2

Issues in the Bill

2.1 A number of submitters to the inquiry raised concerns about aspects of the Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013 (the Bill). Many of these issues were previously raised during the Treasury consultation processes on both schedules of the Bill. Selected key issues are discussed below.

Schedule 1 – General anti-avoidance rules

Overview

2.2 Part IVA of the *Income Tax Assessment Act 1936* (ITAA 1936) covers schemes to reduce income tax. Schedule 1 of the Bill will amend the ITAA 1936 with an aim to ensure that Part IVA continues to counter schemes that comply with the technical requirements but which, when viewed objectively, are conducted in a particular way mainly to avoid tax.

2.3 In his second reading speech on the Bill, the Assistant Treasurer, the Hon David Bradbury MP, comments that without these amendments 'there would be significant scope for taxpayers to plan their way around the law's intended operation and to undermine the revenue base'.[1]

2.4 For Part IVA to apply, three elements must be satisfied:

(1) there is a scheme;

(2) that a tax benefit is obtained in connection with the scheme; and

(3) it must be reasonable to conclude that someone entered into the scheme for the sole or dominant purpose of obtaining a tax benefit in connection with the scheme.

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1 The Hon David Bradbury MP, Assistant Treasurer, *House of Representatives Hansard*, 13 February 2013, p. 10.

2.5 Submitters to the inquiry raised some concerns about the need for, and technical aspects of, the proposed amendments in Schedule 1. These include the amendments as a response to related court decisions, the clarity of the new law, the effect of changes on commercial decision making, the requirement to disregard tax consequences when considering alternative postulates, and some technical issues. These issues are discussed below.

Response to court decisions

Background

2.6 The Assistant Treasurer's second reading speech on the Bill outlined that:

> Some recent cases have focused on the 'tax benefit' element of part IVA's operation. A tax benefit exists if a scheme produces a tax advantage (for example, reduced assessable income or increased deductions) being an advantage that would not have been obtained, or might reasonably be expected not to have been obtained, if the scheme had not been entered into.[2]

2.7 Section 177C of Part IVA sets out consideration of whether a tax benefit is obtained in connection with a scheme.

2.8 When announcing the Government's plan to introduce amendments to Part IVA, the then Assistant Treasurer, former Senator the Hon Mark Arbib, expressed the Government's concern that the outcome of certain cases —lost by the Australian Tax[ation] Office (ATO) on the basis of the 'do nothing' argument—could 'potentially undermine the overall effectiveness of Part IVA'.[3] The then Assistant Treasurer stated:

> In recent cases, some taxpayers have argued successfully that they did not get a 'tax benefit' because, without the scheme, they would not have entered into an arrangement that attracted tax …
>
> For example, they could have entered into another scheme that also avoided tax, deferred their arrangements indefinitely or done nothing at all. Such an outcome can potentially undermine the overall effectiveness of Part IVA and so the Government will act to ensure such arguments will no longer be successful.

2 The Hon David Bradbury MP, Assistant Treasurer, *House of Representatives Hansard*, 13 February 2013, p. 10.

3 Senator the Hon Mark Arbib, Assistant Treasurer, *Maintaining the effectiveness of the general anti-avoidance rule*, Media Release No. 10, 1 March 2012.

> The Government amendments will confirm that Part IVA always intended to apply to commercial arrangements which have been implemented in a particular way to avoid tax. This also includes steps within broader commercial arrangements.[4]

2.9 The EM comments that 'a number of recent decisions of the Full Federal Court have revealed weaknesses in the way in which the tax benefit concept in section 177C operates'.[5]

2.10 The 'do nothing' argument in question that has succeeded in certain cases is where taxpayers have argued that without the offending tax benefit they would not have proceeded with the relevant transaction.

2.11 One such case (on appeal to the Full Federal Court of Australia) was *RCI Pty Limited v Commissioner of Taxation* [2011] involving whether the Commissioner was correct in determining that the general anti-avoidance provisions applied in the circumstances of a particular transaction entered into by the James Hardie Group. It involved the James Hardie Group transferring its operating companies into a new more tax effective structure headed by James Hardie NV.[6]

2.12 The matter concerned a dividend payment of around $478 million made by James Hardie Holdings (JHH(O)), a US company, to RCI [an Australian subsidiary] which was exempt under s. 23AJ of the ITAA 1936. This reduced the value of the RCI's shares and the subsequent capital gains when they disposed of the shares during an international corporate reorganisation. The Commissioner of Taxation took the view that the dividend payment was a tax avoidance measure taken in anticipation of the restructure, and calculated that if the scheme had not been entered into there would be an additional tax cost of $172 million. Following appeal, the Full Federal Court rejected the Commissioner's conclusion.

2.13 In this appeal case, the Hon Justices Edmonds, Gilmour and Logan found:

> … in our view, if the scheme in either of its manifestations had not been entered into or carried out, the reasonable expectation is that the relevant parties would have either abandoned the proposal, indefinitely deferred it, altered it so that it did not involve the transfer by RCI of its shares in JHH(O) to RCI Malta or pursued one or more of the other alternatives referred to in the Information Memorandum; but they would not have proceeded to have RCI

4 Senator the Hon Mark Arbib, Assistant Treasurer, *Maintaining the effectiveness of the general anti-avoidance rule*, Media Release No. 10, 1 March 2012.

5 Explanatory Memorandum, Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013, p. 10.

6 *RCI Pty Limited v Commissioner of Taxation* [2011] FCAFC 104.

> transfer its shares in JHH(O) to RCI Malta at a tax cost of $172 million. On this view, RCI did not obtain the tax benefit it was alleged by the Commissioner to have obtained in connection with the scheme.[7]

2.14 In its Decision Impact Statement in response to the court decision, the ATO acknowledged the Court's findings on dominant purpose 'turned on the facts of the case'. However, the ATO also asserts that:

> The Commissioner will not automatically accept unsubstantiated assertions that a particular commercial transaction would not have been entered into if the tax advantage in question had not been available. The onus of proof remains on the taxpayer to make good such assertions, for example by reference to cogent evidence or compelling commercial logic.[8]

Analysis

2.15 Some submitters claimed that the amendments to Part IVA are an 'over-reaction' to the ATO court loses in these cases. The Corporate Tax Association (CTA) argues that:

> … the proposed changes represent an over-reaction to the Taxation Office losing a number of court decisions that have quite limited application. In addition, they appear to go beyond the scope of the then Assistant Treasurer's policy announcement in March 2012.[9]

2.16 CTA is of the view that 'these losses were not caused by deficiencies in the legislation, but rather by the Taxation Office's case selection and its approach to running the cases it litigates'.[10]

2.17 Similarly, the Law Council of Australia (LCA) argues that these case losses do not signal a design flaw in Part IVA, stating:

> The ATO is concerned that it has lost some recent cases on Part IVA. This does not signal a design flaw in Part IVA. In the 1990's the ATO lost the first case on Part IVA to reach the High Court of Australia. The ATO overcame that loss and over 30 years has found Part IVA to be effective. Part IVA has achieved its purpose.

7 *RCI Pty Limited v Commissioner of Taxation* [2011] FCAFC 104.

8 Australian Taxation Office (ATO), Decision Impact Statement, *Commissioner of Taxation v RCI Pty Ltd*, <http://law.ato.gov.au/atolaw/view.htm?DocID=LIT/ICD/S324of2011/00001>, viewed 28 February 2012.

9 Corporate Tax Association (CTA), *Submission 7*, p. 3.

10 CTA, *Submission 7*, p. 1.

> An administrator of a statute losing cases occasionally is a healthy sign that the administrator is identifying where the boundaries of the statute lie.[11]

2.18 The Tax Institute also questioned the need for the changes, commenting that:

> The Courts have applied the current rules appropriately to find that a tax benefit exists in only those cases where the taxpayer's actions have resulted in a loss to revenue. Recent cases have not resulted in the effectiveness of Part IVA being compromised and as such the amendments in the Bill are an unnecessary overreaction.[12]

2.19 Further, the Tax Institute argues that the circumstances that lead to a 'do nothing' alternative postulate being successfully put in *RCI Pty Limited v Commissioner of Taxation* were 'reasonably unique'.[13]

2.20 The EM comments that what cases like *RCI Pty Limited v Commissioner of Taxation* highlight was that 'it is permissible to reject an alternative course of action on the basis that the tax costs involved in undertaking that action would have caused the parties to do nothing, including deferring or abandoning a wider transaction of which the scheme was a part'.[14]

2.21 The EM asserts that 'another view of the operation of section 177C has become evident in a number of recent decisions'. The EM states:

> The decision in Futuris is an example. Both at first instance and on appeal, the underlying suggestion seems to be that the reference in subsection 177C(1) to tax consequences that 'would have [occurred], or might reasonably be expected to have [occurred], … if the scheme had not been entered into or carried out' is a composite phrase requiring, in every case, a postulate about what would have or might reasonably be expected to have happened in lieu of the scheme. On this view of the provision, 'would have' or 'might reasonably be expected to have' represent ends of a spectrum of certainty within which acceptable postulates must lie.[15]

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11 Law Council of Australia (LCA), *Submission 4*, p. [4].

12 The Tax Institute, *Submission 13*, p. 2.

13 The Tax Institute, *Submission 13*, p. 3.

14 Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013, *Explanatory Memorandum*, p. 13.

15 Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013, *Explanatory Memorandum*, p. 12.

2.22 The EM further comments in relation to this court decision and others that 'it appears to be assumed that all acceptable postulates will involve a prediction about events or circumstances, as opposed to a mere deletion of the scheme'. The EM states:

> The competing constructions of section 177C have yet to be directly considered by a court. To achieve the intended outcome, these amendments include provisions which put it beyond doubt that the 'would have' and 'might reasonably be expected to' limbs of each paragraph of subsection 177C(1) represent separate and distinct bases upon which the existence of a tax benefit can be demonstrated.
>
> From a policy perspective, it is desirable that section 177C(1) should operate in this manner…that reconstruction be permitted in addition to, and not to the exclusion of, voiding an arrangement.[16]

2.23 The Treasury does not accept that these amendments are unnecessary or an over-reaction to court decisions. The Treasury submits the following as key points in this regard:

- The amendments are necessary to ensure the ongoing effective operation of the general anti-avoidance rule known as Part IVA;
- The amendments are a measured response to exposed weaknesses in the operation of the 'tax benefit' concept, not a reaction to whether the Commissioner won or lost a particular case; and
- The amendments protect significant amounts of revenue that would otherwise be at risk.[17]

2.24 The Treasury further states that 'the amendments are wholly directed at addressing problems with the tax benefit test (section 177C) and do not amend the substance of the purpose test (section 177D), which is the main means by which Part IVA distinguishes between legitimate tax planning and impermissible tax avoidance'.[18]

16 Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013, *Explanatory Memorandum*, p. 12.

17 The Treasury, *Submission 16*, p. 3.

18 The Treasury, *Submission 16*, p. 3.

Conclusion

2.25 The committee notes that tax cases, and in particular Part IVA cases, will normally depend on their particular facts and circumstances. However, the reasoning used for decisions in a particular case can have implications for the operation of the tax laws more broadly.

2.26 It is expected that Government will fully consider the implications of relevant court decisions, and take action to ensure the effective operation of legislation, with a view to preserving its policy intent.

2.27 This Bill aims to address the issues that recent cases have highlighted to ensure that the legislation continues to provide a more comprehensive framework to counter tax avoidance schemes.

Operation of alternative postulates

Background

2.28 A Part IVA inquiry into a scheme (to which Part IVA applies) 'requires a comparison between the scheme in question and an alternative postulate'.[19] The EM outlines that 'an alternative postulate could be merely that the scheme did not happen or it could be that the scheme did not happen but that something else did happen'.[20]

2.29 The EM states that the amendments in the Bill aim to 'put it beyond doubt that the "would have" and "might reasonably be expected to have" limbs of each of the subsection 177C(1) paragraphs represent alternative bases upon which the existence of a tax benefit can be demonstrated'.[21]

2.30 The EM further asserts with regard to these alternative postulates:

- …when obtaining a tax benefit depends on the 'would have' limb of one of the paragraphs in subsection 177C(1), that conclusion must be based solely on a postulate that comprises all of the events or circumstances that actually happened or existed other than those forming part of the scheme; and
- …when obtaining a tax benefit depends on the 'might reasonably be expected to have' limb of one of the paragraphs in subsection 177C(1), that conclusion must be based on a

19 Explanatory Memorandum, Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013, p. 9.

20 Explanatory Memorandum, Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013 , p. 9.

21 Explanatory Memorandum, Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013, p. 16.

> postulate that is a reasonable alternative to the scheme, having particular regard to the substance of the scheme and its effect for the taxpayer, but disregarding any potential tax costs.[22]

Analysis

2.31 Issues were raised by submitters on the process that will be used to apply the alternative postulates. Cleary Hoare asserts that 'the language used in the EM when detailing the process for having regard to the alternative postulates is uncertain'.[23] Cleary Hoare argues:

> Specifically, paragraph 1.110 [of the EM] details that the non-tax results should simply be 'comparable' which seems to conflict with paragraph 1.102 that outlines that in order to provide a meaningful comparison the alternative postulate should achieve 'substantially the same non-tax results' as those achieved through the arrangement.[24]

2.32 CPA Australia (CPA) contends that:

> More effort needs to be made to align the Bill with the EM. For example, the EM should provide guidance on when subsection 177CB(2) will apply rather than section 177CB(3).[25]

2.33 The Treasury states however that the EM '…makes it clear that the annihilation approach under subsection 177CB(2) and the reconstruction approach under subsection 177CB(3) are intended to operate as alternative bases for identifying tax benefits…'.[26] The Treasury states:

> The Commissioner is entitled to rely on either limb. This will typically depend on the facts of the case.
>
> It is important to note that, under either approach, a tax benefit that the Commissioner purports to cancel must be a tax benefit that exists as a matter of objective fact—it cannot depend upon the Commissioner's opinion or satisfaction that there is a tax benefit.
>
> Moreover, the tax benefit must, viewed objectively, be obtained by a taxpayer in connection with a scheme that was entered into or carried out with the required tax avoidance purpose.[27]

22 Explanatory Memorandum, Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013, pp. 16–17.

23 Cleary Hoare, *Submission 6*, p. 2.

24 Cleary Hoare, *Submission 6*, p. 2.

25 CPA, *Submission 1*, p. 1.

26 The Treasury, *Submission 16*, p. 4.

27 The Treasury, *Submission 16*, p. 4.

2.34 The Treasury responded to specific concerns about the language used to explain alternative postulates:

> At paragraph 1.102, the Explanatory Memorandum explains that, under the reconstruction approach in subsection 177CB(3), the role of an alternative postulate is to provide a meaningful comparison between the tax consequences of the scheme and the tax consequences of 'an alternative that is reasonably capable of achieving for the taxpayer substantially the same non-tax results and consequences as those achieved by the scheme'.
>
> At paragraph 1.110, the Explanatory Memorandum explains that, for a postulate to constitute a reasonable alternative to a scheme it would be expected to 'achieve for the taxpayer non-tax results and consequences that are comparable to those achieved by the scheme itself'.
>
> There is no conflict between the language of paragraphs 1.102 and 1.110. To say that a thing should be 'comparable' to something else is to suggest that it should be 'similar to', 'equivalent to' or 'analogous to'. To say that something should be 'substantially the same' as something else has broadly the same meaning.[28]

Conclusion

2.35 The amendments to Part IVA of the ITAA 1936 make it clear that either the annihilation and reconstruction alternative postulate can be applied by the Commissioner to cancel a tax benefit. It is also clear from these provisions, and from existing law, the Commissioner can only do so where, objectively viewed, the relevant tax avoidance purpose exists (that is, there was a tax benefit in connection with a scheme to which Part IVA applies).

2.36 It is also clear that if a decision to reconstruct a scheme is taken under Part IVA, the Commissioner must have regard to the substance of the arrangements, including the actual non-tax outcomes achieved by the arrangements (ignoring the scheme).

28 The Treasury, *Submission 16*, pp. 4–5.

Alternative postulates and commercial decision making

Background

2.37 When Part IVA was introduced in 1981, the Government indicated that it was not intended to impede normal commercial transactions:

> … the explanatory memorandum made it clear that the 'test for application' of Part IVA was 'intended to have the effect that arrangements of a normal business or family kind, including those of a tax planning nature' would be beyond the scope of Part IVA.
>
> The distinction between tax avoidance and legitimate commercial and family arrangements was emphasised by the then Treasurer in his second reading speech on the Bill. There he stated that Part IVA was not intended to 'cast unnecessary inhibitions on normal commercial transactions by which taxpayers legitimately take advantage of opportunities available for the arrangement of their affairs'.[29]

2.38 Some submitters to this inquiry express concern however that the changes to Part IVA under Schedule 1 of the Bill will negatively impact on the day to day commercial decision making of businesses. This is further explored below.

Analysis

2.39 CTA expresses its concern in relation to the Part IVA provisions that '…the amended legislation could be administered in a way that would create unexpected tax liabilities in relation to genuine commercial transactions containing no element of contrivance or artificiality'.[30] CTA asserts that:

> The uncertainty that would persist until judicial determination of a number of the new concepts introduced would constrain commercial activity and adversely affect everyday business decision-making.[31]

2.40 In relation to the dominant purpose test, CPA argues that 'contrary to the second reading speech and the EM, the provisions will impact normal commercial transactions'.[32] CPA comments:

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29 Explanatory Memorandum, Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013, p. 6.

30 CTA, *Submission 7*, p. 3.

31 CTA, *Submission 7*, p. 3.

32 CPA, *Submission 1*, p. 2.

> For example, a decision to sell the shares in a company rather than the underlying assets will often be made after taking into account an analysis of costs including tax. Under these proposed amendments tax would be excluded from the analysis, throwing up a tax benefit and, therefore, the need for the taxpayer to demonstrate that there was not a dominant purpose of tax avoidance.[33]

2.41 Similarly, Cleary Hoare argues that the proposed changes disregarded the commercial realities that business must consider when making decisions, stating:

> These proposed changes continue to demonstrate a complete disregard for the commercial reality of decision making that relates to the profitability of an enterprise and the employment of Australians in those enterprises. By seeking to close the door on the 'do nothing' and the 'unreasonable tax burden' alternatives, the legislation will be stepping away from the realities of commercial decision-making. Australian businesses routinely decide to not enter transactions on the basis that an excessive tax burden will make a transaction uncommercial. Preventing this reality from being examined when hypothesising alternative postulates would create an incongruency between regular business decision making and the general anti-avoidance rules.[34]

2.42 Cleary Hoare further argues that 'by preventing consideration of potential tax costs to alternative postulates, the legislation is removing a tool for the judiciary to identify which transactions are tax-avoidant in nature, and which are bona fide transactions meriting no condemnation'.[35]

2.43 CTA expresses further concerns with the proposal to disregard tax costs in alternate postulates (in new subsection 177CB(4)(b)) asserting that 'while such a rule might have some intuitive appeal, it is in fact unnecessary to overcome the "do nothing" argument—the "substance of the scheme" and "result or consequence of the scheme" rules already have that effect'.[36] CTA states:

> There is a risk that a 'disregard tax' rule could potentially be open to abuse by the Commissioner, as it could empower him to construct an alternative postulate that involves what is clearly an excessive amount of tax—for example by taxing the same

33 CPA, *Submission 1*, p. 2.

34 Cleary Hoare, *Submission 6*, pp. 2-3.

35 Cleary Hoare, *Submission 6*, p. 3.

36 CTA, *Submission 7*, p. 4.

> economic gain twice. It has been suggested in the consultation process that such an outcome would be unlikely as the Commissioner would still have to be successful on the 'purpose test' in sec 177D. However, it is far from clear how the purpose test would displace a statutory assumption that tax should be disregarded or how the courts would interpret such a rule.[37]

2.44 The Treasury responded to concerns about disregarding tax when proposing an alternative postulate that '…Part IVA must be capable of exposing the substance or reality of what it is that has been achieved for the taxpayer (tax aside) to the ordinary operation of the taxation laws'.[38] The Treasury states:

> …the focus of the reconstruction approach should be on identifying whether or not there is a reasonable substitute for the scheme. It is not conducive to the effective operation of Part IVA to inquire into whether taxpayers would have pursued an entirely different course of action had they not participated in the scheme.
>
> As the Explanatory Memorandum explains, a tax advantage cannot meaningfully be linked to a scheme by comparing the tax consequences of that scheme to the tax consequences that would have flowed if the parties had chosen to pursue some different objective.[39]

2.45 The Treasury further emphasises that 'having identified a substitute for the scheme, it would undermine the operation of Part IVA to permit the tax consequences of that substitute to be a reason for concluding that the substitute is unreasonable'.[40] The Treasury asserts:

> To do so would be to allow the very tax advantage that Part IVA is seeking to identify and measure to function as a shield against its operation.
>
> The fact that a taxpayer would not have entered into a transaction if it had known in advance that it would be subject to tax should be no answer to Part IVA. To accept such a proposition would be to accept that there are situations in which it is reasonable for a taxpayer to avoid the ordinary operation of the taxation law on the substance or reality of what they have actually done. Applying

37 CTA, *Submission 7*, p. 4.
38 The Treasury, *Submission 16*, p. 6.
39 The Treasury, *Submission 16*, p. 6.
40 The Treasury, *Submission 16*, p. 6.

> Part IVA will not lead to more income tax being payable than results from that ordinary operation.
>
> Furthermore, the Commissioner has the power under existing subsection 177F(3) to provide compensating adjustments where it 'is fair and reasonable' to do so.[41]

Conclusion

2.46 It is appropriate that alternative postulates under Part IVA can be objectively and fairly applied to business transactions in order that they be subject to the ordinary operation of taxation law. The committee acknowledges that permitting businesses to avoid tax on commercial operations on the basis that they would not have conducted these activities if they had been subject to tax is an unacceptable proposition.

2.47 The amendments provide a judicious basis for the Commissioner of Taxation to protect revenue that may otherwise be at risk and will not subject businesses to higher tax than is required under the ordinary operation of the law compared to what they did in substance.

Technical issues

Background

2.48 Some technical issues were raised in the submissions with the operation of proposed sections 177C(1)(bc), 177C(1)(g) and 177CB(3). Section 177C(1)(bc) provides that non-payment of withholding tax shall be considered a tax benefit to which Part IVA can apply. Section 177C(1)(g) is consequential to section 177C(1)(bc) and provides that where paragraph (bc) applies, the amount of the tax benefit shall be taken to be the amount referred to in that paragraph.

2.49 Section 177CB(3) is a new provision introduced by the Bill and provides that:

> A decision that a tax effect might reasonably be expected to have occurred if the scheme had not been entered into or carried out must be based on a postulate that is a reasonable alternative to entering into or carrying out the scheme.[42]

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41 The Treasury, *Submission 16*, p. 6.

42 Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013, s. 177CB(3).

Analysis

2.50 In relation to proposed section 177C(1)(bc) CTA asserts that:

> …there is a technical deficiency in the drafting of proposed sec[tion] 177C(1)(g). In its interaction with proposed sec[tion] 177C(1)(bc), it appears to define the tax benefit in a withholding tax scenario as being the gross amount on which tax would be withheld, rather than the quantum of the withholding tax benefit itself.[43]

2.51 The Treasury states that '…proposed paragraph 177C(1)(g) is a consequential amendment designed to bring the avoidance of withholding tax within the same list as the other tax benefits set out in section 177C'.[44] The Treasury states:

> Proposed paragraphs 177C(1)(bc) and 177C(1)(g) replace, and are consistent with, existing section 177CA of the 1936 Act, which provides that a taxpayer who avoids paying withholding tax on an amount on which it would have, or could reasonably be expected to have, paid withholding tax is taken to have obtained a tax benefit equal to the amount on which withholding tax is avoided.
>
> In a similar way, where Part IVA applies to an amount of assessable income, the cancelled tax benefit is the amount of assessable income, not the tax payable on that assessable income. (The amount of tax payable on that assessable income could then be reduced by other factors such as losses.)[45]

2.52 In relation to concerns regarding most likely alternative postulates, CTA states that '…the use of the test "a reasonable alternative" in proposed sec[tion] 177CB(3) introduces a degree of uncertainty for taxpayers in assessing alternative postulates as "a reasonable alternative" may not always be the most likely alternative'.[46]

43 CTA, *Submission 7*, p. 5.
44 The Treasury, *Submission 16*, p. 7.
45 The Treasury, *Submission 16*, p. 7.
46 CTA, *Submission 7*, p. 3.

2.53 The Treasury asserts that 'Subsection 177CB(3) builds on existing subsection 177C(1), which itself tests the reasonableness of alternative postulates'.[47] The Treasury states:

> Proposed subsection 177CB(3)…will introduce no greater uncertainty than currently exists in Part IVA.[48]

Conclusion

2.54 These amendments are appropriate and necessary and reflect the existing provisions of Part IVA regarding the reasonableness of alternative postulates. It is also appropriate that Part IVA can apply to withholding tax liabilities which would have been incurred but for the operation of a tax avoidance scheme. These amendments are consistent with other sections of the ITAA 1936.

Schedule 2 – Modernisation of the transfer pricing rules

Overview

2.55 Schedule 2 of the Bill aims to modernise Australia's transfer pricing rules and ensure they are aligned with internally accepted principles, of which the *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD TPGs) are a crucial component.

2.56 On 1 November 2011, the then Assistant Treasurer, the Hon Bill Shorten MP, announced that the Government would 'reform the transfer pricing rules in the income tax law and Australia's future tax treaties to bring them into line with international best practice, improving the integrity and efficiency of the tax system'.[49]

2.57 The Treasury indicated that following the consultation substantive changes were made to the draft Bill, and the explanatory material was amended to 'provide further explanation and clarification in response to specific issues raised in submissions'.[50]

2.58 Treasury notes that specific issues raised during the consultation included:

- the extent to which certain concepts are defined in domestic law, as opposed to being left to the OECD TPGs;

47 The Treasury, *Submission 16*, p. 7.

48 The Treasury, *Submission 16*, p. 7.

49 The Hon Bill Shorten MP, Assistant Treasurer, *Robust transfer pricing rules of multinationals*, Media Release No. 145, 1 November 2011.

50 The Treasury, *Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2012 (Schedule 2) – Modernisation of transfer pricing rules: Summary of consultation process*, p. 2.

- a suggestion that the rules should allow a taxpayer to downward assess a liability;
- that the scope of the documentation rules was too broad, as they require a taxpayer to prepare documentation in respect of all conditions that satisfied the cross-border requirement; and
- the link between preparing documentation and having a reasonably arguable position in respect of administrative penalties was inappropriate.[51]

2.59 The Bill repeals Division 13 of the ITAA 1936 and introduces Subdivisions 815-B, 815-C and 815-D to the ITAA 1997 and Subdivision 284-E into Schedule 1 to the *Taxation Administration Act 1953* (TAA 1953). The EM states that these provisions 'modernise and relocate the transfer pricing provisions into the ITAA 1997 to ensure that consistent rules apply to both tax treaty and non-tax treaty cases'.[52]

2.60 Submitters to the inquiry raised concerns in relation to Schedule 2 of the Bill about its consistency with OECD guidelines, the reconstruction of transactions, the time limits to amend assessments, and record-keeping requirements. These issues are explored further below.

Consistency with OECD Guidelines and reconstruction of transactions

Background

2.61 The arm's length principle is central to transfer pricing regimes. It is the international standard that OECD member countries have agreed should be used for determining transfer prices for tax purposes. The arm's length principle is set out in Article 9 of the OECD Model Tax Convention, and is integral to tax considerations for multinational groups and tax administrations. It provides a broad parity of tax treatment for members of multinational groups and independent enterprises, and has been found to work effectively in the vast majority of cases.[53]

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51 The Treasury, *Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2012 (Schedule 2) – Modernisation of transfer pricing rules :Summary of consultation process*, pp. 1-2.

52 Explanatory Memorandum, Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013, p. 33.

53 Organisation for Economic Co-operation and Development (OECD), *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, 22 July 2010, p. 34.

2.62 The *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD TPGs) provide guidance on the application of the 'arm's length principle', the approach to be taken when evaluating the transfer pricing of associated enterprises, i.e. attributing a value, for tax purposes, of cross-border transactions between associated enterprises.

2.63 The OECD TPGs defines transfer prices as 'the prices which an enterprise transfers physical goods and intangible property or provides services to associated enterprises'.[54]

2.64 The OECD TPGs are widely recognised and used. The EM acknowledged that:

> The OECD Guidelines are widely used by both member and non-member tax administrations, and were described by the UK Special Commissioners as 'the best evidence of international thinking on transfer pricing'.[55]

2.65 The amendments proposed in Schedule 2 aim to ensure that Australia's transfer pricing rules in relation to multinational groups align with the OECD TPGs.

2.66 In its summary of the consultation process on Schedule 2 of the Bill, the Treasury noted that most of the submissions supported the alignment of Australia's domestic transfer pricing rules with the OECD TPGs.[56]

2.67 Section 815-130 in the Bill deals with the relevance of actual commercial or financial relations. Paragraph (1) provides the following basic rule:

> (1) The identification of the arm's length conditions must:
>
> (a) be based on the commercial or financial relations in connection with which the actual conditions operate; and
>
> (b) have regard to both the form and substance of those relations.

2.68 Paragraphs (2) to (5) of 815-130 provide for exceptions to the basic rule.

2.69 In its chapter on the arm's length principle the OECD TPGs provide for the recognition of the actual transactions undertaken, specifying that:

> A tax administration's examination of a controlled transaction ordinarily should be based on the transaction actually undertaken

54 OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, 22 July 2010, p. 19.

55 Explanatory Memorandum, Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013, pp. 44-45.

56 The Treasury, *Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2012 (Schedule 2) – Modernisation of transfer pricing rules: Summary of consultation process*, p. 1.

> by the associated enterprises as it has been structured by them, using the methods applied by the taxpayer insofar as these are consistent with the methods described in Chapter II. 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.[57]

2.70 The OECD TPGs then go on to outline two exceptional circumstances where it may be both appropriate and legitimate for a tax administration to consider disregarding the structure adopted by a taxpayer in entering into a controlled transaction. These are where:

- the economic substance of a transaction differs from its form; and
- while the form and substance of the transaction are the same, the arrangements made in relation to the transaction, viewed in their totality, differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner and the actual structure practically impedes the tax administration from determining an appropriate transfer price.[58]

Analysis

General consistency with OECD Guidelines

2.71 A number of submitters to the inquiry comment on the approach taken in Schedule 2 to aligning Australia's transfer pricing rules with the OECD TPGs.

2.72 GE questioned whether it was necessary to introduce the sections proposed, and suggested that 'the policy intent of the legislation could be achieved by incorporating the OECD Guidelines directly into the legislation rather than drafting unique stand-alone provisions'.[59]

57 OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, 22 July 2010, p. 51.

58 OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, 22 July 2010, p. 52.

59 GE, *Submission 2*, p. 1.

2.73 Further, GE argue that some provisions in Schedule 2 of the Bill actually create uncertainty as to whether Australia's transfer pricing rules are consistent with the OECD TPGs. It states:

> Using language in the Bill that is not the same as the language in the OECD Guidelines could lead to differences in interpretation, despite the intention that the new transfer pricing measures be consistent with the OECD Guidelines.[60]

2.74 The committee raised this issue with the Treasury, who reiterated that it is the 'clear policy intent of the Government in relation to these amendments … to better align the rules with international best practice as currently set out by the OECD'.[61]

2.75 The Treasury maintains that the alignment of the rules with the OECD TPGs 'has been achieved through drawing heavily on the language of the relevant treaty provisions and the Guidelines in the construction of the provisions'.[62]

2.76 Proposed subsection 815-135 provides for guidance material which should be referred to when considering the application of the arm's length principle to a given situation. The EM states that:

> The identification of arm's length conditions under Subdivision 815-B must be done in a way that best achieve consistency with the following material:
>
> - the OECD Guidelines; and
> - any other documents, or part(s) of a document, prescribed by the regulations for this purpose.[63]

2.77 The Treasury argues that making provision for guidance material in the Bill, including the OECD TPGs is 'a mechanism that a number of countries have introduced in various forms into their legislation or subordinate rules to assist in the interpretation of what are frequently complex cross-jurisdictional issues'. The Treasury outlined that:

> In addition to using language drawn from the relevant treaty articles and the OECD guidelines, a specific legal pathway is provided to require regard to be had to the OECD material for interpretive purposes. The provision requires that the identification of arm's length conditions be undertaken in a way

60 GE, *Submission 2*, p. 1.
61 The Treasury, *Submission 16*, p. 8.
62 The Treasury, *Submission 16*, p. 8.
63 Explanatory Memorandum, Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013, p. 45.

> that best ensures consistency with prescribed materials, currently the OECD guidelines.[64]

2.78 While the language used in the Bill significantly draws from the OECD TPGs, the provision in the Bill also allow for the inclusion or refocusing on other reference sources, if in the future there are developments in international best practice on transfer pricing methodology that may diverge from, or substantially add to, the OCED TPGs. The Treasury submitted:

> The Explanatory Memorandum explains that the provisions are constructed to provide a mechanism to prescribe interpretive materials (or remove them, for example, if they cease to represent international best practice or are overtaken by more relevant alternative materials). The provision of a regulation making power ensures the Australian Parliament will always retain control over what materials are referred to in the laws of Australia.[65]

Reconstruction of transactions

2.79 GE acknowledged that 'the Bill more closely aligns with OECD principles than the previous exposure draft of the provisions'.[66] However, in its submission it highlights that certain concerns remained. In particular, that proposed section 815-130(4) does not appear to have an equivalent in the OECD Guidelines.[67]

2.80 Subsection 815-130(4) of the Bill provides for one of the exceptions to the basic rule:

> (4) Despite subsection (1), if independent entities dealing wholly independently with one another in comparable circumstances would not have entered into commercial or financial relations, the identification of the arm's length conditions is to be based on that absence of commercial or financial relations.

2.81 CTA shares GE's concern about the perceived inconsistency of proposed section 815-130(4) with the OECD TPGs, stating:

> … proposed sec 815-130(4), which deals with instances where independent entities dealing with each other at arm's length would not have entered into any transactions with each other at all, has no equivalent rule in the OECD Guidelines. It is not

64 The Treasury, *Submission 16*, p. 8.
65 The Treasury, *Submission 16*, p. 8.
66 GE, *Submission 2*, p. 1.
67 GE, *Submission 2*, p. 1.

> entirely clear what this provision is attempting to achieve but if, as we have been assured, the aim of Schedule 2 of the Bill is no more than to import the OECD Guidelines into the Australian domestic law, then it should not include provisions that are not to be found in the OECD Guidelines.[68]

2.82 The Institute of Chartered Accountants Australia (ICAA) argues that the Bill 'appears to provide for a broader application for the reconstruction of transactions than was intended' by the OECD TPGs.[69]

2.83 Some submitters argue that the Bill may enable the Commissioner of Taxation to make changes to transactions in a wider range of circumstances than the 'exceptional circumstances' envisage in the OECD TPGs. They argue that these provisions should be removed or at least qualified.[70] CTA asserts that:

> The scope of the Commissioner's power to reconstruct actual transactions appears to be very broad and to go beyond what is contemplated by the OECD Guidelines. Heavy reliance is placed on the Explanatory Memoranda and guidance material to read down the words in the Bill so as to align the Bill to OECD principles. However, the Courts have recently down played the role of Explanatory Memoranda in statutory interpretation, and there is a significant risk that the Commissioner will use this power routinely in circumstances other than the 'exceptional circumstances' the OECD contemplates.[71]

2.84 Similarly, Deloitte argues that any reconstruction rule in the legislation 'should be explicitly limited to the exceptional circumstances prescribed in the OECD Guidelines'. Deloitte acknowledged that the Government has amended the EM to include reference in paragraph 3.94 to the exceptional circumstances 'discussed in the OECD Guidelines in the context of non-recognition and alternative characterisation of certain arrangements or transactions'. However, Deloitte remains concerned that no corresponding amendments were made to the Bill, and recommends that 'explicit rules be incorporated Subdivision 815-B to reflect the positions stated in paragraphs 3.94 … to allow for clear interpretation of the law'.[72]

68 CTA, *Submission 7*, p. 2.
69 Institute of Chartered Accountants Australia (ICAA), *Submission 8*, p. 1.
70 For example, see KPMG, *Submission 9*, pp. 2-3; PricewaterhouseCoopers, *Submission 10*, p. 2;
71 CTA, *Submission 7*, p. 2.
72 Deloitte, *Submission 12*, p. 1.

2.85 The LCA also did not support the Commissioner having wider powers in relation to reconstruction, arguing that:

> Reconstruction of transactions is an arbitrary exercise liable to result in double taxation. The LCA considers that in certain cases it may be necessary to go beyond the contractual terms and examine the functions, assets and risks to identify the real transaction. However, that should be no warrant for substituting some allegedly more commercially realistic arrangement for that agreed by the parties.[73]

2.86 The ICAA maintains that the relevant paragraphs in the OECD TPGs 'are clearly directed at tax administrations seeking to review transfer prices and make it clear that the review should be of the "actual transactions undertaken". The ICAA does not believe that they were drafted with a view for inclusion in domestic legislation.[74] It submitted that:

> Where reconstruction is considered necessary in line with the OECD TPGs, our members are of the view that the ability to reconstruct should only be relevant on determination by the Commissioner where the basis for the determination is clearly set out. The current drafting of the Bill requires taxpayers to self assess a reconstruction of a transaction which is an overly complex and unnecessary exercise.[75]

2.87 The ICAA cautions that uncertainty surrounding this provision could 'heighten the risk of double taxation and increase the compliance burden…', which could negatively affect international perceptions of Australia's desirability as a location for capital investment.[76]

2.88 In addressing concerns raised by submitters on this matter, the Treasury emphasises that the concept of the arm's length principle is at the core of the OECD material, stating:

> The internationally accepted articulation of this principle is in paragraph 1 of Article 9 of the OECD Model Tax Convention on Income and Capital and is replicated in all of Australia's treaties. This reference is replicated in the Explanatory Memorandum at 2.19 and the OECD guidelines at paragraph 1.6.[77]

73 LCA, *Submission 4*, pp. [6]-[7].

74 ICAA, *Submission 8*, p. 3.

75 ICAA, *Submission 8*, p. 4.

76 ICAA, *Submission 8*, p. 4.

77 The Treasury, *Submission 16*, p. 9.

2.89 In its submission, the Treasury explained that the reconstruction of actual dealings is a 'key feature of all modern transfer pricing regimes'. It states:

> The non-recognition and substitution (commonly referred to as 'reconstruction') of actual dealings or arrangements is one way of achieving an arm's length outcome consistent with the arm's length principle.[78]

2.90 The Treasury maintains that the Bill does not introduce a broad reconstruction power. It argues that the proposed rules on reconstruction 'draw directly upon the language used in the OECD guidelines'. It further noted that proposed subsection 815-130 has a subheading 'exceptions' to cover a number of possible interpretations of the rules.[79] The Treasury states:

> Rather, the ability to reconstruct dealings or arrangements under the proposed rules is entirely consistent with the OECD guidelines, which only permit reconstruction in 'exceptional circumstances'. Examples of 'exceptional circumstances' are described by the OECD as instances where:
>
> - the economic substance of the arrangements does not match the legal form; and
> - where the arrangements, viewed in their totality, differ from those which would have been entered into by independent enterprises acting in a commercially rational manner.[80]

2.91 The Treasury noted other submitters' contentions that the OECD TPGs 'only contemplate non-recognition of arrangements where other arrangements are substituted in their place'. However, the Treasury emphasises that:

> … the clear focus of the arm's length principle is on determining what independent entities would have done in the place of the parties. As such, if independent entities simply would not have entered into any arrangements at all, non-recognition (and substitution with *no* arrangements) is entirely consistent with the OECD guidelines.
>
> It is important to note that this rule only has application where it can be demonstrated that independent entities would not have done anything. This imposes a high threshold because in any

78 The Treasury, *Submission 16*, p. 9.

79 The Treasury, *Submission 16*, p. 9.

80 The Treasury, *Submission 16*, p. 9.

> instance where an alternative set of arrangements or dealings can be postulated, subsection 815-130(4) cannot apply.[81]

Conclusion

2.92 The significant growth in MNEs operating across a number of countries—and consequently different tax jurisdictions—has necessitated the development of methodologies to assist countries to ensure that an appropriate amount of tax is being received by a given country to reflect that country's contribution to the relevant commercial transactions. There is a risk that if multinational groups operating various associated enterprises are only subject to domestic law, their operations could be arranged in such a way that mean they could avoid paying appropriate amounts of tax, or could be subject to double taxation. Consequently, countries enter into tax treaties and international guidelines are developed.

2.93 The OECD takes the view that this issue cannot be effectively dealt with by a single country and that a broader international approach must be taken. Accordingly, the group developed the *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD TPGs).[82]

2.94 The OCED TPGs provide guidance on the application of the 'arm's length principle', the approach to be taken when evaluating the transfer pricing of associated enterprises, i.e. attributing a value, for tax purposes, of cross-border transactions between associated enterprises. The arm's length principle aims to treat the parties to a transaction as if they were independent, and to assess what the tax outcomes would have been in that case.

2.95 The OECD TPGs are widely recognised as providing international best practice on transfer pricing and application of the arm's length principle. The Australian Government aims to align Australia's transfer pricing rules in the *Income Tax Assessment Act 1997* (ITAA 1997) with international best practice through Schedule 2 of the Bill.

2.96 The committee agrees that rather than a simple wholesale incorporation of the OECD TPGs it is appropriate to consider and apply them to the Australian context. While it is clear that the OECD TPGs are currently the best thinking on transfer pricing, the provision for guidance material also

81 The Treasury, *Submission 16*, p. 10.

82 OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, 22 July 2010.

allows for reference to other material as international developments are made in relation to transfer pricing methodologies.

2.97 The Committee considers that ‘reconstruction’ powers are a necessary part of all modern transfer pricing regimes. These amendments incorporate reconstruction powers under the heading ‘Exceptions’, consistent with the OECD TPGs and the overall objective of determining the most appropriate arm’s length outcome.

2.98 The language in the Bill and the EM draws significantly on the OECD TPGs. Furthermore, the Bill includes a specific requirement that the core principle of ‘arm’s length conditions’ be determined to ensure consistency with the OECD TPGs.

2.99 The committee notes the Treasury’s advice that that it has drawn significantly from the OECD TPGs in the language used in the Bill, and have created a ‘direct legal pathway’ by requiring that the central concept of the arm’s length principle is determined consistently with the OECD TPGs.

2.100 It is clear that the OECD TPGs, and the core principle of applying arm’s length conditions to associated enterprises in respect of financial transactions, are reflected in the Schedule 2 amendments in the Bill and expanded on in the EM.

Time limits to amend assessments

Background

2.101 Under the current tax laws, the Commissioner has an unlimited period to amend an assessment to give effect to a transfer pricing adjustment under Division 13 of the ITAA 1936, the tax treaty transfer pricing provisions, or Subdivision 815-A of the ITAA 1997. Specific time limits in relation to transfer pricing adjustments are also provided for in some tax treaties.

2.102 The proposed sections 815-150 and 815-240 in the ITAA 1997 provide that the Commissioner can amend assessments in relation to transfer pricing calculations, for a seven year time period after the day on which the Commissioner gives notice of the assessment to the entity. As is currently the case, some tax treaties will continue to impose specific time limits in relation to transfer pricing adjustments.

2.103 The Assistant Treasurer, in the second reading speech, outlined the introduction of the seven year time limit, stating:

> The new rules also introduce a time limit in which the commissioner may amend a taxpayer’s assessment to give effect to

a transfer pricing adjustment. Under the previous rules, the commissioner had an unlimited period in which to amend an assessment. These rules reduce this period to seven years.[83]

Analysis

2.104 GE commended the introduction of a time limit for the Commissioner of Taxation to make transfer pricing adjustments.[84] However, GE and other submitters felt that the seven years was not justified, and argue that the time limit should align with the four year period applicable to general income tax assessments.[85]

2.105 The American Chamber of Commerce in Australia comments that the transfer pricing adjustment period in many jurisdictions 'is considerably shorter than seven years'.[86]

2.106 Similarly, PricewaterhouseCoopers supports a four year limit, referring in its submission to a survey performed by the OECD's Forum on Tax Administration that revealed that 'the average resolution of transfer pricing cases (amongst 43 OECD and non-OECD countries) was 540 days'.[87]

2.107 PricewaterhouseCoopers comments that their view was supported by the Inspector General of Taxation's findings in the *Review into improving the self assessment system*, which recommended:

> To improve the certainty in relation to the review of transfer pricing matters, the Government should consider providing the same period of review for these matters as exists for the general period of review. [Recommendation 3.10][88]

2.108 In its response to the Inspector-General's recommendation, the ATO indicated that that was a matter for the Government.[89]

2.109 CTA argues that the proposed seven year limit was too long, and for a four year limit for transfer pricing adjustments, 'the same as other tax

83 The Hon David Bradbury MP, Assistant Treasurer, *House of Representatives Hansard*, 13 February 2013, p. 11.

84 GE, *Submission 2*, p. 2.

85 See for example: ICAA, *Submission 8*, p. 1; KPMG, *Submission 9*, p. 4; PricewaterhouseCoopers, *Submission 10*, p. 2; and Deloitte, *Submission* 12, Appendix A, p. 1.

86 American Chamber of Commerce in Australia, *Submission 15*, p. 1.

87 PricewaterhouseCoopers, *Submission 10*, pp. 2-3.

88 Inspector-General of Taxation, *Review into improving the self assessment system*, August 2012, p. 89.

89 Inspector-General of Taxation, *Review into improving the self assessment system*, August 2012, p. 89.

matters, some of which can be at least as complex as transfer pricing matters'.[90]

2.110 However, the Treasury indicated that due to their cross-jurisdictional nature, the review of transfer pricing assessments may take considerably longer than a standard adjustment. It set out the reasons for this as follows:

- Transfer pricing audits are typically highly complex in nature and often require substantial time and resources in order to be properly conducted.
- In contrast to many audits that consider individual income years, transfer pricing audits often require the examination of dealings that take place over a number of income years. The general amendment period does not provide sufficient time to conduct multi-period analysis.
- The ATO has advised that obtaining the information required to conduct transfer pricing audits is typically more difficult and time consuming than for other matters. This issue is exacerbated by the cross-jurisdictional nature of transfer pricing because the ability to acquire information can be impeded by resource constraints of tax administrations in other jurisdictions.[91]

Conclusion

2.111 It is important to provide taxpayers with certainty that ATO adjustments to their assessments can only be made within a fixed number of years. The committee notes the Treasury's advice that it can take a number of years to obtain relevant information from some jurisdictions when the ATO is reviewing a transfer pricing assessment for possible adjustment.

2.112 The proposed seven year limit provides greater certainty than the current unlimited period. It strikes an appropriate balance between providing taxpayers with certainty, and allowing the ATO enough time to conduct transfer pricing audits and make an adjustment to a taxpayer's assessment.

90 CTA, *Submission 7*, p. 2.

91 The Treasury, *Submission 16*, p. 11.

Record keeping to support a 'reasonably arguable' position

Background

2.113 General record keeping provisions of tax law currently apply to the transfer pricing provisions.

2.114 The current section 284-15 of Schedule 1 of the *Taxation Administration Act 1953* (TAA 1953) provides for when a matter is 'reasonably arguable':

> A matter is reasonably arguable if it would be concluded in the circumstances, having regard to relevant authorities, that what is argued for is about as likely to be correct as incorrect, or is more likely to be correct than incorrect.[92]

2.115 The proposed changes in Schedule 2 of the Bill will link the record keeping requirements for establishing a reasonably arguable position to administrative penalties if a transfer pricing adjustment is made to a taxpayer's assessment.

2.116 In Schedule 2, proposed subdivision 284-E in Schedule 1 of the TAA 1953 will cover the special rules about unarguable positions for cross-border transfer pricing, including covering the documents required to be kept for the application of subdivisions 815-B and 815-C of the ITAA 1997. In effect, it 'sets out optional record keeping requirements'. The EM outlined that:

> Records that meet the requirements are necessary, but not sufficient to establish a reasonably arguable position for the purposes of Schedule 1 to the TAA 1953.
>
> If the documentation as specified in the Subdivision is not kept in respect of a matter, an entity is not able to demonstrate that it has a reasonably arguable position in relation to that matter for the purposes of Schedule 1 to the TAA 1953.[93]

2.117 To satisfy the requirements of Subdivision 284-E, transfer pricing documentation must be prepared before the lodgement of the relevant tax return. Establishing a reasonably arguable position is one way in which a taxpayer can seek to lower administrative penalties they may incur if their assessable tax is other than that lodged in their tax return, i.e. following an adjustment made by the Commissioner.

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92 Subsection 284-15(1), *Taxation Administration Act 1953*.

93 Explanatory Memorandum, Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013, p. 39.

2.118 In the second reading speech on the Bill, the Assistant Treasurer emphasises that the new rules operate on a self-assessment basis, enabling taxpayers to self-assess their Australian tax position in accordance with the arm's length principle. This self-assessment approach is in keeping with the overall design of the Australian tax system. The Assistant Treasurer states that:

> Specific rules linking voluntary documentation with a reduction in administrative penalties are included under the new rules. This approach balances compliance costs for taxpayers with incentives to adequately document issues relevant to transfer pricing matters. It allows taxpayers to risk assess matters that could be the subject of administrative penalties and prepare documentation accordingly.[94]

Analysis

2.119 The LCA agreed with linking base document obligations to the level of penalties, but was strongly opposed to having document obligations as a 'pre-condition to demonstrating a reasonably arguable position', stating:

> The assessment of whether a taxpayer has a 'RAP' [reasonably arguable position] is an objective inquiry that ought not be pre-judged by reference to the level of documentation …[95]

2.120 CTA described the documentation requirements as 'quite onerous', submitting that:

> The standard and scope of the documentation required to meet the requirements of the Bill is very high. Given the significant adverse consequences of having documentation that does not meet these strict requirements, the time frame allowed for document preparation is extremely limited and should be extended.[96]

2.121 PricewaterhouseCoopers took the view that while taxpayers may have made an assessment of their 'reasonably arguable' position, they may not have prepared formal transfer pricing documentation by the time of lodging their tax return. They made two suggestions to improve the operation of the record keeping requirements in relation to a taxpayer establishing a reasonably arguable position:

- to allow for documentation to be provided within 90 days of a requestion from the ATO; and

94 The Hon David Bradbury MP, Assistant Treasurer, *House of Representatives Hansard*, 13 February 2013, p. 11.

95 LCA, *Submission 4*, p. [8].

96 CTA, *Submission 7*, p. 2.

- the ATO to provide guidance, as a matter of priority, on how they will assess whether a taxpayer's transfer pricing documents meets the requirements of proposed subsection 284-255 of the TAA 1953, to ensure taxpayers have a clear understanding of what will be required to establish a reasonably arguable positions in relation to the transfer pricing arrangements.[97]

2.122 The EM states that 'while the Subdivision does not mandate the preparation or keeping of documentation, failing to do so prevents an entity from establishing a reasonably arguable position'.[98] However, this point is qualified in the EM:

> Establishing a reasonably arguable position is one avenue through which an entity can lower administrative penalties. However, nothing in these amendments prevents the Commissioner from exercising a general discretion to remit administrative penalties where appropriate (as currently available under the law).[99]

2.123 The Treasury outlined that under current administrative practice, the Commissioner will generally reduce administrative penalties in cases where a taxpayer has prepared documentation in accordance with ATO Tax Ruling 98/16. The Treasury comments that 'the proposed record keeping rules, including the nature of the documentation, are consistent with the approach taken in that ruling and therefore should be familiar to taxpayers'.[100]

2.124 In its submission, the Treasury states that linking the preparation of transfer pricing documentation to establishing a reasonably arguable position leaves it at the taxpayer's discretion to prepare documentation for transactions for which they believe there is a higher risk of a transfer pricing adjustment being made by the Commissioner of Taxation. The Treasury states:

> This approach provides an incentive for taxpayers to evaluate their cross-border dealings and prepare documentation in respect of matters that they consider to be at risk of transfer pricing adjustments. Allowing taxpayers to determine which matters, if any, should be documented provides appropriate flexibility for smaller taxpayers and taxpayers with low-risk dealings to self-

97 PricewaterhouseCoopers, *Submission 10*, p. 2.

98 Explanatory Memorandum, Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013, p. 36.

99 Explanatory Memorandum, Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013, p. 36.

100 The Treasury, *Submission 16*, p. 12.

> assess whether transfer pricing documentation is needed to support their cross-border dealings.[101]

2.125 The Treasury also noted that special *de minimis* rules will also apply to exempt transfer pricing adjustments under certain thresholds from administrative penalties. It submitted:

> These thresholds provide additional protection to smaller taxpayers. The transfer pricing thresholds are directly linked to the general thresholds under the law, ensuring that they will be automatically updated by any changes to the general thresholds.[102]

Conclusion

2.126 The reporting requirements will not be mandatory. Linking the preparation of transfer pricing documentation to establishing a reasonably arguable position leaves it at the taxpayer's discretion to prepare documentation for transactions for which they believe there is a higher risk of a transfer pricing adjustment being made by the Commissioner of Taxation.

2.127 The Commissioner of Taxation will continue to have 'broad discretion to remit penalties where tax payers have not prepared documentation', and that further protection for taxpayers is afforded to exempt transfer pricing adjustments under certain thresholds.

Overall conclusion

2.128 Schedule 1 of the Bill aims to ensure that Part IVA of the ITAA 1936 can continue to counter schemes that comply with the technical requirements of the law, but upon objective examination are clearly engineered to avoid tax. It is appropriate for Government to legislate for weaknesses in existing taxation legislation that have been revealed by recent decisions of the courts against the Commissioner of Taxation. The amendments in Schedule 1 are an appropriate, reasoned and measured response to these identified weaknesses in the legislation.

2.129 Schedule 1 provides that the Commissioner may use either the annihilation or reconstruction approach to cancel a tax benefit. This is appropriate as it will enable the Commissioner to protect legitimate revenues that may otherwise be at risk. The committee does not accept that there is any lack of clarity in how these provisions will operate, or that

101 The Treasury, *Submission 16*, p. 12.

102 The Treasury, *Submission 16*, p. 12.

they will require businesses to pay more tax than is fair or negatively affect commercial activities. These provisions will enable the Commissioner to objectively and reasonably enforce tax avoidance measures and collect revenue to which the Commonwealth is entitled under the law.

2.130 Schedule 2 of the Bill is vital to modernise Australia's transfer pricing rules and bring these into line with accepted international arm's length principles recommended by the OECD. The committee agrees that rather than a simple wholesale incorporation of the OECD TPGs, it is appropriate to consider and apply them to the Australian context.

2.131 It is clear that the OECD TPGs are currently the 'best thinking evident in transfer pricing' and the committee notes the advice from the Treasury that it has drawn significantly from the OECD TPGs in the language used in the Bill.

2.132 The committee considers that 'reconstruction' powers in exceptional circumstances are a core part of modern transfer pricing regimes. The Bill implements these powers consistently with the OECD TPGs.

Recommendation 1

2.133 **The House of Representatives pass the Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013 as proposed.**

Julie Owens MP
Chair
8 March 2013