

# *Pricing Knowledge Network*

Focusing on the impact of major intercompany pricing issues

March 27, 2012

## *PKN Alert / TCDR Alert Australia - Analysis of exposure draft of treaty-equivalent transfer pricing rules*

A Transfer Pricing  
Publication

Further to our PKN Stop Press article dated [16 March 2012](#), which briefly summarised the [Exposure Draft](#) (ED) on a proposed retrospective amendment to Australia's transfer pricing rules, this article provides a more detailed analysis of the ED and its potential implications for Australian taxpayers.

There are several highly controversial aspects of the proposed changes, including:

1. Retrospective application from 1 July 2004;
2. Discrimination against tax treaty partner countries;
3. Expanding the taxing powers available to the Commissioner of Taxation (the Commissioner) by introducing a new domestic taxing power in addition to the existing taxing powers held under Division 13 and, according to Treasury and the Commissioner, under Australia's Double Tax Agreements (DTAs);
4. Potentially enabling the Commissioner to 'reconstruct' transactions between Australian entities and related parties in DTA countries;



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5. Incorporation of certain OECD guidance into the Australian transfer pricing rules on a selective basis, which could pave the way for the Commissioner to only adopt OECD guidance when it suits the Australian Taxation Office (ATO);
  6. Creating a further divide between the application of Australia's transfer pricing rules (with a profit outcomes emphasis) and the imposition of customs duty (which is applied on a transactional basis); and
  7. Only partially addressing issues relating to branch profit attribution, in a way that is likely to increase complexity and uncertainty for Australian branches of foreign companies.

According to Treasury, the purpose of the proposed changes is to clarify the operation of the existing law. In our opinion, far from offering clarity, the proposed changes are likely to increase complexity and uncertainty for Australian taxpayers.

## *Introduction*

The retrospective changes proposed in the ED are the first of two stages of reforms to the Australian transfer pricing rules. The second stage will be a set of new prospective transfer pricing rules (to replace the current rules in Division 13). A draft of the new prospective rules is expected to be released in the coming months. The transfer pricing reforms were initiated due to perceived deficiencies in the existing law on the part of the Australian Taxation Office (ATO) and Treasury. The Commissioner's loss in the SNF case in the Full Federal Court in 2011 was a key trigger that prompted Treasury's review of the transfer pricing rules.

The ED introduces a new Subdivision of the Income Tax Assessment Act 1997 – Subdivision 815-A – which will apply retrospectively from 1 July 2004. The intention of the proposed law was to 'clarify' that the Commissioner holds a taxing power under Australia's double tax agreements (DTAs), but the ED has been drafted in a way that will give the Commissioner a new power to issue transfer pricing assessments under the domestic tax law.

The key difference between Subdivision 815-A and the existing transfer pricing rules in Division 13 is the way they each apply the arm's length principle. Division 13 applies the arm's length principle by testing whether the price of specific transactions is arm's length, whereas Subdivision 815-A applies the arm's length principle by testing whether arm's length profits have accrued. Interpretation of Subdivision 815-A requires consideration of transactional as well as profit based transfer pricing methods, so transactional methods will still be applicable in cases where comparable transaction data is available that is at least as reliable as data available for applying profit based methods.

The proposed changes outlined in the ED are most likely to impact Australian taxpayers who engage in transactions with related parties in DTA countries *and* are at risk of ATO scrutiny due to factors such as:

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- Poor profitability in Australia during the period from 2004 to 2012, either at a whole of entity level or in specific parts of a taxpayer's business;
  - Significant amounts of debt borrowed from related parties, for example a debt amount that is close to the thin capitalisation safe harbour and/or debt giving rise to interest expenses that turn a profit before interest and tax into net a loss before tax; or
  - Cross-border business restructuring.

The impact could be particularly significant for taxpayers who are already under review or audit by the ATO. These taxpayers may need to revisit their audit defence strategies, especially if they are relying on a transaction based method to support their transfer pricing position.

There will also be many taxpayers for whom the changes will not have a major impact, such as companies who have prepared transfer pricing documentation which is consistent with OECD guidance and whose profits are likely to be accepted by the ATO as 'commercially realistic', or taxpayers who have agreed their transfer pricing arrangements with the ATO in an Advanced Pricing Arrangement.

### *Is this a clarification or retrospective law?*

The [media release](#) and [explanatory memorandum](#) (EM) accompanying the ED maintain the view that the proposed new provisions represent a 'clarification' to confirm that the existing law already provides the Commissioner a taxing power under Australia's DTAs. The EM indicates that Parliament has repeatedly referenced this view, with the most recent reference occurring in 2003; hence the proposed effective date of 1 July 2004.

### *PwC observations:*

In our view, this is clearly a retrospective change to the law and not a clarification of the existing law. Parliament has never explicitly confirmed that DTAs provide a power to impose tax. The Parliamentary reference mentioned in the EM did not, in any way, make it clear that Parliament intended Article 9 of Australia's DTAs to provide the Commissioner with a taxing power. Furthermore, although the question of whether Article 9 of Australia's DTAs provides a taxing power has not been directly tested in court, observations have been made in numerous court cases which confirm that DTAs do not operate independently of domestic rules and do not provide a separate source of assessment power.

Most importantly, while the intention of the proposed law was to 'clarify' that the Commissioner holds a taxing power under Australia's DTAs, the ED has been drafted in a way that will give the Commissioner a *new* power to issue transfer pricing assessments under the domestic tax law. In our view, this makes it clear this new law is retrospective.

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## *What are the criteria for when the new provisions can apply?*

The Commissioner will be able to make a determination using the taxing power under Subdivision 815-A if, in any income year beginning on or after 1 July 2004:

- an Australian entity is subject to Article 9 (Associated Enterprises) or Article 7 (Business Profits) of a relevant DTA;
- the Australian entity has received a “transfer pricing benefit”; and
- the transfer pricing benefit arose due to non-arm’s length conditions that exist between the entity and the related party.

A transfer pricing benefit under Article 9 is defined as a shortfall in actual profits (ie taxable income) compared to the profits which might have been expected to accrue if the parties had been dealing at arm’s length. A transfer pricing benefit may exist under Article 7 if the profits attributed to an Australian branch of a foreign company are less than the profits that the branch might be expected to make if it were a separate entity dealing at arm’s length.

The definition of “conditions” between the parties is tied directly to the relevant DTA.

A provision is also included which enables the Commissioner to make consequential adjustments following a determination under Subdivision 815-A. For example, if the Commissioner applies Section 815-30 to reduce a taxpayer’s royalty expenses paid to a related party, then the Commissioner may also make a determination to apply Section 815-45 to reduce the amount of withholding tax payable on the royalty.

### *PwC observations:*

In order for the associated enterprises article of a DTA to apply to dealings between two parties, there must be a relationship between the parties arising from direct or indirect common management, control or capital of the parties. In this respect, Subdivision 815-A will have narrower application than Division 13, which can apply to dealings between completely independent parties if those dealings have been conducted on a non-arm’s length basis. Until the new prospective transfer pricing rules are introduced, Division 13 will continue to apply to related party dealings with non-DTA countries and non-arm’s length dealings between independent parties.

The focus on profits derived from dealings between the parties is a clear shift in emphasis from Division 13 which tests whether the consideration for specific transactions is arm’s length. Where this leads to more ATO transfer pricing adjustments determined using profit based methods which cannot be clearly traced to specific transactions, this will further the divide that already exists between the transfer pricing and customs duty rules. There is no provision that automatically allows the customs value (and duty payable) for imported goods to be adjusted following an ATO transfer pricing adjustment. The transfer pricing and customs rules are contained in different Acts and are administered by different government departments, so there are legal and administrative issues to overcome for taxpayers

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who seek customs duty refunds where the transfer price of their imported goods has been adjusted for income tax purposes by the ATO.

Subdivision 815-A is likely to broaden the Commissioner's powers to issue transfer pricing assessments and, potentially, may enable the Commissioner to 'reconstruct' transactions between related parties. Reconstruction of transactions may be possible because the manner in which the Commissioner may go about bringing a 'transfer pricing benefit' to tax is very broad. The Commissioner may adjust any existing income or expense item, and it appears that he may also be able to impute new transactions that did not actually take place. The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD TPG) state that tax administrations should ordinarily respect the actual transactions undertaken by a taxpayer, but it may be appropriate to reconstruct transactions in certain 'exceptional' cases. We understand Treasury's policy intent is that reconstruction would only occur in 'exceptional' cases, as contemplated in the OECD TPG. It remains to be seen whether ATO field officers will conduct audits in a manner consistent with this intent. Clear policies and procedures may be required to ensure the Commissioner will apply the law in line with the policy intent.

The fact that the transfer pricing benefit test is linked directly to a specific DTA seems to suggest that the Commissioner may only issue an assessment under Subdivision 815-A for one specific DTA country at a time. If an Australian taxpayer engages in transactions with related parties in several DTA countries and the Commissioner considers these dealings to be non-arm's length, it appears that the Commissioner would need to issue separate determinations covering the dealings with each country if he chooses to exercise his powers under Subdivision 815-A.

### *Relevant interpretative documents*

Subdivision 815-A will prescribe specific documents that are relevant for interpreting whether a transfer pricing benefit has arisen. A regulation making power will also be created to enable additional documents (in whole or part) to be added to the list of relevant reference materials in the future. Initially, the relevant documents will be the OECD Model Tax Convention (MTC) and the OECD TPG. The ED refers to the 2010 versions of these documents; however, the EM explains that for income years prior to 2012-13, the relevant versions of these documents will be the most recent version published before the start of the relevant income year.

### *PwC observations:*

The incorporation of additional documents by regulation will create uncertainty over the status of new OECD materials unless and until they are prescribed by the regulations. It is not clear to what extent there will be consultation on further documents that could be prescribed by the regulations in the future.

The 2010 OECD report on profit attribution to permanent establishments (the OECD branch report) was not specifically mentioned as a relevant document, although it is mentioned in the 2010 OECD MTC. Accordingly, the extent to which this document can be read as an endorsed view relevant for interpretation of Subdivision 815-A is unclear.

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The requirement to consider versions of the relevant documents that were available during the income year will have interesting consequences. For example, the 2010 version of the OECD TPG contained substantial changes from the previous version. Earlier versions of the guidelines included a hierarchy of transfer pricing methods (with transactional methods preferred and profit based methods considered a 'last resort'). The Commissioner will need to have regard to the earlier guidelines if he chooses to make a determination under Subdivision 815-A in cases involving income years between 2004 and 2010.

It is also important to note that the OECD TPG did not include specific guidance on transfer pricing aspects of business restructures until 2010, when a new chapter dealing with this topic was added to the guidelines. If the Commissioner uses Subdivision 815-A to make an assessment on a cross border business restructure that took place during 2004 to 2010, this effectively empowers the Commissioner to have regard to the relevant DTA without compelling him to have regard to Chapter IX of the 2010 OECD TPG or earlier OECD discussion papers on this topic.

Given the intent of this new legislation (as outlined in the EM) was to maintain international consistency and require the arm's length principle to be interpreted as consistently as possible with relevant OECD guidelines, it is curious that the legislation has been drafted in such a way so as to selectively prescribe all or part of current and future OECD materials. A simpler approach would have been to adopt a blanket rule to reference all OECD ratified guidance.

### *Interaction with thin capitalisation rules*

The ED specifically refers to situations where Division 820 (about thin capitalisation) applies to transactions between related parties. The ED proposes that the interest rate on a debt instrument should be determined so as to best achieve consistency with the DTA, OECD MTC and OECD TPG. The ED clarifies that it may be appropriate to determine the interest rate based on a reduced amount of debt (ie an arm's length amount of debt), if that best achieves consistency with the DTA and OECD guidance. This rate should then be applied to the actual value of the debt instrument (subject to limits on the amount of debt under Division 820).

### *PwC observations:*

There has been ongoing speculation about potential changes to the thin capitalisation safe harbour for some time. It has been clear for many years that some stakeholders within the ATO consider the current safe harbour debt to equity ratio of 3:1 to be too generous. There are strong rumours that the thin capitalisation rules will be reviewed in the near future, and a reduction in the safe harbour is likely. In the interim, there may be some uncertainty over the interaction of Subdivision 815-A with the thin capitalisation rules.

According to the EM, the specific comments on interaction with Division 820 included in the new transfer pricing provisions are intended to give legal force to the views put forward by the Commissioner in Taxation Ruling (TR) 2010/7. The EM explicitly incorporates language from TR 2010/7; for example by indicating that an arm's length interest rate should be determined having regard to an arm's length

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amount of debt and whether the arrangements “make commercial sense” for the taxpayer. In contrast, the ED refers to achieving consistency with OECD guidance. There are differing views on the extent to which the Commissioner’s views in TR 2010/7 are consistent with OECD guidance, so it is possible the wording proposed in the ED will not achieve the intent set out in the EM.

Arguably the draft provisions could be interpreted as creating a post-interest profits test for Australian taxpayers. Based on current ATO practice, we consider that there is a risk that the ATO would adopt this interpretation if the ED was enacted in its current form.

Taxpayers with related party debt arrangements will need to carefully consider the implications of the proposed changes based on their specific circumstances.

### *Implications for Mutual Agreement Procedure (MAP) cases*

Australia’s DTA’s include a MAP article which enables taxpayers to seek relief from double tax when taxation has occurred which is ‘not in accordance’ with the DTA. The new law is focused on giving effect to Australia’s taxing rights under the DTAs, so the ATO may take the view that any determination made under Subdivision 815-A will always, by definition, be in accordance with the DTA.

### *PwC observations:*

A number of practical issues may arise for taxpayers seeking to obtain relief from double tax based on assessments made by the Commissioner under Subdivision 815-A. Given the retrospective application of Subdivision 815-A, taxpayers will need to ensure the time limits set out in the DTA have not elapsed before requesting MAP relief. If the ATO insists that its position is in accordance with the DTA, taxpayers may be at the mercy of overseas tax authorities to obtain relief from double tax.

We anticipate that difficult MAP situations could arise for:

- Cases where the ATO uses Subdivision 815-A to reconstruct transactions;
- Cases involving dealings with non-OECD member countries, who may not follow OECD guidance in interpreting the DTA articles;
- Branch profit attribution cases with DTA partners who have adopted the approach outlined in the OECD branch report; and
- Cases where an Australian taxpayer has received multiple determinations from the Commissioner for dealings with related parties in several DTA countries.

We note that the ATO has taken its obligation to attempt to resolve double taxation through the MAP process seriously in the past and we hope that this continues in the future for MAP requests arising from Subdivision 815-A assessments.

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## *Treatment of branches*

As mentioned previously, a transfer pricing benefit for the purposes of Subdivision 815-A includes the under-allocation of profits to an Australian branch of a foreign company. Thus, the new law will apply to Australian branches of foreign multinationals. The ED does not cover the allocation of profits to foreign branches of Australian companies.

### *PwC observations:*

The November Treasury consultation paper indicated that a review of the branch profit attribution rules would be considered separately from the review of the transfer pricing rules. The ED has attempted to deal with branch profit allocation issues on a piecemeal basis and the result is a set of rules that is likely to increase confusion for taxpayers conducting business in Australia through branches.

The ED does not specifically address the allocation of profits to foreign branches of Australian companies but it does address the allocation of profits to Australian branches of foreign companies. Presumably the reason the ED does not address the allocation of profits to foreign branches of Australian companies is because the rights to tax these profits under the DTAs are allocated to the treaty partner. Australia is only able to tax this income under its domestic rules.

Under Subdivision 815-A the ATO may be able to explicitly adjust the branch profits if a transfer pricing benefit can be established by reference to the application of Article 7 of the relevant DTA. Given the lack of clarity on whether the OECD branch report will be 'relevant' for interpreting Subdivision 815-A, taxpayers may be concerned that the ATO will follow the OECD guidance selectively, that is, only when it produces a favourable outcome for the Commissioner.

It is unclear how long foreign branches of Australian companies will need to wait before any further clarity is provided to them in relation to any possible alignment with OECD attribution principles. This may come as a surprise to many foreign observers as Australia is an OECD member and did not make any relevant reservations to the new version of Article 7 included in the 2010 OECD MTC.

### *Conclusion*

Despite the strong objections that the business community raised to the proposed retrospective changes when they were announced in 2011, the Government appears to be intent on pushing the changes through Parliament.

Taxpayers who believe they are likely to be impacted by the changes, especially those who are already under ATO scrutiny, should carefully consider how the proposed changes will impact their position. We will strongly encourage Treasury to provide relief from penalties for any retrospective assessments issued under Subdivision 815-A after the new law is enacted.

PwC is preparing a submission to respond to the ED. The due date for submissions is 13 April 2012. If you have any specific matters you would like us to consider in our submission, please contact us.

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