



Australian Government

The Treasury

Income tax: cross border
profit allocation

Review of transfer pricing
rules

Consultation Paper
1 November 2011

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CONSULTATION PROCESS

Request for feedback and comments

Interested parties are invited to comment on the broad principles contained in this Consultation Paper. While submissions may be lodged electronically or by post, electronic lodgement is preferred. For accessibility reasons, please submit responses sent via email in a Word or RTF format. An additional PDF version may also be submitted.

All information (including name and address details) contained in submissions will be made available to the public on the Treasury website unless you indicate that you would like all or part of your submission to remain in confidence. Automatically generated confidentiality statements in emails do not suffice for this purpose. Respondents who would like part of their submission to remain in confidence should provide this information marked as such in a separate attachment. Legal requirements, such as those imposed by the *Freedom of Information Act 1982*, may affect the confidentiality of your submission.

It is expected that further feedback and comments will be requested during the legislative drafting process.

Closing date for submissions: 30 November 2011

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INTRODUCTION

Transfer pricing rules are designed to make sure Australia receives an appropriate share of tax from multinational firms; ensuring tax is based on profits reflecting the economic activity attributable to Australia in accordance with the arm's length principle. An important consideration in designing these rules is that they should not unreasonably inhibit Australia's attractiveness as a destination for new investment and business activity.

While the transfer pricing rules in Division 13 of the *Income Tax Assessment Act 1936* have been unchanged for some time, international thinking and business practices on transfer pricing have evolved significantly since their introduction in 1982.

In 2010 the OECD released revised *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*. This contained a number of changes to the internationally accepted approach to transfer pricing. In recent years, the judicial opinion in transfer pricing cases such as *Re Roche* and *ECT v SNF* has highlighted differences between the meaning of the domestic rules and the internationally accepted arm's length principle.

This consultation paper highlights a range of issues with Australia's transfer pricing rules. The principal focus is on the extent to which the domestic legislation and the treaty rules should align with international standards. In particular:

- Can the arm's length principle be better reflected in domestic transfer pricing rules?
- How can we best promote interpretation of domestic rules consistently with international guidance used by our major investment partners?

Australian tax treaties contain profit allocation rules based on the OECD Model Tax Convention on Income and on Capital. The paper also seeks views on these rules. Can Australia's treaty practice be better aligned with the international standards in the OECD Model?

In determining the profits of permanent establishments, what are the implications for both our treaty rules and domestic laws if Australia is to move to a functionally separate entity approach?

Another important design issue raised in the paper is a move to self-assessment of transfer pricing issues, which has implications for existing discretions, record keeping, documentation, and time limits for amendments.

The paper also canvasses whether an approach of requiring guidance in the OECD Model *Commentaries* should be extended beyond transfer pricing to enable the *Commentaries* to be taken into account in interpreting and applying other treaty articles.

Comments are sought on the broad principles contained discussed in this consultation paper by 30 November 2011. It is expected that there will be further opportunities to comment on draft legislation.

GLOSSARY

International Tax Agreements Act 1953 (Cth) ('the Agreements Act')

OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, 1995 ('the 1995 OECD Guidelines')

OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, 2010 ('the 2010 OECD Guidelines')

- In this document 'the OECD Guidelines' is used to more generically refer to the Guidelines produced in 1995 and updated in 2010

OECD, *Model Tax Convention on Income and on Capital* ('OECD MTC')

Review of Business Taxation, *A Tax System Redesigned*, Canberra, 1999 ('the Ralph Review')
<http://www.rbt.treasury.gov.au/publications/paper4/index.htm>

Treasury, *Review of Unlimited Amendment Periods in the Income Tax Laws*, Discussion Paper, August 2007,
<http://www.treasury.gov.au/documents/1298/PDF/Reviewofunlimitedamendmentperiods.pdf>

CROSS BORDER PROFIT ALLOCATION

1. Most developed economies have comprehensive ‘transfer pricing’ or cross-border ‘profit allocation’ rules. In Australia, Division 13 of the *Income Tax Assessment Act 1936* provides for the substitution of an arm’s length consideration in respect of international dealings in the calculation of the taxable income of multinational enterprises.
2. While the role of such rules is often seen as limiting the erosion of the tax base through profit shifting, they perform an equally important role for investors and treaty partner governments by clarifying the rules for cross border profit allocation and ensuring broad parity between the tax treatment of multinational enterprises and businesses that operate entirely domestically. These rules need to be sufficiently robust to protect the Australian tax base—but they also need to be balanced so as not to overreach or impose transaction costs which may inhibit Australia’s international competitiveness.

Profit allocation and the arm’s length principle

In accordance with the arm’s length principle as articulated in the OECD MTC,¹ the ultimate goal of the profit allocation rules is to ensure an arm’s length outcome for each party, reflective of their relative overall economic contributions, by allocating profits consistently with the conditions that would most likely have operated between independent parties in comparable circumstances. While in practice this may be achieved by determining the arm’s length price for particular transaction(s), the consideration of a transfer price for a transaction seen in isolation may not always address the broader arm’s length principle as required by our treaties.

PURPOSE OF THE REVIEW

3. The purpose of this review is to consider revisions to Australia’s cross border profit allocation rules in the light of recent experience with their operation. The review will ensure these rules reflect international best practice so that the contribution of Australian economic activity of multinationals to their overall group profit is appropriately rewarded, and taxed in Australia, in a manner that is consistent with internationally accepted transfer pricing principles and concepts. These reforms are also necessary to provide certainty for multinational enterprises that will benefit from rules which are consistent with the frameworks adopted by other jurisdictions.
4. Importantly, litigation has highlighted some aspects of Division 13 requiring review: in particular the extent to which the domestic legislation is consistent — or otherwise — with the internationally accepted arm’s length standard; it has also highlighted the need for clarifying the role of the OECD guidance. Arguably, the current rules need to be refreshed in the light of the 2010 updates to the OECD Guidelines which contain important changes to the way the international community approaches cross border profit allocation.

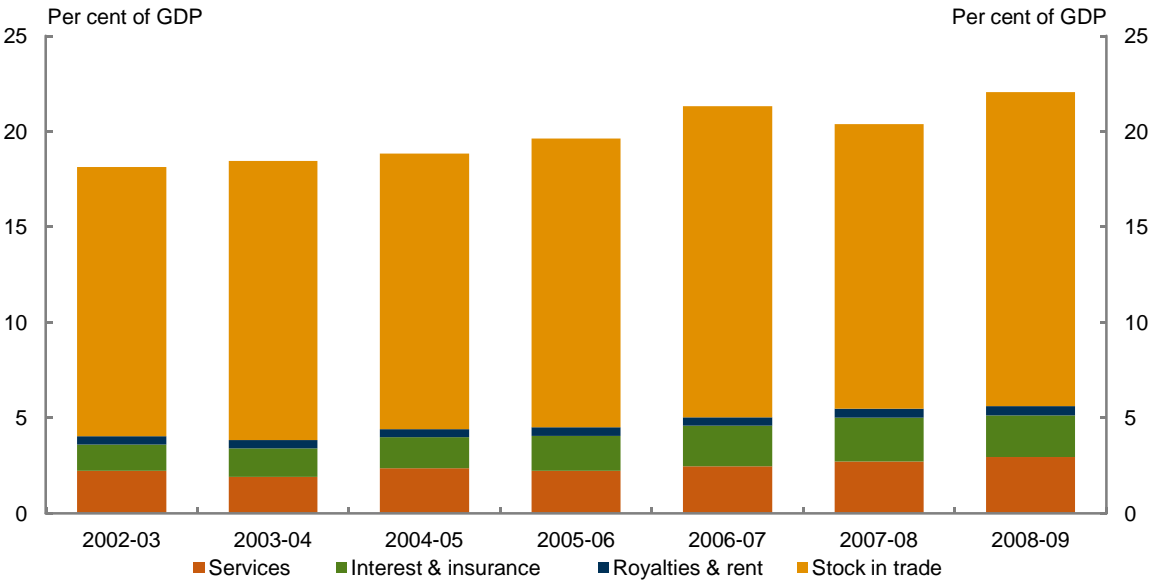
1 Paragraph 1 of Article 9 (Associated Enterprises) of the OECD MTC is described in the OECD Guidelines as the ‘authoritative statement’ of the arm’s length principle. All of Australia’s comprehensive tax treaties incorporate an Associated Enterprises article similar to that in the OECD MTC. Article 7 (Business Profits) addresses inter-branch profit allocation.

5. In addition, a range of issues arising from the Ralph Review are yet to be addressed. Among its more significant recommendations the Review proposed that transfer pricing rules apply on a self assessment basis (Rec 22.12). The issue of amendment periods for transfer pricing adjustments should also be reviewed.

INTRA-FIRM TRADE IS INCREASING

6. The importance of intra-firm trade (over \$270 billion of related party dealings in 2009) underscores the significance of the profit allocation rules. According to ATO data, intra-firm trade is now around 50 per cent of total Australian cross border trade in goods and services.

Figure 1: Selected related party dealings represented as a proportion of GDP²



7. Figure 1 above shows that intra-firm trade was equivalent to more than 20 per cent of GDP in 2009. While stock in trade is the largest component of intra-firm dealings, the areas of intra-firm trade that have experienced the most significant growth relate to interest and insurance, and services components, both of which have more than doubled over this period. The functions, assets and risks associated with these high growth components are highly mobile.

² GDP statistics sourced from ABS data released May 2011; *5352.0 - International Investment Position, Australia: Supplementary Statistics, Calendar year 2010*; <http://www.abs.gov.au/AUSSTATS/abs@.nsf/DetailsPage/5352.0CalendarYear2010OpenDocument>

Related party dealing amounts sourced from ATO Schedule 25A data (21 Sept 2011) exclude 'other tangible' and 'other intangible disposals and acquisitions, as well as 'all other' amounts. These items represent either capital amounts which are transactional in nature or financial instruments that reflect exposures rather than actual flows.

MULTINATIONAL GROUPS ARE CHANGING THE WAY THEY DO BUSINESS

8. Furthermore, in recent decades, many multinationals have reorganised their supply chains (including the location of their intellectual property) on a global rather than geographic basis. This has generated new challenges. Geographic dispersion of business units in a multinational enterprise means profits derived from cross border intra-firm trade can be allocated between business units according to the corporate strategy of the multinational. In this context profit allocation rules have an important role to ensure that profits are appropriately taxed.
9. In response, the ATO has identified the particular problems posed when multinational businesses reorganise their supply chains or other aspects of their business as a significant concern. For example, the ATO Compliance Plan for 2010-11 notes:

We are concerned about the use of arrangements between Australia and offshore affiliates to shift or shelter profits including: restructuring Australian-based operations to shift functions, assets and risks, on a non-arm's length basis, such as the creation and use of marketing hubs or the sale of intellectual property at nominal prices; paying excessive royalties, interest, guarantee and other fees; Australian headquartered companies providing services to overseas affiliates for a non-arm's length consideration; allocating to Australian businesses income and expenses not consistent with the economic activities conducted here . . .

AUSTRALIA'S PROFIT ALLOCATION RULES

10. Division 13 of Part III of the *Income Tax Assessment Act 1936*³ provides a framework for determining the arm's length consideration for transactions between Australia and a foreign jurisdiction.
11. These rules were last revised in the early 1980s, when Division 13 replaced the former section 136. The revision was prompted by the decision of the High Court in *Federal Commissioner of Taxation v. Commonwealth Aluminium Corporation Limited* 80 ATC 4371. That case identified problems with the control test in the former section 136. To address this Division 13 applies to cases where parties do not deal with each other at arm's length—including where parties may not be associated by ownership or control.⁴
12. As an alternative to Division 13, there is an argument that authority for making or amending profit allocation assessments may also be found in an Associated Enterprises Article (or Business Profits Article for inter-branch allocations) of the relevant tax treaty as incorporated into the domestic law by provisions of the *Agreements Act*. While Division 13 seeks to reflect the arm's length principle as it relates to transactions, the Associated Enterprises Article captures the principle in its broader form which acknowledges the increased levels of integration between related parties and has regard to the arrangements between the parties in their totality and what is required to put them on an independent footing.
13. Review or disputes regarding cross border profit allocation may involve negotiation between governments over the practical application of treaty provisions. These issues frequently have an international law dimension. The Mutual Agreement Procedure rules in tax treaties provide governments with a framework to negotiate over the rights set out in Associated Enterprises or Business Profits articles. The treaty is further supplemented by the OECD MTC Commentary

3 References below are to this Act unless stated otherwise.

4 See *San Remo Macaroni v FCT* (1999) FCA 1468.

and the OECD Guidelines which set out the consensus between OECD Member countries (and other countries which rely on those guidelines in negotiating or applying treaties) for determining how to arrive at an arm's length profit allocation.

INTERNATIONAL RULES HAVE EVOLVED

14. The arm's length principle underpins the treaty provisions and its application is extensively explained in the OECD Guidelines. Together these have profoundly influenced the creation, interpretation and administration of domestic profit allocation rules in OECD and non-OECD countries alike. While the arm's length principle is not without its limitations, it has been internationally adopted by multinational enterprises and tax administrations to determine the allocation of profits between parties that enter into non-arm's length arrangements.
15. This convergence to the OECD standard has helped promote consistency in profit allocation decisions across jurisdictions. In Australia the OECD Guidelines have long formed the basis of administrative guidance on transfer pricing.⁵
16. Comprehensive OECD guidance on transfer pricing was first published as a Report in 1979. Since then it has been comprehensively reviewed and issued as the 1995 and 2010 OECD Guidelines to reflect emerging transfer pricing issues in the dynamic setting of global trade and investment. The 2010 OECD Guidelines included new guidance on selecting the most appropriate transfer pricing method, conducting a comparability analysis and applying the transactional profit methods (that is, the transactional net margin method and profit split method). The 2010 Guidelines replace the earlier hierarchy that gave preference to transactional methods over profit methods with a new 'most appropriate method' standard.
17. The UK's transfer pricing provisions,⁶ and the OECD's suggested transfer pricing legislation,⁷ each contain features which may be attractive in an Australian context. Elements of each of these legislative schemes are discussed below.

ADMINISTRATION AND PRACTICE HAS ALSO EVOLVED

18. The ATO continues to work with the OECD, other international bodies, industry and the tax profession in Australia to reach consensus on increasingly complex transfer pricing issues as they come to light.
19. The ATO has issued an extensive series of tax rulings and practice statements to flesh out the practical application of the transfer pricing rules in Australia, consistent with OECD guidance.
20. It has also established a program of forward compliance agreements (generally referred to as Advance Pricing Arrangements or APAs) that allow taxpayers and the relevant tax authorities to agree to a framework based on the arm's length principle but tailored to the taxpayer's

5 See for example: Taxation Rulings TR 94/14; TR 97/20; TR 2000/16.

6 Taxation (International and Other Provisions) Act 2010 (UK), Chapter 8, Part 4

7 OECD, *Transfer Pricing Legislation – A Suggested Approach*, June 2011
<http://www.oecd.org/dataoecd/41/6/45765682.pdf>.

particular facts and circumstances to determine how a multinational enterprise will allocate profits between Australia and other countries.

21. The ATO actively exchanges information with other tax authorities under Australia's treaty arrangements in order to arrive at a proper arm's length allocation of profits from cross border dealings. The ATO also works with the Joint International Tax Shelter Information Centre (JITSIC) and partner tax administrations on intelligence and strategy, and has begun conducting joint audits on transfer pricing matters.

LITIGATION: ROCHE AND SNF

22. Recent litigation⁸ has highlighted two key areas for further consideration: the role of the arm's length principle in the domestic law; and the role of the OECD guidance in interpreting these rules.

Ensuring consistency with the arm's length principle

23. First, in contrast to treaty rules and domestic profit allocation rules of many of our treaty partners, Division 13 focuses on *pricing individual transactions*. A consequence of the transactional focus of the current rules may be a judicial reluctance to accept profit based transfer pricing methods.⁹ Yet from a policy perspective the objective of the rules is to ensure the overall *profits* of the parties reflect an arm's length outcome given their respective economic contributions. While transaction methods are very important and in many cases may prove to be the most appropriate method for determining the arm's length outcome, in practice, profit methods are frequently relied upon by taxpayers and administrators alike.

OECD Guidelines

24. Secondly, there is uncertainty over the role of the OECD Guidelines in applying the profit allocation rules. At a formal level, direct resort to the Guidelines has not been endorsed by the courts in Australia, but evidence based on the approach taken in the Guidelines has been accepted. It appears that the OECD Guidelines could be available if it was demonstrated that parties to a relevant treaty would apply the Guidelines in similar circumstances. In practice the OECD Guidelines are extensively used by treaty partner administrations, the ATO and practitioners. Importantly the Guidelines changed in 2010 to give profit based methods equal priority to traditional methods. There is a strong case for reducing uncertainty by mandating the use of the OECD Guidelines in tax legislation. A clearer legal pathway for use of the Guidelines might also reduce the need for legal argument on this point in litigation.

⁸ Re Roche Products Pty Limited and Commissioner of Taxation [2008] AATA 639; SNF (Australia) Pty Ltd v Commissioner of Taxation [2010] FCA 635 and FC of T v SNF (Australia) Pty Ltd [2011] FCAFC 74.

⁹ While transaction based methods such as CUPs are important, profit based methods such as the Transactional Net Margin Method (TNMM) are widely applied in practice. The *Advance Pricing Arrangement Program 2009-10* update released by the ATO showed that, consistent with previous years, the TNMM was the most commonly applied transfer pricing methodology in APAs. This is consistent with the data produced by the IRS and CRA. Reports published by both of these revenue authorities show that the TNMM is the most widely applied transfer pricing methodology in their APA programs.

REVISED PROFIT ALLOCATION RULES

Policy Objectives

25. Consistent with the arm's length principle, profit allocation rules should ensure that cross border profits attributed to the Australian tax base appropriately reflect the economic activity undertaken here. Broadly, tax should be based on Australia's economic contribution: through functions performed in Australia, the assets used or contributed by Australian entities, and the risks assumed on the Australian side.
 - 25.1. One possible qualification to this objective might arise where the actual allocation of functions, assets and risks differs from that which would have been made by independent parties behaving in a commercially rational manner.
26. As far as practicable these rules should be aligned with and interpreted consistently with the international transfer pricing standards, especially of major investment partners (outlined in the OECD MTC and the 2010 OECD Guidelines). This could reduce uncertainty, minimise compliance and administrative costs and reduce the risk of double taxation — thereby facilitating foreign direct investment.
27. Potentially the objects clause of redesigned legislation could reflect these objectives.

Design of the rules

28. The design of these rules needs to be sufficiently robust to limit erosion of the existing tax base, but also balanced to ensure the rules do not overreach or impose unnecessary transaction costs which may inhibit Australia's attractiveness as a destination for new foreign investment. Like many other jurisdictions the rules would generally reflect high level principles, rather than being overly prescriptive, supported by reference to the 2010 OECD Guidelines and supplemented where necessary by rulings.

OVERVIEW

29. The key elements of the review are likely to be that (a) the arm's length principle will be clearly reflected in revised rules, and (b) the relevant OECD guidance will be applied to the revised laws. Another important change will be that the new rules will apply on a self-assessment basis.
30. Subject to consultation, it is likely that a number of other features will be included in the revised rules:
 - 30.1. Self-assessment is generally inconsistent with the retention of wide discretionary powers to determine the arm's length outcome for particular dealings. A discretion as broad as that in the current subsection 136AD(4) is unlikely to be included in the revised rules and may be replaced with specific provisions dealing with issues previously addressed by the discretion.
 - 30.2. Currently the ATO may make an initial amendment to give effect to a Division 13 determination at any time. Revised rules will introduce time limits for amendments in relation to profit allocation.

31. A number of features of the existing rules are unlikely to change:
 - 31.1. The rules will not depend on the existence of a tax avoidance purpose for their application.
 - 31.2. The rules will only apply to international dealings.
 - 31.3. The rules will extend to dealings or arrangements which are formal or informal, express or implied, whether or not they are intended to be enforceable.
 - 31.4. The rules will extend to non-arm's length dealings of unrelated parties as well as intra-entity dealings (permanent establishments).
 - 31.5. The obligation to substitute an arm's length price or profit for a transaction or series of transactions in place of the actual price or profit will only arise when the non-arm's length price or profit has been detrimental to Australian revenue.
 - 31.6. Similarly to the current section 136AF, tax relief can be provided by making compensating adjustments to ensure excessive taxation does not arise in relation to economic profit that was the subject of the primary transfer pricing adjustment (ie adjustments currently made under section 136AD). The tax positions of all the relevant taxpayers would be able to be adjusted to reflect the outcomes that would have occurred if the relevant dealings had been conducted on an arm's length basis.
 - 31.7. Similarly to the rule in current subsection 136AB(1), other provisions will not limit the operation of profit allocation rules.
32. The legislative design is expected to be relatively high level, setting out the main principles, but key features of a likely structure could include:
 - 32.1. Clear identification of the purpose of the profit allocation rules in an objects clause.
 - 32.2. Incorporation of the OECD arm's length principle in the operative rules of the law.
 - 32.3. A rule setting out when material circumstances of non-arm's length cross border dealings are comparable to the circumstances of dealings between independent parties dealing at arm's length. Consideration will be given to expressly referring to the 2010 OECD Guidelines' comparability factors.
 - 32.4. The inclusion of approved transfer pricing methods, along with criteria for selection of such methods. The 'most appropriate' transfer pricing method for any particular situation would be applied in determining the arm's length outcome. Consistent with the 2010 OECD Guidelines, a combination of these methods could be used where appropriate.
 - 32.5. The inclusion of rules authorising reconstruction of dealings in specific circumstances consistent with the 2010 OECD Guidelines.
 - 32.6. An interpretation rule to promote consistency with the arm's length principle, the 2010 OECD Guidelines and Article 9 of our treaties. Note that our treaties and our purely unilateral rules will have a slightly different scope.

ARM'S LENGTH PRINCIPLE

33. The arm's length principle could be reflected in an operative rule so that to the extent an entity engages in cross border dealings its taxable income is determined in a manner that is consistent with the arm's length principle. The revised rules will be broadened from pricing transactions, as is the case currently, to determining an arm's length outcome for the full range of material dealings or arrangements in place between parties that do not deal at arm's length.
34. All Australian tax treaties contain provisions which reflect the OECD 'arm's length principle' as follows: 'where ... conditions are made or imposed between two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would but for those conditions have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly' (Article 9 of the OECD MTC). The transfer pricing provision for branches is in Article 7.
35. The arm's length principle as used in treaties sets an overarching objective of allocating cross border profits. Note the principle applies to *profits* of the associated enterprises, that is, it is not limited to prices of particular transactions. Profit allocation rules look at the totality of arrangements between firms. This may require an examination of a single transaction or a broader series of arrangements in order to arrive at an arm's length outcome.
36. Of course, transfer pricing of transactions or aggregated transactions remains critical to the profit allocation exercise. Transfer prices in large part determine the income and expenses, and therefore the taxable profits of associated enterprises.
37. In its tax legislation the UK aligns with the OECD approach and achieves a broader focus by using the term 'arm's length provision' (paragraph 147(1)(d) of the United Kingdom legislation.)¹⁰
38. The arm's length provision is that which would have been made as between independent enterprises. The term 'provision' is not further defined in the legislation. The HMRC International Manual explains that the term is, however, broadly analogous to the phrase 'conditions made or imposed' in the Article 9 of the OECD MTC, and embraces all the terms and conditions attaching to a transaction or series of transactions.
39. In order to reinforce the broader profit focus of the UK arrangements, the rules seek to emphasise the ability to consider a wide array of interactions through the use of the term 'transaction or series of transactions'. Transaction is defined very broadly. A series of transactions is also widely defined and can include transactions entered into in pursuance of, or in relation to, the same arrangement.

OECD Guidelines

40. Countries around the world recognise the benefits of a consistent approach to cross border profit allocation. Most of our trading and investment partners look to the OECD material on

¹⁰ Taxation (International and Other Provisions) Act 2010 (UK).

transfer pricing to provide that consistency.¹¹ Use of the OECD guidance is implicit in Australian tax treaty negotiations.¹² Likewise OECD guidance is used extensively in the private sector. This is not to say the Guidelines themselves are always unambiguous and consistent, but they comprehensively examine key transfer pricing issues. To quote the Special Commissioners in *DSG Retail Limited and others v HMRC (2009)*: 'in determining the arm's length price, the approach of the OECD model [as set out in the Guidelines] is a useful aid which we should apply in the absence of any other guidance as they are the best evidence of international thinking on the topic.'

41. Jurisdictions use a variety of approaches to reflect the OECD MTC and Guidelines in their domestic legislation. Some countries (such as India and New Zealand) reproduce elements of the Guidelines and replicate them in their domestic legislation. The OECD itself has suggested legislation¹³ which essentially summarises key points in the Guidelines.

United Kingdom

42. The United Kingdom has also used familiar OECD concepts in their profit allocation legislation but they go further requiring that the rules be construed in a way that best ensures consistency with the expression of the arm's length principle in Article 9 of the OECD MTC and the OECD Guidelines.¹⁴ Where interpretations of the basic rule conflict, the OECD material takes precedence. The legislation also requires interpretation consistently with Article 9 and the OECD Guidelines regardless of whether there actually is a double taxation agreement between the UK and country in question.¹⁵
43. By incorporating the OECD Guidelines and incorporating a rule for updated Guidelines into its law the UK has been able to 'future proof' its rules. As economic and accounting issues of comparability and transfer pricing methodology evolve, users will be able to refer to up-to-date guidance. As with the UK, it would be expected that updating the rules for new

11 The OECD Council has recommended that Member countries' tax administrations follow the Guidelines when reviewing and if necessary adjusting transfer prices for the purposes of determining taxable income and encourages taxpayers to follow the Guidelines.

12 In its treaty practice Australia has expressly addressed this issue in one treaty, but the provision is not part of Australia's usual treaty practice. Australia's tax treaty with Japan includes an Exchange of Notes to ensure transfer pricing adjustments are consistent with the international consensus as embodied by the OECD Guidelines. See *Convention between Australia and Japan for the Avoidance of Double taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital, Protocol and Exchange of Notes* [2008] ATS 21 (entered into force 3 December 2008).

13 OECD, *Transfer Pricing Legislation – A Suggested Approach*, June 2011
<http://www.oecd.org/dataoecd/41/6/45765682.pdf>

14 The reference to the OECD transfer pricing guidelines originally meant documents published by the OECD before 1 May 1998 with any documents published in the future being incorporated into the rules via an order made by the Treasury. The law has now been updated to refer the 2010 OECD Guidelines.

15 The actual legislation appears to be ambiguous, but this is understood to be the effect of the rules: See *DSG Retail Limited and others v HMRC (2009)* UKFTT 31 (TC00001 at paragraphs 70 and 71) : 'It seems to us that "in cases where double taxation arrangements incorporate" is not referring to a specific double tax treaty: if the draftsman had intended the model to be applied only where there was a double tax treaty relevant to the parties, the natural way to draft it would have been to set out the condition at the start of the paragraph.'

versions of the OECD Guidelines would be subject to oversight by the legislature (for example in reviewing legislative instruments).

OECD MTC Commentary

44. The OECD MTC Commentary on Article 9 also refers to the OECD Guidelines. It describes them as representing 'the internationally agreed principles and ... guidelines for the application of the arm's length principle of which the Article is the authoritative statement'. Australia's transfer pricing legislation could be conformed to provide a legal pathway to the use of the OECD Guidelines for the interpretation and application of those provisions. UK transfer pricing legislation makes reference to the use of the OECD MTC and the OECD Guidelines for the purpose of interpreting domestic profit allocation rules. The UK rules do not, however, also provide an express link to the OECD MTC Commentary for this purpose.
45. Given the OECD MTC Commentary to Article 9 provides some guidance on the interpretation of the arm's length principle, there is a case for also including the MTC commentary in this context.
46. Requiring treaty profit allocation rules to be interpreted and applied consistently with OECD materials raises broader questions of whether, in the light of some uncertainty as to the application of the Commentary in tax treaty cases generally, a general rule of interpretation (applying to all the articles of our tax treaties) should be considered. Including a specific expectation of consistency with OECD materials in only one aspect of the tax treaty would leave it unclear what approach was intended for the remaining tax treaty provisions. A more holistic approach may be desirable.
47. This could involve introducing a specific rule to ensure interpretive consistency between tax treaty provisions *generally* and the explanations provided in OECD materials, where treaty provisions reflect those in the OECD MTC. Attachment A sets out some of the broader considerations in designing such a rule.

Comparability

48. The internationally accepted approach to determining an arm's length outcome for dealings entered into by related parties requires a comparison of the related party dealings with the dealings entered into between independent parties. To arrive at a reliable arm's length outcome it is important to ensure that the economically relevant characteristics of the situations being compared are sufficiently comparable to the related party dealings in question.
49. Comparability of the circumstances of the transaction being compared has been the subject of judicial comment. There seems to be merit in clarifying in revised legislation what is required for non-arm's length cross border dealings to be considered comparable to dealings between independent parties dealing at arm's length. Namely: that none of the differences (if any) between the material circumstances of the dealings being compared could materially affect the relevant outcomes of those dealings, or reasonably accurate adjustments can be made to eliminate the effect of any such differences.
50. The OECD suggested legislation provides an example of how comparability requirements can be explicitly addressed. It achieves this by stating the essential standard expected for

transactions to be considered comparable and by also referencing the factors that should be taken into account in determining whether this standard has been met.¹⁶

51. Similarly, New Zealand specifically lists comparability as a factor that should be taken into account both in deciding which method is most appropriate and in applying that method.¹⁷ Establishing the comparability of an independent dealing with a related party dealing requires an assessment of those comparability factors that have an impact on the tested outcome (price or margin). The comparability factors are designed to ensure that the conditions that operate in the commercial or financial relations are arm's length and include the:
 - 51.1. characteristics of the property or services being traded in each of the dealings;
 - 51.2. economically significant activities and responsibilities undertaken, assets used and risks assumed by the parties in each case;
 - 51.3. contractual terms of each of the dealings;
 - 51.4. economic circumstances of the markets for the goods or services traded in each of the dealings; and
 - 51.5. business strategies pursued by each of the parties to the dealings.
52. Achieving an acceptable balance between the necessary degree of comparability and appropriate methodology might be achieved by applying the 2010 OECD Guidelines discussed above. The Guidelines stress the importance of choosing the most appropriate method (or combination of methods) having regard to the availability of comparables information, looking for comparable transactions that are truly comparable, and where truly comparable transactions are not available, the need to strive to make reliable adjustments which improve comparability where possible.

Comparability standards — to what extent are the circumstances of the taxpayer relevant?

53. While it is generally understood that the application of the profit allocation rules requires a comparison with comparable, independent dealings, the standard of comparability required, and in particular, to what extent the specific circumstances of the taxpayer are relevant, has been subject to debate. For example, in *Roche* and *SNF* (at first instance) there was discussion that indicated further guidance may be desirable on when arm's length concepts should depart from market valuation concepts — a market valuation approach would largely ignore special factors relating to the parties to the transaction.
54. The Full Federal Court in *SNF* seemed to acknowledge the circumstances in which the actual transaction occurred were relevant to some degree, for example in its analysis of at least some of the five comparability factors put forward in evidence. Likewise in rejecting a notion that the comparison involves an inquiry into what a purchaser in *identical* circumstances would pay, the Court noted that differences in circumstances which were material should be taken into account through a process of adjustment.

¹⁶ OECD, *op cit*, section 3.

¹⁷ *Income Tax Act 2007* (NZ) ss GC13(3)(a).

55. From a policy perspective, and in accordance with the concepts expressed in Article 9 and the 2010 OECD Guidelines, income reflected in the Australian tax base from functions, assets and risks in this country should reflect, to the extent possible, the material circumstances of the taxpayer in its dealings with the rest of the multinational group. Thus, a question arises as to whether the circumstances of the taxpayer(s) should be explicitly addressed as in Canadian legislation which includes an hypothesis which involves the taxpayer: ‘the amount ... that would have been reasonable in the circumstances if the non-resident person and the taxpayer had been dealing at arm’s length.’ The Full Federal Court in *SNF* considered that rigidly applied, such a rule could set a very high, if not impossible comparability standard. But in designing revised rules a judgement has to be made as to whether the absence of a specific rule (and reliance on the OECD Guidelines alone) could lead to a conclusion that the circumstances of the taxpayer are not particularly relevant; leading to a market valuation, rather than an arm’s length outcome.

METHODOLOGIES

Using the most appropriate methodology

56. The current Division 13, with its requirements to determine an arm’s length consideration for particular transactions, clearly favours the application of traditional transactional transfer pricing methods. This reflected the international consensus existing at the time Division 13 was introduced.¹⁸ While profit methods are arguably permitted when applying subsection 136AD(4), the international approach has evolved since 1982 — in practice profit methods are now extensively used by taxpayers and tax administrations alike. The 2010 OECD Guidelines now explicitly acknowledge that profit based methods should be used wherever they are the most appropriate method.
57. This approach was supported in the Ralph Review which recommended (Rec 22.16) that Australia should introduce a legislative requirement to use the most appropriate methodology along with guidance on how to determine the most appropriate methodology. Revised rules should therefore implement the Ralph Review recommendation and align with the international standard.
58. Likewise the rules could provide examples of approved transfer pricing methods and criteria for selection of the most appropriate method or methods. According to the 2010 OECD Guidelines, selecting the most appropriate method requires an assessment of:
- 58.1. the nature of the dealings entered into by the related parties;
 - 58.2. the context in which the dealings occur and the aspects of the financial and commercial relations between the parties that may be giving rise to distortions in profit allocation;
 - 58.3. the respective strengths and weaknesses of different transfer pricing methods to address the full range of the profit allocation problems arising in the context of all the financial and commercial relations between the parties;

18 The 1979 OECD *Transfer Pricing Report* and the 1995 Guidelines expressed a strong preference for the traditional transaction methods. The former allowed recourse to “other approaches” where necessary, but cautioned they should be used with care; the latter expressly considered profit methods but regarded them as appropriate only in exceptional circumstances.

- 58.4. the availability of information on comparable independent dealings and whether the information is sufficiently reliable for the purposes of the method; and
- 58.5. whether the application of a method gives an outcome that could be expected to arise between independent parties dealing wholly independently with each other and produces an allocation of profit consistent with the functions performed, assets used and risks assumed by the tested party.

Permanent establishments — attribution issues

59. There remains a question as to whether Australia should make the necessary legislative and treaty amendments to move to a 'functionally separate entity' approach for attributing profits to a 'branch' or the 'headquarters' of a single entity, as has been adopted by the OECD.¹⁹ While these issues are relevant to the current reform of Australia's profit allocation rules, decisions on the treatment of permanent establishments will be treated as a separate policy question to those outlined in the remainder of this paper. Views on the desirability of a change in approach for permanent establishments are invited. Relevant to any policy change would be the revenue consequences of that change, therefore details on possible revenue impacts flowing from adoption of the separate entity approach should also be provided.

Current rules: Relevant business activity approach

60. Australia's current rules for the attribution of profits between a 'branch' and its 'headquarters' (or other parts of the entity), and for the determination of the source of those profits, is achieved by allocating the *actual* income and expenses of an entity between its parts. This can apply to both an Australian resident with an offshore branch or vice versa to a foreign resident with an Australian permanent establishment.
61. In making this allocation, the rules take account of the extent to which the activities carried on at or through each permanent establishment contribute to the derivation of the income or the incurring of the expenses. The rules also have regard to the circumstances that would have existed if the permanent establishment were a distinct and separate entity dealing at arm's length with the other parts of its business and with other parties — arm's length prices may be used to allocate the actual income and expenses of entity between its parts. But the assessable income and allowable deductions of the entity, and hence the amounts attributable to a branch, do not include any 'notional' income or expenses from intra-entity 'dealings'. This is because as a matter of law, an entity cannot transact with itself.
62. While this approach (referred to by the OECD as the 'relevant business activity approach') allocates actual income and expenses it does not necessarily constrain the 'profit' attributed to the permanent establishment (and so indirectly the profit attributed to the rest of the entity) to the actual profit made by the entity in a particular period. The permanent establishment could make a profit while the entity makes a loss, or vice-versa.

OECD's functionally separate approach

63. The OECD has endorsed an alternative approach to determining the profit (that is, the income and expenses) attributable to a permanent establishment (known as the 'functionally separate entity approach') that treats the permanent establishment as if it were a separate legal entity

¹⁹ The previous version of the Business Profits article of the OECD MTC, and its commentary (as they read before 22 July 2010) are relevant to the interpretation of Australia's current treaties.

that dealt at arm's length with that entity and all other entities and attributes some income and expenses to it from recognised dealings with the rest of the entity of which it is a part. The income and expenses (and hence the profit) attributable to a permanent establishment would be determined by applying a two-step process.²⁰ The first step requires a factual and functional analysis of the activities of the permanent establishment, to identify the functions performed, the assets economically owned and risks assumed by the permanent establishment, the capital to be attributed to the permanent establishment and which dealings with other parts of the entity can appropriately be recognised.

64. Dealings of the permanent establishment with the rest of the entity are only recognised where there is documentation of the dealings consistent with the economic substance of the activities of the enterprise as revealed by the functional and factual analysis. Further, the documentation should show that the purported dealings do not differ from those which would have been adopted by comparable independent parties behaving in a commercially rational manner. The dealings should also not violate the principles of the functionally separate entity approach.²¹
65. The second step is to ensure that any dealings of the permanent establishment with associated enterprises or with the rest of the entity are priced in accordance with the OECD Guidelines. The process involves the pricing on an arm's length basis of the recognised dealings by assessing comparability between the dealings and uncontrolled transactions and the application by analogy of one of the Guidelines' methods to arrive at an arm's length price for the dealings.²²
66. These steps lead to the attribution to the permanent establishment of amounts actually derived or incurred by it (provided those amounts are arm's length prices where they are prices for transactions with associated entities) as well as arm's length income and expenses from appropriately recognised dealings with the rest of the entity. Unlike the existing approach but subject to the above-mentioned process of appropriate recognition of intra-entity dealings, this last determination is not constrained by whether or not there is an actual amount of income or expense generated from transactions with another legal entity.

Some background

67. Many of the legislative issues associated with a move to the functionally separate entity approach have been canvassed in a paper *Cross-border dealings within a single entity* by Mr Tony Frost.²³
68. After considering both approaches, on balance, the OECD endorsed a move to a separate entity approach.²⁴ However adoption has not been universal: a number of Member countries

20 See paragraph 21 of the OECD MTC Commentary on Article 7.

21 See paragraph 26 of the OECD MTC Commentary on Article 7.

22 See paragraph 22 of the OECD MTC Commentary on Article 7.

23 This paper is available at the webpage to the Consultation Paper. Note that this paper was provided on 10 May 2010, prior to the publishing of the OECD's *2010 Report on the Attribution of Profits to Permanent Establishments* (below, n24).

24 Part I, B at paragraph 50 of the *2010 Report on the Attribution of Profits to Permanent Establishments*; <http://www.oecd.org/dataoecd/23/41/45689524.pdf>.

(including New Zealand) have entered reservations to the change and the United Nations Committee of Experts on International Cooperation in Tax Matters has not viewed changes to the OECD MTC and Commentary to reflect the separate entity approach as relevant to the United Nations Model Convention.²⁵

SELF EXECUTING RULES

69. Division 13 was enacted in the early 1980s, preceding the introduction of self assessment. It is currently framed in terms of the ATO determining that operative provisions in section 136AD and section 136AE are to apply and adjusting the amount of consideration for a cross border supply or acquisition. (For permanent establishments this relates to the reallocation of income and expenses between a permanent establishment and other parts of the company.) There are also supporting discretions to determine the source of any additional income and/or the source of the income which certain expenditure is deemed to have been incurred in relation to. It would be necessary for self executing rules to deem the source to be consistent with the reallocation.
70. A clear obligation (consistent with the self-assessment rules) should be introduced for parties involved in dealings with offshore parties to ensure the taxable profits are calculated on the basis of conditions in the taxpayer's commercial and financial relations being on an arm's length basis and to maintain contemporaneous records that explain the basis on which those conditions were established. The introduction of a self-assessment regime for Australia's profit allocation rules is in line with the recommendation of the Ralph Review (Rec 22.12).

Discretionary powers

71. The current Division 13 provides a wide discretionary power (in subsection 136AD(4)) allowing the Commissioner to determine an arm's length consideration where, for any reason, it is not possible or practicable ascertain that consideration.
72. Retention of wide discretionary powers is inconsistent with Australia's self-assessment regime because they can inhibit taxpayers from applying tax rules to their own circumstances. The question that this gives rise to is whether and how the issues underlying the need for this discretion should be addressed in the revised rules. Potentially this discretion could have application to the following kinds of cases:
 - 72.1. *Insufficient information*: Potentially a residual discretion should be retained to cover cases where there were no comparable dealings or the details of them are held back or otherwise not available to the ATO.
 - 72.2. *Reconstruction*: A residual discretion may also be required to address cases where arrangements are structured in a way that independent parties dealing at arm's length with each other would not structured them, or would not have entered the arrangement at all.

25 UN, Recent work of the Organization for Economic Cooperation and Development on the attribution of profits to PEs: implications for the United Nations Model Double Taxation Convention between Developed and Developing Countries (2009), UN Committee of Experts on International Cooperation in Tax Matters Report on the fifth session (19-23 October 2009); <http://www.un.org/esa/ffd/tax/fifthsession/index.htm>.

Insufficient information

73. A key consideration is that the Australian revenue should not be prejudiced where a taxpayer or a multinational group withholds information about arm's length comparables, or for other reasons is not available. At a practical level it is the operation of subsection 136AD(4) as an averment provision that currently allows the ATO to take the procedural steps that will promote transparency.
74. Determining an arm's length allocation of profits is heavily information driven and in a significant range of cases much of that information may be peculiarly within the possession and control of the multinational group. The integrity of Australia's profit allocation rules depends heavily on the transparency of related party dealings and governance processes adopted by taxpayers to ensure compliance with the arm's length standard.
75. As outlined above in the discussion on discretionary powers, rules may still be needed to determine an arm's length profit allocation in situations where a taxpayer's failure to co-operate prevents this outcome. In New Zealand, for example, a taxpayer's failure to co-operate with the Commissioner provides the Commissioner with the power to determine the arm's length price.²⁶
76. On the other hand, section 167 gives the ATO scope to make an assessment or amend an assessment of taxable income when not satisfied with the return furnished by the taxpayer. The process by which the ATO arrives at the default assessment amount is not specified — while it is not open to the ATO to 'pluck a figure out of the air' in determining the amount of the assessment, the Commissioner's process 'may go close to guesswork and yet be lawful', particularly where a taxpayer has failed to co-operate.²⁷ The taxpayer then has the burden of showing that the assessment amount is excessive in the normal manner.
77. A separate issue is how to arrive at an arm's length outcome in situations where the necessary information to apply profit allocation rules may not exist or may not be available to either the taxpayer or the Commissioner. This could occur where no independent comparables existed, or where comparable information does not exist due to a whole industry being highly vertically integrated, or where an arrangement involves unique intangibles.
78. Similarly, there may be insufficient information to determine the most appropriate point in an arm's length range of results that most closely approximates the taxpayer's circumstances had it dealt on an arm's length basis.
79. Undoubtedly such situations will arise. However, it is important that the general profit allocation rules should incorporate sufficient flexibility to allow the determination of outcomes in accordance with the arm's length principle, limiting the need for a residual discretion.

Reconstruction

80. Profit allocation rules are sometimes insufficient on their own to facilitate the determination of an arm's length outcome in certain situations where the legal arrangements entered into by related parties do not reflect economic reality—or where the related party arrangements

²⁶ *Income Tax Act 2007* (NZ) GC13(4), GC13(5).

²⁷ *Briggs v DFC of T (WA) & Ors; Ex parte Briggs* 87 ATC 4278, at pp 4293-4294, which referred to *Trautwein v FC of T* (1936) 56 CLR 53, per Latham CJ at pp 87-88.

differ from those which would have been made by independent parties behaving in a commercially rational manner.

81. This can arise, for example, where one company in a group provides a loan to a related party that is insufficiently capitalised and does not otherwise have the necessary financial attributes to ever have obtained such a loan from an independent lender dealing at arm's length. It may also be necessary to deal with situations where the arrangement is not one that would have been entered into by independent parties dealing at arm's length with each other.
82. Removal of the wide discretion in subsection 136AD(4) may necessitate the inclusion of specific rules allowing the reconstruction of transactions and arrangements onto an arm's length basis where the actual related party dealings and transactions prevent the ascertainment of a truly arm's length outcome. This would be consistent with the approach endorsed in the 2010 OECD Guidelines.²⁸ It may be possible to address such cases by a voiding rule that puts the taxpayer in an 'as you were' position, unaffected by the non-arm's length arrangement.
83. The United Kingdom transfer pricing rules generally allow an arm's length provision to be determined for those provisions that would not have occurred between independent parties.²⁹ In the case of related party loans or guarantees the United Kingdom rules also provide scope for the arm's length outcome to be determined with reference to whether such a loan or guarantee would ever have been provided between independent parties.³⁰

RECORD KEEPING REQUIREMENTS

84. Similarly to the current practices of the US and Canada there should be a legislative requirement that taxpayers maintain contemporaneous transfer pricing documentation in Australia that evidences the application of the arm's length principle. This was recommended by the Ralph Review (Rec 22.13(a)). It would also assist voluntary compliance with the arm's length principle under self-assessment and is likely to lessen compliance costs and cycle times should any profit allocation review or disputes arise. Given the variety of arrangements that may be subject to the profit allocation rules, any legislative requirements on documentation should not be overly prescriptive so as to avoid imposing unnecessary costs on business.
85. The arm's length standard is a requirement of tax law but may not be relevant for taxpayers to undertake investment or perform their day to day business activities. It is therefore not sufficient to rely on the information in statutory accounts. Accordingly any profit allocation rule record keeping requirements derive directly from, and need to be framed on, the tax law requirements supporting a proper economic basis for the allocation of profit for tax purposes consistent with the arm's length principle.

28 At paragraph 1.65 of the 2010 OECD Guidelines, non-recognition and subsequent reconstruction of controlled transactions is permitted in exceptional circumstances where: (a) the economic substance of a transaction or arrangement differs from its form; or (b) the arrangements, viewed in their totality, would not have been adopted by independent enterprises behaving in a commercially rational manner, and the actual structure practically impedes the determination of an appropriate transfer price.

29 Taxation (International and Other Provisions) Act 2010 (UK) subsection 151(2).

30 Taxation (International and Other Provisions) Act 2010 (UK) sections 152 and 153.

86. Currently, an obligation to keep records only arises from the general record keeping provisions in Part VIII and would require documentation showing the actual amounts paid or received in relation to cross-border transactions. As Division 13 is not self executing, the law does not require records explaining whether or not the amounts paid or received were the arm's length consideration.
87. It is important to keep in mind the cross-jurisdictional context of profit allocation arrangements and to consider the respective burdens on the taxpayer and tax authorities. From the business perspective, the need to keep records in different forms and languages and in several locations adds to costs; from the tax administrators' perspective, inappropriate records can effectively frustrate or deny a country from obtaining its legitimate amount of tax. Indeed, there have been cases where access to records has been effectively denied to a tax administration because they have been kept overseas and/or in an inaccessible form — a problem that is only partially addressed by exchange of information agreements.
88. Both the ATO's taxation ruling on transfer pricing documentation (TR 98/11) and Chapter V of the 2010 OECD Guidelines base the requirements for documentation on the principles of prudent business management. That is, the documentation required should be proportionate to the complexity and importance of the dealings or business decision in question.
89. Ideally, profit allocation issues should be addressed before or at the time structures are being put in place or transactions being undertaken. However, at the very latest such issues should be addressed as part of a due diligence process prior to the filing of a tax return for the current year of income. Where this is not done on a good faith basis it should not be accepted that the records comply with such a statutory requirement and the failure to do so would be evidence that taxpayer has not used reasonable care in the conduct of its tax affairs.
90. If adopted, it may be useful to include in the design of a contemporaneous documentation provision the requirement for documentation that:
- identifies all the aspects of the commercial and financial relations that could give rise to transfer pricing issues;
 - accurately characterises the cross-border dealings and provides an analysis of the economically significant functions performed (taking account of assets used and risks assumed);
 - addresses the selection and application of the most appropriate transfer pricing methodology (or methodologies); and
 - records the basis on which comparables were selected as well as any adjustments for material differences.

The documentation should also explain why the outcome of the profit allocation analysis makes business and commercial sense in the context in which the dealings occurred, the financial circumstances of the taxpayer, and the costs and benefits to each of the parties involved. In other words, it is possible that the contemporaneous documentation requirement could be designed in such a way to reinforce the statutory purpose of the profit allocation rules and internationally accepted practices in how the arm's length principle should be applied.

91. As a result of having a legislative requirement to maintain contemporaneous documentation, it may be that some taxpayers will face increased compliance costs. In some instances, the cost of compliance may outweigh the potential risk faced by the failure to maintain

contemporaneous documentation. The legislative requirement should therefore contain a *de minimis* rule for taxpayers. This would operate so that documentation would only be required for taxpayers that meet a particular threshold, such as the value of their international dealings, or some other measure. This is in line with current ATO practice, which allows for simplified documentation for taxpayers meeting particular criteria.

DOCUMENTATION PENALTIES

92. The United States and Canada have linked contemporaneous documentation to their penalty regimes. Potentially, then, it may be useful to link the proposed requirement to keep contemporaneous documentation to the penalty rules of revised profit allocation rules. This is consistent with a recommendation in the Ralph Review.³¹
93. The penalty provisions in Division 284 of Schedule 1 of the *Taxation Administration Act 1953* ('TAA') may apply to certain transfer pricing adjustment cases when:
 - 93.1. *on an objective analysis, the taxpayer has the dominant purpose of getting a scheme benefit*: cases where taxpayers have entered into arrangements that, objectively evaluated, were intended to shift taxable profits out of Australia or shift losses or expenses into Australia (beyond reasonable levels) in order to reduce tax in Australia. In such cases the base penalty is 50 per cent of the tax involved, and reduced to 25 per cent if it is reasonably arguable that the transfer pricing adjustment provision does not apply.³²
 - 93.2. *Division 13 applies and the evidence does not support a conclusion that there was a dominant purpose of getting a scheme benefit*: cases where the taxpayer was reckless or did not use due care, or where the taxpayer got their transfer pricing wrong. In such cases the base amount of penalty is set at 25 per cent of the tax shortfall, but reduces to 10 per cent if the taxpayer has a reasonably arguable position.
94. Division 284 provides for the base penalty amount to be increased by 20 per cent where the taxpayer takes steps to prevent or obstruct the Commissioner from discovering a shortfall or fails to notify the Commissioner within a reasonable time after becoming aware of a shortfall in tax payments.³³ There may be a policy basis for broadening this provision to include cases where a taxpayer does not provide reasonable cooperation in the course of an examination of the taxpayer's affairs.
95. Conversely, the Division provides for a reduction in the base penalty amount where a taxpayer voluntarily notifies the Commissioner of a shortfall in tax payments. The amount of the reduction varies depending on whether the notification occurs before or after the taxpayer has been notified by the Commissioner of an examination of the taxpayer's affairs.³⁴

31 Rec 22.13(b) of the Ralph Review: 'penalty provisions be modified to reflect the extent to which an enterprise has made reasonable efforts to apply arm's length principles.'

32 Subsection 284-145(1) and paragraph 284-160(a) of the TAA.

33 Section 284-220 of the TAA.

34 Section 284-225 of the TAA.

96. In cases where the taxpayer's voluntary disclosure relates to a shortfall amount of less than \$1000 the base penalty amount is reduced to nil, but this is unlikely to ever apply in profit allocation cases given the much higher amounts involved and the Commissioner's approach of not pursuing marginal profit allocation adjustments.
97. Where taxpayers act with due care and diligence and make reasonable efforts to apply the arm's length principle, the general penalty provisions will reflect their efforts. Due regard should be given to any difficulties that arise in applying the arm's length principle to the particular facts and circumstances of the case and the steps taken by the taxpayer to correctly apply the profit allocation provisions. Reduced penalties could apply where contemporaneous documentation requirements (bearing in mind the prudent business management test) are satisfied. Penalties should be reduced to nil where the taxpayer has made good faith attempts, commensurate with the relative importance of the profit allocation issue in the context of the taxpayer's business, to determine an arm's length price and has maintained contemporaneous documentation. Higher penalties that apply where the tax shortfall is due to the taxpayer's recklessness or intentional disregard of the requirements of the profit allocation rules still seem to be justified on policy grounds.
98. Specific penalties could apply where taxpayers fail to keep in Australia contemporaneous records of the basis for the profit allocation positions they adopt.

TIME LIMITS FOR AMENDMENT

99. Under the domestic law the ATO's power to amend is limited by the general time limits in section 170. Under subsection 170(9B) the ATO may at any time make an initial amendment to give effect to Division 13 or the profit allocation provisions of a double taxation agreement. Subsection 170(9C) restricts subsequent amendments in respect of the same subject matter in relation to that year of income to a time limit of four years.
100. Subsection 170(10), item 24 provides that there is no time limit on making amendments to give effect to consequential adjustments to assessable income or allowable deductions in accordance with section 136AF. Subsection 170(11) provides that there is no time limit on making amendments to give double taxation relief under a double taxation agreement.
101. The 2007 *Review of Unlimited Amendment Periods* considered (at 2.2.2) the issues associated with the current unlimited amendment period as follows:

For most taxpayers, the Government's 2005 changes to the general amendment periods prescribed the time in which the Commissioner should complete compliance activities as within two years, or four years for taxpayers with more complex affairs. However, some tax related transactions require more time for examination, due to complexity or particular conditions.

Example: Transfer Pricing

Section 136AD of ITAA1936 [Arm's length consideration deemed to be received or given] applies where taxpayers have entered into a non-arm's length transaction with an associated entity to supply or acquire property under an international agreement. Under subsection 170(9B) of the ITAA1936, this transaction would currently be subject to an unlimited amendment period.

General amendment rules which allow for a two-year or four-year amendment period may not be sufficient to examine cases such as transfer pricing, due to the complexity of those transactions and the difficulty in obtaining verification information. Nevertheless, even for these cases a finite, albeit longer, amendment period may be more appropriate than an unlimited amendment period. The

timeframe for a longer amendment period should be sufficient for the Commissioner to ensure compliance, but not so long as to create unwarranted risk and uncertainty for taxpayers involved. A compromise of eight years, from the time the Commissioner gives the taxpayer the notice of assessment, may be more appropriate.

102. Public submissions on this recommendation are on the Treasury website at <http://www.treasury.gov.au/contentitem.asp?ContentID=1325&NavID=037>. These submissions will be considered as part of the review.
103. As with other amendment periods, rules would be needed to address cases where delays by taxpayers, lack of reasonable cooperation or hindrance or obstruction prevent the ATO from finalising a profit allocation examination within the statutory time limit. Inordinate delays or a failure by another country (eg a tax haven) to exchange information would also need to be considered.
104. Alignment to amendment periods provided for in our treaties should also be considered. A number of Australia's most recent treaties provide for a time limit for the initiation of a transfer pricing audit, rather than the making of amended assessments.

TREATY ISSUES

105. This section considers some of the interactions between Australia's domestic profit allocation rules and its tax treaty rules.
106. As a matter of practice Australia's tax treaty provisions in the Associated Enterprises Article which closely accord with Article 9 of the OECD MTC, should be considered in the context of the OECD MTC, and more importantly the OECD Guidelines. This practical merging of treaty rules and OECD guidance should be reflected in the law.
107. This section presents the drafting for Article 9 pursued by Australia in its tax treaties. Comments may be provided on any aspect of this drafting, especially with respect to whether drafting that is more consistent with the OECD MTC should be pursued. However, comments on changes to the drafting of treaty provisions should consider the implications of such changes for past treaties, as well as whether drafting changes would raise implications for the expected operation of treaty provisions as explained below.

RELATIONSHIP OF DOMESTIC OUTCOMES WITH TAX TREATY OUTCOME:

108. Profit allocation rules are also set out in relevant tax treaties. The terms of any relevant tax treaty must be considered in relation to profit allocation because the terms of the treaties have been incorporated into the domestic law as part of the *Agreements Act*.³⁵ In the case of any inconsistency between treaty provisions in the *Agreements Act* and provisions in the Assessment Acts, the treaty provisions have precedence.³⁶
109. Treaty provisions are also relevant to negotiations between government representatives over profits properly attributable to their respective jurisdictions and relief of double taxation.
110. As a general proposition it is desirable that outcomes from applying (a) the domestic profit allocation rules and (b) treaty provisions are in alignment as far as possible.³⁷ As discussed, this can be assisted by adopting within the domestic tax laws similar concepts and access to similar interpretive OECD guidance as applies in the international context (being the OECD MTC and Commentaries, as well as the 2010 OECD Guidelines).
111. There is one important exception. The domestic profit allocation rules have a wider reach than equivalent treaty rules because they apply to independent parties who are not dealing with each other at arm's length. This is not inconsistent with treaty obligations and is separately addressed by other jurisdictions (often in general anti-avoidance rules).
112. Once this approach of aligning with the OECD framework is adopted, it follows generally that profit allocation outcomes involving residents of treaty partners and outcomes for non-treaty cases should be broadly similar. Two further issues remain:

35 *Agreements Act* (Cth) subsection 4(1).

36 *Agreements Act* (Cth) subsection 4(2).

37 There may be some differences at the margins reflecting the positions of countries in treaty negotiations. Further, domestic tax rules might have scope for greater precision than is possible within the treaty context.

- It might be desirable to clarify the way the general profit allocation provisions and provisions in the tax treaties (as enacted in domestic law) interact. For the most part business and tax administrators should only be required to apply one set of profit allocation rules.
- It would also be important to ensure in negotiating profit allocation rules in Australia's tax treaties that (as far as possible) departures from the OECD MTC were minimised.

Should treaty rules provide separate authority for profit allocation assessments?

113. There is an argument that under the current law that tax treaties merely allocate taxing rights between treaty parties over particular items of income; in the case of profit allocation rules in the Business Profits Article and the Associated Enterprises Article they act to limit source taxing rights. An alternative view is that the Associated Enterprise Article or Business Profits Article (as appropriate) can be relied upon to give a separate source of assessment power for a profit allocation adjustment.³⁸
114. Leaving aside the merits of these arguments as they apply to the past, domestic profit allocation rules could be redesigned so they clearly act as the principal source of authority for profit allocation assessments and so that treaty provisions operate solely to limit any power contained in the domestic law. A simpler, less uncertain profit allocation framework with reduced transaction costs could emerge for both administrators and businesses dealing with profit allocation issues.

Greater alignment of Australian treaties with the OECD MTC

115. OECD MTC Article 9 (Associated Enterprises) addresses profit allocation between related entities. Profit allocation within the same legal entity (inter-branch and branch/headquarter transactions) are dealt with in Article 7 (Business Profits).³⁹ The following paragraphs explain the departures from the OECD MTC as negotiated by Australia in the past.

Paragraph 1

116. The tax authorities of the Contracting States may, for the purpose of calculating tax liabilities of associated enterprises (parent and subsidiary companies and companies under common control), adjust the profits of the enterprises where, due to the special relations between them, they have entered into transactions on non-arm's length terms. The article aims to ensure that the right amount of tax is paid in either jurisdiction by including a framework to prevent inappropriate international profit allocation by related parties. The following table contains the provisions negotiated by Australia and OECD MTC texts (emphasis added):

38 For a discussion of these issues see D Preshaw, 'The Associated enterprises articles in Australia's DTAs and Division 13,' *Taxation in Australia* Vol 44, No 5 November 2009.

39 See above discussion relating to the attribution of profits to permanent establishments. The previous version of the OECD MTC and its commentary (as they read before 22 July 2010) remain relevant to the interpretation of Australia's treaties.

<u>Australian Treaties</u>	<u>OECD MTC</u>
ASSOCIATED ENTERPRISES	ASSOCIATED ENTERPRISES
<p>1. Where</p> <p>a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or</p> <p>b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,</p> <p>and in either case conditions <u>operate</u> between the two enterprises in their commercial or financial relations which differ from those which <u>might be expected to operate</u> between independent enterprises <u>dealing wholly independently with one another</u>, then any profits which, but for those conditions, <u>might have been expected to accrue</u> to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.</p>	<p>1. Where</p> <p>a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or</p> <p>b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,</p> <p>and in either case conditions <u>are made or imposed</u> between the two enterprises in their commercial or financial relations which differ from those which <u>would be made</u> between independent enterprises, then any profits which <u>would</u>, but for those conditions, <u>have accrued</u> to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.</p>

117. Most of the departures from the OECD wording shown above are intended to clarify that the conditions will be met if non-arm's length conditions exist, irrespective of how they arose. The main departures in terminology are:

- 'operate' for 'are made or imposed'(OECD)
- 'might be expected to operate' for 'would be made'(OECD)
- 'might have been expected to accrue' for 'would have accrued'(OECD)

118. It is thought these departures impose a slightly more objective test on the 'conditions' than the OECD MTC. Similar language is included in all of Australia's tax treaties.

119. The Australian benchmark for determining the profits of associated enterprises are the profits that would result from 'independent enterprises dealing wholly independently with one another' (underlined above). This standard has regard to whether those dealings between the enterprises occurred on a truly independent basis. In other words if parties are arm's length, but do not behave independently (eg through collusion) such dealings would not be regarded as a comparable. This formulation is used in all of Australia's tax treaties.

Paragraph 2: Preserving the applicability of domestic transfer pricing rules

120. Consistent with Australia's reservation to OECD MTC Article 9, paragraph 2 has been introduced in our tax treaties to preserve the applicability of a Contracting State's domestic transfer pricing rules:

2. Nothing in this Article shall affect the application of any law of a Contracting State relating to the determination of the tax liability of a person, including determinations in cases where the information available to the competent authority of that State is inadequate to determine the profits accruing to an enterprise, provided that that law shall be applied, so far as it is practicable to do so, consistently with the principles of this Article.

121. This paragraph is included to preserve the application of Division 13 (when applied consistently with the arm's length principle). In particular this was intended to preserve Division 13's profit adjustment methods and the Commissioner's discretionary power under subsection 136AD(4) (see discussion above).
122. Secondly, it was thought to preserve Division 13's application to cases where the enterprises are not, or are not shown to be, associated (Division 13 has no common management, control or ownership rule). It was thought to prevent the argument being made that, since Article 9 does not apply, in such cases, the application of Division 13 to dealings between independent parties would be inconsistent with Article 9 and therefore limited by the operation of subsection 4(2) of the *Agreements Act*.

Paragraph 3: Correlative Adjustments

123. This provision is included in both Australian treaty practice and the OECD MTC. The rewriting of transactions between associated enterprises may give rise to economic double taxation (taxation of the same income in the hands of different persons). For instance, an enterprise of a Contracting State whose profits are revised upwards will be liable to tax on an amount of profit which has already been taxed in the hands of its associated enterprise in the other Contracting State. Therefore, that other State should make an appropriate adjustment to relieve the double taxation:

3. Where a Contracting State includes in the profits of an enterprise of that State — and taxes accordingly — profits on which an enterprise of the other Contracting State has been charged to tax in that other State and the profits so included are profits which might have been expected to have accrued to the enterprise of the first-mentioned State if the conditions operative between the enterprises had been those which might have been expected to have operated between independent enterprises dealing wholly independently with one another, then that other State shall make an appropriate adjustment to the amount of the taxes charged therein on those profits. In determining such adjustment, due regard shall be had to the other provisions of this Convention and the competent authorities of the Contracting States shall if necessary consult each other.

124. The departures in relation to the OECD MTC (underlined above) reflect those outlined in relation to paragraph 1 of Article 9.

Paragraph 4: Time limits for adjustments

125. Australian treaties include a provision, not included in the OECD MTC, establishing a time limitation (8 years, subject to negotiation) on the tax authorities' power to adjust profits under paragraphs 1 and 2. The provision originated in the 2008 Japanese agreement and it is reflected in Australia's most recent tax treaties. Australia will continue to propose this in treaty negotiations.

4. No adjustments to the profits of an enterprise for a year of income shall be made by a Contracting State in accordance with the provisions of paragraphs 1 and 2 after the expiration of [eight] years from the date on which the enterprise has completed the tax filing requirements of that State for that year of income. The provisions of this paragraph shall not apply in the case of fraud, gross negligence or wilful default or where, within that period of [XXX years], an audit into the profits of an enterprise has been initiated by that State.

126. The policy rationale is to improve certainty and reduce compliance costs for taxpayers. It is also to provide some limit on delays by tax authorities in either country in finalising the tax treatment of certain related dealings. The policy is broadly consistent with the recommended approach in the *2007 Review of Unlimited Amendment Periods in the Income Tax Laws*. This rule does not appear to have been generally used by other governments.

ATTACHMENT A: OECD MTC COMMENTARIES

A specific interpretation rule for OECD MTC Commentaries would have to be carefully drafted to ensure it did not in any way impede Australia's obligations to treaty partners. As such, it would need to be consistent with the treaty interpretation rules established in the *Vienna Convention on the Law of Treaties*.

The rule would also need to deal with the particularities of tax treaties and the OECD MTC Commentaries:

- Commentaries are regularly updated and refer to a Model Tax Convention that is also subject to amendment, resulting in various versions of the Commentaries.
- The OECD Council recommends an ambulatory approach in interpreting tax treaties that are based on the OECD MTC. This approach would be preferred, as it would allow clarifications to the OECD Commentaries to be taken into account. An ambulatory rule would not be expected to operate automatically; rather it would be expected to be subject to legislative oversight as new versions of the Commentary are adopted in the law.
- The rule must be capable of dealing with situations where provisions have been deleted from the OECD Model or changed in a substantive way, yet those deleted or unchanged provisions continue to be included in tax treaties. In these situations the latest Commentaries on the deleted or un-changed provision should be applicable in interpreting a tax treaty.
- Moreover, the OECD Commentaries include alternative provisions that can be used in place of the provisions included on the face of the Model. To the extent that the Commentaries provide an explanation of these provisions, that explanation should inform the interpretation of treaties that adopt alternative provisions.
- The OECD Commentaries explicitly refer to various reports, most notably the OECD Guidelines (see separate discussion) and the *Report on the Attribution of Profits to Permanent Establishments* (see separate discussion). Consideration will need to be given to the extent these Reports are included in an interpretative rule.
- The UN also produces a Model Tax Convention and an associated Commentary, which replicate substantial parts of the OECD materials. These Commentaries should not be ignored in treaty interpretation and they may be directly relevant to an interpretive task. Nonetheless, an interpretive rule in the Australian context would seek to only prompt primary recourse to the OECD and not UN materials.
- There are many other specific rules governing the interpretation to be afforded to particular treaty provisions and these should continue to have effect notwithstanding the inclusion of a new interpretive rule. In particular where: the treaty itself contains different wording or an agreed interpretation that differs from the OECD Commentary; an express or implied interpretation is subsequently agreed in relation to a treaty provision; a mutual understanding is entered into between treaty partners; a party to the treaty has a current observation to the OECD Commentary; or where the application of the Vienna Convention would lead to a different interpretation; the alternative interpretation should take precedence over anything in the OECD Commentary.

- An interpretive rule would seek to endorse the Vienna Convention approach to treaty interpretation. Given this approach was endorsed by the High Court in *Thiel*,⁴⁰ there seems no reason why such an interpretive rule should only apply prospectively.

⁴⁰ *Thiel v FC of T* (1990) 90 ATC 4717.