Chapter 7

Taxation of Multinationals
OECD Guidelines and the Rule of Law

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Perhaps you thought that the problem of taxing multinationals was only a recent thing. If you did, you would be mistaken. In Philip Ayres' splendid biography of Sir Ninian Stephen, there is contained a photograph of Sir Ninian, and that other great titan of the Victorian Bar, Sir Keith Aickin, at a restaurant in New York City in March 1962. They were dining – well, it would seem, with their client. Stephen was still a junior. He had been briefed with Aickin, QC, to represent Vacuum Oil in a forthcoming transfer pricing tax case. Ayres records that this was Stephen's first trip overseas since the war. They "flew out of Sydney", he relates, "on a Pan American 707, first class with all expenses paid, for San Francisco and on to New York . . ." This, I should add, regrettably no longer occurs – unless you are a Sydney silk.

The transfer pricing case was subsequently heard in the Taxation Board of Review, and is reported as 11 CTBR (NS) Case 53. It concerned the correct pricing of oil sold by the parent to its subsidiary in Australia. As you would expect, Aickin and Stephen were victorious. The series of Vacuum Oil and Mobil Oil tax cases of the early 1960s established, according to Ayres, Stephen's reputation as a junior of note.

Stephen had to wait some time before considering again the transfer pricing provisions of the *Income Tax Assessment Act* 1936 (Cth) (the ITAA). In 1980, the High Court of Australia heard and determined *FCT v Commonwealth Aluminium Corporation Ltd* (1980) 143 CLR 646. By then, Stephen was a justice of the High Court. So was Aickin who, interestingly, did not sit on the appeal. The resulting loss to the Commonwealth came as a great shock. The old transfer pricing provisions were consequently repealed and replaced with a new Division 13 in 1982.

As we shall see, it took another 25 years before the occurrence of the first Australian case concerning these new rules. Then, between 2005 and 2015, the level of activity increased substantially. Five cases were reported. Division 13 was effectively replaced by new and different rules contained in subdiv 815-A – with retrospective effect, and then Subdivision 815-A was itself within a year supplanted by another new regime contained in subdiv 815-B.

With each legislative change, the rule of law, it might be argued, eroded in two ways; by the enactment of very retrospective laws, and by adoption of "guidelines" published by the Organization for Economic Co-operation and Development (OECD) as part of the means of ascertaining the liability to tax. But to understand these potential erosions, we must first survey what has happened over the last 10 years.

Taxing multinationals – an overview

There are really three topics of importance in considering how to tax multinationals who carry on business in Australia.

The first concerns transfer pricing and what is called the "arm's length principle". This requires an Australian business which purchases goods or services from its parent or overseas

related company to pay an arm's length price. It also requires the Australian business to be paid an arm's length price for services or goods it may supply to its parent or related overseas company. The principle is very easy to articulate and thus appears attractive. But in practice it is almost unworkable.

The second concerns the level of debt an Australian business is allowed to have. Most countries, including Australia, allow businesses to deduct interest outgoings on loans used to fund income producing activities, but not deduct dividends paid as the cost of raising equity. To prevent an overseas parent from "loading up" its Australian subsidiary with deductible debt, many countries, again including Australia, have what are called "thin capitalisation" rules. These prescribe, amongst other things, a maximum debt to equity ratio. If the ratio is exceeded, interest deductions are disallowed.

The third concerns the location of a business. Traditionally, multinationals have incorporated wholly-owned subsidiaries in Australia to undertake their local businesses. Sometimes, they create large and complex corporate groups here. But, in recent times, and depending on the industry, the need to do so has declined. Using the internet, Australians are able to acquire goods and services from entities that are non-residents who have either no or not much physical presence in Australia. The consideration that is paid for those goods and services flows overseas and is usually not taxed here. The issue for the regulator is whether the overseas entity, by reason of its activities in Australia, has nonetheless created what is called a "permanent establishment" – a local place of business – which Australia can tax.

Complicating all of these topics is the inexorable fact that the overseas parent and the related companies will almost always be residents of other countries. Very often, they, or at least their parent, will be a resident of a country with the same taxing ambitions as Australia. For example, the United States, in general terms, taxes the world-wide income of a resident corporate taxpayer as well as all of the income of its subsidiaries, regardless of where they are located. A credit is then normally given for any tax paid overseas. Australia has a similar system with its controlled foreign company or "CFC" rules. These systems often clash. Double Tax Treaties, entered into by sovereign countries, exist to prevent such conflicts, but these are ceasing to be as effective as they once were because the international competition for revenue is now so acute. (The OECD has reported an increase in unresolved disputes between countries: http://www.oecd.org/ctp/dispute/map-statistics-2013.htm)

The "arm's length principle"

In this paper, I wish to focus on the first topic and its impact on the rule of law. Let me commence with two observations.

First, the "arm's length principle", which Australia's transfer pricing laws adopt, is derived from an internationally accepted standard. This is explained in the Explanatory Memorandum that accompanied the enactment of Division 13 in 1982 (by the *Income Tax Assessment Amendment Act* 1982). It states:

> Once the initial tests in the revised provisions, referred to earlier, permit the Commissioner to make adjustments to an item of income or deduction shown in a taxpayer's return, and the case is one where it is appropriate for the Division to apply, the Commissioner will be required to re-determine the taxpayer's assessable income or allowable deductions, basically

> by using the internationally accepted 'arm's length' principle, a principle relevant under existing section 136. The arm's length principle is also at the base of provisions in each of Australia's comprehensive double taxation agreements that enable the determination of profits attributable to business activities in one or other of the countries concerned.

In 1979 the OECD published guidelines entitled "Transfer Pricing and Multinational Enterprises". The names of the author or authors of the report are not disclosed, although we do know that it was negotiated by representatives of the 24 member countries in Paris, and that it was adopted by the Committee on Fiscal Affairs and then approved by the Council of the OECD. The Guidelines are 96 pages long. They affirm the centrality of the "arm's length" principle and set out suggested methodologies for pricing. The importance of these guidelines will be revealed shortly.

Secondly, whilst representatives of sovereign governments continue to affirm the validity of the "arm's length" principle, in reality it has been found to be a poor means of determining one's liability to pay tax. First, transactions which regularly occur between related parties often do not take place between unrelated parties for perfectly sound commercial reasons. For these, there is no readily identifiable "arm's length price". Secondly, transfer pricing has become a game played by professional experts, with the taxpayer and the revenue authority invariably able to find an "expert" or "experts" to support each side's pricing. In the United States, there are dozens of professional experts who travel the world giving evidence in tax cases. When they do, the principles of economic theory invariably clash with the standards of the lawyers. Good money is also being earned even before a given price is disputed by the revenue. Every year the major accounting firms earn handsome profits by the production of long – often very long – valuation reports to support pricing positions taken by taxpayers.

We then leave it to the judges to decide the issue of price if a dispute does not earlier settle. But lawyers are not necessarily well qualified to determine which economic expert should be preferred. Sometime this has led to remarkable confusion. *Xilinx Inc v Commissioner* illustrates the problem. In that case the Internal Revenue Service of the United States challenged the pricing of a cost allocation agreement entered into by a US parent and its Irish subsidiary under the American transfer pricing rules. The US Tax Court upheld the taxpayer's position. There was an appeal. On 27 May 2009, the 9th Circuit of the US Court of Appeals reversed the decision below (567 F.3d 483 (2009)). Then, remarkably and without comment, on 22 March 2010 the Court reversed itself. It withdrew that "opinion" and issued a new one in replacement of the old. This time the decision below was upheld (2010 US App. LEXIS 5795).

The Australian experience so far

Something should be said about old Division 13 and the cases concerning it. Its provisions were satisfied upon the presence of certain objective conditions. One of these was the Commissioner being satisfied that the parties to a supply of goods and services had not dealt with each other at arm's length. Another was the making by him of a determination that the provision should apply. In other words, the provision is not self-executing. But the most important condition was this:

> the taxpayer gave or agreed to give consideration in respect of the acquisition and the amount of that consideration exceeded the arm's length consideration in respect of the acquisition.

(An equivalent provision was enacted for cases where the Australian taxpayer was the vendor of goods and services.)

The key term in this condition is the phrase, "arm's length consideration". It was defined relevantly in former s 136AA(3)(d) which provided:

> (3) In this Division, unless the contrary intention appears:
> . . .
> (d) A reference to the arm's length consideration in respect of the acquisition of property is a reference to the consideration that might reasonably be expected to have been given or agreed to be given in respect of the acquisition if the property had been acquired under an agreement between independent parties dealing at arm's length with each other in relation to the acquisition; . . .

Plainly, the definition invites us to contemplate a hypothetical transaction between two independent parties, but who are those parties to be? In some cases it may not matter. But in others the economic and legal personality of the hypothetical vendor and purchaser may impact upon pricing. The most obvious example is the provision of financial accommodation. The quantum of the interest payable is affected by the credit worthiness of the borrower who is the taxpayer. Who should the borrower be in the hypothetical transaction? Should it be attributed with the actual assets and liabilities of the taxpayer? Should its credit worthiness include any enhancement that might arise from the fact that it is a member of a larger multinational? Or should one try and find the usual credit profile of participants in the same industry, if any exist. The legislation offers no guidance; the "arm's length principle" offers even less.

These issues become more complex if, as the Commissioner of Taxation presently contends, he is allowed not only to adjust the price paid for goods and services and the terms upon which those goods and services are supplied, but also to change both the amount supplied, and the thing supplied. This contention – commonly described as a "reconstruction" power – would, if accepted, expand dramatically the content of the hypothetical transaction to be priced. It would give the Commissioner a blank slate from which to tax, and would permit him to reverse that long accepted observation of Williams J in *Tweddle v FCT* 180 CLR 1:

> It is not suggested that it is the function of income tax Acts or of those who administer them to dictate to taxpayers in what business they shall engage or how to run their business profitably or economically. The Act must operate upon the result of a taxpayer's activities as it finds them.

To permit taxation by reference to such a wide-ranging fiction, conceived of by the regulator years after the actual impugned transaction has been entered into, raises in itself issues about the rule of law in this country.

Syngenta Crop Protection Pty Ltd v Commissioner of Taxation

A short survey of the five Australian cases concerning these provisions is now required. The first case is *Syngenta Crop Protection Pty Ltd v Commissioner of Taxation* (2005) 61 ATR 186. It neatly illustrates two features of early transfer pricing litigation in this country; first, the quality of the Counsel that appear; and, secondly, the attempt made in the early years by taxpayers to attack the procedures adopted by the Commissioner in assessing the taxpayer, rather than by defending the

price paid. The former feature is noteworthy. It shows that even with the best Counsel, the system still ended up in quite a mess.

The second feature is exemplified by *Syngenta* itself which was a dispute over a request for particulars and not a full trial. The taxpayer wanted to attack the way in which the Commissioner had formed his state of satisfaction that the parties had not dealt with each other at arm's length. He wanted more details about how he became to be so satisfied. *Syngenta* was represented by D. H. Bloom, QC, perhaps Australia's most famous tax silk, with two juniors. The Commissioner was represented by B. J. Shaw, QC, of the Victorian Bar, long regarded as the most intelligent barrister of his day. He led M. M. Gordon, SC, now Justice Gordon of the High Court, and J. Davies, SC, now Justice Davies of the Federal Court. Gyles, J, threw the taxpayer's application out in an *ex tempore* judgment, much to the great surprise of those in Court. With some confidence his Honour observed:

> The question as to whether the consideration is that which might reasonably be expected to have been received or receivable as consideration in either a supply or acquisition if the property had been supplied or acquired under an agreement between independent parties dealing at arm's length is an objective question. It does not depend upon anybody's opinion, save that of the Court or body making that decision. It is a matter for evidence. In cases such as the present, the taxpayer is very much better equipped to cope with such a question than the Commissioner, the taxpayer being in the trade itself. Furthermore, the burden of showing that the consideration nominated by the Commissioner is excessive or inadequate as the case may be is not, in my view, a very high burden as it is to be decided on the balance of probabilities. I am not suggesting that the factual question may not be difficult and may not involve contestable questions of fact, but they are the types of questions with which courts commonly deal. I can see no disadvantage to a taxpayer in addressing itself to that issue. If this is correct, it renders irrelevant almost all of the contentions in the submissions before me which have complicated these matters.

As it happens, in my experience, and with great respect to his Honour, taxpayers are usually in no better position than the Commissioner in pricing what are hypothetical transactions, which usually have no real equivalents in "trade." Moreover, the types of factual questions raised in these cases have – so far at least – been far from commonly encountered.

W. R. Carpenter Holdings Pty Ltd v FCT

The second case (*W R Carpenter Holdings Pty Ltd v FCT* (2006) 234 ALR 45) also concerned a point of procedure and was decided in 2006. On this occasion the taxpayer wanted particulars as to how the Commissioner had decided to make his determination that Division 13 should apply. On this occasion, the taxpayer was represented by Mr Durack, SC, a distinguished tax silk of the Sydney Bar and two juniors. The Commissioner was represented by Justice Gordon. The application was rejected by Lindgren, J, one of Australia's greatest judges, in a typically careful and learned decision handed down almost three months after the hearing. In essence, his Honour decided that the due making of the determination was an essentially procedural step, which did not form part of the criterion for liability under Division 13. It had to be made, but how it was made was irrelevant.

Unlike *Syngenta*, *W R Carpenter* was not content with the first instance decision. It appealed to the Full Federal Court which duly dismissed the taxpayer's case in 2007: (2007) 161 FCR 1. *W*

R Carpenter nonetheless kept going with grim determination, such was its zeal to obtain the long sought after particulars. It sought and was granted leave to appeal to the High Court. The case was heard by a Full High Court on 22 April 2008. By this time Justice Gordon had been appointed to the Federal Court. So the Commissioner assembled a new team of Senior Counsel. Leading it was Mr Alan Robertson, SC, now Justice Robertson of the Federal Court. His Honour would end up as the trial judge in the last of the cases surveyed in this paper. He appeared with Mr J. W. de Wijn, QC, of the Victorian Bar, a tax lawyer of great experience. Poor *W R Carpenter* ultimately lost its appeal. The High Court did not need to decide the correctness of the reasons of the Courts below; that is because they simply decided that the taxpayer was merely fishing.

Roche

Meanwhile, in 2008, the first full transfer pricing trial was heard by Justice Downes, sitting as the President of the Administrative Appeals Tribunal. The taxpayer was Roche Products Pty Ltd. At issue was whether the prices the taxpayer paid to its Swiss parent for pharmaceutical products exceeded the arm's length price for those products. Many of the products were unique, the subject of world-wide patents, and were only ever sold within the Roche group. For these products, it was impossible for find comparable transactions that had been entered into by independent parties. As always, the bar table was full of notable barristers. Roche was represented by T. F. Bathurst, QC, now Chief Justice of New South Wales, leading A. H. Slater, QC, a very senior and talented Sydney tax silk, A. J. Payne, now a Justice of Appeal in NSW, and J. O. Hmelnitsky, now a very much in demand NSW silk. The Commissioner was represented by J. W. de Wijn leading Justice Davies amongst others. The case took place over a month in a small crowded room with instructors spilling into the corridor.

How did each side lead evidence as to the correct arm's length price for the products, in particular the patented products that were sold? They did so by calling upon the American transfer pricing economic experts. These economists are able to price anything and can do so even where there are no comparable sales to examine. They do so by, amongst other things, using a methodology not yet fully sanctioned by the OECD (but approved by US Treasury); it is called the "transactional net margin methodology" or TNMM. Under this method, the economist does not search for the comparable transaction, but rather for a comparable company, having regard to the functions of the actual taxpayer. In *Roche*, Roche Products was characterised as a distributor. This led the experts to look for other distributors of a similar size in a similar market. The product sold, on this approach, did not need to be similar to the products in fact sold, so long as the comparator company assumed similar functions, assets and risks.

For example, in *Roche*, one of the experts decided that a distributor of toys was comparable to Roche Products. Invariably, by trawling through publicly-available databases, such as filings with the Securities and Exchange Commission, a large list (in excess of 100) of possible comparable companies is able to be assembled. That list is then pruned down by rejecting candidates for not being sufficiently similar, or because of some problem with the information they have filed with the SEC. One is usually left with between five and ten companies. Sometimes adjustments are then made to address unique features which might exist with these companies. The profit made by these companies is then averaged over the years in issue. That average figure is then attributed to the taxpayer as being the profit it should have earned if it had dealt at arm's length with its parent. The method is commonly used in the United States.

Justice Downes did not like it at all. He said at par [115] of his reasons:

> 1. The method . . . used requires multiple subjective determinations which admit of error at every step.
> 2. The method requires the use of figures derived from the overall results of companies assessed to be comparable, to determine profit components of part of the activities of the subject. This is because adequate figures relating to divisions of potentially comparable companies are not generally available. This aspect admits the possibility of further error. The profitability of single purpose companies will not necessarily accord with the profitability of divisions of multi-purpose companies.
> 3. The method requires the drawing of profit figures from the results of many companies. These produce statistical averages and not real or actual results.

There was another contention with which Downes, J, did not agree. At the time, the Commissioner was of the view that he had an additional power to adjust prices in accordance with the "arm's length" principle. He argued that this power was contained in each of the Double Tax Treaties to which Australia is a party. These treaties exist primarily to prevent double taxation by two taxing regimes. But each also contains what is called an "Associated Entities Article", usually in this form:

> Article 9 – Associated enterprises
> (1) Where:
> (a) an enterprise of one of the Contracting States participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State; or
> (b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of one of the Contracting States and an enterprise of the other Contracting State, and in either case conditions operate between the two enterprises in their commercial or financial relations which differ from those which might be expected to operate between independent enterprises dealing wholly independently with one another, then any profits which, but for those conditions, might have been expected to accrue to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.
> (Article 9 of the USA/Australia Double Tax Treaty)

The Commissioner submitted that these words conferred on him a power to adjust the "profits" earned by a taxpayer to those that might have been earned if the parties had been independent of each. Downes, J, doubted the existence of this additional power. His Honour said:

> In the result I do not need to decide the issue although I note that there is a lot to be said for the proposition that the treaties, even as enacted as part of the law of Australia, do not go past authorising legislation and do not confer power on the Commissioner to assess. They allocate taxing power between the treaty parties rather than conferring any power to assess on the assessing body. On this basis Division 13 should be seen as the relevant legislative enactment pursuant to the power allocated.

This tentative rejection of the Commissioner's argument should be noted. It becomes important when considering the subsequent legislative changes.

In the end, Downes, J, determined that the arm's length prices were somewhere in the middle of the range comprising the taxpayer's numbers and those of the Commissioner. Understandably, neither side had any appetite to appeal the decision.

SNF (Australia) Pty Ltd v Commissioner of Taxation

In 2009, the next transfer pricing trial took place in Melbourne before Middleton, J, in the Federal Court. The taxpayer was a French subsidiary called SNF (Australia) Pty Ltd which was in the business of distributing its parent's polyacrylamide products in Australia. In the best traditions of the Bar, on this occasion the taxpayer was represented by Mr de Wijn, QC, (he had previously acted for the Commissioner), whilst the Commissioner was represented by Mr Bloom, QC, (he had previously acted for taxpayers). For many years, the subsidiary had made tax losses, thus arousing the suspicions of the Commissioner that it was paying excessive prices to its French parent. In 2010, Middleton, J, found for the taxpayer: (2010) 79 ATR 193. In simple terms, he accepted the taxpayer's explanation for the losses, namely, that it was incompetent.

Like Downes J, Middleton, J, rejected the American TNMM. His Honour said at [129]:

> In my view, undertaking the TNMM does not provide a proper basis for determining what consideration it was reasonable to expect that an independent purchaser would pay for the products. The TNMM does not address the issue as is required by Div 13 of the ITAA, as interpreted earlier in these reasons. I reject the use and applicability of the TNMM as contended for by the Commissioner in the context of applying Div 13.

But, unlike Downes, J, Middleton, J, was tentatively attracted to the Commissioner's contention that he has a separate power to adjust prices under the Double Tax Treaties because of amendments made in 2004 so section 170 of the ITAA which appeared to have been made on the assumption that there already existed that power (section 170 imposes time limits on the Commissioner's power of assessment). His Honour said at par [23]:

> As the stand alone taxing power issue was raised in written submissions, I make the following very brief comment. I do see some force in the argument that by operation of s 170(9B) of the ITAA and the terms 'prescribed provision' and 'relevant provision' as defined in s 170(14) of the ITAA, there is a clear legislative intention (at least from the time of the introduction of s 170 (9B)) that the Commissioner may in amending an assessment, rely on either s 136AD or the relevant associated enterprises article, as conferring upon the Commissioner, as a separate power, a power to amend an assessment. I say this although there is no provision expressly stating that 'the relevant provision' (namely, the associated enterprises article) has been incorporated into the ITAA. However, it seems to me that the express words in the ITAA necessarily and naturally imply the required incorporation of the relevant associated enterprises article into the ITAA.

The Commissioner appealed to the Full Federal Court ((2011) 193 FCR 149) and argued that, in accordance with recent Canadian decisions (*GlaxosmithKline Inc v The Queen* [2010] FCA 201 and *R v General Electric Capital Canada Inc* [2010] FCA 344), the hypothetical transaction to be priced was to consist of all of the facts in the real world with one fact changed, namely, the fact that the taxpayer and its parent were not independent of each other. This required one to assume a set of facts in which the purchaser was an entity with all of the qualities of the taxpayer except its relationship to the parent manufacturers. In the case of SNF (Australia), because it had been

making losses the Commissioner argued that, had it acted as an independent party, it would have bargained for lower prices in order to remain in business.

The argument was decisively rejected. At paragraphs [98] and [99] the Full Court said:

> There is no doubt that s 136AD(3) is, as the Commissioner submits, about the taxpayer; that it requires a comparison between that which was actually paid by the taxpayer and an arm's length consideration; and, that, in appropriate circumstances, it then substitutes one for the other. However, it does not follow from acceptance of all those features that arm's length consideration – which does not, in general, refer to the actual position of either party – must be treated as overlaid by a further requirement that the consideration not only be at arm's length but that the arm in question be attached to the taxpayer.

The foregoing passage creates problems where the personality of the "arm" in question can affect the arm's length price, such as a loan. It provides no guidance as to what, in such a case, the "arm" should comprise.

The Commissioner's associated enterprises article was not directly considered by the Full Court. Inferentially, however, it would appear that the Court doubted its existence. At paragraph [109] the Court observed:

> Article 9(1) attempts to address at a high level of generality the problems thrown up by transfer pricing by providing for pricing as if the transactions had been between independent parties.

The Full Court made one further observation of relevance. It decided that the OECD guidelines on transfer pricing could not be considered at all for the purpose of construing and applying Division 13.

The Commissioner was deeply disturbed by this aspect of the decision and by the result generally in *SNF*. He did not, however, decide to seek special leave to the High Court. Instead, he decided that a complete re-write of the legislation was needed to overcome his losses in court so far. As it happens he did this twice before the next case was heard.

The first new legislation and its retrospective application

By Act No 115 of 2012 new Subdivision 815-A was introduced into the *Income Tax Assessment Act* 1997. It aspires to achieve two principal objects:

(a) first, it effectively incorporates into domestic law the Associated Enterprises Articles of each of Australia's Double Tax Treaties (the American example is set out above), thus giving the Commissioner that long sought after additional power to adjust prices. This is sought to be achieved by making the criteria for liability turn upon whether 'the requirements in the associated enterprises article for the application of that article to the entity are met' (s 815-15(1)(b));

(b) secondly, and for that purpose, it mandates that the OECD Guidelines must be considered, thus reversing *SNF*. Section 815-20(1) provides that subdivision 815-A must be applied 'consistently' with the Guidelines. In 2012, the relevant version of those Guidelines was specified to be those approved on 22 July 2010. These are an updated version of the earlier 1995 Guidelines, which in turn updated the 1979 version I have already referred to.

This new subdivision represents a striking example of the power of the legislative branch to overturn the work of the judiciary. But the new subdivision is not remarkable merely because of that attribute. It is notable because of this: pursuant to section 815-1 of the *Income Tax Assessment (Transitional Provisions) Act* 1997, Subdivision 815-A is expressed to apply to income years commencing on or after 1 July 2004. In other words, it applies retrospectively. And not just by one or two years; it changes the law for a period going back eight years. Australia has never before seen such a retrospective tax.

As it remains a live issue in the *Chevron* tax appeal, described below, I will not comment upon the constitutional validity of this retrospectivity. I do wish to say something about it from a tax policy perspective, however. In the Explanatory Memorandum for the bill which introduced the subdivision, it is asserted that Parliament had made a "consistent assumption" since 1982, when Division 13 was first introduced, that the additional power to adjust prices in the Double Tax Treaties existed. It is then said that the 2004 amendment to section 170 (briefly considered by Middleton, J) was made based on that same assumption, and that therefore retrospectivity to that date was justified. *Roche* is not mentioned at all. *SNF* is dismissed in this way: "[t]his case was argued only on the basis of Division 13" (par 1.12).

These statements in the Explanatory Memorandum are, I regret, false. There is not the slightest evidence of a "consistent assumption" since 1982. Rather, the position is this: the Commissioner for some time had argued publicly that he had the additional power to make pricing adjustments. He was perfectly entitled to make that argument. Some members of the Bar agreed with him. Most did not. He nonetheless argued for it in *Roche* and his arguments were not accepted. He argued for it in *SNF* and Middleton, J, was, as set out above, cautiously attracted to it. As we shall see, he argued for it again in *Chevron*, and it was convincingly rejected.

In 2012, the prevailing view of the law was that articulated by Downes, J, in *Roche* in 2008, Middleton, J, having not overruled it. From that date, given that the Commissioner did not appeal *Roche*, taxpayers were reasonably entitled to rely upon his Honour's observations, and order their affairs accordingly. To subject them to retrospective legislation by which the criteria upon which they were to pay tax in past years changed, in circumstances where that new criteria could not then be ascertained (as it did not then exist) is, in my view, unjustified. It is very bad tax policy. It is equally bad for an explanatory memorandum to contain false statements, and for amendments to be passed based on falsehoods. The result is perhaps an affront to the rule of law.

One year later new subdivision 815-B was introduced by Act No 101 of 2013. It at least has prospective effect only – from 29 June 2013. It repealed Division 13 and replaced Subdivision 815-A with another new set of transfer pricing rules. These are described below.

Chevron

Meanwhile, the *Chevron* case was beginning to brew. Again, I must be careful about what I can say about it as it is the subject of an appeal to the Full Federal Court due to be heard over five days at the end of August. Suffice it to say, certain facts are not in dispute and can be disclosed. The case concerned the pricing of an inter-company loan entered into in 2002 between a subsidiary of Chevron resident in the United States and Chevron's holding company in Australia, called Chevron Australia Holdings Pty Ltd (Chevron Australia). The money was needed to fund the commencement of the Gorgon Project in Western Australia. Interest was paid on the loan by Chevron Australia and deductions accordingly claimed. Chevron Australia thought it was paying

an arm's length rate of interest; the Commissioner disagreed.

We can see an immediate problem following *SNF*. Given that the credit worthiness of a borrower is important in determining what interest independent parties might pay, how should one go about pricing this loan? Do we assume that the borrower has the same assets, liabilities and risks of Chevron Australia. And, if so, is that Chevron Australia as a stand-alone business, or Chevron Australia as the subsidiary of a very credit worthy multinational. Or is it something else entirely?

The Commissioner argued that the hypothetical borrower should be an entity identical to that of Chevron Australia in its capacity as a member of the same credit worthy multinational, albeit with a different name, and now borrowing from an independent entity. On this basis he contended that the hypothetical borrower should be attributed with a very high credit rating, so that the resulting interest rate would be lower than that in fact paid. Chevron disagreed and submitted that the hypothetical borrower should be identical to Chevron Australia, but as a stand-alone and independent entity.

But the disagreements did not end there. The parties could not agree on the thing to be priced. The loan agreement imposed obligations of repayment in Australian dollars. Chevron contended that this was an Australian dollar loan. The Commissioner disagreed because the bank account into which the loan amount was credited was expressed in US dollars. At the time the Australian LIBOR rate was higher than the LIBOR rate in the United States. In the years leading up to the loan being entered into, it had been the other way around.

The Commissioner, nonetheless, said that because the loan should be characterised as a US dollar advance, the base for calculating the interest payable should be the lower US LIBOR rate. He did not stop there. He argued that if the loan was to be properly characterised as an Australian dollar loan, it should, in any event, be substituted for a US dollar loan with different terms and for a different and lower amount. In this way, he wanted to attribute to Chevron interest much lower outgoings on a loan it had never entered into, and he contended he could do this either under Division 13 or Subdivision 815-A with its retrospective effect. The Commissioner had never before argued that he had such an extensive reconstruction power; in the past he had simply priced the thing in fact supplied.

The case was heard over five weeks. The Commissioner called eight expert witnesses. Some experts were called to assess Chevron Australia's credit rating as a subsidiary of Chevron. Some were professional transfer pricing economists. One was a retired Shell executive who gave evidence concerning what in his view should generally have happened. Chevron called twelve experts in response.

The tasks the Commissioner asked his experts to address were entirely different to the tasks undertaken by Chevron's experts. No expert issue was ever joined; the same question was never asked of each side's experts. As a result, each side objected to almost all of the expert evidence of the other party. The objections remained unresolved at the commencement of trial. The Court Book containing the evidence and pleadings was more than 13,500 pages in length and extended over 30 volumes.

Almost a year later, judgment was handed down. The primary judge decided that each of the opinions the Commissioner had asked his experts to form did not assist him because in each case the Commissioner had asked the wrong question or the expert was not properly qualified. He found that Chevron had also asked the wrong questions and that the resulting expert opinions

it had procured did not address the statutory task. Because under our system the onus is on the taxpayer to show that an impugned assessment is excessive, it followed that Chevron had necessarily lost. Because it had asked the wrong questions, it had failed to discharge its onus of proof.

I am sure there is a word to describe what happened in this case; for the moment I just cannot think of it.

Finally, and as mentioned above, the Commissioner again submitted that he had a separate power to adjust prices under the double tax treaties. Robertson, J, considered the arguments in some detail, and rejected the existence of the power. He said at [61]:

> I reject the respondent's submission that Art 9 of the United States convention, independently of the transfer pricing provisions in the domestic legislation, may be relied on to support the 2010 or the 2012 amended assessments.

Thus the premise of subdiv 815-A's retrospectivity was found to be misconceived.

The second legislation

Before addressing the new legislation, something needs to be said about the supposed power of reconstruction. Traditionally, transfer pricing has focused upon a single issue: was the price paid for an actual supply of goods and services an arm's length amount? Whilst it was contemplated that this might include some tampering with the terms of sale used by related parties, generally speaking, one priced the actual supply and not a different supply. And one did this by examining, if possible, the price paid by independent parties for the same, or very similar, products, in the same, or very similar, markets.

This approach is reflected in the OECD Guidelines. Take the 1995 Guidelines; they record the following at par 1.36:

> A tax administration's examination of a controlled transaction ordinarily should be based on the transaction actually undertaken by the associated enterprises as it has been structured by them . . . . .

In other words, the obligation on the taxpayer is to pay the arm's length price. Other than this, related parties do not have to pretend that they are independent of each other. They do not need to enter into faux negotiations; they do not need to mimic the behaviour of arm's length parties in all things. They do not need to create a sham world when they are in fact members of the same group of companies.

Again, the OECD Guidelines have recognised this. It is well understood that related parties might make supplies of goods and services that would never take place between independent parties. Roche, for example, would not sell its patented pharmaceuticals outside its group. As the 1995 Guidelines observe at par 110:

> A practical difficulty in applying the arm's length principle is that associated enterprises may engage in transactions that independent enterprises would not undertake.

At some point during the early 1990s it would appear that some representative members of the OECD decided that transfer pricing should not be just about pricing, but about making

related parties behave as if they are independent in all things. I say, "it would appear", because one does not know what really goes on in Paris. The meetings are not held in public. We do not know who pushed for these changes. Presumably, the process of reform took place incrementally, perhaps over a good bottle or two of Bordeaux at some pleasant bistro on the Ille Saint-Louis – paid for by the taxpayer. In any event, inferentially, the reformers wanted domestic revenue authorities to have the power to second guess how one should undertake one's business; in other words, to have a broad power of reconstruction. This would mean imposing tax by reference to a reconstructed transaction never in fact entered into by the taxpayer.

The result was the insertion of the following words into the 1995 Guidelines following the passage quoted above from par 1.36:

> However, there are two particular circumstances in which it may, exceptionally, be both appropriate and legitimate for a tax administration to consider disregarding the structure adopted by a taxpayer in entering into a controlled transaction. The first circumstance arises where the economic substance of a transaction differs from its form . . . . The second circumstance arises where, whilst the form and substance of the transaction are the same, the arrangements made in relation to the transaction, viewed in their totality, differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner and the actual structure practically impedes the tax administration from determining an appropriate transfer price.

Inferentially, those advocating for a broad power of reconstruction have not had much further success at the OECD. The same words appear in the latest 2010 version of the Guidelines. As the author understands it, this is because there has yet to be any clear agreement between member countries as to whether a broad power of reconstruction should exist and, if so, when it should be engaged. Based on the current Guidelines, and leaving aside the scope of the power, it remains the case that it should only ever be engaged in "exceptional" circumstances, whatever that might mean.

The author also understands that the Guidelines are usually the product of negotiation between member countries. Predictably, where there is disagreement, a compromise is often found and this is reflected by the use of broadly expressed language. Very broadly expressed principles, however, are seldom capable of supplying a criterion for liability.

Nonetheless, the passage set out above was relied upon by the Commissioner in *Chevron* to support a reconstruction of the loan in fact entered into by that taxpayer. There was much debate about the meaning of the words used in it; the passage was scrutinized by the parties with the same rigour reserved for sections in a domestic Act. Chevron even led evidence from the former head of the OECD transfer pricing unit.

Three problems emerge immediately:

(a) First, how should one interpret the Guidelines when they are expressed in only the most general of terms? Taking the passage above, what does it mean when it refers to a 'commercially rational manner'? In the author's limited experience, much ordinary commercial activity could, with the benefit of hindsight, be considered irrational. And what standard of rationality is required? Is imprudence (itself a subjective concept) sufficient? We do not know because the Guidelines supply no further clues. How, one might ask, should one apply domestic law 'consistently' with the Guidelines if they are devoid of sufficient meaning?

(b) Secondly, the command to interpret law consistently with third party Guidelines raises issues about the rule of law in Australia. I do not suggest that it constitutes an impermissible delegation of the taxing power of the Commonwealth (cf *Giris v FCT* (1969) 119 CLR 365). But the rule of law is not promoted by granting to an unelected foreign body the capacity to influence the scope and meaning of domestic tax legislation; *a fortiori* when the body produces a work pregnant with ambiguous meaning and which is not legally binding on taxpayers in any other OECD country. Moreover, it is unsatisfactory that the Guidelines can be amended with or without Australia's consent, and with or without the knowledge, oversight or approval of the Commonwealth Parliament.

(c) Thirdly, enacting legislation of this kind sets a dangerous precedent. For example, in this year's budget, it was announced that new subdiv 815-B will be amended to require one also to take into account proposed amendments to the OECD Guidelines that have yet to be approved by the OECD, and may never be approved. Domestic law could be informed by guidelines that have been rejected.

It is in this context that there are two observations to be made about this new transfer pricing regime in subdiv 815-B:

(a) first, like former subdiv 815-A, one must apply the new rules so 'as best to achieve consistency with' the OECD Guidelines;
(b) secondly, it would appear that the drafter wanted to give to the Commissioner of Taxation a power of reconstruction which goes well beyond the limited language of the OECD Guidelines set out above. Indeed, it is arguably inconsistent with them. Section 815-130(1) sets out a basic rule that requires one to apply the actual commercial or financial relations. But there is then carved out a large exception set out in section 815-130(2) and (3) which obliges one to 'disregard' the actual commercial or financial relations to determine the pricing adjustment. It provides:

> . . .
> (2) Despite paragraph (1)(b), disregard the form of the actual commercial or financial relations to the extent (if any) that it is inconsistent with the substance of those relations.
> (3) Despite subsection (1), if:
> (a) independent entities dealing wholly independently with one another in comparable circumstances would not have entered into the actual commercial or financial relations; and
> (b) independent entities dealing wholly independently with one another in comparable circumstances would have entered into other commercial or financial relations; and
> (c) those other commercial or financial relations differ in substance from the actual commercial or financial relations;
> the identification of the * arm's length conditions must be based on those other commercial or financial relations.
> (4) Despite subsection (1), if independent entities dealing wholly independently with one another in comparable circumstances would not have entered into commercial or financial relations, the identification of the * arm's length conditions is to be based on that absence of commercial or financial relations.
> (5) Subsections 815-125(3) and (4) (about comparability of circumstances) apply for the purposes of this section.

No-one really knows what the term "commercial or financial" conditions means. There is no relevant case law. It could be read in a number of different ways. It might be limited to the contractual terms for a given supply. Or it might encompass the entire basis upon which a business is undertaken. In that respect, asking what "commercial or financial" conditions independent parties would have entered appears to invite the Commissioner to tell you how you should have conducted your business – an effective reversal of *Tweddle* (above). There are other significant difficulties with the design of subdiv 815-B which I will not advert to here. Suffice to say, the field of disputation may be very wide indeed in the years to come.

The confines of this paper have not permitted me to consider these other recent legislative changes:

(a) changes made to the level of debt multinationals may have when investing in Australia;
(b) what is called the Multinational Anti-Avoidance Legislation or "MAAL" which attacks the use by companies of the internet to avoid having a taxable presence in Australia; and
(c) the new "Diverted Profits Tax" to be introduced later this year (2016).

Each of these merits its own paper.

In conclusion, this survey of the law relating to transfer pricing in Australia reveals, I think, the following:

(a) the applicable tests are very unclear. That is because the "arm's length" principle does not work well in practice and especially in a court;
(b) Parliament's reaction to the case law has been extreme. It has even resorted to very retrospective legislation; and
(c) there has been an unprecedented transfer of sovereignty over the content of our tax laws to an unelected and foreign body, namely the OECD.

None of this really promotes the rule of law. Indeed, when John Adams aspired to a "government of laws and not of men", (Novanglus, Essays No.7), I doubt if the foregoing is what he had in mind.