax treaties.

Recommendation 5: Clearer guidance is required on the transitional rules for income years prior to 2012-13.

The ED and EM indicate that relevant documents for interpreting Subdivision 815-A will be the versions of the OECD MTC and OECD TPG that were published most recently prior to the beginning of the relevant income year. This will add complexity to the interpretation of Subdivision 815-A in the context of the historical income years to which it is proposed to apply.

In Section 1.E above we outlined the complexity that this would give rise to particularly for branches, where there have been significant recent developments in OECD guidance.

Other areas of OECD guidance have also developed significantly in recent years. The 2010 version of the OECD TPG included the following major changes:

[16] EM paragraph 1.12

- A significant overhaul of Chapters I to III (for the first time since the OECD TPG were published in 1995); and
- Addition of Chapter IX on the transfer pricing aspects of business restructuring.

The 2010 revision of the OECD TPG did not carry an express date of entry into force, so it is possible that other OECD members will have chosen to apply the 2010 version of the TPG to resolve controversies related to prior years, particularly in cases involving issues that have been more comprehensively addressed in the latest OECD guidance (such as business restructuring).

If the Government proceeds with implementing Subdivision 815-A retrospectively, further thought needs to be given as to how the various interpretative materials will be applied to prior income years, particularly where new OECD guidance has become available that covers issues not previously addressed (or not addressed to the same extent). This should also be considered for new OECD guidance that may be released in the future. The Australian view on how OECD materials should be applied to prior years should not be developed in isolation: the Government should consider the approach adopted by treaty partners when assessing whether to apply new OECD materials to interpret prior year issues.

D. Clarification is required on when Subdivision 815-A will apply

Recommendation 6: The Commissioner should not be given multiple assessing powers for transfer pricing.

The Commissioner should not be permitted to issue multiple determinations for the same amount under Division 13, Subdivision 815-A, and the relevant treaty directly. While s815-50 makes it clear that the Commissioner cannot bring an amount to tax under Subdivision 815-A and also under another provision of the Act, this does not restrict the Commissioner from choosing whichever provision he likes when making a transfer pricing adjustment. Historically, the Commissioner has issued assessments to taxpayers applying both Division 13 and the treaties. We consider this to be bad policy as it places an unfair burden on taxpayers to analyse the potential legal consequences of each.

If the options are left open to the Commissioner, as appears to be the case with the current draft, this would increase the legal burden on taxpayers. This could be particularly onerous for taxpayers engaged in dealings with related parties in several treaty partner countries, as those taxpayers may be required to consider the interpretation of multiple treaties. Given that the Commissioner holds the view that the outcomes should be the same whether he makes a transfer pricing adjustment under Division 13 or the treaties (as evidenced by historical assessments), and Treasury's view that the proposed changes are a clarification of the existing law, there should be no disadvantage in providing a clearer legislative framework on when each provision may (or may not) be applied.

Recommendation 7: The EM should be expanded to provide examples of when Subdivision 815-A will apply. In particular, this should clarify situations in which Subdivision 815-A may be applied on a retrospective basis. This guidance is required to ensure Parliament's policy intent is clear.

As we have repeatedly stated, we strongly disagree with implementing the proposed changes retrospectively to 2004. However, if the legislation is enacted with retrospective effect, we believe further guidance is required to clarify the policy intent of when it would be appropriate for the Commissioner to apply the law to prior income years. Given the potential severity of the retrospective changes, we consider that this should be considered by the Parliament and not merely dealt with in ATO administrative guidelines. We recommend expanding the EM to include examples of situations in which it may be appropriate to apply Subdivision 815-A on a retrospective basis. There should also be examples to clarify when it would *not* be appropriate to apply Subdivision 815-A on a retrospective basis (such as cases that the Commissioner has previously closed or walked away from).

Administrative guidance may also be required to ensure that ATO field officers enforce the law in a manner that is consistent with the policy intent of Parliament.

Recommendation 8: To the extent this is a clarification of existing law, there needs to be some mechanism to prevent the Commissioner from revisiting transfer pricing cases that have previously been closed.

Although we do not agree, Treasury's view and intent is that Subdivision 815-A is consistent with existing law. Therefore, we would expect that transfer pricing cases previously closed or set aside by the ATO would not now be reopened for further investigation. We recommend explicitly confirming this in the EM.

E. Arbitration clauses should be considered for future treaties to ensure the risk of double tax does not increase.

Recommendation 9: The Government should consider including a binding arbitration clause in the MAP article of any new treaties that are negotiated (or renegotiated) in the future.

The MAP article in the 2010 OECD MTC treaty includes a binding arbitration clause which enables taxpayers to request that a double tax dispute be submitted to arbitration if the competent authorities of the two treaty countries are unable to resolve the case. Arbitration clauses have already been introduced to some treaties by important trading partners such as the United States, Canada, Germany and Japan.

An arbitration clause would provide greater comfort to taxpayers that transfer pricing adjustments will not result in double tax.

We acknowledge this cannot be addressed within the scope of the current transfer pricing reforms, but we strongly encourage the Government to place this on the policy agenda for future treaty negotiations.

F. Taxpayers should not be subject to penalties for retrospective determinations made under Subdivision 815-A

Recommendation 10: No penalties or interest charges should apply where the Commissioner applies Subdivision 815-A to make determinations in respect of income years prior to enactment of the law.

Taxpayers recognise and understand that they may be penalised if they do not comply with the law. Subdivision 815-A is a new law with retrospective application. It would be unfair to penalise taxpayers for not complying with a law that did not exist at the time they entered into an arrangement. We therefore recommend that no penalties should be applied to Subdivision 815-A assessments made by the Commissioner for income years prior to enactment of the law.

The ATO has issued a practice statement on the administration of tax law that will apply retrospectively to the date of an announcement.[17] PSLA 2007/11 contemplates situations in which taxpayers face uncertainty when lodging tax returns between the date of the announcement and date of enactment of a law that will be effective from the announcement date. In these situations, the ATO indicates that taxpayers will not be subject to shortfall penalties or interest charges where they have lodged their tax returns based on the existing law.

PSLA 2007/11 does not contemplate situations in which legislative changes may be given retrospective effect to apply to income years prior to the date of an announcement. Clearly the proposed retrospective application date for Subdivision 815-A of 1 July 2004 is well before the date that the proposed changes were announced (1 November 2011). Since the Commissioner already provides a concession on penalties where retrospective legislative changes are backdated to the date of an announcement, we submit that this concession should also apply to all prior income years to enactment of Subdivision 815-A.

While this could potentially be managed through further ATO administrative guidance (such as an additional practice statement or an addendum to PSLA 2007/11), given the extraordinary nature of the retrospective changes proposed in this case we recommend that this issue should be considered by the Parliament. We recommend that the bill or EM that is submitted to Parliament should state that no penalties or interest will apply to assessments made by the Commissioner under Subdivision 815-A for income years prior to the date of enactment.

We note that in cases that the Commissioner considers penalties would be appropriate, it would still be open to him to issue determinations under Division 13.

G. Time limits should be placed on the number of years available for the Commissioner to make amendments under Subdivision 815-A

Recommendation 11: A time limit should be introduced on the period in which the Commissioner may apply Subdivision 815-A to issue amended assessments for prior income years.

[17] Practice Statement Law Administration (PS LA) 2007/11: Administrative treatment of taxpayers affected by announced but unenacted legislative measures which will apply retrospectively when enacted.

The ED does not place any time limit on when the Commissioner may make Subdivision 815-A determinations relating to prior income years, other than the start date of 1 July 2004. If no time limit is introduced, this could leave taxpayers facing uncertainty indefinitely over whether they may be exposed to amended assessments for 2004 onwards. We acknowledge that there is no time limit for amendments under the existing Division 13; however, Treasury has already indicated that a time limit may be included in the new prospective transfer pricing rules.

An indefinite time limit would be inconsistent with amendment periods for other areas of income tax and may be inconsistent with certain treaties. We recommend that a time limit should be introduced for Subdivision 815-A. Since a time limit is already being contemplated for the new prospective transfer pricing rules, this should be consistent with Treasury's policy intent. The amendment period for Subdivision 815-A should not exceed the time limits stated in any relevant treaty and should not exceed the time limit in the new prospective transfer pricing rules. As recommended in our previous submission, we consider a time limit of four years to be appropriate.

H. Amendments should be made to ensure that customs relief is available where an adjustment is made under Subdivision 815-A (or any other transfer pricing provision).

Under the present law there are significant difficulties in ensuring that transfer pricing adjustments can be reconciled to customs value. As explained previously in this submission, this risk is likely to increase under Subdivision 815-A. Treasury should work together with the Department of Home Affairs to achieve better alignment of the transfer pricing and customs rules from a legislative and administrative perspective.

As previously mentioned in Section 2.B above, s815-30(2) and paragraph 1.56 of the EM should also be amended to oblige the Commissioner to attribute determinations under s815-30(1) to specific items of income or expense.

G. Other areas of the ED and EM requiring clarification or amendment

Reference	Issue	Recommendation
s815-30(6) and s815-45(6)	These subsections state that failure by the Commissioner to provide a copy of a determination to a taxpayer does not affect the validity of the determination. We consider this to be unreasonable.	Remove s815-30(6) and s815-45(6)

Reference	Issue	Recommendation
s815-30(7)	Clarification is needed on whether determinations relating to dealings with different treaty countries may be included in the same document or separately. Given that a transfer pricing benefit under s815-22 must be determined by reference to a specific treaty, at a minimum we expect the Commissioner must provide separate determinations showing the amount relating to each country.	Clarify the format that determinations will take where the Commissioner makes determinations in respect of a taxpayer's dealings with more than one treaty country.
s815-45 and EM paragraphs 1.68 and 1.69	The draft provisions on consequential adjustments allow the Commissioner to make consequential adjustments, following a determination under s815-30, if the Commissioner is satisfied that such an adjustment would be "fair and reasonable" for the taxpayer and revenue. There is no need for the Commissioner to hold such a discretion in relation to consequential adjustments. Whether or not a consequential adjustment is required should be determined objectively based on the determinations made by the Commissioner and the collateral tax consequences that these will give rise to.	The draft provisions and EM should be revised to require the Commissioner to make consequential adjustments where a determination made under s815-30(1) if, based on the item(s) the determination is attributed to under s815-30(2), a consequential adjustment should objectively be made. For example, if a determination is made to reduce a taxpayer's royalty expense, a consequential adjustment should be made to withholding tax applied to the royalties without the need for the Commissioner to judge whether this is fair and reasonable to revenue.
EM paragraphs 1.8 to 1.10	The EM makes certain unsubstantiated references to Parliamentary intention, such as "repeatedly referenced its view", "publicly expressed consistently" and "last demonstrated its intention". As evident from the public submissions to Treasury, these statements are disputed by many members of the tax profession and taxpayers.	The EM should not make unsubstantiated statements of this nature without acknowledging that they are not free from doubt.

Reference	Issue	Recommendation
EM paragraphs 1.15, 1.35 and 1.36	The EM makes several references requiring the Commissioner to have regard to “relevant circumstances of the entity” when applying Subdivision 815-A. We consider this to be inconsistent with OECD guidance. Introducing concepts that are based on a particular interpretation of OECD guidance will reduce international consistency and increase the risk of double taxation that cannot be resolved through MAP.	Delete the words “having regard to the relevant circumstances of the entity” from paragraph 1.15. Delete the last sentence of paragraph 1.35 and the last sentence of paragraph 1.36.