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20 December 2012

Dear Sir/Madam

Submission – Transfer Pricing Exposure draft and Explanatory Memorandum

We appreciate the opportunity to provide comments on the exposure draft (ED) and explanatory memorandum (EM) of *Tax Laws Amendment (Cross-Border Transfer Pricing) Bill 2013: Modernisation of transfer pricing rules*.

Contents

Our submission contains:

1. Executive summary
2. Detailed views and recommendations

1. Executive summary

Transfer pricing is an important tax issue for many of our clients. We also recognise that it is in the national interest for Australia to have a robust and modern set of transfer pricing rules to ensure integrity of the corporate tax base in Australia, consistency with international standards, and our obligations are met to our trading partners through our international tax treaties.

We note that this is a comprehensive overhaul of transfer pricing rules (Division 13 of the Income Tax Assessment Act 1936) that have been in place for 30 years. The Commissioner has issued many rulings on aspects of its operation. Accordingly it is important that the new law is drafted thoroughly, and stakeholders are provided sufficient opportunity to consider the impact of the new legislation and to prepare appropriately for any changes. We are pleased that Treasury is seeking stakeholder feedback on the ED. However we note that time allowed for written feedback on the provisions (less than 30 days) is very short for such a significant piece of legislation. It is important that the consultation process is ongoing to ensure that the legislation is drafted in the most effective manner. In this regard we would be very happy to discuss further our comments at your convenience.

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We support aligning Australia's transfer pricing rules with the arm's length principle and the guidance from the Organisation for Economic Cooperation and Development (OECD). However we are concerned that there are particular provisions in the ED which are not consistent with the intent of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (TPGs) and/or do not properly reflect the position of the OECD in its appropriate context. This will lead to uncertainty and increased risk of dispute and potentially double taxation. The most significant area of concern is the apparent requirement for taxpayers to reconstruct their dealings in certain circumstances. This requirement seems to be complex in operation, unnecessary in nature and inconsistent with a self-assessment regime.

We agree, in principle, with applying the rules on a self-assessment basis and we welcome the introduction of a time limit for amendments; however, we consider that four years is more appropriate than the proposed eight years.

The documentation requirements should provide a positive incentive for taxpayers to prepare documentation rather than precluding taxpayers who do not prepare documentation from establishing a reasonably arguable position (RAP). As presently drafted, the documentation requirements are over prescriptive and are drafted in a way that could be interpreted widely. This will create complex compliance burdens for transactions that may be relatively straightforward and low risk.

Further details on our views and recommendations are provided in Section 2 and specific observations on the ED and EM wording are provided in Appendix 1.

Thank you for the opportunity to comment on this important piece of legislation. As mentioned above we would be pleased to discuss any of the comments made in this submission with Treasury.

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2. Detailed views and recommendations

A. Self-assessment and time limits for amendment

Recommendations

1. We agree that the transfer pricing provisions should operate on a self-assessment basis (subject to our comments below in relation to reconstruction)

2. The time limit for amendment of assessments should be four years not eight years.

3. If there are concerns that additional time may be required to implement Mutual Agreement Procedure (MAP) adjustments, this could be dealt with by inserting a provision which makes it clear that nothing in the domestic law limits the time available for the Commissioner to amend assessments in order to give effect to adjustments agreed between Competent Authorities following a MAP negotiation.

4. We recommend a sunset clause on amendments to assessments under Division 13 and/or subdivision 815-A in respect of the years to which these provisions apply.

Explanation

Self-assessment

We agree with the proposal for the transfer pricing rules to operate on a self-assessment basis subject to our comments in relation to the disregarding of actual transactions as structured by the taxpayer (discussed below in section C).

Hindsight

Under a self-assessment approach, taxpayers must be able to form a view about whether their pricing is arm's length based on information that is reasonably available to them at the time of preparing a tax return. The Commissioner should not be able to amend assessments based on information which could only have been known with hindsight. We have commented further on this in our discussion on reconstruction of dealings in section C.

Time limits

We welcome the introduction of a time limit for the amendment of assessments but we consider eight years to be excessive. The time limit for issuing amended transfer pricing assessments should be aligned with the general corporate tax amendment period of four years.

There does not seem to be any particular reason why Australia should adopt a longer time limit on amendments for transfer pricing than its trading partners. We note that the time limits for amendments in comparable jurisdictions are:

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Country	Time limit for transfer pricing amendments	General time limit for corporate tax amendments
Canada	6/7 years[1]	3/4 years
France	3 years	3 years
Germany	4 years	4 years
Japan	6 years	5 years
New Zealand	4 years	4 years
United Kingdom	4 years	4 years
United States	3 years	3 years

With the exceptions of Canada and Japan, these jurisdictions apply the same amendment period for transfer pricing as they do for other corporate tax amendments. Japan provides one additional year for transfer pricing amendments, while Canada provides three additional years.

It is our view that, in most cases, four years will provide an adequate time period for the Australian Taxation Office (ATO) to conduct an audit and make amendments if required. Further, shortening the amendment period will promote more efficiency in the way the ATO conducts transfer pricing audits. If a longer period is required in particular cases, the Commissioner has the ability under s170(7) of the ITAA 1936 to seek an extension by applying to the Federal Court or by seeking the taxpayer's consent.

We are not aware of any particular issues in relation to MAP procedures that would prevent a 4 year amendment period or create any other issues in relation to meeting our obligations under Double Taxation Agreements (DTAs). In fact, the MAP articles in most of Australia's treaties follow the OECD model and include a comment to make it clear that adjustments agreed in MAP negotiations can be implemented regardless of any domestic time limits. There are other treaties which are silent on this question but none appear to limit the ability to implement MAP adjustments based on domestic time limits. If Treasury has any doubt on this matter, a provision could be inserted into the law to make it clear that the Commissioner is able to amend assessments at any point in time in order to give effect to an adjustment agreed with the Competent Authority of a treaty partner following a MAP negotiation.

We would also welcome the introduction of a sunset clause in relation to amendments to assessments under Division 13 and Subdivision 815-A. The ED as it stands does not appear to apply the eight year time limit to prior income years. If Treasury's view is that eight years will be a sufficient time period for the ATO to apply the new transfer pricing rules, we can see no reason why a longer period would be required to apply the existing rules to prior years of income.

[1] 6 years for privately-owned Canadian companies; 7 years for publicly listed or foreign owned companies

B. Documentation

Recommendations

1. The preclusion from having a reasonably arguable position (RAP) if documentation is not prepared by the time of the lodgement of the tax return should be removed.

2. The nature and extent of the documentation required should be subject to a reasonableness test taking into account the quantum of dealings and size of the taxpayer's business.

3. To the extent that the documentation requirements remain as drafted, there should be an exclusion for taxpayers below a certain size so as not to create a compliance burden disproportionate to the transfer pricing risk.

4. Provision should be made for taxpayers that are currently following the administrative practices (safe harbours for services) of Taxation Ruling TR 1999/1 and for taxpayers in Advance Pricing Arrangements (APAs). At present both will be required to prepare documentation (or lose the ability to rely on a RAP) in circumstances where they are currently not required or expected to do.

5. Taxpayers should be permitted to produce documentation on demand within 90 days of an ATO request rather than requiring it to be prepared at the time of preparing the tax return.

6. A transition period should be provided to allow enough time for the Commissioner to issue guidance on how the documentation requirements will be interpreted in practice and to allow enough time for taxpayers to be able to update their documentation processes in light of the Commissioner's guidance.

Explanation

Overview

In our view, it is reasonable and consistent with international transfer pricing practices to expect taxpayers to prepare documentation which considers whether their transfer pricing arrangements are arm's length. It is also consistent with the recommendations of the OECD TPGs.

The documentation requirements in 815-D are described as 'optional'. This implies the following;

- that taxpayers that do not comply will be no worse off relative to the status quo; and,

- that taxpayers that do comply will be in some way better off for having complied.

Based on our understanding, this will not be the case and taxpayers will be at a significant disadvantage if they do not prepare the specified documentation in accordance with Subdivision 815-D. This is largely because the ability to rely on a reasonably arguable position is removed.

Given the extensiveness of the documentation requirements, the short time in which to prepare and the lack of clarity as to how these provisions will be evaluated in practice, we believe the provisions will have the potential to create an unreasonable compliance burden for some taxpayers.

Reasonably arguable position and penalties

The concept of a RAP is defined in s284-15 of the Tax Administration Act 1953 (TAA) and is intended to apply in relation to all areas of taxation law. The proposed Subdivision 815-D requirements would create inconsistencies in how a RAP is assessed for transfer pricing purposes compared to other tax matters. It is not clear why this is necessary.

In our view, the same standard for assessing whether a taxpayer has a RAP should be applied to transfer pricing as would be applied for any other tax matter. That is, whether a transfer pricing position is "reasonably arguable" should be based on whether the position was "about as likely as not" to be correct "having regard to the relevant authorities".[2] This is the view currently adopted by the Commissioner in TR 98/16, which makes it clear that documentation may help a taxpayer to establish a RAP, but it is not a pre-requisite. Whether or not a RAP exists ultimately depends on the reasonableness of the position taken, even if this was not documented at the time of lodging the tax return.

We consider the RAP definition within s284-15 and the Commissioner's guidance in TR 98/16 to provide an adequate framework for determining whether a RAP exists in relation to a transfer pricing matter. The proposal in Subdivision 815-D to require taxpayers to prepare documentation at the time of lodging a tax return imposes an additional burden which would be more onerous than the current practice outlined in TR 98/16. We therefore recommend that Subdivision 815-D should not automatically preclude taxpayers from having a RAP merely because their position was not documented contemporaneously.

A better approach would be to provide a positive incentive for taxpayers to opt into Subdivision 815-D by providing taxpayers with reassurance that they will be eligible for penalty remission if they meet certain minimum documentation requirements.

It would be particularly unfair to impose penalties on taxpayers who have not prepared documentation demonstrating that the transfer pricing rules *do not* apply to them. Taxpayers who engage in minimal or no related party dealings should be able to take a reasonable view that their arrangements are arm's length without needing to document this position at the time of lodgement to be protected from penalties.

Nature and extent of documentation

a. *Why documenting "all conditions" is not reasonable*

The requirement to document "for all conditions operating in the income year" (section 815-305 (4)) is too broad given the scope of the term 'conditions'. For example, a taxpayer may have multiple related party dealings and choose to prepare documentation for the material dealing only. The failure to

[2] TAA, s284-15

prepare documentation covering all of the conditions, in this case, should not mean that this requirement has been failed.

Furthermore, the note under s815-115 that conditions "include, but are not limited to, such things as price, gross margin, net profit and division of profit between the enterprises" could be taken to imply that a taxpayer must analyse all of these things when documenting their transfer pricing arrangements. This interpretation would suggest that a taxpayer would need to apply several transfer pricing methods to test whether their actual conditions are arm's length. It would not be consistent with the OECD TPGs to require taxpayers to assess all of these conditions when reviewing whether an arrangement complies with the arm's length principle. The OECD TPGs generally only require one transfer pricing method to be applied, although more than one method can be applied where the results of the primary method are inconclusive.[3] We do not believe it was Treasury's intention to require taxpayers to apply multiple transfer pricing methods in all cases. This should be made clearer in the law and the EM.

The OECD TPGs indicate that conditions should be considered to the extent that they are "economically relevant" when assessing comparability. [4] Particular comparability factors should be given more or less weight depending on the nature of the transaction and method applied.[5] By requiring taxpayer to consider all conditions, the ED does not currently acknowledge that some factors will be more relevant than others.

b. *Recommended approach*

We would favour a more flexible approach to the form and content of the documentation that reflects:

- the size, scale and complexity of the taxpayer's operations;
- the level of inherent transfer pricing risk in the taxpayer's dealings;
- the extent to which the dealings might change over time (for example, a taxpayer should be permitted to rely on documentation prepared for an earlier year if there has been no material changes in the income year).

c. *Guidance on content*

Guidance for taxpayers may be required to provide a clear, practical framework that that taxpayers can follow to make it clear what needs to be included in documentation if a taxpayer opts to comply with Subdivision 815-D. We recognise that the ATO will have a role to play in this from an administrative perspective, but we would welcome practical guidance from Treasury in the law or EM in order to clarify expectations of what should be included in a taxpayer's documentation rather than leaving this open to interpretation.

For example, Chapter V of the OECD TPGs describes some guidance and recommendations on the extent of documentation required and the content. In particular, the OECD says documentation should

[3] OECD TPGs, paragraph 2.11
[4] OECD TPGs, paragraph 1.34
[5] OECD TPGs, paragraph 1.40

be *"determined in accordance with the same prudent business management principles that would govern the process of evaluating a business decision of a similar level of complexity and importance. Moreover, the need for the documents should be balanced by the costs and administrative burdens particularly where this process suggests the creation of documents that would not otherwise be prepared or referred to in the absence of tax considerations*". This is a sensible approach; however, it is not apparent that such considerations can be relied on or are indeed relevant for taxpayers in meeting the obligations imposed by 815-C.

Clarity in the law and the EM on the content of documentation will be particularly important if the RAP and penalty consequences of not preparing documentation are legislated (although, as noted above, we do not recommend this approach). If the ATO is responsible for assessing whether a taxpayer's documentation is sufficient to provide a RAP, and no formal guidance is provided in the law or EM as to standards, this will place taxpayers at a disadvantage. In our experience, the standards the ATO applies when assessing the quality of a taxpayer's documentation are too high, so leaving the documentation requirements open to interpretation could leave a lot of taxpayers exposed to penalties even if they have made genuine efforts to comply with the law and document their transfer pricing arrangements.

De minimis thresholds

As an alternative to allowing taxpayers flexibility to judge the extent of documentation required, there could be a de minimis exemption for small taxpayers and transactions. If de minimis exemptions are provided, these should be capable of being assessed in advance by taxpayers. The proposal in the ED to provide penalty relief based on the size of the tax shortfall arising from an adjustment is meaningless to taxpayers when they are determining what documentation they need to prepare, because they cannot know whether they will fall below these thresholds until the ATO conducts an audit and issues amended assessments.

We understand that the de minimis penalty thresholds proposed by Treasury are consistent with the current penalty rules for shortfalls on amended assessments (eg as set out in the TAA at s284-90(1) Item 4). The purpose of these thresholds is to waive penalties in cases where the tax impact of an amended assessment is immaterial; they are not intended to reduce the compliance burden on taxpayers. We agree with retaining penalty relief for immaterial amounts; however, our recommendation is that there should be different de minimis thresholds in the transfer pricing documentation rules that will reduce the compliance burden by providing exemptions from preparing documentation based on the size of the taxpayer or transaction.

Administrative concessions and Advance Pricing Arrangements (*APAs)*

Under the current transfer pricing rules, there are particular circumstances where taxpayers are not expected to prepare extensive transfer pricing documentation because they are relying upon a position stated by the Commissioner in a public ruling or agreed in an APA.

For example, in TR 1999/1, the Commissioner provides an administrative practice that permits taxpayers to apply pricing of cost plus 7.5% to services arrangements that satisfy certain conditions, without requiring the taxpayer to benchmark the 7.5% mark-up against arm's length comparable data. Our experience is that this administrative practice is relied upon by many taxpayers for management services transactions (which are very common within multinational groups). The new rules should not

impose any additional documentation requirements upon taxpayers who are relying upon positions taken by the Commissioner. Based on the current law, a public ruling is considered to be a “relevant authority” under the RAP provisions in s284-15, so a taxpayer who has relied upon the administrative practice for their services transactions would not be precluded from having a RAP because they had not documented it. This approach should be preserved under the new rules.

The new documentation rules should also provide some formal recognition of APAs. A taxpayer with an APA who has properly prepared and submitted its Annual Compliance Report to the ATO should be considered to have prepared adequate documentation supporting all transactions covered by the APA.

Timing

The requirement to prepare documentation in the form currently specified in 815-D of the ED by the time of lodgement of the tax return is onerous. As outlined above, a more flexible approach to the scope and content of the documentation may alleviate some of the concerns we have around the timing. We are generally supportive that, under a self-assessment regime, taxpayers need to take reasonable care and have a basis for forming a reasonable view that they have complied with the transfer pricing provisions by the time of lodgement of the tax return.

We would note that, for many taxpayers, the requirement to prepare documentation (at least in respect of the actual conditions) will be a matter of ‘putting to paper’ what is already known. Although this may appear to be a simple matter, the effort required to prepare transfer pricing documentation should not be underestimated. Preparation of transfer pricing documentation that will allow a taxpayer to explain its transfer pricing arrangements to a tax authority and to demonstrate that they are arm’s length generally requires the preparation of documents that would not otherwise be prepared in the ordinary course of business.

Other documents may exist at the time of lodging the tax return that are sufficient to enable the taxpayer to form a view on whether its transfer pricing arrangements are arm’s length. For example, policy documents, intercompany agreements, overseas transfer pricing documentation, transfer pricing documentation from recent prior years, and other business records may be sufficient for a taxpayer to form a reasonable view on whether a “transfer pricing benefit” has arisen at the time of preparing the tax return. We consider this to be consistent with the OECD’s guidance on documentation in Chapter V of the TPGs.

Given that the primary purpose of transfer pricing documentation is to explain a taxpayer’s transfer pricing arrangements to the ATO, it would be reasonable to allow taxpayers to produce this documentation upon demand from the ATO rather than expecting it to be prepared at the time of the tax return. A reasonable timeframe should be provided for taxpayers to respond (such as 90 days).

Transitional considerations

The public guidance issued by the Commissioner on transfer pricing documentation will need to be reviewed and revised when the new rules are introduced. The existing guidance (primarily contained in Taxation Ruling 98/11) will no longer be sufficient because it refers to the old law and has not been updated to reflect developments in the OECD TPGs since 1995. Revising the existing public rulings will take time, and once any new guidance is issued by the Commissioner, taxpayers will need time to respond to this.

Based on this, we recommend that a transition period should be provided before the documentation requirements come into effect. It would be unreasonable to expect taxpayers to prepare documentation at the time of preparing the first tax return impacted by the new rules if the Commissioner has not provided detailed guidance on documentation by then (or if guidance is provided very soon before the lodgement deadline).

C. Reconstruction

Recommendations

1. The ED should be amended to make it clear that taxpayers are only required to apply the transfer pricing provisions to the actual transactions entered into by them. There should be no requirement that taxpayers apply the tax rules to transactions that they have not entered into.

2. If the ability to reconstruct actual transactions is considered necessary it should only be used on determination by the Commissioner and the criteria for a determination should be clearly set out.

Explanation

Reconstruction of transactions under the ED

We are concerned that the ED as currently drafted is open to a much broader interpretation than was intended by the OECD and is reasonable to allow taxpayers sufficient certainty over their tax affairs under a self-assessment regime. This concern relates specifically to the requirement to reconstruct transactions. The particular aspects of the legislation that underlie this concern are:

- the very broad definition and usage of the term "conditions" including the references in the EM at paragraphs 2.39 and 2.40;

- the intent and scope of operation of sections 815-125 (5) to (8) and the corresponding EM at paragraphs 2.82 to 2.91.

Our understanding of the operation of the proposed rules is that it places an obligation on taxpayers to substitute the arm's length conditions for the actual conditions (where the conditions in section 815-120(1)(c) are met). The term "conditions" is very broad and includes, but is not limited to, price, gross margin, net profit and divisions of profits between the entities. Further, in identifying the arm's length conditions, there is no requirement to be limited to the economic substance of what was actually done (section 815-125(6)), nor is it is necessary to be limited by the legal form of what was actually done (section 815-125(8)). Finally, there is a positive obligation for the taxpayer to disregard the actual transaction in the circumstances outlined in 815-120(7).

Taken together, these provisions place an unreasonable onus on the taxpayer and, in our view, go beyond the intent of the OECD TPGs.

OECD TPGs in relation to reconstruction

It is important to recognise the role and purpose of the OECD TPGs. The OECD TPGs were drafted in the context of achieving a consensus view among OECD members as to the interpretation of Article 9 of the OECD Model Treaty. In this context the TPGs state:

"*OECD member countries are encouraged to follow these Guidelines in their domestic transfer pricing practices, and taxpayers are encouraged to follow these Guidelines in evaluating for tax purposes whether their transfer pricing complies with the arm's length principle. Tax administrations are encouraged to take into account the taxpayer's commercial judgement about the*

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application of the arm's length principle in their examination practices and to undertake their analyses of transfer pricing from that perspective.

These Guidelines are also intended primarily to govern the resolution of transfer pricing cases in mutual agreement proceedings between OECD member countries and, where appropriate, arbitration proceedings..." [6]

From the context of the OECD TPGs, it is clear that certain sections of the TPGs are directed specifically at tax administrations (in the context of reviewing transfer prices and resolving double tax) while other areas are of broader application to taxpayers. For example, Chapter IV of the OECD TPGs (titled Administrative Approaches to Avoiding and Resolving Transfer Pricing Disputes) is clearly, from its context and content, aimed at OECD members and their tax administrations rather than taxpayers.

While it is generally desirable, for consistency reasons if nothing else, that the domestic transfer pricing provisions be interpreted consistently with the OECD TPGs, there are aspects of the TPGs that are not appropriate for the purposes of domestic legislation and in fact, were arguably never intended to be and are only relevant in the context of a tax authority seeking to resolve a transfer pricing matter under Article 9.

The relevant paragraphs of the OECD TPGs that are often quoted and sourced as the grounds for reconstructing transactions are replicated in full at Appendix 2. The OECD adopts a strong position (in paragraph 1.64) that "*a tax administration's examination of a controlled transaction should be based on the transaction actually undertaken by the associated enterprise as it has been structured by them...*". Paragraph 1.64 also states "*In other than exceptional circumstances, the tax administration should not disregard the actual transactions or substitute other transactions for them. Restructuring of legitimate business transactions would be a wholly arbitrary exercise the inequity of which could be compounded by double taxation created where the other tax administration does not share the same views as to how the transaction should be structured*". Two examples are then given in paragraph 1.65 *"of particular circumstances where it may, exceptionally, be both appropriate and legitimate for a tax administration to consider disregarding the structure adopted by a taxpayer in entering into a controlled transaction*". There is further discussion of these paragraphs in Chapter IX: Business Restructurings (paragraphs 9.161 to 9.194).

Having regard to the wording of these paragraphs and the context in which they appear, we draw the following observations:

- the context of these paragraphs is of tax administrations seeking to review transfer prices - not taxpayers applying the arm's length principle to their own arrangements as is contemplated under the ED. It is clear that taxpayers are intended to apply the arm's length principle to the actual dealings they have entered into. This is not surprising given the TPGs are "*intended primarily to govern the resolution of transfer pricing cases in mutual agreement proceeding between OECD member countries*"(paragraph 17);

- the circumstances in which reconstruction is permitted is described as 'exceptional'. This is further clarified to mean "rare" or "unusual"[7] - this does not appear anywhere as a limitation on reconstruction under the ED as currently drafted;

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[6] Preface at paragraphs 16 and 17 of the OECD TPGs

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- there is very little, if any, guidance in the OECD TPGs on the flow on consequences of a transaction being reconstructed apart from the recognition of the difficulties that may be faced in MAP proceedings;
- there is a strong flavour of anti avoidance (particularly in relation to the second example of paragraph 1.65).

We also note that the OECD Secretariat released in June 2011 a suggested approach to the drafting of transfer pricing legislation. The purpose of this was to provide countries that are developing transfer pricing rules with a suggested structure and content for their legislation. We recognise the status of this material and that it may not be appropriate to adopt this legislation directly in Australia. However the important point is that there is nothing in this suggested legislation which appears to place an obligation on a taxpayer to reconstruct its dealings in any circumstances. This would suggest that the OECD Secretariat would not regard the incorporation of specific reconstruction powers as part of best practice domestic legislation. Rather it seems apparent that the OECD intended that the ability to reconstruct transactions be retained by tax authorities for the purpose of reviewing transfer prices in the context of MAP proceedings and only in the exceptional circumstances outlined in paragraph 1.65.

Reasons why there is no need for reconstruction provisions in Australia

- There is no evidence that the ATO has needed it to date. We are not aware of any circumstances where the Commissioner has argued that he needs to reconstruct the taxpayer's actual dealings in order to make a transfer pricing adjustment. There have been a number of transfer disputes that have involved complex or unusually encountered transactions between related parties. In some of these cases, the Commissioner has developed transfer pricing positions that involve having regard to alternatively structured transactions between unrelated entities. However, the Commissioner has argued that this does not amount to reconstruction and is merely a way to identify an arm's length consideration and make a pricing adjustment for the actual dealings entered into by the taxpayer. This approach is acknowledged by the OECD in paragraphs 1.68 and 1.69. We are not aware of any particular cases where the ATO has considered it necessary to disregard the actual structure entered into by a taxpayer. There is sufficient scope within the existing framework (and within the OECD TPGs) for the Commissioner to have regard to the pricing of an alternative transaction structure in order to determine the arm's length price of the taxpayer's actual dealings.
- The debt example (in paragraph 1.65 of the OECD TPGs) is already capable of being addressed through the operation of the domestic thin capitalisation provisions, the position outlined in Taxation Ruling TR 2010/7 (and the proposed s815-135) and the domestic debt/equity provisions. There is no need for Division 815-B to potentially require an amount of debt to be reconstructed or for elements of a properly constructed legal agreement not be respected (absent any evidence of abuse or application of Part IVA).
- The Commissioner already has available Part IVA powers which may be applied in circumstances where an arrangement has been entered into with the sole or dominant purpose of achieving a tax benefit. It should follow that where there is no evidence that a taxpayer has structured the arrangements in a way in Part IVA might apply, there should be no further requirement or need to disregard the taxpayers actual transactions and to hypothesise how independent parties might have structured a transaction (other than perhaps for the purpose of determining an arm's length price, margin or profit). The fact that the ED requires taxpayers to apply the tax law to

[7] Paragraph 9.168 of the OECD TPGs

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hypothetical structures also creates a confusing overlap with Part IVA which is intended to be a provision of last resort.

- As a general principle, the concept of reconstruction of dealings is open to the temptation of hindsight. This is even more so when the time limit for amendment is as long as 8 years. In practice, the notion of whether what a taxpayer actually did was commercially rational and whether it should therefore be reconstructed is likely to be considered in light of subsequent events. For example, if a particular business strategy is unsuccessful, there is a greater risk that it will be challenged as uncommercial. It would be inequitable if a taxpayer that has genuinely entered into commercial transactions (that have legal and economic substance) is forced to later to defend why it did not structure their arrangements in a hypothetically alternative manner, in light of subsequent events or evidence produced of how independent entities have structured similar arrangement that could not have been known at the time. Taxpayers should be entitled to apply the law to the transactions entered into by them at the time they are entered into. This is acknowledged by the Commissioner in Taxation Ruling TR 2005/1. *"The High Court in Tweddle has stressed that it is not the function of the income tax legislation, or of those who administer that legislation, to dictate to taxpayers in what business they shall engage or how to run their businesses profitably or economically. Rather, the tax law must operate upon the results of a taxpayer's activities as it finds them."*

- We recognise that there are some similarities between the ED and the current UK transfer pricing legislation in terms of the potential to disregard the actual conditions. However, the context of the UK legislation needs to also be considered. The UK does not have separate thin capitalisation or debt/equity provisions to deal with the debt example in paragraph 1.65 of the OECD TPGs. Also the UK does not have a general anti-avoidance provision.

Potential consequences of retaining the reconstruction provisions

- **Identification of nature of the reconstructed dealing for Australian tax purposes:** The requirement that, in the event of a transfer pricing benefit, the arm's length conditions are taken to apply for the purpose of working out the amount of taxable income (s815-115) makes compliance unnecessarily complex and uncertain for taxpayers. Under Division 13, the quantum of an amount of consideration may be increased or decreased to an arm's length amount, but the character of the transaction or dealing remains as it was structured. This allows certainty as to the application of other sections of the tax law to the taxpayer. However, if the arm's length conditions that are considered to apply are different from the actual transactions entered into by the taxpayer, a great deal of uncertainty will arise as the Tax Act will be applied to a hypothetical transaction for which no legal documentation or agreements exist. For example, assume a taxpayer adopts a profit split method and, transactionally this is implemented through a properly constructed service agreement. If a conclusion were reached that independent parties would have entered into a royalty agreement (instead of a service arrangement), this may have flow on implications for source, withholding tax, timing and deductibility of payments etc. In this example, it is accepted that the transfer pricing provisions may be properly applied to change the quantum of the payments but they should not be used to change the character of the payments.

- **Implications in subsequent income years:** A further consequence of reconstruction is that it creates future uncertainty as the flow on legal effects of the reconstructed dealing may need to be tracked in future years in a sort of hypothetical parallel universe. For example, assume that a taxpayer bears a particular risk (Risk A) under a contract with a related party. It might be concluded that Risk A is valuable but independent parties dealing at arm's length would not have

structured the arrangement such that the Risk A was borne by the taxpayer. In such a scenario it is possible that the arm's length conditions (as currently open to interpretation under the ED) would be determined such that Risk A was not borne by the taxpayer as part of the contract. In a future year Risk A may eventuate such that the taxpayer is legally faced with an economic loss. It is not clear what the consequences would be in such a situation. It might also be that the taxpayer hedged or insured against the risk and receives compensation. Whether this secondary transaction should be respected is also unclear.

- **MAP consequences:** It is highly likely that MAP relief will be increasingly difficult, if not impossible, in cases where reconstruction has taken place. The ATO has had a relatively good record of relieving double taxation through MAP processes where the issue at hand was the price, margin or profit related to particular dealings or transactions that have actually taken place. However, the risk of double taxation remaining unrelieved is significantly higher when the basis for the adjustment is a transaction that did not in fact take place. We are aware of at least one example where the ATO has had a MAP discussion refused with a major trading partner because there was a disagreement as to whether the transaction existed or not. This is one of the very reasons why the OECD so strongly recommends against reconstruction.

- **Ability to obtain relief under self-assessment in other countries:** Some countries may not accept and provide relief where an Australian affiliate has made a self assessed transfer pricing adjustment that relates to a transaction that has not taken place. This further increases the likelihood that double taxation may occur.

D. Permanent establishments (PEs)

Recommendation

Further time is needed to consider the PE profit attribution rules properly, particularly in light of the ongoing Board of Taxation (BOT) review of tax rules applying to PEs.

Explanation

We have provided detailed comments in previous submissions to Treasury outlining our views on the rules for attributing profits to PEs. In short, we support the adoption of the authorised OECD approach (AOA) of attributing profits to PEs as if the PE were a functionally separate entity. Our reasons for supporting this view have been explained to Treasury previously. [8]

It is not immediately apparent what practical change is intended to the current PE rules. The current PE rules are already complex and open to different interpretations between the Commissioner and taxpayers. Taxation Rulings have been issued setting out the Commissioners views on the how the PE attribution rules work in TR 2001/11 and TR 2005/11. It appears that the intent of Subdivision 815-C is not to disturb the current position. However, it is not clear that the law achieves this and appears to go further in some respects than our current understanding of the Commissioner's position in relation to the current law. It is not clear whether this is intended or not.

It is not clear, at this stage, how implementing new legislation in respect of PEs is in the interests of either taxpayers or the Government unless there is a clear policy position on the issue. Our concern is that it will become a stop gap measure (as Subdivision 815-A was) and as a result only create even greater uncertainty and complicate the issue.

We were not expecting that the ED would deal with PEs given the BOT review of the tax arrangements applying to PEs is currently underway and due to report in April 2013. Depending on the recommendations from the BOT's review, further changes to the PE rules may be required. We believe that more time is needed to ensure the PE profit attribution rules are considered properly.

[8] PwC Submission to Treasury on the Attribution of Profits to Permanent Establishments, 30 November 2011

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E. Other comments

We have some key concerns with other aspects of the proposed new rules, including:

1. Use of an arm's length range

   The ED makes several references to "the arm's length conditions", which implies there is only one possible arm's length outcome for any given arrangement. The legislation should be drafted in a way that recognises that there may be a range of arm's length conditions.

   Transfer pricing is not an exact science and there is rarely one single set of arm's length conditions. In practice, taxpayers, advisors and tax authorities usually seek to identify an arm's length range, rather than a single arm's length outcome. This approach is supported by the OECD TPGs.[9]

2. Contrary intention

   The proposed s815-130 requires the transfer pricing rules to be interpreted consistently with the OECD TPGs "except where the contrary intention appears". This is likely to cause confusion for taxpayers and the ATO unless clarity is provided on where a contrary intention exists. If there is a contrary intention, this should be made explicit in the law (or at least in the EM) rather than being left open to interpretation.

3. Applying transfer pricing adjustments to particular items of income and expense

   The ED does not specifically require taxpayers in their self-assessment, or the Commissioner in amended assessments, to determine specific items of income and expense to be adjusted when making an adjustment to eliminate a transfer pricing benefit. This could create complexity for MAP (particularly where the taxpayer deals with related parties in a number of different jurisdictions), customs duty, and other income tax consequences associated with a transfer pricing adjustment. It would be preferable for the law to require adjustments to be attributed to specific items of income and expense, particularly when the Commissioner is making an amended assessment.

4. Multiple years analysis

   It is common practice for taxpayers and the ATO to conduct transfer pricing analyses covering a multiple year period. This is also common practice in other jurisdictions. Multiple year data can be useful in situations where single year data may be impacted by business or product life cycles. The OECD TPGs acknowledge the use of multiple year data in paragraphs 3.75 to 3.79.

   It is not clear whether taxpayers (and the ATO) will be able to continue to refer to multiple year data when applying the proposed new rules. Subdivision 815-B requires taxpayers to assess whether they have received a transfer pricing benefit in a particular "income year". This

[9] The use of an arm's length range is discussed in paragraphs 3.55 to 3.59 of the OECD TPGs and in various other parts of the OECD TPGs

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could be taken to imply that the analysis of the actual conditions and arm's length conditions can only take into account conditions relating to that income year.

We acknowledge that the Australian judiciary has expressed doubt over the use of multiple year data in the application of Division 13.[10] If it is the Government's intention to bring Australia's transfer pricing rules into line with international best practice, we recommend that Treasury consider this and ensure the new transfer pricing rules are drafted in a way that allows the use of multiple year data (as recommended by the OECD) where this will improve the reliability of a transfer pricing analysis.

5. Subdivision 815-A and treaty taxing powers

   The EM refers to transfer pricing provisions contained within Australia's tax treaties (eg in the table under paragraph 1.48 which compares the new law with the current law). Based on the comment in paragraph 1.42, it appears that the intention of this is to limit the scope of the new transfer pricing rules rather than to provide assessment powers beyond what is proposed to be available under Subdivision 815-B. In light of the intense debate that took place surrounding the introduction of Subdivision 815-A and whether Parliament had intended the treaties to provide a taxing power, it would be extremely unfortunate if uncertainty prevailed over the role of treaties after the new transfer pricing rules are introduced. We therefore strongly recommend that the EM is clarified to put the role of treaties beyond doubt. If the intention is that the treaties will now only apply to limit the scope of the new rules (and not to extend them), then we do not object to this.

6. Status of APAs

   There is no formal recognition of the status of an APA in the ED. This is arguably a failing in the existing operation of Division 13. We would recommend that Treasury consider drafting appropriate amendments to ensure certainty that entering into APA will continue to be a mutually beneficial way for both taxpayers and the Commissioner to address transfer pricing risk in a co-operative manner.

7. Transitional issues

   There is no indication of the proposed start date for the new legislation (if passed) or if transitional rules are to be proposed. For example, we would expect that the new legislation would take effect from the commencement of a particular year of income so as not to have the risk of multiple provisions applying in a particular year of income.

   We also recommend that some consideration be given to how the provisions might apply to transactions or agreements that have been entered into prior to commencement of 815-B and which remain on foot.

[10] Roche Products Pty Limited and Commissioner of Taxation [2008] AATA 639

8. Customs

   As Treasury would be aware there are long standing concerns from taxpayers in a number of sectors around the inconsistency of methodologies between customs values and transfer pricing values for imports of goods. We note that the current ED does nothing to address this inconsistency and in some respects (for example where reconstruction is an issue) may exacerbate it. We suggest that the rewrite of transfer pricing legislation is an ideal opportunity to ensure that this issue is properly addressed.

9. Specific comments on wording of the ED and EM

   There are some specific areas of the ED and EM where we consider further clarification is required. We have outlined these in Appendix 1.

Appendix 1 – Specific comments on ED and EM wording

Subdivision 815-B

Provision	PwC comments
Object **815-105 (1) (a)**	It is not clear what is meant by the term "..arm's length contribution made by Australian operations..".
815-105 (2)	The reference to a "tax advantage" from actual conditions is too broad. It brings in the possibility of non-pricing adjustments due to re-characterisation. The OECD would arguably only go as far as allowing the resultant profit to be subject to tax.
When an entity gets a transfer pricing benefit **815-120 (1) (c)**	This provision arguably requires the arm's length conditions to apply for all purposes of the Act, eg CFC provisions, Div 974, etc. This is too broad and brings in an anti-avoidance flavour. It is also drafted differently from Subdivision 815-A in this respect which adopts a two step process for an adjustment (sections 815-15(1)(c) and (d) The definition of transfer pricing benefit should be refined to be clear that the arm's length conditions are only to be applied for the purposes of determining an amount of profit that might otherwise have accrued – not to determine the character of tax amount for other purposes of the Act.
815-120(2)	The requirement for taxpayers to consider conditions that do not actually exist will be difficult to apply in practice. How extensively is the taxpayer required to consider hypothetical transactions that may have existed between third parties? How is a taxpayer expected to go about assessing what conditions would have existed between third parties?
Meaning of arm's length conditions **815-125 (1)**	The reference to "*conditions that might be expected to operate*" is a reference to the wording in the Australian treaties which differs from OECD language "*would operate*". Arguably this is a lesser standard than the OECD and it should be clear what this means in the context of identification of arm's length conditions.
815-125 (2)	This is rather confusing drafting. The context of this paragraph (ie linking it to methods) suggests the use of the word 'conditions' refers to price, margin or profit. This should be made clear. The broader definition of 'conditions' would not make sense in the rest of the provision.
815 – 125 (3)	The factors identified need to be *economically significant* in order to be relevant (refer OECD TPGs paragraph 1.33). It is likely that in most cases not all of the factors identified will be economically relevant and therefore should not prevent identification of 'comparable circumstances'.
815-125(4)	This wording is a little confusing because it is expressed in terms of a difference "materially affecting a condition". Condition in this context must be read in the narrower sense as a price relevant condition. This is the context of the OECD equivalent paragraphs (1.33). Again, the broader definition of condition (ie.

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	including qualitative matters) does not make sense.
Guidance 815-130 (1)	The words "except where the contrary intention appears" is a much stronger caveat on the OECD materials than was the case for Subdivision 815-A (which required OECD materials to be considered "to the extent they are relevant"). What parts of the proposed new law, if any, are intended to be contrary to OECD materials? If there is no policy intention to depart from the OECD this should be made clear the wording should be revised accordingly.

Subdivision 815-D Record keeping requirement

Provision	PwC comments
Records about arm's length principle for cross border conditions between entities **815-305 (1)**	The reference "for an income year" could be construed to suggest an annual obligation. Where documentation has been prepared for a particular year, taxpayers should not be precluded from relying on that documentation in a subsequent year if the facts have not changed.
815-305 (2) (a)	The records must explain the way in which the entity treated 815-B as "*not applying to the entity*". This places a significant compliance burden on taxpayers – particularly those that do not currently lodge an International Dealings Schedule with their tax return because they do not have international related party dealings. If an adjustment is made then the preclusion from relying on a RAP is inherently unfair.
815-305(3)	Does "readily accessible" imply that they need to be in the possession of the entity and in Australia? Many inbound multinational taxpayers prepare documentation centrally using OECD principles or templates.
815-305(4)(a)	"..for all conditions operating in the income year that meet the cross border requirement..", this is unnecessarily broad. There should be some limitation to focus on the **economically relevant** conditions. If the provisions remain as is the taxpayer should not be precluded from relying on a RAP merely because there are conditions that have not been identified for which there is a reasonable view that these are not relevant or which could not have been known at time of lodgement.

	Para 5.7 of the OECD Guidance is relevant stating taxpayers should only need documents to form a reasonable assessment of whether the transfer pricing satisfies the arm's length principle.
284-165(1)	The de minimis exemption from penalties appears to be very low. A higher threshold would be appropriate.

Explanatory Memorandum

Paragraph	PwC comments
1.6	Better wording would be to seek equality of "profits subject to tax" rather than "tax position"
1.15	We recommend that where references are made to the OECD Guidelines that these be properly contextualised and referenced. It is particularly important to ensure that where the EM is taking a particular interpretation of what the OECD TPGs '*allow*' or '*focus on'* there is transparency as to where the OECD says this so that the context and meaning can be properly considered.
2.28	This paragraph should go further to confirm that while the arm's length conditions can result in the change in an amount of profits (or component amounts of profits), it cannot result in a change in the character of an amount such that a different tax treatment follows. For example, an amount of non-assessable, non-exempt income (under actual conditions) cannot be replaced by an amount of assessable income by identifying arm's length conditions that would change the character of the amount for tax purposes.
2.34	The inclusions appear very broad. For example: "unilateral actions". How can this be said to give rise to a condition that is not arm's length?
2.39 and 2.40	These paragraphs have the potential to create uncertainty as to the test required to determine arm's length conditions. References "to issuing shares or paid dividends" are concerning. What is the relevance of this? Why is this here – what is the intended context? We don't fully understand the issue or question being raised with "decision that may affect an entity's liquidity, such as the time at which an amount should be paid" – what is this getting at? If Treasury has specific examples in mind, it would be helpful to explain these by providing worked examples in the EM.
2.83 -2.90	This section should give much greater emphasis to the importance of the presumption that legal and economic substance should be taken to accord other than in exceptional circumstances. The OECD recommendations in paragraph 1.64 and 1.65 should be much more closely reflected in the EM. There is no reference to reconstruction being only in 'exceptional circumstances'

Example 2.5 appears to be a paraphrased version of the second example in paragraph 1.65 of the OECD TPGs. There is an important qualifier that is missing. The example in the OECD context is meant to represent a circumstance where *"..while the form and substance of the transaction are the same, the arrangements made in relation to the transaction, viewed in their totality, differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner* ***and the actual structure impedes the tax administration from determining an arm's length transfer price."*** (Emphasis added). The example provided without the surrounding context of the OECD suggests a much lower standard for reconstruction than the OECD equivalent.

Appendix 2 – OECD commentary on restructuring transactions

[Bold italics indicate emphasis added by PwC]

Extracts from Chapter I

1.11 A practical difficulty in applying the arm's length principle is that associated enterprises may engage in transactions that independent enterprises would not undertake. Such transactions may not necessarily be motivated by tax avoidance but may occur because in transacting business with each other, members of a multi-national enterprise (MNE) group face different commercial circumstances than would independent enterprises. Where independent enterprises seldom undertake transactions of the type entered into by associated enterprises, the arm's length principle is difficult to apply because there is little or no direct evidence of what conditions would have been established by independent enterprises. ***The mere fact that a transaction may not be found between independent parties does not of itself mean that it is not arm's length***.

1.64 A tax administration's examination of a controlled transaction ordinarily should be based on the transaction actually undertaken by the associated enterprises as it has been structured by them, using the methods applied by the taxpayer insofar as these are consistent with the methods described in Chapter II***. In other than exceptional cases, the tax administration should not disregard the actual transactions or substitute other transactions for them. Restructuring of legitimate business transactions would be a wholly arbitrary exercise the inequity of which could be compounded by double taxation created where the other tax administration does not share the same views as to how the transaction should be structured.***

1.65 However, there are ***two particular circumstances in which it may, exceptionally, be both appropriate and legitimate for a tax administration to consider disregarding the structure adopted by a taxpayer*** in entering into a controlled transaction. The first circumstance arises where the economic substance of a transaction differs from its form. In such a case the tax administration may disregard the parties' characterisation of the transaction and re-characterise it in accordance with its substance. An example of this circumstance would be an investment in an associated enterprise in the form of interest-bearing debt when, at arm's length, having regard to the economic circumstances of the borrowing company, the investment would not be expected to be structured in this way. In this case it might be appropriate for a tax administration to characterise the investment in accordance with its economic substance with the result that the loan may be treated as a subscription of capital. The second circumstance arises where, while the form and substance of the transaction are the same, the arrangements made in relation to the transaction, viewed in their totality, differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner and the actual structure practically impedes the tax administration from determining an appropriate transfer price. An example of this circumstance would be a sale under a long-term contract, for a lump sum payment, of unlimited entitlement to the intellectual property rights arising as a result of future research for the term of the contract (as indicated in paragraph 1.11). While in this case it may be proper to respect the transaction as a transfer of commercial property, it would nevertheless be appropriate for a tax administration to conform the terms of that transfer in their entirety (and not simply by reference to pricing) to those that might reasonably have been expected had the transfer of property been the subject of a transaction involving independent enterprises. Thus, in the case described above it might be appropriate for the tax

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administration, for example, to adjust the conditions of the agreement in a commercially rational manner as a continuing research agreement.

1.66 In both sets of circumstances described above, the character of the transaction may derive from the relationship between the parties rather than be determined by normal commercial conditions and may have been structured by the taxpayer to avoid or minimise tax. In such cases, the totality of its terms would be the result of a condition that would not have been made if the parties had been engaged in arm's length transactions. Article 9 would thus allow an adjustment of conditions to reflect those which the parties would have attained had the transaction been structured in accordance with the economic and commercial reality of parties transacting at arm's length.

1.67 Associated enterprises are able to make a much greater variety of contracts and arrangements than can independent enterprises because the normal conflict of interest which would exist between independent parties is often absent. Associated enterprises may and frequently do conclude arrangements of a specific nature that are not or are very rarely encountered between independent parties. This may be done for various economic, legal, or fiscal reasons dependent on the circumstances in a particular case. Moreover, contracts within an MNE could be quite easily altered, suspended, extended, or terminated according to the overall strategies of the MNE as a whole, and such alterations may even be made retroactively. In such instances tax administrations would have to determine what the underlying reality is behind a contracted arrangement in applying the arm’s length principle.

1.68 In addition, tax administrations may find it useful to refer to alternatively structured transactions between independent enterprises to determine whether the controlled transaction as structured satisfies the arm’s length principle. Whether evidence from a particular alternative can be considered will depend on the facts and circumstances of the particular case, including the number and accuracy of the adjustments necessary to account for differences between the controlled transaction and the alternative and the quality of any other evidence that may be available.

1.69 The difference between restructuring the controlled transaction under review which, as stated above, generally is inappropriate, and using alternatively structured transactions as comparable uncontrolled transactions is demonstrated in the following example. Suppose a manufacturer sells goods to a controlled distributor located in another country and the distributor accepts all currency risk associated with these transactions. Suppose further that similar transactions between independent manufacturers and distributors are structured differently in that the manufacturer, and not the distributor, bears all currency risk. In such a case, ***the tax administration should not disregard the controlled taxpayer's purported assignment of risk unless there is good reason to doubt the economic substance of the controlled distributor’s assumption of currency risk***. The fact that independent enterprises do not structure their transactions in a particular fashion might be a reason to examine the economic logic of the structure more closely, but it would not be determinative. However, the uncontrolled transactions involving a differently structured allocation of currency risk could be useful in pricing the controlled transaction, perhaps employing the comparable uncontrolled price method if sufficiently accurate adjustments to their prices could be made to reflect the difference in the structure of the transactions.

Extracts from Chapter IX

9.13 In transactions between independent enterprises, the divergence of interests between the parties ensures that they will ordinarily seek to hold each other to the terms of the contract, and those contractual terms will be ignored or modified after the fact generally only if it is in the interests of both parties. The same divergence of interests may not exist in the case of associated enterprises, and it is therefore important to examine whether the conduct of the parties conforms to the terms of the contract or whether the parties' conduct indicates that the contractual terms have not been followed or are a sham. In such cases, further analysis is required to determine the true terms of the transaction.

9.38 Assume now that the tax administration finds that the taxpayer's arrangements made in relation to its controlled transactions, and in particular the allocation of excess inventory risk to the manufacturer, differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner. In comparable circumstances, a manufacturer would not agree at arm's length to take on substantial excess inventory risk by, for example, agreeing to repurchase from the distributors at full price any unsold inventory. Where this is the case, the tax administration would seek to arrive at a reasonable solution through a pricing adjustment. ***In the exceptional circumstances however where a reasonable solution cannot be arrived at through a pricing adjustment, the tax administration may re-assign the consequences from the risk allocation*** to the associated distributors following the guidance at paragraphs 1.47-1.50 (*e.g.* by challenging the manufacturer's obligation to repurchase unsold inventory at full price) if the allocation of that risk is one of the comparability factors affecting the controlled transaction under examination.

9.60 Thus, in applying the arm's length principle, a tax administration evaluates each transaction as structured by the taxpayer, unless such transaction is not recognised in accordance with the guidance at paragraph 1.65. However, alternative structures realistically available are considered in evaluating whether the terms of the controlled transaction (particularly pricing) would be acceptable to an uncontrolled taxpayer faced with the same alternatives and operating under comparable circumstances. ***If a more profitable structure could have been adopted, but the economic substance of the taxpayer's structure does not differ from its form and the structure is not commercially irrational such that it would practically impede a tax administration from determining an appropriate transfer price, the transaction is not disregarded.*** However, the consideration in the controlled transaction may be adjusted by reference to the profits that could have been obtained in the alternative structure, since independent enterprises will only enter into a transaction if they see no alternative that is clearly more attractive.

9.88 Following that guidance, the main question is to determine whether the valuation was sufficiently uncertain at the outset that the parties at arm's length would have required a price adjustment mechanism, or whether the change in value was so fundamental a development that it would have led to a renegotiation of the transaction. Where this is the case, the tax administration would be justified in determining the arm's length price for the transfer of the intangible on the basis of the adjustment clause or re-negotiation that would be provided at arm's length in a comparable uncontrolled transaction. In other circumstances, ***where there is no reason to consider that the valuation was sufficiently uncertain at the outset that the parties would have required a price adjustment clause or would have renegotiated the terms of the agreement, there is no reason for tax administrations to make such an adjustment as it would represent an inappropriate use of hindsight.*** The mere existence of uncertainty at the time of the transaction

should not require an *ex-post* adjustment without a consideration of what third parties would have done or agreed between them.

Part IV: Recognition of the actual transactions undertaken

A. Introduction

9.161 An important starting point for any transfer pricing analysis is to properly identify and characterise the controlled transaction under review. Paragraphs 1.64-1.69 deal with the relevance of the actual transactions undertaken by associated enterprises and discusses the exceptional circumstances in which it may be legitimate and appropriate for a tax administration not to recognise, for transfer pricing purposes, a transaction that is presented by a taxpayer.

9.162 Paragraphs 1.64-1.69 are limited to the non-recognition of transactions for the purposes of making transfer pricing adjustments covered by Article 9 of the OECD Model Tax Convention (*i.e.* adjustments in accordance with the arm's length principle). They do not provide any guidance as to a country's ability to characterise transactions differently under other aspects of its domestic law. A discussion of the relationship between domestic anti-abuse rules and treaties is found in the Commentary on Article 1 of the OECD Model Tax Convention (see in particular paragraphs 9.5, 22 and 22.1 of the Commentary).

9.163 MNEs are free to organise their business operations as they see fit. ***Tax administrations do not have the right to dictate to an MNE how to design its structure or where to locate its business operations.*** MNE groups cannot be forced to have or maintain any particular level of business presence in a country. They are free to act in their own best commercial and economic interests in this regard. In making this decision, tax considerations may be a factor. Tax administrations, however, have the right to determine the tax consequences of the structure put in place by an MNE, subject to the application of treaties and in particular of Article 9 of the OECD Model Tax Convention. This means that ***tax administrations may perform where appropriate transfer pricing adjustments in accordance with Article 9 of the OECD Model Tax Convention and/or other types of adjustments allowed by their domestic law (e.g. under general or specific anti-abuse rules)***, to the extent that such adjustments are compatible with their treaty obligations.

9.164 In the Article 9 context, ***an examination of the application of the arm's length principle to controlled transactions should start from the transactions actually undertaken*** by the associated enterprises, and the terms of contracts play a major role (see paragraph 1.64). As acknowledged in paragraphs 1.47-1.51 and 1.64-1.69, however, such a review of the contractual terms is not sufficient.

9.165 According to Article 9 of the OECD Model Tax Convention, a tax administration may adjust the profits of a taxpayer where the conditions of a controlled transaction differ from the conditions that would be agreed between independent enterprises. In practice transfer pricing adjustments consist of adjustments regarding the profits of an enterprise attributable to adjustments to the price and/or other conditions of a controlled transaction (*e.g.* payment terms or allocation of risks). This does not mean that all transfer pricing adjustments, whether involving an adjustment only to the price or also (or alternatively) to other conditions of a controlled transaction, or as a result of evaluating separately transactions which are presented as a package in accordance to the guidance at paragraphs 3.11 and

6.18, should be viewed as consisting in the non-recognition of a controlled transaction under paragraphs 1.64-1.69. In effect, such adjustments may result from the examination of comparability, see in particular paragraph 1.33. Paragraphs 1.48-1.54 provide guidance on the possibility for a tax administration to challenge contractual terms where they are not consistent with the economic substance of the transaction or where they do not conform with the conduct of the parties.

9.166 A discussion of how to determine whether the allocation of risks in a transaction between associated enterprises is arm's length is found in Part I of this chapter. As discussed at paragraph 9.11, the examination of risks in an Article 9 context starts from an examination of the contractual terms between the parties, as those generally define how risks are to be divided between the parties. However, as noted at paragraphs 1.48-1.54, a purported allocation of risk between associated enterprises is respected only to the extent that it is consistent with the economic substance of the transaction. Therefore, in examining the risk allocation between associated enterprises and its transfer pricing consequences, it is important to review not only the contractual terms but also whether the associated enterprises conform to the contractual allocation of risks and whether the contractual terms provide for an arm's length allocation of risks. In evaluating the latter, two important factors that come into play are whether there is evidence from comparable uncontrolled transactions of a comparable allocation of risks and, in the absence of such evidence, whether the risk allocation makes commercial sense (and in particular whether the risk is allocated to the party that has greater control over it). Paragraphs 9.34-9.38 contain an explanation of the difference between making a comparability adjustment and not recognising the risk allocation in the controlled transaction and a discussion of the relationship between the guidance at paragraph 1.49 and paragraphs 1.64-1.69.

9.167 A similar reasoning is developed in Part II of this chapter with respect to indemnification rights for the termination or substantial renegotiation of an existing arrangement. Paragraph 9.103 indicates that, in addition to examining whether the arrangement that is terminated, nonrenewed or substantially renegotiated is formalised in writing and provides for an indemnification clause, it may be important to assess whether the terms of the arrangement and the possible existence or non-existence of an indemnification clause or other type of guarantee (as well as the terms of such a clause where it exists) are arm's length.

C. Application of paragraphs 1.64-1.69 of these Guidelines to business restructuring situations

C.1 Non-recognition only in exceptional cases

9.168 ***Paragraphs 1.64-1.69 explicitly limit the non-recognition of the actual transaction or arrangement to exceptional cases***. This indicates that the non-recognition of a transaction is not the norm but an exception to the general principle that a tax administration's examination of a controlled transaction ordinarily should be based on the transaction actually undertaken by the associated enterprises as it has been structured by them.[11] The word "exceptional" in this context is similar in meaning to "rare" or "unusual". It reflects that ***in most cases it is***

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[11] *[Footnote 13 in Ch IX]* As noted at paragraph 1.53, it is important to examine whether the conduct of the parties conforms to the terms of the contract or whether the parties' conduct indicates that the contractual terms have not been followed or are a sham. In such cases, further analysis is required to determine the true terms of the transaction and a pricing adjustment might not be the solution.

expected that the arm's length principle under Article 9 can be satisfied by determining arm's length pricing for the arrangement as actually undertaken and structured.

9.169 In accordance with paragraphs 1.64-1.69, it may exceptionally be appropriate for a tax administration not to recognise the parties' characterisation or structuring of a transaction or arrangement where, having regard to all of the facts and circumstances, it concludes that:

- The economic substance of the transaction or arrangement differs from its form (Section C.2); or

- Independent enterprises in comparable circumstances would not have characterised or structured the transaction or arrangement as the associated enterprises have, and arm's length pricing cannot reliably be determined for that transaction or arrangement (Sections C.3 and C.4).

Both of these situations are instances where the parties' characterisation or structuring of the transaction or arrangement is regarded as the result of conditions that would not have existed between independent enterprises (see paragraph 1.66).

C.2 Determining the economic substance of a transaction or arrangement

9.170 The economic substance of a transaction or arrangement is determined by examining all of the facts and circumstances, such as the economic and commercial context of the transaction or arrangement, its object and effect from a practical and business point of view, and the conduct of the parties, including the functions performed, assets used and risks assumed by them.

C.3 Determining whether arrangements would have been adopted by independent enterprises

9.171 The second circumstance in paragraph 1.65 explicitly refers to the situation where the arrangements adopted by the associated enterprises "differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner..." Consistent with paragraph 9.163, tax administrations should not ordinarily interfere with the business decisions of a taxpayer as to how to structure its business arrangements. ***A determination that a controlled transaction is not commercially rational must therefore be made with great caution and only in exceptional circumstances lead to the non-recognition of the associated enterprise arrangements***.

9.172 Where reliable data shows that comparable uncontrolled transactions exist, it cannot be argued that such transactions between associated enterprises would lack commercial rationality. The existence of comparables data evidencing arm's length pricing for an associated enterprise arrangement demonstrates that it is commercially rational for independent enterprises in comparable circumstances. On the other hand, however, ***the mere fact that an associated enterprise arrangement is not seen between independent enterprises does not in itself mean that it is neither arm's length nor commercially rational*** (see paragraph 1.11).

9.173 Business restructurings often lead MNE groups to implement global business models that are hardly if ever found between independent enterprises, taking advantage of the very fact that they are

MNE groups and that they can work in an integrated fashion. For instance, MNE groups may implement global supply chains or centralised functions that are not found between independent enterprises. It is therefore often difficult to assess whether such business models are of the kind that independent enterprises behaving in a commercially rational manner would have implemented. This lack of comparables does not mean that the implementation of such global business models should automatically be regarded as not commercially rational.

9.174 What is being tested is whether the outcome (the arrangement adopted) accords with what would result from normal commercial behaviour of independent enterprises; it is not a behaviour test in the sense of requiring the associated enterprises to actually behave as would independent enterprises in negotiating and agreeing to the terms of the arrangement. Thus, whether the associated enterprises actually engaged in real bargaining or simply acted in the best interests of the MNE group as a whole in agreeing to a restructuring does not determine whether the arrangement would have been adopted by independent enterprises behaving in a commercially rational manner or whether arm's length pricing has been reached.

9.175 The application of the arm's length principle is based on the notion that independent enterprises will not enter into a transaction if they see an alternative that is clearly more attractive. See paragraphs 9.59-9.64. As discussed there, a consideration of the options realistically available can be relevant to determining arm's length pricing for an arrangement. It can also be relevant to the question of whether arrangements adopted by associated enterprises differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner. ***There may be exceptional cases in which arm's length pricing cannot reliably be determined for the arrangement actually adopted, and it is concluded that the arrangement would not have been adopted in comparable circumstances by independent enterprises behaving in a commercially rational manner*** (see Section C.4).

9.176 An independent enterprise would not enter into a restructuring transaction if it sees an alternative option that is realistically available and clearly more attractive, including the option not to enter into the restructuring. In evaluating whether a party would at arm's length have had other options realistically available to it that were clearly more attractive, due regard should be given to all the relevant conditions of the restructuring, to the rights and other assets of the parties, to any compensation or indemnification for the restructuring itself and to the remuneration for the post-restructuring arrangements (as discussed in Parts II and III of this chapter) as well as to the commercial circumstances arising from participation in an MNE group (see paragraph 1.11).

9.177 In assessing the commercial rationality of a restructuring, the question may arise whether to look at one transaction in isolation or whether to examine it in a broader context, taking account other transactions that are economically inter-related. It will generally be appropriate to look at the commercial rationality of a restructuring as a whole. For instance, where examining a sale of an intangible that is part of broader restructuring involving changes to the arrangements relating to the development and use of the intangible, then the commercial rationality of the intangible sale should not be examined in isolation of these changes. On the other hand, where a restructuring involves changes to more than one element or aspect of a business that are not economically inter-related, the commercial rationality of particular changes may need to be separately considered. For example, a restructuring may involve centralising a group's purchasing function and centralising the ownership of valuable intangible property unrelated to the purchasing function. In such a case, the commercial

rationality of centralising the purchasing function and of centralising the ownership of valuable intangible property may need to be evaluated separately from one another.

9.178 There can be group-level business reasons for an MNE group to restructure. However, it is worth re-emphasising that the arm's length principle treats the members of an MNE group as separate entities rather than as inseparable parts of a single unified business (see paragraph 1.6). As a consequence, it is not sufficient from a transfer pricing perspective that a restructuring arrangement makes commercial sense for the group as a whole: the arrangement must be arm's length at the level of each individual taxpayer, taking account of its rights and other assets, expected benefits from the arrangement (*i.e.* consideration of the post-restructuring arrangement plus any compensation payments for the restructuring itself), and realistically available options.

9.179 Where a restructuring is commercially rational for the MNE group as a whole, it is expected that an appropriate transfer price (that is, compensation for the post-restructuring arrangement plus any compensation payments for the restructuring itself) would generally be available to make it arm's length for each individual group member participating in it. See Part II of this chapter, Section B.

C.4 Determining whether a transaction or arrangement has an arm's length pricing solution

9.180 Under the second circumstance discussed at paragraph 1.65, a second cumulative criterion is that "the actual structure practically impedes the tax administration from determining an appropriate transfer price". ***If an appropriate transfer price (i.e. an arm's length price that takes into account the comparability – including functional – analysis of both parties to the transaction or arrangement) can be arrived at in the circumstances of the case, irrespective of the fact that the transaction or arrangement may not be found between independent enterprises and that the tax administration might have doubts as to the commercial rationality of the taxpayer entering into the transaction or arrangement, the transaction or arrangement would not be disregarded*** under the second circumstance in paragraph 1.65. Otherwise, the tax administration may decide that this is a case for not recognising the transaction or arrangement under the second circumstance in paragraph 1.65.

C.5 Relevance of tax purpose

9.181 Under Article 9 of the OECD Model Tax Convention, the fact that a business restructuring arrangement is motivated by a purpose of obtaining tax benefits does not of itself warrant a conclusion that it is a non-arm's length arrangement.[12] The presence of a tax motive or purpose does not of itself justify non-recognition of the parties' characterisation or structuring of the arrangement under paragraphs 1.64 to 1.69.

9.182 Provided functions, assets and/or risks are actually transferred, it can be commercially rational from an Article 9 perspective for an MNE group to restructure in order to obtain tax savings. However, this is not relevant to whether the arm's length principle is satisfied at the entity level for a taxpayer affected by the restructuring (see paragraph 9.178).

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[12] *[Footnote 14 in Ch IX]* As indicated at paragraph 9.8, domestic anti-abuse rules are not within the scope of this chapter.

Consequences of non-recognition under paragraphs 1.64 to 1.69

9.183 Under the first circumstance of paragraph 1.65, where the economic substance of a transaction differs from its form, the tax administration may disregard the parties' characterisation of the transaction and re-characterise it in accordance with its substance.

9.184 With respect to the second circumstance, paragraph 1.65 contains an example of non-recognition of a sale and note that while it may be proper to respect the transaction as a transfer of commercial property, it would nevertheless be appropriate for a tax administration to conform the terms of that transfer in their entirety (and not simply by reference to pricing) to those that might reasonably have been expected had the transfer of property been the subject of a transaction involving independent enterprises. In such a case, the tax administration would seek to adjust the conditions of the agreement in a commercially rational manner.

9.185 In both circumstances, Article 9 would allow an adjustment of conditions to reflect those which the parties would have attained had the transaction been structured in accordance with the economic and commercial reality of parties dealing at arm's length (see paragraph 1.66). In doing so, tax administrations would have to determine what is the underlying reality behind a contractual arrangement in applying the arm's length principle (see paragraph 1.67).

9.186 Paragraph 1.68 provides some guidance on the case where a tax administration may find it useful to refer to alternatively structured transactions between independent enterprises to determine whether the controlled transaction as structured satisfies the arm's length principle. Whether evidence from a particular alternative can be considered will depend on the facts and circumstances of the particular case, including the number and accuracy of the adjustments necessary to account for differences between the controlled transaction and the alternative as well as the quality of any other evidence that may be available.

9.187 That guidance indicates that the tax administration would seek to substitute for the non-recognised transaction an alternative characterisation or structure that comports as closely as possible with the facts of the case, *i.e.* one that is consistent with the functional changes to the taxpayer's business resulting from the restructuring, comports as closely as possible with the economic substance of the case, and reflects the results that would have derived had the transaction been structured in accordance with the commercial reality of independent parties. For example, where one element of a restructuring arrangement involves the closing down of a factory, any recharacterisation of the restructuring cannot ignore the reality that the factory no longer operates. Similarly, where one element of a restructuring involves the actual relocation of substantive business functions, any recharacterisation of the restructuring cannot ignore the fact that those functions were actually relocated. As another example, where a restructuring arrangement involves a transfer of property between two parties, any non-recognition of the restructuring arrangement would need to reflect that a transfer of such property occurred between the two parties, although it may be appropriate to replace the character of the transfer with an alternative characterisation that comports as closely as possible with the facts of the case (*e.g.* a purported transfer of all rights in the property might be recharacterised as a mere lease or licence of the property, or vice versa).