

Pricing Knowledge Network

Focusing on the impact of major intercompany pricing issues

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PKN/TCDR Alert Australia - Review of Australia's transfer pricing rules

A Transfer Pricing Publication

On 1 November 2011 the Australian Assistant Treasurer [announced](#) that the Government will reform the transfer pricing rules to bring them into line with international best practice, thus improving the integrity and efficiency of the tax system.

The announcement was supported by the release of a detailed [Consultation Paper](#) which outlines the broad principles upon which any change may be based. The consultation process will end on 30 November with submissions due at that time.

Executive summary

Interaction with tax treaties

The announcements are a very clear and strong reaction to the judicial interpretation of the operation of Australia's transfer pricing rules, in particular the Court's decisions in *Roche* and *SNF*. As well as canvassing views on the potential changes set out in the consultation paper, the announcement also indicated that the Government will address the contentious issue of whether tax treaties provide a power to make transfer pricing adjustments independently of Australia's transfer pricing legislation. In a controversial move, the Assistant Treasurer announced that the law would be



amended to clarify that treaties have a taxing power and that the amendments would be made retrospectively effective from 1 July 2004. Treasury has indicated it intends to proceed with these amendments regardless of whether any other changes are made to the transfer pricing law.

Proposed changes to legislation

The Consultation Paper outlines possible changes to Australia's transfer pricing rules that are being considered. The changes outlined in the Consultation Paper are additional changes that may be made to the law prospectively, over and above the changes to clarify the taxing power of treaties. The proposed changes include:

- Broadening the definition of the arm's length principle from the pricing of particular transactions to an overarching objective of allocating cross border profits;
- Specifying approved arm's length pricing methods and criteria for selection of such methods, including guidance on comparability issues;
- Adopting a self assessment approach and removing the Commissioner's discretion to deem an arm's length price (except in extreme circumstances);
- Providing the Commissioner the power to 'reconstruct' non-arm's length dealings in certain circumstances;
- Introducing a mandatory documentation requirement and a new penalty regime which is aligned with taxpayers' efforts in establishing and documenting arm's length practices;
- Limiting the number of years available to the Commissioner to make transfer pricing assessments;
- Issuing more structured guidance on the relevance of the OECD Guidelines and interaction between the domestic transfer pricing law and Australia's double tax treaties; and
- A potential move to formally embrace the more recently developed OECD rules on the attribution of profits to permanent establishments (however, the Consultation Paper notes that this will be treated as a separate policy question to be considered in light of revenue impact).

A more detailed analysis is outlined below.

Background to the review

The review has come about due to growing concern (particularly within the Australian Taxation Office (ATO)) that the existing law, which was introduced in 1982, is not in line with current international thinking and practice on transfer pricing matters.

The existing transfer pricing rules focus on the pricing of specific transactions and could be said to be broadly in line with OECD thinking at the time the law was introduced. More recent changes to OECD guidance have reflected the fact that transactional pricing methodologies are often difficult to use in practice and that

profit methods, rather than be considered a method of “last resort”, are the methods most commonly used. The revised OECD Guidelines issued in 2010 provided detailed guidance on the use of profit methods. The Consultation paper postulates that the transfer pricing rules should be amended to reflect latest OECD guidance and recommended practice.

As well as seeking to update the transfer pricing rules, the Government has taken the opportunity to clarify the interaction of Australia’s transfer pricing rules with tax treaties. The potential “updates” as well as the treaty “clarification” issues are discussed below.

The treaty issue

The announcement states that amendments to the law will be made to “clarify” that tax treaties provide a power to make transfer pricing adjustments independent of Australia’s transfer pricing rules. This is a hotly debated issue and many commentators consider that treaties exist to prevent double taxation rather than provide taxing powers.

Controversially the Government has stated that the “clarifications” will apply from 1 July 2004 in treaty cases. We are extremely surprised and disappointed with this approach. In our view, whilst explained as a clarification, it is clearly a retrospective change to the legislation. We consider such action is unsupported and is likely to be an overreaction to recent case losses. Unfortunately, the retrospective change follows an emerging trend in tax law amendments in Australia.

The need for “clarification” is an interesting one. While most observers would see merit in the need to align domestic legislation and treaty rules, it does beg the question as to whether the Consultation Paper and ensuing process are now redundant as legislating the “clarification” should align the two regimes.

This change could give rise to scenarios where arm’s length pricing arrangements for specific transactions can be overturned where, in the ATO view, they did not result in a sharing of profits which would have occurred at arm’s length. Whilst PwC supports better alignment between our treaties, OECD transfer pricing guidelines and Australia’s domestic legislation prospectively, the retrospective nature of this change is, in our view, unacceptable. This will also create uncertainty and complexity for taxpayers currently in dispute over transfer pricing matters relating to earlier income years.

Possible changes to transfer pricing rules

The arm’s length principle will continue to be the bedrock of any new transfer pricing law that is introduced. It is apparent throughout the Consultation Paper that the ATO will seek a change in emphasis in the law from the price of specific transactions to a focus on the outcomes of a transaction (or group of transactions).

Treasury is considering examples of legislation in other countries, such as NZ and the UK, and the model transfer pricing legislation published by the OECD in June 2011. These examples may provide a ‘model’ for the new Australian law.

Some of the specific changes contemplated in the Consultation Paper are discussed below.

Pricing methods and comparability

The new law will be likely to stipulate approved arm's length pricing methods and provide guidance on when and how these are to be selected and applied. We anticipate this would involve endorsing the methods contained in the OECD Guidelines.

Statutory guidance on comparability issues may also be provided. Treasury indicates that our revised transfer pricing rules should include specific guidance in relation to the importance of the taxpayer's specific circumstances in assessing comparability. Treasury considers this will ensure that a market value, i.e. an arm's length market price, is not substituted for an arm's length price based on the specific circumstances of the taxpayer. This imposes a higher level of comparability than that set out in OECD Guidance and highlights the risk that OECD Guidance is open to interpretation and the proposed rewrite may not necessarily reflect consensus interpretation of the Guidance.

Self-assessment, documentation, and penalties

The Consultation Paper indicates that some recommendations from the Ralph review of business taxation (which was conducted more than 10 years ago) may be adopted, such as:

- The Commissioner's discretion to deem arm's length prices (which is currently contained in s136AD(4)) is likely to be removed, or limited to use only in extreme circumstances. This would put a greater emphasis on self-assessment, as recommended in the Ralph review. Notably, the existing transfer pricing law pre-dates the self-assessment system.
- Introducing a mandatory requirement to maintain contemporaneous transfer pricing documentation which demonstrates compliance with the arm's length principle. The Consultation Paper recommends that this documentation should include an explanation of why the profit allocation outcomes make business and commercial sense for the taxpayer. The Consultation Paper acknowledges that for some taxpayers this could create a compliance burden which outweighs the risk involved, so a *de minimis* rule is likely, whereby taxpayers will only be required to prepare documentation if they meet a particular threshold (such as the value of their international dealings).
- New rules on record retention and new penalty provisions are likely to be introduced which are linked to the documentation requirements. Taxpayers who fail to make reasonable efforts to demonstrate that their transfer pricing arrangements satisfy the arm's length principle may be subject to specific penalties. Reduced (or no) penalties will apply for taxpayers who make good faith attempts to comply with the law and prepare documentation commensurate with the risk of their transactions.

Permanent establishments

The application of transfer pricing principles to attribute profits to permanent establishments may be revised in the new law, although the Consultation Paper makes it clear that this will be a separate policy question from the broader changes to the transfer pricing rules. This has the potential to be a contentious area of the new law as there have been significant developments in OECD thinking on permanent establishments over the past decade.

The Consultation Paper postulates a move away from the single entity (or relevant business activity) approach to a separate entity approach. The single entity approach allows only the allocation of actual income and expenses to a branch. The separate entity approach requires arm's length pricing of the branch's capital structure and dealings between the branch and its headquarters unconstrained by actual income or expenses. The paper acknowledges that such a decision will not be made without consideration of the revenue impacts.

Reconstruction of transactions

A provision may be included which enables the Commissioner to 'reconstruct' transactions in certain circumstances, where the actual transactions are not consistent with what would have been agreed between independent parties behaving in a commercially rational manner. The example provided in the Consultation Paper of where this might be necessary is a situation in which a company with insufficient capital has received a loan from a related party when it would not have been able to borrow from an independent lender dealing at arm's length.

This is an issue that has been of concern to the ATO for some time in the context of business restructures and pricing financial transactions. Whilst there was speculation that this rewrite could lead to a revision of Australia's thin capitalisation rules, we understand that the issue is not considered to be within the scope of the consultation process. However, a rewrite of the thin capitalisation rules at some later stage cannot be ruled out, particularly in light of the potential for the new legislation to be used to recharacterise loans that are allowable under Australia's existing thin capitalisation rules.

Time limit on amended assessments

In a welcome move, the Consultation Paper is seeking input on a proposal to limit timeframes for amendment in respect of transfer pricing adjustments. There is currently no limit on the number of years available to the Commissioner to issue amended assessments under Division 13. A period of eight years is mentioned as one possibility.

Other observations

Interestingly, the Consultation Paper did not specifically comment on transfer pricing issues associated with business restructuring (other than in introductory comments which highlighted restructuring issues as an area of ATO concern). This was the subject of a new chapter added to the OECD Guidelines in 2010 and has been a focus area for the ATO for several years, so it is somewhat surprising that the Consultation Paper did not address this in more detail.

The impact of a change in law in any ongoing transfer pricing disputes, APAs and negotiations of new APAs will need to be considered. If aspects of the revised law are

to be applied retrospectively, as the Assistant Treasurer's press release suggests they might, then we expect that detailed guidance on transitional issues will be required.

The ATO may need to revise some or all of its public rulings on transfer pricing matters if there is a change in the law. The existing rulings are intended to provide guidance on the application of the existing law.

Conclusion

It is not surprising that Government has decided to address perceived weaknesses in the efficacy of Australia's transfer pricing rules. Some aspects of the proposals should be seen as a positive development, in particular the desire for greater consistency between the domestic law, OECD Guidelines and Australia's double tax treaties. Bringing Australia's transfer pricing rules clearly into line with the rules in other OECD countries will allow multinationals to apply consistent transfer pricing policies for their Australian and global operations. However, aspects of the proposals are clearly designed to protect positions long held by the ATO, which are unproven in law and arguably inconsistent with OECD guidance. We are also strongly of the view that any changes to the law should only be made on a prospective basis.

Even though the consultation timetable is very short, we strongly recommend that taxpayers voice their views as part of the consultation process either directly or through your PwC transfer pricing contact. PwC will be making a submission and will play an exclusive, ongoing role in consultation with Treasury.

For more information, please contact your regular PwC transfer pricing contact or one of the individuals listed below:

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