JOINT COMMENTS BY

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

Draft Taxation Ruling TR 2014/D4 Income tax: transfer pricing; documentation requirements

Draft Practice Statement Law Administration PS LA 3673 - Guidance for transfer pricing documentation

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The Professional Bodies welcome the opportunity to comment on the above draft guidance material.

GENERAL COMMENTS

Scope

The Draft Ruling sets out the Commissioner's views on the transfer pricing documentation an entity should keep in order to satisfy section 284-255 of Schedule 1 to the *Taxation Administration Act 1953* (TAA 1953). However, the Draft Ruling does not set out the ATO's views in relation to the records to be kept by a taxpayer in order 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 to keep records that explain all transactions that are relevant for any purposes of the Act (see also paragraph 19 of TR 2014/D4). In this respect, we note the following:

- Paragraph 55 states that records that satisfy section 284-255 will also satisfy a taxpayer's obligations under section 262A, however, the reverse may not necessarily apply; and
- Paragraph 129 says that "(S)ection 262A continues to apply if the documentation under Subdivision 284-E does not sufficiently explain the transaction and related acts".

In light of the above, and the consequences which potentially follow for taxpayers for failing to keep the records required by section 262A, the Professional Bodies submit that guidance should be provided by the ATO in relation to the records taxpayers will need to keep in order to satisfy section 262A of the ITAA 1936.

International developments in relation to transfer pricing documentation

Senior ATO personnel have supported the global BEPS effort but have acknowledged that it needs to be a coordinated, multi-lateral effort. The concern in relation to documentation is that we currently have a parallel process running with the ATO unilaterally formulating documentation guidelines and the OECD currently working on transfer pricing documentation and country by country reporting.

In some instances the OECD local template requires more extensive information than that currently required in the ATO draft guidance, and in other respects the ATO draft guidance goes beyond the OECD's expectations for a global master file. The concern is that once the OECD guidelines are finalised (which looks likely to be after the issue of final ATO rulings and practice statements), we will have inconsistent guidance, thereby complicating matters and leading to increased compliance costs.

The meaning of "Records kept by an entity"

The Draft Ruling addresses a number of interpretative matters associated with specific phrases appearing in various paragraphs of section 284-255 (paragraph 3). However, the Draft Ruling has not specifically addressed a key interpretative matter in subsection 284-255(1) relating to the meaning of the words "Records kept by an entity …". Instead, the Draft Ruling includes various statements which provide only indirect insight into the ATO's interpretation of these words. For example, paragraph 82(b) of the Draft Ruling says:

> "For a record to be kept by an entity, that entity is required to have knowledge of more than the record's existence, it needs to have knowledge of its existence, format and content and be reasonably assured that it is fit for purpose i.e. that it is ready and available."

No support is provided for this interpretation.

In the view of the Professional Bodies, paragraph 82(b) goes far beyond any reasonable meaning of the word "kept". By way of contrast, in TR 96/7, the ATO interprets the word 'keep' in subsection 262A(1) as meaning both 'make' and 'retain' (paragraph 18). This interpretation seems far more consistent with dictionary definitions of the word keep. The word 'kept' is a derivative of the word 'keep' and the Draft Ruling does not explain why it should be given a different meaning in subsection 284-255(1) to that given in subsection 262A(1).

The meaning of the phrase "Records kept by an entity …" in subsection 284-255(1) is critical as it provides the context within which paragraphs (a) to (d) of subsection 284-255(1) should be considered.

Relevance of Chapter V (Documentation) of the OECD Transfer Pricing Guidelines

Paragraph 12 states that "Sections 815-135 and 815-235 of the ITAA 1997 require the application of Subdivisions 815-B and 815-C of the ITAA 1997 in a way that best achieves consistency with the OECD Guidance material". This statement is arguably not consistent with either section 815-135 or section 815-235. Subsection 815-135(1) is as follows:

> "For the purpose of determining the effect this Subdivision has in relation to an entity, identify *arm's length conditions so as best to achieve consistency with the documents covered by this section." (emphasis added)

That is, it is *only* for purposes of identifying arm's length conditions that the OECD guidance material referred to subsection 815-135(2) is relevant and nothing more. The purpose of Chapter V (Documentation) of the OECD Transfer Pricing Guidelines is not about identifying arm's length conditions but about providing "general guidance for tax administrations to take into account in developing rules and/or procedures on documentation to be obtained from taxpayers in connection with a transfer pricing inquiry" (paragraph 5.1 of the OECD Transfer Pricing Guidelines). Subsection 815-235(1) is to similar effect.

If, contrary to the above, the ATO view is that Chapter V (Documentation) of the OECD Transfer Pricing Guidelines *is* relevant for purposes of identifying arm's length conditions, then the Professional Bodies request that a clear statement to this effect be included in the 'Ruling' part of the Draft Ruling and not in the 'What this ruling is about' part of the Draft Ruling.

Documentation requirements with respect to section 815-130

Paragraph 27 of TR 2014/D3 states that "In most cases, it is expected that the identification of the arm's length conditions will be able to be accomplished by applying the 'basic rule' and determining the arm's length contribution made by the Australian operations based upon the form and substance of the actual commercial or financial relations." In the Professional Bodies' view, this is the outcome that should apply in most cases. However, the Draft Ruling places an onerous, unreasonable and unrealistic documentary burden on taxpayers to try and convince the ATO that this outcome will actually result. This documentary burden results from paragraphs 38 and paragraphs 105-106 of the Draft Ruling which state the ATO's expectations in the following terms:

> "(A)n entity needs to prepare and maintain documentation to demonstrate that they addressed the steps involved in applying section 815-130 and identified arm's length conditions on the basis required by the section. The records will need to evidence whether the basic rule and the three exceptions apply or do not apply." (paragraph 38)

Further, paragraph 105 sets out a long list of things that taxpayers are required to document with a view to showing that they have had proper regard to section 815-130. Such requirements go far beyond the spirit and intent of the 'exceptional circumstances' situations described in paragraph 1.65 of the OECD Transfer Pricing Guidelines.

In the Professional Bodies' view, far more thought needs to be given to how the documentation burden associated with section 815-130 can be reduced before the Draft Ruling is finalised so that the position stated in paragraph 27 prevails and that taxpayers are able to satisfy the documentary requirements in section 284-255 without incurring disproportionate costs to document their transfer pricing outcomes.

Specific comments in relation to each draft guidance document are provided below.

SPECIFIC COMMENTS - TR 2014/D4 (Draft documentation ruling)

Senior ATO personnel have indicated that the ATO is cognisant of the compliance burden on small businesses arising from the new transfer pricing rules and draft guidance for documentation. It is therefore disappointing that the draft documentation ruling and draft documentation practice statement do not provide documentation concessions for small to medium businesses or entities with low risk or low levels of international related party dealings.

There are vague references throughout the draft documentation ruling to OECD "prudent business management principles", the exercise of "good judgement" and undertaking a "risk assessment" to assess the appropriate level of documentation, but the ruling should go further to ease the compliance burden of meeting section 284-255 requirements for small and medium businesses or those with low risk or low level dealings.

- In particular, the following recommendations are made in relation to paragraph 61:
  - The Commissioner's views on materiality should be located in the 'Rulings' and not 'Explanation' part of the Draft Ruling;
  - The meaning of a 'relevant' condition in the second sentence should be reviewed as it provides no additional limitation on the information to be documented by taxpayers over and above any limitation arising due to the meaning of the word 'material' in the context of a material condition. This is because every condition will be either relevant to the application or non-application of the transfer pricing rules;
  - The Commissioner should redefine the materiality of a "condition" to a dollar amount or threshold. It is suggested that this be set, at a minimum, to the same level as the $2m threshold for completion of Section A of the International Dealings Schedule with the threshold applying on an aggregated basis, that is, to all international related party dealings,. The last sentence does not provide helpful guidance as drafted because a $1 difference in taxable income will affect an entity's Australian tax position.
  - Further, it is considered that any documentation concessions should also apply to low value or low risk dealings, irrespective of the size of the taxpayer.
- Paragraphs 64, 66 and 67 should be located in the 'Rulings' and not 'Explanation' part of the Draft Ruling as these paragraphs contain important guidance as to how the ATO intends to interpret the record-keeping rules in section 284-255.
- There are references to taxpayers undertaking "risk assessments" in paragraphs 62 and 68 of the draft documentation ruling to assess the appropriate level of documentation for their transfer

pricing exposure. Guidance in relation to how taxpayers should do this needs to be provided. In particular, what factors / criteria should be taken into account in determining the level of risk?

- In relation to records and documentation being "prepared" and "kept" in order to be contemporaneous, the ruling should specify whether all elements of the documentation need to be in one place or just accessible to an entity.

- The ruling should clarify that, although documentation not prepared contemporaneously cannot be taken into account in determining whether the documentation requirements in section 284-255 have been met, documentation prepared post return lodgement may still be useful in that it will help to determine whether arm's length conditions apply, though not provide protection from penalties if they do not.

- Paragraphs 20 and 21 indicate that keeping documentation may reduce the risk of a transfer pricing audit or streamline risk assessment and audit activity. The draft documentation ruling needs to explain / elaborate on how documentation decreases the risk of an audit.

- In reference to paragraph 102 of the ruling, further guidance would be helpful in relation to application of the guidelines to dealings between non-associated entities and non-treaty cases.

- The evidentiary requirements of sections 815-130 and 815-140 are particularly onerous. The ruling states that an entity needs to prepare and maintain documentation to demonstrate that it has addressed the steps involved in applying section 815-130 and also if the modifications set out under section 815-140 apply, entities need to prepare and maintain documentation to demonstrate that they have appropriately applied section 815-140.

  Paragraph 105 of the ruling then goes on to list the steps involved in applying section 815-130 that need to be documented. These steps involve consideration and application of the basic rule and the application or non-application of the three exceptions. For simple transactions with no unique or high risk characteristics, an extensive analysis of the three exceptions should not be necessary. Overall, it is currently unclear how much further the ATO expects taxpayers to go in hypothesising what third parties would have done differently in structuring a comparable arrangement.

- In paragraph 130, further clarification of the documentation requirements for section 262A purposes would be useful. For instance, in the case of a cross border loan, will taxpayers need more than just the loan agreement and accounting records?

- Paragraphs 45 and 130 discuss the meaning of the term 'readily ascertained' in subsection 284-255(2). In paragraph 45, the Commissioner considers that for information to be 'readily ascertained', an entity must keep records that objectively enable the information as specified in subsection 284-255(2) to be quickly and easily understood. Further, in paragraph 130, the Commissioner considers that the information recorded in the documentation needs to enable an ATO officer with accounting skills to understand the essential features of the matter or matters. These paragraphs should be reviewed for the following reasons:

  - In relation to paragraph 45, whether information can be quickly and easily understood will often depend on the ATO officer's training and experience. This is even more so in the context of transfer pricing;

  - In relation to paragraph 130, the reference to "accounting skills" is not appropriate in the context of the transfer pricing rules and the associated record-keeping rules. Transfer pricing is not simply an exercise in accounting as it involves amongst other things the application of economic analysis, relevant industry knowledge and experience and the exercise of professional judgment. The ATO has specifically recognised this in PS LA 2013/2 (Provision of accredited economic advice) in relation to functions specifically allocated to the ATO's Economist Practice.

- Paragraph 48 also goes into the alternative conditions that need to be hypothesised, this appears to place a significant documentation burden on the taxpayer. Further guidance should be given as to the number of hypothesis. In addition the EM (3.102-3.103) provides some further guidance constraining the hypotheticals to be considered in relation to section 815-130(3), this should be specifically referenced in the ruling.

- Paragraph 127 states that the Commissioner is required, to the extent it is ascertainable, to attribute the arm's length conditions to the value of individual components for that part of the tax equation. We note that this paragraph is not included in the ruling itself and therefore, the Commissioner is not bound by it. We suggest that this paragraph form part of the Ruling (inserted after paragraph 51). Taxpayers who import goods from related parties need to satisfy the Australian Customs Service that any adjustments made by the ATO are properly referable to the relevant goods.

GENERAL COMMENTS - PS LA 3673 (Draft documentation practice statement)

The Draft Ruling sets out the Commissioner's views on the transfer pricing documentation an entity should keep in order to satisfy section 284-255. By way of contrast, the draft practice statement outlines a practical process for transfer pricing documentation to be followed by tax officers when undertaking a review of transfer pricing (paragraph 7). The five-step process is a process that is designed to assist tax officers to risk assess an entity's transfer pricing arrangements and to make judgements about whether further attention is warranted (eg escalation to a transfer pricing audit) (paragraph 9). Subject to our comments below, the outcome of tax officers applying the process described in the draft practice statement is not determinative of whether a taxpayer has satisfied the documentation requirements in section 284-255. In both a real and a practical sense, the answer to this question will ultimately be determined by the ATO at the time it issues or proposes to issue the taxpayer with an amended assessment based on applying the transfer pricing rules and in light of all the information available to the ATO at that time, not just the transfer pricing documentation provided by a taxpayer to the ATO at the time of a transfer pricing review.

Further, whether a taxpayer that has transfer pricing documentation satisfying the documentation requirements in section 284-255 also has a RAP is determined amongst other things by whether the taxpayer has had regard to 'relevant authorities' within the meaning of subsection 284-15(3) (see also paragraphs 79-80 of PS LA 3672). In this respect, a practice statement is not a relevant authority for purposes of subsection 284-15(3). More particularly, a practice statement is not a public ruling within the meaning of section 358-5 of Schedule 1 to the TAA 1953.

However, the draft practice statement states that the transfer pricing documentation requirements in section 284-255 will be met where an entity has made its best efforts to comply with the requirements having regard to the materiality of the matter to the entity's overall Australian tax position and that an entity's best efforts to comply with the transfer pricing documentation requirements will be demonstrated if the entity has contemporaneous records that document the five-step process (paragraphs 6, 11 and 13).

Further, the draft practice statement clearly envisages that taxpayers who contemporaneously document the five-step process will have made best efforts to comply with section 284-255 requirements and the documentation requirements would therefore have been met. The five-step process and the "best efforts to comply" concept are therefore highly relevant to taxpayers from the perspective of when the ATO will consider that they have met the requirements of section 284-255 and ultimately whether they have a RAP. However, as mentioned above, given that these matters are discussed in a practice statement which is not a 'relevant authority' for the purposes of Subsection 284-15(3) in determining whether an entity satisfies the general reasonably arguable position test in subsection 284-15(1), they are not matters that can be taken into account in determining whether a taxpayer has a RAP.

SPECIFIC COMMENTS - PS LA 3673 (Draft documentation practice statement)

- The Professional Bodies strongly support the ATO's efforts in trying to develop a practical solution to mitigate the onerous documentation requirements in section 284-255, however, it is imperative from a taxpayer's perspective that the Draft Ruling reflects the comments made in the practice statement on the five-step process and "best efforts". Specifically, we request the following statements (which appear in the practice statement at paragraphs 6, 11 and 13) also be inserted into the ruling part of the draft Ruling:

  > "The transfer pricing documentation requirements in section 284-255 will be met where an entity has made its best efforts to comply with the requirements having regard to the materiality of the matter to the entity's overall Australian tax position. An entity's best efforts to comply with the transfer pricing documentation requirements will be demonstrated if the entity has contemporaneous records that document the five-step process referred to in PS LA 3673"

- Unlike TR 98/11, there is no guidance as to the quality of the documentation which leaves it open for the ATO officers to make very subjective judgements as to whether the five-step process has been documented in accordance with the practice statement. It would be useful to provide criteria or examples, similar to the documentation quality criteria provided in TR98/11, to assist ATO officers in making assessments as to whether the five-step process has been documented in accordance with the Practice Statement.

- The practice statement makes no attempt to reconcile the four-step process and the new five step process. The ATO should clearly and precisely set out what additional work taxpayers need to do to comply with section 284-255, otherwise taxpayers are faced with the prospect of having to build documentation from scratch rather than building on existing documentation. Given that the message we are hearing from the ATO is that there should not be significant additional work required to comply with section 284-255, taxpayers would benefit from explicit guidance as to what new sections need to be drafted in their documentation reports – apart from section 815-130 / 140 analyses.

  For example, in relation to paragraph 30 of the draft practice statement, can the ATO provide examples as to the degree of documentation they expect taxpayers to have in terms of the nature and extent of the connection between commercial / financial relations and the actual conditions operating between parties?

- Please clarify the iterative process referred to in the last sentence of paragraph 20. An iterative process for steps 1 to 3 of the five step process does not make sense as the actual conditions in connection with the commercial or financial relations in step 1 do not / will not change.

- The draft practice statement seeks information over and above what is currently contained in local transfer pricing documentation reports, and often such information may not be in the custody or control of local subsidiaries. For example in paragraph 34, the ATO states that information pertaining to organisational structure, decision making systems and processes, and management performance systems and processes should be included in documentation. Information pertaining to the capital structure of the Australian operations in the context of the MNE global group, to the extent relevant, is also sought. Provision of this information represents a whole new set of onerous evidentiary requirements for taxpayers to comply with.

- Further, the practice statement needs to clarify that the legislation relates to arm's length conditions that operate between an entity and another entity, that is, between the Australian taxpayer and its foreign counterpart. While the ATO may wish to obtain other global information, it is not a legislative requirement for documentation to comply with the relevant requirements set out in the Practice Statement.

- Further guidance / clarification is required on the commentary in paragraphs 41 and 42 in relation to joint ventures and similar arrangements, that is, where taxpayers may not have rights to or access to all information required.