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Tax Update: Transfer Pricing

Tax Laws Amendment Bill 2013

Further to Treasury's exposure draft released in mid-November, the Government has now introduced into Parliament stage two of the transfer pricing reforms, the *Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013*. This Bill contains both stage two of the transfer pricing reform project, and the new general anti-avoidance provisions. These measures combined present the Commissioner with substantially increased powers at a time of falling tax revenue. The anti-avoidance provisions are discussed in detail in our *Tax Update: Anti-Avoidance Rules.*

The proposed transfer pricing changes in the Bill largely reflect those announced in the November exposure draft (and our alert *Tax Update: Transfer Pricing - Stage 2 of Australia's Transfer Pricing Reforms)* with a few differences. The main aspects of the Bill are as follows:

- The arm's length principle will be interpreted to achieve consistency with the arm's length principle endorsed by the OECD. This requires an examination of the "economic contribution of the entity", rather than just an examination of the arm's length pricing of transactions.
- The Bill provides the Commissioner with an ability to retrospectively reconstruct transactions. The circumstances in which this power can be used however, are more restrictive than contained in the exposure draft.
- An amendment period limitation will be introduced for transfer pricing adjustments. The time limit will be seven years from the date of assessment, shortened from the eight years proposed in the exposure draft, and the current unlimited period.
- Documentation will **not** be mandatory, however entities who fail to keep documentation in accordance with the regulations will not be able to argue they have a reasonably arguable position and may expose themselves to greater penalties.
- That a withholding tax advantage could be specifically the basis for receiving a transfer pricing benefit.
- The proposed rules will apply to both treaty and non-treaty country residents, and new provisions will be introduced which apply the rules in

the same manner to both Trusts and Partnerships.

- The currently existing provisions in Division 13 will be repealed, and Subdivision 815-A will become largely redundant.
- The new legislation is proposed to take effect for income years beginning on or after the earlier of 1 July 2013 or the date the legislation receives royal assent.

The Bill, together with the prevailing political and international environment will require taxpayers to reconsider their transfer pricing position and their exposure to potential risks. The key areas of interest and action for taxpayers are as follows:

Arm's Length Principle

Taxpayers will be required to assess the 'economic contribution' of their Australian subsidiaries, and ensure it is reflective of the economic contribution of an independent entity in order to comply with the arm's length principle. In order to undertake this comparison, taxpayers will need to examine and document **all** the conditions surrounding each transaction or transactions to ensure each one is reflective of arm's length dealings. The actual substance of the conditions will be the critical factor, with the legal form being disregarded when not consistent with the substance.

For those taxpayers operating through a permanent establishment (PE), the allocation of profits will be assessed on an arm's length **profit** amount, being the profit the PE would be expected to make if it was a standalone independent entity. Importantly, deductions will be limited to actual expenditure of the PE in line with the ATO's long standing position.

The new legislation comes at a time when Australia and the OECD are comprehensively reviewing their approach to the taxation of PEs. There is a developing concern amongst the OECD member nations who face an eroding tax base. In part, this is due to the increased value attributable to IP, and the ease with which transactions are now conducted across borders. As a result, matters pertaining to the attribution of profits and transfer pricing are high on the agenda.

The approach in the Bill is at odds with the 'Authorised OECD Approach' ("AOA"), which assesses the profit of a PE as if it was a functionally separate entity. This permits internal deductions, which the current Australian approach does not. With a Board of Taxation review currently considering whether Australia should adopt the AOA, further fundamental change could be in store.

Documentation

While documentation is not mandatory, entities who do not prepare documentation in line with the new legislation will be unable to argue a reasonably acceptable position in the event of an ATO dispute, and will therefore find themselves open to harsher penalties. The new requirements encompass the documentation of all business and economic conditions facing an entity that are material and may impact decisions in relation to related party transactions. There is also an increased emphasis on taxpayers being able to demonstrate a process of negotiation, akin to that undertaken by unrelated parties in setting related-party prices. Benchmarking may be required at both the transactional and profit level, depending on the types of transactions being undertaken in accordance with the 'most appropriate' method as set out in the 2010 OECD guidelines.

Treasury suggests that much of the required documentation will be kept by taxpayers as a matter of course, however prudent taxpayers are strongly advised to review their current agreements and documentation to ensure it will meet the requirements.

Reconstruction Powers

One of the more controversial aspects of the new legislation is the Commissioner's powers to reconstruct transactions. These powers have been watered down from the initial exposure draft released and are now more in line with the OECD's interpretation of reconstruction powers. The powers are available in 'exceptional circumstances' where there is a difference between the form and substance of the transaction, or where transactions are entered into that would otherwise not have been entered into by unrelated parties. It remains to be seen how aggressively the ATO makes use of these new powers, with the wording of the legislation still providing a significant degree of flexibility and interpretation. Given the current political environment, one would expect the powers will not be sparingly used.

Thin Capitalisation

The Bill extends the thin capitalisation-transfer pricing interaction outlined in subdivision 815-A to the new provisions. The first requirement is to determine the arm's length price of debt in accordance with the new transfer pricing provisions, including a consideration of all the conditions operating between the relevant entity and other entities in relation to the commercial or financial relations that exist between them. The arm's length rate is then applied to the actual debt amount of the entity, to ascertain a notional deduction to which the thin capitalisation rules are then applied.

This is a difficult area of transfer pricing and tax law. Taxpayers with intra-group financing arrangements should seek professional advice in this area to ensure compliance with its complex nature.

OECD Guidance

The bill requires the OECD's model tax convention and transfer pricing guidelines be used in interpreting the new provisions. These documents are substantial documents and will require taxpayers to be aware of, and consider their guidance in implementing and documenting transfer pricing policies and practices.

The OECD guidance covers several areas that the ATO has failed to release guidance on, or has taken a one size fits all approach. The commentary addresses issues such as the business strategy of the entity, and its relevance to the selection of comparables. In addition, the guidance includes commentary on losses and the circumstances under which entities would be expected to make them. This commentary may be helpful to taxpayers who find themselves outside the ATO's expected profit margins and the subject of further scrutiny.

Conclusion

Taxpayers are strongly advised to carefully review their related party transactions, both current, past and planned, in light of the new legislation and the prevailing political climate. This review should seek to ensure they are correctly documented in accordance with the reinterpreted arm's length standard, and determine any gaps that may exist. Group policies should also be revisited to ensure they align with the new provisions and local rules. To further mitigate risk and prepare for the transfer pricing changes, taxpayers should:

- review profitability levels/ continuous losses and assess whether these may place the entity into a high risk category;
- examine internal transactions, such as loans and restructures, to determine if these create a higher transfer pricing risk profile; and
- ensure the public officer is aware of their obligations under the new self-assessment regime. This requires the public officer to declare that all intra-group transactions are conducted at arm's length and that they are adequately documented.

In light of the substantial changes now underway, we recommend you contact your local transfer pricing advisor to discuss any potential exposure you may have, or if you require any further information on the practical issues arising from the changes.