

JOINT SUBMISSION BY

The Taxation Institute, Institute of Chartered Accountants Australia, CPA Australia,
Law Council of Australia and the Corporate Tax Association

***Draft Practice Statement Law Administration PS LA 3672 - Administration of transfer
pricing penalties for income years commencing on or after 29 June 2013***

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The Professional Bodies welcome the opportunity to comment on Draft Practice Statement Law Administration PS LA 3672 (**Draft Practice Statement**).

GENERAL COMMENTS

Scope

The Draft Practice Statement explains how the ATO intends to administer the penalty provisions in subsection 284-145(2B) (paragraphs 2 and 6-8). In particular, it discusses how the penalty provisions apply in light of the record-keeping rules in Subdivision 284-E of Schedule 1 to the *Taxation Administration Act 1953* ("TAA 1953").

However, the Draft Practice Statement does not address how the ATO intends to administer the penalty provisions in section 288-25 of Schedule 1 to the TAA 1953 or potential criminal penalties (see PS LA 2005/2 (Penalty for failure to keep or retain records)) where a taxpayer's records do not satisfy Subdivision 284-E and the ATO forms the view that the taxpayer's records *also* fail to satisfy section 262A of the ITAA 1936.

As Subdivisions 815-B and 815-C operate in a self-assessment environment, taxpayers are required by section 262A of the ITAA 1936 to keep records that explain all transactions that are relevant for any purposes of the Act. In this respect, we note the final sentence of paragraph 129 of TR 2014/D4 which says that "(S)ection 262A continues to apply if the documentation under Subdivision 284-E does not sufficiently explain the transaction and related acts."

The ATO should provide guidance in relation to the following matters:

- What records taxpayers will need to maintain to avoid administrative penalties arising under section 288-25 of Schedule 1 to the TAA 1953 for failing to keep the records required by section 262A of the ITAA 1936; and
- How the ATO intends to administer the penalties arising under section 288-25 of Schedule 1 to the TAA 1953 for failing to keep the records required by section 262A of the ITAA 1936.

Such considerations are likely to be of significant importance to public officers who have to sign the declaration on the annual income tax return that the information in the tax return is true and correct.

Further, the Draft Practice Statement does not explain how the ATO intends to administer the penalty provisions in Subdivision 284-B of Schedule 1 to the TAA 1953 in cases where the transfer provisions are applied. In this respect, we note that paragraphs 14 and 15 of PS 2008/18 (*Interaction between Subdivisions 284-B and 284-C of Schedule 1 to the Taxation Administration Act 1953*) clearly state that penalties can be imposed under *both* Subdivisions 284-B and 284-C where an entity has entered

into a scheme *and* has made a false or misleading statement in relation to the scheme. As this is an important matter for taxpayers, we have extracted these paragraphs below:

- “14. Where an entity enters into a scheme and obtains a scheme benefit that is cancelled pursuant to an adjustment provision (that is, where the scheme benefit is allowable under general provisions and the adjustment provision applies to cancel the scheme benefit), penalties will be imposed under Subdivision 284-C. However, Subdivision 284-B penalty should also be considered where the conditions for its imposition are or may be satisfied. It does not necessarily follow that because Subdivision 284-C does apply Subdivision 284-B does not apply.
15. Penalties may be imposed cumulatively under both Subdivisions. That is, where an entity has entered into a scheme and has made a false or misleading statement in relation to the scheme, penalties can be imposed under *both* Subdivisions 284-B and 284-C.”

Notwithstanding the above, we note that PS LA 2008/18 was drafted prior to the introduction of the new transfer pricing rules in Subdivisions 815-B and 815-C and the associated documentation rules in Subdivision 284-E. It is therefore reasonable to ask whether the views expressed in PS LA 2008/18 continue to reflect the ATO's view in relation to the interaction between the penalty provisions in Subdivisions 284-B and 284-C?

General impression

The Professional Bodies' overall impression of the Draft Practice Statement is that it is not particularly helpful. In large part, this is due to the following:

- The Draft Practice Statement has a tendency to express itself in overly broad terms which are not consistent with the law (examples are provided in our specific comments below);
- There are a number of examples where the Draft Practice Statement simply restates the law in cases where the law's meaning or intention is clear rather than provide useful guidance as to how the ATO intends to administer the law (eg paragraphs 45-51 in relation to the meaning of transfer pricing benefit; paragraphs 74-75 in relation to documentation requirements);
- Where the Draft Practice Statement could provide useful guidance, it doesn't. For example, in the discussions on:
 - Whether a taxpayer entered into a scheme with the sole or dominant purpose of getting a transfer pricing benefit, the Draft Practice Statement does not provide any guidance in relation to when the ATO would or would not seek to assert that the taxpayer entered into the scheme with the sole or dominant purpose of getting a transfer pricing benefit; and
 - The general power of remission in section 298-20 of Schedule 1 to the TAA 1953 (paragraphs 101-111), the Draft Practice Statement does not provide any guidance in relation to the types of cases or in what circumstances the ATO would consider exercising the general power of remission in section 298-20 to remit penalties imposed by subsection 284-145(2B); and
- The Draft Practice Statement does not address the complex and controversial area of how the ATO intends to administer the penalty provisions in cases where the Commissioner applies the reconstruction provisions in section 815-130.

To summarise, in the Professional Bodies view, considerably more thought and work is needed on the Draft Practice Statement prior to its finalisation in order to provide useful guidance to taxpayers and ATO personnel in relation to how the ATO intends to administer the various penalty provisions that could be applied where transfer pricing adjustments are made under Subdivisions 815-B and 815-C.

Specific comments in relation to the Draft Practice Statement are provided below.

SPECIFIC COMMENTS

Determining the BPA under subsection 284-160(3) (paragraphs 35 to 41)

Paragraphs 36 to 39 should be redrafted as they are expressed in words which are too broad and not consistent with the law. First, the words “sole or dominant purpose of getting a transfer pricing benefit” in each paragraph are too broad and should be replaced by the words “sole or dominant purpose of getting a transfer pricing benefit from the scheme”. Second, the words “the transfer pricing rules do not apply” in each paragraph are again too broad and should be replaced by the words “the transfer pricing rules do not apply to a matter in a particular way that is reasonably arguable”.

‘From a scheme’ (paragraphs 52 to 56)

This section of the Draft Practice Statement should be redrafted:

- First, the section as drafted could be misinterpreted as inferring that the transfer pricing benefit must come ‘from the scheme’ *only* with respect to matters falling within Item 1 of the table in subsection 284-160(3). Such an inference, if intended, is not correct as subsection 284-145(2B) requires that the application of Subdivision 815-B or 815-C be in relation to a *scheme in *all* cases before an administrative penalty can be imposed.
- Second, as penalties imposed by subsection 284-145(2B) must relate to the application of Subdivision 815-B or 815-C to a *scheme, it will be important for the Commissioner to particularise what the scheme is to which Subdivision 815-B or 815-C has been applied. This need is all the more important when regard is had to the introductory words (“the sum of”) in Column 2 of both Items 1 and 2 of the table in subsection 284-160(3) and to the inclusion of the words “to the extent” in paragraphs (a) and (b) of Column 2 of both Items 1 and 2 of the table in subsection 284-160(3), as these words clearly envisage that the *scheme shortfall amount could be comprised of a number of different amounts arising from transfer pricing adjustments made to a number of different matters where some of the positions taken are reasonably arguable while other positions are not.

The Draft Practice Statement should state that ATO officers are required to clearly identify the particulars of the scheme or schemes to which subsection 284-145(2B) applies.

In light of the above, the Professional Bodies do not agree with the view expressed in paragraph 56 that “the whole or part of the commercial or financial relations in connection with which the actual conditions operate will constitute a ‘scheme’ as defined in subsection 995-1(1) of the ITAA 1997.” While it may be possible to say that the whole or part of the commercial or financial relations in connection with which the actual conditions operate *may* be relevant for purposes of particularising the ‘scheme’ to which subsection 284-145(2B) applies, it is not consistent with the law to say that “the whole or part of the commercial or financial relations in connection with which the actual conditions operate will constitute a ‘scheme’ as defined in subsection 995-1(1) of the ITAA 1997.” (emphasis added)

Further, as a transfer pricing benefit only arises where the actual conditions differ from the arm’s length conditions, the relevant scheme for purposes of subsection 284-145(2B) should also particularise how the actual conditions differ from the arm’s length conditions and give rise to the transfer pricing benefit.

In addition, the breadth of the drafting of paragraph 56 does not readily facilitate penalties being applied at different rates in the following cases:

- Where part of the scheme shortfall amount relates to matters where the taxpayer has a reasonably arguable position while some other part of the scheme shortfall amount relates to matters where the taxpayer does not have a reasonably arguable position.
- Where part of the scheme shortfall amount relates to a scheme entered into by the taxpayer with the sole or dominant purpose of getting a transfer pricing benefit while some other part of the

scheme shortfall amount relates to a scheme entered into by the taxpayer without the sole or dominant purpose of getting a transfer pricing benefit.

- Some combination of the above.

Sole or dominant purpose requirement (paragraphs 57 to 68)

This section does not provide any guidance in relation to differentiating between cases where the ATO would ordinarily **not** seek to assert that the taxpayer entered into the scheme with the sole or dominant purpose of getting a transfer pricing benefit – which ought to be the vast majority of cases – from cases where the ATO **would** seek to assert that the taxpayer entered into the scheme with the sole or dominant purpose of getting a transfer pricing benefit. The last sentence in paragraph 66 is far from sufficient to provide any guidance or comfort in this respect.

On the contrary, the underlying intention seems to be to emphasise the breadth of the matters that the ATO can take into account in trying to establish that a taxpayer had the sole or dominant purpose of getting a transfer pricing benefit.

Paragraph 64 is of particular concern as the matters listed in the seven dot points relate to matters that taxpayers should ordinarily take into account in determining arm's length conditions for purposes of self-assessing Subdivision 815-B or 815-C.

The Professional Bodies recommend that this section be redrafted with the aim of providing guidance and examples in relation to differentiating between cases where the ATO would ordinarily not seek to assert that the taxpayer entered into the scheme with the sole or dominant purpose of getting a transfer pricing benefit from cases where the ATO would seek to assert that the taxpayer entered into the scheme with the sole or dominant purpose of getting a transfer pricing benefit.

When a transfer pricing treatment is not reasonably arguable (paragraphs 69-78)

Paragraphs 70 and 75 both state that ATO personnel need to determine whether or not the records kept by the taxpayer meet the documentation requirements in Subdivision 284-E. However, the Draft Practice Statement provides no guidance as to *how* ATO personnel should determine whether a taxpayer has met the documentation requirements in Subdivision 284-E beyond repeating the words of section 284-255 (paragraphs 73-74) and referring readers to TR 2014/D4 (paragraph 76).

Further, the Draft Practice Statement provides no link to PS LA 3673 (Guidance for transfer pricing documentation) and the five step process outlined therein to assist ATO personnel when undertaking a review of a taxpayer's transfer pricing documentation.

A link to PS LA 3673 is important because paragraph 6 of PS LA 3673 states that: "The transfer pricing documentation requirements of an entity as outlined in section 284-255 will be met where the entity has made its best efforts to comply with those requirements, having regard to the materiality of the matter to the entity's overall Australian tax position." This indicates that matters such as a taxpayer using its 'best efforts' to comply with the transfer pricing documentation requirements and the 'materiality' of the matter to the entity's overall tax position are matters which are relevant for purposes of determining whether the requirements of section 284-255 have been satisfied and therefore whether a taxpayer has a reasonably arguable position for purposes of the penalty provisions.

However, we also note that paragraph 108 of PS LA 3672 indicates that "whether the entity has made its best efforts to comply with the transfer pricing documentation requirements, taking into account the resources available to the entity and the materiality of the matter to the entity's overall tax position" are matters for ATO personnel to consider for purposes of the general power of remission in section 298-20. In this respect, the approach taken in PS LA 3672 is not consistent with the approach taken in PS LA 3673. We suggest that the ATO include examples of the ATO bearing the general considerations in paragraph 108 in mind when exercising its power of remission.

Further, from the perspective of a taxpayer trying to comply with the onerous documentation requirements in Subdivision 284-E, the approach taken in PS LA 3673 is to be preferred as it provides greater potential for taxpayers to mitigate Subdivision 284-C penalties.

Step 2d – Determine if remission is appropriate (paragraphs 101-111)

As mentioned in our general comments, paragraphs 101-111 do not provide any useful guidance in relation to the types of cases or in what circumstances the ATO would consider exercising the general power of remission in section 298-20 to remit penalties imposed by subsection 284-145(2B). In this respect, the Professional Bodies recommend that the Draft Practice Statement provide guidance in relation to the types of cases or in what circumstances the ATO would consider exercising the general power of remission in section 298-20 to remit penalties imposed by subsection 284-145(2B) to:

- an amount less than 25% (including to nil) where a taxpayer does not have a reasonably arguable position; or
- an amount less than 10% (including to nil) where a taxpayer does have a reasonably arguable position.

Notwithstanding the preceding comment, we note that paragraph 108 indicates that a relevant consideration for ATO personnel to take into account in considering whether or not to exercise the discretion to remit is “whether the entity has made its best efforts to comply with the transfer pricing documentation requirements, taking into account the resources available to the entity and the materiality of the matter to the entity’s overall tax position”. However, the Draft Practice Statement does not provide any further guidance in relation to what ‘best efforts’ means in this context or how ‘materiality’ would be determined for purposes of the remission power. We suggest that the ATO include examples of ATO exercising its power of remission in a situation where a taxpayer has used its best efforts to comply with the transfer pricing requirements.

In this respect, we draw attention to paragraph 36 of TR 98/16 (international transfer pricing - penalty tax guidelines) which sets out four requirements the ATO considers need to be met in order for the ATO to exercise the general power of remission (that existed in the Act at the time of issue of the ruling) in relation to transfer pricing adjustments made under the former Division 13. The general experience of the transfer pricing members of the Professional Bodies is that the four requirements set out in paragraph 36 of TR 98/16 have worked well in practice for more than fifteen years and that they would provide an appropriate basis for the ATO to develop an updated set of requirements for purposes of the current general power of remission.