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

***Email: transferpricing@treasury.gov.au***

Dear Sir/Madam,

## Exposure Draft - Stage One Transfer Pricing Reforms

We refer to the release of the Exposure Draft of *Tax Laws Amendment (2012 Measures No. 3) Bill 2012: Cross Border Transfer Pricing* on 16 March 2012, and welcome the opportunity to provide our comments.

We understand the Exposure Draft is intended, at least in part, to implement the proposed changes first detailed in the Consultation Paper released on 1 November 2011. RSM Bird Cameron provided a submission to Treasury in relation to this Consultation Paper, dated 30 November 2011, which specifically noted:

- Our concern that the adoption by Australia of transfer pricing rules which emphases profits based methodologies would not be consistent with international best practice or reflect internationally recognised transfer pricing principles.

- Our view that Australia's Double Tax Agreements ("***DTA***") do not under current law provide a separate and independent right to tax, and accordingly that it would be highly inappropriate for any changes in this regard to apply retrospectively.

- Our welcome of the proposals to introduce self assessment and time limits for amended assessments in a transfer pricing context, as well as legislated transfer pricing documentation requirements.

We do not propose to again cover the above matters in our present submission. However, we do note our considerable disappointment that the Exposure Draft not only fails to remedy the weakness identified in our previous submission, but also does not include any of the positive proposals included in the Consultation Paper.

If these positive proposals were to be extensively delayed or abandoned as now seems likely, the staged approach to transfer pricing reform proposed would appear to unjustifiably prioritise short term budgetary objectives over quality tax reform, We strongly believe that the proposed approach will ultimately lead to deleterious consequences for the Australian economy.

Accordingly, if the Government retains a serious commitment to the principal objectives for this reform as set out in the Consultation Paper (particularly Australia's attractiveness as an investment location), we strongly recommend the staged approach be abandoned and for Australia's transfer pricing rules to be completely rewritten.

Such comprehensive reform of Australia's transfer pricing regime would not only include the positive proposals discussed above, but would also allow for the manifold weakness in the Exposure Draft (which are discussed further below) to be addressed.

It is quite clear from the numerous submissions to the Consultation Paper that considerable and justifiable concerns need addressing by Government. Furthermore we note that none of the concerns raised have been adopted in this Exposure Draft. This leads one to conclude, and this has been confirmed by representatives of the Government, that the nature of the transfer pricing reforms is a "done deal". We therefore wish to make public our concerns about the submission process and its apparent futility. This is not the way to introduce meaningful and economically critical reforms.

If the Government is serious about the significance of our transfer pricing regime and it is committed to serious reform it should adopt an inclusive, contemplative and thorough approach to reform. A rushed and exclusive approach will not only undermine Australia's international credibility, but also diminish confidence with our trading partners.

We therefore submit that the Government take stock of the previous submissions and those that will emanate from this Exposure Draft to fundamentally rethink its reform process.

## 1.0 New Taxing Power

### *1.1 Multiple Regimes*

The Exposure Draft and its associated Explanatory Memorandum contemplate three distinct sets of transfer pricing rules being able to be applied to taxpayers, being:

- Division 13 of the *Income Tax Assessment Act 1936* ("***ITAA 1936***");
- Division 815 of the *Income Tax Assessment Act 1997* ("***ITAA 1997***"); and
- Articles 7 and 9 of any relevant DTA.

Further, at least in respect of Divisions 13 and 815, it is clearly expected these rules will need to be applied separately by taxpayers and their advisors.

This unnecessary multiplication of regimes, which could be avoided if Australia's transfer pricing rules were completely rewritten, will create further complexity for taxpayers seeking to comply with Australia's already cumbersome transfer pricing regime.

This complexity will undoubtedly lead to higher compliance costs for taxpayers, particularly small and medium taxpayers, for which no de minimus thresholds or easy to apply safe harbours are proposed to be provided.

Ultimately, this complexity will just simply reduce the ability of taxpayers acting in good faith to understand how to comply with their transfer pricing obligations. Thus they may not do so. Thus the proposed reform is self defeating.

### *1.2 Perverse Incentives*

The new Division 815 is proposed to apply only to taxpayers subject to a DTA which contain provisions equivalent to Article 7 and 9 in the Australia / UK DTA.

Therefore, to the extent Division 815 operates as intended and allows the Commissioner of Taxation ("***Commissioner***") to assess higher levels of taxable income than under Division 13, Division 815 will have the perverse incentive of encouraging the use of tax haven and other non-treaty jurisdictions for international related party dealings with Australian taxpayers.

This result, which could be avoided if Australia's transfer pricing rules were completely rewritten, is clearly inconsistent with the policies Australia has previously adopted both in respect of the Organisation for Economic Co-Operation and Development ("***OECD***") efforts to combat harmful tax competition and the principles of non-discrimination embodied in some of Australia's DTAs.

### *1.3 Unclear Drafting*

We note Division 815 introduces new terminology, particularly with reference to the concept of a transfer pricing benefit in Section 815-22(1), which does not feature prominently in existing case law and discourse on the ITAA 1936 and ITAA 1997.

For example, the Exposure Draft refers to "*an amount of profits …. which … might have been expected to accrue*" and "*profits attributed … falls short of the amount of profits … might be expected to make*", rather than to more traditional terms such as derivation of assessable income and incurrence of deductible expenses.

It is therefore difficult to anticipate how these terms will be interpreted, and accordingly if the law will operate as intended. For example, from the wording of Section 815-22(1), it would appear uncertain the extent to which the specific circumstances of a taxpayer and its transactions are relevant in determining if the taxpayer has received a transfer pricing benefit (e.g. will matters of a non-financial nature, such as supplier reliability and cultural fit, be relevant).

### *1.4 Retrospectivity*

We note Division 815 is proposed to retrospectively apply from 1 July 2004. In this regard, while we acknowledge retrospective application may be justified in limited and exceptional circumstances., for example in relation to validating Advance Pricing Agreements using profit based methodologies entered into by the Commissioner in good faith, we consider blanket retrospective application would be highly inappropriate and completely unnecessary.

This approach will be particularly onerous in respect of the potential reconstruction of "uncommercial" transactions by the Commissioner, a power which was not considered by taxpayers to be available under Division 13. Accordingly, at the very least, we recommend this power be specifically excluded from having retrospective application.

### *1.5 OECD Guidance*

Section 815-25 seeks to explicitly incorporate guidance published by the OECD into the determination of whether a transfer pricing benefit exists.

However, the Exposure Draft contains very little detail as to the extent of the guidance which will be incorporated, with much left for Regulations to be made. Accordingly, significant uncertainty remains as to the extent to which OECD guidance can be relied upon by taxpayers.

In terms of the general approach adopted by the Exposure Draft, being a static and discretionary incorporation of OECD guidance, we note the following areas of concern:

- A failure to incorporate all relevant OECD guidance materials on an ambulatory basis would seem to us to be inconsistent with the purpose of harmonising Australia's transfer pricing rules with international norms. While we understand there may be a reluctance to delegate tax law to an international body such as the OECD, we note the entry into Australia's various DTAs may arguably already have this effect.

- The OECD guidance to be incorporated may not be comprehensive. For example 1979 OECD Transfer Pricing Report, which will not be incorporated unless referred to in Regulations, is the major source of guidance in respect of loan arrangements.

- The proposed legislation does not, outside its associated Explanatory Memorandum, provide any principles for how Regulations may be made to include or exclude OECD guidance materials from incorporation into Australian law.

- The OECD Transfer Pricing Guidelines, before their 2010 update, included a clear hierarchy which treated profit based methodologies as only being available as a last resort. Even in the 2010 update profit methods are not given equality to transactional methods. Under the 'most appropriate method', where a transactional method and a profit method are equally reliable, the transactional method prevails. Therefore, the incorporation of this guidance in respect of the retrospective period would seem to conflict with the overall thrust of the Exposure Draft, which is to allow and prefer profit based methodologies.

## 2.0 Interaction of Transfer Pricing and Thin Capitalisation Rules

The Exposure Draft proposes to legislate the interaction of the transfer pricing and thin capitalisation rules, which has previously been subject to interpretation by the Commissioner in Taxation Ruling TR 2010/7.

However, the proposed legislation appears to raise a number of questions, including:

- The interaction of the reference to the "rate of return for the debt interest" in Section 815-22(4) and the definition of debt capital in Division 820 of the ITAA 1997. The thin capitalisation rules apply to all debt interests, not just related party debt, and therefore Section 815-22(4) may inappropriately operate to cover transactions undertaken between completed unrelated parties.

- The meaning of "actual value of the debt interest" in Section 815-22(4)(b) is ambiguous. For example, it may refer to the face value of a debt interest, the market value of a debt interest or some other value.

- The interaction of the time periods on which the transfer pricing and thin capitalisation rules operate. That is, while the thin capitalisation rules apply to an accounting period (i.e. income year), the transfer pricing rules can operate in respect of specific transactions within an accounting period.

## 3.0 Conclusion

We are grateful for the opportunity to respond to the Exposure Draft. We look forward to a thoughtful and objective response from Government which takes on board the deep concerns held by taxpayers and their professional advisors. We strongly believe such an approach is vital in order for these reforms to have a chance in meeting the objectives set for them by Government.

Failure to do so will lead to a complex, unclear and inconsistently applied regime. Multinational enterprises may well be discouraged from investing in Australia and we will have rules that are far from consistent with international norms. Small and medium Australian taxpayers taking up the challenge of international expansion face disproportionate compliance costs imposed by the regime.

We submit that a rethink of the proposed transfer pricing reforms be undertaken and that the current approach be abandoned.

Yours Faithfully,

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