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Abstract

The Assistant Treasurer on 24 July 2013, in releasing the Australian Treasury's *Scoping Paper on Risks to the Sustainability of Australia's Corporate Tax Base* ('Scoping Paper') and the Government's response to the Scoping Paper's recommendations, noted that '[t]he release of the paper follows the significant efforts of the Government to strengthen Australia's corporate tax system. This includes modernising Australia's transfer pricing rules'.

Modernisation of transfer pricing rules was identified as a domestic pressure point requiring unilateral action by States in the February 2013 OECD's *Addressing Base Erosion and Profit Shifting* discussion paper ('OECD BEPS Report').

This paper seeks to explore in detail the operation of Australia's new transfer pricing rules before determining whether the 'modernisation' provides a solution to BEPS or whether the solution to BEPS lies in international cooperation.

Keywords

Australia's corporate tax system, BEPS, Australia's transfer pricing rules

ON THE EVE OF THE GLOBAL RESPONSE TO BEPS: AUSTRALIA'S NEW TRANSFER PRICING RULES

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1. INTRODUCTION

The Assistant Treasurer on 24 July 2013, in releasing the Australian Treasury's *Scoping Paper on Risks to the Sustainability of Australia's Corporate Tax Base* ('Scoping Paper')[1] and the Government's response to the Scoping Paper's recommendations,

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noted that '[t]he release of the paper follows the significant efforts of the Government to strengthen Australia's corporate tax system. This includes modernising Australia's transfer pricing rules'.[2] As modernisation of transfer pricing rules was identified as a domestic pressure point requiring unilateral action by affected States in the OECD's 2013 *Addressing Base Erosion and Profit Shifting* discussion paper ('OECD BEPS Report'),[3] it is not surprising that the Assistant Treasurer had sought to previously link these transfer pricing rules reforms to the Government's overall base erosion and profit shifting ('BEPS') initiatives.[4]

However, it is clear that the modernisation did not arise from the call in June 2012 by the G20 for a multilateral response to prevent BEPS,[5] nor was it in response to the pressure points identified in the OECD's BEPS Report. This modernisation predates both those events. Its origins lie in adverse judicial interpretation of the then existing rules in 2011 which appeared to threaten the sustainability of a number of large and

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Institute, Munich, 3 September 2013) and Michael Dirkis, 'On the eve of the global response to BEPS: Australia's new transfer pricing rules' (paper delivered to the University of Uppsala/Vienna University of Economics and Business 'Arbitration in Tax Treaty Law: Providing Legal Protection and Avoiding Qualification Conflicts in the Future' conference, Uppsala, 21 August 2013).

1 Australian Government, Treasury, *Scoping Paper on Risks to the Sustainability of Australia's Corporate Tax Base*, (2013) <http://www.treasury.gov.au/PublicationsAndMedia/Publications/2013/Aus-Corporate-Tax-Base-Sustainability/HTML>.

2 David Bradbury, Assistant Treasurer, 'Tackling base erosion and profit shifting' (Media Release, No 139, 24 July 2013) <http://assistant.treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2013/139.htm&pageID=003&min=djba&Year=&DocType=0>.

3 OECD, *Addressing base erosion and profit shifting* (2013) OECD Publishing, Paris, endorsed 12 February 2013 (OCED BEPS Report), 10, 52, 53 <http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/addressing-base-erosion-and-profit-shifting_9789264192744-en>.

4 David Bradbury, Assistant Treasurer, 'Towards a Fair, Competitive and Sustainable Corporate Tax Base', (Speech delivered at Institute of Chartered Accountants in Australia's National Tax Conference, Sydney, 22 November 2012) <http://assistant.treasurer.gov.au/DisplayDocs.aspx?doc=speeches/2012/013.htm&pageID=005&min=djba&Year=&DocType=0>.

5 *G20 Leaders Declaration*, 18-19 June 2012, [48] <http://g20mexico.org/images/stories/docs/g20/conclu/G20_Leaders_Declaration_2012.pdf>. This call was echoed in the *Communiqué of Meeting of G20 Finance Ministers and Central Bank Governors*, Mexico City, 5 November 2012, [21] <http://www.g20.utoronto.ca/2012/2012-121105-finance-en.html>.

high value audits that were being conducted by the Australian Taxation Office ('ATO').

Given that these measures were designed prior to the world response to BEPS, the paper seeks to explore in detail the operation and scope of the new transfer pricing rules before determining whether the 'modernisation' is consistent with BEPS or whether the solution to BEPS still lies in international cooperation (as outlined by the OECD on 19 July 2013 in its *Action Plan on Base Erosion and Profit Shifting* ('OECD Action Plan')).[6] In order to contrast the major structural changes undertaken in modernising the transfer pricing rules this examination will also briefly describe the former rules in the context of a brief history of the reforms.

2. THE REFORM PROCESS

2.1 Status quo: Australia's Transfer pricing rules applicable pre 1 July 2013

From 1982 to 30 June 2013 Australia dealt with the allocation of profits in cases where tax treaties were not applicable through the domestic transfer pricing rules that were contained in Div 13 of the *Income Tax Assessment Act 1936* (Cth) (ITAA 1936).[7] Also from 1982 to 30 June 2004, where a tax treaty applied, the allocation of profits in accordance with Articles 7 and 9 of that tax treaty was also dealt with under Div 13.[8]

The rules in Div 13 applied more narrowly than Articles 7 and 9 of Australia's tax treaties focusing 'on determining the arm's length consideration for the supply or acquisition of property and/or services under an international agreement' between

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6 OECD, *Action Plan on base erosion and profit shifting* (2013) OECD Publishing, Paris (OECD Action Plan) released on 19 July 2013 <http://www.oecd-ilibrary.org/taxation/action-plan-on-base-erosion-and-profit-shifting_9789264202719-en>.

7 On 27 May 1981, Div 13 of Part III of the *Income Tax Assessment Act 1936* (Cth) (ITAA 1936) was introduced to replacing the former transfer pricing rule in s 136. The former s 136, which was based on s 31 of *Finance (No 2) Act 1915 (United Kingdom)*, was easily avoided, and despite recommendations in the Taxation Review Committee, Commonwealth, *Full Report* (1975) (Asprey Report) for its replacement, it took the loss in *Federal Commissioner of Taxation v Commonwealth Aluminium Corporation Ltd* (1980) 11 ATR 42 to facilitate this change.

8 Division 13 did apply to treaty cases up to 8 September 2012, however, with the grant of royal assent to the *Tax Laws Amendment (Cross-Border Transfer Pricing) Act (No 1) 2012* (Cth) ('2012 Transfer Pricing Act'), its operation was retrospectively curtailed as at 30 June 2004 – see discussion [2.4].

both associated and unassociated entities.[9] Division 13 did not apply automatically and required an exercise of the Commissioner's discretion.[10]

As the general income provisions of Australia's income tax laws have not traditionally captured net amounts (ie assessable income less deductions) within the assessable income calculation, Div 13 was similarly structured. It provided for individual transfer pricing adjustments to income, deductions and withholding taxes. It did not provide for global adjustments.

However, despite this structural form the Commissioner of Taxation (Commissioner) over the last 10 years had sought to use transactional profit methods (such as the transactional net margin method (TNMM) or the profit split methods) in determining an arms-length price.[11] As TNMM uses comparisons at the net profit level between the taxpayer and independent parties dealing wholly independently in relation to a comparable transaction or dealings for calculating an arms-length price, there were questions whether it could be accommodated within the adjustment provisions in Div 13.

The Commissioner has also asserted, at least since 1963, that Articles 7 and 9 in Australia's tax treaties provided a separate, alternative basis for making transfer pricing adjustments.[12]

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9 Explanatory Memorandum to *Tax Laws Amendment (Cross-Border Transfer Pricing) Bill (No 1) 2012*, [2.14] and ITAA 1936, ss 136AD and 136AE. The Commissioner's view on the operation of Australia's PE attribution rules in respect international transfer pricing is set out in Australian Taxation Office, *Income Tax: International transfer pricing - operation of Australia's permanent establishment attribution rules,* TR 2001/1, 9 February 2011 and Australian Taxation Office, *Income Tax: Arm's length transfer pricing methodologies for international dealings,* TR 97/20, 5 November 1997 sets out internationally accepted methodologies that test compliance with the arm's length principle.

10 ITAA 1936, ss 136AD(1)(d), (2)(d), (3)(d) and (4) and s 136AE (4) to (6).

11 This approach was preferred as it overcame the perceived deficiencies of the traditional transaction methods (eg comparable uncontrolled price (CUP), resale price and cost plus).

12 See Case N69 (1963) 13 *Taxation Board of Review Decisions (TBRD)* 270, 275-284, where the Commissioner contended (at 277) that Article IV of the 1947 taxation treaty between Australian and the United Kingdom and the former s 136 of the ITAA1936 were 'separate independent powers of assessment which are additional and complementary to each other and either or both may be applied in cases which are covered by the terms of both provisions.' Also see Damian Preshaw 'The associated enterprises articles in Australia's DTAs and Division 13' (2009) 44 *Taxation in Australia* 262.

2.2 The challenge to the status quo

In 2010 the use of TNMM under Division 13 was challenged in the Federal Court in *SNF (Australia) Pty Ltd v Commissioner of Taxation*.[13] Justice Middleton found that Div 13 'contains the statutory provisions the Court needs to interpret and apply, and the Court needs go no further.'[14] Justice Middleton also noted that he did not consider that tax treaties could be used to alter or impact upon the clear operation and wording of s 136AD(4) of Div 13[15] and that 1995 OECD's *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* could not be used in interpreting Div 13 as they are effectively 'part of the submissions of Counsel as referring to a number of methods by which an arm's length consideration might be calculated.'[16]

Justice Middleton rejected 'the use and applicability of the TNMM as contended for by the Commissioner in the context of applying' Div 13.[17] Justice Middleton concluded that in light of the fact SNF had paid comparable prices for the product the arm's length consideration for the products was paid.

On appeal, in *Commissioner of Taxation v SNF (Australia) Pty Ltd*,[18] the full Federal Court also agreed that the OECD's Transfer Pricing Guidelines were not a legitimate aid to the construction of the transfer pricing rules in Div 13. The Court concluded that the taxpayer 'proved that the prices paid by it were less than the prices paid by

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A similar view has been adopted in respect s 136's successor, Div 13 (eg, Australian Taxation Office, *Income Tax: The interaction of Division 820 of the Income Tax Assessment Act 1997 and the transfer pricing provisions*, Taxation Ruling TR 2010/7, 27 October 2010, [39]-[42]). This approach was endorsed by the Government in Explanatory Memorandum, *Tax Laws Amendment (Cross-Border Transfer Pricing) Bill (No 1) 2012*, [1.11], [1.16], [1.22]. At [1.25] the following extract from Explanatory Memorandum, *Income Tax Assessment Amendment Bill 1982* is cited:
Technically, therefore, the provisions of a double taxation agreement that deal with profit shifting, either under a "business profits" article (e.g, Article 5 of the Australia/UK agreement), or an "associated enterprises" article (e.g, Article 7 of that agreement), may have to be applied instead of Division 13. Where the profit shifting provisions of a double taxation agreement are to apply in these circumstances, sub-sections 170(9B) and (9C) confer the same specific powers of amendment of an assessment as are to be provided in relation to revised' Div 13.

13 See *SNF (Australia) Pty Ltd v Commissioner of Taxation* [2010] FCA 635.

14 Ibid [20].

15 Ibid [49].

16 Ibid [58]-[59].

17 Ibid [129].

18 *Commissioner of Taxation v SNF (Australia) Pty Ltd* [2011] FCAFC 74.

independent comparable purchasers. Those prices were arm's length; the taxpayer's prices did not therefore exceed arm's length consideration.'[19]

As the taxpayer had established a comparable price there was no need for the Court to consider alternative pricing methods such as TNMM. Also, the Court did not have to decide whether the Commissioner could apply the relevant treaty rules as an alternate basis for transfer pricing adjustments.

In response to the SNF case, and to a lesser extent the outcome in the earlier decision in *Re Roche Products Pty Ltd and the Federal Commissioner of Taxation*,[20] on 1 November 2011 the Minister for Financial Services and Superannuation announced a two stage reform process.[21] The first stage was to amend the law to ensure that tax treaties do provide a power to make transfer pricing adjustments independently of the transfer pricing rules in the ITAA 1936. The second stage was to totally rewrite the transfer pricing rules. To facilitate consultation in respect of the rewrite the Government released a Consultation Paper - *Income Tax: Cross Border Profit Allocation - Review of Transfer Pricing Rules*.[22]

On 7 November 2011 the Commissioner, six days after the Government's announcement, released a decision impact statement on the *SNF* case.[23] The Commissioner concluded that:

> the appeal did not resolve the question of whether the TNMM, and by extension any other profit-based transfer pricing method such as the profit split method, is relevant to the positive determination of the arm's length consideration under Division 13. Therefore, the ATO must accept that the TNMM is not a valid

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19 Ibid [128].

20 *Re Roche Products Pty Ltd and the Federal Commissioner of Taxation* [2008] AATA 639.

21 Bill Shorten, Minister for Financial Services & Superannuation, 'Robust transfer pricing rules for multinationals' (Media Release, No 145, 1 November 2011) <http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2011/145.htm&pageID=003&min=brs&Year=2011&DocType=0>.

22 Australian Government, The Treasury, *Income Tax: Cross Border Profit Allocation - Review of Transfer Pricing Rules Consultation Paper* (1 November 2011) <http://www.treasury.gov.au/~/media/Treasury/Consultations%20and%20Reviews/2011/Transfer%20Pricing%20Rules/Key%20Documents/PDF/Review_of_transfer_pricing_rules_CP.ashx>.

23 Australian Taxation Office, 'Decision Impact Statement: *Commissioner of Taxation v SNF (Australia) Pty Ltd*', released 7 November 2011 <http://law.ato.gov.au/atolaw/view.htm?dbwidetocone=04%3ALRP%3ADecision%20Impact%20Statements%3A2011%3ASNF%20Australia%20Pty%20Ltd%20(VID%20731%20of%202010)%3B>.

> method of establishing an arm's length consideration for the purpose of s 136AA(3).[24]

Despite appearing to accept the Court's decision, the Commissioner indicated that the ATO would continue to use profit based methods in Div 13 in cases where it is considered to be not possible or practicable to ascertain the arm's length consideration by other means.

2.3 The stage one reforms

On 16 March 2012, after consultation on the 1 November 2011 Consultative Paper, the Government released *Exposure Draft – Stage One Transfer Pricing Reforms* for consultation.[25] The Assistant Treasurer claimed that 'the proposed amendments confirm that, in relation to treaty cases, the transfer pricing articles contained in Australia's tax treaties are able to be applied and operate independently of Australia's unilateral transfer pricing rules.' Legislation to give effect to these Stage One reforms (Subdiv 815-A of the *Income Tax Assessment Act 1997* (Cth) (ITAA 1997)) was introduced into Parliament on 24 May 2012 with royal assent received 8 September 2012.[26]

The Subdivision 815-A operates retrospectively. It applies to income years commencing on or after 1 July 2004, where the matter involves a tax treaty.[27] It had

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24 Ibid.

25 David Bradbury, Assistant Treasurer, 'Draft amendments to Transfer Pricing Regime released for consultation' (Media Release, No 006, 16 March 2012) <http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2012/006.htm&pageID=003&min=djba&Year=2012&DocType=0>.

26 2012 Transfer Pricing Act, above n 8.

27 *Income Tax Assessment Act 1997* (ITAA 1997), s 815-40. The retrospectivity was based upon a view that since the introduction of Div 13 that the Arts 7 and 9 in Australia's tax treaties provided a separate, alternative basis for making transfer pricing adjustments (see above n 12).This approach was opposed by the business community and professional association who saw there is no justification for the retrospective application of the amendments – see Taxation Committee of the Business Law Section, Law Council of Australia, *Submission: Tax Laws Amendment (Cross-Border Transfer Pricing) Bill (No 1) 2012 to assist the Senate Economics Legislation Committee (SELC)*, 11 July 2012 <http://www1.lawcouncil.asn.au/lawcouncil/images/LCA-PDF/docs-2600-2699/2630%20-%20Tax%20Laws%20Amendment%20(Cross-Border%20Transfer%20 Pricing)%20Bill%20(No.1)%202012.pdf>. Also see Peter Collins, Lyndon James and Piotr Klank 'The smoke and mirrors around the "stage one" transfer pricing reforms' (2012) 15 *The Tax Specialist* 210 and Jock McCormack 'New transfer pricing rules: Subdiv 815-A' (2012) 47 *Taxation in Australia* 98, 99.

priority over Div 13 in respect of matters involving tax treaty. The Subdivision was designed:

- to explicitly incorporate into the ITAA 1997 rules to ensure that the transfer pricing articles contained in Australia's tax treaties are able to be applied and operate to make transfer pricing adjustments independently of Div 13; and
- to require the arm's length principle to be interpreted as consistently as possible with relevant OECD guidance.[28]

Thus, the Assistant Treasurer's 16 March 2012 assertion that rules would ensure tax treaties provided a separate alternative basis for making transfer pricing adjustment was not realised. The liability to tax under subdiv 815-A arises under the domestic law rather than the operation of a relevant tax treaty.

2.4 The stage two reforms

On 22 November 2012 the Government released for consultation an exposure draft bill and explanatory material in the Stage 2 proposed amendments to reform Australia's transfer pricing rules.[29] On 13 February 2013 legislation to give effect to these Stage two reforms (subdivs 815-B, 815-C and 815-D of the ITAA 1997 in Sch 2 of the *Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting)*

The constitutionality of the retrospective operation of the rules is being challenged – see *Chevron Australia Holdings Pty Ltd v Commissioner of Taxation* NDS 440 of 2013, The Hon Justice Michelle Gordon, Federal Court of Australia 'The Commonwealth's taxing powers and its limits - Are we there yet?', (Speech delivered at Melbourne Law School, 29 August 2012) and Reynah Tang, Stewart Grieve and Bridie Andriske 'Are the retrospective transfer pricing measures unconstitutional?' (18 October 2012) Corrs Chambers Westgarth <http://www.corrs.com.au/thinking/insights/are-the-retrospective-transfer-pricing-measures-unconstitutional/>.

28 ITAA 1997, s 815-20. Explanatory Memorandum to *Tax Laws Amendment (Cross-Border Transfer Pricing) Bill (No 1) 2012*, [1.90] makes it clear that in 'establishing whether an entity gets a transfer pricing benefit, as well as the interpretation of a provision of an international tax agreement (for the purposes of this Subdivision), must be done consistently with the guidance material developed by the OECD.'

29 David Bradbury, Assistant Treasurer, 'Progressing reforms to Australia's transfer pricing rules' (Media Release, No 144, 22 November 2012) <http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2012/144.htm&pageID=003&min=djba&Year=2012&DocType=0>.

Bill 2013 (Cth)), was introduced into Parliament with royal assent received on 29 June 2013.[30]

The new subdivisions replace both Div 13 and subdiv 815-A. They impose, for income years commencing on or after 1 July 2013, consistent rules applying to both tax treaty and non-tax treaty cases. In addition to the new transfer pricing rules, new rules related to transfer pricing documentation and administrative penalties were inserted into the *Taxation Administration Act 1953* (Cth) (TAA 1953). [31]

3. THE NEW RULES

Subdivision 815-B applies the arm's length principle to relevant dealings between both associated and non-associated entities, while subdiv 815-C applies the approach to the attribution of profits to permanent establishments (PEs) that is currently incorporated into Australia's tax treaties (the relevant business activity approach). The subdivisions generally align with Art 7 (associated enterprise) and Art 9 (business profits) in Australia's tax treaties. Consistent with the former transfer pricing rules, the subdivisions do not require a tax avoidance motive to operate.

The scope of the transfer pricing rules under Div 13 and subdivs 815-B and 815-C are similar. They both have precedence over other provisions of the ITAA 1936 and ITAA 1997, unless a specific limitation exists.[32] The priority rules do not override the priority of the *International Tax Agreements Act 1953* (Cth) (ITAA 1953) over the Assessment Acts,[33] and also do not apply in respect of specific Australian PEs of

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30 *Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Act 2013*(Cth), *Schedule 2*. The *Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013* and Explanatory Memorandum, *Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013* (*EM to Multinational Profit Shifting Bill*) <http://www.aph.gov.au/Parliamentary_Business/Bills_Legislation/Bills_Search_Results/Result?bId=r4965>.

31 *Taxation Administration Act 1953* (Cth) (TAA 1953), Sch 1, subdivs 284-E, 284-C.

32 ITAA 1997, ss 815-110(1), 815-210(1) and ITAA 1936, s 136AB(1), which states that its operation is not limited by any other provision of the ITAA 1936.

33 This is because the priority rules in subdivs 815-B and 815-C apply to provisions of the Assessment Acts, whereas s 4(2) of the *International Tax Agreements Act 1953* (Cth) (ITAA 1953) applies to the extent of an inconsistency between the ITAA 1953 and the Assessment Acts.

foreign banks as the functionally separate entity approach is applied by another specific provision in the ITAA 1936 to such PEs.[34]

Although Div 13 is silent on its interrelationship with the thin capitalization rules, subdivs 815-B and 815-C (and the former subdiv 815-A) expressly provide for the application of the thin capitalisation rules in reducing, or further reducing, an entity's debt deductions.[35] The *Explanatory Memorandum to Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013* (EM to Multinational Profit Shifting Bill) states that this reservation merely reflects the Commissioner's administrative practice[36] and preserves the role of Div 820 in its application to an entity's amount of debt.[37]

As trusts and partnerships are not 'taxable entities' under the income tax law, neither have taxable income and partnerships do not have tax losses. Subdivision 815-D contains special rules to ensure that subdivs 815-B and 815-C apply to trusts and partnerships by address the differences in terminology without otherwise changing the substantive effect of the subdivisions. Prior to exploring the operation and scope of subdivs 815-B or 815-C in detail, it is useful to highlight key features of the new rules that differentiate them from the former transfer pricing regime.

3.1 Major policy changes adopted

The six key features of the new rules that differentiate them from the former transfer pricing regime are the:

- adoption of a self-assessment regime;
- adoption of a postulation of independent entity dealings to be used in identifying the arm's length conditions;
- enhanced role of OECD guidance;
- imposition of a time limit for transfer pricing adjustments;

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34 ITAA 1997, s 815-210(3). Consistent with the interaction between Pt IIIB of the ITAA 1936 (which applies the functionally separate entity approach in respect of the attribution of income and expenditure to the Australian PEs of foreign banks) and former Div 13 (ITAA 1936, s 160ZZW(5)), subdiv 815-C does not apply to PEs dealt with under Pt IIIB.

35 ITAA 1997, ss 815-110(2), 815-210(2).

36 See Australian Taxation Office, *Income Tax: The interaction of Division 820 of the Income Tax Assessment Act 1997 and the transfer pricing provisions*, Taxation Ruling TR 2010/7, 27 October 2010.

37 EM to Multinational Profit Shifting Bill, above n 31, [3.144]-[4.145].

- introduction of a de minimis test in respect of administrative penalties; and
- linking of specific record keeping requirements to the level of administrative penalties imposed.

An evaluation of these key changes is set out in the following paragraphs.

3.1.1 Adoption of self-assessment regime

Unlike the transfer pricing rules in Div 13 and in subdiv 815-A, which both rely on the Commissioner making a determination, subdivs 815-B and 815-C are self-executing in their operation (ie they impose a self-assessment regime on taxpayers).

This change represents a major shift in responsibilities from the Commissioner to taxpayers. Taxpayers are required to self-assess, face the additional compliance costs that that work entails and are subject to harsh penalties if they get it wrong. The Commissioner on the other hand has to merely audit where the taxpayers are viewed as 'higher consequence' under the ATO's compliance risk models.[38] This power shift is a common outcome where there is an adoption of self-assessment.[39] Past experience in Australia indicates that Governments are slow to create a more balanced position between that of the revenue, with all its resources, and the position of the smaller, vulnerable taxpayers.[40]

This balance between the taxpayers and the protection of the tax base was a key consideration of Senate Economics Legislation Committee's *Inquiry into Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013 [Provisions*] ('Senate Economics Legislation Committee Inquiry').[41] Given that there

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38 For large business taxpayers the ATO applies the Risk differentiation framework (RDF). The RDF is intended to assess tax risk and determine the intensity of ATO's response. It is intended to complement the existing compliance model, which in turn suggests an appropriate choice of remedy.

39 For further discussion of this issue see Michael Dirkis and Brett Bondfield, 'ROSA's last gasp: The final steps in self assessment's 21 year journey?' (2008) 3(2) *Journal of the Australasian Tax Teachers' Association*, 202, 203-206, 223-224 and Michael Dirkis and Michael Payne-Mulcahy, 'Time for a change: Self assessment 14 years on' (2002) 36 *Taxation in Australia* 417.

40 Dirkis and Bondfield (2008), ibid.

41 Senate Economics Legislation Committee, Parliament of Australia, *Inquiry into Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013 [Provisions]* ('Senate Economics Legislation Committee Inquiry') (14 May 2013), <http://www.aph.gov.au/Parliamentary_Business/Committees/Senate_Committees?url=

was disagreement on issues of balance between the majority of the Senate Economics Legislation Committee (consisting of one Independent and three Government Senators) and its two opposition ('Coalition') Senator members,[42] it remains to be seen whether the Government has managed to achieve the correct balance between extra compliance cost and the need to protect the tax base.

3.1.2 Adoption of a postulation of independent entity dealings to be used in identifying the arm's length conditions

The second distinguishing feature of the rules is that subdiv 815-B is broadly the domestic incorporation of para 1 of Art 9 of the *2010 OECD Model Tax Convention on Income and on Capital* ('OECD Model Tax Convention').[43] As a result subdiv 815-B requires the Australian entity to postulate how independent entities, in comparable circumstances, would have dealt with one another had they been dealing at arm's length. It specifies that where an entity would otherwise get a tax advantage from actual conditions (the actual functions performed, assets used and risks assumed in Australia) that differs from arm's length conditions, the arm's length conditions are taken to operate for income tax and withholding tax purposes.[44]

However, as Australia adopts the 'relevant business activity' approach in respect of the attributable profit of PEs, a different approach is adopted under subdiv 815-C. Under subdiv 815-C an entity operating through a PE is required to postulate if the PE were a distinct and separate entity engaged in the same or comparable activities under the same or comparable circumstances, but dealing wholly independently with the entity, would the profits be greater than the actual profits attributed to the PE.[45] Under the 'relevant business activity' approach, the arm's length profits must be

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economics_ctte/completed_inquiries/2010-13/tlab_countering_tax_avoidance_2013/report/index.htm>.

42 Ibid, 'Coalition Senators' Dissenting Report', 61, Recommendation 1.

43 *Model Tax Convention on Income and on Capital* ('OECD Model Tax Convention'), as adopted by the Council of the OECD and last amended on 22 July 2010. The EM to Multinational Profit Shifting Bill, ibid [2.19] notes that it is paraphrased in ITAA 1997, s 118-115(1). As the adjustments under domestic transfer pricing rules in respect of independent entities are made to a resident, Art 9 in reality is an acknowledgement under a tax treaty of the rights of a state to tax make adjustments to its residents' income rather than being a permissive power.

44 ITAA 1997, ss 815-105(2), 815-115, Note 1.

45 Ibid s 815-205. Australia taxes the entity on its Australian source profit (ie the net profit earned by the PE) not the PE. The arm's length allocation of profits between a PE and the entity is determined by analysing the functions performed, the assets used or contributed, and the risks assumed or managed by the various parts of the business.

identified subject to the constraint that the allocation is determined within the confines of the actual income and expense position (as they apply for Australian tax purposes) of the entity of which the PE is a part.[46]

3.1.3 *Enhanced role of OECD guidance*

Consistent with the adoption of Australia's tax treaty position in domestic legislation and with the former subdiv 815-A, these rules ensure that the process of determining:

- the arm's length conditions in the context of relevant dealings between both associated and non-associated entities under subdiv 815-B; or
- the arm's length profits and arm's length conditions under subdiv 815-C;

is done in a way that best achieves consistency with 'prescribed guidance material'[47] (which includes the OECD *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* ('OECD Guidelines')). [48] A similar approach has been adopted in other jurisdictions such as Norway in 2008[49] and the United Kingdom in 2010. [50]

Regulation making powers were enacted to allow for modifications to the list of guidance material,[51] the removal of irrelevant material[52] and prescribe which

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46 Ibid s 815-225(3).

47 Ibid ss 815-135(1), 815-235(1).

48 Ibid ss 815-135(2), 815-235(1)(b), 815-235(2). The OECD Guidelines are specified to be the 'OECD Model Tax Convention', to the extent that document extracts the text of Art 7 and its Commentary as they read before 22 July 2010, the OECD *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* ('OECD Guidelines') as approved by the OECD Council and last amended on 22 July 2010 and any other documents, or part(s) of a document, prescribed by the regulations for this purpose. The reference to the pre 22 July 2010 Commentary on Art 7 reflects the fact that the subdiv 815-C is adopting the 'functionally separate entity' approach to the attribution of profits to PEs. Therefore the OECD Guidelines are only to be used within the confines of the 'relevant business activity' approach.

49 *Taxation (International and Other Provisions) Act 2010 (UK)*, s 164. This express obligation applies for accounting periods ending on or after 1 April 2010

50 *Tax on Wealth and Income (Norway)*(the Tax Act), s 13-1(4). The rules apply from 1 January 2008 when applying the arm's length principle under s 13-1 of the Tax Act. However, the OECD Guidelines shall only prevail, however, to the extent Norway has acceded to the OECD TPG and provided that the Ministry of Finance has not decided otherwise. <http://www.skatteetaten.no/no/Bedrift-og-organisasjon/Drive-bedrift/Aksjeselskap/Internprising/Information-in-english/Act-relating-to-Tax-on-Wealth-and-Income-the-Tax-Act/>.

51 ITAA 1997, ss 815-135(2)(b), 815-235(2)(b).

documents, or parts of documents, are to be used or removed in specific circumstances.[53] The EM to Multinational Profit Shifting Bill in noting that the regulations will ensure that guidance material developed in the future is taken into account, states that:

> Requiring such modifications to be prescribed by regulation strikes an appropriate balance between ensuring ongoing consistency with developing international arrangements while providing for Parliamentary scrutiny of future developments.[54]

Although this prescription removes any 'uncertainty' around the applicability of the OECD's Guidelines in Australian domestic tax law, and that the OECD Model Tax Convention and Commentary in force at the time a treaty is entered into can be taken into account in the interpretation of a tax treaty,[55] there still remains uncertainty about whether subsequent amendments to the OECD Commentary inform the meaning of existing treaties. The difficulty in applying the current OECD Commentary is that as Australia's treaties have been signed over a 40 year period, they all vary in content and wording from each other[56] (as has the OECD Tax Model Convention and Commentary over that period).[57]

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52 Ibid ss 815-135(3), 815-235(3)-(4). This power would be used where Australia reserves its position in respect of OECD or other guidance.

53 Ibid ss 815-135(4), 815-235(5).

54 EM to Multinational Profit Shifting Bill, above n 31, [3.30].

55 *Thiel v Federal Commissioner of Taxation* (1990) 171 CLR 338 and *Commissioner of Taxation v SNF (Australia) Pty Ltd* [2011] FCAFC 74.

56 These differences are due to variations between the version of the OECD Model over time (eg, removal of Art 14 in OECD Model, and the introduction of new exchange of information, assistance in tax collection and arbitration articles). Other differences are due to compromises arising from:

- the relative economic positions of the contracting states (eg, source v residence taxation);
- long held positions on particular income (eg, in respect of natural resources for both Australia and New Zealand);
- differences in business structures (eg, the use of trusts as Managed Investment Trusts (MITs) and Collective Investment Vehicles (CIVs) in Australia); and
- tax competition (eg, reduction in withholding tax rates).

57 The oldest continuing unchanged tax treaty is that signed with Germany on 24 November 1972. Although the Singapore tax treaty, which was originally signed on 11 February 1969, has been the subject two amending Protocols and two exchange of notes re Art 18(3) it contains a substantial number of Articles in the form as originally agreed, including the original maximum source country withholding tax rates.

The OECD Commentary makes it clear that the later Commentaries are intended by OECD Member states to be used for interpretation and application of tax treaties concluded before their adoption, except where the OECD Model has been changed in substance.[58] As Australia has given an undertaking to the OECD to ensure that its bilateral income tax treaties conform with the OECD Model Tax Convention as interpreted by the Commentaries,[59] the approach adopted by the ATO in analysing the scope of a tax treaty Articles is:

> unless it is apparent that the substance of the OECD Model has itself changed since a DTA was negotiated or the treaty in question does not conform to the OECD Model, or unless the Commentaries make clear that a former interpretation has actually been substantively altered, rather than merely elaborated, the ATO considers it appropriate, as a matter of practice, to consider, at least, the most recently adopted/published OECD Commentaries ... as well as others which may have been available at the time of negotiation.[60]

However, there is contrary judicial opinion on this issue, with the Courts indicating that only the Commentary existing at the time is relevant in interpreting tax treaties.[61] If the Courts are correct, the narrower scope of Art 7 and Art 9 in Australia's aged treaties would limit the scope of the operation of the new domestic transfer pricing

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58 OECD Commentary, *Introduction* [33]–[36.1].

59 See OECD, *Recommendation of the OECD Council concerning the Model Tax Convention on Income and on Capital*, doc C(97) 195/final as adopted by the Council on 23 October 1997 and Australian Taxation Office, *Income tax: Interpreting Australia's Double Tax Agreements*, Taxation Ruling TR 2001/13, 19 December 2001, [101], which notes that 'while not binding (since they are not formal OECD 'Decisions', binding on OECD Members under the OECD Constitution), the OECD Model and Commentaries create a general or "quasi-political", rather than "legal", expectation that OECD Members will basically comply, subject to specific "Observations" and "Reservations" lodged with the OECD'.

60 Australian Taxation Office, *Income Tax: Interpreting Australia's Double Tax Agreements*, Taxation Ruling TR 2001/13, 19 December 2001, [108]. The ATO states that 'these changes to the Commentaries reflect the fact that the Commentaries are usually expressed not as forming an agreement between countries as to a new meaning but as reflecting a common view as to what the meaning is and *always has been*'.

61 Justice Einfeld J in the Federal Court decision of the first instance in *Lamesa Holdings BV v Federal Commissioner of Taxation* 97 ATC 4229 at 4237 expressed the view that the OECD Commentaries are only relevant to those DTAs subsequently concluded. He referred comments made by Dawson J in *Thiel v Federal Commissioner of Taxation* (1990) 171 CLR 338 who also indicated that the OECD model and commentaries are only applicable to those bilateral treaties subsequently concluded.

rules where those treaties have operation. The question remains unresolved in Australia.

3.1.4 Imposition of a time limit for transfer pricing adjustments

Unlike Div 13, which imposed no time limit upon transfer pricing adjustments,[62] an adjustment as a result of the application of subdivs 815-B or 815-C must be made within seven years of the day on which the Commissioner gives notice of the assessment to the entity.[63] This time limit does not apply to ascertaining additional amounts of withholding tax payable as this does not constitute an assessment.[64] There is no time limit for the Commissioner to make a consequential amendment.[65]

The seven year limit was subject to criticism by many professional associations and business groups in their submissions to the Senate Economics Legislation Committee Inquiry as being too long on the basis that there was no reason why the standard four year period should be used.[66] However, in contrast the Tax Justice Network Australia argued that an eight year time limit was more appropriate.[67] The majority of the Senate Economics Legislation Committee concluded that:

> the seven year time limit in the bill strikes a good balance between the need to provide taxpayers with certainty and the need to provide the Commissioner with adequate time in which to conduct a transfer pricing audit, which it accepts are typically highly complex in nature.[68]

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62 ITAA 1936, s 170(9B).

63 ITAA 1997, ss 815-150(2), 815-240.

64 As ITAA 1936, s 128C(6) states that the determination of withholding tax does not constitute an assessment, no time limit exists for withholding tax adjustments. Consequently, there is no time limit in respect of adjustments to withholding tax under subdiv 815-B. Subdivision 815-C does not apply in respect of amounts of withholding tax payable. This is because subdiv 815 C applies in respect of the intra-entity allocation of income and expenses and as such its effect does not have any implications for withholding tax.

65 ITAA 1997, ss 815-150(2), 815-240. This is consistent with the unlimited time period that was available for making consequential adjustments under Div 13.

66 Senate Economics Legislation Committee Inquiry, above n 41, [3.35].

67 Ibid [3.36].

68 Ibid [3.39].

3.1.5 Introduction of a de minimis test in respect of administrative penalties

Where the Commissioner determines that a taxpayer has not correctly self-assessed their tax position under subdivs 815-B and 815-C and amends an assessment (or determines an additional amount of withholding tax) that results in a liability to an additional amount of income tax or withholding tax (the 'scheme shortfall amount') the taxpayer is subject to an administrative penalty under TAA 1953.[69]

Under the revised administrative penalty rules under subdiv 284-C of the TAA 1953, a lower base penalty applies to the extent the scheme shortfall amount arose as taxpayer (or their agent) had a reasonably arguable position for either treating the transfer pricing rules as applying or not applying.[70] However, consistent with Div 13, where the Commissioner concludes that the entity entered into the scheme with the sole or dominant purpose of obtaining a transfer pricing benefit (for themselves or another entity), the base penalty is at least doubled.[71]

However, unlike Div 13, where the transfer pricing adjustment is small a de minimis test was enacted to provide that administrative penalties will not apply where the 'scheme shortfall amount' is equal to or less than an entity's reasonably arguable threshold.[72] That reasonably arguable threshold is the greater of:

- $10,000 or 1 per cent of income tax payable, or minerals resource rent tax (MRRT) payable by an entity for the income year; and
- $20,000 or 2 per cent of an entity's net income for an income year, where the entity is a trust or partnership.[73]

The thresholds are directly linked to the general thresholds under the law, ensuring that they will be automatically updated by any changes to the general thresholds.

Although the de minimis threshold will provide an administrative penalty concession for small businesses or for larger businesses where there is only a minor transfer pricing adjustments, the relatively low shortfall threshold does mean the scope of the concession is very narrow. The width of the penalty concession was subject to criticism by many professional associations and business groups in their submissions to the Senate Economics Legislation Committee Inquiry.[74] The majority

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69 TAA 1953, subdiv 284-C, s 284-145(2B). A similar administrative penalty applied where the Commissioner exercised the Commissioner's discretion to apply Div 13.

70 Ibid s 284 160(3), table item 2.

71 Ibid s 284-160(3), table item 1.

72 Ibid s 284-165(1).

73 Ibid s 284-90(3).

74 Senate Economics Legislation Committee Inquiry, above n 41, [3.56]-[3.62].

of the Senate Economics Legislation Committee, in noting concerns about the adequacy of the de minimis threshold, merely recommended that the government continue to consult with business in respect of the compliance impact of the transfer pricing amendments. [75]

3.1.6 Linking specific record keeping requirements to the level of administrative penalties imposed

Another new aspect of the rules, relevant to the reasonably arguable position touched on above, is that where an entity has adopted a position in respect of subdivs 815-B or 815-C but has not met the record keeping requirements under the TAA 1953 ('transfer pricing documentation' rules),[76] the entity is deemed not to have a reasonably arguable position.[77] This means the higher base administrative penalty will apply.

The transfer pricing documentation rules specifically require an entity to prepare and maintain transfer pricing documentation which is relevant to the position adopted (eg the information explains of all the steps that are undertaken in identifying which method should be selected, and the comparable conditions used in that process).[78] If they do so, the entity will have established that it had a reasonably arguable position in respect of that matter and is eligible for a lower base administrative penalty.

This requirement will have the effect of dramatically increasing compliance costs.[79] However, the EM to Multinational Profit Shifting Bill states that the keeping of such records is not mandatory, it is merely is 'one avenue through which an entity can lower administrative penalties.'[80] The ATO in its submission to the Senate Economics Legislation Committee Inquiry notes 'it provides various forms of guidance to taxpayers so that they could make an informed judgement about the level of risk taxpayers are exposed to in terms of related party dealings, and the level of

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[75] Recommendation 3, Ibid [3.67]. The Coalition members of the Committee disagreed with the majority. They recommended the creation of a safe habour for small business – ibid, 'Coalition Senators' Dissenting Report' [1.32].

[76] TAA 1953, subdiv 284-E. The records must be prepared before the time the entity lodges its income tax return for the income year, and either be in English or be readily accessible and convertible into English, ibid s 284-255(1)(a)-(b).

[77] Ibid s 284-250.

[78] Ibid s 284-255(2)(a)-(e) and EM to Multinational Profit Shifting Bill, above n 31, [6.27].

[79] See arguments by the professional associations and business groups in their submissions to the Senate Economics Legislation Committee Inquiry, above n 41, [3.40]-[3.48].

[80] EM to Multinational Profit Shifting Bill, above n 31, [2.34], [6.26].

compliance that they might therefore consider.'[81] The majority of the Senate Economics Legislation Committee agreed concluding that:

> the record keeping requirements … allow taxpayers to evaluate their cross-border dealings and prepare documentation in respect to matters that they consider to be at risk of transfer pricing adjustments. The committee believes that this approach appropriately balances the risk to revenue of transfer mispricing and the compliance burden placed on entities engaged in cross-border related party dealings.[82]

3.1.7 Summary

In combination, the six distinguishing features clearly indicate that the new transfer pricing rules have been radically revised. In doing so, there has been a deliberate decision by the Government to shift the compliance burden from the ATO to taxpayers. As a result, to suggest in light of the higher base penalties that can be imposed if a taxpayer's judgment is considered by the Commissioner to be flawed, it is farcical for the Government to suggest that these compliance costs are optional and can be abated. It would be a 'brave decision' to not create the 'required' documentation in all but the most simple of situations.

3.2 Application to related entities: Subdivision 815-B in more detail

Given the complexity of the drafting of subdiv 815-B, this paper focuses on the key elements that need to be satisfied before the Subdivision can apply. To enhance readability, the more technical aspects of each of the key operative elements have been placed in the footnotes.

As stated above, subdiv 815-B is a self assessing regime. Therefore, an Australian entity that has engaged in cross border transactions is required to review its transactions to examine whether the Subdivision applies to the transactions. If so, they are required to adjust the financial outcome by substituting an arm's-length outcome.

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81 Senate Economics Legislation Committee Inquiry, Above n 41, [3.4]-[3.18].

82 Ibid [3.52]. However, the Coalition members of the Committee disagreed with the majority noting that they believed that the amendments 'will disproportionately increase compliance costs relative to the risk to revenue spared - ibid, 'Coalition Senators' Dissenting Report' [1.28].

3.2.1 Key operative provision

The key operative provision in subdiv 815-B is s 815-115(1). Essentially, it prescribes that an entity gets a *transfer pricing benefit* from the *actual conditions* that operate between the entity and another entity in connection with their *commercial or financial relations*:[83]

- those conditions are taken not to operate and;
- **the arm's length conditions*' are taken to operate;

in working out the *amount of the transfer pricing benefit* (in terms of s 815-115(2)).[84] The key elements that need to be satisfied in any given circumstance are italicised.

A *transfer pricing benefit* is merely where a lower level of Australian tax payable (the 'shortfall amount' of Australian tax) that an entity has as the result of entering into its non-arm's length dealings with other entities.[85]

3.2.2 First step: determining the actual conditions in connection with the commercial or financial relations

The first step in applying s 815-115 is to determine if an entity gets a 'transfer pricing benefit' from the 'actual conditions' that operate between the entity and another entity (including an unrelated entity) in connection with their 'commercial or financial relations' is to identify those 'actual conditions' and the connected 'commercial or financial relations'.

The term 'actual conditions' is not defined in the legislation. The EM to Multinational Profit Shifting Bill states that actual conditions are:

> things that ultimately affect each of the entities' economic or financial positions. Conditions need not be explicit contractual terms, but can include the price paid for the sale or purchase of goods or services, terms of an agreement that have an

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83 EM to Multinational Profit Shifting Bill, above n 31, [3.45] notes, '[i]n cases where the multinational enterprise has a relatively straightforward value chain and there is clarity regarding the identification, location and ownership of key profit drivers in that value chain, relevant conditions might include the price at which trading stock items are sold or the fees charged for common services such as transportation or freight.'

84 ITAA 1997, ss 815-115(1).

85 EM to Multinational Profit Shifting Bill, above n 31, [3.37] notes, '[i]n the context of a self-assessed position under these rules, this tax advantage is a notional one as it would only be realised in the absence of the entity applying Subdivision 815-B.'

> economic impact (such as the allocation of an expense), the margin of profits earned by one or both the entities, or a division of profits between the entities.[86]

What constitutes 'commercial or financial relations' is also not defined in the legislation. However, the EM to Multinational Profit Shifting Bill states that the term is intended to 'be sufficiently broad so as to take into account any connections or dealings between the entities that relate to or could otherwise affect the commercial or financial activities of one of the entities.'[87] Thus, it covers everything from a single transaction or a series of transactions to a practice, understanding, arrangement, whether express or implied and whether or not legally enforceable. It could cover unilateral actions or mutual dealings.[88]

3.2.3 Second step: determining if the actual conditions satisfy a 'cross-border test'

A further requirement is that the 'actual conditions' identified must satisfy a 'cross-border test', which ensures that subdiv 815-B does not apply to purely domestic arrangements.[89] The cross-border test is satisfied in relation to the conditions that operate between two entities where the 'overseas requirement' for those conditions is satisfied by either or both of the entities.[90] Different overseas requirements apply in relation to different types of entities.[91]

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86 Ibid [3.43]. The EM to Multinational Profit Shifting Bill, ibid [3.71]-[3.75], also notes that although subdiv 815-B can only apply to particular actual conditions, any third party arrangements or conditions that indirectly impact on the actual conditions will be taken into account in the context of the determination of the arm's length conditions. As the arm's length conditions are identified by hypothesising what independent entities in comparable circumstances dealing wholly independently would have done in the place of the actual entities, interactions that each of the entities have with third party entities may be relevant where they impact upon the actual conditions.

87 EM to Multinational Profit Shifting Bill, ibid [3.41].

88 Ibid [3.42].

89 Ibid s 815-120(3).

90 Thus, although the test examines the conditions from the perspective of each entity individually, it is satisfied where either entity meets its requirements.

91 See EM to Multinational Profit Shifting Bill, above n 31, [3.59]-[3.70]. ITAA 1997, s 815-120(3)(b) enables the cross-border test to also be satisfied where the conditions operate in connection with a business an entity carries on in an area covered by an international tax sharing treaty. Where the entities are dual residents ITAA 1997, ss 815-120(4) and (6) aligns the application of subdiv 815-B and their treatment under a treaty. This required as the treaty tie-breaking rules in Australia's international tax agreements only have effect for the purpose of applying the agreement. The rule does not have any operation

3.2.4 Third step: determining if the actual conditions give rise to specified benefits

Having identified the 'actual conditions' and that they satisfy the 'cross border test', the 'actual conditions' must give rise to specified benefits (referred to as 'tax advantage' in the EM to Multinational Profit Shifting Bill) in Australia, relative to the arm's length conditions for a 'transfer pricing benefit' to arise.[92] A 'tax advantage' arises in Australia for an entity where:

- taxable income for the income year would have been greater;
- loss of a particular sort for the income year would have been less;
- tax offsets for the income year would have been less; or
- withholding tax payable in respect of interest or royalties would have been greater. [93]

In order to determine the 'tax advantage' there is a need to postulate the 'arm's length conditions' that could apply.

3.2.5 Fourth step: determining 'arm's length conditions'

As a 'transfer pricing benefit' can only arise if the 'actual conditions' differ from the 'arm's length conditions',[94] is a need to postulate the 'arm's length conditions' that could apply.

The arm's length conditions are the conditions that might be expected to operate, in place of the actual conditions, between entities dealing wholly independently with one another in comparable circumstances.[95] As discussed above, the identification of arm's length conditions involves hypothesising what independent entities would have done in comparable circumstances (ie, it requires a postulation of how

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in relation to treaties that do not apply to dual residents (eg Chile), or to non treaty cases as in such circumstances an entity continues to be taxed in Australia as an Australian resident.

92 Ibid s 815-120(1).

93 ITAA 1997, s 815-120(1)(c). To ensure that the calculation can still be performed where an entity has no actual taxable income, no losses of a particular sort, or no tax offsets (or would not have had such an amount under arm's length conditions) ITAA 1997, s 815-120(5) deems an amount of nil (as appropriate).This allows the relevant amount to be compared with the nil amount.

94 Ibid s 815-120(2) prescribes that a difference will also exist where an actual condition exists that is not one of the arm's length conditions, or a condition does not exist in the actual conditions but is one of the arm's length conditions.

95 Ibid s 815-125(1).

independent entities would have dealt with one another had they been dealing at arm's length).

3.2.5.1 Basic rule and exceptions

In determining arm's length conditions a so-called 'basic rule' generally applies to constrain the way in which the 'arm's length conditions' must be identified. Under this rule, the identification of 'arm's length conditions' must be based on the 'commercial or financial relations' that actually gave rise to the 'actual conditions' that operated, having regard to both the form and substance of those relations.[96] The EM to Multinational Profit Shifting Bill states that the:

> 'form' of commercial or financial relations describes the prima facie features or legal characteristics of the dealings between entities. In contrast, the 'substance' of the commercial or financial relations describes the economic reality or essence of those dealings. [97]

There are three exceptions to the 'basic rule' for identifying 'arm's length conditions', which in turn provide the alternative means of identifying 'arm's length conditions' and also constrain the way in which the 'arm's length conditions' must be identified. The EM to Multinational Profit Shifting Bill states that the:

> exceptions to the basic rule are intended to be consistent with the 'exceptional circumstances' discussed in the OECD Guidelines in the context of non-recognition and alternative characterisation of certain arrangements or transactions (for example under Chapters I and IX…).[98]

In determining whether the exceptions apply, as well as identifying the 'arm's length conditions' under the exceptions, the rules related to the comparability of circumstances[99] continue to apply.[100]

The first exception merely requires the form of the actual commercial or financial relations to be disregarded to the extent (if any) that it is inconsistent with the substance of those relations.[101]

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96 Ibid s 815-130(1).

97 EM to Multinational Profit Shifting Bill, above n 31, [3.84]

98 Ibid [3.89]

99 They are set out in ITAA 1997, s 815-125(3)-(4).

100 ITAA 1997, s 815-130(5).

101 Ibid s 815-130(2). EM to Multinational Profit Shifting Bill, above n 31, [3.95] states that the 'exception is based on the approach taken under the OECD Guidelines in relation to economic substance (see for example paragraphs 1.65, 9.169 and 9.183 of the OECD Guidelines).'

The second exception operates where independent entities dealing wholly independently with one another in comparable circumstances, having regard to their own economic interests, would not have entered into the actual commercial or financial relations. In such circumstances the identification of 'arm's length conditions' is based on the alternative, commercial or financial relations' that independent entities would have entered into instead.[102] The EM to Multinational Profit Shifting Bill states that the:

> requirement that independent entities 'would' have done something different to the actual entities imposes a higher standard of proof than simply demonstrating that independent entities 'might' or 'might be expected to' have entered into alternative commercial or financial relations.[103]

The third exception applies in cases where independent entities dealing wholly independently with one another in comparable circumstances would not have entered into any 'commercial or financial relations'. In such circumstances the identification of 'arm's length conditions' is based on the assumption that no 'commercial or financial relations' existed.[104]

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102 ITAA 1997, s 815-130(3). EM to Multinational Profit Shifting Bill, above n 31, [3.101] states that the relevant question is 'whether independent entities behaving in a commercially rational manner and acting in their own best commercial and economic interests would have dealt with one another in the same way, given the options that are realistically available to them. Without detracting from the relevance of actually observed dealings, nothing prevents each aspect of the test from being established hypothetically.' The EM also notes [3.96] that this 'and third exceptions are based on the approach taken under the OECD Guidelines in relation to the non-recognition and alternative characterisation of certain arrangements (see for example 169 and 9.185 of the OECD Guidelines)'.

103 EM to Multinational Profit Shifting Bill, above n 31, [3.102]-[3.103]. This standard is intended to reduce the number of possible alternatives that can be hypothesised under the exception.

104 ITAA 1997, s 815-130(4). EM to Multinational Profit Shifting Bill, ibid [3.105] notes that: In such cases, the actual conditions connected with the commercial or financial relations are likely to be disregarded, and the arm's length condition is that nothing would have occurred.
3.106 Any arm's length conditions that are identified under this exception are still subject to the general transfer pricing benefit requirements set out under s 815-120, meaning that this exception does not apply if disregarding the commercial or financial relations would result in the entity obtaining an Australian tax advantage (for example, an actual payment to the entity could not be disregarded under this exception). As such, application of this exclusion is limited to disregarding positive actions of an entity that give rise to a transfer pricing benefit.

This exception provision was subject to criticism by many professional associations and business groups in their submissions to the Senate Economics Legislation Committee Inquiry on the grounds that the legislation goes beyond the OECD Guidelines in the breadth of its application of the 'reconstruction' approach.[105] They argued that by doing so it gave the Commissioner unnecessarily wide powers to disregard the actual conditions connected with the commercial or financial relations between parties. They called for limitations on power, ie it should only be used in 'exceptional cases' as indicated at paras 1.64 and 1.65 of the OECD Guidelines.

Despite the concerns of professional associations and business groups the majority of the Senate Economics Legislation Committee concluded that it did 'not believe that the bill introduces a broad reconstruction power, but rather that it sets out reconstruction rules in a manner that is consistent with the international best practice standard set by the OECD.'[106]

3.2.5.2 Methods to determine the arm's length conditions

Where an entity is required to identify 'arm's length conditions', the entity is required to use the method or methods that produces the most 'appropriate and reliable assessment' of the conditions having regard to:

- the respective strengths and weaknesses of the possible transfer pricing methods;
- the circumstances, including the functions performed, the assets used and the risks borne by the entities;
- the availability of reliable information required to apply a particular method; and
- the degree of comparability between the actual circumstances and the comparable circumstances, including the reliability of any adjustments to eliminate the effect of material differences between those circumstances.[107]

As discussed above the relevant methods are those specified in the OECD Guidelines.

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105 Senate Economics Legislation Committee Inquiry, Above n 41, [3.4]-[3.18].

106 Ibid [3.21]. However, the Coalition members of the Committee disagreed with the majority noting that they believed that power was too broad – ibid, 'Coalition Senators' Dissenting Report' [1.36].

107 ITAA 1997, s 815-125(2).

One of the factors in selecting and applying a method is the degree of comparability between the actual circumstances and any circumstances being compared. The legislation requires that the independent entities be in 'comparable circumstances' to the actual entities.[108] This ensures 'the nature of the actual entities and the context within which they operate is directly relevant in constructing the profile of the hypothetical entities.'[109] In identifying 'comparable circumstances', regard must be given to all relevant factors including:

a. the functions performed, assets used and risks borne by the entities;

b. the characteristics of any property or services transferred;

c. the terms of any relevant contracts between the entities;

d. the economic circumstances; and

e. the business strategies of the entities.[110]

None of the differences between the situations being compared should be capable of materially affecting a condition that is relevant to the method chosen.[111] A situation which is different may still be considered comparable if a reasonably accurate adjustment can be made to eliminate the impact of the difference on a condition.[112]

3.2.6 Fifth step: determining the 'amount of the transfer pricing benefit'

Having determined that a transfer pricing benefit has arisen, the fifth step is to determine the 'amount of the transfer pricing benefit'. It is defined to be:

- an entity's taxable income;
- a tax loss, film loss or net capital loss;[113]
- tax offsets; or
- withholding tax payable in relation to interest or royalties.[114]

Thus, an entity is required to work out its taxable income, loss, tax offsets or withholding tax payable on the basis that independent conditions operated. This

108 Ibid s 815-125(3)-(4).

109 EM to Multinational Profit Shifting Bill, above n 31, [3.80].

110 ITAA 1997, s 815-125(3).

111 Ibid s 815-125(4)(a).

112 Ibid s 815-125(4)(b).

113 These losses are referred to collectively as 'a loss of a particular sort' in ITAA 1997, s 815-115(2), which is defined in ITAA 1997, s 701-1(4).

114 ITAA 1997, ss 815-115(1).

process is different to an overall adjustment approach permitted under the former Subdivision 815-A as it requires the identification and valuing of items that are relevant in determining the aggregated amounts.[115] As mentioned above such an approach was not available under Div 13.

The aggregate approach was criticised by the Federal Chamber of Automotive Industries, in their submissions to the Senate Economics Legislation Committee Inquiry. They believed that the approach would lead to double taxation as it would create problems in obtaining refunds of customs duties (tariffs).[116] This difficulty arises as the Customs Valuation rules are levied on a transaction-by-transaction basis, while the Commissioner can make a 'transfer pricing adjustment' based on an adjustment to 'taxable income.'[117] Further, it was argued that as the rules:

> do not require the ATO to identify individual transaction amounts with a sufficient level of granularity to ensure relief under the [Mutual Agreement Procedure] articles of Australia's double tax agreements and address the impact on other areas, such as the ability to claim Customs duty or withholding tax refunds.[118]

The Treasury argued that the non-inclusion in subdiv 815-B of the requirement in subdiv 815-A that the Commissioner is required to make secondary adjustments in respect of the component amounts has 'created the false impression that … there can be an aggregate-level adjustment without the requirement to identify the component parts of the income or deductions that are being adjusted. And that is not actually how these provisions work.'[119] They stated that:

> The 'working out' of particular amounts is a long-established and key feature of the core provisions of ITAA 1997 (as set out in section 4-15), and by definition requires the identification of component amounts ... the requirement that an entity 'work out' particular amounts ensured that subdivision 815-B could not be applied without:

115 EM to Countering Tax Avoidance and Multinational Profit Shifting Bill, above n 31 at [3.17] notes, "even if a profit based method is used in applying Subdivision 815-B, taxpayers (and the Commissioner in the case of an amended assessment) must attribute the arm's length conditions to the value of individual components that form part of the tax equation. The determination of an entity's tax position must therefore include all questions (for example the identification of specific amounts of income and expenditure) that would ordinarily be considered in calculating any elements of the entity's tax position.

116 Senate Economics Legislation Committee Inquiry, above n 41, [3.24]-[3.25].

117 Ibid [3.24].

118 Ibid [3.26].

119 Ibid [3.28].

> '…drilling down to those component amounts, because in effect what it does is feed into the primary tax calculation in the core rules of the income tax act which requires you to sum up the components of assessable income and allowable deductions and arrive at a taxable income amount.'[120]

The majority of the Senate Economics Legislation Committee, in finding the potential double tax issue between transfer pricing and Customs Valuation rules was not a new problem, recommended that the Government consider further consultation on the issue.[121]

3.2.7 *The sixth and final step: to make the adjustment and any consequential adjustments*

Where the application of subdiv 815-B potentially impacts the tax result of another entity, or of the same entity, in the same or a different income year, the Commissioner has the discretion to make a consequential adjustment to ensure that the appropriate amount of tax is paid in Australia.[122]

3.3 Application to PE: Subdivision 815-C

Similar to the approach adopted in respect of subdiv 815-B, in analysing the operation of subdiv 815-C, this paper focuses on the key elements that need to be satisfied before the Subdivision can apply. Again, to enhance readability, the more technical aspects of each of the key operative elements have been placed in the footnotes.

As noted above, the structure of subdiv 815-C varies from that adopted in subdiv 815-B as Australia adopts the 'relevant business activity' approach in respect of the attributable profit of PEs. Under subdiv 815-C entities operating through PEs in Australia are required to postulate:

- if the PE was a distinct and separate entity,
- engaged in comparable activities under the same circumstances,
- but dealing wholly independently with the entity,

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120 Ibid [3.29].

121 Ibid [3.34], Recommendation 1.

122 ITAA 1997, s 815-145.

would the profits be greater than the actual profits attributed to the PE in Australia. If profit is less, under this self assessing regime they are required to substitute the arm's length profits attributed to the PE.[123]

As subdiv 815-C is focused on the allocation of an amount to a PE impacting upon a non-resident entity's Australian tax position, there is no express cross border test. As a non-resident entity is only taxable on Australian source income, any impact on its tax position can only occur in respect of income derived through an Australian PE. As those transactions have an implicit cross border element, an express cross border test is not required.

3.3.1 Key operative provision

Unlike subdiv 815-B, a principal operative provision setting out the key elements to be satisfied is difficult to discern under subdiv 815-C. This complexity in drafting arises in part as Subdiv 815-C, consistent with Australia's current treaty practice, applies to the 'actual' amounts of income and expenditure allocated to the PE rather than any notional amount.[124] As a result the principal operative provision is two distinct sections (ss 815-215(1)-(2) and 815-220(1)(b)(i)-(iii)) that are 'clumsily' interlinked.[125]

The interlinked operative statement broadly provides:

- ❑ that for the purposes of working out an amount of the entity's:
  - taxable income; and
  - 'loss of a particular sort' (a tax loss, film loss or net capital loss); and
  - tax offset;[126]
- ❑ a 'transfer pricing benefit' arises127 in respect of one of the amounts being calculated; and

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123 Ibid s 815-205.

124 The accuracy of Treasury's suggestion that an 'actual' amount could consist of an aggregate of multiple transactions was questioned by the majority of the Senate Economics Legislation Committee – see Senate Economics Legislation Committee Inquiry, above n 41, [3.73], [3.77]-[3.78].

125 EM to Countering Tax Avoidance and Multinational Profit Shifting Bill, above n 31 glosses over this complexity in describing the operation of s 815-215(1) - see [4.11]-[4.17].

126 ITAA 1997, s 815-215(2). Withholding tax payable is not an issue under subdiv 815-C as the subdivision applies intra-entity allocation of income and expenses. As such there is no scope for a withholding tax liability to arise.

- if the entity gets a 'transfer pricing benefit' from the attribution of profits to a PE of the entity:
    - (a) the amount of profits actually attributed to the PE are taken not to have been attributed to the PE; and
    - (b) instead the arm's length profits are taken to have been attributed to the PE.

Thus, the subdiv requires that a 'transfer pricing benefit' must occur in respect of both the amount calculated and the profit attributed to the PE. Therefore, if there is a change in an amount of profit, or a component amount of profit (eg an expense), but the change does not impact an entity's Australian tax position the entity does not have transfer pricing benefit.[128]

The two tier approach is reinforced in the definition of a 'transfer pricing benefit'. Thus, an entity is deemed to have a 'transfer pricing benefit' in respect of the attribution of profits to a PE of the entity if:

- the amount of actual profits attributed to the PE differ from the arm's length profits for the PE; and
- had the arm's length profits, instead of the actual profits, been attributed to the PE, the entity would have had greater taxable income, less 'losses of a particular sort' or less tax offsets.[129]

The 'actual profits' are the profits that are actually or are intended to be attributable to the PE.

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127 Ibid s 815-220(1)(b) states that 'The arm's length profits for a *PE of an entity are worked out by allocating the actual expenditure and income of the entity between the PE and the entity so that the profits attributed to the PE equal the profits the PE might be expected to make if: …

(b) had the arm's length profits, instead of the actual profits, been attributed to the PE, one or more of the following would, apart from this Subdivision, apply:

(i) the amount of the entity's taxable income for an income year would be greater;

(ii) the amount of the entity's loss of a particular *sort for an income year would be less;

(iii) the amount of the entity's *tax offsets for an income year would be less.'

128 EM to Countering Tax Avoidance and Multinational Profit Shifting Bill, above n 31, [4.35] provides an example – 'if an amount of profit that might have been expected to have accrued to an entity would have been non assessable, non-exempt income of the entity, then the entity would not have a transfer pricing benefit in respect of that amount.'

129 ITAA 1997, s 815-220(1).

To ensure that the calculation can still be performed where an entity has no actual taxable income, no losses of a particular sort, or no tax offsets (or would not have had such an amount under arm's length conditions), the amount of the taxable income, losses of a particular sort, or tax offsets is deemed to be nil.[130]

3.3.2 Determining the arm's length profit

In determining whether an entity gets a 'transfer pricing benefit', the actual profits attributed to the PE of the entity must differ from the 'arm's length profits' that would have been attributed to the PE.[131]

The 'arm's length profits' of a PE are worked out by allocating the actual income and expenditure of an entity between itself and its PE so that the profits attributed to the PE equal the profits that the PE might be expected to make if it was postulated that:

(a) the PE were a distinct and separate entity; and

(b) the activities and circumstances of the PE, including the functions performed, assets used and risks borne by the PE, were those of that separate entity; and

(c) the conditions (based on the two assumptions above) operated between that separate entity and the entity of which it is a PE were the *arm's length conditions.[132]

The EM to Multinational Profit Shifting Bill notes that as the PE is taken to be an entity that deals with the entity of which it is actually a part, in determining: [133]

- whether the arm's length conditions are directly relevant in ascertaining the arm's length profits for the PE; or
- the comparability factors; or
- the most appropriate method;

subdiv 815-B may provide guidance in that postulation. The identification of arm's length profits and arm's length conditions is required to be undertaken in a way that best ensures consistency with the OECD guidance material.[134]

There are limitations in the identification of the 'arm's length profits' as 'the allocation is determined within the confines of the actual income and expense

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130 Ibid s 815-220(2).

131 Ibid s 815-220(1)(a).

132 Ibid s 815-225(1)-(2).

133 EM to Multinational Profit Shifting Bill, above n 31, [4.42].

134 ITAA 1997, s 815-235.

position ... of the entity of which the PE is a part.'[135] Specific source rules exist to deem any arm's length profits of an Australian PE, or a PE located in an area covered by an international tax sharing treaty, to have an Australian source.[136]

3.4. Summary

The incorporation of paragraph 1 of Art 9 of the OECD Model Convention and Australia's current approach to PEs, as reflected in Art 7 of its recent tax treaties, in the new transfer rules was described by the Assistant Treasurer as 'aligning our transfer pricing rules with international best practice.'[137] Despite this allegation of international best practice there are still some observations and concerns.

First, at the practical level, the drafting is complex which has created uncertainty, as illustrated in the submissions to Senate Economics Legislation Committee. The rules have also come at a cost to taxpayers due to the deliberate decision by the Government to shift the compliance burden from the ATO to taxpayers. As concluded above, whether the correct balance between compliance costs and protection of the revenue has been achieved is also an open question.

Second, it is curious that the Government decided to enact the existing approach to Art 7 given that they had received the Board of Taxation's completed *Review of Tax Arrangements Applying to Permanent Establishments* in April 2013. The Report includes recommendations on whether Australia should change its current tax treaty practice to adopt the functionally separate entity approach.[138] If the Board of Taxation's recommendation is for adoption of the OECD approach, then further amendment will be required.

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135 EM to Multinational Profit Shifting Bill, above n 31, [4.45].

136 ITAA 1997, s 815-230(1)-(2). These deeming rules are consistent with the special source rules contained in Australia's tax treaties or because Australia's ability to impose tax upon income sourced in an area covered by an international tax sharing treaty (or deal with expenditure in relation to such income), is affected by the terms of such agreements.

137 David Bradbury, Assistant Treasurer, '"Stateless Income" - A Threat to National Sovereignty' (Paper delivered at The Tax Institute's 28th National Convention, Perth, 15 March 2013) <http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=speeches/2013/003.htm&pageID=005&min=djba&Year=&DocType=1>.

138 See the Board of Taxation website <http://www.taxboard.gov.au/content/content.aspx?doc=reviews_and_consultations/permanent_establishments/default.htm&pageid=007>.

Third, uncertainty arises from the fact that the modernisation rules may give rise to more extensive adjustments than permissible under Australia's aged tax treaties, if the judicial view that the subsequent amendments to the OECD Commentary do not inform the meaning of existing treaties prevails. This also remains an unresolved issue.

Fourth, the timing for the adoption of new rules, which require reference to OECD Guidance when determining the arms-length profit, has been questioned by a number of authors.[139] Australia has adopted these OECD guidelines at a time when many commentators are suggesting that there is a divergence between United Nations (UN) and OECD in respect of certain technical transfer pricing issues.[140] It is argued that this is illustrated by emerging economies in Australia's region (such as China and India) as well as Brazil setting out in Chapter 10 of the UN's October 2012, *Practical Transfer Pricing Manual for Developing Countries* (UN's Transfer Pricing Manual)[141] their individual countries approach to transfer pricing. The UN's model does differ from the OECD's June 2012 discussion drafts for revising the transfer pricing guidelines.

Whether this is a rift between the UN and the OECD, or the 'flexing of muscles' by the emerging economies of Brazil, India and China against the OECD order or merely three states setting out their countries' approach to transfer pricing (unendorsed by the UN) is open for debate. However, what is clear is that Australia has aligned its domestic law to the OECD model at a time of uncertainty.

4. DOES THE MODERNISATION ADDRESS THE BEPS ISSUES?

Finally, as the modernisation of Australia's transfer pricing rules predates the two key OECD's responses to the global concerns about BEPS, the questions arise of whether Australia needs to do more work on its transfer pricing rules domestically to

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139 Richard Vann 'Topical Tax Treaty Issues for the Finance Sector', (Paper delivered at Tax Institute's 2013 Financial Services Taxation Conference, Sanctuary Cove, 13–15 February 2013) 23 and Leslie Prescott Haar and Alejandro Ces 'Australia: proposed amendments to transfer pricing rules' (2012) Bloomberg BNA's *Transfer Pricing International Journal* (5 November 2012).

140 See further Richard Vann 'Current trends in balancing residence and source taxation', (Paper delivered at Institute of Chartered Accountants in Australia's National Tax Conference, Sydney, 22 November 2012), 14-15.

141 As illustrated in United Nations, *Practical Transfer Pricing Manual for Developing Countries* (2012) <http://www.un.org/esa/ffd/tax/documents/bgrd_tp.htm> which reflects the concerns of developing countries with the complexity of the OECD Guidelines and its approach to intangibles.

address BEPS and to what extent do any further transfer pricing reforms to counter BEPS lay outside Australia's unilateral action.

The first of the two key reports produced as part of the global response to concerns about BEPS was the release of the OECD BEPS Report on 12 February 2013.[142] Its primary focus was to provide the G20 with the background information on the causes, scope and magnitude of the problem.[143] It also effectively provided a checklist of unilateral reforms that countries can undertake to counter BEPS by identifying the main pressure areas in tax systems where BEPS can arise.[144]

In respect of transfer pricing the BEPS Report recommends the need for 'improvements or clarifications to transfer pricing rules to address specific areas where the current rules produce undesirable results from a policy perspective.'[145] It recognises that the resolution of the issues associated with intangibles would need to be addressed 'in a broader reflection on transfer pricing rules.'

Although Australia's reforms predate the OECD BEPS Report, they were targeted squarely addressing the 'undesirable' risk to revenue posed by the *SNF* case. By generally aligning the domestic law with the approach adopted in Australia's tax treaties and prescribing the use of OECD guidance, the revised rules have broadly countered that risk.

In respect of the broader issues associated with intangibles, the EM to Multinational Profit Shifting Bill does in two paragraphs indicate that the transfer pricing rules could apply to complexity of cross-border intra-firm financing transactions involving various forms of debt and hybrid securities in the context of determining the arm's length conditions.[146] Despite these statements there has been constant acknowledgement by the Government, arguably since 22 November 2012, that there

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142 OECD's BEPS Report, above n 3.

143 OECD's BEPS Report, ibid, provided background information on the publically available studies and data concerning the existence and magnitude of BEPS and an overview of the key principles that underlie the taxation of cross-border activities, as well as the weakness that permits or creates opportunities for BEPS.

144 See eg Australian Government, Treasury, *Implications of the modern global economy for the taxation of multinational enterprises: Issues paper*, May 2013, [83] <Treasury website>. <http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2013/062.htm&pageID=003&min=djba&Year=&DocType=0>

145 OECD's BEPS Report, above n 3, 10, 52.

146 EM to Multinational Profit Shifting Bill, above n 31, [3.78]-[3.79].

are issues, such as intangibles, that will not be remedied by the new transfer pricing rules.[147]

The Treasury's Scoping Paper released on 24 July 2013, again acknowledging this gap in the legislation,[148] indicated that the solution to the intangible issues lies in international cooperation. The Scoping paper concedes that 'there are some actions Australia can and has taken unilaterally; these are primarily focused on improvements that can be made without significant divergence from international tax settings'.[149] It recommended that 'the key focus of Australia's efforts should be working multilaterally through international organisations to modernise international tax rules.'[150]

The OECD Action Plan, released on 19 July 2013:[151]

- identified the actions needed to address BEPS;
- set the OECD's deadlines to implement these actions; and
- identified the resources needed and the methodology to implement these actions.

Of the 15 Actions identified in the Action Plan, five are related to transfer pricing reform. They are:

- Action 4: Limit base erosion via interest deductions and other financial payments;[152]

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147 On 22 November 2012, the same day the Assistant Treasurer released for consultation the stage exposure draft bill and explanatory material rules (Assistant Treasurer, Media Release, No 144, 22 November 2012, above n 29) the Assistant Treasurer in a speech (Assistant Treasurer, Towards a Fair, Competitive and Sustainable Corporate Tax Base, above n 4) 'in effect questioned the current international tax system of which transfer pricing rules are a central part.' (see Tony Frost, 'Australia: Transfer Pricing and Corporate Tax Developments for Australia' (7 January 2013) <http://www.mondaq.com/australia/x/213674/Corporate+Tax/Transfer+Pricing+and+Corporate+Tax+Developments+for+Australia>)
Similarly, on 15 March 2013, a month after introducing the Stage 2 reforms into Parliament the Assistant Treasurer noted the legislation did not addressed the defects in the current transfer pricing rules, such as hybrids and intangibles – see Assistant Treasurer, "Stateless Income" - A Threat to National Sovereignty, above n 137.

148 Scoping Paper, above n 1, [57].

149 Ibid [209].

150 Ibid [210].

151 OECD Action Plan above n 6.

- In the context of assuring that transfer pricing outcomes are in line with value creation - Action 8: Intangibles;[153] Action 9: Risks and capital;[154] and Action 10: Other high-risk transactions;[155] and
- Action 13: Re-examine transfer pricing documentation.[156]

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152 Ibid, 17: 'Develop recommendations regarding best practices in the design of rules to prevent base erosion through the use of interest expense, for example through the use of related-party and third-party debt to achieve excessive interest deductions or to finance the production of exempt or deferred income, and other financial payments that are economically equivalent to interest payments … transfer pricing guidance will also be developed regarding the pricing of related party financial transactions, including financial and performance guarantees, derivatives (including internal derivatives used in intra-bank dealings), and captive and other insurance arrangements. The work will be co-ordinated with the work on hybrids and CFC rules' – complete December 2015.

153 Ibid, 20: 'Develop rules to prevent BEPS by moving intangibles among group members. This will involve: (i) adopting a broad and clearly delineated definition of intangibles; (ii) ensuring that profits associated with the transfer and use of intangibles are appropriately allocated in accordance with (rather than divorced from) value creation; (iii) developing transfer pricing rules or special measures for transfers of hard-to-value intangibles; and (iv) updating the guidance on cost contribution arrangements' – complete September 2015.

154 Ibid, 20: 'Develop rules to prevent BEPS by transferring risks among, or allocating excessive capital to, group members. This will involve adopting transfer pricing rules or special measures to ensure that inappropriate returns will not accrue to an entity solely because it has contractually assumed risks or has provided capital. The rules to be developed will also require alignment of returns with value creation. This work will be co-ordinated with the work on interest expense deductions and other financial payments' – complete September 2015.

155 Ibid 20, 21: 'Develop rules to prevent BEPS by engaging in transactions which would not, or would only very rarely, occur between third parties. This will involve adopting transfer pricing rules or special measures to: (i) clarify the circumstances [21] in which transactions can be recharacterised; (ii) clarify the application of transfer pricing methods, in particular profit splits, in the context of global value chains; and (iii) provide protection against common types of base eroding payments, such as management fees and head office expenses' – complete September 2015.

156 Ibid 23: ‚Develop rules regarding transfer pricing documentation to enhance transparency for tax administration, taking into consideration the compliance costs for business. The rules to be developed will include a requirement that MNE's provide all relevant governments with needed information on their global allocation of the income, economic activity and taxes paid among countries according to a common template' – complete September 2014. The OECD has already (on 30 July 2013) released a *Public Consultation: White Paper on Transfer Pricing Documentation*

The OECD's Action Plan was endorsed by the Australian Government at the G20 Finance Minister's meeting in Moscow.[157] More broadly in terms of Australia's commitment to combating BEPS, the Treasurer on 20 July 2013 announced that Australia and Britain have agreed on a shared agenda to combat tax avoidance and evasion by Britain making it a priority for its G8 presidency this year and Australia making it a priority for its G20 presidency next year.[158]

In summary, Australia's modernised transfer pricing rules do overcome the structural weaknesses in the domestic law identified by the SNF case. They do not, however, effectively counter BEPS as they embody the current flawed OECD approach. As a result, the Government is awaiting the outcome of international efforts to modernise international tax rules relating to transfer pricing before introducing complementary domestic solutions to deal with the problem issues identified in the OECD Action Plan.

5. CONCLUSION

From the above it is clear that Australia's revised transfer pricing rules have gone some way to addressing BEPS in Australia. However, the effectiveness of these rules going forward is totally reliant on the work of the OECD. The Assistant Treasurer

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<http://www.oecd.org/ctp/transfer-pricing/white-paper-transfer-pricing-documentation.pdf> which:
surveys the current state of affairs regarding transfer pricing documentation, considers the purposes and objectives of transfer pricing documentation, and makes suggestions as to how transfer pricing documentation rules might be modified to make transfer pricing compliance simpler and more straightforward, while at the same time providing tax authorities with more focused and useful information for consideration in connection with transfer pricing risk assessment and transfer pricing audits.

157 G20 Meeting of Finance Ministers and Central Bank Governors, *Communiqué,* 20 July 2013, [18] <http://www.g20.utoronto.ca/2013/2013-0720-finance.html>. Also see Chris Bowen, Treasurer, 'Treasurer's Economic Note', No 003, 28 July 2013 <http://www.treasurer.gov.au/DisplayDocs.aspx?doc=economicnotes/2013/003.htm&pageID=012&min=cebb&Year=&DocType=4> and David Bradbury, Assistant Treasurer, 'Tackling base erosion and profit shifting' (Media Release, No 139, 24 July 2013) <http://assistant.treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2013/139.htm&pageID=003&min=djba&Year=&DocType=0>.

158 Wayne Swan, Treasurer, 'Australia and Britain agree joint agenda to address global tax avoidance', (Media Release, No 009, 20 July 2013) <http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2013/009.htm&pageID=003&min=cebb&Year=&DocType=0>.

argues '[t]his is not, as some have suggested, an abrogation of Australia's sovereignty. Rather, it is a sensible way of ensuring that our transfer pricing rules keep pace with multilateral reforms.'[159]

However, the effectiveness of any global response is dependent upon the ability of it OECD and non-OECD states to commit to the adoption effective solutions. This is far from assured given the existing divergence between United Nations and OECD in respect of certain technical transfer pricing issues, and the rejection of the OECD's approach to transfer pricing by emerging nations such as China, India, and Brazil.

159 Assistant Treasurer, "Stateless Income" - A Threat to National Sovereignty, above n 137.