TR 2014/8EC - Compendium

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Draft Ruling Compendium – TR 2014/8

This is a compendium of responses to the issues raised by external parties to draft TR 2014/D4 *Income tax: transfer pricing documentation and Subdivision 284-E*.[1]

This compendium of comments has been edited to maintain the anonymity of entities that commented on the draft ruling.

Summary of issues raised and responses

Issue No.	Issue raised[2]	ATO Response/Action taken[3]
1	**General record keeping requirements** In light of the above [about section 262A of the *Income Tax Assessment Act 1936* (ITAA 1936)], 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.	While the final Ruling does provide guidance on the interactions between section 262A of the ITAA 1936 and Subdivision 284-E, it deals with the documentation requirements in Subdivision 284-E. Accordingly, providing guidance on the records needed to satisfy section 262A of the ITAA 1936 is considered to be outside the scope of the final Ruling.
2	**OECD developments** Given the significant developments at an international level in relation to transfer pricing as part of the OECD action plan on Base Erosion and Profit Shifting, it may be premature to provide guidance on the documentation requirements.	The final Ruling provides guidance in respect of the documentation requirements under Australia's transfer pricing rules.

[1] All legislative references are to the Schedule 1 of the *Taxation Administration Act 1953* (TAA) unless otherwise indicated.
[2] All references to the draft Ruling are to TR 2014/D4.
[3] All references to the final Ruling are to TR 2014/8.

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3	**The meaning of the word 'kept'** 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 …'. 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. As to whether documentation is 'kept' by the taxpayers, somewhat greater guidance is required in circumstances where that documentation is 'available' to the taxpayer but held by the parent company overseas. We submit that for the Public Officer to sign the required 'true and correct' declaration of an income tax return, unless 'immaterial', he or she must personally have perused that documentation and satisfied him or herself that it accords with Australia's legislative requirements.	See the final Ruling.
4	**OECD guidance material** Paragraph 12 of the draft Ruling 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 of the ITAA 1997. Subsection 815-135(1) of the ITAA 1997 is as follows: > For the purpose of determining the effect this Subdivision has in relation to an entity, <u>identify *arm's length conditions</u> so as best to achieve consistency with the documents covered by this section. (emphasis added)	See the final Ruling. Given that the final Ruling deals with transfer pricing documentation, the practical application of the transfer pricing rules is considered to be beyond the scope of the final Ruling. However, the same principles will apply in determining whether or not an entity gets a transfer pricing benefit in non-treaty and non-associated entity cases.

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4 cont.	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. In reference to paragraph 102 of the draft Ruling, further guidance would be helpful in relation to application of the guidelines to dealings between non-associated entities and non-treaty cases.	
5	**Section 815-130** Paragraph 38 of the draft Ruling in relation to section 815-130 of the ITAA 1997 states that: > The records will need to evidence whether the basic rule and the three exceptions apply or do not apply. This appears to put a large onus on the taxpayer to go through the three exceptions when it is acknowledged that the basis rule will typically apply (paragraph 27 of TR 2014/D4) and exceptions should only apply in exceptional cases (and OECD paragraph 1.64-1.69). There needs to be further guidance and clarification to limit the documentation burden on when the exception in section 815-130 of the ITAA 1997 need to be considered and to what level of detail they need to be documented. This is also referred to in the steps set out in paragraph 105 and paragraph 106 of the draft Ruling and likewise should be reconsidered.	The final Ruling clarifies the matters raised.

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6	**Compliance burden** 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 Ruling and PS LA 3673[4] do not provide documentation concessions for small to medium businesses or entities with low risk or low levels of international related party dealings.	Refer to the Simplification Options.
7	**Materiality** Paragraph 61 of the draft Ruling states: A condition is material if it affects the entity's Australian tax position. We submit that paragraph 61 requires serious attention and should ideally refer one back to accounting concepts or a specific dollar value (as to what is or is not 'material'). We further suggest that paragraph 61 also appears to conflict with PS LA 3673 (refer paragraphs 6, 11, et al) where the term 'materiality' appears to have been somewhat better considered (albeit in want of further clarification). Paragraph 61 also appears to conflict with paragraphs 66 and 67 insofar as OECD Guidelines dealing with documentation expectations, are restated and the suggestion put that taxpayers should exercise '…good commercial judgement in determining the level of documentation …'	See final Ruling. Further principles-level guidance on 'materiality' is provided. Practical guidance on what is 'material' can be found in the Appendix 2 of the final Ruling. These concepts have been superseded in the final Ruling.

[4] Draft Law Administration Practice Statement PS LA 3673 *Guidance for transfer pricing documentation*.

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7 cont.	Under the third sentence in paragraph 61 of the draft Ruling all conditions are material because all they need to do is affect the Australian tax position. This gives no real margin of materiality. The 'best efforts', 'materiality', and 'reasonable business person' concepts outlined in the explanations sections of PS LA 3673 and the draft Ruling should be brought into the rulings section of the final Ruling so that they can be considered for the purposes of determining whether an entity has a reasonably arguable position (see comments under PS LA 3672).[5]	
8	**Risk** The draft Ruling needs to explain / elaborate on how documentation decreases the risk of an audit (paragraphs 20 and 21 indicate that keeping documentation may reduce the risk of a transfer pricing audit or streamline risk assessment and audit activity) Paragraphs 64, 66 and 67 of the draft Ruling should be located in the 'Rulings' and not 'Explanation' part of the final Ruling as these paragraphs contain important guidance as to how the ATO intends to interpret the record-keeping rules in section 284-255. The draft Ruling makes references to taxpayers undertaking 'risk assessments' to assess the appropriate level of documentation (paragraphs 62 and 68 of the draft Ruling). The final Ruling needs to provide some guidance in relation to how taxpayers do this. Specifically, what factors are relevant to a taxpayer determining the level of risk for the purposes of assessing the appropriate level of documentation?	See final Ruling. Also, please refer to the Simplification Options. As regards the practical matter of risk assessment, the following is observed: Section 284-255 codifies the records to be kept by an entity for the application (or non-application) of Subdivisions 815-B and 815-C. In a self-assessment regime, this is a matter of risk assessment for each entity. From a practical perspective, to the extent that an entity contemporaneously records the application (or non-application) of these subdivisions year by year and that record explains what was done, including all relevant and material differences or changes with reference to the arm's length conditions from the previous year, it may mitigate the risk of failing to comply with section 284-255.

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

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8 cont.	Guidance should be provided on the parameters the ATO would expect to be considered in assessing transfer pricing risk, such as materiality, guidance on the types of transaction the ATO considers to be particularly high (or low) risk, and profitability measures the ATO expects to be considered (for example, a comparison with the profitability of industry peers). The risk assessment process referred to in paragraph 68 of the draft Ruling is somewhat of a 'catch 22' comment as far as SMEs are concerned because their risk assessment will be driven by their expectations of how they will be treated by the ATO in any reviews. In our view, there needs to be some buy in from the ATO in the draft Ruling on this point – it should not be completely the taxpayer's call.	
9	**Documentation not contemporaneous** The final 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.	Agreed.
	Readily ascertained Paragraphs 45 and 130 of the draft Rulig discuss the meaning of the term 'readily ascertained' in subsection 284-255(2). 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;	Agreed and clarified. It is noted that 'readily ascertained' should be read in the context of subsection 284-255(1).

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10 cont.	- 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[6] in relation to functions specifically allocated to the ATO's Economist Practice.	
11	**Alternative conditions** Paragraph 48 of the draft Ruling goes into the alternative conditions that need to be hypothesised. This appears to place a significant documentation burden on the taxpayer.	The law requires a hypothesis which goes to the heart of the statutory tests (Subdivisions 815-B and 815-C of the ITAA 1997 – identifying arm's length conditions based on what independent parties would have done). Entities are not compelled to include and document every alternative condition in any hypotheses, just conditions that are part of realistically available options. Refer TR 2014/6.[7]
12	**Components of the tax equation** Paragraph 127 of the draft Ruling 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 that form part of the tax equation.	Given that this point does not relate to documentation itself, it is considered to be outside the scope of the Ruling.

[6] Law Administration Practice Statement PS LA 2013/2 *Provision of accredited economic advice*.
[7] Taxation Ruling TR 2014/6 *Income tax: transfer pricing - the application of section 815-130 of the Income Tax Assessment Act 1997*

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12 cont.	We note that this paragraph is not included in the legally binding section 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.	Furthermore, consultation arrangements dealing with interactions with Customs on importation are being held currently as part of a separate process.
13	**Substitution of arm's length conditions** The final Ruling should ensure that there is a very unambiguous statement that taxpayers should add back to assessable income any self-assessed adjustment they may determine to ensure actual conditions align with arm's length conditions.	This matter involves the practical application of the transfer pricing rules rather than documentation and Subdivision 284-E. As a result, the matter raised is considered to be beyond the scope of the final Ruling.
14	**Reasonably arguable position** It would be helpful if there was further guidance around the circumstances where it will be difficult for a taxpayer to achieve a reasonably arguable position so that taxpayers focus on ensuring that these circumstances are addressed.	This matter is considered to be outside the scope of the final Ruling. The tests to be applied in determining whether a taxpayer has a reasonably arguable position are discussed in MT 2008/2.[8]

[8] Miscellaneous Taxation Ruling MT 2008/2 *Shortfall penalties: administrative penalty for taking a position that is not reasonably arguable*.

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15	**Application of transfer pricing rules** An additional area where taxpayers would benefit from further clarification is situations where the ATO would utilise the new rules as an integrity measure in terms of the interaction between an entity's overall profitability and its withholding tax obligations. For example, where selective/artificial allocation of expenses items are made to achieve a more favourable withholding tax outcome, whilst maintaining the same level of overall arm's length profitability (that is, increasing expenses that are not subject to withholding tax and decreasing expenses that are subject to withholding tax).	See Issue 13 of this Compendium.
16	**Integration of the guidance documents** Although TR 2014/D4, PS LA 3672 and PS LA 3673 are intended to be read together, the links between these documents are not clearly explained. There needs to be a better integration of the guidance in these documents, particularly between TR 2014/D4 and PS LA 3673 (for example, there is no explanation of where a taxpayer's analysis of section 815-130 of the ITAA 1997 should be considered within the 5 step process).	See final Ruling. Please note that PS LA 3673 is now contained in Appendix 2 of the final Ruling.

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17	**Reconciling the old, new and future documentation requirements** Given that taxpayers are faced with two significant changes in transfer pricing documentation requirements within a short space of time (with the introduction of the new Australian rules and further changes likely to follow soon thereafter when the OECD's new transfer pricing documentation guidance is finalised), the ATO should provide clear guidance to taxpayers on the differences between the new requirements under section 284-255 and the previous guidance on the 4 step process in TR 98/11,[9] and, in due course, guidance on the differences between the Australian requirements and the new OECD requirements. This will help taxpayers to better understand how their existing documents can be adapted to meet the new requirements rather than imposing the burden of preparing new documents from scratch.	See Issue 8 of this Compendium.
18	**Clarification of paragraph 28** Paragraphs 27 and 28 of the draft Ruling deal with what the records should demonstrate to show the conditions are consistent with the arm's length principal and that: ..there were no material differences between actual and comparable circumstances or that accurate and reliable adjustments were made to neutralise any differences. Paragraph 815-125(2)(d) of the ITAA 1997 refers to the 'reliability of any adjustments to eliminate the effect of material differences…' implying that the difference has to be material before you need to adjust, the wording in paragraph 28 as set out above implies that this could be wider '…to neutralise any differences.' This should be changed by adding the word 'material' before differences.	Agreed. See paragraph 40 of the final Ruling.

[9] Taxation Ruling TR 98/11 *Income tax: documentation and practical issues associated with setting and reviewing transfer pricing in international dealings*.

Issue No.	Issue raised[2]	ATO Response/Action taken[3]
19	**Clarification of paragraph 121** Paragraph 121 of the draft Ruling states that the records not only need to explain the application of the transfer pricing rules, but that the records must also explain the result of the application and compare this to the result of the actual conditions. This needs to be clarified that this is only required if the taxpayer considers the actual conditions to be different to the arm's length conditions.	Paragraph 121 of the draft Ruling was not included in the final Ruling. See paragraphs 107 to 115 of the final Ruling.
20	**Simplification** The ATO has acknowledged that the compliance burden of meeting section 284-255 requirements on small businesses and entities with low level transactions may be onerous. We are aware of the simplification measures currently being considered by the ATO, however, we would like to see something in the final Ruling addressing this point. Specifically, we are of the view that the final Ruling should stipulate a dollar amount in respect of the materiality of a condition in paragraph 61 of the draft Ruling. In this respect, we support the suggestion that this be set at a minimum level of $2 million to reflect the threshold amount for completion of Section A of the International Dealings Schedule. Such a concession would go some way to easing the compliance burden of meeting section 284-255 requirements for small and medium businesses or those with low level dealings. We submit that the draft Ruling in its current form provides little guidance to the middle market - to be useful to the middle market it is crucial that the ATO explains exactly what (if anything) it expects middle market taxpayers to now do under section 284-255 over and above: • The transfer pricing risk review process for small to medium businesses under the simplified approach to compliance outlined in chapter 6 of TR 98/11, and	This is considered to be outside the scope of the final Ruling. Refer Simplification Options.

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20 cont.	• The existing 'simplified approach to documentation and risk assessment for small to medium businesses' set out on the ATO website. In this regard, we welcome the ATO's agreement with the recommendation made by the Inspector-General of Taxation in its 'Review into the Australian Taxation Officer's management of transfer pricing matters', that the ATO 'provide simplified transfer pricing documentation requirements for taxpayers with international transactions valued below for example $15 million'. We submit however, that the ATO should also consider providing a short pro-forma document on its website that small to medium businesses could fill in and which would ask taxpayers to complete the questions that the ATO believes will provide the crucial 'bare minimum' to satisfy the ATO that the taxpayers have documented their transfer pricing policies and practices.	
21	**Status of TR 1999/1**[10] It is important that the ATO explains in the final Ruling whether it expects taxpayers to undertake a detailed analysis and documentation process if they are following the guidelines set out in TR 1999/1 for intra-group services. In particular, to satisfy section 284-255 do taxpayers need to do anything more than just continue to apply and document the 'mark-ups' they are currently using for such services?	TR 1999/1 remains in effect until such time it is withdrawn or superseded via the publication of new guidance. Entities will need to be aware that TR 1999/1 does not apply for the purposes of the application (or non-application) of Subdivisions 815-B and 815-C of the ITAA 1997.

[10] Taxation Ruling TR 1999/1 *Income tax: international transfer pricing for intra-group services*.