

Transfer Pricing Insight



Changes to transfer pricing laws and increased ATO scrutiny

At a glance

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Current legislative proposals and planned transfer pricing administration initiatives by the Australian Taxation Office (ATO) will have a significant and cumulative impact on the transfer pricing landscape in Australia.

The initiatives are:

- ▶ A Treasury consultation paper on the review of Australia's transfer pricing rules, including legislative changes with retrospective effect
- ▶ A proposed new international dealings tax return schedule (IDS) starting for the 2012 income year
- ▶ An ATO pilot program calling for disclosure of reportable tax positions (RTPs) which includes transfer pricing

Businesses need to factor these significant changes into their transfer pricing processes and strategy prior to their next tax return and, in some cases, retrospectively.

In particular, businesses should:

- ▶ Review the quality of documentation maintained for transfer pricing purposes, as the law is likely to require increased documentation for 2012 and beyond
- ▶ Consider the impact of potential law changes (dating back to 2004) if they have international related party financial arrangements or business restructures

The situation is fluid and subject to further change. This Transfer Pricing Insight examines the proposed reforms and planned initiatives as they currently apply to taxpayers and we will keep you informed as matters develop.

Reforming Australia's transfer pricing rules

On 1 November 2011 the Assistant Treasurer released a consultation paper on proposed changes to Australia's transfer pricing rules, to "bring them into line with Australian and international developments". This reform is driven by recent judicial decisions to the effect that the ATO's practice does not align with Australia's tax laws.

Australia's tax treaties with its major trading partners are based on an internationally accepted approach to transfer pricing based on application of the arm's length principle. In 2010 the OECD released guidance containing a number of changes to the internationally accepted approach.

Australia's current transfer pricing law was introduced in 1982. In recent transfer pricing court cases such as Roche¹ and SNF Australia², judicial opinion highlighted differences between the meaning of these rules and the broad application of the internationally accepted arm's length principle. Treasury has therefore proposed changes to bring domestic rules and international practice into alignment and has released the consultation paper as the first step to implementing new transfer pricing legislation.

Ahead of the 30 November deadline for responses to the consultation paper, Ernst & Young has engaged in discussions with Treasury officials. The key issues emerging are:

- ▶ **Treasury intends to move quickly with legislative change**

An exposure draft of the legislation is expected early next year. Legislation is then expected to be introduced into the Autumn 2012 sittings of Parliament and finalised in the Winter 2012 sittings. Treasury intends to incorporate the 2010 OECD Transfer Pricing Guidelines into the operative rules of the law.

- ▶ **There are retrospective aspects to the changes**

While the legislation will operate on a prospective basis, the Government will 'clarify' that transfer pricing rules in Australia's tax treaties provide a separate taxing power. It is proposed that this will apply for years commencing on or after 1 July 2004.

The application and retrospectivity of the treaty provisions will be controversial for some taxpayers and would appear to be linked to preserving the ATO's position in several high profile audit cases. This proposal will be of great concern for taxpayers that have taken the position that existing legislation and treaties have different outcomes.

- ▶ **Transfer pricing rules will now operate on a self assessment basis**

The Commissioner's wide discretionary powers under section 136AD(4) of the *Income Tax Assessment Act 1936* (ITAA 1936) will be replaced, however there will be a residual discretionary power to deal with cases involving insufficient information and requiring reconstruction.

- ▶ **Requirement for contemporaneous documentation, with penalties for non-compliance**

The new legislation may require that taxpayers prepare contemporaneous documentation that evidences application of the arm's length principle or risk penalties for failure to keep such documentation.

¹ Roche Products Pty Ltd v Commissioner of Taxation, [2008] AATA 639

² Commissioner of Taxation v SNF (Australia) Pty Ltd [2011] FCAFC 74 (1 June 2011)

- ▶ **Transitional arrangements may be needed for taxpayer structures affected by the changes**
For transactions involving non-treaty countries, there could be transitional issues and asymmetries caused by the changes. Treasury has noted our recommendation for transitional arrangements for taxpayer structures affected by the changes.
- ▶ **Permanent establishment issues may not be dealt with until later**
Treasury flagged the issue of permanent establishment in the consultation paper but will not proceed with revisions at the same time as the transfer pricing changes.

In our view the new legislation could, to a large degree, more closely align Australia's transfer pricing rules with the OECD Guidelines and international practice. However, there are several areas of concern, including the application and retrospectivity of the treaty provisions, as mentioned above.

We are also concerned about the residual discretionary powers, where the Commissioner might seek to reconstruct transactions, for example in related party loan situations. Such a reconstruction may not be reflective of the economic substance of the underlying transactions and this would seem to be a departure from international practice.

On 7 November 2011, after the release of the Treasury paper, the ATO released a Decision Impact Statement (DIS) on the implications of the abovementioned SNF Australia decision. While the Commissioner will consider whether changes may be required to various existing public rulings, the DIS notes that the SNF Australia decision reflects the existing legislation only and the legal position will be different if the proposed transfer pricing law reform proceeds.

International Dealings Schedule - 2012

The ATO intends to replace the current Schedule 25A and thin capitalisation schedule with a new international dealings schedule (IDS).

The IDS will apply to 2012 tax returns, including early balancers such as those balancing at 31 December 2011 in lieu of 30 June 2012.

The information being sought in the 2012 IDS is far more extensive and detailed than in the current Schedule 25A. In our view, many taxpayers will find it onerous to provide the level of detail being sought by the ATO, placing pressure on accounting and other systems.

The consultation process was very rushed and has now closed despite adverse comments and concerns. We understand that the IDS will be finalised on 15 November 2011. The IDS will be discussed at various tax forums in the next few weeks and we expect that the ATO is likely to resist any suggested changes to the format and type of information being sought.

The ATO recognises that some taxpayers might not be able to fully complete the schedule and has stated that taxpayers should approach the 2012 IDS on a 'best efforts' basis i.e., use their best efforts to fill in the 2012 IDS correctly. However, the ATO will expect taxpayers to be in a position to be fully compliant in the 2013 IDS.

Reportable Tax Position Schedule - Pilot 2012

The ATO is undertaking a pilot program for the 2012 income year that will require some taxpayers to disclose whether they have a material reportable tax position (RTP). The test for an RTP is 'what is argued is less likely or about as likely to be correct as incorrect' i.e., where there is 50% or less likelihood of the position being upheld by a Court.

The 2012 pilot applies to selected large and key taxpayers in Australia balancing on 30 June, other than those with advance compliance arrangements with the ATO. It is expected that the RTP pilot will be rolled out to a wider population, including taxpayers with substituted accounting periods, in 2013.

Given the proposed law changes and the inherent complexity and uncertainty of transfer pricing issues, taxpayers will need to carefully assess whether they have a RTP with respect to transfer pricing.

Action required - review and re-engineer transfer pricing procedures and systems

Businesses should: review their transfer pricing processes, including documentation procedures; consider the impact of these developments on their tax controversy strategies; and plan their current and future actions.

For some businesses the ATO IDS and RTP initiatives will require increased documentation and procedures in the near term. Some businesses will want to engage in submissions relating to the proposed law changes, especially those with potential retrospective impact. For other businesses the proposed law changes will require changed systems and documentation standards to be operational by the time the law commences.

Ernst & Young will continue to liaise with the ATO on the above reforms and will keep you updated on the impacts of these changes.

How Ernst & Young can help

Ernst & Young brings together a multi-disciplinary team of professionals well experienced in both transfer pricing and tax issues. We can work with you to analyse your situation, identify immediate action and plan your future transfer pricing strategies. For more information or to discuss the impact of these changes on your business, please contact your local Transfer Pricing advisor listed below.

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