

JOINT SUBMISSION BY

**Institute of Chartered Accountants Australia, Law Council of Australia,
CPA Australia, The Tax Institute and the Corporate Tax Association**

Draft Taxation Ruling TR 2014/D3

***Income tax: transfer pricing – the application of section 815-130 of the
Income Tax Assessment Act 1997***

Date: 30 May 2014

The Professional Bodies welcome the opportunity to comment on Draft Taxation Ruling TR 2014/D3 (**Draft Ruling**).

The Professional Bodies are extremely concerned with the approach taken by the Australian Taxation Office (**ATO**) in the interpretation of s. 815-130 of the *Income Tax Assessment Act 1997* (**ITAA 1997**) as it appears to envisage the reconstruction of transactions and arrangements in circumstances well outside the “exceptional circumstances” envisaged by the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (**OECD TP Guidelines**).

This is of particular concern in the context of the transfer pricing rules now applying in a self-assessment environment and the ATO’s expectation that taxpayers will have turned their mind to the application of s. 815-130 in their documentation (see paragraph 38 of TR 2014/D4), no matter how common the transactions and arrangements under consideration might be.

Further, the Professional Bodies are also concerned that the Draft Ruling does not provide any guidance in relation to when application of Subdivision 815-B will merely result in a pricing adjustment, as opposed to application of the reconstruction provisions in s. 815-130. This matter was discussed at a number of meetings of the Division 815 Working Group and it was the Professional Bodies’ understanding that the Draft Ruling would include examples of both situations.. This is an important matter for taxpayers from the perspective of being able to show that they have satisfied the record keeping provisions in Subdivision 284-E of Schedule 1 of the *Taxation Administration Act 1953* (**TAA 1953**), with a view to mitigating any penalties which may be imposed under Subdivision 284-C if transfer pricing adjustments are made.

The expansive interpretation of s.815-130 adopted in the Draft Ruling is also inconsistent with the government’s stated drive for ‘red tape’ reduction, and the steps that are being taken by the ATO – in conjunction with the Professional Bodies – to identify opportunities to reduce red tape within the tax system. If retained in its current form, it would greatly increase the cost of compliance for taxpayers by requiring them to address the application of the provision when it really should only be an issue in a small number of situations. Further, it would inevitably lead to protracted and costly disputes for taxpayers and an increasing likelihood of double taxation.

We outline below our more detailed concerns with the Draft Ruling for your consideration.

ANALYSIS

Substance vs. form

- 1 Paragraphs 24 to 26 provide the ATO's interpretation of what is meant by "form" and "substance" contained in the basic rule, s.815-130(1), and in the first exception to this rule, s.815-130(2).
- 2 The Draft Ruling suggests that the basic tenet of the interaction of these two terms is the difference that exists between "*prima facie features or legal characteristics of the dealings between entities*" and "*economic substance of the actual transactions, arrangements or other such relations between the entities*". This appears to be inconsistent with the manner in which these terms are used more widely in interpreting other tax issues where it is applied to non-conformity between the legal documents and what is actually occurring between the parties. By contrast, "*economic substance*" is the term used in accounting to describe the overall reality of the financial statements of an entity. The definition in the Draft Ruling at paragraph 78 describes the facts relevant to determining the substance (for the purposes of s.815-130) of commercial and financial relations of which the conduct of the entities is merely one aspect.
- 3 While we have no specific issue with the contextual overlay of having substance requiring "*making a difference in terms of the economic benefits and outgoings...*" or "*produce an effect that is proportionate to the economic risk and rewards...*" (paragraph 80), it is our view that the term "*economic substance*" is inappropriate in that it broadens the scope of the first exception beyond what may be reasonably inferred from the words of the legislation in the way in which it is used to describe substance by contradistinction to form. Instead we consider that the Draft Ruling should just refer to the substance of the commercial or financial relations that exist.
- 4 Further, paragraphs 81 to 82 outline certain situations where there appears to be a lack of commercial or economic benefit to the transaction eg. funds beginning and ending with same entity, some form of indemnity or reimbursement or recoupment being made or self cancelling transactions. Similarly paragraph 83 identifies situations and examples said to be relevant to the determination of the substance of arrangements. Although these matters may in some circumstances be connected to transactions that lack substance, they are more generally relevant to consideration of the General Anti-Avoidance Rule, Part IVA, than an examination of substance in a transfer pricing context.
- 5 This seems to be out of line with the intended operation of the transfer pricing provisions and is more relevant to instances of deliberate structuring to avoid tax. Again it is noted that transfer pricing is not seen, generally, as a vehicle for deliberate tax avoidance, particularly as the Draft Ruling notes that it is intended that the basic rule will prevail in most cases.
- 6 In place of the examples used in the ruling, we submit it would be more appropriate to outline key transfer pricing issues dealing with "substance", for example in relation to risk structuring, transactions:
 - with no real underlying risk;
 - where the entity with legal responsibility has no practical functional control; or
 - with an entity that has legal responsibility for the risk but does not have the financial capacity to absorb a risk event
- 7 Paragraph 85 – dealing with the tripartite arrangements – should also be reviewed as it is not consistent with paragraph 2.33 of the OECD TP Guidelines on which it purports to be based. Paragraph 85 presents the following example of when tripartite arrangements may be relevant:

"where a foreign parent company requires an Australian subsidiary to enter non-arm's length dealings with a company in a tax haven that is operating as a conduit,

potentially enabling the nature of the income flows the haven entity receives to be converted and remitted on to the parent in a tax exempt form." (emphasis added)

- 8 We submit it is not relevant, for purposes of determining whether the Australian subsidiary obtained a transfer pricing benefit, whether a payment made by the conduit is received by the parent company in a tax exempt form. What is relevant for such a purpose, and what paragraph 2.33 of OECD TP Guidelines does say, is that:

"If it cannot be demonstrated that the intermediate company either bears a real risk or performs an economic function in the chain that has increased the value of the goods, then any element in the price that is claimed to be attributable to the activities of the intermediate company would reasonably be attributed elsewhere in the MNE group ..." (emphasis added)

- 9 That is, it must be shown that some part of the price received by the conduit from the Australian taxpayer does not belong to the conduit and that it may belong to the Australian taxpayer.

Exceptional circumstances

- 10 At paragraph 27, the Draft Ruling notes that *"in most cases, it is expected that the identification of the arm's length conditions will be able to be accomplished by applying the 'basic rule'"*. This appears to be consistent with the requirement in the OECD TP Guidelines that reconstruction is "exceptional" (paragraph 1.65).
- 11 However, this threshold condition which equates with the "rare" or "unusual" circumstances (see paragraphs 9.168 of the OECD TP Guidelines) appears to be lost in the treatment provided within other sections of the Draft Ruling. In particular the Draft Ruling fails to provide the appropriate level of emphasis on "exceptionality" to ensure its conformity with the OECD TP Guidelines, and instead it implies a much broader requirement in considering the potential application of the exceptions.
- 12 Among other issues, we submit that this is well beyond the scope of reconstruction under the OECD TP Guidelines and places a burden on taxpayers well beyond a level that can be considered reasonable or practical. It is our view that the Draft Ruling should therefore expressly adopt the language used in the OECD TP Guidelines and require guidance and consideration as to whether the arrangements are truly exceptional in the sense contemplated.

Operation of s.815-130(2) to debt

- 13 The Draft Ruling has included, at paragraph 31, debt being re-characterised as equity as being an example of the application of s.815-130(2). While it is acknowledged that this example has been taken from the OECD guidelines and was mentioned in the TR 2010/7 Compendium, neither source has outlined the details relevant to supporting such a reconstruction.
- 14 TR 92/11 also discusses this matter and, at Part C, suggests a number of considerations in forming a view as to whether the payment may be debt or equity. It states that the starting point for situations such as this example would always be that the transaction would be taken to be a loan (ie. based on the legal relationship between the parties). Further, the OECD recommends a flexible approach to these matters and ultimately the total picture that emerges from the transaction is relevant, including the legal character of the financial arrangement.
- 15 The example as provided is too simplistic when read in the context of TR 92/11 and also does not recognise some of the cautions inherent in that ruling or in the OECD TP Guidelines. As such the Professional Bodies seek the removal of this example from the ruling, and its replacement with something more in accordance with the suggestions contained under the heading "More Guidance Required", later in this document.
- 16 We note that in a recent Division 815 Working Group meeting the ATO indicated that it would consider this request favourably.

Interpretation of s.815-130(3)

- 17 At paragraph 111 (footnote reference 51), the Draft Ruling refers to the fact that s.815-130(3) is based on the second set of circumstances described in paragraphs 1.64 to 1.66 of the OECD TP Guidelines. However the second condition of its application, that the *“structure practically impedes the tax administration from determining an appropriate transfer price”* is not outlined and applied in the Draft Ruling.
- 18 While circumstances may exist where it is impractical or impossible to determine a transfer price, this will not always be the case. This second caveat implies that the ATO must first determine that a price cannot be determined using the existing conditions before it can replace those conditions with alternate ones they deem appropriate. If the legislation is to be interpreted to best achieve consistency with the OECD TP Guidelines, as it must by virtue of s.815-135(2)(a), then this implies that the additional requirement should be imported as a condition of the application of this particular section.
- 19 This is also consistent with paragraph 1.11 of the OECD TP Guidelines (see also paragraphs 1.67 and 1.69) which recognise that members of a multinational group face different commercial circumstances than independent enterprises, but the *“mere fact that a transaction may not be found between independent parties does not of itself mean that it is not arm’s length”*.
- 20 Alternatively, if in the ATO’s view s.815-130(3) cannot be interpreted consistently with the second situation described in paragraph 1.65 of the OECD TP Guidelines notwithstanding s. 815-135(2)(a), then the Draft Ruling should clearly state that such a limitation exists.
- 21 The Draft Ruling also does not address the interpretative question of whether the Commissioner can support an amended assessment on the basis of using more than one counterfactual for purposes of s. 815-130(3)(b). This interpretative question should be addressed in the Draft Ruling.
- 22 Further, the Draft Ruling does not address how the Commissioner would administer the documentation rules in Subdivision 284-E or the penalty provisions in Subdivision 284-C of the TAA 1953 in circumstances where the Commissioner supports an amended assessment on the basis of using more than one counterfactual.
- 23 We consider that example 3 (starting at paragraph 98) should be reviewed, as mentioned at the recent Division 815 Working Group Meeting, because on the facts presented, a transfer pricing benefit may not necessarily arise for the Australian taxpayer. Consequently, s.815-115 may not apply to the arrangement.
- 24 Also, in example 4 (starting at paragraph 122), the ATO refers to the fact that taxpayer *“consistently returns tax losses”* as relevant to demonstrating the arm’s length conditions are different. This appears to be inconsistent with the recognition in cases (albeit in the context of Division 13) that losses may have nothing to do with the commercial or financial relations between the related parties, and rather be the result of economic conditions, poor sales performance, etc. In particular, we note the observations of the President in his preliminary decision in *Re Roche Products Pty Ltd v Commissioner of Taxation* [2008] AATA 639 at paragraph 185:
- “One of the problems of profit based methodology is that, when applied to transfer pricing, it inevitably attributes any loss to the pricing. Where operating expenses are higher these may place some of the emphasis of the cause of the loss on the wrong area. After all, it is certainly true that there are companies which make losses for reasons other than the prices for which they acquire their stock. The Australian operations of multinational companies are not necessarily excluded from this.”*
- 25 Accordingly, the reference to losses in that paragraph should indicate the need to understand if there are other reasons for losses being incurred.

- 26 Lastly, in paragraph 124, there is a footnote (60) referencing the “Revised Discussion Draft on Transfer Pricing Aspects of Intangibles – 30 July 2013”. This is not relevant guidance for the purposes of s.815-135. Accordingly, the reference should be removed.

Operation of s.815-130(4)

- 27 As discussed at the recent Division 815-B Working Group meeting, it is hard to identify an appropriate example for the operation of this provision. However, in our view, the examples that currently exist in paragraph 45 and paragraphs 131 to 135 are not necessarily appropriate situations in which transactions should be entirely ignored.

Interaction of sections 815-130 and 815-140

- 28 The final sentence of paragraph 56 should be reviewed. The preceding sentence in the paragraph posits that “Aus Co’s credit standing would allow it to borrow \$300m from independent lenders”. Given this, the arm’s length consideration for such a \$300m loan should (and ordinarily can) be based on rates observable in the market. It is therefore not appropriate to add a caveat, as paragraph 56 does, to the effect that the price for the loan (ie the interest rate) may need to be less than the market rate (ie a non-arm’s length rate) in order to produce an outcome that in the Commissioner’s view would make commercial sense for both For Co and Aus Co. It would be different if Aus Co’s credit standing would not allow it to borrow \$300m from independent lenders, however, that is not what paragraph 56 says. Paragraph 58 addresses this latter scenario.
- 29 The ATO’s approach to this example in the Draft Ruling raises a question as to how this approach is consistent with the application of the arm’s-length standard. If the transaction is priced at appropriate rates but still fails the ATO’s view of profitability then why should taxpayers concern themselves with the arm’s-length nature of the transaction (apart from its interaction with other areas of law such as thin capitalisation) if it is irrelevant in the end.
- 30 Also, what of other conditions that have not been addressed by the Draft ruling may be relevant, such as gearing levels and what independent parties operating in their own best interest may be willing to accept under certain economic conditions. It may be argued, if such conditions are deemed relevant, that the pricing of the transaction may be more relevant than the bottom line result, at least in the shorter term.

Consequential adjustments and other impacts

- 31 In addition to our general observations relating to the nature of examples in the Draft Ruling, we also have concerns that the content of some examples do not properly assist taxpayers to understand the operation of the new laws. In particular we draw attention to the example of the application of s.815-130(2) in relation to the incorporation, by an Australian company, of an offshore subsidiary as a distribution and invoicing centre (paragraph 103). This arrangement changes with the assignment of an intangible to the entity, but upon examination the conditions are reconstructed to reflect the substance of the arrangement such that the subsidiary is rewarded only for its re-invoicing and reimbursement functions.
- 32 The outcome in this example is too simplistic for the conditions established and is silent on the consequences for the IP transfer itself, and whether (and if so, how) these may be addressed by s.815-145. It also fails to discuss the flow-on consequences of the use of a trademark by the subsidiary now it is (deemed to be) back in the hands of the Australian entity, the change in the risk/reward structure of the subsidiary and how service charges might now be applied. Again, these issues can all be considered consequential to the reconstruction of the existing conditions.
- 33 The example also raises a wider question of when, if at all, the ATO considers that it may reconstruct one transaction, but leave another related (but legally separate) transaction intact because of the requirement in s.815-120 that there be positive adjustments to taxable income. If such a position were to be adopted it would likely

lead to the application of the Mutual Agreement Provision, where a tax treaty exists, at additional cost to taxpayers.

Application of s.815-130 to arrangements entered into before 29 June 2013

- 34 In the Draft Ruling, the ATO does not currently provide guidance on how the rules in s.815-130 apply to arrangements entered into before Subdivision 815-B has effect ie. 29 June 2013. In particular, a difficult interpretative question arises as to whether s.815-130 can apply to such arrangements. If this is the case, then s.815-130 would effectively allow reconstruction of past transactions. That is, s.815-130 would become another example of retrospective transfer pricing legislation in Australia. For instance, assume that the transfer in the example in paragraphs 39 to 41 of the Draft Ruling occurred in 2011. Does the ATO consider it has a power to look at that arrangement in 2014 as if it were a continuing research agreement?
- 35 If the ATO's answer to the above question is yes, then the Draft Ruling should also explain how the ATO intends to apply the reconstruction provisions in subsections 815-130(3) and (4) in such situations. For example, assume that the transfer in the example in paragraph 45 of the Draft Ruling occurred in 2011, how does the ATO propose to deal with the following matters:
- The proceeds of sale received by the Australian taxpayer in 2011 and presumably subject to tax in that year? Presumably, the sale proceeds brought to tax would also be annihilated, however, the example does not make this clear. This raises the following further questions (not addressed in the Draft Ruling):
 - In determining whether the Australian taxpayer obtained a transfer pricing benefit in 2011, presumably the proceeds of sale of the IP rights would need to be deducted from the calculations to be undertaken for purposes of subparagraph 815-120(1)(c)(i)?
 - Can the consequential adjustment provisions in s.815-145 also apply retrospectively?
 - As the Australian taxpayer will be regarded as still owning the intellectual property rights, what return might it earn, if any, on these IP rights over the period from 2011 to the date of amendment given it has not actually exploited these IP rights in any other way than the way that it actually did?
 - Based on the facts presented in paragraph 39, the Australian taxpayer has continued to conduct research since the sale of the IP rights in 2011. At a practical level, how does the Australian taxpayer cover its R&D costs if it hasn't earned any income from its IP rights?
- 36 In our submission, for these reasons, the implicit assumption and the more appropriate position is that Division 815-B applies to arrangements entered into before 29 June 2013 as it finds them, and so s.815-130 cannot operate to reconstruct past transactions.
- 37 Further, if the ATO view is that s.815-130 can apply to arrangements entered into before Subdivision 815-B applies to a taxpayer, then it would also seem to follow that a taxpayer would not be able to satisfy the recordkeeping provisions in Subdivision 284-E of Schedule 1 of the TAA 1953 and would therefore be deemed not to have a reasonably arguable position. Consequently, the taxpayer would have penalties imposed at a minimum of 25%. Such an outcome would be harsh and oppressive because at the time of entering into the transaction the taxpayer could not possibly have known that the tax laws would be amended to introduce recordkeeping rules that would be applied retrospectively.

More guidance required

- 38 We submit that in its current form, the Draft Ruling does not provide sufficient guidance on how the arm's length commercial and financial relations should be identified.

- 39 Given the requirement for taxpayers to maintain documentation in order to have a reasonably arguable position, and the fact that they bear the onus of proof, it is incumbent on taxpayers to document the arm's length commercial and financial relations, but practical guidance is necessary on how to do so as it is extremely difficult in practice to be able to get copies of arm's length arrangements.
- 40 As such, it would be helpful for the ATO to articulate what evidence it expects to see when conducting its reviews of the requirement in s.284-255(2)(a) of the TAA 1953. Further, it would be helpful if the ATO clarified what is meant in paragraph 112 of the Draft Ruling, and whether this suggests that a taxpayer is required to analyse all possible alternatives to the transactions and arrangements actually undertaken.
- 41 To help clarify the guidance obtained from the examples used in the ruling it is suggested that:
- Examples are built from a base case that would justify application of the basic rule.
 - Key characteristics relevant to triggering each exception type are added separately and defined.
 - Each example defines the transfer pricing benefit that is determined to exist.
 - Where there are consequential adjustments, these are clearly defined, particularly in relation to examples of the operation of s.815-130(4).
- 42 It would also be appropriate to include more examples in relation to areas that are known to give rise to issues such as business restructures, financial arrangements and technology licensing arrangements.