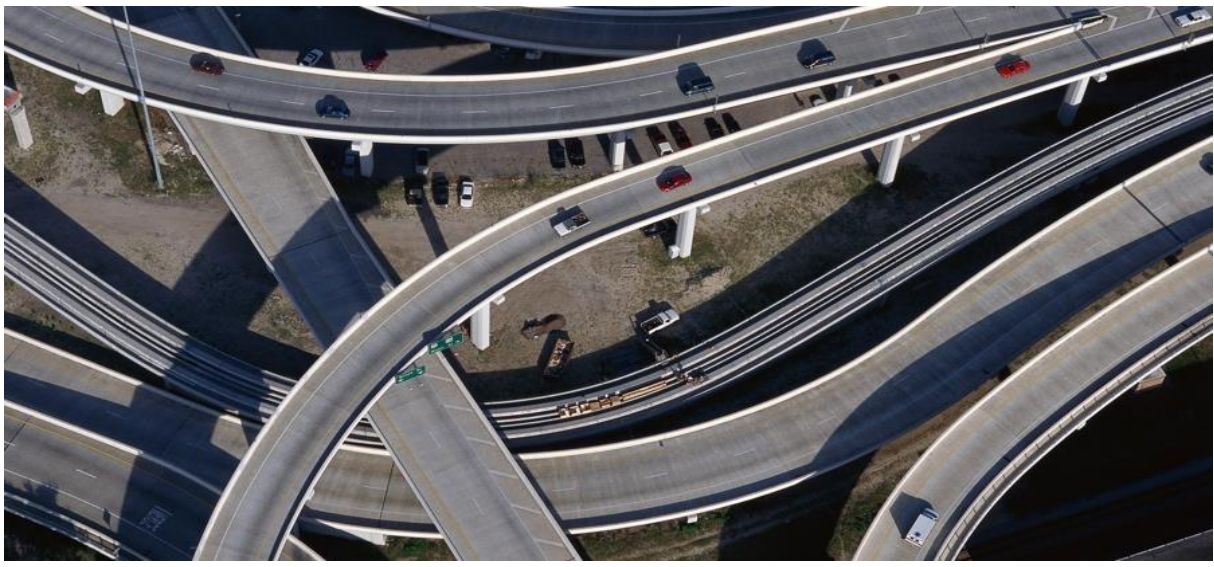
Deloitte.

14 November 2014

Tax insights

Final guidance on the ATO's controversial transfer pricing 'reconstruction' powers



Two days before G20 leaders gather in Brisbane to address multinationals' tax avoidance, Taxation Ruling TR 2014/6 has been released, representing the Commissioner of Taxation's guidance on the application of section 815-130 of the Income Tax Assessment Act 1997 (ITAA 1997).

The ruling drives home Australia's message that it is taking a tough stand against multinationals' base erosion and profit shifting activities, and that the Australian Taxation Office (ATO) will use its strong and wide-ranging powers to challenge such activities.

Overview of the reconstruction provisions

Section 815-130 ITAA 1997 is often referred to as the 'reconstruction' provision, as it provides the Commissioner with wide powers to reconstruct actual transactions undertaken by Australian taxpayers. Such 'reconstruction' may result in transfer pricing adjustments being made on the basis of how independent parties would hypothetically have dealt with one another, as well as where the form of actual commercial or financial relations between Australian taxpayers and their international affiliates is inconsistent with the substance of those relations.

TR 2014/6 also addresses the interaction of Sections 815-130 and 815-140 ITAA 1997. The ruling confirms that Section 815-140 requires the arm's length interest rate on inbound intra-group debt to be applied to the debt actually issued, rather than to the arm's length amount of debt – though this arm's length debt amount is important in determining the applicable interest rate

Deloitte comments

Disappointingly, TR 2014/6 does little to allay taxpayers' concerns about the ATO's ability to reconstruct Australian taxpayers' cross-border related party transactions and creates uncertainty about how and when the reconstruction provisions will apply.

In particular, the tone of TR 2014/6 does not align with that of the OECD Transfer Pricing Guidelines' sections dealing with the recognition of actual transactions undertaken. These sections of the OECD Guidelines make it explicitly clear that, other than in 'exceptional circumstances', tax administrations should not disregard actual transactions or substitute other transactions for them. TR 2014/6 adopts a different – that is, very wide ranging – interpretation of when the reconstruction provisions will apply.

With the finalisation of ATO guidance on the reconstruction provisions, the concern from taxpayers is that these rules will encourage ATO auditors to second-guess business decisions. This takes us into a space fraught with guesswork, where the ATO will be hypothesising about what would have happened in the real world.

Taxpayers fear that ATO auditors will ask the question: "why did you do it like that?", and answer it with "you could have made more profits if you'd done it like this, so that's what an independent party would have done and that's what we'll be taxing you on". The concern here is the tension that will arise if and when the ATO tries to tell taxpayers how to run their businesses, bringing with it the inevitable potential for differing views, greater disputes, and unrelieved double taxation.

What should taxpayers do in response to TR 2014/6?

Section 815-130 is a wide ranging and uncertain provision, and taxpayers need to be mindful when implementing, analysing and documenting their transfer pricing arrangements that the section's requirements for reconstruction are not met. Importantly, taxpayers should be aware that the reconstruction provisions can apply to arrangements implemented before the provisions' introduction, if relevant arrangements affect an Australian tax position in a year covered by the new transfer pricing rules.

Further, with Australia's transfer pricing rules being brought into the self-assessment regime, the reconstruction provisions are not reserved for just the ATO to apply. Accordingly, taxpayers need to prepare and maintain documentation to demonstrate that they have addressed the steps involved in applying section 815-130. This imposes additional – and potentially significant – compliance obligations on taxpayers, beyond those required under the previous transfer pricing rules in Division 13 of the Income Tax Assessment Act 1936.

In addressing sections 815-130 and 815-140 ITAA 1997, taxpayers should:

- Ensure pricing policies with international affiliates reflect the underlying substance of the parties' commercial or financial relations, and that such relations are consistent with those that would have been entered into by independent entities in comparable circumstances
- Undertake and document regular reviews confirming whether their operating models are consistent in practice with the form of their legal arrangements, and evaluate and document what independent parties would have done in similar circumstances. The reconstruction provisions do not require related parties to choose options that

have the highest tax outcomes, but the commercial thinking behind why such options were considered and rejected should be documented

- In relation to inbound, intra-group debt, prepare and maintain documentation to demonstrate that section 815-140 has been appropriately applied (i.e. supporting both the arm's length quantum and pricing of inbound intra-group debt). This will require a detailed analysis of intra-group loans' terms and conditions
- Consider preparing Reasonably Arguable Position papers on the application of the reconstruction provisions to transactions with material transfer pricing risks – e.g. significant business restructures (especially where they lead to lower profits and tax in Australia) and material financing transactions.

Contacts

For more information, please contact

Cam Smith
Partner
+61 (3) 9671 7440
camsmith@deloitte.com.au

Fiona Craig
Partner
+61 (2) 9322 7770
ficraig@deloitte.com.au

Jacques van Rhyn
Partner
+61 (8) 9365 7122
jvanrhyn@deloitte.com.au

John Bland
Partner
+61 (7) 3308 7275
jbland@deloitte.com.au

For further information, visit our website at www.deloitte.com