THE TAX INSTITUTE

16 April 2012

Mr Neil Motteram
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The Treasury
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Dear Mr Motteram

SUBMISSION: EXPOSURE DRAFT "STAGE ONE TRANSFER PRICING REFORMS"

The Tax Institute welcomes the opportunity to make this submission to Treasury in response to the Exposure Draft and supporting Explanatory Material intended to effect Stage One of the transfer pricing reforms announced by the then Assistant Treasurer on 1 November 2011 (the "**press release**").

We have set out our comments at Appendix A in five separate sections, as follows:

- Section 1: Our comments on the policy underpinning the proposed reforms;
- Section 2: Our general comments on the Exposure Draft (on the presumption that the Exposure Draft legislation is intended to effect the policy as set out in the press release);
- Section 3: Our general comments on the Explanatory Material (on the presumption that the Exposure Draft legislation to which the Explanatory Material relates is intended to effect the policy as set out in the press release);
- Section 4: Our concerns in relation to the interaction between the transfer pricing rules and the thin capitalisation rules under the Exposure Draft and Explanatory Material; and
- Section 5: Our comments on other significant issues of note.

We understand that many of the issues raised in this submission will be the subject of ongoing consultation during the legislative drafting process. We look forward to participating in such ongoing consultations and making further submissions as appropriate.

We have copied this submission to the Treasurer and Assistant Treasurer due to the level of concern that exists amongst our members in relation to the proposed retrospective amendments to the transfer pricing rules.

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Should you wish to discuss any aspect of our submission, please do not hesitate to contact me on (02) 8223 0011 or The Tax Institute's Tax Counsel, Deepti Paton on (02) 8223 0044.

Yours sincerely

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Ken Schurgott
President

CC: The Hon Wayne Swan MP, Deputy Prime Minister and Treasurer

CC: The Hon David Bradbury MP, Assistant Treasurer and Minister Assisting for Deregulation

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APPENDIX A

SECTION 1: Comments on the policy underpinning the proposed reforms

Retrospectivity

As noted in our submission in response to the Consultation Paper preceding the release of the Exposure Draft, The Tax Institute has grave concerns as to the appropriateness of retrospective legislation to effect this announced change.

It is our strongest view that legislative changes should not apply retrospectively except in very specific circumstances and after thorough public consultation. Where the Government considers a deviation from this principle to be warranted, any such deviation should be thoroughly consulted on and explained including an explanation of the anticipated impact on revenue.

Retrospective legislation that may be disadvantageous to taxpayers is in our view inappropriate for a number of reasons, including:

- Retrospective changes in tax law that alter a taxpayer's tax liability are likely to disturb the substance of bargains struck between taxpayers who have made every effort to comply with the prevailing law as at the time the agreement was entered into;
- Retrospective changes in tax law that result in taxpayers being issued with amended assessments that rely upon the retrospective law changes expose taxpayers to penalties in circumstances where taxpayers could not possibly have taken steps at the earlier time to mitigate the potential for penalties to be imposed;
- The taxpayer's tax expense and current tax liability/assets as disclosed in financial accounts may be rendered incorrect due to the retrospective change, resulting in adverse implications for investors and capital markets that have relied on the financial statements;
- Retrospective amendments to change tax liability and therefore a taxpayer's tax profile can materially impact the financial viability of investment decisions and the pricing of those decisions; and
- A retrospective amendment with an application date of more than 7 years before the date of enactment, especially without clear reasons for the retrospectivity will exacerbate persistent concerns in the international community of the increased 'policy risk' of investing in Australia.

We urge the Government to reconsider the circumstances in which retrospective legislation is appropriate in light of the comments set out above. Certainty in relation to the operation of tax laws is in the best interests of taxpayers, the ATO and the broader economy. At the very least, we urge the Government to put a stronger case to the tax community to support the use of retrospective legislation in this circumstance.

Powers afforded to the Commissioner under proposed Division 815 vs. the current Division 13

As noted in the Explanatory Material at paragraph 1.9 "Whether the treaty transfer pricing rules could give rise to a different arm's length outcome than that arrived at through an application of Division 13 is unclear."

In this regard, and as discussed in our submission in response to the Consultation Paper (attached as appendix B to this submission), we again submit that a treaty-based power will be much broader than the rules contained in Division 13 of Part III of the *Income Tax Assessment Act 1936* ("**ITAA1936**") as it accommodates a reconstruction mechanism which is clearly far broader than currently exists in Division 13.

Due to the lack of clarity in relation to the scope of operation of the new rules and the limited number of comparable international jurisdictions that apply treaty provisions in the fashion proposed under the new Division 815, it is clearly open for the conclusion to be drawn that the scope of the new Division 815 is intended to have a wider ambit of operation than the current Division 13.

As a result, most taxpayers that engage in related-party dealings with international parties that are resident in tax treaty partner countries will be required to undertake separate transfer pricing analyses in order to ensure that the taxpayer is not in breach of either Division 815 or Division 13.

This compliance obligation is particularly onerous in the context of income years already passed, in relation to which taxpayers had undertaken analysis to determine whether the requirements of Division 13 were satisfied, but will now need to consider the potential application of the new Division 815.

In this regard, the presumption underpinning the proposed changes, that both the Australian Taxation Office ("**ATO**") and taxpayers had been applying the law as though the tax treaty transfer pricing rules were always an alternative, independent and unconstrained set of transfer pricing liability provisions continues, in our view, to be incorrect (see following section).

This is because while Parliament may have referenced a somewhat similar but ambiguous view over time, the press release of 1 November 2011 was the first instance in which such a view was specifically expressed in such terms. In addition, judicial authority on this issue is inconsistent and inconclusive. Further, even if the Commissioner does have such a power, it has not been clear whether there are constraints imposed on that power under the ITAA1936, *Income Tax Assessment Act 1997* ("**ITAA1997**") or the *International Tax Agreements Act 1953* (together the "**Tax Acts"**) as those Acts interact.

According to our members, a significant number of taxpayers have adopted this alternative view, and will be required now to undertake transfer pricing analysis again under the new Division 815 once introduced.

Whether the specific transfer pricing related articles in Australia's Double Tax Agreements provide alternative and independent transfer pricing liability provisions to Division 13

Paragraph 1.8 of the Explanatory Material states that "Over time the Parliament has repeatedly referenced its view that the specific transfer pricing related articles as incorporated into Australia's domestic law provide alternative and independent transfer pricing liability provisions to those contained in Division 13". As discussed in our submission in response to the Consultation Paper (attached as appendix B to this submission), we strongly disagree with this view. We will not repeat here the various arguments raised in our previous submission, nevertheless, we do wish to draw the Government's attention to the following additional material, which in our view, is particularly relevant to this issue.

Part IIIB (Australian branches of foreign banks) of the ITAA 1936 (Part IIIB) was introduced into the tax laws in 1994 and clearly contemplates that taxpayers could get a more favourable outcome under an applicable Double Tax Agreement ("**DTA**") than under Part IIIB (subsection 160ZZVB(2)). Paragraph 5.4 of the Supplementary Explanatory Memorandum to Government

Proposed Amendments to *Taxation Laws Amendment Bill (No.3) 1994* clearly shows that such an outcome constituted the underlying rationale for providing taxpayers with the ability to elect that Part IIIB should not apply to them. This position has been accepted by the ATO for many years (paragraph 2 of TD 2002/28).

As Division 13 is clearly intended to apply to matters dealt with in Part IIIB (albeit via section 136AD rather than by section 136AE in certain situations – see subsection 160ZZW(5)), the proposition stated in paragraph 1.8 of the Explanatory Material that "Over time the Parliament has repeatedly referenced its view that the specific transfer pricing related articles as incorporated into Australia's domestic law provide alternative and independent transfer pricing liability provisions to those contained in Division 13" is incompatible with the view expressed by Parliament in 1994 at the time Part IIIB was introduced into the tax laws.

This follows because, if the transfer pricing related articles in Australia's DTAs provide alternative and independent transfer pricing liability provisions to Division 13, there would have been no point in allowing taxpayers to elect out of Part IIIB because the Commissioner could still apply Division 13 (as an alternative and independent transfer pricing liability provision to the transfer pricing articles in Australia's DTAs) irrespective of the fact that a taxpayer could get a more favourable outcome under an applicable DTA.

In light of the above, we urge the Government to reconsider the view expressed in paragraph 1.8 of the Explanatory Material.

At the very least, we request the Government to amend paragraph 1.8 of the Explanatory Material to refer to the broadly-held contrary view held in Australia (that Australian tax treaties do not under the current law constitute an alternative, independent and unconstrained power to make transfer pricing adjustments) in order to provide the Courts with appropriate guidance when interpreting the application of the new Division 815 in years to come.

Discrimination against treaty countries

The new Division 815 creates greater compliance obligations and therefore discriminates against taxpayers that trade with related parties resident in countries with which Australia has a tax treaty.

Discrimination between different types of taxpayer

The new Division 815 will create different rules for companies and permanent establishments ("**PEs**"). Furthermore, the rules for PEs will be different depending on whether the PE is an inbound branch of a treaty country (with potential variations from treaty to treaty), an inbound branch of a non-treaty country, or an outbound branch of an Australian company.

Transfer pricing adjustments and customs duty interaction

The new Division 815 creates greater capacity for transfer pricing adjustments for which there will not necessarily be any corresponding relief from customs duty (because customs rules focus on values for individual import transactions).

In this respect, recommendations contained in the report of the *Review of Business Taxation* ("**Ralph Review**") appear to have been overlooked. In particular, we note that the Ralph Review recommended (Recommendation 22.16) that legislative changes should be developed to provide rules to link transfer pricing for customs and income tax purposes.

SECTION 2: General comments on the Exposure Draft

Objects clause – proposed section 815-10

The objects clause should also include a statement to the effect that the operation of Subdivision 815-A is not intended to override the safe harbour limits in Division 820 of the ITAA1997.

Whether an entity gets a transfer pricing benefit for purposes of section 815-22 – retrospective reconstruction power

We are particularly concerned at the potential for the Commissioner to raise amended assessments in reliance upon a retrospective reconstruction power that is far broader than currently exists under Division 13. As mentioned elsewhere in this submission, we are also concerned at the potential for the Commissioner to impose penalties on taxpayers in such cases.

Further, we are concerned that the Commissioner would use a retrospective reconstruction power to commence new audits with reliance being placed on the wider powers that will be provided by Subdivision 815-A rather than on the Commissioner's long held view that there should be no fundamental difference between Division 13 and the Associated Enterprises Articles of Australia's DTAs (discussed at length in our submission in response to the Consultation Paper, attached at appendix B).

This is a key area of concern as it goes to the very heart of taxpayers' concerns that the Exposure Draft is not simply clarifying the law but is proposing to provide the Commissioner with additional taxing powers that do not currently exist under Division 13.

With respect to the reconstruction of transactions between related parties, 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 what constitutes exceptional circumstances, we note 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."*

In our 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 perceived notion of what independent parties would or would not do if acting in a commercially rational manner.

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[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

Proposed section 815-22 should be modified to make it clear that the Commissioner is not permitted to raise amended assessments in reliance on a retrospective reconstruction power.

The Commissioner's ability to amend assessments on a prospective basis in reliance on a 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 (i.e., the exceptional circumstances in which a reconstruction power might be applied consistently with the OECD Transfer Pricing 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 (counterfactual) transaction would be.

Section 815-30(1) determinations

Under proposed section 815-30, the Commissioner is not required to provide any detail as to the adjustments to assessable income or deductions that will result in the taxpayer's taxable income having changed (i.e. the Commissioner is only required to a make a determination under section 815-30(1) but is not also required to make a determination under section 815-30(2) that would provide such detail). As a result, the flow on effects of, for example and in particular, net adjustments to taxable income, including how the adjustment will relate to other aspects of the Tax Acts may be unclear.

One consequence of such an approach is that taxpayers could be left in the invidious position of not being able to determine whether they should, and if so how they might challenge an amended assessment. That is, taxpayers should be told the taxable facts upon which any amended assessment has been based.

It is also not consistent with principles of good tax policy development or good tax administration for taxpayers to be left in the dark in relation to how their tax liabilities have been determined. In this respect, we draw attention to the following remarks of the Commissioner of Taxation delivered in a speech on 2 April 2012[3]:

> *"To achieve this vision we are committed to working with taxpayers, their intermediaries and the wider community to <u>move from a 'game of hide and seek' to one of mutual transparency</u>." (emphasis added)*

Further, the effect of the Commissioner only making a subsection 815-30(1) determination could also have the following adverse consequences for taxpayers:

[3] *'Mitigating Risk', speech by the Commissioner of Taxation Michael D'Ascenzo to the 10th International Tax Administration Conference (ATAX), Sydney, 2 April 2012.*

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- Lead to amounts being included in net adjustments to a taxpayer's taxable income that do not constitute assessable income;

- Lead to increased difficulties in taxpayers seeking refunds of overpaid customs duty (because customs rules focus on values for individual import transactions);

- Requiring taxpayers to give written requests to the Commissioner in order to establish their entitlement to consequential adjustments under section 815-45;

- Lead to taxpayers not knowing whether a transfer pricing benefit brought to tax under section 815-30(1) might not also be subject to tax based on the application of Division 13, notwithstanding section 815-50; and

- Impact a multinational enterprise's ability to obtain a corresponding adjustment under Article 9(2) or the mutual agreement procedure article of a relevant tax treaty. More particularly, such an approach is not consistent with the spirit of the OECD TP Guidelines which places the burden of demonstrating that a primary transfer pricing adjustment is justified both in principle and as regards the amount on the country that has proposed the primary transfer pricing adjustment (paragraph 4.17).

There may be a need to clarify that the definition of "transfer pricing benefit" does not unintentionally erode the MAP process and the ability to have contrary adjustments (in favour of the taxpayer) in general.

The connection between "profit" (in tax treaties) and "taxable income" in the exposure draft should be drawn in a way that ensures that exempt / non-assessable income is not unintentionally 'picked up' and taxed through the new Subdivision.

The Commissioner should be required (and not merely permitted) to provide taxpayers with the level of detail contained in proposed section 815-30(2), and in that context should be required to:

- Provide the relevant taxpayer with sufficient detail to evaluate how the relevant amount or amounts referred to in sections 815-30(1)(a) to (c) as the case may be have been ascertained for purposes of the determination (as well as the determinations' flow-on effects with respect to other parts of the Tax Acts); and

- Specify the amount or amounts referred to in sections 815-30(1)(a) to (c) as the case may be which relate to particular international tax agreements in cases where more than one international tax agreements is applicable.

- While it is our preferred approach that the Commissioner should be required to provide taxpayers with the level of detail contained in proposed section 815-30(2), an alternative approach would be to provide taxpayers with the ability to request the Commissioner to provide them with the requisite level of detail together with the ability to object in the manner set out in Part IVC of the *Taxation Administration Act 1953* where the taxpayer is dissatisfied with the Commissioner's decision. Such an approach would enable taxpayers to obtain sufficient details in relation to how the relevant amount or amounts referred to in sections 815-30(1)(a) to (c) as the case have been ascertained to enable them to determine whether they should, and if so how they might challenge an amended assessment. The correctness or otherwise of the amended assessment could then be challenged in the usual manner under Part IVC of the *Taxation Administration Act 1953.*

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Net adjustments to taxable income arising as a result of a section 815-30(1)(a) determination do not sit comfortably with other areas of the Tax Acts

The following examples illustrate potential problematic outcomes where net adjustments to taxable income arise as a result of a section 815-30(1)(a) determination being made:

- Taxpayers may not be able to claim carry-forward losses that are available to them under section 36-17 of ITAA 1997. Given that subsection 36-17(2) is based on assessable income and allowable deductions, no mechanism has been provided by which carry-forward losses available to a taxpayer can be offset against an additional amount of taxable income that has been determined under subsection 815-30(1)(a) for a particular year of income.

- How does exempt income interact with determinations under the proposed section 815-30? For example, will exempt income (such as dividends exempt under section 23AJ of the ITAA1936) be able to give rise to an increase in taxable income under Section 815-30 effectively unwinding the tax treatment afforded to this income under domestic laws?

The relevance of the debt/equity rules in Division 974 of the ITAA1997 to Subdivision 815-A except in relation to the application of the thin capitalisation provisions in Division 820 of the ITAA1997 is unclear.

SECTION 3: General comments on the Explanatory Material

- Paragraph 1.10 of the Explanatory Material should also appropriately refer to situations where the revenue of other jurisdictions is compromised i.e. income is over-reported in Australia in order to constitute a fair and balanced description of the policy underpinning the amendments.

- Paragraph 1.32 of the Explanatory Material should be rewritten to make it more consistent with the position set out in the Commentary to the Business Profits Article of the OECD Model DTC in relation to internal payments of interest made by different parts of a financial enterprise to each other on advances (see paragraphs 19 and 20 of the 2005 Model DTC and paragraphs 41, 42 and 49 of the 2008 Model DTC).

SECTION 4: Interaction of transfer pricing and thin capitalisation rules

It appears to us that proposed subsections 815-22(4) and (5) seek to give legislative effect to the ATO's position in TR 2010/7 with respect to the interaction between the thin capitalisation rules in Division 820 and the transfer pricing rules (see paragraph 1.39 of the Explanatory Materials). More particularly, and of more concern, the retrospective application of subdivision 815-A to years of income commencing on or after 1 July 2004 will have the effect of giving legislative backing to an interpretative approach which the ATO had not finally developed until TR 2010/7 was issued on 27 October 2010, i.e. more than 6 years after 1 July 2004.

As a preliminary point, we wish to have it noted that the approach ultimately developed by the ATO in TR 2010/7 does not enjoy widespread taxpayer support. On the contrary, the views expressed by the ATO in TR 2010/7 are controversial and in this respect, we refer to the Joint Submission by The Institute of Chartered Accountants in Australia, The Taxation Institute of Australia (as our organisation was known at that date), CPA Australia, National Institute of Accountants (as that organisation was known at that date) and Taxpayers Australia on *Draft Taxation Ruling TR 2009/D6* dated 16 February 2010 (a copy of which is attached at appendix C).

In this regard, it is our view that the intent of proposed subsections 815-22(4) and (5) as set out in the Explanatory Material does not reflect the current law. Instead, these subsections merely seek to reflect the ATO's interpretation of the law. As such, legislating this position does not constitute a "mere clarification", but represents a retrospective change in the tax law that should be consulted on.

Notwithstanding the above, the following comments are provided on our understanding that it is nevertheless the Government's intention to give legislative effect to the approach ultimately developed by the ATO in TR 2010/7. In this respect, we have a number of concerns that the drafting of the relevant subsections does not necessarily achieve the desired policy intent as articulated in TR 2010/7. For example:

- Proposed section 815-22(4)(a) uses the term "rate of return for the debt interest". While the "rate of return" for a simple loan might conceivably be regarded as the interest rate set out in the applicable loan agreement, although this is not without doubt, it is far less clear as to what the expression "rate of return" means with respect to more complex financial instruments such as zero coupon bonds, convertible notes, swaps, redeemable preference shares, etc. It is also unclear what the expression "rate of return" means in cases where financial instruments are originally issued at a discount or premium to their face value;

- Proposed section 815-22(4)(b) states that the "rate of return is to be applied to the actual value of the debt interest". However, it is far from clear as to how these words are to be interpreted. For example:

    - How is the "actual value" of a debt interest to be determined? Is this to be based on market value, fair market value, face value or arm's length value?

    - When is the "actual value" of a debt interest to be determined? Is this to be determined at the time of issue of the debt interest, in each year of income, at some other time?

- Similar questions to those in the preceding dot point arise in relation to proposed section 815-22(5) and its use of the term "reduced value".

- We also note at this point that proposed sections 815-22(4) and 815-22(5) respectively include the words "so as to best achieve the consistency mentioned in subsection (3)" and "if that best achieves the consistency mentioned in subsection (3)" (i.e. with the documents covered by proposed section 815-25). In this respect, it is worth noting that the OECD Transfer Pricing Guidelines do not include any detailed guidance on how an arm's length consideration might be determined with respect to a financial instrument (e.g. a loan). The 1979 OECD Transfer Pricing Guidelines did include a chapter on loans (Chapter V) but neither the 1995 OECD Transfer Pricing Guidelines nor any later version includes such specific guidance.

- The interaction between proposed subsections 815-22(4) and (5) and proposed subsections 815-22(1) to (3) is unclear. "Profits" for the purposes of s815-22(1) are currently equated to taxable income (see Note following section 815-22(1)). However, taxable income is determined on post-interest profits. Based on the current drafting, the potential exists for the Commissioner to override any concession made to a taxpayer under proposed subsections 815-22(4) and (5) by adjusting other items of income or expense where the taxpayer's post-interest profits fall below the Commissioner's expectations of the profits that would have accrued if the taxpayer had been dealing at arm's length.

We also have a number of concerns that the drafting of the relevant Explanatory Material is not consistent with the Exposure Draft or with TR 2010/7 in a number of important respects. For example:

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- Paragraph 1.40 (first dot point, second sentence) of the Explanatory Material states that "The normal application of this Subdivision would require consideration of the conditions operating between the Australian entity and its foreign associates, and a comparison of the profits which would have accrued to the entity had it been wholly independent." By comparison, TR 2010/7 only goes so far as to state that "it is necessary to take account of whether the outcome makes commercial sense in all of the circumstances of the case" (paragraph 50). There is no requirement in TR 2010/7 for "a comparison of the profits which would have accrued to the entity had it been wholly independent" to be made;

- Paragraphs 1.39 and 1.40 of the Explanatory Material refer to "the arm's length cost of debt capital" in a number of places. Debt capital is defined in s995-1 of the ITAA 1997 as meaning any debt interests issued by the entity that are still on issue at a particular point in time. The definition of debt capital does not therefore distinguish between debt interests issued to related parties and debt interests issued to independent parties. *Prima facie*, debt interests issued to independent parties will be undertaken on an arm's length basis. Paragraph 1.40 is contrary to the position taken in TR 2010/7 which is that transfer pricing provisions can apply to debt funding that is provided on a non-arm's length basis, for example, where debt interests issued to related parties have not been priced on an arm's length basis; and

- Paragraphs 1.39 and 1.40 of the Explanatory Material state that "the arm's length cost of debt capital is applied to the entity's actual amount of debt" in a number of places. This seems to require the calculation of an average (arm's length) cost for all of a taxpayer's debt interests. Such an approach is not consistent with proposed subsections 815-22(4)(a) and 815-22(4)(b) which clearly require that the relevant rate of return is in respect of a particular debt interest. A requirement to calculate an average (arm's length) cost for all of a taxpayer's debt interests is also likely to be problematic where an entity has more than one debt interest on issue in any year of income.

SECTION 5: Other significant issues of note

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Regulation making power contained in proposed section 815-25(1)(c)

Neither proposed subsection 815-25(1)(c) nor the corresponding Explanatory Material (in paragraphs 1.47-1.48) provide any guidance as to the type of documents that might be prescribed by regulation in order to work out whether an entity gets a transfer pricing benefit for purposes of proposed subsection 815-22(3).

Using documents issued by the OECD as a guide, these can be broadly divided into three categories:

- **Tier 1 documents:** documents which have been specifically adopted by the OECD Council including the making of specific recommendations to OECD member countries in accordance with Article 5(b) of the Convention on the OECD of 14 December 1960. Broadly speaking, such documents represent an international consensus (or at least a consensus amongst OECD member countries). Examples of such documents include the OECD Model DTC, the OECD Transfer Pricing Guidelines and the 2008 and 2010 Attribution of Profits to Permanent Establishments reports.

- **Tier 2 documents:** documents which have not been specifically adopted by the OECD Council but have been prepared by the OECD's Committee on Fiscal Affairs. While there is clearly a level of consensus amongst OECD member countries in relation to the views expressed in these documents, the OECD Council has not adopted them and has made no recommendations to OECD member countries in relation to them. Examples of such documents include the 1987 Thin Capitalisation Report (No.2 in Issues in

International Taxation series) and the 2002 Attribution of Income to Permanent Establishments Report (No.5 in Issues in International Taxation series).

- **Tier 3 documents:** documents which have been published under the responsibility of the Secretary-General of the OECD and which clearly state that the views expressed therein are not necessarily those of the OECD and its members. An example of such a document is The Taxation of Employee Stock Options (Tax Policy Study No. 11) 2004.

In our view, it is only Tier 1 (OECD) documents and other documents that follow a similar process of adoption and recommendation by an international organisation such as the United Nations that should be within contemplation as documents that could be prescribed by regulation for purposes of working out whether an entity gets a transfer pricing benefit.

Proposed section 815-25 should provide greater clarity as to the type of documents that might appropriately be prescribed by regulation in order to work out whether an entity gets a transfer pricing benefit. Alternatively, greater guidance should be included in the Explanatory Material as to the type of documents that are within reasonable contemplation of being used, and also of not being used, for purposes of working out whether an entity gets a transfer pricing benefit.

Penalties

The Exposure Draft is silent in relation to the matter of administrative penalties that can be imposed on taxpayers under Division 284 of the *Taxation Administration Act 1953 (Division 284) where the Commissioner issues* an amended assessment in reliance upon Subdivision 815-A.

The Exposure Draft should make it clear that administrative penalties under Division 284 cannot be imposed on taxpayers following the issuing of an amended assessment in reliance upon Subdivision 815-A of an amount greater than the amount that might reasonably have been expected to have been imposed if, notwithstanding section 815-50, the Commissioner had issued an amended assessment in reliance upon Division 13.

Consequential adjustments

In our view, proposed subsection 815-45(1)(d) gives the Commissioner discretionary powers that are too broad for the efficient operation of the transfer pricing laws. As such, we recommend that the Exposure Draft be amended so that if the conditions in paragraphs (b) and (c) are met, then the Commissioner should be required to make the relevant consequential adjustments i.e. such amendments should not be discretionary.

Moreover, the Explanatory Material at paragraph 1.69 notes that the discretion must be exercised with reference to the points of view of both the taxpayer and the revenue. As a result, even in circumstances where an adjustment is fair and reasonable and warranted on technical grounds, the Commissioner may, following the guidance in the Explanatory Material, allow considerations of quantum and impact on revenue to affect the exercise of his discretion. We recommend that this paragraph be rewritten so that the Commissioner is required to consider the merits of the relevant adjustment only in applying the discretion.

Potential application of Subdivision 815-A to Part IIIB (Australian branches of foreign banks)

The Government's stated intention, as expressed in the press release, is to clarify the existing law (rather than to provide additional taxing powers to the Commissioner). If subdivision 815-A is able to apply to an Australian branch of a foreign bank that has elected out of Part IIIB (see section 160ZZVB), and in light of the uncertainty noted in paragraph 1.9 of the Explanatory Material and discussed in Section One above, it is therefore possible that the Commissioner could make a determination under section 815-30(1) which resulted in such a taxpayer having a

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higher taxable income than would otherwise be the case under an applicable DTA. Such an outcome would not be consistent with the Government's stated intention.

To prevent such an outcome from arising, the ED should clearly provide that Subdivision 815-A has no application to taxpayers who elect out of Part IIIB.

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