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Reconceptualising Australia's transfer pricing rules: An approach based on adopting economic presence as a basis for taxation

Nicole Wilson-Rogers¹ and Professor Dale Pinto²

Abstract

Against the background of a global focus on base erosion and profit shifting and well-publicised cases of high profile multinationals minimising their taxable burden in high tax jurisdictions, including the use of transfer pricing as a major tax minimisation strategy, this paper argues for a reconceptualisation of Australia's Transfer Pricing rules by adopting an approach based on using economic presence as a basis for source based taxation.

The approach of the paper is to first discuss and evaluate the evolution of Australia's transfer pricing legislation. In this part, it will be argued that the most current reforms to Australia's transfer pricing regime present several fundamental deficiencies. In response to these deficiencies, the second part of the paper advocates a policy response focused on a reconceptualised version of current source rules applying economic presence as a foundation for taxation.

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1. INTRODUCTION

Transfer pricing occurs when goods and/or services are sold or purchased between entities that are located in different countries, but which are members of the same multinational group.³ The price allocated to such goods and/or services can materially impact upon the profitability of entities within the group and therefore can ultimately determine the amount of tax they pay.⁴

Tax benefits associated with base erosion and profit shifting (BEPS) have featured prominently worldwide⁵ including examples of high profile multinationals, such as Apple, Starbucks, Microsoft, Google and Amazon⁶ minimising their taxable burden in high tax jurisdictions through complex international structures,⁷ including the use of transfer pricing as a major tax minimisation strategy.⁸

This focus on reforming transfer pricing and targeting BEPS has been occurring internationally, with the Organisation for Economic Co-operation and Development (OECD) releasing its discussion paper, *Addressing Base Erosion and Profit Shifting* and subsequent *Action Plan*, as part of its BEPS project.⁹ Furthermore, the G8,¹⁰ G20¹¹ and the OECD have agreed to undertake substantive action to curtail problems associated with BEPS, including those caused by transfer pricing.

At the same time as these international developments have been unfolding, several countries, including Australia, have taken active steps to reform and revisit their domestic transfer pricing rules.¹²

³ Department of Parliamentary Services (Cth), *Bills Digest to Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013*, <http://parlinfo.aph.gov.au/parlInfo/download/legislation/billsdgs/2299302/upload_binary/2299302.pdf;fileType=application/pdf>.

⁴ Ibid.

⁵ See, for example, Richard Gluyas, 'Call for Law Reform to Close Tax Loopholes', *The Australian*, 10 March 2014, 19.; Michael Bingemann and Andrew Main, 'Billions in Revenue 36 million in tax: It's the Apple Way', *The Weekend Australian*, 1–2 February 2014, 25, Dipesh Gadher and Simon Duke, 'British Hit Google with \$4 Million Tax Bill', *The Australian*, 6 January 2014, 5; Katie Walsh 'Labor Targets Digital Giants for Tax', *Australian Financial Review*, 22 November 2012, 1. Former Assistant Treasurer Hon. David Bradbury MP, 'Towards a Fair Competitive and Sustainable Corporate Tax Base', (Speech delivered at the ICAA National Tax Conference, Hilton Sydney, 22 November 2012) <<http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=speeches/2012/013.htm&pageID=005&min=djba&Year=&DocType=>>. Note since the date this article was originally submitted and accepted for publication there has been a substantial number of articles dealing with this issue.

⁶ See as examples the references provided in n 5.

⁷ Ibid.

⁸ Richard Vann, "Tax Base Erosion—What is likely to be the Australian Legislative Response Going Forward?" (Paper presented at the Corporate Tax Masterclass NSW Division of Taxation Institute, 23 October 2013) states at p. 3 that, "there has been an increasing crescendo in the press about the tax planning of multinational in the digital economy which has captured attention round the world".

⁹ OECD, *Addressing Base Erosion and Profit Shifting* (OECD Publishing, Paris, 2013), (OECD BEPS Report), 10, 52, 53. Action Items 8, 9 and 10 deal with transfer pricing. The deadline for examination of these issues is September 2015. Action Item 13 deals with transfer pricing documentation. The most recent Federal Budget has adopted the recommendations in relation to Action Item 13 (see below).

¹⁰ Group of 8 industrialised countries.

¹¹ Group of 20 Finance Ministers and Central Bank Governors.

¹² Examples of some countries other than Australia that have revised their transfer pricing rules include most recently Greece, Ukraine, Mexico, Costa Rica and Nigeria.

The catalyst for Australia's reforms in this area has been three-fold.¹³

First, in Australia the significance of transfer pricing arrangements as a percentage of GDP has been increasing and was estimated to be over 20% of Australia's GDP in 2009.¹⁴ This appears to be, at least in part, a direct consequence of growing globalisation¹⁵ which has led to increased mobility of capital and has allowed companies to incorporate in different jurisdictions with increasing ease.¹⁶

Next, the decisions delivered in *Commissioner of Taxation v SNF (Australia) Pty Ltd*¹⁷ and *Roche Products Pty Ltd v FCT*¹⁸ were contrary to the Australian Taxation Office's (ATO) views in relation to the application of the transfer pricing provisions and were seen as highlighting a perceived deficiency in the rules.

Finally, the worldwide focus on reforming transfer pricing to address BEPS strategies has also given further impetus to countries like Australia to review the efficacy of their domestic transfer pricing rules.

The response to these drivers has resulted in a three-phased reform process in Australia.

Currently, Australia's transfer pricing rules are contained in two sources, namely the *Income Tax Assessment Act 1997* (Cth) (ITAA 1997) and the associated enterprise

¹³ In July 2010, the OECD updated the report, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration*. All the member countries accepted the concept on 1 November 2011 and the Australian Government announced it would modernise the existing transfer pricing rules to further align them with international best practice.

¹⁴ Department of Parliamentary Services (Cth), above n 3. The *Digest* states at p. 7: "Any set of transactions representing over 20 percent of Australia's gross domestic product is a sizeable piece of its economic activity. It would concern any government that the expected revenue arising from such activity was not collected".

¹⁵ OECD, *Glossary of Statistical Terms*, <<http://stats.oecd.org/glossary/detail.asp?ID=1121>>. Notably, former UN secretary Kofi Anan stated that, "It has been said that arguing against globalization is like arguing against the law of gravity". The OECD defines globalisation as:

an increasing internationalisation of markets for goods and services, the means of production, financial systems, competition, corporations, technology and industries. Among other things this gives rise to increased mobility of capital, faster propagation of technological innovations and an increasing interdependency and uniformity of national markets.

¹⁶ Inspector General of Taxation, *Report into the ATO's Management of Transfer Pricing Matters* (IGOT TP Report) (released June 2014), <http://igt.gov.au/files/2014/11/management-of-transfer-pricing-matters.pdf>. In the IGOT TP Report stated at p. 1:

1.4 Most submissions impressed on the IGT that the above issues have been exacerbated by major changes in the global business environment over the past two decades such as:

- ongoing evolution of globalisation leading to the decline of trade barriers and increasing the privatisation of business activity, which is said to have facilitated the expansion of many businesses globally and increased the importance of transfer pricing policies;
- ongoing (re)location of the production of final products and components to various jurisdictions to improve business efficiency with decisions based on production costs, infrastructure, tax incentives and skilled labour force;
- the concentration of service functions and assets, such as research and development, internal finance, production and intangible assets within different business units of a Multi-National Enterprise (MNE) which may be located in different jurisdictions; and
- advances in telecommunications that has allowed, among other things, the advent of electronic commerce and '24/7' trading.

¹⁷ [2011] FCAFC 74.

¹⁸ [2008] AATA 639.

articles of Australia's Double Tax Agreements (DTAs) in the *International Tax Agreements Act 1953* (Cth).¹⁹

In order to get to the current legislative framework, Australia's domestic transfer pricing regime has undergone a significant three-phase transformation. Phase One consisted of former Division 13 of the *Income Tax Assessment Act 1936* (Cth) (ITAA 1936). Division 13 applied from 1982 but was repealed on 29 June 2013 and replaced by the current transfer pricing regime.

The second phase involved the enactment of former Division 815-A of the ITA 1997. These rules were introduced from 2012 and were controversially enacted retrospectively to deal with perceived deficiencies in existing Division 13, which applied from 2004 onwards. Division 815-A only applied if there was a DTA in force and was designed to ensure that the DTA functioned as an independent head of power. Where no DTA was in force, Division 13 continued to apply.

The third and current phase involved the termination of Division 13 and Subdivision 815-A for income years on or after 29 June 2013 and the replacement of new transfer pricing rules in Subdivision 815-B, 815-C, 815-D of the ITAA 1997 and 284-E of the *Taxation Administration Act 1953* (Cth) (TAA 1953).²⁰

Against this background, the purpose of this paper is twofold. Firstly, the paper discusses the evolution of Australia's transfer pricing legislation and evaluates the regime, over the three phases of its reform.²¹ It will be argued that the most current reforms to Australia's transfer pricing regime present several fundamental deficiencies and rather than overcoming the difficulties recently noted by the OECD in its BEPS report, they actually legislatively entrench those difficulties.

In response to these deficiencies the second part of this paper advocates a reconceptualised version of current source rules as a possible policy response. It is contended that current source rules have an established theoretical justification and policy underpinnings to address the limitations of the current transfer pricing regime and also have sufficient flexibility to remain relevant in the modern economy. While it is beyond the scope of this paper to address the logistics of translating this solution into legislation, it will be argued that the strong theoretical justifications for adopting the source rules to allocate jurisdiction to tax in transfer pricing transactions warrants further consideration.

It is recognised that there are other potential legislative solutions, such as a formulary approach or greater reliance on the recently amended general anti-avoidance rule (GAAR) contained in Part IVA of the ITAA 1936. However, the limitations associated with adopting a formulary approach for transfer pricing has been debated in

¹⁹ Australia has over 40 DTAs with other countries. For a list of countries with which Australia has a DTA see, <http://www.treasury.gov.au/Policy-Topics/Taxation/Tax-Treaties/HTML/Income-Tax-Treaties>.

²⁰ These rules were enacted by the *Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Act 2013* (Cth). Enacted as Act 101 of 2013.

²¹ Note that in parallel to these transfer pricing reforms other significant reforms have been occurring in the international tax landscape in Australia. These include the proposal to require the Commissioner to publish the tax information of large corporates. The introduction of the International Dealing Schedule and Reportable Tax Position Schedule which requires increased disclosure of reportable tax positions and international dealings.

the literature and currently most jurisdictions do not seem to have a ready appetite to adopt such an approach.²² Furthermore, the limitations associated with the use of a GAAR to combat tax avoidance activities has also been widely investigated by various commentators and scholars.²³

By contrast, the idea of a return to relying on source rules as a conceptual basis for allocating the right to tax income in related party transactions has not received significant recent consideration by the literature, especially in the context of transfer pricing, and therefore warrants further consideration.

This paper is based on the assumption that protection of the corporate income tax base is a justifiable policy goal. It is acknowledged that other commentators and reports have suggested that instead of constantly reforming the corporate income tax base there should be greater emphasis on looking for other more robust and efficient taxes such as a consumption taxes.²⁴ However, a discussion of this issue is beyond the scope of this paper.

The structure of this paper is as follows:

- Part two considers the purpose of transfer pricing regimes;
- Part three traces the three phases of Australia's transfer pricing legislation and outlines areas of future action;
- Part four details some of the major benefits and difficulties associated with the current Australian transfer pricing legislation;
- Part five argues that a reconceptualisation of existing source rules using economic presence as a basis for taxation could provide an alternative response to addressing cross-border profit shifting that warrants further investigation; and
- Part six concludes.

²² See, for example, Erik Roder, 'Proposal for an Enhanced CCTB as Alternative to a CCTB with Formulary Apportionment' (Working Paper, Max Planck Institute for Tax Law and Public Finance, 2012). Also see Arthur J Cockfield, 'Formulary Taxation Versus the Arm's Length Principle: The Battle Among Doubting Thomases, Purists and Pragmatists' (2004) 52(1) *Canadian Tax Journal*, 114.

²³ See, for example, Rachel Tooma, *Legislating Against Tax Avoidance* (IBFD, 2008) which considers the advantages and disadvantages of utilising a GAAR to combat tax avoidance. Given the similarity of the GAAR to the current transfer pricing provisions in Australia which also require ascertainment of a counterfactual, this alternative has not been investigated in any detail.

²⁴ Vann, above n 8, 9 states:

The main objective of the whole BEPS exercise is the protection and restoration of the international corporate income tax base, which is assumed to be such a policy no-brainer that there is little OECD argument for it. Yet the OECD has for over two decades sponsored economic research indicating that the corporate income tax is inefficient (particularly because of the mobility of capital) and should be replaced by more efficient taxes, such as indirect taxes. The Henry Review picked up on this work which is now regularly referred to in Treasury policy documents.

2. PURPOSE OF TRANSFER PRICING REGIMES

Transfer pricing rules are integrity measures designed to ensure that a taxing jurisdiction retains taxing rights over an appropriate return for the Australian operations of a business. In the Australian context, the stated objective of the current transfer pricing rules suggests that these measures are designed to ensure that the tax amount imposed in Australia reflects the economic contribution made by Australian operations.²⁵

An appropriate return is generally defined by what is considered to be 'arm's length'. This is the accepted basis for regulation by Australia and other OECD members.²⁶

Transfer pricing rules are pivotal in Australia, with related party transactions being valued at \$270 billion in 2009.²⁷ Likewise, the 2012/2013 ATO Compliance Program suggests that international related party transactions now comprise approximately 50% of all cross-border trade.²⁸ Furthermore, Treasury reports that intra-firm trade was equivalent to greater than 20% of gross domestic product (GDP) in Australia in 2009.²⁹

It is expected that the scope and effect of transfer pricing will intensify as the world continues to be increasingly globalised and also as a greater trade occurs in services and in intangibles through the agency of related developments in e-commerce and advances in information and communication technologies.³⁰

2.1 Transfer pricing strategies

While transfer pricing strategies can take various forms, at their most basic level they represent an attempt to shift profits from high tax to low tax jurisdictions by artificially inflating the costs of goods or services between related entities. This shifting can provide the group of companies with a tax benefit or advantage. In this respect, the ATO *2012/2013 Compliance Program* suggests:

Multinational groups may attempt to structure their global operations to minimise tax costs by, for example, maximising the proportion of their profits recorded in low-tax jurisdictions such as Singapore and Hong Kong. Our concern is with related-party dealings that are contrived to avoid paying a fair share of tax on profits earned in Australia.³¹

Two very basic transfer pricing strategies are described below.

²⁵ See the Objects sections in Subdivision 815-B in the form of section 815-105. Also see paragraph 3.1 to the Explanatory Memorandum, Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013.

²⁶ OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD Publishing, Paris, 2010).

²⁷ See paragraph 1.8 of the Explanatory Memorandum, Tax Laws Amendment (Cross Border Transfer Pricing) Bill (No 1) 2012.

²⁸ Australian Tax Office (ATO), *Compliance Program 2012/2013*.

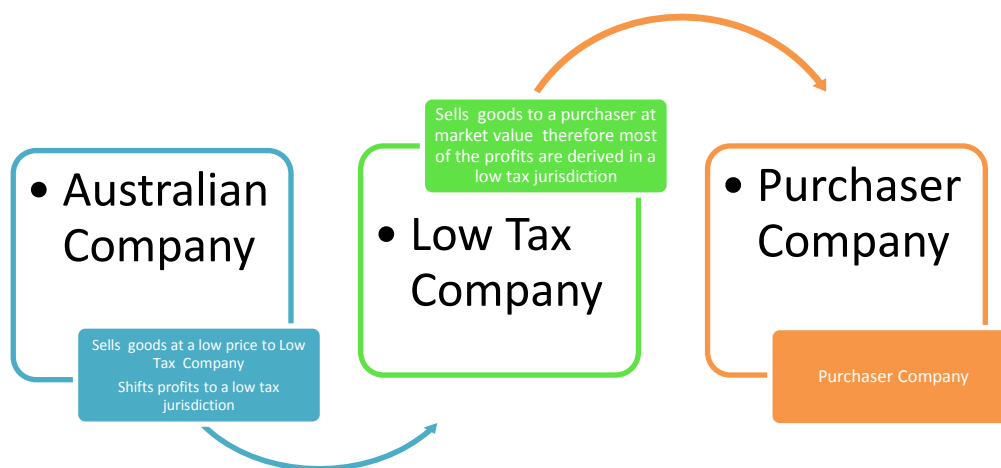
²⁹ Commonwealth Treasury, *Income tax: Cross border Profit Allocation: Review of Transfer Pricing Rules* (Consultation Paper, November 2011).

³⁰ IGOT TP Report, above n 16.

³¹ ATO, *Compliance Program 2012/2013*.

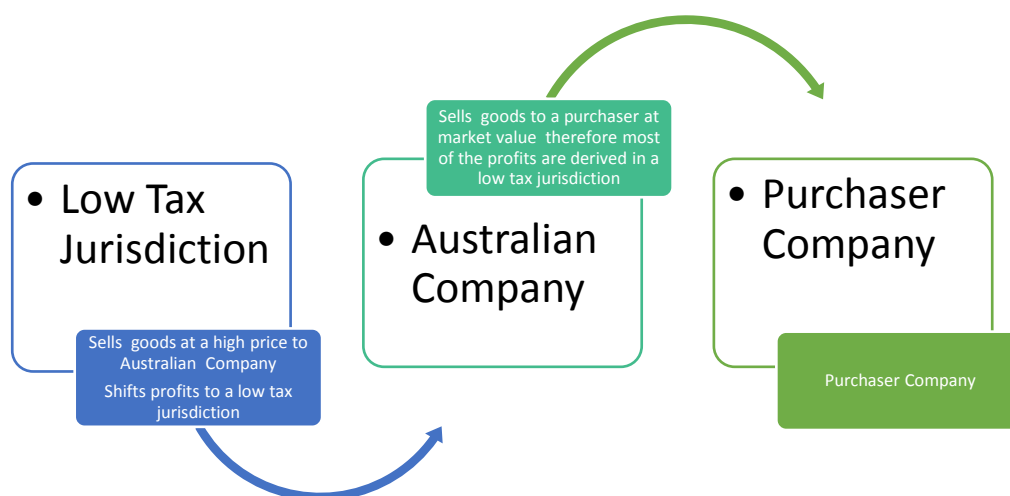
The first strategy involves a company selling goods or services in a high tax jurisdiction (for example, Australia) at a low price to a related company in a low tax jurisdiction and the company in the low tax jurisdiction on-selling them to a third party purchaser. This enables the profits to be shifted to the low tax jurisdiction and the profits booked in the high tax jurisdiction (for example, Australia) to be minimised. This is depicted in the diagram below.

Figure 1: Basic transfer pricing strategy 1



Selling goods at a low price to a low tax jurisdiction that on-sells those goods at market value.

The second strategy involves a company in a low tax jurisdiction selling goods or services to a company in a high tax jurisdiction at a high price, thereby shifting profits to the low tax jurisdiction, as the low tax company's profits will be maximised thereby minimising the company's overall tax liability. The company can then on-sell those goods at market value to the ultimate purchaser. A common example of this arrangement is depicted in the diagram below.

Figure 2: Basic transfer pricing strategy 2

Low tax jurisdiction sells goods at a high price to a high tax jurisdiction that on-sells those goods at market value, thereby shifting profits to the low tax jurisdiction.

The well-publicised activities of Starbucks are a good example of the way transfer pricing strategies can be utilised. Despite appearing to be a very commercially successful company Starbucks reported losses for a sustained period (a substantial proportion of the history of its operations) in the UK.³² Thus, there was a significant disconnect between this position for taxation purposes and the reports presented to shareholders that the business was successful. To a large degree these losses were due to a substantial payment made to a Netherlands subsidiary for intellectual property and for payments relating to its coffee making activities.³³ In relation to Starbucks and the low quantum of company tax collected, the House of Commons, Public Accounts Committee, HM Revenue and Customs Annual Report and Accounts made the following observation:

Starbucks told us that it has made a loss for 14 of the 15 years it has been operating in the UK, but in 2006 it made a small profit. We found it difficult to believe that a commercial company with a 31% market share by turnover, with a responsibility to its shareholders and investors to make a decent return, was trading with apparent losses for nearly every year of its operation in the UK. This was inconsistent with claims the company was making in briefings to its shareholders that the UK business was successful and it was making 15% profits in the UK. Starbucks was not prepared to breakdown the 4.7% payment for intellectual property (which was 6% until recently) that the UK company pays to the Netherlands based company. The Committee was sceptical that the 20% mark-up that the Netherlands based company pays to the Swiss based company on its coffee buying operations,

³² This was for 14 out of the 15 years Starbucks was in the UK.

³³ Public Accounts Committee, HM Revenue and Customs: Annual Report and Accounts, *Tax Avoidance by Multinational Companies*, House of Commons, United Kingdom, 3 December 2012.

with a further mark up before it sells to the UK, is reasonable. Starbucks agreed that it had a special tax arrangement with the Netherlands that made it attractive to locate business there, which the Dutch authorities asked Starbucks to hold in confidence, and that Switzerland offers a very competitive tax rate. In addition, there is an inter-company loan between the US Starbucks business and the UK Starbucks business over a period of time with the interest rate set at higher rate than any similar loan we have seen. We suspect that all these arrangements are devices to remove profits from the UK to these areas with lower tax.³⁴

In order to combat activities like this, governments worldwide have enacted and reviewed their transfer pricing legislation. Australia's protracted legislative history in this area is described below.

3. THREE-PHASED REFORM OF AUSTRALIA'S TRANSFER PRICING REGIME

3.1 Phase One: Former Division 13

Former Division 13 of the ITAA 1936 applied into two situations, where there was:

the supply or acquisition of 'property'³⁵ or services pursuant to an 'international agreement'³⁶ between separate legal entities; or

dealings internationally between a multinational head office and branch or permanent establishment (PE).

Once the existence of these circumstances or preconditions was ascertained, the Commissioner could exercise his discretion to determine that the parties were not acting at arm's length and had therefore received a transfer pricing benefit.³⁷ Where such a determination was made, the Commissioner could notionally substitute arm's length consideration for the supply or acquisition. Hence, this provision focused on the Commissioner ascertaining what the arm's length consideration was for a supply/receipt of property and services under an international agreement.³⁸

³⁴ Ibid.

³⁵ Property was defined expansively in former section 136AA to include:

- (a) a chose in action;
- (b) any estate, interest, right or power, whether at law or in equity, in or over property;
- (c) any right to receive income; and
- (d) services.

³⁶ An international agreement was defined in former section 136AC to be an agreement pursuant to which:

- (a) a non-resident supplied or acquired property under the agreement otherwise than in connection with a business carried on in Australia by the non-resident at or through a permanent establishment of the non-resident in Australia; or
- (b) a resident carrying on a business outside Australia supplied or acquired property under the agreement, being property supplied or acquired in connection with that business.

³⁷ Former section 136AD(1) to (3) of the ITAA 1936.

³⁸ Former section 136AD(4) operated where the Commissioner was unable to ascertain arm's length consideration in respect of the transaction and it was deemed to be such amount as the Commissioner determined.

Notably, where the Commissioner couldn't practically ascertain an arm's length consideration he could deem an arm's length amount. Likewise, where adjustments were made to a taxpayer's taxable affairs pursuant to former section 136AD the Commissioner could provide for a compensating adjustment.³⁹

Like Part IVA of the ITAA 1936, former Division 13 had overriding operation over the other provisions of the Act, but not the provisions of the *International Agreements Act 1953* (Cth) which continued to have effect. However, it was subsequently made subject to Division 815-A of the ITAA 1997 which is discussed in further detail below.

Under former section 170(9B) of the ITAA 1936,⁴⁰ the Commissioner could amend an assessment to give effect to a transfer pricing determination at any time.⁴¹

Notably, the onus was on the taxpayer to disprove the Commissioner's assessment⁴² and therefore the taxpayer had to prove what the arm's length consideration would be.

While the core of former Division 13 was the determination of arm's length price, there was nothing specific in the terms of former Division 13 that specified how to determine an arm's length price.

Australia and other OECD countries have adopted accepted methodologies in the *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (2010)* (*OECD Transfer Pricing Guidelines*) to determine what is meant by arm's length in this context. Broadly these methodologies can be categorised into two types: traditional transaction methods and the profits methods. Under these two umbrella terms there are different methods that can be applied. A brief discussion of these methods is provided below.

3.1.1 How to determine arm's length price

i. Traditional transaction methods

There are three broad traditional transaction methods the comparable uncontrolled price method (CUP), the resale price method (RPM) and the cost plus method (CPM).

The CUP is the most direct comparator. Under this method a comparable transaction between unrelated parties in a comparable market is identified and the price is then set in the controlled transaction by reference to this. Difficulties in utilising this method result where there is no direct comparison or in cases which involve intangibles where such comparators may not be readily available.

The RPM is based on the price that a product purchased from an associated enterprise is sold to an independent enterprise or third party. The resale price is then reduced by the resale price margin and what remains is supposed to

³⁹ Former section 136AF of the ITAA 1936.

⁴⁰ Repealed by Act 101 of 2013.

⁴¹ ATO, *Income tax assessments for the 2003–04 and Earlier Nil Years: Effect of Transfer Pricing Determination on the Period Within Which an Original Assessment Can Be Made*, ID 2012/44, <<http://law.ato.gov.au/atolaw/view.htm?docid=%22AID%2FAID201244%2F00001%22>>.

⁴² *WR Carpenter Holdings Pty Ltd v FCT* [2007] FCAFC 103.

represent an arm's length price. This method is most accurate where the party reselling the product does not add substantial value to the good. The difficulty with this method lies in determining what an appropriate mark-up is and finding a comparable arm's length re-seller.

The CPM refers to profit mark up to suppliers cost (the same supplier in a comparable dealing with an independent party). This requires an assessment to be made of what should be added to the suppliers cost to make arm's length consideration (for example, what is the mark up). This can be found by looking at a supplier in a comparable dealing with an independent party. This method is accurate where semi-finished goods are sold between related parties.

ii. The profit methods

There are two types of profit methods: the profit split method (PSM) and the transactional net margin method (TNMM).

The profit split method identifies the combined profit or loss from dealings between associated enterprises and then splits the profit on a basis which represents the division of profits which would flow from an arm's length agreement. Accordingly, the first step is to identify what is the quantum of the profit that should be split and the second is to split these profits on an economic basis.

Under the TNMM, the net profit is examined in light of a base comprising of costs of sales and assets and then profits are attributed on a basis similar to the CPM and RPM.

3.1.2 Double tax agreements and the OECD Guidelines

In phase one a further source of transfer pricing/profit allocation rules were found in the associated enterprise articles of Australia's DTAs and the *OECD Transfer Pricing Guidelines*. While the specific articles can differ, broadly such rules allow related-party transactions to be scrutinised and to hypothesise the position if the entities had been dealing on an 'independent basis'.⁴³

⁴³ For examples of associated enterprise articles see the Australian/Malaysian DTA Article 9 which states:

1. Where—

(a) an enterprise of one of the Contracting States participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State; or

(b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of one of the Contracting States and an enterprise of the other Contracting State, and in either case conditions operate between the two enterprises in their commercial or financial relations which differ from those which might be expected to operate between independent enterprises dealing at arm's length, then any income or profits which, but for those conditions, might have been expected to accrue to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the income or profits of that enterprise and taxed accordingly.

2. If the information available to the competent authority of a Contracting State is inadequate to determine the income or profits to be attributed to an enterprise, nothing in this Article shall affect the application of any law of that State relating to the determination of the tax liability of a person by the exercise of a discretion or the making of an estimate by the competent authority, provided that that law shall be applied, so far as the information available to the competent authority permits, in accordance with the principles of this Article.

3.1.3 The demise of Phase One—the SNF and Roche decisions

There were two major court decisions in Australia that led to the ultimate demise of Division 13, *Roche*⁴⁴ and *SNF*.⁴⁵

The *Roche* decision was the first to test the transfer pricing regime in Australia. The ATO audited Roche (a multinational pharmaceutical company) for the years 1993–2003 and issued assessments totalling \$126 million. Ultimately this was reduced to \$45 million.

The taxpayer was a subsidiary of a Swiss holding company and carried on a business selling and supplying prescription and over-the-counter pharmaceuticals and other pharmaceutical products.

The taxpayer had three divisions—pharmaceutical, consumer and diagnostic. The Roche Group would sell through its subsidiaries and Roche agreed these sales were not at arm's length.

As a result of an audit, the ATO increased the taxpayer's assessable income, alleging amounts paid were more than the arm's length price. The ATO made this adjustment on the basis of former section 136AD in Division 13⁴⁶ and Article 9 of the Australia/Switzerland DTA. One of the main basis for the adjustment was external reports prepared by American expert witnesses.

Broadly, the ATO used the TNMM method. The Administrative Appeals Tribunal (AAT) substituted its own view on the arm's length consideration, stating that the traditional transactional methods were preferable. The AAT preferred the use of the *OECD Transfer Pricing Guidelines* on transfer pricing and the CUP, RPM and CPM.

The transfer pricing regime was again under the spotlight in *SNF*.⁴⁷ SNF was a distributor of chemical products and a wholly-owned distributor of chemical products. The ATO undertook a transfer pricing audit and the ATO adopted the TNMM to estimate the arm's length prices. The basis for making these adjustments were said to be Article 9 of the US/Australian DTA, Article 9 of the Chinese/Australian DTA and Article 8 of the French/Australian DTA. As a result of these articles the ATO increased the assessable income of SNF by approximately \$13 million. Specifically, the ATO stated:

3. Where profits on which an enterprise of one of the Contracting States has been charged to tax in that State are also included, by virtue of the provisions of paragraph 1 or 2, in the profits of an enterprise of the other Contracting State and charged to tax in that other State, and the profits so included are profits which might reasonably have been expected to have accrued to that enterprise of the other State if the conditions operative between the enterprises had been those which might reasonably have been expected to have operated between independent enterprises dealing wholly independently with one another, then the firstmentioned State shall make an appropriate adjustment to the amount of tax charged on those profits in the firstmentioned State. In determining such an adjustment, due regard shall be had to the other provisions of this Agreement and for this purpose the competent authorities of the Contracting States shall if necessary consult each other.

⁴⁴ 2008 AATA 639.

⁴⁵ [2011] FCAFC 74.

⁴⁶ Repealed by Act 101 of 2013.

⁴⁷ [2011] FCAFC 74.

when a business is faced with persistent losses it would not have continued to purchase products from an arm's length supplier at a price that led to the perpetuation of those losses.⁴⁸

The ATO lost this case on appeal to the Full Federal Court where it was held that prices paid by the taxpayer were on an arm's length basis and the CUP method was an acceptable estimation of arm's length price and therefore, the Commissioner's adjustment on the basis of TNMM were not valid. The Court held that the fact that there were sustained losses did not invalidate the taxpayer's case and significantly the Court stated that the *OECD Transfer Pricing Guidelines* were of limited assistance in interpreting Division 13.

Following this case, commentators argued that there was uncertainty in relation to the following:

- Whether Australia's DTAs could indeed act as a sword and not a shield, that is, could DTAs be a repository of taxing powers?;
- What role profit-based calculations of arm's length could play in reallocating transfer prices; and
- The Commissioner's power to reconstruct or annihilate the transaction that satisfied other specific anti-avoidance rules such as the thin capitalisation provisions.⁴⁹

3.2 Phase Two—former Subdivision 815-A

Former Subdivision 815-A of the ITAA 1997 was enacted in September 2012 and applied retrospectively from 1 July 2004.⁵⁰ It was designed to boost the efficacy of Australia's DTA rules and was specifically created to ensure that the domestic rules in Australia were interpreted consistently with 'international transfer pricing standards' as enunciated in the *OECD Transfer Pricing Guidelines*.⁵¹

More specifically it was enacted in response to the *Roche* and *SNF*⁵² decisions (discussed above) as the government perceived these cases highlighted issues with the existing Australian transfer pricing provisions.⁵³

The stated purpose of Subdivision 815-A was to limit taxable profits being redirected outside Australia and one way the government sought to achieve this was by providing

⁴⁸ Ibid.

⁴⁹ Significant literature exists discussing these points as examples see comments made in the following papers: Bob Deutsch, 'International Tax Hot Topics' (Paper presented at 28th National Convention, Tax Institute, Perth Convention and Exhibition Centre, 13-15 March 2013); Janelle Sadri, 'Responding to Australia's Transfer Pricing Reforms' (Paper presented on International Day, Tax Institute City West, West Perth, 10 May 2013); Soulla McFall, Marc Simpson and Leesan McLeish, 'Transfer Pricing Reforms in Australia' (2012) 46(8) *Taxation in Australia*, 357.

⁵⁰ *Tax Laws Amendment (Cross-Border Transfer Pricing) Act (No. 1) 2012* (Cth).

⁵¹ Explanatory Memorandum, *Tax Laws Amendment (Cross Border Transfer Pricing) Bill (No 1) 2012*.

⁵² [2011] FCAFC 74.

⁵³ The Hon Bill Shorten MP (then Assistant Treasurer), 'Robust Transfer Pricing Rules for Multinationals', (Media Release, No 145, 1 November 2011)
<<http://parlinfo.aph.gov.au/parlInfo/search/display/display.w3p;query=Id%3A%22media%2Fpressrel%2F1197735%22>>.

reference to the OECD guidance material, to enable interpretation of the rules.⁵⁴ It further provided clarification of how this worked in conjunction with Division 820 of the ITAA 1997 in relation to the thin capitalisation rules. As discussed, these guidelines were held not to be a legitimate aid to the construction of the DTAs or Division 13 in *SNF* and *Roche* and this change was directed at seeking to overcome these difficulties by allowing a transfer pricing adjustment to be made under Subdivision 815-A, relevant provisions of a DTA or Division 13. Specifically, the Explanatory Memorandum to the Act stated that:

The decision of *SNF* highlighted that Division 13 may not adequately reflect the contributions of the Australian operations to multinational groups and as such in some cases treaty transfer pricing rules may produce a more robust outcome.⁵⁵

Subdivision 815-A allowed the Commissioner to determine a liability under the domestic law rather than the DTA to negate a transfer pricing benefit. The Commissioner could negate the transfer pricing benefit and increase the taxable income or reduce the loss or net capital loss of the entity. No tax avoidance purpose was required and the associated enterprise or business profits articles of the DTA could apply. However, overall this Division operated to allow the ATO to maintain the position that DTAs indeed did provide a separate power to make transfer pricing adjustments.

Thus, Division 815-A ultimately created a situation where a DTA could act as a sword rather than a shield and it is arguable that this leads to a situation where DTAs are exceeding their intended purposes as the commonly understood purpose of a DTA is to allocate taxing rights in cases of possible double tax rather than to create taxing powers per se. For example, in the case of *Undershaft (No 1) Ltd v FCT*⁵⁶ the Court stated that a 'DTA does not give a Contracting State power to tax' but rather allocates the right to tax between Contracting States in case of possible double taxation.

Finally, there was an unlimited amendment period for determination by the Commissioner under Subdivision 815-A.⁵⁷

One of the major difficulties with Subdivision 815-A was that it applied only to cross-border dealings with treaty countries and therefore this created a patchwork of inconsistent rules discriminating on the basis of whether a treaty was in place with the country where the related part was resident.

3.3 The Final Phase - Subdivision 815-B to D of the ITAA 1997, Subdivision 284-E of Schedule 1 of the TAA

Australia's current transfer pricing regime is contained in Subdivision 815-B to D of the ITAA 1997 and Subdivision 284-E Schedule 1 of the TAA 1953.

⁵⁴ Section 815-20(2) ITAA1997.

⁵⁵ Above n 51, paragraph 1.12.

⁵⁶ [2009] FCA 41.

⁵⁷ The transitional provisions apply to penalty imposition 2004/5–2011/12 income years.

This new regime replaces the former two regimes and applies to income years commencing on or after 29 June 2013 and unlike previous section 815-A, it only operates prospectively.

The regime as a whole is designed to create alignment between the application of the arm's length principle in Australia's domestic law and the *OECD Transfer Pricing Guidelines*. The stated aim of these provisions is to ensure that the taxable amount imposed reflects the economic contribution made by Australian operations.⁵⁸ Furthermore, the operation and drafting of these provisions are designed to put beyond any doubt that the Commissioner can have reference to the *OECD Transfer Pricing Guidelines* and also to look at the "totality of the arrangements where taxpayer takes place instead of the particular circumstances of a specific set of transactions".⁵⁹

Section 815-B requires amounts brought to tax in Australia where there are cross border transactions to be worked out by applying arm's length conditions.⁶⁰

Section 815-120 states that a transfer pricing benefit can include an increase in taxable income or withholding tax amount, reduction in losses or tax offsets.

Where this type of benefit is obtained, section 815-115 requires that arm's length conditions are substituted in place of financial relations it may have with another entity. Arm's length conditions are those that would be expected to operate between independent entities in comparable circumstances.

Section 815-125(2) provides significantly more flexibility in relation to the calculation of an arm's length price by requiring the use of the 'most appropriate and reliable method' to calculate arm's length conditions. This is ascertained by having regard to a defined set of circumstances including the:

- strengths and weaknesses of the method is in their application to the actual conditions;
- circumstances such as the functions performed, assets used and risks that are taken by each of the entities;
- availability of reliable information required to enable the use of a particular valuation method;
- degree of comparability between the actual circumstances and the comparable circumstances.

⁵⁸ Above n 25.

⁵⁹ Department of Parliamentary Services (Cth), above n 3, 10.

⁶⁰ Section 815-105(1) ITAA 1997.

Section 815-135 allows the use of documentation to identify arm's length conditions including the *OECD Transfer Pricing Guidelines*.

The new rules specify an amendment period of seven years.⁶¹

Subdivision 815-C also applies to transfer pricing benefits that arise for entities PE and is designed to ensure that the attribution of income and expenses between parts of an entity reflects the allocation that may be expected had the parts been separate entities dealing with each other on a 'wholly independent' basis. The new rules are triggered where an entity that is a PE gets a tax advantage that it would not have obtained where the PE had been a separate entity dealing with the entity on an arm's length basis.⁶²

Section 815-215 requires that if a PE gets a transfer pricing benefit it should disregard amounts of profit attributed to it and calculate the amounts on an arm's length basis.

Section 815-220 defines a tax benefit arising when the profit calculated on an arm's length basis is different to the actual profit.

Section 815-235 specifies that the arm's length profits will be worked out in accordance with the *OECD Model Tax Convention* and commentaries as amended on 22 July 2010.

Subdivision 815-D sets out special rules that apply to trusts and partnerships attempting to ensure transfer pricing rules will apply to these entities.

A significant feature of the new rules in relation to the new provision is that they are self-executing and are therefore no longer dependent on the discretion of the Commissioner making a determination arguably this approach brings the rules more into line with the self-assessment basis of Australia's tax system.

These rules operate in conjunction with Subdivision 284-E Schedule 1 of the TAA 1953 which notes the documentation that an entity should retain in -assessing the tax position under Subdivision 815-B or 815-C.

A *de minimis* threshold applies, and below that threshold penalties will not be incurred. To comply with the new rules, documentation must be prepared before lodgement of the relevant taxpayer's return. While the documentation requirements are not mandatory they are relevant for the taxpayer being able to establish that a reasonably arguable position was maintained in the context of penalties, which effectively makes the rules mandatory.⁶³

One notable aspect is that this Subdivision will apply to *all* dealings between related and unrelated parties to ensure that the dealings are arm's length and recreates the transactions so that they will be what they would have been if the entities were dealing on a 'wholly independent basis'. The reason for this broader casting of the net is to ensure that:

⁶¹ Section 815-150 ITAA 1997.

⁶² Section 815-225 ITAA 1997.

⁶³ See also section 4.3.2 of this paper where this point is dealt with in detail.

Independent parties engaging in, for example, collusive behaviour or other practices where they are not dealing exclusively in their own economic interests will not circumvent the rules by reason of their non-association.⁶⁴

3.4 Future reforms

Despite the consolidation of Australia's transfer pricing provisions described above, there are still substantial future reforms and activities taking place in this area. The OECD has released a draft booklet on moderating transfer pricing,⁶⁵ a draft white paper on transfer pricing documentation⁶⁶ and a Discussion Paper on the issues associated with intangibles in the transfer pricing context.⁶⁷ The Commonwealth Treasury has released an Issues Paper in relation to dealing with multinational profits shifting.⁶⁸ The ATO has established an anti-profit shifting taskforce. The two key functions of the taskforce are to work with offshore tax authorities to investigate the substance of the operations of Australian multinational entities, offshore entities or associates and investigate profitable multinational companies (MNCs) doing business in Australia.

In the 2015–16 Federal Budget, the Australian Government announced various measures to combat BEPS including:

- The implementation of new transfer pricing documentation standards based on the OECDs recommendations. These documentation requirements will provide information being provided on the global operations of large corporates, including the location of its global income and the taxes paid on a global basis;⁶⁹
- A master file that contains a complete overview of the corporations global business, organisational structure and overarching transfer pricing policies;⁷⁰
- A file that provides information on the local taxpayers related intercompany transactions;⁷¹ and
- Developing a 'targeted anti-avoidance law' within Part IVA *Income Tax Assessment Act 1936* (Cth) to address multinationals that seek to 'artificially

⁶⁴ Above n 25.

⁶⁵ OECD BEPS Report, above n 9.

⁶⁶ OECD, *White Paper on Transfer Pricing Documentation* (OECD Publishing, Paris, 30 July 2013), <http://www.oecd.org/ctp/transfer-pricing/white-paper-transfer-pricing-documentation.pdf>. This was developed in response to Action 13 in the OECD's Action Plan which stated that there should be rules surrounding transfer pricing documentation. It is stated that MNEs should provide governments with information on their global allocation of income, economic activity and taxes paid.

⁶⁷ This is a Revised Discussion Draft on the transfer pricing aspects of intangibles.

⁶⁸ The Commonwealth Treasury released a Scoping Paper *Risks to the Sustainability of Australia's Corporate Tax Base* to look at the integrity issues associated with BEPS. The Scoping Paper acknowledged the risk to Australia's and the international community's corporate tax bases and endorsed the OECD's BEPS Report.

⁶⁹ See Commonwealth Treasury, 'Budget Paper Number 2—2015 Budget', p 15, available at <http://www.budget.gov.au/2015-16/content/bp2/html/bp2_revenue-07.htm>.

⁷⁰ Ibid.

⁷¹ Ibid.

avoid' a taxable presence in Australia. An associated measure will be doubling the penalties the Commissioner can apply to such corporates.⁷²

It is expected that the OECD's BEPS project will make further recommendations in this area and continued focus on the efficacy of these rules is likely to persist and intensify.

4. EVALUATION

This section firstly sets out some base comparisons between the regimes detailed previously. Utilising these comparisons, it then analyses the advantages and deficiencies of these changes.

4.1 Comparisons

The table below summarises the different outcomes for each of the three phases of Australia's transfer pricing rules.

⁷² Ibid.

Table 1: Different outcomes for each of the three phases of Australia's transfer pricing rules.

	Phase One	Phase Two	Phase Three
	Division 13 of the ITAA 1936 Relevant articles of Australia's DTAs	815-A of the ITAA 1997 Division 13 of the ITAA 1936	815-B, C, D and E of the ITAA 1997 Subdivision 284-E Schedule 1 of the TAA 1953
Feature of the transaction under scrutiny	Pricing of transactions Arm's length consideration	Looking at economic activity and profitability of the transaction	Looking at profits—arm's length conditions
Self-assessment or assessed by the Commissioner	Assessed by the Commissioner but onus on the taxpayer to disprove the Commissioner's assessment	Assessed by the Commissioner but onus on the taxpayer to disprove the Commissioner's assessment	Self-assessed by the taxpayer
Documentation requirements	No	No	Documentation 284-E of Schedule 1 to the TAA 1953
Amendment period	Unlimited (former section 170(9B) of the ITAA 1936)	Unlimited	7 years (section 815-150 of the ITAA 1997)

4.2 Advantages of the new regime

4.2.1 Enhancing certainty, consistency and equity

The policy goals of the new legislation as noted above appear to be robust and highly justifiable: to align Australia's domestic measures with the OECD *Transfer Pricing Guidelines* and to bolster the efficacy of Australia's transfer pricing rules. The importance of having effective integrity measures are well documented and the overall advantage is every multinational pays their 'fair share' of tax in the jurisdictions in which they have an economic presence. This in turn creates greater equity for all Australian taxpayers. As the former Assistant Treasurer David Bradbury stated these types of integrity measures ensure multinationals are unable to gain:

an unfair competitive advantage over domestic companies and disadvantage Australian taxpayers who must make up the tax shortfall or accept fewer Government services.⁷³

Rather than representing a patchwork of legislative measures, the consolidation of the rules into a single regime appears to provide more coherence and certainty which is also desirable. The integration of the *OECD Transfer Pricing Guidelines* into the domestic tax rules also appears to create a more certain pathway for applying and incorporating these rules.

The Taxation Institute stated in their submission on the (then) proposed transfer pricing amendments:

cohesive and co-ordinated approach to transfer pricing between Australia and our major trading partners is essential to ensure that multi-national enterprises (MNEs) are broadly taxed in line with mutually agreed principles as encapsulated in the OECD Guidelines. MNEs also stand to benefit via lower compliance costs stemming from consistency across the many compliance frameworks to which each enterprise is likely to be subject.⁷⁴

4.3 Deficiencies of the new regime

4.3.1 Uncertain application and administration

However, while the policy goals noted above are highly justifiable, the practical ramifications for users are unclear and could in fact potentially significantly increase the compliance burden for taxpayers. This increase in compliance costs may negatively impact upon Australia's competitiveness. Under the new rules the ATO appears to have much broader reconstruction powers and as it is not yet clear how these will be exercised, thus creating much uncertainty.

In April 2014 the ATO released draft ruling TR 2014/D3 on the Commissioner's view of the application of s 815-130 of the ITAA 1997 which includes the new power to reconstruct the actual transaction. However despite this draft guidance many uncertainties in the practical application of this power remain and some of these uncertainties are discussed in the ensuing sections of the paper.

Interestingly in June 2014 the Inspector General of Taxation released a report, *Review into the Australian Taxation Office's management of transfer pricing matters*.⁷⁵ The catalyst for this was concerns raised by various stakeholders including taxpayers, practitioners and professional bodies that there were unnecessary costs, protracted timeframes and insufficient communication by the ATO regarding areas of concern, consultation, guidelines and advice. Also, a key underpinning was that the ATO lacked capability to deal with these complex matters.

⁷³ The Hon. David Bradbury MP 'Reforms to Crack Down on Tax Avoidance and Profit Shifting', (Media Release, 010, 13 February 2013), <<http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2013/010.htm&pageID=003&min=djba&Year=&DocType=>>.

⁷⁴ Taxation Institute of Australia, *Exposure Draft—Modernising Australia's Transfer Pricing Rules* (21 December 2012).

⁷⁵ The Review was announced on 25 October 2012.

4.3.2 Increased documentation requirements

As noted above, the documentation requirements are significantly increased under the new rules, which coincide with the self-executing nature of these provisions. While preparation of such documentation or maintaining these standards is not mandatory, failure to do so will impact on the availability for entities to advocate they have a reasonably arguable position (RAP). Public officers have to sign off on the appropriateness of the transfer pricing position adopted. This is particularly onerous given the notorious difficulties and divergent opinions that arise in determining comparability especially where specialised transactions or intangible assets are involved. In certain circumstances a public officer may be subject to penalties for inaccuracies and to ensure certainty taxpayers may need to seek several opinions. This leads to questions of how much detail and substantiation will be sufficient to reduce penalties.

Williamson and Lam⁷⁶ argue that some of the questions arising include: will documentation that is prepared and stored overseas be sufficient and what degree of contemporaneity does the documentation need to have? For example, does it need to be prepared before the return is lodged?

The Bills Digest⁷⁷ also notes that one of the reactions to the introduction of the amending Bill which introduced these changes was the onerous record-keeping requirements with no carve out for small and medium enterprises (SMEs). This issue was again raised in the Inspector General's Report⁷⁸ where it was noted that taxpayer's compliance costs were increased by responding to ATO queries regarding transfer pricing. It was noted this particularly impacts small medium entities. As a result of these findings the ATO had agreed to a number of recommendations aimed at decreasing compliance burdens for SME taxpayers included the increased use of safe harbours for lower value and more common transactions, decreasing the overall documentation requirements.⁷⁹

4.3.3 A multi-faceted hypothetical inquiry

The new rules create a much more onerous burden on public officers as they necessitate looking at the overall commerciality and pricing of a particular transaction. Taxpayers need to determine if a transfer pricing benefit has arisen as a result of the transaction being subject to non-arm's length circumstances. This is different to the former inquiry that looked at arm's length consideration. In this context, Cain argues that:

The most controversial aspect of the new legislation is the requirement to hypothesise arm's length conditions, which may involve speculation about the broader terms and conditions independent parties may have agreed. This potentially empowers the ATO to 'reconstruct' related party transactions, in

⁷⁶ Sue Williamson, Ada Lam, Keir Cornish, Amita Pradhan and Zong Aw, "New Tax Avoidance and Profit Shifting Laws—Uncertainty for Taxpayers" *Taxchat*, (9 July 2013), <<http://www.taxchat.com.au/?p=1722>>).

⁷⁷ Department of Parliamentary Services (Cth), above n 3, 13.

⁷⁸ IGOT TP Report, above n 16.

⁷⁹ *Ibid.*

certain circumstances, replacing the actual conditions with the 'arm's length conditions'.⁸⁰

Cain also notes that this further aligns these provisions with the GAAR and may be indicative of why the new transfer pricing provisions were introduced in the same Bill as the GAAR:

The approach to transfer pricing is now very much aligned with an anti-avoidance mindset and language. Taxpayers must now be able to demonstrate they have considered and documented the overall commercial context of their cross border arrangements and concluded their behaviour is consistent with the way independent parties would have behaved. This process can be complex.

Entities need to ensure that the new provisions have been applied accurately in calculating their taxable income, which includes making adjustments for transfer pricing benefits. The *quid pro quo* is that where penalties are levied as a result of transfer pricing the public officer may be personally liable for this and prosecuted where a false or misleading statement has been made.⁸¹

Arguably, this may be too great a burden to impose on many public officers who may not be in a position to ascertain the level of detail needed. It may necessitate asking such questions as: what conditions actually operate between this entity and another entity? Do these differ from an arm's length condition? This difficulty is consolidated by the amorphous nature of an arm's length condition or price.

Given the conditions in the legislation in order to satisfy their obligations public officers will have to enter into an inquiry regarding the alternative postulate, similar to the inquiry that is necessary under Part IVA of the ITAA 1936. For example, they will need to satisfy themselves with the commercial conditions between independent parties in the same or similar circumstances. It is unclear what needs to be done if they would have structured things differently. Does this mean that the entire transaction must be notionally treated as if it was supplanted with these new requirements? What if there is a range of transactions that the arm's length parties may have entered into or if they simply chose to do nothing? A multitude of factors could influence what an arm's length dealing would look like. As Williamson and Lam state:

This means that intercompany pricing might need to be based on hypothetical transactions that did not exist. This may include alternative terms that could significantly impact the appropriate pricing of such transactions. These provisions give the Commissioner wide ranging powers to effectively 'second guess' transactions that taxpayers have entered into, rather than pricing the actual transactions that took place.⁸²

⁸⁰ Alexander Cain, 'Australia Tightens Transfer Pricing Regulations', *In the Black* (CPA Australia) (December 2013), <<http://www.itbdigital.com/tools-of-the-trade/2013/12/11/australia-tightens-transfer-pricing-regulations/>>).

⁸¹ Williamson et al., above n 76.

⁸² Ibid.

The necessity to prepare for the counterfactual appears to be incredibly onerous and difficult and would require considerable time and resources to be spent by public officers, which would add to compliance costs and the complexity of the current rules.

4.3.4 *Retrospective v prospective application*

One particularly contentious aspect of Division 815-A of the ITAA 1997 is that it applied retrospectively from 1 July 2004. However, transitional rules provided that penalties for schemes in income years before 1 July 2012 were limited to the amount that could be substantiated under the existing provisions prior to Subdivision 815-A. The reasons cited for the fact that these rules were enacted retrospectively was that the amendments merely represented a clarification of the longstanding legislative intent that the law operated in this way.

The retrospective nature of the interim measures was highly controversial. However, the High Court has confirmed that the parliament can pass retrospective legislation, but should justify the need to do so and ensure that it does not impede a person's rights.⁸³

Despite there being a basis in law for retrospective legislation, are obvious issues with retrospectivity in terms of challenges to the rule of law, certainty and overall stability in the tax system which can impact upon business confidence.⁸⁴

By contrast, the current transfer pricing rules in Australia are prospective. While prospective application has an obvious attraction in terms of the rule of law and certainty, it also means that these new and arguably more effective provisions cannot apply to previous aggressive tax planning structures that may be identified. This may be contrary to the public interest and protection of the revenue base. In this regard, the Bills Digest states:

There is a significant public interest reason for allowing the Commissioner to re-examine past transfer pricing transactions under the proposed arrangements. The above example of Starbucks' conduct in the UK is an alleged example of the unacceptable abuse of that countries corporate tax arrangement, together with the provisions applying in other countries. It is safe to argue that these provisions were used in a manner far beyond the intention of the United Kingdom (UK) Parliament. Should such examples exist in Australia then it would be in the public interest for the Commissioner for Taxation to re-examine such cases using the proposed provisions. For where such cases exist Australia's tax laws at the time were similarly abused, though their legal form may have been adhered to.⁸⁵

⁸³ The constitutional validity to pass retrospective legislation was affirmed in the High Court in *Polyukhovich v Commonwealth* (1991) 172 CLR 501.

⁸⁴ For the issues associated with retrospective legislation, see the Hon. David Bradbury MP, –'Tax Reform for an Economy in Transition' (Speech delivered at the Tax Institute NSW 5th Annual Tax Forum, 18 May 2012), <<http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=speeches/2012/003.htm&pageID=005&min=djba&Year=&DocType=>>.

⁸⁵ Department of Parliamentary Services (Cth), above n 3, 6ff.

Overall, the authors believe that in the absence of some egregious abuse of an existing tax law, remedial legislation should, as far as possible, be prospective.

4.3.5 Time limits

Another interesting aspect of the current legislation is that time limits that have now been imposed on the Commissioner's ability to amend assessments as per the transfer pricing provisions. Under the new law the amendment period is seven years whereas by contrast under former Division 815-A there was an unlimited period. Whether or not this is a welcome development depends on the perspective adopted.

On the one hand it does create significant further certainty for taxpayers, however, it is still not aligned with the general amendment period of four years for the Commissioner to amend an assessment.⁸⁶ On the other hand it limits the Commissioner's ability to amend assessments that may be subject to this type of aggressive tax planning. As identified in the *Discussion Paper on the Review of Unlimited Amendment Periods*,⁸⁷ the imposition of a time limit involves a very fine balancing act between two competing policy objectives. Taxpayers need certainty in relation to their taxation affairs particularly in the self-assessment context however the ATO needs sufficient time to complete its verification procedures, audits and investigations. As the Discussion Paper states:

So, while short amendment periods provide greater certainty for taxpayers, setting periods too short may jeopardise the capacity of the Commissioner to detect non-compliance. A balance needs to be reached between the two competing objectives.⁸⁸

The Report specifically recommended an eight year amendment period in transfer pricing case. However, a seven year time period was ultimately adopted.

The Bills Digest states that one of the main submissions made the objection that seven years was too long and a four year period was preferable.⁸⁹ It was noted that an extension of time is available to the Commissioner under section 170(7) of the ITAA 1936, although this is only achievable through a Federal Court order which is expensive and onerous to obtain.

4.3.6 Self-assessment v Commissioner's assessment

Whereas former Divisions 13 and 815-A required an assessment by the Commissioner to trigger the operation of the transfer pricing provisions, the new provisions are self-executing. This means taxpayers must undertake a review of their transfer pricing position before completing their income tax return.

⁸⁶ The Tax Institute, Submission to Standing Committee on Economics, *Inquiry into Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013*, 22 February 2013, 11.

⁸⁷ Commonwealth Treasury, 'Review of Unlimited Amendment Period in the Income Tax Laws', (Discussion Paper, August 2007), <<http://archive.treasury.gov.au/documents/1298/PDF/Review%20of%20unlimited%20amendment%20periods%20DP.pdf>>.

⁸⁸ Ibid.

⁸⁹ Department of Parliamentary Services (Cth), above n 3, 15.

One of the issues associated with the provisions being self-executing is that they may catch many arrangements that are not within the scope of the mischief. The advantage of the alternative method where the Commissioner had to exercise discretion was that this allowed him to weigh up all relevant facts to decide whether to ultimately pursue a matter.

This considerable onus now being placed on the taxpayer may see a greater move by multinational entities to secure advanced consent (before entering into the transaction) from the revenue authority in the form of a vehicle such as an Advance Pricing Agreement⁹⁰ with the Commissioner.

4.3.7 *Pricing-based v Profits-based assessments*

Australia's current transfer pricing legislation has shifted focus from looking at the pricing of the transactions to an overall allocation of profits. The implications of this subtle change are likely to be profound.

In this regard, Hearder states that profits based approach may result in the Commissioner second guessing business decisions rather than focusing on factors influencing pricing. Specifically Hearder states:

The line might be blurred as a matter of practice, meaning that the Commissioner could be second-guessing business decisions, even if that was not the intention, rather than focusing solely on those factors influencing pricing. It might also mean that the Commissioner could too readily reconstruct a transaction and ignore the actual transaction, based on his conclusions about what independent parties would have done.⁹¹

This apparent intervention in the business dealings of multinational entities is a considerable departure from *Tooheys v DCT; Sydney Ferries*⁹² where it was reinforced that is not for the tax office to say how a taxpayer should run their business:

The question is what he **did in fact** spend on his business. If he chooses to employ a hundred men where 20 would have been ample that is his own affair. (emphasis added)

4.3.8 *Multilateral v unilateral action*

A bigger question that arises from the reform of Australia's transfer pricing system is whether this type of unilateral action can be effective in combatting what is a multilateral issue. In this regard, former Assistant Treasurer David Bradbury states:

It will be crucial that efforts to address BEPS occur on a multilateral basis. While there has been considerable rhetorical support for this cause by many key global leaders, the proof of the pudding will be in the eating.

⁹⁰ For details regarding the history and use of Advanced Pricing Agreements, see Dr Michelle Markham, 'Are Advanced Pricing Agreements the Transfer Pricing Controversy Management Tool of the Future?' (2011) 40(4) *Australian Tax Review* 222.

⁹¹ Dixon Hearder, 'New Transfer Pricing Legislation—Phase Two', (March/April 2013) *Asia-Pacific Tax Bulletin*, 136, 137.

⁹² (1922) 22 NSW SR (NSW) 432.

It is perfectly understandable for governments to focus on making their tax systems internationally competitive. What is not sustainable is for national governments to ignore the global implications of turning a blind eye to their own harmful preferential regimes, especially where the interactions between their laws and the laws of the other nations are facilitating the rise of stateless income or worse still, stateless entities.⁹³

Likewise, Vann states:

It is not enough to tackle international problems individually or sequentially, rather BEPS requires that the issues be tackled holistically.⁹⁴

With the continued onset of globalisation and rapid and continued advances in information communication technology, accompanied by the growth in the international trade in intangibles and services, it is increasingly likely that problems which previously could have been viewed through the lens of the Nation State now need a different theoretical construct, requiring the problems to be analysed on a global and multilateral basis.

4.3.9 *A flawed premise based on a concept that is difficult to ascertain*

A common theme of all three phases of Australia's transfer pricing reforms is that they are based on a hypothecation which attempts to attribute arm's length prices to dealings between different parts of (in most cases) the same entity. Such a policy is arguably not grounded in sound economics. As the Head of the Revenue Section of Treasury, Rob Heferan, states, attributing arm's length pricing to a transaction ignores the synergistic reasons why a firm enters into such transactions:

While the arm's length method, if able to be applied, can highlight some cases of profit shifting, the economics underlying it are not strong. For an economist, a firm can never be reduced to a series of arm's length transactions. As Ronald Coase argued so compellingly in 'The Theory of the Firm' in 1937, firms exist precisely because they create and capture value beyond what is obtainable through market based external contracts.⁹⁵

Similarly, Sadiq argues that as a theoretical basis the arm's length model "fails to take into account the synergies arguably inherent in a multinational enterprise".⁹⁶ Likewise, not only is this theory flawed, it is also notoriously difficult to ascertain an arm's length price. Again Heferan states:

The difficulties in applying the arm's length price is nothing new, but the nature of intangibles in the digital age makes it even harder and where the

⁹³ Matthew Gilleard, 'BEPS—The Australian Perspective' *International Tax Review*, (10 December 2013), <<http://www.internationaltaxreview.com/Article/3288298/Latest-News/BEPS-The-Australian-perspective.html>>.

⁹⁴ Vann, above n 8, 4.

⁹⁵ Rob Heferan Executive Director of Revenue Group in a speech delivered at the 2014 Economic and Social Outlook Conference, Melbourne Institute, 4 July 2014, <<http://www.treasury.gov.au/PublicationsAndMedia/Speeches/>>.

⁹⁶ Kerrie Sadiq, 'The Traditional Rationale of the Arm's Length Approach and Transfer-pricing. Should the Separate Accounting Model be Maintained for Multinational Entities?' (2004) 7(2) *Journal of Australian Taxation*, 196, 241.

intangible in question is unique, it simply does not exist in the market. And by its very nature, intellectual property is always unique in some way.⁹⁷

Similarly Vann argues that:

... the theory of the firm—that firms generate additional profits to those available in the market as otherwise they would not exist and hence the application of a market paradigm to allocate profits is likely to miscarry. The outcome may be allocation of profits to countries where activities occur (value is added) rather than where capital and asset ownership (particularly of intangibles) is located.⁹⁸

5. RELYING ON A RECONCEPTUALISED VERSION OF THE EXISTING SOURCE RULES

The preceding analysis has argued that the current regime, while exhibiting some desirable aspects, also continues to present several practical difficulties for taxpayers and administrators and is arguably based on a flawed premise.

Thus, while the amendments to the transfer pricing regime have taken Australia on a long and complex journey, it appears that if Australia continues to rely on the current conceptual basis for allocating transfer prices, these amendments will be far from the last chapter. In fact, the amendments to Australia's transfer pricing regime appear to entrench (rather than overcome) the issues associated with the 2010 *OECD Transfer Pricing Guidelines* which are currently under review. As Vann states:

Although the Australian government linked its revision of the legislation on transfer pricing on BEPS, in fact that legislation adopts the 2010 version of the *OECD Transfer Pricing Guidelines* which have been much of the cause of the activity that the recent OECD draft is trying to shut down.⁹⁹

Given transfer pricing practices and BEPS are driven by the ingenuity and creativity of taxpayers and their advisers when combined with globalisation and constantly evolving technologies, a fundamental attribute of any potential solution must be flexibility and responsiveness to change to ensure rules remain robust and relevant in a dynamic business environment. However, this adds to compliance costs and creates business uncertainty.

Trying to put in place static rules to address an evolving problem will inevitably result in frequent amendment and a need to constantly revise the rules.

While it is beyond the scope of this paper to suggest a definitive solution to the mischief associated with transfer pricing, the authors advocate that greater reliance upon a reconceptualised version of existing source rules that uses economic presence as a basis for taxation warrants further research. Furthermore, this provides a sound conceptual basis on which to ground the transfer pricing rules.¹⁰⁰

⁹⁷ Heferan, above n 95.

⁹⁸ Vann, above n 6.

⁹⁹ Ibid 18.

¹⁰⁰ In the article by Gluyas, above n 5, there was a discussion of Dr Antony Ting's two recommended reform methods—recognition that multinationals are single enterprises that are not capable of dealing

Ascertaining the source of the income from an overall cross-border related party transaction could result in a more correct allocation of the profits than the current arm's length basis addressed by the transfer pricing rules. However, it is suggested that the existing common law sources rules may need to be modified or reconceptualised to take into account economic and related developments consequent upon globalisation and related challenges presented by developments in information technology.

The approach advocated by the authors involves two steps which draws from the thesis of Pinto and related literature on source-based taxation.¹⁰¹

First, the source of the income from the related party transaction would need to be ascertained. In this regard, the idea of an economic presence (instead of relying on formalistic rules like physical presence which are easily manipulated in an economic environment) or economic footprint could be used to identify the true source of such profits, rather than concepts like a permanent establishment or fixed base which are easily manipulated. Notably, the new transfer pricing reporting standards that are to be implemented in Australia would assist in ascertaining the economic footprint of a multinational by providing an overall picture of the global operations of the entity.

It is argued that tracing or establishing the economic presence of a company in a particular jurisdiction would allow a more accurate identification of the place where the value is created or the profits should be allocated.

This approach takes a substance over form approach to determining the source of income. Pinto¹⁰² notes that economic presence could be determined by reference to a 'regular and systematic direction of activities in a country'. Pinto's work refers in turn to Harris where he states:

Did the taxpayer 'purposefully avail' itself of the benefits of a taxing state? Did the taxpayers conduct and operations in the taxing State rise to a level where it should have reasonably anticipated being hauled into court? Were the taxpayers in-state activities a continuous and systematic part of its general business in the state.¹⁰³

Once the source of the income is ascertained, on the basis of economic presence the second step would be looking at the overall profits of the jurisdiction and attributing them to that particular jurisdiction based on the source.

This type of approach would achieve greater flexibility and durability to truly consider the place where the source of profits is derived and would be more adaptable to changing economic circumstances. Interestingly, in the G20 Declaration in September the Heads of Government stated: 'Profits should be taxed where economic activities

with one another and the utilisation of subject to tax conditions as have appeared in German tax treaties, where parties can only claim benefits on offer where they are subject to reasonable tax levels. As noted earlier in the paper, the authors concede other solutions may also be possible including formulary apportionment methods for transfer pricing but an evaluation of this is well covered in the literature and is therefore beyond the scope of this paper.

¹⁰¹ Dale Pinto, 'The continued application of source-based taxation in an electronic commerce environment', (PhD Thesis, The University of Melbourne, 2002), 44–45.

¹⁰¹ *Ibid*, 44–45 and 242.

¹⁰² *Ibid*.

¹⁰³ Pinto, above n 101, 44–45, 242.

deriving the profits are performed and where value is created.’¹⁰⁴ This supports the proposition advocated in this paper that it is the source of the profits which one should endeavour to locate rather than an artificial allocation based on arm's length prices.

The authors concede that utilisation of the source rules may lead to less certain or predictable results than a more mechanistic specific anti-avoidance rule like the arm's length rules adopted by the current transfer pricing regime but would better reflect the economic creation of profits to determine taxing rights.

As a related point it could also be argued that the need to refer to alternative postulates and difficult concepts to ascertain such as an arm's length price is already entrenching significant legislative uncertainty that is based on a flawed premise. Conversely, the source rules are based on the correct premise that taxing rights should be attributed based on the source of the profits, which in the case of digitised industries, e-commerce or related party dealings may most accurately be reflected by where the entities' economic presence lies.

In this way, source rules that are based on economic presence have the advantage of being more readily adaptable to the business model or method of transaction that is under scrutiny. For example, where a cross-border transaction involves e-commerce the most important variable to consider may be where the customers are located rather than searching for a fixed place of business.

In terms of re-conceptualising how this might operate, the starting point in relation to ascertaining source is the seminal statement of Isaacs J in *Nathan v FCT*¹⁰⁵ that the source of a transaction is 'a practical hard matter of fact' and involves looking at what a "practical man would regard as a real source of income". Notably, the term source is not defined in the ITAA 1936 and is defined in a very circular manner in the ITAA 1997 to refer to the fact that income will have an Australian source if it is 'derived from an Australian' source.

By looking for the source of the transaction between related parties rather than trying to attribute an arm's length price between related entities, it will allow a more 'in substance approach' to help to circumvent any artificial measures that seek to artificially shift profits, by ascertaining the location of the actual source of the transaction or income. For example, returning to the transfer pricing strategies, where a company sells goods or services in a high tax jurisdiction (for example, Australia) at a low price to a related company in a low tax jurisdiction and the company in the low tax jurisdiction on-selling them to a third party purchaser, a source-based approach would focus on the overall profits of the enterprise and then locate the true source of the transaction. The source would depend upon the nature of the goods. If it were tangible goods, the rule would look at the types of functions performed on the asset and if all the production occurred in Australia. If little was done to the goods in the low tax jurisdiction before it was on-sold to the ultimate consumer then the source rules would allow Australia to tax the majority of the income in the transaction.

¹⁰⁴ Jerin Matthew, 'Sydney G20 Meeting Communiqué: Full Text' *International Business Times*, (24 February 2014), <<http://www.ibtimes.co.uk/sydney-g20-meeting-communique-full-text-1437618>>.

¹⁰⁵ (1918) 25 CLR 183.

In support of adopting such an approach, cases such as *Cliffs International Inc v FCT*¹⁰⁶ and *Thorpe Nominees Pty Ltd v FCT*¹⁰⁷ illustrate a propensity by the judiciary in Australia to focus on a substance over form approach, with the Court inquiring where the economic activity that gives rise to the income has occurred. Likewise, this is consistent with the ATO's approach in *Taxation Ruling TR 2013/1*¹⁰⁸ where it is stated that a substance over form approach will be adopted, and in circumstances where there is a disconformity between the two the actual behaviour of the parties rather than the formal terms of the contract will be given precedence.¹⁰⁹

Pinto argues¹¹⁰ elsewhere that source rules have continued theoretical justification for allocating income that arises from international transactions, even in the case of e-commerce transactions.

The submissions made by Pinto and others in relation to e-commerce specifically have broader application to related-party transfer pricing transactions. Specifically, Pinto's thesis addresses a situation where income should be said to be generated if all the value of what is sold is created in the country of residence (for example, where the intellectual property is located in a low tax jurisdiction) but the customers that determine this value are in the source country (where the goods are ultimately sold in a high tax jurisdiction).¹¹¹

Pinto maintains that in those cases the only contribution of the source country is the customers it could be argued that source countries provide marginal benefits relevant to the production of the income that would justify the right to tax that income in the first place. However, he concedes that such an argument can be challenged on several policy grounds.¹¹² Pinto opines that even if a business doesn't have a physical presence in the source country it nevertheless **benefits substantially** from the infrastructure in the source country. Therefore, consistent with the benefit theory, it should contribute to the government of the source country via taxation. Similarly, another work by Pinto¹¹³ concerns the broad nature of what can be construed as a 'benefit'. He states:

Benefits that may be provided by source countries can either be general or specific. In terms of general benefits, education (which relates to the availability and level of labour), policy, fire and defence protection represent obvious examples. However, apart from these general benefits, there are more specific benefits that source countries may provide, including a conducive and operational legal infrastructure for the proper functioning of business. Allied with this may be specific government policies, such as

¹⁰⁶ 85 ATC 4374.

¹⁰⁷ 88 ATC 4886.

¹⁰⁸ ATO, *Income Tax: The Identification of 'Employees' for the Purposes of the Short Term Visit Exception Under the Income from Employment Article or its Equivalent, of Australia's Tax Treaties*, TR 2013/1.

¹⁰⁹ Ibid.

¹¹⁰ Pinto, above n 101, 44–45 and 242, Chapter 2.

¹¹¹ Ibid.

¹¹² Ibid.

¹¹³ Dale Pinto, 'The Theoretical Foundations and Continued Rationale for Source-based Taxation in an Electronic Commerce Environment', (2012) 27 *Australian Tax Forum* 443.

keeping exchange rates stable and interest rates low, thereby providing economic stability and business and consumer confidence.¹¹⁴

Likewise, businesses that do not maintain a physical presence derive benefits from a country's legal system in 'as much as they rely upon it to enforce payments, uphold intellectual property rights and maintain a pro-competitive and conducive business environment'.¹¹⁵ Other benefits provided from the country where the consumers are located include 'waste disposal for packaging materials, consumer protection laws and an infrastructure upon which delivery vehicles can travel'.¹¹⁶ Pinto's thesis refers to this as 'entitlement theory' and supports the fact that there can be taxation in source countries even where a business lacks a physical presence in those countries. In fact Pinto states:

Given that physical presence can be largely insignificant for an electronic commerce transaction, economic presence may be a better indicator upon which source-country tax nexus may be based.¹¹⁷

Thus, in e-commerce related party transactions, it may be necessary to reconceptualise the source concept to focus on the economic presence of the transaction.

It is acknowledged that ascertaining the source of each transaction could potentially be a difficult task and seen as practically and administratively onerous. Furthermore, there may be difficulties in determining when a series of distinct transactions should be aggregated.

However, these reasons for not adopting a source-based approach are as stated by Pinto elsewhere 'based on practical and administrative considerations and therefore based on expedience rather than being founded on theoretical grounds ...'.¹¹⁸ Likewise, in the same work Pinto acknowledges that the logistics and practicalities of administering a particular methodology should be a secondary condition to if it should be done to begin with 'how something can be done (which involves practical and administrative considerations should be a secondary considerations to whether it should be done in the first place'.¹¹⁹

Arguably, an approach that looks to the true source of a transaction rather than utilising hypothecations based on arm's length price is much more grounded in reality and would be a more stable basis to allocate taxing rights. Furthermore, the use of such a conceptual framework reflects to a greater extent the overall goal of the taxpaying regime, which is to truly allocate a fair share of tax based on the Australian entity's 'economic contribution'.¹²⁰

A reconceptualised source rule would not be based on a fiction, trying to artificially segregate a multinational into a series of different arm's length transactions, so therefore does not exhibit the same conceptual flaw as an arm's length price. In this

¹¹⁴ Ibid, 445.

¹¹⁵ Ibid.

¹¹⁶ Ibid

¹¹⁷ Pinto, above n 101.

¹¹⁸ Ibid.

¹¹⁹ Ibid.

¹²⁰ Above n 25.

regard, Sadiq argues¹²¹ that the application of arm's length rules incorporates a 'legal fiction of imagining transactions between unrelated parties'.¹²² Sadiq further states that this fiction fails to accord with the reality of the situation, that multinational entities exist to operate in a way independent entities would transact.¹²³

6. CONCLUSION

Given the evolving nature of technology, the increasing mobility of labour and individuals consequent upon globalisation, along with the growing trade in services and intangibles, it is inevitable cross-border transactions will continue to rise. Therefore, Australia's response to transfer pricing strategies must be flexible and adaptable in order to remain relevant and robust to adapt to constant change. It will no longer be sufficient to use a static 'old world approach' to a dynamic 'new world problem'.

If sufficient flexibility can be entrenched into the transfer pricing legislation, the story of Australia's legislative transfer pricing provisions may come to an end and a new chapter of flexible and responsive legislation may supersede it.

Accordingly, in light of these unprecedented changes to the world economy, this paper has suggested a paradigm shift in approach to the allocation of taxing rights in transfer pricing transactions. This shift is from ascertaining a fiction in the form of arm's length price between related entities under current transfer pricing rules to adopting an approach grounded in reality by ascertaining the source of such profits using a reconceptualised notion of source-based taxation on the adoption of economic presence to ground a jurisdiction's right to tax.

While the rules may need to be reconceptualised, the ascertainment of source continues to have a strong theoretical underpinning and significant flexibility to deal with the mischief of transfer pricing in the current globalised world economy. It is acknowledged that this represents a substantial change from the currently utilised approach. Nevertheless, it is argued that this change in approach is necessary to deal with the unprecedented globalisation and continued digitisation of the world economy.

As recently stated by Heferan these conditions have presented policy makers with the chance to reconsider what is an appropriate tax system and to challenge the status quo:

... where successful thinkers are those who embrace change and challenge the state of play. Globalisation and digitisation have presented policy advisers and policy makers with opportunities to consider what constitutes an appropriate tax system in this ever changing world.¹²⁴ (emphasis added)

¹²¹ Sadiq, above n 96.

¹²² Ibid.

¹²³ Ibid.

¹²⁴ Heferan, above n 95.