Tax Laws Amendment (Cross-Border Transfer Pricing) Bill (No. 1) 2012

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Economics Section

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Tax Laws Amendment (Cross-Border Transfer Pricing) Bill (No. 1) 2012

Date introduced: 24 May 2012

House: House of Representatives

Portfolio: Treasury

Commencement: The formal sections of the Bill commence on Royal Assent. The measure to insert proposed Subdivision 815-A into the ITAA 1997, to limit taxable profits being shifted or misallocated overseas, commences retrospectively for income years commencing on or after 1 July 2004. Transitional rules to be inserted into the IT(TP)Act 1997, provide that penalties in respect of benefits under a scheme, in relation to income years prior to 1 July 2012, will be limited to amounts that can be substantiated under the provisions existing immediately prior to the enactment of proposed Subdivision 815-A.

Links: The links to the Bill, its Explanatory Memorandum and second reading speech can be found on the Bill’s home page, or through http://www.aph.gov.au/Parliamentary_Business/Bills_Legislation. When Bills have been passed and have received Royal Assent, they become Acts, which can be found at the ComLaw website at http://www.comlaw.gov.au/.

Purpose

The purpose of this Bill is to limit taxable profits being shifted or misallocated offshore.¹

Background

What is cross-border transfer pricing?

Cross-border transfer pricing (transfer pricing) refers to the prices charged when one entity of a multinational group buys or sells products or services from another entity of the same group in a different country. The prices charged will impact the level of profits of each entity of the multinational group, and therefore the amount of tax they have to pay, in the respective countries. These rules are intended to require multinational firms to price intra-group goods and services between related parties to properly reflect the economic contribution of their Australian operations.


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Division 13 of Part III of the Income Tax Assessment Act 1936 (the ITAA 1936)

Under the Australian tax system, the inappropriate shifting of income or profits overseas to jurisdictions with lower tax regimes will normally be caught by Division 13 of Part III of the *Income Tax Assessment Act 1936* (ITAA 1936) which provides transfer pricing rules.

The arm’s length test in Division 13 of Part III of the ITAA 1936

Compliance with the arm’s length principle is a requirement of the Australian transfer pricing rules in Division 13 of Part III of the ITAA 1936. These rules have generally been unchanged for some time since their introduction in 1982.

An arm’s length transaction is generally one in which the buyers and sellers of a product act independently and have no relationship to each other. The concept of an arm’s length transaction is to ensure that both parties in the deal are acting in their own self interest and are not subject to any pressure or duress from the other party or a related party that controls both parties, as in a multinational group. The Australian Taxation Office (ATO) Guide titled *International Transfer Pricing: Applying the arm’s length principle* describes the arm’s length principle as follows:

> The arm’s length principle uses the behaviour of independent parties as a guide or benchmark to determine how income and expenses are allocated in international dealings between related parties. It involves comparing what a business has done and what a truly independent party would have done in the same or similar circumstances.\(^2\)

Section 136AD, in Division 13 of Part III of the ITAA 1936, provides that where a taxpayer has supplied property under an international agreement, and if the Commissioner having regard to the connection between the parties to the agreement is satisfied that the parties were not dealing at arm’s length with each other in relation to the supply, the Commissioner determines that the provisions of subsections 136AD(1), (2) and (3) apply so that the consideration for the supply must be the arm’s length consideration for all purposes of the application of the ITAA 1936.

Subsection 136AD(1) covers the case of the actual consideration being less than the arm’s length consideration for the supply; subsection 136AD(2) covers the case where there has been no consideration for the supply; and subsection 136AD(3) covers the case where the actual consideration has been greater than the arm’s length consideration.

Further, subsection 136AD(4) of the ITAA 1936 provides that where for any reason the Commissioner is unable to ascertain the arm’s length consideration, the arm’s length consideration shall be deemed to be the amount that the Commissioner determines.

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Cross-border transfer pricing rules in Australia’s tax treaties

Australian tax treaties also contain profit allocation rules. These treaties are generally based on the OECD Model Tax Convention on Income and on Capital (OECD Model). The terms of any relevant tax treaty must be considered in relation to profit allocation, because the terms of the treaties have been incorporated into domestic law as part of the ITAA 1953.

Subsection 4(1) of the ITAA 1953 states that the ‘Assessment Act’ is incorporated and shall be read as one with the ITAA 1953. Assessment Act is defined in subsection 3(1) of the ITAA 1953 as meaning the ITAA 1936 and the ITAA 1997.

In the case of any inconsistency between treaty provisions in the ITAA 1953 and provisions in the ITAA 1936 and the ITAA 1997, the treaty provisions have precedence. Subsection 4(2) of the ITAA 1953 states:

The provisions of this Act have effect notwithstanding anything inconsistent with those provisions contained in the Assessment Act (other than Part IVA of the Income Tax Assessment Act 1936) or in any Act imposing Australian tax.

Each of Australia’s tax treaties has transfer pricing articles and these include the associated enterprises article and the business profits article. Australia’s tax treaties are generally based on the OECD Model. In consequence the treaty transfer pricing rules require profits to be allocated in accordance with OECD guidance on the ‘arm’s length principle’.

The Explanatory Memorandum to the Bill states that transfer pricing rules have been rarely litigated in Australia. It states further that in June 2011, in Commissioner of Taxation v SNF (Australia) Pty Ltd (SNF), the Full Court of the Federal Court of Australia considered its first substantive transfer pricing case, which was argued only on the basis of Division 13.

Proposal to reform cross-border transfer pricing rules announced by the Australian Government on 1 November 2011

On 1 November 2011, the then Assistant Treasurer, Bill Shorten, announced that the Government would reform the transfer pricing rules in the income tax law and Australia's future tax treaties to

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5. Part IVA of the ITAA 1936 contains the general anti-avoidance measures.
7. Explanatory Memorandum, paragraph 1.12, pp. 6 and 7.

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bring them into line with international best practice, in order to improve the integrity and efficiency of the tax system. In his media release he stated:

A recent court case has highlighted some difficulties for Australia to appropriately assess transfer pricing cases in a way that is consistent with our major trading partners.

"The Government is taking action to ensure multinationals pay the correct amount of tax in Australia on their income and to provide certainty on our transfer pricing laws."

"Multinational groups operating in Australia will not have to deal with transfer pricing rules that haven't kept pace with international practice to inform how they allocate profits around their group," Mr Shorten said.

Modernised transfer pricing rules will reinforce the integrity of the corporate tax base and align our rules more closely to international standards.

"International thinking on transfer pricing has moved on since the current transfer pricing rules were inserted in the income tax law," Mr Shorten said.

"Last year, for example, the OECD substantially updated its Transfer Pricing Guidelines, which are used by governments and business alike. Further, recent court decisions suggest our existing transfer pricing rules may be interpreted in a way that is out-of-kilter with international norms."

"The Government has asked the Treasury to review how the transfer pricing rules can be improved, including but not limited to how to be more in line with international best practice. I urge all interested parties to participate in this consultation process," he added.

Mr Shorten indicated the Government will also address a related area of potential uncertainty: whether tax treaties provide a power to make transfer pricing adjustments independently of the transfer pricing rules in the Income Tax Assessment Act 1936.³

### Treasury review of the cross-border transfer pricing rules

On 1 November 2011, the Treasury released a Consultation Paper titled *Income tax: cross border profit allocation - Review of transfer pricing rules* (the Consultation Paper). Simultaneously, the Government announced that it would introduce changes to the existing transfer pricing rules, to bring them in line with Australian and international developments in the area.⁹

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³ Bill Shorten, (then Assistant Treasurer and Minister for Financial Services and Superannuation and Minister for Employment and Workplace Relations), *Robust transfer pricing rules for multinationals*, media release, no. 145, 1 November 2011, viewed 26 May 2012, [http://parlinfo.aph.gov.au/parlInfo/search/display/display.w3p;query=Id%3A%22media%2Fpressrel%2F1197735%22](http://parlinfo.aph.gov.au/parlInfo/search/display/display.w3p;query=Id%3A%22media%2Fpressrel%2F1197735%22)


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The introduction to the Consultation Paper sets out the main issues which needed to be dealt with by the reform measures. The principal focus was on the extent to which the domestic legislation and the treaty rules should align with international standards. In particular:

- can the arm’s length principle be better reflected in domestic transfer pricing rules?
- how can we best promote interpretation of domestic rules consistently with international guidance used by our major investment partners?
- Australian tax treaties contain profit allocation rules based on the OECD Model Tax Convention on Income and on Capital. The paper also seeks views on these rules. Can Australia’s treaty practice be better aligned with the international standards in the OECD Model?
- in determining the profits of permanent establishments, what are the implications for both our treaty rules and domestic laws if Australia is to move to a functionally separate entity approach and
- another important design issue raised in the paper is a move to self assessment of transfer pricing issues, which has implications for existing discretions, record keeping, documentation, and time limits for amendments.  

Treasury received 28 submissions in response to the Consultation Paper. Twenty-five of these are public submissions and three were confidential. The public submissions are listed in the hyperlink below.

Release of the exposure draft of the Bill to give effect to the first stage of the reform of cross-border transfer pricing rules

On 16 March 2012, the Assistant Treasurer, David Bradbury, released an exposure draft of proposed amendments that will implement the first stage of reforms to transfer pricing with retrospective effect from 1 July 2004 and stated:

"This draft legislation and associated explanatory materials take into account a number of key issues raised by stakeholders through earlier consultation processes," said Mr Bradbury. "The Government is committed to working with industry to implement these important reforms."

The proposed amendments confirm that, in relation to treaty cases, the transfer pricing articles contained in Australia’s tax treaties are able to be applied and operate independently of Australia’s unilateral transfer pricing rules.

"These amendments have been introduced to ensure that effect is given to the intentions of the Parliament, that revenue is not compromised, and that international consistency is maintained with our tax treaty partners.


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"These amendments will apply to income years commencing on or after 1 July 2004, being the income year commencing after the Parliament last demonstrated its intention that the law should operate in this way."\(^{12}\)

Treasury received 21 submissions on the exposure draft of the Bill and the objection to the retrospective application of the proposed Subdivision 815-A by the Law Council of Australia is referred to in the concluding comments of this Bills Digest.

Financial implications

The Explanatory Memorandum to the Bill states that this measure has no revenue impact as it is a revenue protection measure.\(^{13}\)

What is the significance of cross-border transfer pricing rules to the Australian economy?

The Explanatory Memorandum to the Bill states that related party trade was valued at approximately $270 billion in 2009, representing about 50 per cent of Australia’s cross-border trade flows. The Explanatory Memorandum also states that there is no financial impact from these amendments as they protect the existing revenue base.\(^{14}\)

However, some may consider that a measure which is claimed to protect the revenue base more effectively than what is capable of being achieved under existing legislation, is likely to result in the collection of additional revenue or prevent loss of revenue. There is a reasonable expectation that there will be additions to revenue. If there will be no revenue impacts, the question may be raised as to why there is a need for retrospectivity from 1 July 2004.

It may be difficult to quantify what the additional impact on the Budget might be for the forward estimates period, but given that the anticipated surplus for 2012-13 is a slim $1.5 billion, the proposed measure may only contribute to bolster the Budget surpluses for the forward estimates period.\(^{15}\)

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12. D Bradbury (Assistant Treasurer and Minister Assisting for Deregulation), Draft amendments to transfer pricing regime released for consultation, media release, 16 March 2012, viewed 26 March 2012, [http://parlinfo.aph.gov.au/parlInfo/search/display/display.w3p;query=Id%3A%22media%2Fpressrel%2F1508733%22](http://parlinfo.aph.gov.au/parlInfo/search/display/display.w3p;query=Id%3A%22media%2Fpressrel%2F1508733%22)


14. Ibid.


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Human rights implications

The Statement of Compatibility with Human Rights states that the Bill does not engage any of the applicable rights or freedoms and adds that this Bill is compatible with human rights as it does not raise any human rights issues.

However, it adds the following qualifications before arriving at the above conclusions.

1.155 This Bill ensures Parliament’s view as to the way in which the transfer pricing rules in Australia’s tax treaties operate is effective even though there are strong arguments for concluding that under the current income tax law these rules apply alternatively to Division 13. If this is the case, these amendments constitute a mere rewrite of those rules. To the extent that some deficiency exists in the current law, these amendments ensure the law can operate as the Parliament intended.

1.156 Although the Parliament has indicated the law applies in this way since at least 1982, the application date for this Bill of income years commencing on or after 1 July 2004 follows the most recent Parliamentary statement to this effect.

1.157 For income years commencing prior to 1 July 2012, to the extent administrative penalties are applicable as a result of adjustments made under Subdivision 815-A, the amount of the penalty under Subdivision 284-C of Schedule 1 to the TAA 1953 will be limited to amounts that would otherwise have applied had Subdivision 815-A not been enacted. This ensures for the retrospective years, commencing on or after 1 July 2004, that an entity will only be liable to administrative penalties in relation to the scheme benefit which could have been denied by another provision of the tax law had Subdivision 815-A not been enacted.16

The question of retrospectivity is considered in the concluding comments of this Bills Digest.

Key provisions

Amendments to the ITAA 1997 proposed in Schedule 1

Item 6 of Schedule 1 to the Bill inserts proposed Division 815 into ITAA 1997, to deal with cross-border transfer pricing. Proposed Subdivision 815-A is titled ‘Treaty-equivalent cross-border transfer pricing rules’.

16. Explanatory Memorandum, pp. 43–44.
What is the object of proposed Subdivision 815-A: Treaty equivalent cross-border transfer pricing rules?

Proposed section 815-5, in Subdivision 815-A of the ITAA 1997, states that the object of the Subdivision is to ensure that the following amounts are appropriately brought to tax in Australia, consistent with the arm’s length principle:

- profits which would have accrued to an Australian entity if it had been dealing at arm’s length, but, by reason of non-arm’s length conditions operating between the entity and its foreign associated entities, have not so accrued and
- profits which an Australian permanent establishment (within the meaning of the relevant international tax agreement) of a foreign entity might have been expected to make if it were a distinct and separate entity engaged in the same or similar activities under the same or similar conditions, but dealing wholly independently.

What is a transfer pricing benefit and when does an entity derive a transfer pricing benefit for the purposes of Subdivision 815-A?

Transfer pricing benefit made by an associated enterprise

Proposed section 815-15 deals with this question in two parts.

Firstly, proposed section 815-15 considers the transfer pricing benefit made by an entity that satisfies the requirements in the associated enterprises article in a tax treaty that applies to that entity (proposed paragraphs 815-5(1)(a) and (b)).

An associated enterprises article is defined in proposed subsection 815-15(5) as:

- Article 9 of the United Kingdom convention (within the meaning of the ITAA 1953) or
- a corresponding provision of another international tax agreement.

Proposed subsection 815-15(1) states how the transfer pricing benefit is to be calculated for an Australian resident entity to whom the associated enterprises article in a tax treaty applies. Basically, it states that the transfer pricing benefit is the amount of profits that would have accrued to an

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entity, but has not accrued to it because the conditions in Article 9 of the United Kingdom convention or an equivalent article in another international agreement have not been satisfied (proposed paragraph 815-15(1)(c)). Proposed paragraph 815-15(1)(d) states that had these conditions been satisfied, the amount of profits so accrued to that entity would have resulted in:

- the amount of the taxable income of the entity for an income year being greater than its actual amount (proposed paragraph 815-15(1)(d)(i))
- the amount of a tax loss of the entity for an income year of the entity being less than its actual amount (proposed paragraph 815-15(1)(d)(ii)) or
- the amount of the net capital loss of the entity for an income year being less than its actual amount (proposed paragraph 815-15(1)(d)(iii)).

Proposed subsection 815-15(1) concludes by stating that the amount of the transfer pricing benefit to that entity is the difference between the amounts mentioned in bullet points above, as the case requires.

Cross-border transfer pricing benefit made by a foreign resident entity

Proposed subsection 815-15(2) considers the case of a transfer pricing benefit made by a foreign resident entity, comprising the business profits that entity makes through a permanent establishment of that entity in Australia.

Proposed paragraphs 815-15(2)(a) and (b) apply to a foreign resident entity which has a permanent establishment in Australia when the amount of the profits, attributed to that permanent establishment in Australia, falls short of the amount of profits the permanent establishment might have been expected to make if it were a distinct and separate entity, engaged and dealing in the manner described in the business profits article applicable to that permanent establishment.

Proposed paragraph 815-15(2)(c) states had the profits attributed to the permanent establishment included the amount of the shortfall:

- the amount of the taxable income of the entity for an income year would be greater than its actual amount (proposed paragraph 815-15(2)(c)(i))
- the amount of a tax loss of the entity for an income year would be less than its actual amount (proposed paragraph 815-15(2)(c)(ii)) or
- the amount of the net capital loss of the entity for an income year would be less than its actual amount (proposed paragraph 815-15(2)(c)(iii)).

Proposed subsection 815-15(2) concludes by stating that the amount of the transfer pricing benefit to the foreign resident entity is the difference between the amounts mentioned in the bullet points above, as the case requires.

The meaning of ‘business profits article’ is given in proposed subsection 815-15(6). It states that the business profits article is:

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• Article 7 of the United Kingdom convention (within the meaning of the ITAA 1953)\textsuperscript{19} or
• a corresponding provision of another international tax agreement.\textsuperscript{20}

**Cross-border transfer pricing guidance**

**Proposed section 815-20** indicates the documents that may be used to interpret a provision of an international agreement in working out whether an entity has derived a transfer pricing benefit in accordance with **proposed section 815-15**.

**Proposed subsection 815-20(2)** states that the documents covered by **proposed subsection 815-20(1)** are as follows:

• the Model Tax Convention on Income and Capital, and its Commentaries, as adopted by the Council of the Organisation for Economic Cooperation and Development and last amended on 22 July 2010
• the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, as approved by that Council and last amended on 22 July 2010 and
• a document, or part of a document, that is prescribed by the regulations.

**Determinations by the Commissioner negating transfer pricing benefit**

**Proposed section 815-30** provides details of the types of determinations the Commissioner may make to negate a transfer pricing benefit.

**Proposed subsection 815-30(1)** states that the Commissioner may make:

• a determination of an amount by which the taxable income of the entity for an income year is increased
• a determination of an amount by which the tax loss of the entity for an income year is reduced and
• a determination of an amount by which the net capital loss of the entity for an income year is decreased.

**Proposed subsection 815-30(5)** provides that the Commissioner may take such action as the Commissioner considers necessary to give effect to a determination under this section.


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Application of amendments to the Taxation Administration Act 1953

Item 13 of Schedule 1 of the Bill amends the scheme penalty provisions in the TAA 1953 so that they apply to the scheme benefit calculated under proposed Subdivision 815-A of the ITAA 1997 for a particular income year.

Item 14 of Schedule 1 of the Bill provides that the amendment made by item 13 applies to income years starting on or after 1 July 2012.

Concluding comments

The second reading speech, referred to the consultation that the Government has engaged in with the business community prior to the introduction of this Bill, which is the first stage of the transfer pricing reform process, and stated as follows:

This government has engaged extensively with the business community in relation to this measure. The measure is not wholly supported by multinationals and their advisors—and given this is a robust integrity measure—this is not altogether unexpected.

That said, the bill has greatly benefited from the inclusion of some important features following consultation.

The bill will essentially achieve three key objectives.

First, as explained, it will ensure the transfer pricing articles contained in Australia's tax treaties are able to be applied and provide assessment authority independent of division 13.

This will be achieved through providing an express liability provision in the Income Tax Assessment Act 1997.

Secondly, it will require that the transfer pricing rules in this bill are interpreted as consistently as possible with the relevant OECD guidance.
The work of the OECD reflects the best international thinking on transfer pricing and has shaped transfer pricing regimes around the world. The OECD's transfer pricing guidelines are widely used by tax administrations and multinational enterprises globally.

This provision will provide a clear legal pathway to the use of OECD guidance. It will avoid the costly necessity for users to get expert advice on whether the state parties to a particular treaty apply the guidance and will make it clear which set of guidelines is to be used.

Finally, as mentioned, the government has had many discussions with the business community in developing these rules. As a result of those talks we are moving to clarify the interaction between transfer pricing and the thin capitalisation rules. 21

Some of the issues raised in the consultation process include the retrospective application of the measures proposed in the bill will be briefly considered in this section of the Bills Digest.

**Retrospective legislation and the rule of law**

The application of proposed Subdivision 815-A of the ITAA 1997 from 1 July 2004 is retrospective and may be regarded as contrary to the rule of law. 22 This view was put forward by the Taxation Committee of the Business Law Section of the Law Council of Australia (the LCA Committee) in its submission on Treasury’s Consultation Paper 23:

Retrospective Laws

7. The Committee considers that any legislative amendments should have prospective and not retrospective operation. The Committee considers that retrospective laws:

(a) are contrary to the rule of law, destroy certainty of law and undermine the international confidence in our legal systems;

(b) create adverse perceptions of sovereign risk in relation to Australian taxation laws generally;

(c) are quite simply 'bad for business'.

8. The Committee is very concerned with the statements from the Assistant Treasurer that aspects of the proposed changes that may be implemented following the Review of Transfer

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22. Recognising that the High Court of Australia has affirmed the validity of some retrospective laws – see Polyukhovich v Commonwealth (1991) 172 CLR 501
23. A link to the Consultation Paper is provided at footnote 9.

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Prising [sic] Rules will be made retrospective, to income years commencing on or after 1 July 2004. In short the Committee sees no justification for making any of the proposed rule changes retrospective. 24

The Explanatory Memorandum to the Bill justifies the provisions of proposed Subdivision 815-A being applied retrospectively from 1 July 2004, on the grounds that Parliament, when it enacted the current Division 13 of the ITAA 1936 in 1982, and thereafter with subsequent amendments to Division 13, always intended that treaties provided a separate basis for making transfer pricing adjustments:

Application of the amendments

1.16 Given the consistent assumption by Parliament since at least 1982 that treaties provided a separate basis for making transfer pricing adjustments, the proposed amendments could apply from the commencement of Division 13 and the accompanying changes to section 170 and former section 226 of the ITAA 1936.

1.17 Subdivision 815-A, however, will only apply to income years commencing on or after 1 July 2004. The 2004 income year commenced immediately after the Parliament’s most recent amendment to the income tax laws in 2003 which again evidenced the Parliament’s understanding that tax treaties could be used as a separate basis for making transfer pricing adjustments. The 2003 amendments included a modification to the definition of ‘relevant provision’ contained in subsection 170(14) of the ITAA 1936 and contained explicit statements as to the ability for such provisions to allow for adjustments to the profits of permanent establishments or associated enterprises on an arm’s length basis (see paragraph 3.5 of the Explanatory Memorandum relating to Act No 123 of 2003). 25

This justification was initially made in the media release of the Assistant Treasurer of 1 November 2011. 26

The LCA Committee’s submission on the Consultation Paper responded to this argument by pointing out that there was no specific amendment to the law that stated Parliament’s position:

12. The Committee therefore considers that since 1 July 2004 (the proposed date for application of the measures as referred to in the Assistant Treasurer’s Press Release), taxpayers could legitimately have adopted a contrary view of the operation of the law, namely that the tax treaty rules do not operate independently of, and do not provide a separate taxing power from the domestic law. The Committee therefore regards the proposed amendments as


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implementing a significant change to the existing law, rather than merely clarifying the operation of the existing law. It is unclear what justification there is, if any, for this change being made retrospective to 1 July 2004.

13. The Press Release states that "Parliament has indicated that the law should operate in this way on a number of occasions, most recently in 2003." The Committee has been unable to locate a specific reference to Parliament indicating that the law should operate this way. Ordinarily, it would be expected that Parliament's position on an important matter of tax law would be expressed clearly in the form of amending legislation. No such amending legislation has been passed by Parliament.\(^{27}\)

The issue is whether an entire new Division 815-A, which will add to the complexity and length of tax law, must necessarily take effect retrospectively from 1 July 2004, if the proposed law merely restates the law as it now stands.

**Is there an alternative to the arm’s length test?**

In the second reading speech to the Bill, the Assistant Treasurer thanked the Justice and International Mission Unit of the Victorian and Tasmanian Synod of the Uniting Church (the Unit) for its ongoing contribution to the consultative process. The submissions of the Unit included the following matters.

**Shortcomings of the arm’s length principle for sharing of profits**

The Unit pointed out the shortcomings of the arm’s length principle for the sharing of profits which underpins the OECD Model of international agreements as follows:

> While supporting the efforts to combat tax evasion through transfer mispricing outlined in the Consultation Paper, the Unit is concerned about the limitations of the ‘arm’s length’ principle and would urge supporting other methods at a multilateral level to combat tax evasion through transfer mispricing. There is great scope for misunderstanding or deliberate mispricing in areas around intellectual property such as patents, trademarks and other proprietary information within the arm’s length principle. Multinational enterprises arise in large part due to organisational and internalisation advantages relative to the efforts of unrelated, separate companies that seek to do business with one another. Such advantages mean that within multinational enterprises, profit is generated in part by internalising transactions within the firm. Thus, for companies that are truly integrated across borders, holding related entities within the commonly controlled group to an ‘arm’s length’ standard for pricing of intracompany transactions does not make sense, nor does allocating income and expenses on


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a country-by-country basis. Reuvan Avi-Yonah (2009) argues the arm’s length transfer pricing rules have spawned a huge industry of lawyers, accountants and economists whose professional role is to assist multinational companies in their transfer pricing planning and compliance. He concludes that no matter how assiduously one performs “functional analyses” designed to identify “uncontrolled comparables” that are reasonably similar to members of multinational groups, one is rarely going to find them. He argues such comparables have not been found with sufficient regularity to serve as the basis for a workable transfer pricing system.28

Should the arm’s length principle be replaced with formulary apportionment of profits and unitary taxation?

The Unit’s submissions suggested that the Australian Government should persuade the OECD to consider the adoption of the formulary apportionment of the profits of a multinational to all the jurisdictions where a multinational operates, accompanied by the taxing of the multinational as a single unit. Such apportionment of profits being based on real factors such as total third-party sales, total employment measured by headcount or by salaries and the value of physical assets of the multinational in each jurisdiction. Under this unitary system of taxation of a multinational in each jurisdiction, the centres of taxation of a multinational will be the economic substance and transactions rather than the structures put in place by a multinational to cover its operations in various jurisdictions.29

In the current debate about the overall taxes not paid by some multinationals and the difficulty of implementing the arm’s length rule, the pursuit of alternatives including unitary taxation, as pointed out in the Unit’s submissions, deserves consideration by the Australian Government and the OECD.

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29. Ibid.

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