THE TAX INSTITUTE

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Mr Tim Bryant
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Dear Mr Bryant

Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013

The Tax Institute thanks the Senate Standing Committee on Economics (the "**Committee**") for this opportunity to make a submission in relation to the *Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013* (the "**Bill**").

Our submission below is set out in two parts, relating to:

- **Part 1:** Schedule 1 of the Bill which seeks to amend Part IVA of the *Income Tax Assessment Act 1936* ("**Part IVA**" or "**the income tax general anti-avoidance rule**"); and

- **Part 2:** Schedule 2 which seeks to modernise Australia's transfer pricing rules via introduction of Subdivisions 815-B, 815-C and 815-D into the *Income Tax Assessment Act 1997* and Subdivision 284-E into Schedule 1 to the *Taxation Administration Act 1953* ("**TAA 1953**").

Given that the issues raised in our submission are complex, we would be keen to further explore these issues at a hearing of the Committee.

SUMMARY

Income Tax General Anti Avoidance Rule

The Tax Institute supports the maintenance of a robust general income tax anti avoidance rule within the tax system to ensure that tax is levied fairly, consistently and according to the policy intention of the relevant tax laws.

However, the amendments in the Bill are an unnecessary overreaction to recent Court cases and not required to maintain the integrity of the system.

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Furthermore, we are concerned that the Bill as drafted will bestow excessively wide powers on the Commissioner to levy tax on the basis of an unreasonable alternative postulate. Such an unconstrained power will result in an inappropriate erosion of taxpayer rights and create potential for undesirable behavioural changes.

Our submission contains a number of recommended amendments for the Committee's consideration.

Transfer Pricing

The Tax Institute is supportive of the Government's efforts to ensure an equitable return on Australian operations is taxed in Australia by updating our current transfer pricing laws.

However, we are concerned that the Bill as currently drafted will:

- bestow unnecessarily wide powers on the Commissioner to reconstruct actual transactions leading to taxpayer uncertainty;
- impose excessively high documentation requirements, especially on small-to-medium enterprises; and
- unnecessarily broaden the scope for penalties to apply.

The Bill will require taxpayers to do more for less. That is, the proposed documentation rules when considered in conjunction with the proposed new penalty rules will require taxpayers to keep more records than currently necessary under Australian Taxation Office ("**ATO**") taxation rulings of many years standing but provide taxpayers with less favourable penalty outcomes in the event a transfer pricing adjustment is made.

The Committee should recommend that Schedule 2 be removed from the Bill for further consideration by Treasury. The Bill should be accompanied by a Regulation Impact Statement that sets out the compliance cost impost on all, but most especially small to medium enterprise taxpayers. Delay in the introduction of revised transfer pricing rules should not result in integrity concerns of note due to the earlier introduction of Subdivision 815-A.

Our submission contains a number of detailed recommendations for the Committee's consideration.

PART 1: CHANGES TO THE INCOME TAX GENERAL ANTI-AVOIDANCE RULE

No need for amendments

The changes in Schedule 1 of the Bill seek to amend Part IVA with the aim of ensuring that the Act "continues to counter schemes that comply with the technical requirements of the tax law but which, when viewed objectively, are conducted in a particular way mainly to avoid tax."[1]

[1] Second Reading Speech, *Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013*, House of Representatives, Assistant Treasurer, the Hon. David Bradbury MP

The Tax Institute supports the maintenance of a robust general income tax anti avoidance rule within the tax system to ensure that tax is levied fairly, consistently and according to the policy intention of the relevant tax laws. Widespread faith in the integrity of our tax laws is essential to securing taxpayer trust and voluntary compliance.

Nevertheless, it is our view that the existing income tax general anti-avoidance laws already fulfil this function. The Courts have applied the current rules appropriately to find that a tax benefit exists in only those cases where the taxpayer's actions have resulted in a loss to revenue. Recent cases have not resulted in the effectiveness of Part IVA being compromised and as such the amendments in the Bill are an unnecessary overreaction.

This is because the repeated assertion in Government media releases and the Explanatory Memorandum to the Bill that the ability to successfully posit a "do nothing" alternative postulate would allow the "tax advantage" obtained from a scheme to function as a shield against the application of Part IVA is misguided and incorrect.

The circumstances that lead to this alternative postulate being successfully put in the *RCI case*[2] were reasonably unique. As such, the capacity to successfully put such a defence in other situations is very limited under current laws. The perceived resulting integrity risk is, in our view, based on an incorrect reading of the case.

At any rate, a "do nothing" alternative postulate does not come into play if the Commissioner is able to posit another reasonable alternative postulate that involved doing something. This integrity protection mechanism already exists under the current law.

As such, we do not anticipate that the *RCI case* will open a floodgate of taxpayers that can successfully rely on this argument at law. Any concerns that the case may result in an increase in taxpayer risk appetite via more taxpayers seeking to rely on the "do nothing" alternative postulate are better addressed via rigorous administration rather than legislative change.

With any such major changes in tax law, much effort and expense is typically required to be invested over the subsequent years to define and determine the legal effect and commercial impact of the change/s. In this case, all such efforts by the Australian Taxation Office, taxpayers and the Courts will represent a waste of resources, as no amendments to Part IVA are necessary to protect the integrity of the tax system.

In light of the above, we would be keen to explore the Government's quantification of revenue protected as a result of these amendments ($1 billion), as noted in the Assistant Treasurer's media release no. 010 dated 13 February 2013.

Recommendation 1

In recognition of the lack of necessity of changes to the current Part IVA, the Committee should recommend that Schedule 1 of the Bill be removed.

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

Problems with the Bill

Should the Committee not proceed with recommendation 1, our comments on and recommended changes to the Bill are as follows.

Broadly, Part IVA applies where a taxpayer enters into a *scheme* for the *sole or dominant purpose* of obtaining a *tax benefit*. Where Part IVA applies, the Commissioner may cancel the tax benefit.

In our view, the two safeguards in Part IVA (the tax benefit and purpose tests) were intentionally inserted by the legislature to ensure an appropriate balance in the current structure between the competing concerns of tackling tax avoidance and limiting the power to do so to an appropriate range of circumstances.

In applying the second safeguard, the tax benefit test, a tax benefit should not result unless a taxpayer's tax avoidance conduct has adversely affected the revenue i.e. the taxpayer has paid less tax than would or might reasonably be expected to be the case had the scheme not been entered into.

Annihilation provision

The Bill appears to bestow a wide and unrestricted power on the Commissioner with respect to the use of the annihilation provision in section 177CB(2).

Although the Explanatory Memorandum indicates that this provision will typically be used "where the scheme in question does not produce any material non-tax results or consequences for the taxpayer"[3] there is no such restriction on a wider use of this provision in the legislation itself.

If this power were applied broadly, the Commissioner could annihilate a 'scheme' in a way that produces an unreasonable basis on which the tax benefit is calculated without any capacity for taxpayer challenge.

Construction of alternative postulate

Under the current Part IVA, the Commissioner may put any reasonable alternative postulate as the basis for calculating the tax benefit. This test of course prevents other tax avoidance schemes from constituting a reasonable alternative postulate and as such protects the integrity of the tax system in a relatively unobtrusive fashion.

In contrast, the Bill seeks to amend the tax benefit test to allow the positing of all alternative postulates that are reasonable only once tax consequences are disregarded[4]. Such an amendment is inappropriate and unnecessary.

Under this assumption, the "tax benefit" will not necessarily correctly quantify the loss to revenue as the taxpayer may not reasonably be expected to have engaged in the posited course of conduct once this commercially unrealistic assumption is removed. This is because taxpayers legitimately take tax into account when considering business decisions. Significantly, taxpayers often legitimately evaluate commercially different alternatives on a post-tax basis.

[3] Paragraph 1.82 of the Explanatory Memorandum to the Bill
[4] Sections 177CB(3) and (4)

Due to ambiguous drafting of section 177CB, it is unclear whether the alternative postulate is required to be reasonable in all of the facts and circumstances.

Concerns regarding lack of reasonableness requirement

This issue is of concern for two reasons:

- It significantly diminishes the second safeguard in Part IVA (the tax benefit test) and therefore disturbs the inherent balance in the current Part IVA between tackling tax avoidance and allowing taxpayers a reasonable right to challenge the Commissioner's assessment – an essential right in a self-assessment system to guard against the imposition of arbitrary assessments. The potential for adverse behavioral changes in the form of heightened taxpayer risk, negative effects on business sentiment and a greater taxpayer tendency not to challenge excessively high tax assessments is high, undesirable and unnecessary.

- Where Part IVA does apply, the Commissioner should only be permitted to reverse the ill-gotten gains of the taxpayer. Instead, the proposed amendment appears to confer a much wider power on the Commissioner to cancel any tax advantage obtained via the scheme, whether inappropriately or not. That is, the Commissioner may posit a commercially unrealistic set of circumstances following an annihilation of the scheme or construction of the alternative postulate (such as for example, a scenario involving double taxation of the same economic gain) and levy additional tax on that basis without any capacity for taxpayer challenge at Court.

The uncertainty caused by the ambiguous drafting in the Bill is also undesirable. Greater clarity with respect to whether an unreasonable alternative postulate is allowable under section 177CB(4) would greatly assist taxpayers in managing their tax risk.

It is our view that the Bill should be clarified to ensure that:

- Regard is required to be had to the substance of the scheme and the results or consequences produced for the taxpayer when applying the annihilation provision in section 177CB(2); and

- The Commissioner cannot put an unreasonable alternative postulate without any capacity for taxpayer challenge.

While we do not suggest that the Commissioner would seek to abuse such powers, the possibility will incite undesirable behavioral change, is inconsistent with the goal of taxpayer certainty and represents the rule of administration rather than the rule of law.

Such wide powers are also unnecessary to achieve the Government's stated policy intention of foreclosing on the "do nothing" alternative postulate, protecting the integrity of the tax system and tackling tax avoidance, as these objectives can be achieved by an appropriate limitation on the broad "disregard tax" assumption.

Recommendation 2

Should the Committee not proceed with recommendation 1, we recommend that the Bill be amended to restrict the capacity to apply the annihilation provision and require any alternative postulate to be "reasonable" *after* the disregard tax assumption has been applied. Such amendments should not pose any further integrity risks as compared to the Bill as:

- Insofar as the Commissioner's alternative postulate is considered to be reasonable, the taxpayer has no further right of reply. That is, the Commissioner's ability to apply Part IVA should not be restricted in any way that is counter to the Government's objectives via such an amendment.

- A Court would not consider another tax avoidance scheme to be reasonable in these circumstances.

- Any concern that such an amendment would pose an integrity risk by allowing taxpayers to argue that the Commissioner's alternative postulate is unreasonable due to its tax cost is unfounded.

  To the extent that a taxpayer has appropriately taken the tax cost of the substance of the scheme into account in a decision making process, Part IVA should not be applicable i.e. the success of such an argument should not pose an integrity risk.

  To the extent that a taxpayer has sought to engage in blatant, artificial or contrived behaviour in order to secure a tax advantage, a Court would not find an alternative postulate which comprises of correctly applying the tax laws to the substance of the scheme to be unreasonable exclusively because of the resulting tax cost.

- The recommended restriction of the annihilation provision is in accordance with the provision's intended use, as set out in the Explanatory Memorandum to the Bill (paragraph 1.82).

The amendments required to effect recommendation 2 are set out below for the Committee's consideration.

Section 177CB(2) should be amended so that regard must be had to the factors in section 177CB(4)(a) (i.e. substance of the scheme and non-tax results or consequences produced) before the section can be applied.

Extract from section 177CB, marked up for suggested amendments.

(3) A decision that a tax effect might reasonably be expected to have occurred if the scheme had not been entered into or carried out must be based on an alternative postulate ~~that is a reasonable alternative~~ to entering into or carrying out the scheme.

(4) In ~~determining~~ constructing an alternative postulate for the purposes of subsection (3) ~~whether a postulate is such a reasonable alternative~~:

(a) have particular regard to:

(i) the substance of the scheme; and

(ii) any result or consequence for the taxpayer that is or would be achieved by the scheme (other than a result in relation to the operation of this Act); but

(b) disregard any result in relation to the operation of this Act that would be achieved by the postulate for any person (whether or not a party to the scheme).

(5) Notwithstanding subsection (4), an alternative postulate to entering into or carrying out the scheme under subsection (3) must be reasonable.

PART 2: MODERNISING AUSTRALIA'S TRANSFER PRICING RULES

As noted in the Assistant Treasurer's media release no. 010 on introduction of the Bill (13 February 2013), "[t]ransfer pricing rules are critical to the integrity of the tax system. They seek to ensure that an appropriate return for the contribution of Australian operations of a multinational group is taxable in Australia for the benefit of the broader community."

The Tax Institute is supportive of the Government's efforts to ensure an equitable return on Australian operations is taxed in Australia by updating our current transfer pricing laws.

The transfer pricing rules modernisation project will, if implemented appropriately, yield benefits for the revenue authority and taxpayers alike. A closer alignment of Australia's transfer pricing rules with the 2010 OECD Transfer Pricing Guidelines ("**OECD guidelines**")[5] should ensure that multi-national enterprises ("**MNEs**") are broadly taxed in line with mutually agreed principles via a cohesive and co-ordinated international approach to transfer pricing.

The anticipated benefits of this policy objective are plentiful – lower compliance costs for MNEs due to standardised rules across jurisdictions and more appropriate tax collections for revenue authorities.

Nevertheless, we are concerned that the Bill as currently drafted will not yield many of the lauded simplicity and certainty benefits and will increase the compliance burden especially and disproportionately on small to medium enterprises.

Furthermore, many of these additional costs do not yield any commensurate benefit for the revenue. That is, the Bill may be amended to address these concerns without compromising the integrity of the proposed transfer pricing rules or any other part of the tax system. Our concerns and recommended changes to the Bill are set out in further detail below.

[5] As noted in the Assistant Treasurer's media release no. 010, dated 13 February 2013.

Reconstruction powers

The Bill, as currently drafted allows the Commissioner to tax MNEs on the basis of a situational construction rather than the actual dealings in a range of situations, including:

- where the form of the actual dealings is inconsistent with the substance of the dealings; and

- where taxpayers dealing at arm's length would not have entered into the actual dealings.

In these circumstances, the Commissioner may disregard the form of the actual dealings and/or reconstruct the actual transaction and then levy tax on the basis of an arm's length alternative in *all* cases where a taxpayer obtains a transfer pricing benefit.

In sharp contrast, under the OECD guidelines, transactions may only be reconstructed in *'exceptional'* circumstances (paragraphs 1.64 and 1.65 of the OECD guidelines).

The powers created by the Bill are unnecessarily broad to achieve the relevant policy objectives. Furthermore, the wide scope of potential application of this power will create difficulties for taxpayers in self-assessing the likelihood that the power will be exercised. The resulting uncertainty will significantly increase compliance costs for taxpayers in seeking to comply with the rules.

Such wide powers are also out of sync with international best practice as expressed in the OECD guidelines. This is an unfortunate and unnecessary deviation and will undermine the policy intention of closer alignment, as set out above.

The section intended to achieve closer alignment with the OECD guidelines (section 815-135) is an inadequate safeguard against the broad scope of the reconstruction power for the following reasons:

- The OECD guidelines (paragraph 1.65) refer to two circumstances in which it is appropriate for a revenue authority to disregard the actual transactions. However, even these circumstances represent only basic conditions in which a reconstruction power may be considered. In order for a revenue authority to legitimately apply a reconstruction power, it is also necessary that the case in relation to which use of a reconstruction power is being considered is itself exceptional;

- The OECD guidelines (paragraph 1.65) do not provide any clarity around what might constitute 'exceptional' cases, leaving such matters to be determined under the domestic tax law of each country. This is understandable given the consensus nature of the OECD guidelines. This also provides an as yet unutilised opportunity to Australian law makers to define what should constitute "exceptional" circumstances for the purposes of our domestic laws; and

- The text of paragraph 1.65 of the OECD guidelines is consistently permissive rather than mandatory in nature. This can be contrasted with subsections 815-130(2)-(4) which, as noted above, require the arm's length conditions to replace the actual conditions in *all* cases where a taxpayer obtains a transfer pricing benefit. A permissive guideline offers no reliable protection against the text of Australian law.

Subsections 815-130(2)-(4) as currently drafted are not consistent with paragraphs 1.64 and 1.65 of the OECD guidelines and therefore are not in keeping with the Government's policy objective of aligning Australia's transfer pricing rules with international best practice as expressed in the OECD guidelines.

As set out below, we recommend that this power be more appropriately restricted (in line with OECD guidelines) in order to lessen uncertainty and compliance costs for taxpayers. Furthermore, establishing appropriate boundaries for the exercise of such a power will not result in any integrity concerns of note.

While we do not intend to suggest that the Commissioner would seek to abuse such a broad power, a lack of further guidance/restriction on the use of this power will result in uncertainty, confusion and undesirable behavioural changes in the form of negative business sentiment and increase in tax risk.

Recommendation 1

The Committee should recommend that:

- Subsections 815-130(2)-(4) be amended to ensure that they apply only in exceptional cases, consistent with paragraphs 1.64 and 1.65 of the OECD guidelines; and

- Clearer guidance be provided in Subdivision 815-B as to what constitutes the reconstruction of a cross-border related party dealing as distinct from the re-pricing of a cross-border related party dealing based on a comparability analysis.

Annihilation provision

The annihilation provision in subsection 815-130(4) seeks to calculate the transfer pricing benefit by disregarding the actual arrangement between the parties.

Treasury's submission to the House of Representatives Standing Committee on Economics on this Bill is misguiding in asserting that this position is entirely consistent with the OECD guidelines. This is not so because the OECD guidelines also recognise that the mere fact that an arrangement between related parties is not seen between independent enterprises does not in itself mean that it is not arm's length or commercially rational (see paragraphs 1.11, 1.67 and 9.172).

Such a provision is likely to result in harsh or potentially oppressive outcomes if the Commissioner seeks to annihilate an actual arrangement that involves real activities being undertaken by the Australian taxpayer in Australia.

Disregarding transactions where real activities are undertaken in Australia is also inconsistent with the Objects clause (paragraph 815-105(1)(a)) and the Government's policy intention i.e. to ensure that an appropriate return for the contribution of Australian operations of a multinational group is taxable in Australia for the benefit of the broader community. See also paragraph 3.1 of the Explanatory Memorandum.

Recommendation 2

The Committee should recommend that subsection 815-130(4) be deleted or amended to enable real activities undertaken by Australian taxpayers to be taken into account in determining whether a taxpayer has obtained a transfer pricing benefit.

Transactions entered into before date of effect of the Bill

While the Bill purports to only apply on a prospective basis, it is unclear whether transactions entered into prior to the date of commencement of Schedule 2 can also be reconstructed under subsections 815-130(2)-(4). This situation is likely to arise as many dealings entered into by MNEs span over several income years, and the tax effect of a particular transaction may also span several income years.

If transactions entered into prior to the date of effect of the Bill are able to be reconstructed under Subdivision 815-B, the Bill will in effect have retrospective application to transactions entered into potentially years before the relevant date of effect. Such a retrospective application is inappropriate as the reconstruction powers in subsections 815-130(2)-(4) are significantly broader than current transfer pricing laws, and taxpayers could not have had any awareness of the breadth of these powers at the time of entering into such dealings.

Recommendation 3

The Committee should recommend that:

- The Bill be amended so that the reconstruction powers in subsections 815-130(2)-(4) can only be applied to transactions entered into on or after the date of effect of the Bill for a particular taxpayer; and
- The Explanatory Memorandum should be revised to include examples showing how subsections 815-130(2)-(4) and Subdivision 815-A and/or Division 13 interact in relation to dealings entered into by MNEs that span several income years including the first year of income in which Subdivision 815-B would apply to a taxpayer.

Record keeping and penalty requirements

The record keeping and penalty requirements imposed by the Bill as currently drafted are unnecessarily onerous to achieve their policy objective and offer little incentive for voluntary compliance.

Specifically:

- Taxpayers complying with the documentation standards set out in the Bill may still incur a 10% penalty, even if the taxpayer does not fall foul of the standard penalty rules;

- There is little clarity on whether making a good faith effort to satisfy the documentation requirements set out in the Bill will offer any protection against even further penalties that may apply under the general record keeping requirements; and

- The *de minimis* rules are far too low – the international dealings of small to medium enterprises that trade internationally are too high in quantum for the $10,000 and $20,000 thresholds to provide any real relief from onerous documentation requirements.

Onerous documentation requirements

The Bill currently creates an obligation to maintain and prepare documentation for *all* conditions that are relevant to the transfer pricing rules, no matter how significant or material in order to achieve *some* protection from penalties. Such an obligation will be particularly onerous for small-to-medium enterprises operating internationally.

The Explanatory Memorandum helpfully attempts to soften this requirement as follows: "an entity only maintain and prepare documentation in respect of those conditions that are both material and relevant to the application of Subdivision 815-B and 815-C to them." (paragraphs 6.25 and 6.26).

However, as recently reiterated by the High Court, the task of statutory construction must begin with a consideration of the statutory text itself considered in its context. Legislative history and extrinsic materials cannot displace the meaning of the statutory text[6]. That is, the Explanatory Memorandum is well-intentioned but insufficient to excuse the onerous documentation requirements imposed by the Bill in order to obtain a reasonably arguable position.

Contrary to the view expressed by Treasury in its submission to the House of Representatives Standing Committee on Economics, the Bill significantly increases the compliance burden on taxpayers in comparison to current ATO determined and administered requirements for less protection i.e. taxpayers will need to do more work for less benefit, without any commensurate additional benefit to the Government.

Recommendation 4

The Committee should recommend that subsections 284-250 and/or 284-255 of Schedule 1 to the TAA 1953 be amended to allow the materiality and relevance of conditions to be taken into account in determining whether sufficient and appropriate documentation has been maintained.

Application of penalties even where documentation requirements fulfilled

At the moment, under TR 98/11 and TR 98/16, the ATO will generally remit transfer pricing penalties to nil where the documentation requirements have been fulfilled.

[6] *Alcan (NT) Alumina Pty Ltd v Commissioner of Territory Revenue* [2009] HCA 41 at paragraph 47; *Commissioner of Taxation v Consolidated Media Holdings* Ltd [2012] HCA 55 at paragraph 39). Also, Section 15AB of the *Acts Interpretation Act 1901* (use of extrinsic material) does not assist where the meaning of the statutory text is clear on its face.

In contrast, under the proposed rules, where documentation is maintained to the same standard but a tax shortfall nevertheless results, taxpayers will have penalties imposed at a rate of *at least 10%* of the scheme shortfall amount under proposed subsection 284-160(3) of Schedule 1 to the TAA 1953.

The imposition of this greater penalty does not yield any discernible benefit to taxpayers or the Government.

<u>Recommendation 5</u>

The Committee should recommend that:

- Subsection 284-160(3) of Schedule 1 to the TAA 1953 be amended so that taxpayers that have obtained a reasonably arguable position by fulfilling the relevant documentation requirements will not be subject to a penalty; and

- Greater discretion be provided to the Commissioner to determine penalties in accordance with degrees of compliance with the documentation requirements.

Interaction of proposed penalty provisions with general record keeping requirements

In a self-assessment environment, taxpayers are required by section 262A of the Income Tax Assessment Act 1936 ("**ITAA 1936**") to keep records that explain all transactions that are relevant for any purposes of the Act. The record keeping rules in section 262A of the ITAA 1936 apply irrespective of the record keeping rules proposed in Subdivision 284-E of Schedule 1 to the TAA 1953 (paragraph 6.6 of the Explanatory Memorandum to the Bill).

Taxpayers and public officers are potentially exposed to administrative penalties under section 288-25 of Schedule 1 to the TAA 1953 and also to criminal penalties for failing to comply with section 262A (see PS LA 2005/2: Penalty for failure to keep or retain records). These administrative penalties are separate to and independent of any administrative penalties that might apply under Subdivisions 284-B or 284-C of Schedule 1 to the TAA 1953.

The Government has not provided any guidance on what records taxpayers will need to maintain for transfer pricing purposes to avoid administrative penalties arising for failing to keep the records required by section 262A of the ITAA 1936.

Under the rules as currently drafted, taxpayers that have made a good faith effort to comply with both sets of record keeping requirements may nevertheless have penalties imposed. This is due to the applicability of two sets of incongruent penalty provisions. The resulting complexity and uncertainty for taxpayers can be avoided by a single layer of penalties in transfer pricing cases.

<u>Recommendation 6</u>

The Committee should recommend that:

- Further work should be undertaken on the Bill with the aim of developing a single set of administrative penalties that would apply in transfer pricing cases; and
- Clearer guidance be provided in the Bill in relation to the type of records that taxpayers will need to maintain in a self-assessment environment for purposes of section 262A of the ITAA 1936.

De minimis penalty thresholds

The proposed *de minimis* thresholds of $10,000 and $20,000 thresholds will not carve out many enterprises operating in the small-to-medium enterprise market as intended. The international operations of most small to medium enterprises ("**SMEs**") typically far exceed the proposed *de minimis* penalty thresholds thresholds, which were originally introduced via *A New Tax System (Tax Administration) Act (No. 2) 2000* to exempt individual taxpayers (rather than companies) in an altogether separate context.

To exempt SMEs from documentation requirements in order to minimise penalty exposure, the relevant *de minimis* threshold should be set to $5,000,000. This amount represents a modest threshold in comparison to comparable international comparisons, as set out below.

Notably, the thresholds employed in the United Kingdom exempt qualifying entities from the operation of the transfer pricing rules *altogether* rather than from the documentation requirements only.

In this context, an internationally modest threshold at which Australian taxpayers may be exempted from transfer pricing documentation requirements in order to obtain protection from transfer pricing penalties is wholly justifiable, especially in light of the likely compliance burden that would otherwise be borne by such entities. This is especially so since such taxpayers will still bear record keeping responsibilities under section 262A (see above) and be subject to penalties if the taxpayer falls short of the objective standard of behaviour in the ordinary penalty provisions (e.g. not taking reasonable care).

Alternatively, consideration should be given to setting a *de minimis* revenue-based threshold on an entity basis (rather than by reference to the tax shortfall amount). Such a basis has the advantage of exempting certain entities from onerous documentation requirements altogether, rather than having to incur the expense in calculating the potential tax shortfall to determine if the benefit of the exemption can be obtained.

SME thresholds

Countries such as the United Kingdom exempt small *and* medium enterprises from their transfer pricing rules with only limited exceptions. For purposes of the UK law, small and medium enterprises are defined as follows:

	Maximum number of staff	**AND less than one of the following limits:**	
		Annual turnover	Balance sheet total assets
Small Enterprise	50	€10 million	€10 million
Medium Enterprise	250	€50 million	€43 million

By way of comparison, the ATO classifies taxpayers for purposes of its internal administrative arrangements as shown in the following table[7]:

	Turnover	**Number of entities**
Micro-enterprises	Less than $2 million	Almost 3 million businesses
Small-medium enterprises	$2 million to $10 million (S1)	About 183,000 businesses. Around 80% have a turnover of between $2-10 million
	$10 million to $50 million (S2)	
	$50 million to $100 million (S3)	
	$100 million to $250 million (S4)	
Large businesses	Greater than $250 million	About 1,300 economic groups and entities

If a *de minimis* revenue-based threshold is set on a per entity basis, we recommend that the threshold not be set at the small business capital gains tax threshold of $2 million turnover, as entities of this size are unlikely to engage in significant international dealings[8].

While additional data from the ATO would assist in determining the most appropriate threshold, it is our view that the compliance costs that would otherwise be borne by S1 and many S2 taxpayers would outweigh the potential benefits to the Government of requiring these taxpayers to fulfil the transfer pricing documentation requirements. As

[7] ATO Compliance Program 2012-13.

[8] The small business capital gains tax threshold of $2 million turnover is relevant for purposes of the Simplified Tax System in Division 328 of the ITAA 1997 introduced in 2001 and modifies the method of determining taxable income for certain businesses with straightforward, uncomplicated tax affairs.

such, we recommend that an SME exemption be extended to entities with a specified turnover of between $10 million and $50 million.

Recommendation 7

The Committee should recommend that the de minimis threshold in relation to the resulting tax shortfall either be raised to $5,000,000 to have the intended effect or be set on a per entity basis for entities with a specified turnover of between $10 million and $50 million to exempt SME taxpayers from excessively onerous record keeping requirements.

Interaction between transfer pricing rules and customs duty rules

The Bill does not address the interaction between the transfer pricing rules and customs duty rules. Transfer pricing adjustments involving the importation of goods can cause customs duty problems because a separate adjustment then needs to be sought to the customs value of the goods. This is particularly problematic where a transfer pricing adjustment results from the use of a profit method.

Recommendation 8

The Committee should recommend that a whole-of-government approach be instituted with the aim of creating a simple legislative mechanism by which taxpayers can obtain refunds of any overpaid customs duty following the making of a transfer pricing adjustment by the Australian Taxation Office.

Amendment period

Amendment periods should be set to the shortest time that is reasonable taking ATO and taxpayer activities into account, in order to maximise certainty in the tax system.

This is because a brief amendment period encourages timely standard business practices both for the ATO and taxpayers, encourages the timely identification and resolution of issues and maximises certainty.

While both the ATO and taxpayers require a reasonable period of amendment in order to allow for the correction of errors and settling of disputes, there is no discernible reason why the amendment period in the context of the transfer pricing rules should not align with the standard amendment period in section 170 of the ITAA 1936 (typically 4 years).

Unnecessarily long amendment periods can discourage the speedy resolution of disputes and increase compliance costs for taxpayers in the form of requirements to retain records for longer periods of time in the tax context than other reporting requirements (such as under the *Corporations Act 2001*), increased cost of obtaining information from tax periods long past, and the loss of corporate knowledge as a result of staff turnover.

A standard 4 year amendment period is justifiable in the transfer pricing context as significant movements in the international tax arena in the past few decades have greatly expanded the ATO's capacity to collect information in a timely fashion. Note, specifically:

- Australia's tax treaty network has substantially expanded since the current Division 13 was introduced in 1982[9]:

  - In 1982 (when Division 13 was introduced into the tax laws), Australia had around 15 comprehensive double tax agreements ("DTAs") in force that included an exchange of information article (an exchange of information article provides a mechanism by which information necessary for purposes of administering domestic tax laws can be supplied between the treaty partners);

  - Australia currently has around 44 DTAs in force that include an exchange of information article and has concluded a DTA with Turkey which is not yet in force; and

  - Since November 2005, Australia has concluded 33 Tax Information Exchange Agreements ("**TIEAs**") which are in force, primarily with jurisdictions commonly regarded as tax havens or offshore financial centres that include an exchange of information article; and

- The OECD has taken significant steps at both a framework level and a practical level to enhance the Exchange of Information between tax treaty partners by:

  - Replacing Article 26 (Exchange of Information) of its Model DTC (upon which Australia's DTAs are based) and to its associated Commentary in 2004; and

  - Issuing the '*Manual on the Implementation of Exchange of Information Provisions for Tax Purposes*' to improve the efficiency of the exchange of information process in January 2006.

Further to the above, subsection 170(7) of the ITAA 1936 (and its predecessor provisions in subsections 170(4) and (4A)-(4C) of the ITAA 1936 which were introduced in 1990) enables the Commissioner to seek additional time to complete an examination of a taxpayer's affairs where an examination has started but is not completed by the time the limited amendment period is reached.
We note that Treasury's submission to the House of Representatives Standing Committee on Economics Inquiry on this Bill has not referred to any of the above factors. It is therefore unclear whether and if so how Treasury has taken the above factors into account in determining the most suitable amendment period.

Any changes in the amendment period for transfer pricing purposes would of course not alter the current unlimited time periods for amendments in cases involving fraud or evasion.

[9] Treasury website.

Recommendation 9

The Committee should recommend that the normal time limits for amending assessments under section 170 of the ITAA1936 should also apply in transfer pricing cases.

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If you would like to discuss this matter, please contact me or The Tax Institute's Tax Counsel, Deepti Paton

Yours sincerely

Steve Westaway
President