

Tax Brief

19 December 2011

Transfer Pricing Consultation Paper

On Tuesday 1 November 2011 when the foreigners were taking over the Melbourne Cup, the Assistant Treasurer put out a Press Release and Consultation Paper which deals with a number of well known issues in the transfer pricing area but has a surprise for foreigners – a retrospective amendment to the law to support the Australian Taxation Office (**ATO**) view that tax treaties provide a separate power to make transfer adjustments.

This tax brief discusses what the proposed retrospective amendment may mean and comments on the issues canvassed in the Consultation Paper.

The general impression is that this project has a fairly high priority for quick legislation though there is a suggestion that the Board of Taxation may become involved if responses to the Paper raise significant problems. As the Paper sends mixed messages about whether Australia will follow international norms or push beyond them, it already appears that there will be opposition to some of its proposals.

Do tax treaties confer an independent transfer pricing adjustment power?

The ATO considers that treaties provide an independent source of power to make adjustments apart from Division 13 of the *Income Tax Assessment Act 1936* and routinely issues transfer pricing determinations under both. This view is regarded by many in the private sector as contrary to the normal international approach to the operation of tax treaties and has had a cool reception in the courts. So far as we are aware, Australia is the only country that takes this approach to transfer pricing which has caused a lot of unproductive heat in disputes. The Press Release announces that the ATO view will be legislated with effect for years of income commencing on or after 1 July 2004.

More recently and without resiling from its view, the ATO has also taken the position that Division 13 is very broad and so it is not necessary to rely on treaty powers. This approach has been evident in both of the substantive transfer pricing cases that have reached the courts, *Roche Products* and *SNF Australia*, as well as the ATO ruling TR 2010/7 on the relationship of thin capitalisation and transfer pricing rules (see our Tax Briefs http://www.gf.com.au/829_632.htm,

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here http://www.gf.com.au/829_1009.htm on the cases and http://www.gf.com.au/829_857.htm on the ATO draft ruling that preceded the final ruling).

Two issues that have been agitated in relation to the question are whether Division 13 permits the use of profit methods such as the transactional net margin method (**TNMM**) and whether the treaty power can be relied on in effect to overrule the thin capitalisation safe harbour rules. As regards the first, the Full Federal Court in *SNF Australia* seemed to accept profit methods but gave primacy to the comparable uncontrolled price method which was in any event the position under the 1995 OECD Transfer Pricing Guidelines in issue in that case. In its recent Decision Impact Statement on the case, the ATO nonetheless states that it 'must accept that TNMM is not a valid method of establishing an arm's length consideration' under Division 13 on the basis of the trial judge's rejection of TNMM.

On the second issue, the ATO has accepted in a series of rulings that Division 13 and treaties do not trump thin capitalisation safe harbours and it is difficult to imagine that reversal of this position is what is intended by the Press Release, though there is a worrying example on the question in the Paper. So in our view there is little to be achieved by a retrospective amendment except taxpayer resentment.

The justification in the Press Release for the retrospectivity is that 'Parliament has indicated the law should operate in this way on a number of occasions, most recently in 2003'. Our enquiries have produced references to the original 1982 Explanatory Memorandum (**EM**) introducing Division 13 and to the EM for the 2003 legislation implementing the UK treaty. The Treasury Consultation Paper itself refers to a journal article by a former ATO officer arguing that the 1982 EM says no such thing. The Paper does not take sides on the issue but puts forward a proposal to legislate the exact opposite position for certainty in the future! The 2003 EM says, 'These paragraphs in Australia's tax treaties *allow* for adjustments to the profits of permanent establishments or associated enterprises on an arm's length basis'. [Our emphasis.] This hardly is a statement that they provide an independent adjustment power.

The Press Release is likely to be counterproductive in a number of dimensions. It will cloud private sector responses to some of the apparently sensible discussion in the Paper for fear of a hidden agenda. For example, the Paper proposes to give legislative recognition of the OECD Guidelines with a power to extend this recognition to future changes to the Guidelines subject to Parliamentary disallowance. What is not clear is whether such recognition will be prospective only. In light of the Press Release, other passages in the Consultation Paper may be read and attract opposition as indicating that new OECD Guidelines and Commentary can be used for events prior to their publication, even if that is not what is intended.

More generally and importantly the Press Release will be read as another indicator to foreign investors that Australia is a country of high tax uncertainty and

risk. Within the last year the Government has made three announcements concerning foreign funds to improve certainty of Australian tax treatment and highlighting uncertainty in Australian tax law. The Government needs to stay on message if it wants Australia to be regarded as a desirable place for investment.

On the domestic political front, the Press Release is one of a number of straws in the wind indicating that the Government may increasingly resort to retrospective legislation to help shore up its 'no deficit' commitment for the next financial year.

Possible transfer pricing changes

Because the issues have not been publicly ventilated by the Government previously, the Consultation Paper raises areas for possible law change with some indicators of direction but makes few real commitments (in contrast to discussion papers following more specific policy announcements).

The policy context which has given rise to the Paper has several elements:

- the continuing growth in international intra-firm trade;
- the restructuring that has been common for multinationals in the last two decades;
- the evolution of the international transfer pricing rules and practice under the aegis of the OECD while Australia's domestic law has remained essentially untouched since 1982;
- unimplemented recommendations of the 1999 Review of Business Taxation (which has a rather strange ring over a decade later and after the Henry Review); and
- 'uncertainties' created by litigation (clearly the perspective of the ATO, not taxpayers).

Legislating OECD views

The Paper generally endorses the OECD approach to transfer pricing and wants to incorporate it more fully into Australian law for conformity with international norms and securing certainty for investors. This would likely be achieved by a two step process. First, the tax law, drawing on an OECD specimen statute for transfer pricing and current legislation in similar countries like the UK and New Zealand, would legislate the transfer pricing concepts of tax treaties and the OECD Guidelines as rules at a high level and would then refer to the Guidelines for assistance in interpretation of the rules. Secondly, there would be a process of applying OECD updates in interpretation as noted above. The recently introduced MRRT Bill has a provision for this process in Division 205.

At the same time in some places the Paper seems to put an ATO spin on OECD views. For example, it generally endorses the functions, assets and risks

approach of the OECD but at one point adds a caveat that, 'One possible qualification to this objective might arise where the actual allocation of functions, assets and risks differs from that which would have been made by independent parties behaving in a commercially rational manner'. This reflects a theme of many years in public rulings and the SNF Decision Impact Statement of the ATO pushing the OECD envelope and is the kind of comment that will produce concern. The Paper refers to differences between Australia's treaties and the OECD Model in relation to the test of independence but not its possible implications on how far Australia actually follows OECD guidance.

More generally the MRRT Bill may be some guide as to legislation that may arise out of the Consultation Paper. There is an important difference, however, between the MRRT and the income tax. The former is an Australian only tax effectively in payment for non-renewable resources owned by Australia – the Government can determine what it requires to be paid for the resources and generally that will have little impact on the foreign tax position of a foreign owned MRRT taxpayer.

The income tax by contrast is a tax used by most countries and the tax position in one country directly affects the tax position of the same or a related taxpayer in another country. One purpose of tax treaties is to deal with this double taxation to ensure that it is not an impediment to international business and investment, particularly in the transfer pricing area. The Paper quite rightly recognises the need to avoid overreaching and to achieve balance in transfer pricing rules in income tax so that other countries are likely to accept Australia's approach. This necessarily means *not* pushing the OECD envelope.

The Paper notes one difference between domestic law and tax treaties that will continue – the extension of transfer pricing rules in domestic law to cases involving unrelated parties which nonetheless do not deal at arm's length.

Profits not prices

The Paper proposes that the legislation (like treaties) focus on profits of taxpayers rather than prices of specific transactions. While it is always possible to work from one to the other so that in one sense it should make no difference, this approach is more consistent with the 2010 OECD Guidelines in particular. They no longer give complete priority to transactional methods but support a most appropriate method approach though with the gloss that, if a transactional method and a profit method are equally reliable, the transactional method is to be preferred (OECD 2010 Guidelines para 2.3). While the most appropriate method approach is endorsed several times in the Paper, the OECD gloss is nowhere mentioned and the overall tenor of the paper is a clear preference for profit methods – more cause for concern?

Similarly the Paper refers on a number of occasions to reflecting the business outcomes that would be achieved by independent parties and taking account of the particular commercial positions of the parties. These in part are a reference to the point which the ATO lost in the *SNF Australia* case that an independent party

would not purchase at prices that kept it in perennial loss even if they reflected market prices. The Court could find no warrant for this view in the 1995 OECD Guidelines. The Paper suggests in effect rejecting the *SNF Australia* approach even if it is supported by the Guidelines, as has occurred in the MRRT Bill which also ignores the OECD gloss in enacting its 'most appropriate and reliable measure' rule.

The ATO has also suggested another tack in the SNF Decisions Impact Statement – constructing a separate service contract under which the loss making Australian taxpayer is providing market penetration services to its foreign parent (requiring additional reward to the Australian entity). In other words constructing a transaction into which the parties themselves did not expressly enter.

Restructures

Business restructures are noted as a specific concern in the context part of the Paper – in this case the concern is clearly sheeted home to the ATO by quoting from the Compliance Plan for 2010-11. The OECD has dealt with this topic in its 2010 Guidelines concluding that the same approach should be taken to arrangements arising from restructures as would be applied to structures originally implemented in the same way and then setting out specific issues to consider. It also encourages 'approaches that are realistic and reasonably pragmatic'.

The kinds of comments in the Paper referred to under the previous headings may in combination be read as again not fully accepting OECD guidance. It would be helpful in subsequent material produced in the project that Australia accepts the OECD Guidelines on this important topic.

Permanent establishments

Although part of Division 13 and tax treaties, the transfer pricing (profit allocation) rules for permanent establishments (**PEs**) are identified as a 'separate policy question' apparently meaning that it is to be progressed more slowly. The OECD over the period of 2008-2010 has adopted a functionally separate entity approach to profit allocation to PEs which means so far as possible treating a PE like a separate but related taxpayer from the rest of the entity of which it is part with the result that revenue and expense between different parts of the taxpayer are recognised.

There are three reasons for the greater reticence here. Australian domestic law generally and Division 13 in particular do not proceed on this OECD mandated basis but use an allocation of actual revenue and expense of the taxpayer to different sources, with the arm's length principle playing a part in that allocation. Hence there is potential inconsistency in outcome between the treaty approach and domestic law for PEs. Legislating the OECD approach in domestic law is a larger legislative project than transfer pricing for separate but related taxpayers.

Secondly, not all countries have accepted the OECD work in this area. In particular New Zealand has been vociferous in criticism and has convinced the UN not to accept the OECD work (which is a matter of global moment considering countries like China and India look more to the UN than the OECD for guidance). Thirdly, in this context only in the Paper, there is reference to potential revenue loss arising from adopting the OECD approach, which is automatically a go-slow signal in the current environment.

In practice PEs are encountered most commonly in the finance industry, in particular, but not only, of banks. In this regard the Treasury has released on its website together with its Consultation Paper a paper by Greenwoods & Freehills' director Tony Frost on the issues involved. The finance industry would obviously welcome progress on the issues outlined there but this may not require new legislation.

Self assessing transfer prices

Currently there is a special determination procedure for transfer pricing adjustments (like Part IVA) which does not sit comfortably in a self assessment environment for transfer pricing rules which the Paper makes clear are not intended to depend on a determination of avoidance purpose for their operation. Accordingly it is proposed that transfer pricing move to a self assessment approach. As most taxpayers treat the current rules as in effect self executing, this should not make a significant difference in practice.

In this context, it is suggested that the current residual discretion for the ATO to determine the arm's length consideration where there are information or other problems can be limited, though perhaps retained in a reduced form. It is not clear why there should be a special rule in this area – the ATO has no great difficulty assessing in other areas where information is lacking (such as asset betterment assessments in cash economy situations which the courts have generally upheld). Dropping or significantly reducing the scope of this power may also lead to adoption of a separate possibility in the Paper of omitting a special treaty rule that Australia currently insists on to cover the situation.

Similarly it is suggested that a reconstruction power may be necessary in cases where it is desired to disregard the parties' transactions under transfer pricing rules. The OECD has reinforced in 2010 that the scope for doing so is very limited to be consistent with the general treaty rule. If the legislation follows treaty rules and the Guidelines that should be sufficient in Australia.

Conferring a specific power to disregard transactions will open up questions whether it goes beyond what the OECD accepts. In this regard, the SNF Decision Impact Statement indicates that the ATO will in future more generally deploy the argument that the related parties' actual transactions can be ignored for tax purposes because they would not have been entered into at all between unrelated parties.

Documentation

The Paper says that there 'should' be a documentation regime similar to Canada and the US. Those regimes are notoriously resented by taxpayers and set the bar very high. There is a caveat that the rules should not be over-prescriptive and the more detailed discussion suggests perhaps greater flexibility (eg as to whether the documents must be strictly contemporaneous or completed by the time of filing a tax return). A less rigorous small business rule also is contemplated.

It seems a full blown Australian transfer pricing analysis will be required in the documentation, rather than a global policy and documentation along with some national add-ons as is used by a number of multinationals. This is because it is contemplated that the analysis would specifically be required to address some of the suggested features referred to above that may go beyond the OECD Guidelines.

Penalties

The Paper also follows the US and Canada in making a link between documentation and penalties, though proper documentation seems to show up as a penalty reduction mechanism.

On penalties more broadly it seems to be contemplated that the current special regime for transfer pricing will remain which does not seem consistent with the reasons for moving transfer pricing to a self assessment basis (at the moment the penalty regime is linked to that for application of the general anti-avoidance rules). It is also suggested that the 20% penalty increase for obstruction be extended to cases of lack of reasonable cooperation. No clear justification is provided why normal self assessment penalties are not sufficient for transfer pricing.

Limitation periods

The same applies to limitation periods – as readers will be aware currently there is no limitation period in domestic law for transfer pricing adjustments. One justification put forward for requiring documentation is to speed up dispute resolution but the Paper merely repeats the suggestion for an eight year limitation period in the earlier review of unlimited periods and indicates that submissions made then will be taken into account. Moreover, the Paper contemplates that it will be necessary to provide for extension of that period to address delays by taxpayers etc.

The only additional justification for a longer period in the Paper is failure by another country such as a tax haven to exchange information which does not indicate a great deal of confidence in Australia's burgeoning network of information exchange treaties with tax havens. It should be noted that an eight year period will lead to the result with the UK that Australia will still have power to amend when the period under UK law for invoking the mutual agreement

procedure under tax treaties has expired leading to unrelieved double taxation in transfer pricing cases.

The Paper notes that recent Australian treaties have included an eight year limit and indicates that Australia will continue to propose the position in negotiations. The comment is made that this provision is not generally used by other governments – but not the reason that Australia is probably the only important country which has no limitation period for transfer pricing cases.

Broader tax treaty interpretation changes

The Paper notes that legislating the OECD views on transfer pricing raises the broader issue whether a similar rule should be legislated for tax treaties generally, given the existence of the OECD Commentaries which contain material on many other treaty interpretation issues. This is not explored in depth in the Paper, other than to note that some similar uncertainties exist as for OECD transfer pricing material, but an Attachment lists some of the issues:

- Interpretation in accordance with the Vienna Convention on the Law of Treaties would be required;
- A process would be needed similar to the Guidelines for updating the interpretation norm for new versions of the Commentaries;
- The latest Commentary on provisions subsequently deleted from the OECD Model would apply to such provision in existing treaties, e.g. for the article on independent personal services deleted from the OECD Model and Commentaries in 2000, the 1997 Commentary would apply;
- The same interpretation rule would apply for commentary on alternative treaty provisions contained in the Commentaries;
- OECD reports leading to Commentary changes would be included in the interpretation rule; and
- When the interpretation rule would not apply, such as where Australia has indicated disagreement with OECD Commentary by an Observation therein.

These changes would seem to be in keeping with the general position in the Consultation Paper of conforming more clearly and closely to international norms established by the OECD.

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