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Review of Transfer Pricing – consultation paper

In response to adverse court decisions, the treasury has released a consultation paper entitled *Income tax: cross border profit allocation - review of transfer pricing rules*. The paper examines a possible government response to those decisions which illustrated how the Australian legislation is incompatible with recent Organisation for Economic Co-operation and Development (OECD) transfer pricing advances.

Introduction

The paper opens with a reference to the 2010 OECD revised *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, and discusses how the new guidelines have changed the internationally accepted approach to transfer pricing.

The paper notes how recent court decisions (*Roche* and *SNF*) illustrate the inconsistencies between the current legislation and the new international approach to transfer pricing. The premise is that these inconsistencies make Division 13 unworkable and impractical, and that the legislation needs to be redrafted to address these issues.

The balance of the paper considers the way in which the current legislation could be redrafted to bring Division 13 into line with the new OECD guidelines.

The new OECD guidelines

The 2010 revised OECD guidelines are widely used by revenue authorities and across the treaty network, as well as by many taxpayers.

The guidelines are important because they have been updated to better reflect the current business practices of most multinational companies. The general approach of transfer pricing in the 2010 guidelines is a recognition of profit based pricing methodologies in conjunction with the more traditional transactional pricing methods.

Division 13 and the courts

When the transfer pricing provisions of Division 13 were drafted, the traditional transaction based pricing methods were the accepted approach to transfer pricing and the legislation reflects this approach.

The paper notes that Division 13 is inconsistent with the new approach to transfer pricing, as traditional methods have given way to profit based pricing methodologies.

This is the difficulty for the Tax Office and taxpayers. While the new approach to transfer pricing favours profit based methods, Division 13 precludes the use of these methods. Furthermore, the transfer pricing cases have rejected (according to the paper) profit methods on the basis Division 13 contemplates transactional methods.

It is for these reasons the paper concludes Division 13 needs to be redrafted.

Design rules for the new division 13

The paper contemplates how the new transfer pricing rules could be drafted. In broad guidelines, the treasury proposes areas of the existing rules unlikely to change and main principles and features of the new approach.

Areas unlikely to change

- The rules will not depend on the existence of a tax avoidance purpose for their application.
- The rules will only apply to international dealings.
- The rules will extend to all dealings.
- The rules will cover non-arms length dealings of related and unrelated parties and within entities.
- An arms length price or profit will be substituted where there is a detriment to the revenue.
- Relief provided by compensating adjustments.

Key areas of the new structure

- Clear identification of the purpose of the profit allocation rules in an objects clause.
- Incorporation of the OECD arms length principles in the operative rules of the law.
- A rule setting out when non-arms length dealings are comparable to arms length independent parties, including expressly referring to the factors identified in the 2010 OECD guidelines.
- Inclusion of approved transfer pricing methods, including criteria for selecting which is the most appropriate method in given circumstances.
- Rules authorising reconstruction of dealings in specific circumstances consistent with the 2010 OECD guidelines.
- Interpretation to promote consistency between the legislation, the OECD guidelines and Australia's treaty network.

Further comments

- Self assessment - when Division 13 was drafted, all legislative action required a determination by the Tax Office. This approach is inconsistent with self assessment. Treasury notes that the new transfer pricing rules will need to be drafted in accordance with self assessment.
- Discretionary powers - Treasury proposes the Commissioner retain discretionary powers under Division 13 where there is insufficient information (lack of comparable dealings or information not provided to the Tax Office), and where the Tax Office could reconstruct transactions because they do not reflect an arms length transaction.
- Record keeping - Treasury proposes that record keeping requirements be introduced which would be consistent with self assessment. Taxpayers would be obliged to prepare contemporaneous documentation to support their transfer prices - currently this is a Tax Office requirement, and would become a legislative requirement.

Permanent establishments

The current approach to transfer pricing permanent establishments and inter-entity transactions is the relevant business activity approach. In this approach, actual income and expenses of an entity are allocated across the various parts of the entity.

The allocation takes account of the extent to which the activities conducted at each part of the entity contribute to the derivation of income and the incurring of expenses.

The OECD proposes a new approach referred to as the functionally separate approach. Under this approach, the permanent establishment is treated as a separate legal entity and the profit attributable to the permanent establishment is determined by undertaking a functions, assets and risk analysis of the permanent establishment and identifying the dealings of the entity. Those dealings are then priced using the OECD guidelines (as you would for ordinary stand alone entities).

While the paper discusses this approach, it does not reach any conclusions. Treasury notes further work is required, and they welcome comments on this area.

Further action

Treasury raises the possibility of changing the time limit for transfer pricing amendments. Treasury has already received submissions on the time limit and they suggest these will be considered in the context of the overall review of transfer pricing.

The paper is an invitation for submissions from taxpayers and practitioners on the structure of Division 13 and the transfer pricing rules. If you have comments you would like to make in a submission, please contact your local PKF partner and we can assist in making your submission.

Submissions close on 30 November 2011.

Should you require assistance or additional information, please contact your PKF Tax Adviser
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