The Institute of Chartered Accountants in Australia

17 April 2012

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Email: transferpricing@treasury.gov.au

Dear Lisa

Exposure draft of proposed amendments to implement the first stage of the transfer pricing reforms

The Institute of Chartered Accountants in Australia (the Institute) welcomes the opportunity to put forward its views on the exposure draft legislation (ED) and explanatory memorandum (EM) of the proposed amendments to implement the first stage of the transfer pricing reforms. These were released by the Assistant Treasurer on 16 March 2012.

Firstly, it will be well known to Treasury that the Institute remains concerned about yet another retrospective amendment to the law being proposed in circumstances where it cannot be justified on either a policy or revenue integrity basis.

Despite our concerns with the proposal, if the government decides to proceed with the retrospective amendment of the law, it is critically important that the level of power to be exercised by the Commissioner under the treaties be clearly defined and understood. We do not believe that the ED in its current form achieves this. Issues include:

- The current drafting does not appropriately require that an adjustment under it be linked to an item of assessable income, deduction or capital gain/loss in respect of particular transaction(s). This drafting deficiency gives the Commissioner substantially more power than is contemplated by both the Commentary to Article 9 of the OECD Model Tax Convention and the OECD Transfer Pricing Guidelines.
- The potential new retrospective reconstruction power which is claimed to be available to the Commissioner under the ED cannot be justified. Given the limited practical application of this power and for the sake of clarity, reconstruction power should be excluded from the proposed new Subdivision 815-A in totality. The Commissioner's ability to amend assessments on a prospective basis in reliance on a new reconstruction power should be strictly limited.
- The ED does not clearly set out the interaction between the proposed amendments and the thin capitalisation rules. In particular, it would appear that the specific provisions of the ED as they relate to Division 820 of the *Income Tax Assessment Act 1997* are open to interpretation.

The Institute also considers that the retrospective application of the proposed amendments must not give rise to penalties. (We understand that this is the Treasury's intention but it should be made clear in the EM). Neither should a shortfall interest charge (SIC) arise in such circumstances as this would otherwise represent an inequitable retrospective administrative penalty.

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In our view, in a proper balancing of compliance costs against revenue risks, it is essential that some taxpayers are completely carved out of the transfer pricing rules. We therefore recommend that an appropriate de minimis threshold be introduced.

These matters are further discussed in the attached submission.

If you need to discuss any aspect of this submission further please do not hesitate to contact me on (02) 9290 5623 or Karen Smith on 0425 326 564.

Yours sincerely

Yasser El-Ansary
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The Institute of Chartered Accountants in Australia

1. Retrospective amendment not justified

The Institute of Chartered Accountants in Australia (the Institute) considers that the retrospective amendment to the law being proposed in the Exposure Draft legislation (ED) cannot be justified on either a policy or revenue integrity basis.

We disagree with the statement by the then Assistant Treasurer in his Media Release of 1 November 2011 that the amendment is to merely "clarify that transfer pricing rules in our tax treaties operate as an alternative to the rules currently in the domestic law". The Institute maintains the view that technically, outside the context of resolving a double tax issue, the ATO does not have the power under current law to raise an assessment under a Double Tax Agreement (DTA) that increases the tax payable position of a taxpayer in the absence of the amendment proposed.

The Institute's 5 December 2011 submission in response to the Treasury's November 2011 consultation paper, *Income Tax: Cross Border Profit Allocation - Review of Transfer Pricing Rules* details our opposition to the proposed changes having retrospective effect.

2. Linkage of adjustment to an item of assessable income, deduction or capital gain/loss in respect of particular transaction(s)

In our view, the current drafting of Subdivision 815-A does not appropriately require that an adjustment under it be linked to an item of assessable income, deduction or capital gain/loss in respect of particular transaction(s). This drafting deficiency results in a position that gives the Commissioner substantially more power than is contemplated by both the Commentary to Article 9 of the OECD Model Tax Convention and the Transfer Pricing Guidelines. These materials make clear that the amount of "profits" to which Article 9 applies must be determined by reference to particular transactions.

As currently drafted, subsection 815-30(1) authorises the Commissioner to make determinations to subject a transfer pricing benefit to tax by increasing an entity's taxable income, decreasing its tax loss, or decreasing its net capital losses. According to paragraph 1.53 of the Explanatory Memorandum (EM), a determination under subsection 815-30(1) only contemplates an overall adjustment to an entity's taxable income, tax loss or net capital losses, and this determination does not impact on how the entity is treated by other areas of the tax law because the determination does not apply to individual items of the entity's assessable income, particular deductions or particular capital gains/losses. Subsection 815-30(2) provides for the making of a further determination attributing the adjustment under s.815-30(1) to a particular amount of assessable income, deductible expenditure or capital gain/loss. However, there is no requirement to make a determination under s.815-30(2) except in respect of an entity's debt deductions where Division 820 applies. Thus, s.815-30 gives the Commissioner a general discretion to make an adjustment to taxable income without being required to specify what particular item of income, expenditure or capital gain/loss is affected.

The potential problems this can cause for the affected taxpayer can best be illustrated by an example. Say the taxpayer has various categories of cross-border dealings with numerous related parties, including trading stock purchases. The ATO conducts an audit and makes an adjustment under s.815-30 applying a transactional net margin method on a whole of entity basis. The issues raised for the taxpayer by its lack of knowledge of the basis for the adjustment, if the Commissioner in this case does not make determinations under s.815-30(2) attributing the adjustment to particular items, include:

- The extent to which the adjustment is referrable to an applicable Associated Enterprises Article for purposes of s.815-22 and knowing whether the adjustment relates to a "transfer pricing benefit" as defined for Subdivision 815-A so that the Commissioner has authority to make the adjustment under that provision;
- The extent to which the adjustment is referrable to an applicable Associated Enterprises Article for purposes of requesting correlative relief or Mutual Agreement Procedure (MAP) under that treaty;
- The extent of the effect of the adjustment, if any, on the treatment of deductions for trading stock under other provisions of the Act; and

- The extent of the effect of the adjustment, if any, on the valuation of the trading stock purchases for other purposes, eg. customs duties payable.

In our view the Commissioner should be required in all cases to identify and characterise what specific item is being adjusted so as to link that adjustment to the other provisions of the Act.

We recommend that s.815-30(2) be amended to require that the Commissioner make determinations in all cases attributing the adjustment under s.815-30(1) to a particular amount of assessable income, deduction or capital gain/loss.

Requiring the Commissioner to identify the particular item(s) to which the profits that are subject to a s.815-30 adjustment are attributable would accord with subsection 815-22. Subsection 815-22 essentially defines "transfer pricing benefit" as an amount of profits within the meaning of the applicable treaty article, interpreted so as to best achieve consistency with the OECD Model Tax Convention and the OECD Transfer Pricing Guidelines. Both the Commentary to Article 9 of the OECD Model Tax Convention and the Transfer Pricing Guidelines make clear that the amount of "profits" to which Article 9 applies is determined by reference to transactions. Thus, for instance, paragraph 1 of the Commentary to Article 9 states:

> "This Article deals with adjustments to profits that may be made for tax purposes where transactions have been entered into between associated enterprises (parent and subsidiary companies and companies under common control) on other than arm's length terms."

In accordance with this, the OECD's Transfer Pricing Guidelines recognise five arm's length pricing methods to be used in applying Article 9, with these methods categorised as "traditional transaction methods" and "transactional profit methods". Under the Guidelines, the comparability analysis prescribed for applying those methods is performed at the level of individual transactions or an appropriate level of aggregation of transactions. The Commentary and the Guidelines do not contemplate the arm's length principle under Article 9 being applied to adjust profits in a way that does not attribute that adjustment to particular transactions between the associated enterprises. Accordingly, we do not see how the Commissioner can satisfy s.815-22(3) and hence make a valid adjustment under s.815-30 unless he determines the transfer pricing benefit by reference to the profits in respect of a particular transaction or transactions.

3. Reconstruction of transactions

The Institute has significant concerns in relation to the potential new retrospective reconstruction power which is claimed to be available to the Commissioner under the current ED.

With respect to the reconstruction of controlled transactions, the OECD's Transfer Pricing Guidelines state that this should only occur in two exceptional circumstances[1]:

- Where the economic substance of a transaction differs from its legal form; and
- Where arrangements made in relation to a controlled transaction differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner.

In terms of limiting application, the Institute notes the additional cautionary words in the OECD Transfer Pricing Guidelines[2]:

> "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] Paragraph 1.37 of the OECD Transfer Pricing Guidelines as they existed before amendments made in the 2010 OECD Transfer Pricing Guidelines, paragraph 1.65 of the 2010 OECD Transfer Pricing Guidelines.
[2] Paragraph 1.36 of the OECD Transfer Pricing Guidelines as they existed before the amendments made in the 2010 OECD Transfer Pricing Guidelines, paragraph 1.64 of the 2010 OECD Transfer Pricing Guidelines.

It is the view of the Institute that, in effect, OECD guidance limits any potential reconstruction powers to the most exceptional of circumstances such that these powers would be largely inoperative. Even if it is accepted that this power does have some practical application (which is very unlikely), this power would be further restricted by a number of key administrative issues. In the Institute's view, the Commissioner should not be able to raise an Amended Assessment in reliance on a reconstruction power, retrospective or otherwise, that is not soundly based on evidence of what third parties actually do or do not do in the same or similar circumstances. That is, the Commissioner should not be able to issue amended assessments in reliance on a reconstruction power that is simply based on some notion of what independent parties would or would not do if acting in a commercially rational manner.

Having said this, given that for the phase one retrospective legislation, the government states that we are dealing with a retrospective clarification of the law rather than an establishment of new prospective powers, short of providing confirmation that reconstruction power is completely excluded, it would be inappropriate to place any arbitrary restrictions on this power in the retrospective ED as any such restrictions could potentially change the prior law rather than to clarify it. However, in contrast for the phase two prospective legislation, it will be imperative to ensure that any new prospective reconstruction powers are clearly defined so that it is properly understood under what limited exceptional circumstances these reconstruction powers will operate under going forward.

The Institute recommendations are:

- Given the limited practical application of this power and for the sake of clarity, reconstruction power should be excluded from Subdivision 815-A in totality.
- To the extent that reconstruction power is not excluded in totality, Subdivision 815-A should not be modified by way of partial amendments in relation to this matter. This will ensure that the existing law is not inadvertently altered in favour of the ATO rather than being properly clarified (in line with the stated objectives of Treasury).
- The Commissioner's ability to amend assessments on a prospective basis in reliance on a new reconstruction power should be strictly limited, for example, by:
    - Only being applicable to transactions entered into on or after the date on which the relevant Bill is introduced to the House of Representatives;
    - Setting out clearly the types of transactions and circumstances in which a reconstruction power could be applied (ie, the exceptional circumstances in which a reconstruction power might be applied consistently with the OECD Guidelines);
    - Introducing clear and objective criteria, all of which must be satisfied, before a reconstruction power could be applied;
    - Requiring that application of reconstruction power is to be soundly based on evidence of what third parties actually do or do not do in the same or similar circumstances;
    - Allowing for merits review by the Administrative Appeals Tribunal of any determination made by the Commissioner to apply a reconstruction power; and
    - Placing the onus of proof on the Commissioner rather than the taxpayer in litigation under Part IVC of the Taxation Administration Act 1953 to show what the reconstructed transaction would be.

4. Interaction with thin capitalisation

The Institute understands that the policy intent is to ensure that the outcome of the Commissioner's position in TR 2010/7 is preserved. The Institute is concerned that the ED as it is currently drafted does not clearly set out the interaction between Subdivision 815-A and the thin capitalisation rules. In particular, it would appear that the specific provisions of the ED as they relate to Division 820 of the *Income Tax Assessment Act 1997* are open to interpretation.

One interpretation is that Subdivision 815-A could undermine the safe harbour in the thin capitalisation provisions. The ED requires the Commissioner to consider whether an entity's "profits" are less than what would have been earned under arm's length conditions. Profits in the Treaty context are defined in the *International Agreements Act 1953* as taxable income. This implies that the Commissioner should consider whether a taxpayer's post interest profits are arm's length. Arguably this could lead to the Commissioner applying Subdivision 815-A to reduce interest deductions that would otherwise be deductible simply because the Commissioner considers the post interest profits to be below the Commissioner's expectation of an arm's length outcome. This would clearly undermine the policy intent of the thin capitalisation safe harbour.

However, subsections 815-22(4) and (5) would appear to be an attempt to preserve the principles from TR 2010/7 within the law. TR 2010/7 requires the Commissioner to apply an arm's length interest rate to the actual amount of the debt (provided this is within the safe harbour). Subsection815-22(4) appears to attempt to do this but the Institute notes the potential for the other provisions within s.815-22 to be interpreted in a way that allow the Commissioner to further limit interest deductions a taxpayer may have been entitled to claim.

The Institute supports the inclusion of s.815-22(4) to ensure that Subdivision 815-A does not override Division 820 in determining the maximum amount of debt allowable for a taxpayer. It also notes that s.815-22(4)(a) refers to the use of OECD guidance in determining an arm's length rate of return on a taxpayer's debt.

However, s.815-22(5) presupposes that OECD guidance would allow the rate of return on the debt to be calculated by reference to a notional "arm's length amount of debt" in certain circumstances. The Institute does not consider that this interpretation of the OECD guidance is necessarily correct and submits that the clause should be removed so that the Commissioner and taxpayers can interpret the OECD guidance as they see fit.

The Institute is also concerned about the ED giving retrospective legislative effect to views put forward by the Commissioner in a taxation ruling and concerned that this will set a precedent for further retrospective law changes. If there are other cases where a change in law is necessary to reinforce a view held by the Commissioner, then the change should only be made prospectively.

5. Penalties

The Institute considers that the retrospective application of Subdivision 815-A must not give rise to penalties under the *Taxation Administration Act 1953.*

We consider that Division 284, without amendment, will not give rise to administrative penalties where the taxable income is increased pursuant to s.815-30. Further, we understand that this is Treasury's intended policy outcome. Therefore, we consider that a statement to this effect should be included in the EM.

It appears that a shortfall interest charge (SIC) can still arise under Division 280 of the *Taxation Administration Act 1953.* We submit that this represents an inequitable retrospective administrative penalty. The SIC is intended to ensure that taxpayers do not have any advantage from the time value of money arising from the amount of tax properly payable. Under the existing law, assuming that Division 13 of the *Income Tax Assessment Act 1936* did not apply and there is no treaty taxing power, the taxpayer has and continues to fully comply with the law. We therefore consider that the taxpayer had and continues to have every right to retain the use of the funds. The tax liability will now arise only because there is a retrospective imposition of tax. The taxpayer has had no undue advantage. We note that the Commissioner has the power to remit all or part of the SIC and where retrospective changes to the law are concerned the Commissioner has exercised this discretion. However, this is not a case where the taxpayer should be forced to seek remission. The Institute therefore submits that the amending act should include provision to ensure that no SIC can be imposed.

6. Implications for small to medium enterprises (SMEs)

The proposed Subdivision 815-A does not adequately address the high costs for transfer pricing compliance that will be imposed on SMEs.

Transfer pricing is a highly specialised area which requires access to skills and information that SME taxpayers do not internally possess. Therefore, their only way to comply with both the pricing and documentation requirements is to engage an external firm to perform this work. Due to the nature of the work, such services are generally very expensive.

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

If the proposed Subdivision 815-A is legislated, SMEs will have to find the resources to follow three different transfer pricing regimes (of which two are Australian - Division 13 and the proposed new Subdivision 815 - and the third is the associated enterprises article in our tax treaties). Larger taxpayers may have the resources to deal with all of these requirements but SMEs do not - the middle market is struggling to cope with the existing law and so imposing new requirements on top of the existing law increases the risk of non-compliance by SMEs.

De Minimis Threshold

In our view, in a proper balancing of compliance costs against revenue risks, it is essential that some taxpayers are completely carved out of the transfer pricing rules. This is on the basis that below a certain point it is just not cost effective or practical to impose transfer pricing guidelines. The UK has recognised this in its transfer pricing rules which provide that small and medium enterprises are exempt from the transfer pricing rules. A small or medium enterprise under this definition is one that has less than 250 employees and either:

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

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

We note that this approach of completely carving SME taxpayers out of the transfer pricing rules need not however, prevent the ATO from still being able to gather information to address any concerns it has around related party dealings by SMEs. In this regard, we attach as an Appendix some suggested changes which could be made to the body of the company, individual, partnership and trust tax returns to accommodate such information gathering.

Documentation - No Penalties if Reasonable Efforts made

Even if our submission point above regarding penalties is not accepted, the Institute believes that penalties should not be imposed for any adjustment made under Subdivision 815-A on a SME taxpayer that has made reasonable efforts to comply with the legislation.

That is, it would be (especially) unfair in our view to impose transfer pricing penalties on any SME taxpayer that has made reasonable efforts to determine an arm’s length price - notwithstanding that they may not have contemporaneous transfer pricing documentation.

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

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

Appendix

Implications of the proposed Subdivision 815-A and the new International Dealings Schedule ("IDS") for small to medium enterprises ("SMEs")

As noted in the body of the submission, we are concerned by the fact that the proposed Subdivision 815-A and the new IDS do not adequately address the high costs for transfer pricing compliance that will be imposed on SMEs who are already struggling to cope with the existing law.

Accordingly, whilst we understand that the ATO and Treasury:

- believe some SME taxpayers are still engaging in 'Wickenby' style transactions (for want of a better description);
- have concerns around related party dealings by SMEs; and
- think that an education process is needed for SMEs regarding compliance with Division 13, CFC and thin capitalisation issues,

we believe that there must be a better way to deal with these concerns than asking SME taxpayers to comply with the new IDS and the proposed Division 815-A.

(As an aside, we also question whether the proposed Subdivision 815-A and the new IDS will actually address the above issues. That is, while the new IDS will certainly provide the ATO with a greater quantity of data it will still only be information as to the value of related party services or loans - which is exactly what the current Schedule 25A does (but with far less questions). In addition, requiring SME taxpayers to comply with the proposed Subdivision 815-A is not what we would regard as an 'education process' regarding the transfer pricing rules).

We submit that if 'Wickenby' style transactions and concerns around related party dealings are indeed the issues that the ATO and Treasury believe them to be for SME taxpayers, then a better targeted measure for SMEs would be more appropriate.

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

1. Have you made advances and/or loans to a foreign related party?
2. Have you received advances and/or loans from a foreign related party?
3. Have you provided goods and/or services to a foreign related party?
4. Have you received goods and/or services from a foreign related party?
5. If you answered 'Yes' to any of the above questions, have you taken reasonable care (i.e. made reasonable efforts and sought appropriate advice) to ensure that all of the relevant transactions are priced on arm's length terms?
6. If you answered 'Yes' to any of the above questions and you are a large taxpayer (i.e. have a turnover of more than $250m per year) have you complied with Subdivision 815-A and completed the International Dealings Schedule?

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

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