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Global Transfer Pricing

Contacts:

Cam Smith
camsmith@deloitte.com.au

Fiona Craig
ficraig@deloitte.com.au

Jacques van Rhyn
jvanrhyn@deloitte.com.au

John Bland
jbland@deloitte.com.au

Australia Issues Final Guidance on ATO's Controversial Transfer Pricing Reconstruction Power

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The Australian Taxation Office on November 12 issued a ruling that grants the Commissioner of Taxation broad powers to "reconstruct" transactions undertaken by Australian taxpayers if they are deemed not to have occurred at arm's length.

The timing of the release -- two days before the G20 leaders gather in Brisbane to address multinational companies' tax avoidance -- drives home Australia's message that it is taking a tough stand against multinationals' base erosion and profit shifting activities, and that the ATO will use its strong and wide-ranging powers to challenge such activities.

Overview of reconstruction provisions

Taxation Ruling TR 2014/6 represents the Commissioner's guidance on the application of section 815-130 of the Income Tax Assessment Act 1997 (ITAA 1997). Section 815-130 is often referred to as the reconstruction provision, because it gives the Commissioner broad 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 hypothetically would have dealt with one another, and when 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 intragroup debt to be applied to the debt actually issued, rather than to the arm's length amount of debt – although this arm's length debt amount is important in determining the applicable interest rate.

The ruling applies to income years commencing on or after 29 June 2013.

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 it gives rise to uncertainty about how and when the reconstruction provisions will apply.

The tone of TR 2014/6 In particular does not align with that of the OECD transfer pricing guidelines' sections on the recognition of actual transactions. Those 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 – and wide-ranging – interpretation of when the reconstruction provisions will apply.

The finalization of ATO guidance on the reconstruction provisions gives rise to taxpayer concerns that the rules will encourage ATO auditors to second-guess business decisions. This is an area fraught with guesswork, where the ATO will hypothesize what would have happened in the real world.

Taxpayers fear that ATO auditors will ask: "Why did you do it like that?", and answer that "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." Tension may 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 number of 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 should be mindful when implementing, analyzing, and documenting their transfer pricing arrangements that the section's requirements for reconstruction are not met.

It is important for taxpayers to 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 only for the ATO to apply. Taxpayers must 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 that pricing policies with international affiliates reflect the underlying substance of the parties' commercial or financial relations, and that those 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, intragroup debt, prepare and maintain documentation to demonstrate that section 815-140 has been appropriately applied (supporting both the arm's length quantum and pricing of inbound intragroup debt). This will require a detailed analysis of intragroup loans' terms and conditions.
- Consider preparing Reasonably Arguable Position papers on the application of the reconstruction provisions to transactions with material transfer pricing risks, such as significant business restructurings (especially when they lead to lower profits and tax in Australia) and material financing transactions.

The ATO's ruling may be found at **http://law.ato.gov.au/atolaw/view.htm?docid=%22TXR%2FTR20146%2FNAT%2FATO%2F00001%22.**

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