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THE PARLIAMENT OF THE COMMONWEALTH OF AUSTRALIA

HOUSE OF REPRESENTATIVES

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TAX LAWS AMENDMENT (COUNTERING TAX AVOIDANCE AND  
MULTINATIONAL PROFIT SHIFTING) BILL 2013

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EXPLANATORY MEMORANDUM

(Circulated by the authority of the  
Deputy Prime Minister and Treasurer, the Hon Wayne Swan MP)



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## ***Glossary***

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The following abbreviations and acronyms are used throughout this explanatory memorandum.

<b><i>Abbreviation</i></b>	<b><i>Definition</i></b>
CFC	Controlled Foreign Company
Commissioner	Commissioner of Taxation
ITAA 1936	<i>Income Tax Assessment Act 1936</i>
ITAA 1953	<i>International Tax Agreements Act 1953</i>
ITAA 1997	<i>Income Tax Assessment Act 1997</i>
IT(TP) Act 1997	<i>Income Tax (Transitional Provisions) Act 1997</i>
OECD	Organisation for Economic Cooperation and Development
OECD Guidelines	<i>OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations</i> as approved by the Council of the OECD and last amended on 22 July 2010
PE	permanent establishment
TAA 1953	<i>Taxation Administration Act 1953</i>



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## ***General outline and financial impact***

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### **The general anti-avoidance rule**

Schedule 1 to this Bill amends Part IVA of the *Income Tax Assessment Act 1936* to ensure its effective operation as the income tax general anti-avoidance provision.

The principal role of Part IVA is to counter arrangements that, objectively viewed, are carried out with the sole or dominant purpose of securing a tax advantage for a taxpayer.

Broadly speaking, Part IVA operates to counter such arrangements by exposing the substance or reality of the arrangements to the ordinary operation of the income tax law.

***Date of effect:*** The amendments apply to schemes entered into, or commenced to be carried out, on or after 16 November 2012, the day on which draft legislation was released for public comment.

***Proposal announced:*** This measure was announced in the Assistant Treasurer's Media Release No. 010 of 1 March 2012.

***Financial impact:*** The amendments are expected to prevent the loss of over \$1 billion a year.

***Human rights implications:*** This Schedule does not raise any human rights issue. See *Statement of Compatibility with Human Rights* — Chapter 1, paragraphs 1.131 to 1.137.

***Compliance cost impact:*** Low.

### **Modernisation of the Transfer Pricing Rules**

Schedule 2 to this Bill inserts Subdivisions 815-B, 815-C and 815-D into the *Income Tax Assessment Act 1997* and Subdivision 284-E into Schedule 1 to the *Taxation Administration Act 1953*. These amendments modernise Australia's domestic transfer pricing rules.

The amendments apply to both tax treaty and non-tax treaty cases, ensuring greater alignment between outcomes for international arrangements involving Australia and another jurisdiction irrespective of whether the other jurisdiction forms part of Australia's treaty network.

The amendments also contain specific rules relating to transfer pricing documentation.

***Date of effect:*** The rules apply to income years commencing on or after the earlier of:

- 1 July 2013; and
- the day this Bill receives Royal Assent.

In respect of withholding tax, the rules apply in relation to income derived, or taken to be derived, in income years commencing on or after the earlier of the above two dates.

***Proposal announced:*** This measure was announced by the then Assistant Treasurer and Minister for Financial Services and Superannuation's Media Release No. 145 of 1 November 2011.

***Financial impact:*** Nil.

***Human rights implications:*** This Schedule does not raise any human rights issues. See *Statement of Compatibility with Human Rights* — Chapter 7, paragraphs 7.22 to 7.29.

***Compliance cost impact:*** Not expected to be significant. Much of the required information is already kept by taxpayers in complying with their tax obligations and the existing transfer pricing rules.

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# **Chapter 1**

## ***The general anti-avoidance rule***

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### **Outline of chapter**

1.1 Schedule 1 to this Bill amends Part IVA of the *Income Tax Assessment Act 1936* (ITAA 1936) to ensure its effective operation as the income tax general anti-avoidance provision.

1.2 The principal role of Part IVA is to counter arrangements that, objectively viewed, are carried out with the sole or dominant purpose of securing a tax advantage for a taxpayer.

1.3 Broadly speaking, Part IVA operates to counter such arrangements by exposing the substance or reality of the arrangements to the ordinary operation of the income tax law.

### **Context of amendments**

1.4 Some recent decisions of the Full Court of the Federal Court concerning the way in which Part IVA determines whether or not a tax advantage has been obtained in connection with an arrangement have revealed a weakness in the capacity of Part IVA to effectively counter arrangements that, objectively viewed, have been carried out with a relevant tax avoidance purpose.

1.5 The amendments in Schedule 1 to this Bill address this weakness and ensure that Part IVA is effective to counter tax avoidance.

1.6 This measure was announced by the Government on 1 March 2012.

1.7 The amendments apply to schemes that are entered into, or commenced to be carried out, on or after 16 November 2012, the day when the draft amendments were released for public comment.

1.8 The amendments were prepared after consultation with a roundtable of independent experts and with the benefit of formal advice from senior barristers, as well as the normal consultation processes for tax measures.

## Legislative history

1.9 Part IVA was enacted in 1981 to overcome deficiencies that judicial decisions had exposed in the operation of the previous general anti-avoidance provision — section 260 of the ITAA 1936.

1.10 The explanatory memorandum accompanying Part IVA explained that Part IVA was ‘designed to overcome’ the difficulties with section 260 and ‘provide — with paramount force in the income tax law — an effective general measure against those tax avoidance arrangements that — inexact though the words may be in legal terms — are blatant, artificial or contrived’ (see explanatory memorandum, Income Tax Laws Amendment Bill (No 2) 1981).

1.11 Further, the explanatory memorandum made it clear that the ‘test for application’ of Part IVA was ‘intended to have the effect that arrangements of a normal business or family kind, including those of a tax planning nature’ would be beyond the scope of Part IVA.

1.12 The distinction between tax avoidance and legitimate commercial and family arrangements was emphasised by the then Treasurer in his second reading speech on the Bill. There he stated that Part IVA was not intended to ‘cast unnecessary inhibitions on normal commercial transactions by which taxpayers legitimately take advantage of opportunities available for the arrangement of their affairs’.

1.13 Part IVA gives effect to this distinction by requiring an examination of whether, having regard to eight objective matters (including the manner in which an arrangement was entered into, its form and substance, and the taxation results it produces), it would be concluded that the arrangement was entered into in the particular way it was for the sole or dominant purpose of obtaining a tax advantage.

1.14 Part IVA does not inquire into the subjective motives of taxpayers and it does not therefore strike at every arrangement that is entered into with an eye to tax minimisation. This has been established by decisions of the High Court of Australia. Their Honours Gleeson CJ and McHugh J said in *Commissioner of Taxation v Hart* (2004) 206 ALR 207 (*Hart*) at [15]:

‘... the fact that a particular commercial transaction is chosen from a number of possible alternative courses of action because of tax benefits associated with its adoption does not of itself mean that there must be an affirmative answer to the question posed by s 177D. Taxation is part of the cost of doing business, and business transactions are normally influenced by cost considerations. Furthermore, even if a particular form of transaction carried a tax benefit, it does not follow

that obtaining the tax benefit is the dominant purpose of the taxpayer in entering into the transaction. A taxpayer wishing to obtain the right to occupy premises for the purpose of carrying on a business enterprise might decide to lease real estate rather than to buy it. Depending upon a variety of circumstances, the potential deductibility of the rent may be an important factor in the decision. Yet, if there were nothing more to it than that, it would ordinarily be impossible to conclude, having regard to the factors listed in s 177D, that the dominant purpose of the lessee in leasing the land was to obtain a tax benefit. The dominant purpose would be to gain the right to occupy the premises, not to obtain a tax deduction for the rent, even if the availability of the tax deduction meant that leasing the premises was more cost-effective than buying them.’

1.15 It does not follow, however, that Part IVA is incapable of applying to arrangements that also advance wider commercial objectives. There is no ‘dichotomy’ between a ‘rational commercial decision’ and ‘the obtaining of a tax benefit’ (see Gummow and Hayne JJ in *Hart* (2004) 206 ALR 207 at [64]).

1.16 The High Court has confirmed on a number of occasions that Part IVA will apply to an arrangement if the particular form in which the arrangement is implemented evinces the requisite tax avoidance purpose (see *Federal Commissioner of Taxation v Spotless* (1996) 141 ALR 92 (*Spotless*) at pp 97-98 and 105, and *Hart* (2004) 206 ALR 207 at [16][52] and [94]).

1.17 More particularly, as Callinan J observed in *Hart* (2004) 206 ALR 207 at [94], ‘an aspect of’ the direction in Part IVA to consider the ‘form and substance’ of a scheme ‘is whether the substance of the transaction (tax implications apart) could more conveniently, or commercially, or frugally have been achieved by a different transaction or form of transaction.’

## **The statutory regime<sup>1</sup>**

1.18 The Commissioner of Taxation (Commissioner) may cancel a tax benefit obtained by a taxpayer in connection with a scheme ‘to which Part IVA applies’ (see subsection 177F).

1.19 Section 177D provides that Part IVA applies to a scheme in respect of which:

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<sup>1</sup> References in this part of the Explanatory Memorandum are to the provisions of Part IVA as they applied prior to the amendments made by Schedule 1 of this Bill.

- a taxpayer has obtained, or would but for section 177F obtain, a tax benefit in connection with the scheme (see paragraph 177D(a)); and
- one or more of the persons who participated in the scheme (or part of the scheme) did so for the sole or dominant purpose, objectively ascertained, of enabling the taxpayer to obtain a tax benefit in connection with the scheme (see paragraph 177D(b)).

1.20 Although the Commissioner is entitled to put his case in relation to the scheme and the tax benefit in alternative ways, the existence of the Commissioner's discretion to cancel the tax benefit does not depend upon the Commissioner's opinion or satisfaction that there is a tax benefit or that, if there is a tax benefit, it was obtained in connection with a scheme. The existence of a scheme and a tax benefit must be established as matters of objective fact (see *Peabody v Commissioner of Taxation* (1994) 123 ALR 451 (*Peabody*) at pp 458-459).

1.21 Moreover, the 'bare fact' that a taxpayer can be shown to have obtained a tax benefit in connection with a scheme does not in itself compel the application of Part IVA (see Gummow and Hayne JJ in *Hart* (2004) 206 ALR 207 at [53] and Callinan J at [92]). The tax benefit must be obtained in connection with a scheme to which Part IVA applies.

1.22 In determining whether Part IVA applies to a scheme, the critical question — indeed the fulcrum upon which Part IVA turns (Callinan J in *Hart* (2004) 206 ALR 207 at [92]) — is whether a person or persons who participated in the scheme did so for the sole or dominant purpose of enabling the taxpayer to obtain a tax benefit that has been so obtained. The relevant purpose must be established objectively based on an analysis of how the scheme was implemented, what the scheme actually achieved as a matter of substance or reality as distinct from legal form (that is, its end effect) and the nature of any connection between the taxpayer and other parties (and each of the other factors in paragraph 177D(b)). A person's subjective motive is irrelevant.

1.23 Gummow and Hayne JJ observed in *Hart* ((2004) 206 ALR 207 at [37]) that each of the concepts of 'tax benefit', 'scheme' and 'scheme to which this Part applies' have their 'part to play' in deciding whether a section 177F determination is permitted, and each of them 'must be given operation in the interrelated way which section 177F(1) requires'. Further (at [36]):

'Although it will often be convenient to begin any consideration of the application of the Part by attending to the operation of these elucidating and definitional provisions [that is sections 177A and

177C], approaching a particular case in this way must not be allowed to obscure the way in which the Part as a whole is evidently intended to operate.’

### **The role of an alternative postulate**

1.24 Implicitly, the Part IVA inquiry ‘requires [a] comparison between the scheme in question and an alternative postulate’ (Gummow and Hayne JJ in *Hart* (2004) 206 ALR 207 at [66]).

1.25 A comparison between the scheme and an alternative postulate serves the Part IVA inquiry in two ways:

- first, comparisons between the tax consequences of the scheme and the tax consequences of alternative postulates provide a basis for identifying (and quantifying) any tax advantages (of the relevant kind) that may have been obtained from the scheme; and
- second, a consideration of alternative postulates may, in the course of considering the paragraph 177D(b) matters, assist in reaching a conclusion about the purposes of the participants in the scheme (Gummow and Hayne JJ in *Hart* (2004) 206 ALR 207 at [66] to [68]): a consideration of whether there were other ways that the participants in the scheme could have achieved their non-tax purposes facilitates a weighing of those purposes against any tax purposes that can be identified.

1.26 An alternative postulate could be merely that the scheme did not happen or it could be that the scheme did not happen but that something else did happen.

### **Tax benefit**

1.27 The purpose and function of section 177C is to define the kind of tax outcomes that a participant in the scheme must have had the purpose of securing for the taxpayer, and which must have been secured in connection with the scheme, if Part IVA is to apply.

1.28 The tax outcomes with which section 177C(1) is concerned, and which are labeled ‘tax benefits’, are:

- an amount not being included in assessable income;
- a deduction being allowed;

- a capital loss being incurred; and
- a foreign income tax offset being allowed.<sup>2</sup>

1.29 In order to reach a conclusion that one of the specified outcomes has been secured, and to quantify it, it is necessary to compare the tax consequences of the scheme in question with the tax consequences that either would have arisen, or might reasonably be expected to have arisen, if the scheme had not been entered into or carried out. This involves a comparison with an alternative postulate.

1.30 A tax consequence of a scheme or of an alternative postulate is relevant if it arises in connection with the scheme or with the alternative postulate. The inquiry is not confined to the immediate tax consequences of the steps that comprise the scheme or the alternative postulate (see *Commissioner of Taxation v Futuris Corporation* [2012] FCAFC 32 (*Futuris*) at [34]).

### **Perceived weaknesses in the ‘tax benefit’ concept**

1.31 A number of recent decisions of the Full Federal Court have revealed weaknesses in the way in which the tax benefit concept in section 177C operates.

1.32 The Government is concerned that these weaknesses may reduce the effectiveness of Part IVA in countering tax avoidance arrangements.

#### ***Alternative bases for identifying tax benefits***

1.33 Subsection 177C(1) contains two bases upon which the existence of a tax benefit can be demonstrated. The first is that, absent the scheme, a relevant tax outcome ‘would have been’ the case. The second is that, absent the scheme, a relevant tax outcome ‘might reasonably be expected to have been’ the case.

1.34 The first limb requires a comparison of the tax consequences of the scheme with the tax consequences that ‘would have’ resulted if the scheme had not occurred.

1.35 The second limb requires a comparison of the tax consequences of the scheme with the tax consequences that ‘might reasonably be expected to have’ resulted if the scheme had not occurred.

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<sup>2</sup> A tax benefit from eliminating a liability to withholding tax is also provided for by section 177CA in the current law.

1.36 The two limbs have been viewed as alternatives (see *Peabody v Commissioner of Taxation* ([1993] FCA 74 at [36]) and *Commissioner of Taxation v Consolidated Press Holdings* [1999] FCA 1199 (*Consolidated Press*) at [85]).

1.37 One approach to the first limb has been to view it as satisfied in cases where a relevant tax advantage is exposed by applying the taxation law to the facts remaining once the statutory postulate has done its work in deleting the scheme. In those cases, a tax benefit exists if it can be demonstrated that the relevant tax advantage flows, as a matter of law, once the scheme is assumed not to have happened. This may be referred to as an ‘annihilation approach’. Although this approach involves an alternative postulate, that postulate consists solely of deleting the scheme.

1.38 Cases that appear to have been decided on the basis of this approach to the first limb include the decisions of the Full Court of the Federal Court in *Puzey v Commissioner of Taxation* [2003] FCAFC 197 (*Puzey*) and *Commissioner of Taxation v Sleight* [2004] FCAFC 94 (*Sleight*). For example, in *Puzey*, at [66], Hill and Carr JJ (with French J concurring) identified the tax benefit on the basis that ‘had Puzey not entered into the scheme he would not have had the deductions which became available to him’. However, no court has expressly considered whether this approach to the first limb is correct.

1.39 On this view, the second limb is a qualitatively different test that may be satisfied notwithstanding an element of uncertainty in the postulate. For example, it has been applied in cases where the mere deletion of the scheme would not necessarily leave a coherent state of affairs for the tax law to apply to — where a prediction is required about facts not in existence and/or about facts which are in existence not being in existence. In other words, it contemplates a postulate based on a reasonable *reconstruction* of either the scheme, or of the scheme and things that happened in connection with the scheme. This is sometimes referred to as a ‘reconstruction approach’.

1.40 The second limb has also been applied in cases where a first limb tax benefit, resting as it does on a postulate that the scheme merely would not have happened, would be inconsistent with the non-tax results and consequences sought for the taxpayer by the participants in the scheme. In those cases a reconstruction of either the scheme, or of the scheme and things that happened in connection with the scheme, may expose other ways in which the non-tax results and consequences of the scheme could have reasonably been achieved without the impugned tax advantages (see, for example, *Hart* (2004) 206 ALR 207).

1.41 The High Court decisions in *Peabody* (1994) 123 ALR 451, *Spotless* (1996) 141 ALR 92, and *Hart* each concerned an application of

the second limb. In each of those cases, the postulate upon which the Commissioner relied to identify the tax benefit was based upon what was argued to be a reasonable expectation about how the scheme, or the scheme and things that happened in connection with the scheme, could have been done differently to achieve the same commercial ends.

1.42 Another view of the operation of section 177C has become evident in a number of recent decisions.

1.43 The decision in *Futuris* is an example. Both at first instance and on appeal, the underlying suggestion seems to be that the reference in subsection 177C(1) to tax consequences that ‘would have [occurred], or might reasonably be expected to have [occurred], ... if the scheme had not been entered into or carried out’ is a composite phrase requiring, in every case, a postulate about what would have or might reasonably be expected to have happened in lieu of the scheme. On this view of the provision, ‘would have’ or ‘might reasonably be expected to have’ represent ends of a spectrum of certainty within which acceptable postulates must lie (see *Futuris* [2012] FCAFC 32 at [54], [59], [62] and [79] and *Commissioner of Taxation v Trail Brothers Steel & Plastics Pty Ltd* [2010] FCAFC 94 at [26] and [29]). It appears to be assumed that all acceptable postulates will involve a prediction about events or circumstances, as opposed to a mere deletion of the scheme.

1.44 The competing constructions of section 177C have yet to be directly considered by a court. To achieve the intended outcome, these amendments include provisions which put it beyond doubt that the ‘would have’ and ‘might reasonably be expected to’ limbs of each paragraph of subsection 177C(1) represent separate and distinct bases upon which the existence of a tax benefit can be demonstrated.

1.45 From a policy perspective, it is desirable that section 177C(1) should operate in this manner. As the Explanatory Memorandum accompanying Part IVA explained, a ‘limitation’ of section 260, which Part IVA was intended to overcome, was that once section 260 had ‘done its job of voiding an arrangement’ it, did not ‘provide a power to *reconstruct* what was done, so as to arrive at a taxable situation (emphasis added)’. This was typically a problem in relation to income schemes where voiding the arrangement served to annihilate not only the tax shelter but also the underlying economic gain as well.

1.46 It is desirable that reconstruction be permitted in addition to, and not to the exclusion of, voiding an arrangement. Voiding an arrangement can be a simple and effective way to identify the tax advantage produced by an arrangement, particularly an aggressive arrangement directed at obtaining income tax deductions.

***Nature of the inquiry permitted in constructing an alternative postulate***

1.47 The second limb of subsection 177C(1) has been interpreted as permitting a broad-ranging inquiry into what might reasonably be expected to have happened absent the scheme, unconstrained by the matters that must be considered under section 177D(b) in testing purpose (see *Epov v Federal Commissioner of Taxation* [2007] FCA 34 at [62]) and the limits of what it is that the scheme has achieved (see *Commissioner of Taxation v Axa Asia Pacific Holdings Ltd* [2010] FCAFC 134 (*Axa Asia*) at [131]).

1.48 Put differently, it is viewed as an open-ended inquiry into what, if anything, the taxpayer might reasonably have done if it had not participated in the scheme.

1.49 While a consideration of what the taxpayer did in the commercial circumstances that existed is viewed as shedding light on what the taxpayer would have done in the absence of the scheme (*Commissioner of Taxation v Ashwick (Qld) No 127 Pty Ltd* [2011] FCAFC 49 at [153]), the matters that can be taken into account in the inquiry are unlimited and can include evidence from the taxpayer as to what it would have done in the absence of the scheme (provided foundation facts are given to support what would otherwise be a bald speculative statement) (see *McCutcheon v Federal Commissioner of Taxation* [2008] FCA 318 (2008) 168 FCR 149 at [37], cited with approval in *Axa Asia* [2010] FCAFC 134 (at [140])).

1.50 Further, it is permissible to reject an alternative course of action on the basis that the tax costs involved in undertaking that action would have caused the parties to do nothing, including deferring or abandoning a wider transaction of which the scheme was a part (see, for example, *RCI Pty Ltd v Commissioner of Taxation* [2011] FCAFC 104 (*RCI*) at [145] to [150]).

1.51 From a policy perspective, the operation of Part IVA as a general anti-avoidance provision would be better served if the inquiry focused on whether or not there were other ways (for example, more convenient, or commercial, or frugal ways) in which the taxpayer might reasonably have achieved the substance and effect (tax implications aside) that it achieved from, or in connection with, the scheme. That inquiry would assist in exposing the purposes of the participants in a scheme and prevent taxpayers who achieve substantive non-tax effects from a scheme avoiding the normal tax consequences of what they have actually done by arguing that they would have done something completely different, or done nothing at all.

1.52 It is also not conducive to the effective operation of Part IVA for the inquiry to take into account the potential tax consequences of an alternative postulate in determining whether it is a reasonable alternative to the scheme.

1.53 The function of section 177C is to compare the tax consequences of the scheme with the tax consequences of a reasonable substitute for the scheme. Having identified a postulate that is in other respects functionally substitutable for the scheme, it would be undesirable to consider the tax consequences of that postulate to be a basis for disregarding it as unreasonable. To do so would be to allow the normal tax consequences of what it is that the taxpayer has achieved to function as a shield against the operation of Part IVA.

1.54 An inquiry of the kind proposed would better assist an analysis of the purposes of the persons who participated in the scheme and expose the tax advantages that they have in fact enjoyed.

***Deciding whether Part IVA applies***

1.55 In part, the weaknesses in the reconstruction limb of subsection 177C(1) may be an unintended consequence of the way that section 177D approaches the question whether Part IVA applies to a scheme.

1.56 Under the current law, the first question to be answered when determining whether Part IVA applies is whether a taxpayer has obtained a tax benefit in connection with the scheme (as defined in section 177C). Only if the answer is yes does attention turn to the section 177D inquiry and the question whether a participant in the scheme had the dominant purpose of securing a tax benefit for the taxpayer in connection with the scheme.

1.57 For instance, in *RCI* [2011] FCAFC 104 (at [151]) the Full Federal Court concluded it was ‘strictly unnecessary’, in disposing of that matter, for it to consider the paragraph 177D(b) issue as to purpose (although it did in fact go on to consider the issue out of ‘deference to the primary judge’s reasons and to the submissions on the hearing of the appeal’). Similarly, a differently constituted Full Federal Court in *Futuris* [2012] FCAFC 32 was able to dismiss the Commissioner’s appeal (at [81]) without considering the question of whether any person had the relevant tax avoidance purpose.

1.58 This approach is undesirable from a policy perspective. The objects of Part IVA are more likely to be served if the analysis starts with the section 177D inquiry about whether a person participated in a scheme for the sole or dominant purpose of enabling the taxpayer to obtain a tax

benefit. This inquiry has two components, in that the relevant purpose must be about a tax benefit, but it is nonetheless a single inquiry.

1.59 The inquiry looks at how the scheme was implemented, what it achieved as a matter of substance or reality (that is, its end effect) and the nature of any connection between the taxpayer and other parties. A consideration of alternative possibilities should form part of that inquiry. Gummow and Hayne JJ indicated in *Hart* (2004) 206 ALR 207 [at 66] that subsection 177C(1) and paragraph 177D(b) must be read together.

### **The Government's response**

1.60 On 1 March 2012, the Government announced that it would introduce amendments to ensure Part IVA continued to be effective in countering tax avoidance schemes.

1.61 The Government's announcement was made after reviewing a number of judicial decisions, including the decision of the Full Federal Court in *RCI* [2011] FCAFC 104, handed down on 22 August 2011. The High Court dismissed the Commissioner's application for special leave to appeal against that decision on 10 February 2012.

1.62 The Government was concerned that some taxpayers had argued successfully that they did not get a 'tax benefit' because, absent the scheme, they would not have entered into an arrangement that attracted tax — for example — because they would have entered into a different scheme that also avoided tax, because they would have deferred their arrangements indefinitely or because they would have done nothing at all.

1.63 The Government was also concerned that Part IVA might not be working effectively in relation to schemes that were steps within broader commercial arrangements.

1.64 Mindful that any amendments should not interfere with genuine commercial transactions, the Government established a comprehensive consultation process to assist it design the amendments. That process involved setting up a roundtable of industry representatives, legal academics and tax experts to assist Treasury identify and explore possible approaches to clarifying the law. It also involved the Government seeking advice on different design options from senior members of the bar with particular expertise in Part IVA.

1.65 The role of the roundtable was not to revisit the policy decisions announced by the Government on 1 March 2012. The roundtable was established because of the unique role that Part IVA plays in the income tax laws, in addition to the normal Treasury consultation processes, to

improve the legislative response to the problems that have emerged with Part IVA.

1.66 The roundtable process was constructive, and significantly deepened the Government's understanding of the issues with Part IVA that the Government is seeking to address.

1.67 As originally announced, the amendments were to apply from 2 March 2012. However, the Government announced a deferral of the application date until the release date of the exposure draft (16 November 2012) to allow for the additional time taken to progress the amendments to the exposure draft stage (time that was spent in consultation) and to recognise that the amendments may not have been in a form the public would have readily anticipated when the measure was first announced.

## **Summary of new law**

1.68 Schedule 1 to this Bill amends Part IVA of the ITAA 1936.

1.69 The amendments target deficiencies in section 177C, and the way it interacts with other elements of Part IVA, particularly section 177D, as revealed by recent decisions of the Full Federal Court.

1.70 The amendments are not intended to change the operation of Part IVA in any other respect.

1.71 Consistent with the policy underlying Part IVA, the amendments are intended to have the following effects:

- to put it beyond doubt that the 'would have' and 'might reasonably be expected to have' limbs of each of the subsection 177C(1) paragraphs represent alternative bases upon which the existence of a tax benefit can be demonstrated;
- to ensure that, when obtaining a tax benefit depends on the 'would have' limb of one of the paragraphs in subsection 177C(1), that conclusion must be based solely on a postulate that comprises all of the events or circumstances that actually happened or existed other than those forming part of the scheme;
- to ensure that, when obtaining a tax benefit depends on the 'might reasonably be expected to have' limb of one of the paragraphs in subsection 177C(1), that conclusion must be

based on a postulate that is a reasonable alternative to the scheme, having particular regard to the substance of the scheme and its effect for the taxpayer, but disregarding any potential tax costs; and

- to require the application of Part IVA to start with a consideration of whether a person participated in the scheme for the sole or dominant purpose of securing for the taxpayer a particular tax benefit in connection with the scheme; and so emphasising the dominant purpose test in section 177D as the ‘fulcrum’ or ‘pivot’ around which Part IVA operates.

### Comparison of key features of new law and current law

<i>New law</i>	<i>Current law</i>
It is clear that the ‘would have’ and ‘might reasonably be expected to have’ limbs of each of the subsection 177C(1) paragraphs represent alternative bases upon which the existence of a tax benefit can be demonstrated.	It is unclear whether the ‘would have’ and ‘might reasonably be expected to have’ limbs of each of the subsection 177C(1) paragraphs represent separate and distinct bases upon which the existence of a tax benefit can be demonstrated.
It is clear that the ‘would have’ limbs of each of the subsection 177C(1) paragraphs operate on the basis of a postulate that comprises existing facts and circumstances minus the scheme.	The operation of the ‘would have’ limbs of each paragraph of subsection 177C(1) is uncertain. Recent Federal Court cases appear to have proceeded on the basis that the ‘would have’ limb involves a prediction about events or circumstances, as opposed to a mere deletion of the scheme.
It is clear that the ‘might reasonably be expected to have’ limbs of each of the subsection 177C(1) paragraphs operate on the basis of postulates that are reasonable alternatives to the scheme, having particular regard to the substance of the scheme and the non-tax results and consequences achieved by the taxpayer from the scheme, but disregarding potential tax costs.	The operation of the ‘might reasonably be expected to have’ limbs of each of the subsection 177C(1) paragraphs depends on an inquiry about what other courses of action were reasonably open to the participants in the scheme.

<i>New law</i>	<i>Current law</i>
The question whether Part IVA applies to a scheme starts with a consideration of whether any person participated in the scheme for the sole or dominant purpose of securing for the taxpayer a tax benefit in connection with the scheme. This ensures that the examination of the tax benefit happens in the context of examining a participant's purpose.	The question whether Part IVA applies to a scheme starts with a consideration of whether a taxpayer has secured a particular tax benefit in connection with the scheme.

## **Detailed explanation of new law**

### **The bases for identifying tax benefits**

1.72 Schedule 1 to this Bill amends Part IVA to address weaknesses that have come to light in how it works out whether there is a tax benefit in connection with a scheme and what that tax benefit is. *[Schedule 1, item 5, section 177CB]*

1.73 A conclusion that one of the paragraphs of subsection 177C(1) is satisfied requires a conclusion that one of the tax effects specified in that subsection (for example, the inclusion of an amount of assessable income) 'would have', or 'might reasonably be expected to have', happened, absent a particular scheme. *[Schedule 1, item 5, subsection 177CB(1)]*

1.74 The new provision puts it beyond doubt that the 'would have' and 'might reasonably be expected to have' limbs of each of the paragraphs in subsection 177C operate as alternative bases for identifying relevant tax effects. *[Schedule 1, item 5, subsections 177CB(2) and (3)]*

### **Alternative bases**

1.75 Whilst the Commissioner, in exercising the discretion under subsection 177F(1) to cancel a tax benefit, is entitled to put his or her case in alternative ways (including by relying, in the alternative, on the different limbs of the paragraphs in subsection 177C), the tax benefit cancelled must be a tax benefit that has been obtained in connection with a scheme to which Part IVA applies.

1.76 As such, the question in every case will be whether or not it can be established, as a matter of objective fact, that the tax benefit the Commissioner is purporting to cancel is a tax benefit that was obtained in

connection with a scheme that was entered into or carried out with the requisite tax avoidance purpose.

### **An annihilation approach**

1.77 A decision that a tax effect ‘would have’ occurred if the scheme had not been entered into or carried out must be made solely on the basis of a postulate comprising all of the events or circumstances that actually happened or existed, other than those that form part of the scheme.

*[Schedule 1, item 5, subsection 177CB(2)]*

1.78 This provision makes it clear that, when postulating what would have occurred in the absence of the scheme, the scheme must be assumed not to have happened — that is, it must be ‘annihilated’, ‘deleted’ or ‘extinguished’. Otherwise, however, the postulate must incorporate all the ‘events or circumstances that actually happened or existed’.

1.79 In other words, the speculation that is permitted about any other state of affairs that might have come about if the scheme had not been entered into or carried out is limited to the removal of the scheme. A postulate cannot assume the existence of events or circumstances not in existence, nor can it assume the non-existence of events or circumstances that are in existence (other than those that form part of the scheme).

1.80 Under this approach, a taxpayer will have obtained a tax benefit in connection with a scheme if it can be demonstrated that a relevant tax effect would have flowed, as a matter of law, from the application of the taxation law to the facts remaining once the scheme is assumed away, that is, a tax effect less advantageous to the taxpayer than the tax effect secured by the taxpayer in connection with the scheme.

#### **Example 1.1: Postulating the absence of the scheme**

Sandy enters into a scheme from which he secures a large, up-front, tax deduction. The scheme is structured so as to provide him with a highly contingent right to income payable some years in the future. The potential investment returns are speculative and clearly subordinate to the tax deduction.

When postulating what the tax effects would have been absent the scheme, the events and circumstances comprising the scheme must be assumed not to have happened, and it is impermissible to speculate about events or circumstances that did not exist (for example, that Sandy would have done something else that would have also secured a tax deduction).

If the scheme is assumed not to have happened, Sandy would not have obtained a tax deduction. Sandy has therefore obtained a tax benefit in

connection with the scheme that is equal to the amount of the tax deduction that he secured by entering into the scheme.

1.81 An annihilation approach is a simple and effective way to identify a tax benefit in a case where the mere deletion of a scheme exposes a coherent taxable situation — without the need to engage in any kind of reconstruction or speculation.

1.82 Typically, this will be the case where the scheme in question does not produce any material non-tax results or consequences for the taxpayer.

1.83 For example, a straightforward application of this approach would be expected to expose the same deduction benefits as the Full Federal Court found had been obtained in connection with the agricultural schemes at issue in *Puzey* [2003] FCAFC 197 and *Sleight* [2004] FCAFC 94.

1.84 Similarly, it can be expected that this approach would be effective to expose tax benefits obtained in connection with schemes that shelter economic gains already in existence.

#### **Example 1.2: Changing the source of income**

Deborah, a foreign resident, enters into an arrangement under which assessable income that would otherwise be derived by her from Australian sources is instead derived by her from foreign sources with the result that it is not assessable in Australia.

If the scheme had not been entered into, the income *would have* been included in Deborah's assessable income because the only operation of the scheme was to change the source of the income for taxation purposes. The tax benefit is the reduction in Deborah's assessable income.

No speculation is necessary or permitted in deciding what else might have happened if Deborah had not entered into the scheme.

#### **A reconstruction approach**

1.85 A decision that a tax effect 'might reasonably be expected to have' occurred if a scheme had not been entered into or carried out must be made on the basis of a postulate that is a reasonable alternative to the scheme, having particular regard to the substance of the scheme and its results and consequences for the taxpayer, and disregarding any potential tax results and consequences. [*Schedule 1, item 5, subsections 177CB(3) and (4)*]

1.86 The amendment makes it clear that when postulating what might reasonably be expected to have occurred in the absence of a scheme, it is not enough to simply assume the non-existence of the scheme — the postulate must represent a reasonable alternative to the scheme, in the sense that it could reasonably take the place of the scheme.

1.87 Such a postulate will necessarily require speculation about the state of affairs that would have existed if the scheme had not been entered into or carried out. This may include speculation about the way in which connected transactions would have been modified if they had had to accommodate the absence of the scheme.

1.88 Under this approach, a taxpayer will obtain a tax benefit in connection with a scheme if it can be demonstrated that a relevant tax effect would have flowed, as a matter of law, from the application of the taxation law to the alternative postulate; again, a tax effect that is less advantageous to the relevant taxpayer than the tax effect secured by the taxpayer in connection with the scheme.

**Example 1.3: Reconstructing events**

Mr and Mrs Heginbothom want to borrow money to acquire both a family home and a holiday house that they plan to rent to holidaymakers. They borrow the money under an arrangement in which the repayments are applied exclusively to the borrowing in relation to the family home. The result is that the deductible interest payments are increased for the holiday home borrowing and the non-deductible interest payments for the family home borrowing are minimised.

Merely annihilating the scheme would not leave a sensible result because there would be no borrowing at all, so some reconstruction is necessary. It is therefore necessary to consider what might reasonably be expected to have happened if the scheme had not been entered into. A reasonable alternative in this case might be that the Heginbothoms took out two loans, one for each of the homes they wished to acquire, each of which was entered into on normal commercial terms.

1.89 A reconstruction approach is an effective way to identify a tax benefit in relation to a scheme that achieves substantive non-tax results and consequences. In these cases, simply annihilating the scheme would be inconsistent with the non-tax results and consequences sought for the taxpayer by the participants in the scheme.

1.90 Typically this will be the case in an income scheme (or a withholding tax scheme) that both produces and shelters economic gains. In such cases an annihilation approach would be an ineffective way to expose the tax avoidance achieved by the tax shelter, since deleting the

scheme would destroy both the gain and the shelter. In such cases, a prediction will necessarily be required about other ways in which a comparable gain could have been produced without the tax shelter.

1.91 The role of the reconstruction approach in relation to income schemes is usefully illustrated by the High Court decision in *Spotless* (1996) 141 ALR 92. There (at pp 103-104) the Court rejected a submission on behalf of the taxpayers, in relation to paragraph 177C(1)(a), that, had they not entered into the investment scheme, there would have been no interest, and no amount included in their assessable income that would satisfy the definition of ‘tax benefit’.

‘In our view, the amount to which para (a) refers as not being included in the assessable income of the taxpayer is identified more generally than the taxpayers would have it. The paragraph speaks of the amount produced from a particular source or activity. In the present case, this was the investment of \$40 million and its employment to generate a return to the taxpayers. It is sufficient that at least the amount in question might reasonably have been included in the assessable income had the scheme not been entered into or carried out.’

1.92 A reconstruction approach may also be effective in relation to schemes that result in a taxpayer obtaining a tax advantage of the kind mentioned in paragraphs 177CB(1)(b), (c), (d) and (e): a deduction benefit, a capital loss benefit, a foreign tax offset benefit or a withholding tax benefit.

1.93 If a postulate that the scheme merely would not have happened would be inconsistent with the non-tax results and consequences sought for the taxpayer by the participants in the scheme then a reconstruction of either the scheme, or of the scheme and things that happened in connection with the scheme, may expose other ways in which the non-tax results and consequences of the scheme could reasonably have been achieved without the impugned tax advantages.

1.94 This is usefully illustrated by the decisions in *Consolidated Press* [1999] FCA 1199 and in *Hart* (2004) 206 ALR 207.

1.95 In *Consolidated Press* the Full Federal Court concluded (at [89]) that, absent the scheme, an amount of interest on a borrowing ‘might reasonably be expected ... not to have been allowable’. In so doing, it upheld the trial judge’s hypothesis that, had the particular scheme not been entered into, it was reasonable to expect that the borrowed money would have been directly invested in a foreign subsidiary and therefore been non-deductible because of former section 79D of the ITAA 1936. The trial judge based his hypothesis on the way in which the actual investment had been structured ((1998) 98 ATC 4983 at 4998 per Hill J).

1.96 Similarly in *Hart*, where a husband and wife had borrowed money on unusual terms with advantageous taxation consequences, the High Court concluded that absent the scheme it was reasonable to expect the taxpayers would have still borrowed the money (for two purposes, one private and the other income producing) but that they would have done so on standard financing terms rather than the special terms which had produced the relevant tax advantages.

1.97 In each of *Consolidated Press* and *Hart*, the reasonable expectation as to what would have happened absent the respective schemes was informed by the commercial results to which the schemes were directed.

***The matters to which particular regard must be had***

1.98 The amendments make it clear that in determining whether a postulate is a reasonable alternative to the entering into or carrying out of the scheme, particular regard must be had to the ‘substance of the scheme’ and to ‘any result or consequence for the taxpayer that would be achieved by the scheme’ (tax results aside). [*Schedule 1, item 5, paragraph 177CB(4)(a)*]

1.99 These matters are ones to which regard must also be had under section 177D in determining whether it would be concluded that a person who entered into or carried out the scheme, or any part of it, did so for the purpose of enabling the relevant taxpayer to obtain a tax benefit.

1.100 Particular regard must be given to the specified matters: they are not intended to be an exhaustive list of the matters to which regard may be had.

1.101 Particular attention is directed to the specified matters in order to ensure that postulates identified under the reconstruction limbs of the subsection 177C(1) paragraphs are reasonable substitutes for the scheme.

1.102 A tax advantage cannot meaningfully be linked to a scheme by comparing the tax consequences of the scheme to the tax consequences that would have flowed if the parties had chosen to pursue some other objective. To provide a meaningful comparison, the tax consequences of the scheme should be compared with the tax consequences of an alternative that is reasonably capable of achieving for the taxpayer substantially the same non-tax results and consequences as those achieved by the scheme.

***Having particular regard to the substance of the scheme***

1.103 An examination of the substance of a scheme [*Schedule 1, item 5, subparagraph 177CB(4)(a)(i)*] requires a consideration of its commercial and economic substance as distinct from its legal form or shape.

1.104 For example, in *Sleight* [2004] FCAFC 94, Hill J, when considering the substance of a tea tree oil scheme, said (at [81]):

‘There is a difference between the form and the substance of the present scheme. In form there is an option whether to farm alone or to employ the management company. There is a management agreement and financing and interest payments. The form involving pre-payment of management fee and interest is, it may be concluded readily, designed to increase the taxation deductions available to an investor. The substance is, however, quite different. As senior counsel for the Commissioner put it, in substance the investor is a mere passive investor in what, once the tax features are removed, is a managed fund where no deduction would be available, or perhaps an alternative characterisation of the substance of the scheme is an investment in shares in the land company which at the expiration of 15 years is to own the tea tree plantation.’

1.105 Similarly, in *Hart* (2004) 206 ALR 207, Gummow and Hayne JJ (at [71]) agreed with Hill J below that the substance of the arrangement, in form two separate loans, was in fact one advance to be repaid by 300 instalments.

1.106 In order for a postulate to constitute a reasonable alternative to the entering into and carrying out of the scheme, the substance of the postulate should correspond to the substance of the scheme.

**Example 1.4: A postulate with the same non-tax results and consequences**

Assume Paul & Co placed \$1 million dollars on deposit for 12 months for a return of \$50,000, payable in arrears. The income produced by the investment is exempt for taxation purposes.

From Paul & Co’s perspective, the substance of the transaction is an investment for a fixed term carrying a right to a non-contingent return.

A reasonable alternative to this transaction would be an investment of the same amount, for the same period at a comparable risk and for a comparable return.

An investment in ordinary shares would not represent an investment of comparable risk and comparable return.

***Having particular regard to the results and consequences of the scheme for the taxpayer***

1.107 An examination of the results or consequences for the taxpayer that would be achieved by the scheme (tax results aside) [*Schedule 1, item 5, subparagraph 177CB(4)(a)(i)*] requires a consideration of any financial or other consequences for the taxpayer that would be accomplished or achieved as an end result of the scheme having been entered into and carried out.

1.108 Such matters could include changes in the taxpayer's financial position that result from the scheme, including the impact of transaction costs, such as fees, stamp duties, payroll taxes, and also non-financial considerations, such as the effect that the scheme has on personal or family relationships.

1.109 The fact that the scheme satisfied certain regulatory requirements, such as directors' duties, workplace health or safety requirements and environmental standards, would also be relevant consequences of the scheme.

1.110 It would be expected that a postulate that is a reasonable alternative to the entering into and carrying out of a scheme would achieve for the taxpayer non-tax results and consequences that are comparable to those achieved by the scheme itself.

**Example 1.5: The results achieved for the taxpayer**

Gadget Co negotiates, with the assistance of its selling agent, Banker Co, to sell its Sydney factory to Widget Co for \$500,000. However, rather than transferring the factory directly to Widget Co, Gadget Co enters into a complex transaction that involves the factory passing through the hands of Banker Co before it is finally transferred to Widget Co.

Gadget Co realizes \$475,000 from the transaction and Banker Co takes the \$25,000 balance. The transaction is constructed in such a way that Gadget Co is not liable for capital gains tax on the disposal of the property.

From Gadget Co's perspective, the end result achieved by the transaction was the disposal of its factory to Widget Co for \$500,000. A reasonable alternative to the transaction, that would have achieved the same non-tax effect for Gadget Co, would have been for Gadget Co to dispose of the factory directly to Widget Co for \$500,000 and for Gadget Co to have paid Banker Co a fee reflecting the value of its services in finding a buyer.

1.111 The amendments are intended to make it clear that the focus is on the results and consequences achieved by the scheme for the taxpayer,

as distinct from the results and consequences achieved by the scheme for one or more of the other participants in the scheme (compare the emphasis that was placed on the fact that a direct sale of Axa Health to MB Health would have denied Macquarie Bank Limited its underwriting and sell-down fee in *Axa Asia* [2010] FCAFC 134 (at [143])).

1.112 More particularly, there is no need for the alternative postulate to involve all the same participants as the scheme itself comprised (see, for example, the alternative postulate relied upon by the High Court in *Spotless* (1996) 141 ALR 92).

#### ***Schemes within broader transactions***

1.113 Where a scheme forms part of a broader commercial transaction, a postulate would be a reasonable alternative to the scheme if it performs the same role in relation to the broader transaction as the scheme itself performs, disregarding its tax effects.

1.114 Consequently, if the scheme itself has no non-tax results and consequences and the broader transaction remains effective without the scheme, there would be no warrant for an alternative postulate involving a reconstruction of the broader transaction (compare *Futuris* [2012] FCAFC 32).

1.115 Where, however, a scheme is integral to a broader transaction in the sense that it is intertwined with the broader transaction and facilitates it in some way, then it would be reasonable for an alternative postulate to involve a reconstruction of the broader transaction, so long as the reconstruction produces the same non-tax results and consequences as were in fact achieved by the broader transaction.

1.116 The extent to which the broader transaction should be reconstructed should be limited by the role the scheme plays in that transaction.

#### **Example 1.6: A scheme that facilitates a broader transaction**

Assume that in order for Kerry-Anne to secure a tax deduction for borrowing money to invest in an offshore company (Offshore Co) it is necessary for her to interpose a resident Australian company. She does this by using the borrowed funds to buy shares in an Australian shelf company (Oz Co). In turn, Oz Co buys ordinary shares in Offshore Co. Oz Co performs no other role.

The Commissioner makes a Part IVA determination on the basis that the interposition of Oz Co is a scheme to which Part IVA applies.

Objectively viewed, the interposition of Oz Co achieves two effects. One is securing a deduction for interest on the borrowing, and the other is the acquisition of shares in Offshore Co.

A correct alternative postulate should be another way in which Kerry-Anne could reasonably be expected to have acquired ordinary shares in Offshore Co. An alternative postulate that involved Kerry-Anne lending the borrowed monies to Offshore Co would achieve a different effect. So too would be a postulate that involved Kerry-Anne investing the borrowed monies in a completely different company.

### ***Disregarding tax costs***

1.117 The amendments make it clear that, in determining whether a postulate is a reasonable alternative to the entering into or carrying out of the scheme, regard should not be had to any tax costs that are generated for the taxpayer by the scheme itself or that would be generated for the taxpayer or any other person by the postulate. [*Schedule 1, item 5, subparagraph 177CB(4)(a)(ii) and paragraph 177CB(4)(b)*]

1.118 In other words, potential tax liabilities are not to be taken into account in assessing the likelihood or reasonableness of any alternative postulate.

1.119 Tax costs that are to be disregarded include the same tax costs that are taken into account under the purpose inquiry in paragraph 177D(2)(d).

1.120 The disregarding of the potential liability of a person to tax extends not just to the taxpayer and participants in the scheme but to any person who might be a potential participant in an alternative to a scheme.

1.121 This amendment is intended to make it clear that alternative postulates should not be rejected as unreasonable postulates on the grounds that the tax costs involved in undertaking those postulates (including denial of the tax benefit impugned by the Commissioner) would have caused the parties to either abandon or indefinitely defer the schemes and/or the wider transactions of which they were a part (compare *RCI* [2011] FCAFC 104 at [145]-[150] and *Futuris* [2012] FCAFC 32 at [71]).

### **When does Part IVA apply?**

1.122 The amendments provide that the first question to be answered when determining whether Part IVA applies to a scheme is to ask whether a participant in the scheme had the requisite purpose of securing a tax

benefit for the taxpayer in connection with the scheme. [*Schedule 1, item 5, subsections 177D(1) and (2)*]

1.123 The questions whether a tax benefit was obtained in connection with the scheme and whether the scheme was entered into or commenced to be carried out after 27 May 1981 follow as subsidiary questions. [*Schedule 1, item 5, subsections 177D(3) and (4)*]

1.124 To support this, an amendment is made to subsection 177F(1) to further emphasise that an examination of Part IVA should commence with the question whether there is a scheme to which Part IVA applies. [*Schedule 1, item 7, subsection 177F(1)*]

1.125 These amendments complement section 177CB and ensure that Part IVA operates as an integrated whole: by emphasizing the central role of the dominant purpose test in section 177D (described by Callinan J in *Hart* (2004) 206 ALR 207 at [92] as the ‘fulcrum’ upon which Part IVA turns) and ensuring that section 177C, whose role is to define when a tax benefit has been obtained in connection with a scheme, is read with section 177D in the inter-related way envisaged by Gummow and Hayne JJ in the High Court in *Hart*.

## **Application provisions**

1.126 The amendments apply in relation to schemes that were entered into, or that were commenced to be carried out, on or after 16 November 2012, the date on which an exposure draft of this Bill was released for public consultation. [*Schedule 1, item 10*]

1.127 The amendments apply from that date, rather than from some later date, such as the date of Royal Assent, to minimize the potential for taxpayers to obtain unintended tax advantages in the period before the amendments become law.

## **Consequential amendments**

1.128 Section 177CA of the ITAA 1936 provides that a taxpayer who avoids paying withholding tax on an amount on which it would have, or could reasonably be expected to have, paid withholding tax, absent a scheme, is taken to have obtained a tax benefit.

1.129 The amendments bring the avoidance of withholding tax within the list of other tax benefits set out in section 177C. This ensures that the amendments concerning assumptions that can be made in relation to

alternative postulates apply with equal force to withholding tax benefits. [Schedule 1, items 2 to 5 and 8 and 9, paragraphs 177C(1)(bb), (bc) and (g), section 177CA, subsection 177F(2A) of the ITAA 1936, and paragraph 18-40(1)(a) in Schedule 1 to the Taxation Administration Act 1953]

1.130 A number of consequential amendments are also required by reason of the restructuring of section 177D. [Schedule 1, items 1 and 6, paragraphs 45B(8(k), 177EA(17)(j), and 177EB(10)(f)]

## **STATEMENT OF COMPATIBILITY WITH HUMAN RIGHTS**

### **Prepared in accordance with Part 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011***

#### **General anti-avoidance rule**

1.131 This Schedule is compatible with the human rights and freedoms recognised or declared in the international instruments listed in section 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011*.

#### **Overview**

1.132 Part IVA is the income tax law's general anti-avoidance rule that operates to protect the integrity of the tax law from contrived or artificial arrangements designed to obtain a tax advantage.

1.133 Recent court cases have brought to light some weaknesses in Part IVA that put at risk its capacity to properly perform that operation. The amendments made by this Schedule ensure that Part IVA can continue to protect the integrity of the income tax law.

#### **Human rights implications**

1.134 This Schedule ensures that the income tax law continues to be protected from artificial or contrived schemes designed to avoid tax, and so improves the likelihood that the income tax law applies in the way Parliament intended. It does not change any legislative policy.

1.135 The amendments apply from 16 November 2012; that is, from a date before the amendments become law. 16 November 2012 was the date on which a draft of the amendments was released for public comment. Applying it from that date is necessary to ensure that taxpayers are not able to benefit from artificial or contrived tax avoidance schemes

entered into in the period between that date and the date of Royal Assent. Application from that date does not affect the operation of any criminal law.

1.136 For those reasons, this Schedule does not engage any of the applicable rights or freedoms.

### **Conclusion**

1.137 This Schedule is compatible with human rights as it does not raise any human rights issues.

**Assistant Treasurer, the Hon David Bradbury**

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## **Chapter 2**

# ***Modernisation of the transfer pricing rules***

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### **Outline of Chapters 2 to 7**

2.1 Schedule 2 inserts Subdivisions 815-B, 815-C and 815-D into the *Income Tax Assessment Act 1997* (ITAA 1997) and Subdivision 284-E into Schedule 1 to the *Taxation Administration Act 1953* (TAA 1953). These Subdivisions contain amendments that modernise the transfer pricing rules contained in Australia's domestic law. They ensure Australia's transfer pricing rules better align with the internationally consistent transfer pricing approaches set out by the Organisation for Economic Cooperation and Development (OECD).

2.2 The amendments also ensure greater alignment between outcomes achieved for international arrangements involving Australia and another jurisdiction irrespective of whether the other country forms part of Australia's tax treaty network.

2.3 Schedule 2 also makes consequential amendments to:

- the ITAA 1997;
- the *Income Tax Assessment Act 1936* (ITAA 1936);
- the *Income Tax (Transitional Provisions) Act 1997* (IT(TP) Act 1997); and
- the TAA 1953.

2.4 All legislative references in Chapters 2 to 7 are to the ITAA 1997 unless otherwise stated.

### **Context of amendments**

2.5 The amendments ensure that application of the arm's length principle in Australia's domestic rules is aligned with international transfer pricing standards, especially those of our major investment partners. These standards are currently set out in the *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* as approved by the Council of the OECD and last amended on 22 July 2010 (OECD Guidelines).

2.6 The OECD Guidelines are widely recognised as representing international best practice. Greater consistency with international standards reduces uncertainty and the risk of double taxation, and assists in minimising compliance and administration costs.

2.7 Transfer pricing rules are critical to the integrity of the tax system. Related party trade in Australia was valued at approximately \$270 billion in 2009, representing a considerable proportion of Australia's cross-border trade flows (about 50 per cent).

2.8 Multinational trade has grown over the last decade. Further, since 2002 the compositional change in multinational trade in Australia has been striking. For example, whilst trade in tangible items such as stock in trade grew by 67 per cent between 2002 and 2009, trade in highly mobile factors such as services grew by more than 100 per cent and trade in insurance products and interest flows grew by more than 160 per cent over the same period.

2.9 Growth of this nature underscores the need for modern, robust transfer pricing rules capable of dealing with complex arrangements.

2.10 Australia's transfer pricing rules seek to ensure that an appropriate return for the contribution made by an entity's Australian operations is taxable in Australia for the benefit of the community. The appropriate return is determined through the application of the arm's length principle, which aims to ensure that an entity's tax position is consistent with that of an independent entity dealing wholly independently with others.

2.11 The new rules apply the arm's length principle by identifying the conditions that might be expected to operate in comparable circumstances between independent entities dealing wholly independently with one another.

2.12 In addition, where the allocation of an entity's profits to an Australian or overseas permanent establishment is relevant in determining its tax position, the arm's length principle ensures that the allocation is performed on the basis that the permanent establishment was a distinct and separate entity dealing wholly independently with the entity of which it is a part. Under this approach the allocation of profits to the permanent establishment is constrained to the allocation of actual income and expenses of the entity.

## Current transfer pricing rules

2.13 Australia's domestic transfer pricing rules are currently set out in Division 13 of the ITAA 1936 (Division 13) and in Subdivision 815-A. Transfer pricing rules are also contained in Australia's bilateral tax treaties. Division 13 is to be repealed and Subdivision 815-A will no longer have effect when Subdivisions 815-B and 815-C are enacted.

2.14 The rules in Division 13 generally focus on determining the arm's length consideration for the supply or acquisition of property and/or services under an international agreement. By contrast, in determining whether outcomes are consistent with the arm's length principle, Australia's tax treaties and the OECD Guidelines also allow for consideration of the totality of arrangements that would have been expected to operate had the entities been dealing with each other on a wholly independent basis. This focus permits the consideration of a broad range of methods in determining arm's length outcomes. Such methods include, but are not limited to, traditional transaction methods.

2.15 Subdivision 815-A, enacted by the *Tax Laws Amendment (Cross-Border Transfer Pricing) Act (No. 1) 2012*, applies to ensure that Australia's tax treaty transfer pricing rules operate as intended. The purpose of Subdivision 815-A is to limit taxable profits being shifted or misallocated offshore. Subdivision 815-A also provides direct access to the OECD Guidance material and clarifies how the Subdivision should interact with Division 820 of the ITAA 1997, which deals with thin capitalisation.

## Summary of new law

2.16 Subdivisions 815-B, 815-C and 815-D modernise and relocate the transfer pricing provisions into the ITAA 1997 to ensure that consistent rules apply to both tax treaty and non-tax treaty cases. In addition, Subdivision 284-E of Schedule 1 to the TAA 1953 contains rules related to transfer pricing documentation. Consistent with the approaches under Division 13, the new rules in Subdivision 815-B apply the arm's length principle to relevant dealings between both associated and non-associated entities.

2.17 Unlike the current transfer pricing rules in Division 13 and in Subdivision 815-A, which both rely on the Commissioner of Taxation (Commissioner) making a determination, Subdivisions 815-B and 815-C are self-executing in their operation. This better aligns Australia's domestic transfer pricing rules with the design of Australia's overall tax system which generally operates on a self-assessment basis.

### **Subdivision 815-B: Arm's length rule for entities**

2.18 Subdivision 815-B modernises Australia's transfer pricing rules in respect of dealings between separate legal entities. The Subdivision requires certain amounts (taxable income, a loss of a particular sort, tax offsets and withholding tax payable) to be worked out by applying the internationally accepted arm's length principle.

2.19 The authoritative statement of the arm's length principle is set out in Paragraph 1 of Article 9 (the associated enterprises article) of the *OECD Model Tax Convention on Income and on Capital* and the OECD Guidelines. Paragraph 1 states:

'[Where] conditions are made or imposed between the two [associated] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued 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.'

2.20 Each of Australia's tax treaties includes an associated enterprises article based on Article 9 of the OECD Model Tax Convention. Although the application of Article 9 is restricted to associated enterprises, Subdivision 815-B also applies to unrelated entities.

2.21 Consistent with the current transfer pricing rules, Subdivision 815-B does not rely on or assume a tax avoidance motive.

2.22 Broadly, the arm's length principle is introduced into Australia's domestic law by requiring actual conditions that operate between entities in their commercial or financial relations and which result in a transfer pricing benefit for an entity, to be replaced with the arm's length conditions.

2.23 The arm's length conditions for the commercial or financial relations are those conditions that might be expected to operate between entities dealing wholly independently with one another in comparable circumstances. As such, Subdivision 815-B applies the arm's length principle consistent with the associated enterprises articles of Australia's tax treaties.

2.24 Determining the arm's length conditions involves an analysis of the functions performed, the assets used or contributed, and the risks assumed or managed by the entities. From this analysis, the most appropriate and reliable transfer pricing method, or combination of methods, must be selected. Applying the most appropriate and reliable

transfer pricing method or methods determines the arm's length conditions that are applicable to the relevant entity.

2.25 In applying the arm's length principle, the actual conditions arising from the commercial or financial relations between entities must be compared to the arm's length conditions that might reasonably be expected to have operated between independent entities in comparable circumstances.

2.26 The identification of arm's length conditions must be done in a way that best achieves consistency with the OECD Guidelines, as well as any documents that are prescribed by regulation.

2.27 Consistent with Division 13 and Subdivision 815-A, Subdivision 815-B allows for consequential adjustments.

### **Subdivision 815-C: Arm's length rule for permanent establishments**

2.28 Subdivision 815-C modernises Australia's transfer pricing rules in respect of the attribution of profits between a permanent establishment and the entity of which it is a part. Consistent with Australia's current treaty practice, the relevant business activity approach (also known as the single entity approach) must be followed in applying Subdivision 815-C.

2.29 Broadly, the allocation of profits between a permanent establishment and the entity of which it is a part is determined by analysing the functions performed, the assets used or contributed, and the risks assumed or managed by the various parts of the business. From this analysis, the most appropriate and reliable transfer pricing method or combination of methods should be chosen, having regard to the circumstances of the commercial or financial relations — bearing in mind the limitation in the attribution process to the actual expenditure and income of the entity.

2.30 Within this framework, applying the most appropriate and reliable transfer pricing method or methods determines the arm's length profits that are attributable to the permanent establishment of an entity.

2.31 The arm's length principle is interpreted so as to best achieve consistency with the OECD Model Tax Convention and Commentaries, as well as the internationally accepted OECD Guidance material.

### **Subdivision 815-D: Special rules for trusts and partnerships**

2.32 Subdivision 815-D sets out special rules about the way Subdivisions 815-B and 815-C apply to trusts and partnerships. The rules

ensure that the transfer pricing rules apply in relation to the net income of a trust or partnership in the same way they apply to the taxable income of a company. The Subdivisions also apply to the partnership loss of a partnership in the same way they apply to the tax loss of a company.

### **Amendments to the TAA 1953: Record keeping and penalties**

2.33 Subdivision 284-E of Schedule 1 to the TAA 1953 sets out the type of documentation that an entity may prepare and keep in self-assessing its tax position under Subdivision 815-B or 815-C. This documentation is referred to as transfer pricing documentation. In order to satisfy the requirements of Subdivision 284-E, transfer pricing documentation must be prepared before the lodgement of the relevant tax return.

2.34 While the Subdivision does not mandate the preparation or keeping of documentation, failing to do so prevents an entity from establishing a reasonably arguable position. Establishing a reasonably arguable position is one avenue through which an entity can lower administrative penalties. However, nothing in these amendments prevents the Commissioner from exercising a general discretion to remit administrative penalties where appropriate (as currently available under the law).

2.35 Other amendments to the TAA 1953 ensure that administrative penalties can apply to tax liabilities that arise from the Commissioner adjusting a taxpayer's position under Subdivision 815-B or 815-C.

2.36 If however the additional tax liability is equal to or less than the relevant de minimis thresholds, no administrative penalty applies.

### **How do Subdivisions 815-B and 815-C interact with Australia's tax treaties more generally?**

2.37 Subdivisions 815-B and 815-C are generally aligned with the associated enterprise and business profits articles in Australia's tax treaties (generally Articles 7 and 9). Subsection 4(2) of the *International Tax Agreements Act 1953* (ITAA 1953) continues to apply in the event of an inconsistency between Australia's tax treaties and the domestic transfer pricing rules.

2.38 While Subdivision 815-B and 815-C apply where an entity gets a transfer pricing benefit in Australia, nothing in either Subdivision prevents Australia's tax treaties from applying in circumstances where a tax treaty results in a different adjustment relative to a taxpayer's position under the domestic law provisions.

## Comparison of key features of new law and current law

<i>New law</i>	<i>Current law</i>
<b>Transfer pricing adjustments</b>	
<p>A transfer pricing adjustment may be made under Subdivision 815-B, Subdivision 815-C, or the relevant transfer pricing provisions of a tax treaty.</p> <p>Subdivision 815-B applies to certain conditions between entities and Subdivision 815-C applies to the allocation of actual income and expenses of an entity between the entity and its permanent establishment.</p> <p>To the extent they have the same coverage as the equivalent tax treaty rules, an adjustment under Subdivision 815-B or Subdivision 815-C gives the same result as the transfer pricing provisions of a tax treaty.</p>	<p>A transfer pricing adjustment may be made under Division 13, the transfer pricing provisions of a tax treaty, or Subdivision 815-A.</p> <p>Subdivision 815-A, for practical purposes, generally gives the same result as the application of the transfer pricing provisions of a tax treaty by adopting the terms and text of the relevant parts of the transfer pricing articles contained in Australia's tax treaties.</p>
<b>Assessment of transfer pricing adjustments</b>	
<p>Subdivisions 815-B and 815-C apply on a self-assessment basis.</p>	<p>The Commissioner must make a determination under Division 13 or Subdivision 815-A in order to give effect to a transfer pricing adjustment.</p>
<b>Application of the rules to conditions between entities</b>	
<p>Subdivision 815-B applies to conditions that satisfy the cross-border test, irrespective of whether entities are associated or not and/or operating in treaty or non-treaty countries.</p> <p>The transfer pricing provisions of a tax treaty may apply in the event of an inconsistency with Subdivision 815-B.</p>	<p>Division 13 applies to international agreements between both associated and unassociated entities irrespective of tax treaty coverage (although the transfer pricing provisions of a tax treaty may apply in the event of an inconsistency).</p> <p>Subdivision 815-A and the tax treaty transfer pricing provisions apply in treaty cases and in respect of associated entities only.</p>

<i>New law</i>	<i>Current law</i>
<b>Allocation of profits between entities and their permanent establishments</b>	
<p>Subdivision 815-C applies to the allocation of actual income and expenses of an entity between the entity and its permanent establishment.</p> <p>Subdivision 815-C applies to a foreign permanent establishment of an Australian resident and to an Australian permanent establishment of a foreign resident entity, irrespective of whether a tax treaty applies.</p> <p>The transfer pricing provisions of a tax treaty may apply in the event of an inconsistency with Subdivision 815-C.</p>	<p>Subdivision 815-A and the relevant tax treaty transfer pricing provisions allocate profits (the income and expenses) to the Australian permanent establishment of a foreign resident entity in treaty cases only.</p> <p>The transfer pricing provisions of a tax treaty may apply in the event of an inconsistency with Subdivision 815-A.</p>
<b>Arm's length principle</b>	
<p>Subdivisions 815-B and 815-C and the tax treaty transfer pricing provisions apply the internationally accepted arm's length principle which is to be determined consistently with the relevant OECD Guidance material.</p>	<p>Division 13 operates to ensure that for all purposes of the Act, an arm's length amount of consideration is deemed to be paid or received for a supply or acquisition of property or services under an international agreement.</p> <p>Subdivision 815-A and the tax treaty transfer pricing provisions apply the internationally accepted arm's length principle which is to be determined consistently with the relevant OECD Guidance material.</p>

<i>New law</i>	<i>Current law</i>
<b>Record keeping</b>	
<p>Subdivision 284-E of Schedule 1 to the TAA 1953 sets out optional record keeping requirements for entities to which Subdivision 815-B or 815-C applies.</p> <p>Records that meet the requirements are necessary, but not sufficient to establish a reasonably arguable position for the purposes of Schedule 1 to the TAA 1953.</p> <p>If the documentation as specified in the Subdivision is not kept in respect of a matter, an entity is not able to demonstrate that it has a reasonably arguable position in relation to that matter for the purposes of Schedule 1 to the TAA 1953.</p>	<p>The general record-keeping provisions of the tax law apply to the transfer pricing provisions.</p>
<b>Administrative penalties</b>	
<p>Administrative penalties may apply if an assessment is amended by the Commissioner for an income year to give effect to Subdivisions 815-B or 815-C and the provisions of section 284-145 of Schedule 1 to the TAA 1953 have been met.</p>	<p>Administrative penalties may apply where a transfer pricing adjustment has been made by the Commissioner under Division 13 or Subdivision 815-A and the provisions of section 284-145 of Schedule 1 to the TAA 1953 have been met. This is subject to the operation of a transitional rule where the Commissioner makes a determination under Subdivision 815-A in respect of income years prior to the first income year starting on or after 1 July 2012.</p>
<b>Amendment period</b>	
<p>An amendment to give effect to Subdivision 815-B or Subdivision 815-C can be made within seven years after the day on which the Commissioner gives notice of the assessment to the entity.</p> <p>Some tax treaties impose specific time limits in relation to transfer pricing adjustments under the tax treaty.</p>	<p>Subject to subsection 170(9C), subsection 170(9B) of the ITAA 1936 provides an unlimited period in which the Commissioner may amend an assessment to give effect to a transfer pricing adjustment under Division 13, the tax treaty transfer pricing provisions, or Subdivision 815-A.</p> <p>Some tax treaties impose specific time limits in relation to transfer pricing adjustments under the tax treaty.</p>



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## **Chapter 3**

# **Arm's length principle for conditions between entities**

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### **Subdivision 815-B**

#### **What is the object of Subdivision 815-B?**

3.1 The object of Subdivision 815-B is to ensure that the amount brought to tax in Australia from cross-border conditions that operate between entities reflects the arm's length contribution made by an entity's Australian operations. Any such amounts should reflect the conditions that might be expected to operate between independent entities dealing at arm's length. *[Schedule 2, item 2, subsection 815-105(1)]*

3.2 Subdivision 815-B seeks to achieve this outcome in a way that facilitates trade and investment through alignment with international standards. The international standard that is widely accepted by Australia's trade and investment partners is the arm's length principle, the application of which is set out in the *Organisation for Economic Cooperation and Development (OECD) Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* as approved by the Council of the OECD and last amended on 22 July 2010 (OECD Guidelines).

3.3 The Subdivision implements this principle by requiring entities that would otherwise get a tax advantage in Australia from non-arm's length conditions, to calculate their Australian tax position as though the arm's length conditions had instead operated. *[Schedule 2, item 2, subsection 815-105(2)]*

#### **How does Subdivision 815-B interact with the rest of the Act?**

3.4 Subdivision 815-B takes precedence over other provisions of the *Income Tax Assessment Act 1936* (ITAA 1936) and the *Income Tax Assessment Act 1997* (ITAA 1997) unless a limitation to its operation is explicitly provided within the Subdivision. *[Schedule 2, item 2, subsection 815-110(1)]*

3.5 This means that to the extent that an entity is liable to a different tax result under Subdivision 815-B relative to other provisions of the tax law because of the operation of arm's length conditions instead of actual

conditions, Subdivision 815-B must be applied in working out the entity's Australian tax liability.

3.6 This priority rule does not however overcome the effect of subsection 4(2) of the *International Tax Agreements Act 1953* (ITAA 1953) (referred to at paragraphs 2.37 and 2.38 above). This is because Subdivision 815-B takes precedence over provisions in the ITAA 1936 and the ITAA 1997 (the Assessment Acts), whereas subsection 4(2) applies to the extent of inconsistencies between the ITAA 1953 and the Assessment Acts.

3.7 Subdivision 815-B does not limit the application of Division 820 (which is about thin capitalisation) in reducing, or further reducing, an entity's debt deductions. [*Schedule 2, item 2, subsection 815-110(2)*]

3.8 This rule preserves the role of Division 820 in its application to an entity's amount of debt. In addition to this rule, Subdivision 815-B contains other special rules that apply in working out an entity's transfer pricing adjustment where Division 820 also applies (these rules are described in further detail below at paragraphs 3.143 to 3.149).

3.9 In contrast to former subsection 136AB(2) of the ITAA 1936, Subdivision 815-B does not disregard the effect of sections 70-20, 420-20, 420-30 or 355-400 (which relate to market value amounts). A rule of this kind is not required under Subdivision 815-B because in the event that a market value substitution has already been applied under one of those provisions (or a similar provision), Subdivision 815-B still applies to the extent that an adjustment under Subdivision 815-B is greater than the market value amount.

3.10 Conversely, where the market value amount is greater than the adjustment under Subdivision 815-B, Subdivision 815-B does not apply where the market value amount has already been substituted (because the entity does not have a transfer pricing benefit). Similarly, if Subdivision 815-B were to be applied before the market value amount has been substituted, sections 70-20, 420-20, 420-30 or 355-400 (or a similar provision) would continue to apply to the extent of the difference between Subdivision 815-B and the market value amount. These outcomes are consistent with those that applied under Division 13 of the ITAA 1936 (Division 13), given that Division 13 relied upon the Commissioner of Taxation (Commissioner) issuing a determination and this would only have occurred where the arm's length consideration under former section 136AD of the ITAA 1936 exceeded the market value amount.

## **Working out an entity's tax position**

3.11 Subdivision 815-B applies where an entity gets a transfer pricing benefit in an income year from conditions that operate between the entity and another entity in connection with their commercial or financial relations. In such instances, the actual conditions are taken not to operate and instead, the arm's length conditions are taken to operate for the purposes of working out the amount to which the transfer pricing benefit relates. [*Schedule 2, item 2, subsection 815-115(1)*]

3.12 These amounts can be the amount of an entity's taxable income, a loss of a particular sort or tax offsets for an income year, as well as withholding tax payable in relation to interest or royalties. [*Schedule 2, item 2, subsection 815-115(2)*]

3.13 A tax loss, film loss or net capital loss are all identified by subsection 701-1(4) as a loss of a particular sort.

3.14 For simplicity, the process of working out the amount of an entity's taxable income, a loss of a particular sort, tax offsets for an income year, or an amount of withholding tax payable in relation to interest or royalties on the basis of arm's length conditions, is referred to in this Explanatory Memorandum as working out 'an entity's tax outcome under arm's length conditions'.

3.15 After an entity's arm's length conditions are identified, whether and how those conditions would affect the entity's Australian tax result (and any elements in the calculation of its tax result under the relevant sections of the tax law) must be considered.

3.16 In contrast to the transfer pricing rules that were introduced by Subdivision 815-A (in particular, section 815-30), Subdivision 815-B does not contain an explicit rule requiring individual amounts to be specified. A rule of this kind is not necessary because under Subdivision 815-B an entity is required to *work out* its taxable income, loss of a particular sort, tax offsets or withholding tax payable on the basis that independent conditions operated. This process is different from simply making an overall adjustment to these amounts (as was permitted under Subdivision 815-A) and by definition allows and requires the identification and valuing of items that are relevant in determining the aggregated amounts.

3.17 As such, even if a profit based method is used in applying Subdivision 815-B, taxpayers (and the Commissioner in the case of an amended assessment) must attribute the arm's length conditions to the value of individual components that form part of the tax equation. The determination of an entity's tax position must therefore include all

questions (for example the identification of specific amounts of income and expenditure) that would ordinarily be considered in calculating any elements of the entity's tax position.

3.18 One example of this type of consideration would be where the question of source is relevant to an entity's Australian tax position. This could occur where the entity is a foreign resident or where source is relevant in calculating the entity's tax position insofar as it impacts upon other entities (for example, where the entity is a trust or partnership with foreign resident beneficiaries or partners). In such cases, the question of whether the arm's length conditions would have resulted in an amount of Australian sourced income being made by the entity may need to be determined.

***Working out withholding tax under Subdivision 815-B***

3.19 If a taxpayer receives a transfer pricing benefit in relation to withholding tax, the actual conditions are substituted with the arm's length conditions for the purpose of working out the amount of withholding tax payable in respect of interest or royalties. The effect of substituting the actual amount with the arm's length amount is that the actual amount is treated as never having been paid or received, and that for all purposes of the Act, the arm's length amount was received in accordance with the arm's length conditions.

3.20 In such circumstances, the time the liability to withholding tax under the arm's length conditions arises is determined by those conditions (as opposed to when an adjustment to the actual conditions is made).

3.21 The omission of 'for the income year' from paragraph 815-115(2)(d) requires the working out of withholding tax be based on the receipt of the royalty or interest payment to which the arm's length conditions related. Assuming there had been an actual payment it would generally be reasonable to conclude that the timing of the arm's length payment would have been the same (unless the arm's length conditions changed this timing).

**Guidance material**

3.22 Applying the arm's length principle is the internationally accepted approach to dealing with transfer pricing issues. The OECD Guidelines, in particular, expand on the application of the arm's length principle and contain authoritative international know-how on the application of transfer pricing rules. The OECD Guidelines are widely used by both member and non-member tax administrations, and were

described by the UK Special Commissioners as 'the best evidence of international thinking on transfer pricing'.<sup>3</sup>

3.23 In establishing the effect of Subdivision 815-B for an entity, the identification of arm's length conditions must be done in a way that best achieves consistency with prescribed guidance material. The OECD Guidelines are included as guidance material under Subdivision 815-B. *[Schedule 2, item 2, subsection 815-135(1) and paragraph 815-135(2)(a)]*

3.24 The OECD's Committee on Fiscal Affairs (CFA) is the primary international tax policy forum for Australia and other developed countries. The OECD Guidelines are initially developed by working parties of the CFA, vetted by that Committee, and finally approved or adopted at Council level. Australia is represented at each of these stages and the OECD consults extensively with the international business community as part of this process.

3.25 Most of Australia's major trading and investment partners look to the OECD Guidelines to ensure consistent application of transfer pricing rules. In the event that different standards were used there would be a greater risk that jurisdictions might each tax the same amount under their transfer pricing rules (resulting in double taxation), or not tax an amount at all (leading to double non-taxation).

3.26 The identification of arm's length conditions under Subdivision 815-B must be done in a way that best achieve consistency with the following material:

- the OECD Guidelines; and
- any other documents, or part(s) of a document, prescribed by the regulations for this purpose.

*[Schedule 2, item 2, subsection 815-135(2)]*

3.27 Insofar as it is possible, the OECD Guidance material is to be used in all cases to determine the arm's length conditions. That is, the Guidance material is relevant in applying the Subdivision to dealings between associated entities and equally to dealings between non-associated entities, and in both treaty and non-treaty cases. Although the OECD Guidelines refer to associated enterprises or related parties, it is intended that in the context of Subdivision 815-B such references be read as references to entities not dealing wholly independently with one another.

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<sup>3</sup> *DSG Retail Ltd; Mastercare Coverplan Service Agreements Ltd; Mastercare Service and Distribution Ltd* [2009] UKFTT 31 (TC)

3.28 This approach to the use of OECD Guidance material is consistent with the intended operation of former Division 13 (which the amendments in this Schedule replace).

3.29 Similarly, some aspects of the OECD Guidelines assume that transfer pricing adjustments will be made by the tax administrations rather than the taxpayer. Because Subdivision 815-B operates on the basis of self-assessment, where appropriate the references in the OECD Guidelines to tax administrations making adjustments, taking actions, or being prevented from taking actions should be read as references to whoever is applying the rules (which may be the taxpayer or the Commissioner).

***Regulation making powers in relation to documents***

3.30 Regulation making powers are included to allow for modifications to the list of guidance material. Requiring that such modifications be prescribed by regulation strikes an appropriate balance between ensuring ongoing consistency with developing international arrangements while providing for Parliamentary scrutiny of future developments.

3.31 The regulation making powers include the ability to prescribe additional documents or parts of a document. *[Schedule 2, item 2, paragraph 815-135(2)(b)]*

3.32 These powers ensure sufficient flexibility to prescribe further guidance material that may be published by the OECD or by other organisations that may be relevant for interpretive purposes in the future. Such material might be supplementary in nature or address issues that are not considered in the current OECD Guidance material.

3.33 The OECD Guidelines may also be removed from the list of guidance material by regulation. This allows material to be removed in the event that it is no longer relevant to determining the arm's length conditions of an entity. *[Schedule 2, item 2, subsection 815-135(3)]*

3.34 It may be appropriate to remove a document where it is subsequently revised in such a way that it is no longer relevant, or if an alternate model or guidance material is adopted in the future. The regulation making power may also remove a part of a document; this power may be used, for example, where Australia reserves its position on part of a document.

3.35 Regulations may also prescribe which documents, or parts of documents, are to be used or removed in specific circumstances. *[Schedule 2, item 2, subsection 815-135(4)]*

3.36 An example of this would be where a document explains a specific approach that should be adopted in relation to a certain arrangement in a specific industry but would result in an inappropriate outcome for similar arrangements in all other industries. In such cases it may be appropriate to prescribe that document as relevant guidance material, but confine its application to particular arrangements or industries. Alternatively, a regulation that removes a document specified from the guidance provision may prescribe the circumstances in which those documents are to be disregarded.

### **When does an entity get a transfer pricing benefit?**

3.37 The term 'transfer pricing benefit' describes the shortfall amount of Australian tax that an entity has as the result of its non-arm's length dealings with other entities. In the context of a self-assessed position under these rules, this tax advantage is a notional one as it would only be realised in the absence of the entity applying Subdivision 815-B.

3.38 An entity gets a transfer pricing benefit in an income year from conditions that operate between the entity and another entity in connection with their commercial or financial relations if:

- the actual conditions differ from the arm's length conditions;
- the actual conditions result in a tax advantage in Australia, relative to the arm's length conditions; and
- the actual conditions satisfy the cross-border test.

*[Schedule 2, item 2, subsection 815-120(1)]*

3.39 While the Subdivision only operates where the entity would otherwise have received a tax advantage in Australia, it does not rely on or assume any tax avoidance purpose or motive.

### ***What are 'commercial or financial relations'?***

3.40 The term 'commercial or financial relations' describes the totality of arrangements related to the interactions of two entities. The term is particularly relevant in identifying actual and arm's length conditions, and can be seen as the context in which each set of conditions arises.

3.41 It is intended that 'commercial or financial relations' be sufficiently broad so as to take into account any connections or dealings between the entities that relate to or could otherwise affect the commercial or financial activities of one of the entities.

3.42 In this regard, ‘commercial or financial relations’ could include (but are not limited to) one or more of the following:

- a single transaction or a series of transactions;
- a practice, understanding, arrangement, thing to be done or not be done, whether express or implied and whether or not legally enforceable;
- the options realistically available to each entity;
- unilateral actions or mutual dealings;
- a strategy; or
- overall profit outcomes achieved by the entities.

***What are the actual conditions?***

3.43 Conditions that operate in connection with the commercial or financial relations of two entities are the things that ultimately affect each of the entities’ economic or financial positions. Conditions need not be explicit contractual terms, but can include the price paid for the sale or purchase of goods or services, terms of an agreement that have an economic impact (such as the allocation of an expense), the margin of profits earned by one or both the entities, or a division of profits between the entities.

3.44 The ‘actual conditions’ are therefore those conditions that did in fact operate in connection with the actual commercial or financial relations of the entities.

3.45 In cases where the multinational enterprise has a relatively straightforward value chain and there is clarity regarding the identification, location and ownership of key profit drivers in that value chain, relevant conditions might include the price at which trading stock items are sold or the fees charged for common services such as transportation or freight.

***The actual conditions must differ from the arm’s length conditions***

3.46 In determining whether an entity gets a transfer pricing benefit, the conditions which operate between the entity and another entity in connection with their commercial or financial relations must differ from the arm’s length conditions. [*Schedule 2, item 2, paragraph 815-120(1)(a)*]

3.47 A difference will exist when arm's length conditions and actual conditions are not the same.

3.48 A difference will also exist where an actual condition exists that is not one of the arm's length conditions, or a condition does not exist in the actual conditions but is one of the arm's length conditions. [Schedule 2, item 2, subsection 815-120(2)]

***The actual conditions result in a tax advantage in Australia relative to the arm's length conditions***

3.49 Subdivision 815-B requires an assessment of what an entity's Australian tax position would have been had the arm's length conditions operated.

3.50 Assessing what the entity's tax position would have been requires a comparison between the arm's length conditions and the actual conditions. In order to have a transfer pricing benefit, it must be demonstrated that the entity would have received a tax advantage in Australia because of the operation of non-arm's length conditions.

3.51 An entity has a tax advantage of this kind where under arm's length conditions, relative to actual conditions:

- the amount of the entity's taxable income for the income year would have been *greater*;
- the amount of the entity's loss of a particular sort for the income year would have been *less*;
- the amount of the entity's tax offsets for the income year would have been *less*; or
- the amount of the entity's withholding tax payable in respect of interest or royalties would have been *greater*.

[Schedule 2, item 2, paragraph 815-120(1)(c)]

3.52 In general terms, an increase in an entity's income or a decrease in an expense under arm's length conditions relative to actual conditions would generally result in that entity having a greater amount of assessable income or a reduction in an allowable deduction in an income year. All things being equal, this would be expected to result in the entity having a greater amount of taxable income or a lesser amount of a tax loss (which is a loss of a particular sort) for the income year.

3.53 Where a change in an amount of profit or component amounts of profit (for example, certain amounts of revenue or expense) would not

have affected an entity's Australian tax position, the entity does not have a tax advantage of the kind referred to above. For example, if an amount of profit that might have been expected to have accrued to an entity would have been non-assessable, non-exempt income of the entity, then the entity would not have a transfer pricing benefit in respect of that amount.

3.54 Where an entity receives a royalty or interest payment in an income year that is subject to withholding tax (for example the entity is a foreign resident company that receives a royalty payment from an Australian resident company), and under arm's length conditions the payment would have been expected to have been greater, the entity would generally not be expected to have a greater amount of taxable income or a lesser amount of a tax loss. This is because income that is subject to withholding tax is generally non-assessable, non-exempt income due to the operation of section 128D of the ITAA 1936. In such circumstances however, the entity would be expected to have had a greater amount of withholding tax payable. As such, the entity would have a transfer pricing benefit in respect of that amount.

*Determining whether an entity gets a transfer pricing benefit when there is no taxable income, loss of a particular sort, tax offsets*

3.55 An assessment of whether an entity receives a tax advantage of the kind referred to above, as well as the amount of any such benefit, requires consideration of the difference between two amounts: the first being based on the actual conditions that operate between entities, and the second being based on the arm's length conditions that might be expected to operate between entities and which is ascertained in accordance with the arm's length principle.

3.56 In instances where an entity has no taxable income, no loss of a particular sort, or no tax offset in an income year, it is not correct to say that the entity has a nil amount (rather it has no amount at all).

3.57 To ensure that the necessary calculation can still be performed where an entity has no actual taxable income, no losses of a particular sort, or no tax offsets (or would not have had such an amount under arm's length conditions), a rule is included to deem the entity to have a taxable income, loss of a particular sort, or tax offsets equal to an amount of nil (as appropriate) in the income year. This allows the relevant amount to be compared with the nil amount (or amounts). [*Schedule 2, item 2, subsection 815-120(5)*]

3.58 A similar rule is not required in respect of withholding tax, however, because in cases where an entity has no withholding tax payable, the amount of withholding tax payable can still appropriately be described as nil.

***The actual conditions must satisfy the cross-border test***

3.59 In order for an entity to get a transfer pricing benefit in an income year, the actual conditions that operate between that entity and another entity must satisfy the cross-border test. *[Schedule 2, item 2, paragraph 815-120(1)(b)]*

3.60 The cross-border test is consistent with former section 136AC of the ITAA 1936 and ensures that Subdivision 815-B does not apply to purely domestic arrangements.

3.61 The test applies to the conditions that operate between two entities in connection with their commercial or financial relations. Although the test examines the conditions from the perspective of each entity individually, it is satisfied where either entity meets its requirements. *[Schedule 2, item 2, section 815-120(3)]*

3.62 The cross-border test is satisfied in relation to conditions that operate between entities where the 'overseas requirement' for those conditions is satisfied by either or both of the entities. Different overseas requirements apply in relation to different types of entities. *[Schedule 2, item 2, paragraph 815-120(3)(a)]*

3.63 Where one of the entities is an Australian resident, a resident trust estate or a partnership in which all of the partners are ultimately Australian residents, the overseas requirement will be met where the conditions operate at or through an overseas permanent establishment of that entity. *[Schedule 2, item 2, table item 1 in subsection 815-120(3)]*

3.64 Where one of the entities is not an Australian resident, is not a resident trust estate, and is not a partnership in which all of the partners are ultimately Australian residents, the overseas requirement will be met where the conditions do *not* operate solely at or through an Australian permanent establishment of that entity. *[Schedule 2, item 2, table item 2 in subsection 815-120(3)]*

Note: for simplicity, any references in the following examples to 'table items' refer to the table items in subsection 815-120(3). Further, an entity that is an Australian resident, a resident trust estate or a partnership in which all of the partners are ultimately Australian residents will be referred to as a 'resident entity'. Similarly, an entity that is not a resident entity will be referred to as a 'foreign resident entity'.

*Application of the overseas requirement to conditions that operate between two resident entities*

**Example 3.1**

Aus Co (an Australian resident company) sells goods to Aus Trust (a resident trust estate). The sale and purchase are each conducted solely through the Australian business operations of Aus Co and Aus Trust.

The overseas requirement cannot be met under table item 1 because the conditions do not operate at or through an overseas permanent establishment of either Aus Co or Aus Trust.

Table item 2 is not relevant for either Aus Co or Aus Trust because they are both resident entities.

**Example 3.2**

Aus Co also sells goods to Aus Part (a partnership in which all of the partners are Australian residents). The sale is conducted through the Australian business operations of Aus Co and the purchase is conducted through an overseas permanent establishment of Aus Part.

The overseas requirement is met under table item 1 because the conditions operate through an overseas permanent establishment of Aus Part.

**Example 3.3**

Aus Part purchases goods from Aus Trust. The sale and purchase are each conducted through the overseas permanent establishments of Aus Part and Aus Trust.

The overseas requirement is met under table item 1 because the conditions operate through an overseas permanent establishment of Aus Part.

The overseas requirement is also met under table item 1 because the conditions operate through an overseas permanent establishment of Aus Trust.

*Application of the overseas requirement to conditions that operate between a resident entity and a foreign resident entity*

**Example 3.4**

Aus Co sells goods to For Co (a foreign resident company). The sale is conducted solely through the Australian business operations of Aus Co and the purchase is conducted solely through an Australian permanent establishment of For Co.

The overseas requirement cannot be met under table item 1 because the conditions do not operate at or through an overseas permanent establishment of Aus Co.

Similarly, the overseas requirement cannot be met under table item 2 because the conditions operate solely through the Australian permanent establishment of For Co.

### **Example 3.5**

Aus Co sells goods to For Trust (a non-resident trust estate). The sale is conducted solely through the Australian business operations of Aus Co and the purchase is conducted solely through the overseas business operations of For Trust.

The overseas requirement is met under table item 2 because the conditions do not operate solely at or through an Australian permanent establishment of For Trust.

### **Example 3.6**

Aus Co purchases goods from For Part (a partnership with three partners — two of which are Australian residents and one of which is a foreign resident). The purchase is conducted through an overseas permanent establishment of Aust Co and the sale is conducted solely through an Australian permanent establishment of For Part.

The overseas requirement is met under table item 1 because the conditions operate through an overseas permanent establishment of Aus Co.

### **Example 3.7**

Aus Co purchases goods from For Co. The purchase is conducted through an overseas permanent establishment of Aust Co and the sale is conducted solely through the overseas business operations of For Co.

The overseas requirement is met under table item 1 because the conditions operate through an overseas permanent establishment of Aus Co.

The overseas requirement is also met under table item 2 because the conditions do not operate solely at or through an Australian permanent establishment of For Co.

*Application of the overseas requirement to conditions that operate between two foreign resident entities*

**Example 3.8**

For Co sells goods to For Trust. The sale and purchase are each conducted solely through the overseas business operations of For Co and For Trust.

The overseas requirement is met under table item 2 because the conditions do not operate solely at or through an Australian permanent establishment For Co.

The overseas requirement is also met under table item 2 because the conditions do not operate solely at or through an Australian permanent establishment of For Trust.

**Example 3.9**

For Co sells goods to For Part. The sale is conducted through the overseas business operations of For Co and the purchase is conducted solely through an Australian permanent establishment of For Part.

The overseas requirement is met under table item 2 because the conditions do not operate solely at or through an Australian permanent establishment of For Part.

**Example 3.10**

For Part purchases goods from For Trust. The sale and purchase are each conducted solely through the Australian permanent establishments of For Part and For Trust.

The overseas requirement cannot be met under table item 2 because the conditions operate solely through an Australian permanent establishment of For Part.

Similarly, the overseas requirement cannot be met under table item 2 because the conditions operate solely through an Australian permanent establishment of For Trust.

*Special rule for entities that are dual-residents*

3.65 An additional rule is also included in respect of entities that are dual-residents of both Australia and a country with which Australia has an international tax agreement containing a residence article (a residence article is defined as Article 4 of the United Kingdom convention or a comparable provision of another agreement). If as the result of the residence article an entity is treated as a resident of the other country under the agreement, they are deemed *not* to be an Australian resident for

the purposes of meeting the overseas requirement. In addition to applying to the entity to which the overseas requirement directly applies, this rule also applies to a trustee in determining whether a trust estate is a resident trust estate, as well as the partners of a partnership in determining whether all of the partners are Australian residents. [*Schedule 2, item 2, subsections 815-120(4) and (6)*]

3.66 The dual-resident rule is required because the treaty tie-breaking rules in Australia's international tax agreements only have effect for the purpose of applying the agreement. This rule aligns the application of Subdivision 815-B to that entity with its treatment as a dual-resident under a treaty (which results in Australia being limited to taxing the entity as though it were a foreign resident).

3.67 There is no need for a rule to deem a dual-resident that is treated as an Australian resident under an international tax agreement to be an Australian resident because such entities are already Australian residents. Similarly, the rule does not have any operation in relation to treaties that do not apply to dual-residents (such as the Chile and Turkey agreements), or to non-treaty cases because in such circumstances an entity continues to be taxed in Australia as an Australian resident.

### **Example 3.11**

Aus Co purchases goods from Dual Co. Dual Co is an Australian resident company but is also a resident company of the UK. Under Article 4 of the Australia-UK convention, Dual Co is treated as a UK resident.

For the purposes of the overseas requirement, Dual Co is not an Australian resident and is instead taken to be a resident of the UK only.

### **Example 3.12**

Aus Co purchases goods from Dual Part (a partnership with three partners — two of which are Australian residents and one of which is both an Australian resident and a resident of the UK).

For the purposes of the overseas requirement, the dual-resident partner is not an Australian resident and is instead taken to be a resident of the UK only. This means that in meeting the overseas requirement, Dual Part is taken to be a partnership in which not all of the partners are Australian residents.

### *Conditions that operate in connection with an area covered by an international tax sharing treaty*

3.68 The cross-border test will also be satisfied where the conditions operate in connection with a business an entity carries on in an area

covered by an international tax sharing treaty. [*Schedule 2, item 2, paragraph 815-120(3)(b)*]

3.69 Although some parts of an area covered by an international tax sharing treaty (for example the Timor Sea Treaty) may still be in Australia, Australia's ability to impose tax upon income sourced in those areas (or deal with expenditure in relation to such income) will be affected by the terms of the agreement. As such, the cross-border test is satisfied in relation to conditions that operate in connection with a business carried on by an entity in an area covered by an international tax sharing treaty, irrespective of the residency status of that entity.

*Application to parties that are not related*

3.70 In satisfying the cross-border test, it is not necessary for the relevant entities to be associated. This approach is consistent with Division 13 and ensures that this Subdivision applies to any conditions that exist between entities that do not operate on an arm's length basis (such as collusive arrangements between unrelated entities).

***Conditions that are affected by arrangements entered into by other entities***

3.71 Although Subdivision 815-B can only apply to particular actual conditions where the above requirements are satisfied in respect of those conditions, it may be the case that other arrangements or conditions are relevant in determining whether the actual conditions are different from arm's length conditions or result in a tax advantage. These other arrangements need not be covered by Subdivision 815-B.

3.72 Because arm's length conditions are identified by hypothesising what independent entities in comparable circumstances dealing wholly independently would have done in the place of the actual entities, interactions that each of the entities have with other entities may be relevant where they impact upon the actual conditions.

3.73 For example, if two entities were to enter into a loan arrangement under which repayment of the loan was contingent upon one of the entities achieving a certain profit position in an income year, the question under Subdivision 815-B is whether independent entities dealing wholly independently would have agreed to a repayment term of that nature. If the borrower also had arrangements in place with another entity that allowed that other entity to strip profits from the borrower in order to keep it below the specified repayment threshold, those profit shifting arrangements would clearly be a relevant consideration in determining whether the loan arrangement would have been entered into by

independent entities. This is the case irrespective of whether the profit stripping arrangement is also covered by Subdivision 815-B.

3.74 It could also be the case that arrangements with other entities appear to justify the existence of actual conditions that result in a tax advantage relative to arm's length conditions. In such circumstances, the relevant question must still be whether independent entities dealing wholly independently would have dealt with one another in the way the actual entities did.

3.75 For example, if a resident entity were to purchase raw materials from a foreign resident at an inflated price, the purchase price would only be at arm's length if independent entities dealing wholly independently in comparable circumstances would have agreed to the purchase price. This is the case irrespective of whether the resident entity sells a product manufactured from those materials to a third entity at an equally inflated price because, having regard to its own economic interests, an independent entity dealing with the seller of the raw materials would still have an incentive to minimise their input costs.

### **What are the arm's length conditions?**

3.76 The arm's length conditions in relation to conditions that operate between an entity and another entity are the conditions that might be expected to operate between entities dealing wholly independently with one another in comparable circumstances. [*Schedule 2, item 2, subsection 815-125(1)*]

3.77 Arm's length conditions are the conditions that would have operated between independent entities in place of the actual conditions. The identification of arm's length conditions involves hypothesising what independent entities would have done in the place of the actual entities. This process requires the postulation of how independent entities in comparable circumstances would have dealt with one another had they been dealing at arm's length. Cross-border intra-firm trade in services and intangible assets has increased dramatically for Australian entities over recent years. Determining the arm's length conditions in these situations is likely to go beyond looking at the consideration provided in relation to a single condition (such as the price of trading stock) or a discrete element of the overall arrangement.

3.78 Similarly, there have been significant increases over recent years in the volume and complexity of cross-border intra-firm financing transactions involving various forms of debt and hybrid securities. In the more complex cases involving these financing facilities, determining the arm's length conditions could include factors that relate to an entity's relative financial strength, and how the market would perceive the entity's

financial strength with explicit consideration given to the fact that the entity is part of a larger multinational group.

3.79 It may also be important to consider issues such as whether independent entities operating in comparable circumstances would have advanced loans with the same or similar characteristics, provided various forms of credit support, sought to refinance at a different market interest rate, issued shares or paid dividends. The consideration of what price and under what conditions those transactions would have occurred between independent parties dealing wholly independently with one another may also be necessary. Similar questions could also be asked regarding royalties or licence payments (such as whether a sale and licence back of a strategic intangible would happen between independent parties), and could also include decisions that may affect an entity's liquidity, such as the time at which an amount should be paid.

3.80 The term 'comparable circumstances' relates to the profile of each of the hypothetical independent entities. By requiring that the independent entities be in 'comparable circumstances' to the actual entities, the nature of the actual entities and the context within which they operate is directly relevant in constructing the profile of the hypothetical entities.

3.81 Although the profile of the independent entities must be comparable to that of the actual entities, arm's length conditions are simply those conditions that might be expected to operate between independent entities dealing wholly independently. The definition of arm's length conditions does not of itself require that the arm's length conditions reflect or conform to actual conditions or the commercial or financial relations of the entities.

***Identifying arm's length conditions: the 'basic rule'***

3.82 In order to inform the characterisation of what the independent entities would have done, Subdivision 815-B sets out a 'basic rule' which generally applies in determining arm's length conditions. Under this rule, the identification of arm's length conditions must be based on the form and substance of the commercial or financial relations in connection with which the actual conditions operate. *[Schedule 2, item 2, subsection 815-130(1)]*

3.83 This rule constrains the way in which the arm's length conditions must be identified. As a result, the form and the substance of the commercial or financial relations that actually existed between the entities (and which gave rise to the actual conditions related to the arm's length conditions that are being identified), must be considered in the identification of the arm's length conditions.

3.84 The 'form' of commercial or financial relations describes the *prima facie* features or legal characteristics of the dealings between entities. In contrast, the 'substance' of the commercial or financial relations describes the economic reality or essence of those dealings. The substance of commercial or financial relations is determined by examining all relevant facts and circumstances, including the economic and commercial context of any arrangements entered into, its object and effect from a practical and business point of view, the conduct of the entities and the functions performed, assets used and risks assumed by them.

***The arm's length condition is the most appropriate and reliable condition***

3.85 The identification of the arm's length conditions involves hypothesising what independent entities would have done in comparable circumstances to the actual entities. As such, a number of alternative conditions may be hypothesised as potentially operating between independent entities.

3.86 In order to quantify a transfer pricing benefit and make the consequent adjustment, Subdivision 815-B requires the selection of the *most appropriate and reliable* condition as the arm's length condition.

3.87 For example, where the identification of an arm's length condition requires the consideration of a range of values (as opposed to a single value), the most appropriate and reliable point within that range will determine the arm's length condition. Where a number of points within the range are equally appropriate and reliable, any of those points may be selected.

***Entities dealing wholly independently with one another***

3.88 Whether entities (associated or not) deal with each other in accordance with the arm's length principle is essentially a question of fact. The relevant question for the purposes of Subdivision 815-B is whether the conditions which operate between the entities would make commercial sense if the entities were dealing wholly independently with one another.

3.89 When considering whether parties have dealt with one another independently, the question is whether they have acted as independent parties would in comparable circumstances, so that the outcome of the dealings is a matter of real bargaining: *Trustee for the Estate of the late AW Furse No. 5 Will Trust v Federal Commissioner of Taxation* (1990) 21 ATR 1123 at 1132.

3.90 The relationship between the parties is relevant but not determinative. Thus, parties that are related to each other may deal

independently with one another and parties that are not related to each other might not deal independently with one another: *Barnsdall v Federal Commissioner of Taxation* (1988) 81 ALR 173; *Furse* 21 ATR 1123 at 1132; *RAL and Ors and Federal Commissioner of Taxation* (2002) 50 ATR 1076 [at 45-51].

3.91 Examples of where parties that are unrelated to each other are not dealing independently with one another include where:

- one of the parties submits to the will or direction of the other, perhaps to promote the interests of the other: *Granby v Federal Commissioner of Taxation* 129 ALR 503 at 507;
- one party is indifferent to an outcome sought by the other party on a particular aspect of their dealings: *Collis v Federal Commissioner of Taxation* (1996) 33 ATR 438 at 443; or
- the parties collude, or act in concert, to achieve an ulterior purpose or result: *Granby* 129 ALR 503 at 507.

***Identifying arm's length conditions: exceptions to the 'basic rule'***

3.92 There are three exceptions to the 'basic rule' for identifying arm's length conditions. Where these exceptions apply, actual commercial or financial relations in connection with which the actual conditions operate are disregarded for the purposes of identifying arm's length conditions. Specific rules for each exception then provide the alternative means of identifying arm's length conditions. As with the basic rule, the exceptions continue to constrain the way in which the arm's length conditions must be identified.

3.93 In determining whether the exceptions apply, as well as identifying the arm's length conditions under one of the exceptions, rules related to the comparability of circumstances remain relevant. [*Schedule 2, item 2, subsections 815 130(5)*]

3.94 The exceptions to the basic rule are intended to be consistent with the 'exceptional circumstances' discussed in the OECD Guidelines in the context of non-recognition and alternative characterisation of certain arrangements or transactions (for example under Chapters I and IX of the OECD Guidelines). Given that the OECD Guidelines are prescribed as relevant guidance material under the guidance provision in Subdivision 815-B, the identification of arm's length conditions under one of the exceptions must be done that best achieves consistency with any aspects of the Guidelines that are relevant.

3.95 The first exception is based on the approach taken under the OECD Guidelines in relation to economic substance (see for example paragraphs 1.65, 9.169 and 9.183 of the OECD Guidelines). In this regard paragraph 9.183 of the OECD Guidelines states:

‘Under the first circumstance of paragraph 1.65, where the economic substance of a transaction differs from its form, the tax administration may disregard the parties' characterisation of the transaction and re-characterise it in accordance with its substance.’

3.96 The second and third exceptions are based on the approach taken under the OECD Guidelines in relation to the non-recognition and alternative characterisation of certain arrangements (see for example paragraphs 1.65, 1.66, 9.61, 9.175, 9.169 and 9.185 of the OECD Guidelines). In this regard, paragraph 1.66 of the OECD Guidelines states:

‘Article 9 would thus allow an adjustment of conditions to reflect those which the parties would have attained had the transaction been structured in accordance with the economic and commercial reality of parties dealing at arm's length.’

*The form of the commercial or financial relations differs from the substance*

3.97 In cases where the form and substance of the actual commercial or financial relations of the entities differ, the form is disregarded to the extent of the inconsistency with the substance. [*Schedule 2, item 2, subsection 815-130(2)*]

3.98 The arm's length principle is fundamentally concerned with ensuring that entities are appropriately rewarded for their economic contributions. Although in many cases, the substance of the commercial or financial relations will be identical to the legal form, where this is not the case the identification of arm's length conditions must be based on the substance of the entities' commercial or financial relations. Although the effect of this rule is that certain aspects of the commercial or financial relations are disregarded, the identification of arm's length conditions still relates to actual commercial or financial relations that exist between the entities.

*Independent entities would have entered into different commercial or financial relations*

3.99 In cases where independent entities dealing wholly independently with one another in comparable circumstances would not have entered into the actual commercial or financial relations, the identification of arm's length conditions is based on the commercial or

financial relations that independent entities would have instead entered into. *[Schedule 2, item 2, subsection 815-130(3)]*

3.100 This exception only applies where, having regard to their own economic interests, independent entities dealing wholly independently would not have entered into the actual commercial or financial relations, but would have instead entered into alternative commercial or financial relations that differ in substance from the actual commercial or financial relations.

3.101 As each element of this test must be positively satisfied, it is not of itself sufficient to propose that independent entities might have dealt with one another in an alternative manner. Moreover, the mere fact that actual independent entities have not been observed to have dealt with one another in a particular way (or that information on such independent dealings is not available) will not necessarily mean that independent entities would not have entered into the commercial or financial relations that the entities actually did. The relevant question is instead whether independent entities behaving in a commercially rational manner and acting in their own best commercial and economic interests would have dealt with one another in the same way, given the options that are realistically available to them. Without detracting from the relevance of actually observed dealings, nothing prevents each aspect of the test from being established hypothetically.

3.102 The requirement that independent entities ‘would’ have done something different to the actual entities imposes a higher standard of proof than simply demonstrating that independent entities ‘might’ or ‘might be expected to’ have entered into alternative commercial or financial relations.

3.103 This standard is intended to reduce the number of possible alternatives that can be hypothesised under the exception. In the event that more than one alternative set of commercial or financial relations would have been entered into by independent entities (for example, because the overall effect of each alternative is similar enough that independent entities would be indifferent about which one operated), the substituted commercial or financial arrangements under this exception should comport as closely as possible with the facts and economic substance of what actually occurred. This approach is consistent with both the OECD Guidelines (see for example paragraph 9.187 of the OECD Guidelines) and the requirement in the exception that in the course of identifying arm’s length conditions, the independent entities must be in comparable circumstances to the actual entities.

*Independent entities would not have entered into any commercial or financial relations*

3.104 In cases where independent entities dealing wholly independently with one another in comparable circumstances would not have entered into any commercial or financial relations, the identification of arm's length conditions is based on the assumption that no commercial or financial relations existed. *[Schedule 2, item 2, subsection 815-130(4)]*

3.105 This exception will only apply where independent entities dealing wholly independently would not have entered into the actual commercial or financial relations, or any other commercial or financial relations whatsoever. The effect of this exclusion is that the actual commercial or financial relations are disregarded for the purposes of identifying arm's length conditions. In such cases, the actual conditions connected with the commercial or financial relations are likely to be disregarded, and the arm's length condition is that nothing would have occurred.

3.106 Any arm's length conditions that are identified under this exception are still subject to the general transfer pricing benefit requirements set out under section 815-120, meaning that this exception does not apply if disregarding the commercial or financial relations would result in the entity obtaining an Australian tax advantage (for example, an actual payment to the entity could not be disregarded under this exception). As such, application of this exclusion is limited to disregarding positive actions of an entity that give rise to a transfer pricing benefit. One example of this would be where the actual commercial or financial relations result in an expense being borne by an entity that would simply not have been borne by an independent entity in comparable circumstances. In such instances, the non-recognition of the expense would result in the entity not being able to claim a deduction.

***Selecting the method or combination of methods to determine the arm's length conditions***

3.107 Transfer pricing methods seek to determine what the arm's length conditions would be if the parties involved were dealing wholly independently with one another. An entity required to identify arm's length conditions under Subdivision 815-B must use the method or methods that produces the most appropriate and reliable assessment of the conditions having regard to:

- the respective strengths and weaknesses of the possible transfer pricing methods;

- the circumstances, including the functions performed, the assets used and the risks borne by the entities;
- the availability of reliable information required to apply a particular method; and
- the degree of comparability between the actual circumstances and the comparable circumstances, including the reliability of any adjustments to eliminate the effect of material differences between those circumstances.

*[Schedule 2, item 2, subsection 815-125(2)]*

3.108 The method must be capable of practicable application and produce an arm's length outcome that is a reasonable estimate of what would have been expected if the dealings had been undertaken between independent entities dealing wholly independently with one another.

*Which methods are relevant?*

3.109 The OECD Guidelines provide a framework for the application of the arm's length principle.

3.110 Pursuant to the guidance rules in Subdivision 815-B, entities must have regard to the OECD Guidelines in identifying arm's length conditions.

3.111 Although the various methods currently outlined in the OECD Guidelines are explained in the following paragraphs, these methods are not the only methods that may be used. Consistent with the OECD Guidelines, where an alternative method (or combination of methods) gives a more appropriate arm's length outcome, that alternate method (or combination of methods) may be used.

Comparable uncontrolled price method

3.112 The comparable uncontrolled price (CUP) method compares the price actually charged for property or services that have been transferred with the price that would be charged for materially the same property or services by the same supplier in a comparable dealing with an independent party or by a comparable independent entity dealing wholly independently with another entity in comparable circumstances.

Cost plus method

3.113 The cost plus method provides an estimate of an independent margin by adding an appropriate cost plus mark-up to the supplier's costs. The profit mark-up is determined by reference to the cost-plus mark-up

earned by the same supplier in comparable dealings with independent parties or by independent entities dealing wholly independently with each other in comparable circumstances.

#### Resale price method

3.114 The resale price method estimates an independent price for property or services by taking the price at which the product is sold to or by independent entities and reducing it by an independent resale price margin. The margin would be determined by reference to the resale price margins earned by the same supplier in comparable dealings with independent parties or by independent entities dealing wholly independently with each other in comparable circumstances.

#### Transactional Net Margin Method

3.115 The transactional net margin method (TNMM) compares the net profit margin that the taxpayer has achieved with that which independent parties dealing wholly independently in relation to a comparable transaction or dealings would have achieved.

3.116 Comparisons at the net profit level can be made on a single transaction or in relation to an aggregation of dealings between the taxpayer and one or more other entities.

3.117 The TNMM examines the net profit margin relative to an appropriate base (for example, costs, sales, assets) that a taxpayer realises from an activity or transaction.

#### Profit split method

3.118 The profit split method identifies the combined profit of two or more enterprises and then splits those profits between the enterprises on an economically valid basis that approximates the division of profits that independent entities would have expected to realise had the arrangements existed between parties dealing wholly independently.

3.119 The profit split method may be appropriate where different activities undertaken by the entities make unique and valuable contributions. In these cases, it may not be practical or feasible to assess arm's length outcomes with reference to a specific comparable.

#### *Equally appropriate methods*

3.120 Consistent with the OECD Guidelines, where it is considered that more than one method can be applied in an equally reliable manner, the more direct method should be preferred. For example, where a transaction based method and a profit based method are equally reliable

(taking into account the factors provided for in subsection 815-125(2)), the transaction based method should be preferred.

### ***Comparability of circumstances***

3.121 One of the factors in selecting and applying a method is the *degree* of comparability between the actual circumstances and any circumstances being compared.

*What is meant by the term ‘comparable’?*

3.122 For circumstances to be comparable, none of the differences (if any) between the situations being compared should be capable of materially affecting a condition that is relevant to the method. [*Schedule 2, item 2, paragraph 815-125(4)(a)*]

3.123 Where differences exist, a situation may be considered comparable if reasonably accurate adjustments can be made to eliminate the effects of the difference on a condition that is relevant to the method. [*Schedule 2, item 2, paragraph 815-125(4)(b)*]

### **Example 3.13: Comparability adjustments**

Most of Aus Co’s dealings are with wholly independent enterprises. Aus Co does however undertake limited dealings with a non-arm’s length party that operates in the same market, undertakes comparable commercial roles, does not undertake a commercial strategy, is of comparable market importance and takes possession of comparable amounts of production inputs as the independent enterprises with which Aus Co deals. However, the dealings between Aus Co and the non-arm’s length party are on different freight terms to those with other independent enterprises. The non-arm’s length dealing, while not being completely comparable, is capable of being adjusted for freight terms such that the circumstances are comparable, to achieve comparability between the conditions of the commercial or financial relations of the independent and non-arm’s length arrangements.

3.124 Where reliable comparability adjustments cannot be made, this may indicate that another method should be used, which relies on different points of comparison.

3.125 In determining the degree of comparability, including any adjustments that may be necessary, consideration must be given to the range of options that would be realistically available to an independent enterprise in comparable circumstances. That is, consideration needs to be given to what an independent enterprise would consider in terms of the options available to it and whether the options would significantly affect the value of an arrangement.

*What factors must be taken into account in determining comparability?*

3.126 In identifying comparable circumstances, regard must be had to all relevant factors including but not limited to the following:

- the functions performed, assets used and risks borne by the entities;
- the characteristics of any property or services transferred;
- the terms of any relevant contracts between the entities;
- the economic circumstances; and
- the business strategies of the entities.

*[Schedule 2, item 2, subsection 815-125(3)]*

*How do the OECD Guidelines describe these factors?*

3.127 Below is a selected discussion of the factors as presented by the OECD Guidance material. However, the entire text of the OECD Guidance material should be taken into account when determining whether the circumstances are of a sufficient level of comparability.

#### Functional analysis

3.128 In general, the level of compensation that passes between entities should reflect the functions that each entity performs (taking into account assets used and risks assumed). Therefore in determining whether certain arrangements or entities are comparable, a functional analysis is required. Such a comparison must seek to identify and compare the commercially significant activities and responsibilities undertaken, assets used and risks assumed by the parties.

3.129 The types of functions that may be relevant include those relating to design, manufacture, assembly, research and development, servicing, purchasing, distribution, marketing, advertising, transportation, financing and management. It is important to consider the assets used or intended to be used and the condition and value of those assets. Assets might include, but would not be limited to, plant and equipment, valuable intellectual property, and financial assets.

3.130 The risks assumed by different parties are an important feature of a functional analysis. Generally, in an open market, the assumption of increased risk would also be compensated by an increase in the expected return.

3.131 The types of risks that might be considered would include but not be limited to market risks such as fluctuations in input costs and output prices, risks associated with investment in and use of property, plant and equipment, risks of the success or failure of investment in research and development; financial risks, credit risks and so forth.

3.132 The functions carried out (taking into account the assets used and risks assumed) determine to some extent the allocation of risks between the parties. In considering this allocation it is important that the risks allocated on a contractual basis match the economic substance of the arrangements. In this regard, the parties' conduct should generally be taken as the best evidence concerning the true allocation of risk. Furthermore, in considering the economic substance of a purported risk allocation, it generally makes sense for parties to be allocated a greater share of those risks over which they have relatively more control — arm's length parties would generally not be willing to assume risks over which another party has significantly more control.

#### Characteristics of the property or services

3.133 Any differences in the specific characteristics of the property or services that are relevant to the arrangements in place between the relevant entities and those that are potentially comparable need to be carefully considered. Such differences would often account, at least in part, for differences in value.

3.134 In general, the requirement for comparability of property or services is the strictest when using the comparable uncontrolled price method, as any material difference in the characteristics of property or services can have an effect on the price and would require an appropriate adjustment to be considered. By contrast, the remaining methods, which look at gross profit margins, mark-up on costs or other profit-based indicators, are generally less sensitive to such differences.

3.135 In considering the specific characteristics of the property or services transferred, it is important to consider such things as the physical features of the property, its quality and reliability, and the availability and volume of supply.

#### Contractual terms

3.136 Contractual terms often shed light expressly or implicitly on the nature of arrangements. There may be written documentation in place of, or in addition to contractual documents that add to the overall picture of how responsibilities, risks and benefits are to be divided between parties.

3.137 Where no written documents exist, the contractual relationship between parties must be deduced from their conduct and the economic principles that generally govern relationships between independent parties.

3.138 When parties are dealing wholly independently their separate interests will usually motivate them to hold the other to the contractual terms unless it is in their mutual interests to modify them. When parties are not dealing wholly independently the same incentives may not be present and it is important to establish whether the economic substance of arrangements matches the contractual terms.

#### Economic circumstances

3.139 Prices and other financial indicators may vary across different markets even where relevant transfers are for the same property or services. Therefore comparability requires that the relevant markets are comparable, if indeed they are not in the same market. In identifying the relevant market or markets regard should be had, amongst other things, to:

- geographic location;
- the size of the markets;
- the extent of competition in the markets and the relative competitive positions of the buyers and sellers;
- the availability of substitute goods and services;
- the levels of supply and demand;
- consumer purchasing power;
- the nature and extent of government regulation;
- costs of production;
- transport costs;
- the level of the market; and
- the date and time of transactions.

#### Business strategy

3.140 Business strategies must also be examined in determining comparability for transfer pricing purposes. The business strategies employed by an entity may materially impact on the conditions that

operate in the commercial or financial relations between entities. The business strategies adopted may influence the degree of innovation and new product development, risk diversification and aversion; and would take into account the enterprise's assessment of future changes in the commercial environment.

3.141 Business strategies could also include market penetration schemes. An enterprise seeking to penetrate a market to increase market share might temporarily charge a price for its product or services that is lower than the price charged by otherwise comparable products in the same market. Furthermore, an enterprise seeking to enter a new market or expand (or defend) its market share might temporarily incur higher costs (for example, due to start-up costs or increased marketing efforts).

3.142 Generally a market penetration scheme results in lower profits as it is being prosecuted, with an expectation of higher profits in the future. When evaluating purported business strategies, factors such as the actual conduct of the parties, the nature of the relationships between them, and whether there is a plausible expectation that the strategies will succeed (within a period of time that would be acceptable in an arm's length arrangement) are likely to be relevant.

### **How does the arm's length principle apply when the thin capitalisation rules also apply to an entity for the relevant period?**

3.143 Where Division 820 applies to an entity for an income year and the entity has worked out elements of its tax position under arm's length conditions that relate to its debt deductions, a special rule modifies the way in which Subdivision 815-B applies to the entity. *[Schedule 2, item 2, subsection 815-140(1)]*

3.144 The rule preserves the role of Division 820 in respect of its application to an entity's amount of debt. If under the arm's length conditions, working out an entity's debt deductions involves applying a rate to a debt interest, the rule requires the rate to be worked out as if the arm's length conditions had operated. However, this rate is applied to the debt interest the entity actually issued instead of the debt interest that would have been issued had the arm's length conditions operated (in the event that there is a difference between the interests). *[Schedule 2, item 2, subsection 815-140(2)]*

3.145 The rule maintains the administrative approach under Taxation Ruling TR 2010/7, which was confirmed in Subdivision 815-A.

3.146 To the extent that an entity's debt deductions are worked out by applying a rate to a debt interest (such as by applying a rate of interest to a loan amount, or applying a rate to the amount of debt covered by a

guarantee) the identification of arm's length conditions in respect of those debt deductions is modified so that only the rate may be adjusted. As such, Subdivision 815-B allows the rate to be adjusted to an arm's length rate, but that rate must be applied to the debt interest actually issued (and still on issue from time to time). This ensures that Subdivision 815-B does not prevent the operation of the thin capitalisation rules.

3.147 Debt deductions (as defined in section 820-40) include any costs directly incurred in obtaining or maintaining a debt interest, for example interest or amounts in the nature of interest, guarantee fees, line fees and discounts on commercial paper.

3.148 The interaction of this Subdivision with Division 820 operates as follows:

- First, to the extent relevant, the arm's length rate applying to a debt interest is determined in accordance with the normal rules contained in section 815-115. In doing so, it is necessary to consider the conditions operating between the relevant entity and other entities in relation to the commercial or financial relations that exist between them. The arm's length rate may need to be determined by having regard to the conditions which could be expected to operate between entities dealing wholly independently with each other. For example, in some exceptional cases (as provided by the relevant OECD guidance material), it may be appropriate to determine the arm's length rate having regard to the amount of debt the entity is likely to have had, had the conditions operating between it and its associate(s) been consistent with what they would have been if the entities had been independent of each other. Alternatively, it may be possible to determine an arm's length rate, directly or indirectly, by some other means without having to determine an arm's length amount of debt. Whether an entity's amount of debt meets the safe harbours provided for the purposes of Division 820 is not relevant for this first step.
- Secondly, the arm's length rate for a particular debt interest is applied to the actual amount of debt for that debt interest. The entity's remaining debt deduction after the arm's length rate of interest has been applied then becomes the relevant debt deduction for the purposes of Division 820.
- Finally, and after the consideration of any other relevant parts of the ITAA 1936 and ITAA 1997, Division 820 may reduce an entity's otherwise allowable debt deductions if the entity's adjusted average debt exceeds its maximum allowable debt.

3.149 Similar to Subdivision 815-A, the following examples illustrate the interaction of Subdivision 815-B and Division 820. They are intended to illustrate the respective fields of operation of Subdivision 815-B and the thin capitalisation rules and are not intended to suggest that a particular method for pricing debt must be applied to the circumstances of a particular case. Nor are the examples intended to preclude the use of other methods that produce an arm's length outcome.

**Example 3.14: Thin capitalisation adjustment and transfer pricing adjustment**

Aus Co is an Australian resident subsidiary company of For Co, a resident of the UK. Aus Co is an 'inward investment vehicle (general)' for the purposes of Subdivision 820-C.

For an income year, Aus Co has:

- a 'safe harbour debt amount', determined in accordance with section 820-195 of \$375 million; and
- 'adjusted average debt' determined in accordance with subsection 820-185(3) of \$400 million, of which \$200 million is borrowed from For Co at an interest rate of 15 per cent, and \$200 million from an independent lender at an interest rate of 10 per cent.

Aus Co's only debt deductions are for the interest incurred at a rate of 15 per cent on its \$200 million related party debt, and 10 per cent on its \$200 million debt from the independent lender, meaning that it has \$50 million of debt deductions for the income year.

Aus Co needs to consider whether they would receive a transfer pricing benefit as a result of actual conditions that it would not receive if arm's length conditions instead operated. In doing so, Aus Co has regard to the arm's length rate in relation to the debt interest (that is, the arm's length interest rate), applied to the actual amount of the related party debt.

Assume that the loan from the independent lender is sufficiently similar to the loan from For Co. Also assume that the circumstances in which each amount of debt funding was provided do not present material differences that would affect the rate applicable to the debt interest or Aus Co's ability to obtain \$400 million in debt funding (that is, the independent loan is directly comparable to the related party loan). As a result, using a comparable uncontrolled price is the most appropriate method for determining the arm's length rate. In these circumstances it is commercially realistic for Aus Co to determine that the arm's length interest rate is 10 per cent. In this case, Aus Co gets a transfer pricing benefit of \$10 million (being the difference between an arm's length rate of 10 per cent applied to the debt interest arising from

the loan from For Co (\$200 million) and the actual interest rate of 15 per cent on the debt interest).

Further, to the extent that Aus Co has 'excess debt', Division 820 applies to deny Aus Co's otherwise allowable debt deductions.

**Example 3.15: Transfer pricing adjustment and no thin capitalisation adjustment**

Assume the facts and circumstances are the same as in Example 3.14, except that Aus Co has \$300 million of debt (\$150 million from For Co and \$150 million from an independent lender) and \$100 million of equity, producing a safe harbour debt amount for Division 820 purposes of \$300 million. The interest rate on Aus Co's debt to For Co is 15 per cent, so that, before applying Subdivision 815-B and Division 820, Aus Co has total debt deductions of \$37.5 million.

As was the case in Example 3.14, Aus Co determines that an arm's length interest rate of 10 per cent is to be applied to the debt interest from For Co. As such, Aus Co gets a transfer pricing benefit of \$7.5 million (being the difference between the arm's length rate of 10 per cent applied to the debt interest from For Co (\$150 million) and the actual interest rate of 15 per cent on the debt interest).

**Example 3.16: Transfer pricing adjustment and no thin capitalisation adjustment**

Assume the facts and circumstances are the same as in Example 3.15, except that the entire \$300 million of debt is borrowed from For Co at an interest rate of 15 per cent. Aus Co's debt deductions for the interest incurred on its \$300 million debt total \$45 million for the income year.

Unlike the previous examples, there is no internal comparable uncontrolled price that provides an arm's length rate. As such, Aus Co determines the arm's length rate of interest for the loan having regard to available data of market reference rates and the credit standing that the capital markets would be likely to give Aus Co. Aus Co determines that its credit standing would allow it to borrow \$250 million from independent lenders. Having regard to the information available, the closest commercially realistic arm's length scenario at which a loan might reasonably be expected to exist between independent parties dealing wholly independently with one another is a loan of \$250 million at 10 per cent.

In this case the amount of the transfer pricing benefit is determined by reference to an amount less than the actual amount of the debt interest (being an arm's length amount). The fact that Aus Co's debt amount is less than its safe harbour debt amount for Division 820 purposes is not relevant to determining the amount of the transfer pricing benefit.

Alternatively structured arrangements do not need to be considered in this case.

Aus Co's transfer pricing benefit is \$15 million (as required under subsection 815-135(2)). This is worked out by applying the 10 per cent arm's length interest rate to Aus Co's actual debt amount (\$300 million), and comparing this to Aus Co's actual debt deductions of \$45 million.

### **Consequential Adjustments**

3.150 The application of Subdivision 815-B to determine the tax position of an entity could potentially impact the tax result of another entity, or of the same entity, in the same or a different income year. Accordingly, the Commissioner may make a consequential adjustment to ensure that taxpayers are subject to an appropriate amount of tax in Australia.

3.151 The Commissioner may make a determination in relation to a disadvantaged entity if:

- an entity is required by section 815-115 to work out its tax outcome under arm's length conditions;
- the disadvantaged entity would have had a more favourable tax result if the arm's length conditions had operated: that is, the disadvantaged entity would have been expected to have a smaller taxable income, a greater loss of a particular sort, a greater tax offset, or a smaller amount of withholding tax payable in respect of interest or royalties had the arm's length conditions operated; and
- the Commissioner considers that it is fair and reasonable that the consequential adjustment should be made.

*[Schedule 2, item 2, subsection 815-145(1)]*

3.152 The disadvantaged entity may be the entity to which Subdivision 815-B applied, or another entity.

3.153 In determining whether the application of Subdivision 815-B has resulted in an entity being disadvantaged, the Commissioner must consider whether a similar calculation to that which is performed under section 815-115 is required. That is, the disadvantaged entity must be able to show that it would have had a smaller taxable income, a greater loss of a particular sort, greater tax offsets or a smaller amount of

withholding tax payable. This involves a comparison between the actual amounts and the arm's length amounts.

***How are consequential adjustments be made?***

3.154 Where the Commissioner considers that it is fair and reasonable to make an adjustment to the tax position of the disadvantaged entity, the Commissioner may make a determination in order to:

- decrease the entity's taxable income for an income year;
- increase the entity's loss of a particular sort for an income year;
- increase the entity's tax offsets for an income year; or
- decrease the entity's withholding tax payable in respect of interest or royalties.

*[Schedule 2, item 2, subsection 815-145(2)]*

3.155 The Commissioner may also take actions necessary to give effect to the determination made under this section. For example, the Commissioner may remit the relevant tax paid by an entity subject to a specific determination under this section, notwithstanding the absence of a specific provision in the law to that effect. *[Schedule 2, item 2, subsection 815-145(3)]*

3.156 The Commissioner must provide a copy of the determination to the disadvantaged entity. However a failure to provide a copy of the determination does not affect the validity of the determination. *[Schedule 2, item 2, subsections 815-145(4) and (5)]*

3.157 Determinations relating to different income years may be included in the same document. The Commissioner may include all or any determinations in relation to a particular entity, including different kinds of determinations, within the same document. *[Schedule 2, item 2, subsection 815-145(6)]*

3.158 An entity may make a request to the Commissioner to make a determination in relation to a consequential adjustment. The Commissioner must decide whether to grant the request, and give the entity notice of his decision. If the entity is dissatisfied with the decision, the entity may object against that decision in the manner that is set out in Part IVC of the *Taxation Administration Act 1953*. *[Schedule 2, item 2, subsections 815-145(7) and (8)]*

**Example 3.17: Consequential adjustment to interest withholding tax paid**

Aus Co is an Australian resident company that has paid interest on a loan to a foreign resident related party. In accordance with the arm's length principle, Aus Co determines that the interest is excessive and, in order to apply the arm's length assumption, works out that it has received a transfer pricing benefit under section 815-120. Aus Co has therefore applied paragraph 815-115(2)(a), and increased its taxable income by reducing its allowable deductions.

The interest payment to the foreign resident associated entity was subject to interest withholding tax. Aus Co applies to the Commissioner under subsection 815-145(7) to make a consequential adjustment. The Commissioner determines that it is fair and reasonable to make a consequential adjustment in respect of the interest paid to the foreign company in excess of the arm's length amount that was subject to withholding tax.

To give effect to the determination the Commissioner refunds the relevant amount of interest withholding tax to the foreign resident associated entity.

**Time limit for amending assessments**

3.159 Under Division 13 and Subdivision 815-A, the Commissioner had an unlimited period in which to make or amend an assessment in relation to a transfer pricing adjustment.

3.160 Under Subdivision 815-B, the Commissioner is subject to a time limit for amending assessments. A transfer pricing adjustment to the tax position of an entity as a result of the application of Subdivision 815-B must be made within seven years of the day on which the Commissioner gives notice of the assessment to the entity. *[Schedule 2, item 2, subsection 815-150(2)]*

3.161 This time limit does not apply to the Commissioner's ability to ascertain additional amounts of withholding tax payable under Subdivision 815-B. This is because, pursuant to subsection 128C(6) of the ITAA 1936, any ascertainment of withholding tax does not constitute an assessment. A time limit in respect of adjustments to withholding tax under Subdivision 815-B is not included because no such time limit exists generally in respect of withholding tax.

3.162 There is no time limit for the Commissioner to make a consequential amendment under section 815-145. This is consistent with the unlimited time period that was available for making consequential adjustments under Division 13. *[Schedule 2, item 2, subsection 815-150(2)]*

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## **Chapter 4**

# **Arm's length principle for permanent establishments**

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### **Subdivision 815-C**

#### **What is the object of Subdivision 815-C?**

4.1 The object of Subdivision 815-C is to ensure that the amount brought to tax in Australia by entities operating at or through permanent establishments is not less than it would be if the permanent establishment (PE) were a distinct and separate entity engaged in the same or comparable activities under the same or comparable circumstances, but dealing wholly independently with the entity of which it is a part. *[Schedule 2, item 2, section 815-205]*

4.2 In recent years the Organisation for Economic Cooperation and Development (OECD) has revised its approach to the attribution of business profits to PEs. The authorised OECD approach now reflects the functionally separate entity approach. The Government has yet to determine whether it will change its tax treaty practice to adopt the functionally separate entity approach and as such Subdivision 815-C reflects the approach to the attribution of profits to PEs that is currently incorporated into Australia's tax treaties (the relevant business activity approach).

#### **How does Subdivision 815-C interact with the rest of the Act?**

4.3 Consistent with Subdivision 815-B, Subdivision 815-C takes precedence over other provisions of the *Income Tax Assessment Act 1936* (ITAA 1936) and the *Income Tax Assessment Act 1997* (ITAA 1997) unless a limitation to its operation is explicitly provided within the Subdivision. *[Schedule 2, item 2, subsection 815-210(1)]*

4.4 This means that to the extent that an entity is liable to a different tax result under Subdivision 815-C because arm's length profits are taken to have been attributed to a PE of the entity, Subdivision 815-C must be applied in working out the entity's Australian tax liability.

4.5 This priority rule does not however overcome the effect of subsection 4(2) of the *International Tax Agreements Act 1953* (ITAA 1953) (referred to at paragraphs 2.37 and 2.38 above). This is

because the priority rule in Subdivision 815-C applies to provisions of the ITAA 1936 and ITAA 1997 (the Assessment Acts), whereas subsection 4(2) applies to the extent of an inconsistency between the ITAA 1953 and the Assessment Acts.

4.6 Subdivision 815-C does not limit the application of Division 820 (which is about thin capitalisation) in reducing, or further reducing, an entity's debt deductions. *[Schedule 2, item 2, subsection 815-210(2)]*

4.7 This rule preserves the role of Division 820 in its application to an entity's amount of debt. In addition to this rule, Subdivision 815-B contains other special rules that apply in working out an entity's transfer pricing adjustment where Division 820 also applies (the rule in Subdivision 815-B may be relevant in determining the arm's length profits of a PE).

4.8 A specific rule is not required to deal with the interaction between Subdivision 815-C and the thin capitalisation rules because Subdivision 815-B applies in identifying arm's length profits for a PE. In this process the PE is treated, under certain constraints, as an entity. The provisions of Subdivision 815-B, including the thin capitalisation interaction rule, then apply to determine the arm's length conditions for the PE to the extent they are relevant.

4.9 Subdivision 815-C does not apply in respect of a branch that is taken not to be a permanent establishment under Part IIIB of the ITAA 1936. *[Schedule 2, item 2, subsection 815-210(3)]*

4.10 Part IIIB applies the functionally separate entity approach in respect of the attribution of income and expenditure to the Australian PEs of foreign banks. Consistent with the interaction between Part IIIB and former Division 13 of the ITAA 1936 (Division 13), Subdivision 815-C does not apply to PEs dealt with under Part IIIB.

### **Working out an entity's tax position**

4.11 Subdivision 815-C applies where an entity gets a transfer pricing benefit in an income year from the attribution of profits to a PE of the entity. In such cases, the actual amount of profits are taken not to have been attributed to the PE, and instead the arm's length profits are taken to have been attributed to the PE for the purposes of working out the amount to which the transfer pricing benefit relates. *[Schedule 2, item 2, subsection 815-215(1)]*

4.12 These amounts can be the amount of an entity's taxable income, a loss of a particular sort or tax offsets for an income year. *[Schedule 2, item 2, subsection 815-215(2)]*

4.13 In contrast to Subdivision 815-B, Subdivision 815-C does not apply in respect of amounts of withholding tax payable. This is because Subdivision 815-C applies in respect of the intra-entity allocation of income and expenses and as such its effect does not have any implications for withholding tax.

4.14 A tax loss, film loss or net capital loss are all identified by subsection 701-1(4) as a loss of a particular sort.

4.15 Subdivision 815-C ensures that the attribution of profits between a PE and other parts of the entity reflect the contribution made by the operations of those parts of the entity (consistent with the entity's actual income and expenses). After the arm's length profits are attributed to the PE of the entity, whether and how those profits affect the entity's Australian tax result and any elements in the calculation of its tax result under the relevant sections of the tax law must be considered.

4.16 As with Subdivision 815-B, Subdivision 815-C does not contain an explicit rule requiring individual amounts to be specified. A rule of this kind is not necessary because under Subdivision 815-C an entity is required to *work out* its taxable income, loss of a particular sort or tax offsets on the basis that arm's length profits had been attributed to its PE. This process is different from simply making an overall adjustment to these amounts and by definition requires that the entity identify and value the various items that are relevant in determining the aggregated amounts.

### **Guidance material**

4.17 In establishing the effect that Subdivision 815-C has in respect of an entity, the identification of arm's length profits and arm's length conditions (under the assumption that the PE is a distinct and separate entity) must be done in a way that best ensures consistency with certain guidance material. [*Schedule 2, item 2, subsection 815-235(1)*]

4.18 This guidance material is:

- the Model Tax Convention on Income and on Capital, and its Commentaries, as adopted by the Council of the OECD and last amended on 22 July 2010, to the extent that document extracts the text of Article 7 and its Commentary as they read before 22 July 2010;
- the guidance documents specified by Subdivision 815-B which currently include the *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax*

*Administrations* as approved by the Council of the OECD and last amended on 22 July 2010 (OECD Guidelines); and

- any other documents, or part(s) of a document, prescribed by the regulations for the purposes of either Subdivision 815-C or Subdivision 815-B.

*[Schedule 2, item 2, paragraph 815-235(1)(b) and subsection 815-235(2)]*

4.19 Requiring consistent interpretation with the OECD Guidelines (where relevant) does not imply that the legislation is adopting the functionally separate entity approach to the attribution of profits to PEs. As stated earlier, the Government has yet to determine whether it will change its current tax treaty practice to adopt the functionally separate entity approach. Subdivision 815-C therefore reflects the approach to the attribution of profits to PEs that is currently incorporated into Australia's tax treaties (the relevant business activity approach).

4.20 Further, Australia's tax treaties are generally based on the OECD's Model Tax Convention. The revised Commentary to Article 7 (which deals with the taxation of business profits, including the allocation of such profits to PEs) of the OECD Model Tax Convention as it read prior to 22 July 2010 contains specific references to the OECD Guidelines, and how they are to be used in the context of attributing profits to the PE of an enterprise. Within the confines of the relevant business activity approach, this is the approach that is adopted by Subdivision 815-C.

4.21 Because arm's length conditions under Subdivision 815-B have some relevance in identifying the arm's length profits of a PE, the documents that are relevant for identifying arm's length conditions under Subdivision 815-B are also relevant under Subdivision 815-C.

4.22 Given the hypothesis that a PE is a separate and distinct entity, arm's length profits must be determined by applying by analogy the principles developed for the application of the arm's length principle between associated enterprises (these are articulated in the OECD Guidelines). This is done by reference to the functions performed, assets used and risks assumed by the enterprise in carrying on business at or through the PE and through the rest of the enterprise.

4.23 Consistent with applying the Guidelines by analogy in attributing profits to PEs, generally the references in the OECD Guidelines to associated enterprises or related parties should be read in the context of Subdivision 815-C to be references to entities and their PEs dealing with each other as distinct and separate entities.

***Regulation making power in relation to documents***

4.24 Consistent with Subdivision 815-B, regulation making powers are included to allow for modifications to the list of guidance material under Subdivision 815-C. Requiring such modifications to be prescribed by regulation strikes an appropriate balance between ensuring ongoing consistency with developing international arrangements while providing for Parliamentary scrutiny of future developments.

4.25 The regulation making powers include the ability to prescribe additional documents or parts of a document. These powers ensure sufficient flexibility to prescribe further guidance material that may be published by the OECD or by other organisations that may be relevant for interpretive purposes in the future. Such material might be supplementary in nature or address issues that are not considered by the current OECD Guidance material. *[Schedule 2, item 2, paragraph 815-235(2)(b)]*

4.26 Material prescribed under either Subdivision 815-B or 815-C may also be removed by regulation from the list of guidance material for Subdivision 815-C. This allows material to be removed in the event that it is no longer relevant to determining arm's length profits of a PE. *[Schedule 2, item 2, subsection 815-235(3) and (4)]*

4.27 It may be appropriate to remove a document where it is subsequently revised in such a way that it is no longer relevant, or if an alternate model or guidance material is adopted in the future. The regulation making power may also remove a part of a document. This power may be used, for example, where Australia reserves its position on part of a document.

4.28 Regulations may also prescribe which documents, or parts of documents, are to be used or removed in specific circumstances. *[Schedule 2, item 2, subsection 815-235(5)]*

4.29 An example of this may be where a document explains a specific approach that should be adopted in relation to a certain arrangement in a specific industry but would result in an inappropriate outcome for similar arrangements in all other industries. In such cases it may be appropriate to prescribe that document as relevant guidance material, but confine its application to particular arrangements or industries. Alternatively, a regulation that removes documents specified from the guidance provision may prescribe the circumstances in which those documents are to be disregarded.

### **When does an entity get a transfer pricing benefit?**

4.30 An entity gets a transfer pricing benefit under Subdivision 815-C in respect of the attribution of profits to a PE of the entity if:

- the actual profits attributed to the PE differ from the arm's length profits for the PE; and
- had the arm's length profits, instead of the actual profits, been attributed to the PE, the entity would have received a tax advantage in Australia.

*[Schedule 2, item 2, subsection 815-220(1)]*

#### ***The actual profits differ from the arm's length profits***

4.31 In determining whether an entity gets a transfer pricing benefit, the actual profits attributed to the PE of the entity must differ from the arm's length profits. Arm's length profits are discussed in further detail at paragraphs 4.41 to 4.50 below. *[Schedule 2, item 2, paragraph 815-220(1)(a)]*

#### ***The actual profits result in a tax advantage in Australia***

4.32 Subdivision 815-C requires an assessment of what an entity's Australian tax position would have been had the arm's length profits been attributed to its PE.

4.33 Assessing what the entity's tax position would have been requires a comparison between the arm's length profits and the actual profits. In order to have a transfer pricing benefit, it must be demonstrated that the entity would have received a tax advantage in Australia because of the actual profits attributed to its PE, relative to the arm's length profits being attributed to its PE.

4.34 An entity has a tax advantage if the attribution of arm's length profits to its PE, relative to its actual profits, would mean that one of the following applies:

- the amount of the entity's taxable income for the income year would have been *greater*;
- the amount of the entity's loss of a particular sort for the income year would have been *less*; or
- the amount of the entity's tax offsets for the income year would have been *less*.

*[Schedule 2, item 2, subsection 815-220(1)]*

4.35 Where a change in an amount of profit or component amounts of profit (for example, certain amounts of revenue or expense) would not have affected an entity's Australian tax position, the entity does not have a tax advantage of the kind referred to above. For example, if an amount of profit that might have been expected to have accrued to an entity would have been non-assessable, non-exempt income of the entity, then the entity would not have a transfer pricing benefit in respect of that amount.

*Calculating a transfer pricing benefit when there is no taxable income, loss of a particular sort, or tax offsets*

4.36 An assessment of whether an entity receives a tax advantage of the kind referred to above, as well as the amount of any such benefit, requires consideration of the difference between two amounts: the first being based on the actual attribution of profits to the entity's PE, and the second being the attribution of arm's length profits to the entity's PE.

4.37 In instances where an entity has no taxable income, no loss of a particular sort, or no tax offset in an income year, it is not correct to say that the entity has a nil amount (rather it has no amount at all).

4.38 To ensure that the necessary calculation can still be performed where an entity has no actual taxable income, no losses of a particular sort, or no tax offsets (or would not have had such an amount under an attribution of arm's length profits to its PE), a rule is included to deem the entity to have a taxable income, loss of a particular sort, or tax offsets equal to an amount of nil (as appropriate) in the income year. This allows the relevant amount to be compared with the nil amount (or amounts).  
*[Schedule 2, item 2, subsection 815-220(2)]*

***Why is there no cross-border test in Subdivision 815-C?***

4.39 Although Subdivision 815-C does not contain an express cross-border test, the rules only have application where the allocation of an amount to a PE has an impact upon an entity's tax position. Such an impact will only occur in respect of dealings through a PE that have a cross-border element.

4.40 For example, the attribution of amounts to an Australian PE of an Australian resident does not affect the resident's tax position, whereas the attribution of amounts to a foreign PE of such an entity has implications for their access to the foreign branch income exemption or the business profits articles of a relevant treaty. Conversely, the attribution of amounts to a foreign PE of a foreign resident does not affect the foreign resident's Australian tax position, whereas attribution to an Australian PE does (either because of the sourcing rules in Australia's tax

treaties or the equivalent deeming provision under subsection 815-225(3)).

### **What are the arm's length profits?**

4.41 The arm's length profits of a PE are worked out by allocating the actual expenditure and income of an entity between itself and its PE so that the profits attributed to the PE equal the profits that the PE might be expected to make if:

- the PE was a distinct and separate entity;
- that separate entity was engaged in the same or comparable activities under the same or comparable conditions; and
- the conditions that operated between that separate entity and the entity of which it is a PE were the arm's length conditions.

*[Schedule 2, item 2, subsections 815-225(1) and (2)]*

4.42 Because the PE is taken to be an entity that deals with the entity of which it is actually a part, the approach under Subdivision 815-B to determining arm's length conditions is directly relevant in ascertaining the arm's length profits for the PE. As such, any factors relevant to determining arm's length conditions under Subdivision 815-B may be directly relevant to determining the arm's length profits under Subdivision 815-C. Similarly, the comparability factors and the issues to have regard to under Subdivision 815-B in selecting the most appropriate method may be relevant to applying the arm's length principle under Subdivision 815-C.

4.43 Comparable activities and circumstances should therefore be identified having regard to all relevant factors, including the factors mentioned in subsection 815-125(3). This is achieved by determining the arm's length conditions based on the assumption that the entity is a distinct and separate entity and engaged in the same or comparable activities in the same or comparable circumstances.

4.44 In determining whether an entity has attributed the arm's length profits to its PE, the economically relevant and material characteristics of the situations being compared must be sufficiently comparable. To be comparable, none of the differences (if any) between the situations being compared should be capable of materially affecting the arm's length profits.

4.45 Consistent with the approach adopted in Australia's domestic law and in Australia's tax treaties, the arm's length profits must however be identified subject to the constraint that the allocation is determined within the confines of the actual income and expense position (as they apply for Australian tax purposes) of the entity of which the PE is a part.

4.46 For the purposes of determining the arm's length profits, the actual expenditure of an entity includes losses or outgoings. Similarly, the actual income of an entity includes any amounts that would be assessable income of the entity. [*Schedule 2, item 2, subsection 815-225(3)*]

#### ***Source rules for arm's length profits***

4.47 Subdivision 815-C includes a deeming rule in relation to the arm's length profits of an entity's Australian PE. The effect of this rule is that the arm's length profits for that PE are taken to be attributable to Australian sources. [*Schedule 2, item 2, subsection 815-230(1)*]

4.48 This deeming rule is consistent with the special source rules contained in Australia's tax treaties and has the effect of ensuring that any arm's length profits of an Australian PE are taken to be Australian sourced. Whether or not amounts are Australian sourced is relevant for foreign residents as they are taxed on their Australian sourced income. Similarly, questions of source are relevant for foreign resident beneficiaries of Australian resident trust estates and foreign resident partners of partnerships.

4.49 A similar deeming rule is also included in respect of the arm's length profits of a PE located in an area covered by an international tax sharing treaty. This rule deems any arm's length profits of such PEs to be sourced in the area in which the PE is located. [*Schedule 2, item 2, subsection 815-230(2)*]

4.50 This rule ensures that the arm's length profits (which can include income and expenditure) of the PE are taken to be sourced in the area covered by the relevant international tax sharing treaty. Although such areas may be within Australia, the rule is relevant for all entities irrespective of residence because Australia's ability to impose tax upon income sourced in an area covered by an international tax sharing treaty (or deal with expenditure in relation to such income), is affected by the terms of such agreements.

#### **Time limits for amending assessments**

4.51 Under Division 13 and Subdivision 815-A, the Commissioner of Taxation (Commissioner) had an unlimited period in which to make or amend an assessment in relation to a transfer pricing adjustment.

4.52 Subdivision 815-C introduces a time limit for amending assessments. A transfer pricing adjustment to the tax position of an entity as a result of the application of Subdivision 815-C must be made within seven years of the day on which the Commissioner gives notice of the assessment to the entity. *[Schedule 2, item 2, section 815-240]*

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## **Chapter 5**

### ***Additional rules for trusts and partnerships***

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#### **Subdivision 815-D**

5.1 Subdivisions 815-B and 815-C make a number of references to the taxable income or loss of a particular sort of an entity. Because trusts and partnerships do not have taxable income and partnerships do not have tax losses, special rules are included in Subdivision 815-D to ensure that Subdivisions 815-B and 815-C apply appropriately to trusts and partnerships. These rules address the differences in terminology but do not otherwise change the substantive effect of Subdivisions 815-B or 815-C.

5.2 As such, where Subdivisions 815-B and 815-C apply in relation to the taxable income of an entity, they apply in the same way to the net income of an entity that is a trust or partnership. [*Schedule 2, item 2, section 815-305 and subsection 815-310(1)*]

5.3 Further, Subdivisions 815-B and 815-C apply to a partnership loss of a partnership in the same way that they apply to the tax loss of an entity that is not a partnership. Although the term ‘tax loss’ is not explicitly used in Subdivisions 815-B or 815-C, those Subdivisions use the definition of ‘loss of a particular sort’ which includes a tax loss but not a partnership loss. As such, a partnership that has a partnership loss is treated as having a loss of a particular sort under Subdivisions 815-B or 815-C. [*Schedule 2, item 2, subsection 815-310(2)*]



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## **Chapter 6**

# **Record keeping requirements and penalties**

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### **Subdivision 284-E of Schedule 1 and other amendments to the *Taxation Administration Act 1953***

#### **Link between record keeping and penalties**

6.1 A taxpayer is liable to an administrative penalty under the *Taxation Administration Act 1953* (TAA 1953) where the Commissioner of Taxation (Commissioner) takes certain actions to give effect to Subdivisions 815-B or 815-C.

6.2 Whether or not a taxpayer has a reasonably arguable position in respect of the way they had self-assessed their position under Subdivision 815-B or 815-C prior to the Commissioner determining that additional tax is payable by the taxpayer impacts upon the amount of the administrative penalty. Where an entity is able to demonstrate that its position was reasonably arguable, the entity is entitled to a reduced penalty amount.

6.3 Subdivision 284-E of Schedule 1 to the TAA 1953 sets out the records that an entity or the agent of the entity may prepare and maintain in order to demonstrate that they have correctly applied Subdivisions 815-B or 815-C. Records that are kept in accordance with Subdivision 284-E are required (but not sufficient) to establish a reasonably arguable position about the application of those Subdivisions.

6.4 In the event that an entity is liable for a scheme shortfall amount due to the application of Subdivision 815-B or 815-C, the entity is only able to establish it has a reasonably arguable position if it has prepared and maintained documentation in respect of the matter that gives rise to the shortfall amount. To the extent that it has not kept documentation in respect of such conditions, it is unable to establish that it has a reasonably arguable position about how the Subdivisions apply and is therefore unable to access the lower scheme penalty amount should it be liable to a shortfall penalty.

6.5 Although establishing a reasonably arguable position is one avenue through which an entity can lower the applicable penalty amount, the requirement that a taxpayer keep records under Subdivision 284-E has

no impact upon the Commissioner's general ability to exercise a discretion to remit administrative penalties.

***Interaction with section 262A of the ITAA 1936***

6.6 Section 262A of the *Income Tax Assessment Act 1936* (ITAA 1936) imposes a general requirement that a person who is carrying on a business keep records that explain all transactions and other acts engaged in by the person that are relevant for any purposes of the ITAA 1936 and the *Income Tax Assessment Act 1997*. It would be expected that to the extent that documents prepared in accordance with Subdivision 284-E relate to transactions or acts that would otherwise need to be recorded under section 262A, the documents prepared in accordance with Subdivision 284-E would satisfy the more general record keeping requirement under section 262A. However where this is not the case, section 262A continues to apply in respect of any relevant transactions and acts.

**Penalties for adjustments made under Subdivision 815-B or 815-C**

***When will penalties apply?***

6.7 Subdivision 284-C in Schedule 1 to the TAA 1953 imposes a liability to an administrative penalty where the Commissioner takes certain actions to give effect to Subdivision 815-B or 815-C that result in a liability to an additional amount of income tax or withholding tax. [*Schedule 2, item 3, subsection 284-145(2B) in Schedule 1 to the TAA 1953*]

6.8 The relevant actions of the Commissioner are the amendment of an assessment in an income year in respect of a liability to additional income tax, or the serving of one or more notices that additional withholding tax is payable. [*Schedule 2, item 3, subparagraphs 284-145(2B)(a)(i) and (ii) in Schedule 1 to the TAA 1953*]

6.9 As such, if the Commissioner determines that a taxpayer has not correctly self-assessed their tax position under Subdivision 815-B or 815-C and amends an assessment or issues a notice in respect of withholding tax, the taxpayer is liable to an administrative penalty.

***What is the amount of the penalty?***

6.10 Administrative penalties under Subdivision 284-C in Schedule 1 to the TAA 1953 are determined by the scheme shortfall amount to which the relevant adjustment relates. In the context of adjustments made under Subdivision 815-B or 815-C, the scheme shortfall amount is the amount of the additional income tax or withholding tax payable as the result of the

Commissioner taking action against the taxpayer. *[Schedule 2, item 4, subsection 284-150(4) in Schedule 1 to the TAA 1953]*

6.11 In most cases, the administrative penalty for transfer pricing related scheme shortfall amounts is the sum of:

- 25 per cent of the scheme shortfall amount; and
- 10 per cent of the scheme shortfall amount to the extent it is attributable to the taxpayer (or their agent) having treated the transfer pricing rules as applying or not applying to a matter in a way that was reasonably arguable.

*[Schedule 2, item 5, table item 2 in subsection 284-160(3) in Schedule 1 to the TAA 1953]*

6.12 However, where it is reasonable to conclude that the entity entered into the scheme with the sole or dominant purpose of obtaining a transfer pricing benefit (for themselves or another entity), the base penalty amount is the sum of:

- 50 per cent of the scheme shortfall amount; and
- 25 per cent of the scheme shortfall amount to the extent it is attributable to the taxpayer (or their agent) having treated the transfer pricing rules as applying or not applying to a matter in a way that was reasonably arguable.

*[Schedule 2, item 5, table item 1 in subsection 284-160(3) in Schedule 1 to the TAA 1953]*

6.13 Increased penalties in respect of schemes that were entered into for the sole or dominant purpose of obtaining a transfer pricing benefit are consistent with the former penalty provisions that applied in relation to Division 13 of the ITAA 1936 (Division 13). Penalties in relation to adjustments under Division 13 only applied where penalties for the sole or dominant purpose of obtaining a scheme benefit did not apply.

6.14 The base penalty rule for Subdivisions 815-B and 815-C includes higher penalties in relation to sole or dominant purposes. Accordingly, to the extent that a scheme shortfall amount is attributable to the Commissioner giving effect to Subdivision 815-B or 815-C, that amount is not included in a scheme shortfall amount covered by subsection 284-145(1) (which applies to schemes entered into for the sole or dominant purpose of obtaining a scheme benefit). This carve-out ensures that taxpayers are not subject to administrative penalties under both provisions in relation to the same scheme. *[Schedule 2, item 4, subsection 284-150(5) in Schedule 1 to the TAA 1953]*

6.15 In addition to rules for transfer pricing related adjustments under Subdivisions 815-B and 815-C, the base penalty rules for schemes with the sole or dominant purpose of obtaining a scheme benefit and for transfer pricing adjustments under Subdivision 815-A have been rewritten into new subsections but have not been modified in substance. *[Schedule 2, item 3, subsections 284-160(1) and (2) in Schedule 1 to the TAA 1953]*

***Scheme shortfall amounts that are less than the reasonably arguable threshold***

6.16 Administrative penalties do not apply in respect of Subdivisions 815-B or 815-C where the scheme shortfall amount is equal to or less than an entity's reasonably arguable threshold. *[Schedule 2, item 6, subsection 284-165(1) in Schedule 1 to the TAA 1953]*

6.17 Special rules also apply for partnerships and trusts to ensure that administrative penalties in respect of Subdivision 815-B or 815-C do not apply to scheme shortfall amounts that result in a trust having a greater amount of net income or a lesser amount of a tax loss, or a partnership having a greater amount of net income or a lesser amount of a partnership loss than the trust or partnerships' reasonably arguable threshold. *[Schedule 2, item 6, subsections 284-165(2) and (3) in Schedule 1 to the TAA 1953]*

6.18 In instances where a trust or partnership has no net income, a trust has no tax loss, or a partnership has no partnership loss, it is not correct to say that the entity has a nil amount (rather they have no amount at all). To ensure that the necessary calculation can still be performed in such instances, a rule is included to deem the trust or partnership to have net income, a tax loss, or a partnership loss equal to an amount of nil (as appropriate) in the income year. This allows the relevant amount to be compared with the nil amount (or amounts). *[Schedule 2, item 6, subsection 284-165(4) in Schedule 1 to the TAA 1953]*

***What is the reasonably arguable threshold?***

6.19 Amendments made to the TAA 1953 in relation to administrative penalties remove the threshold references from items 4 to 6 of the table to subsection 284-90(1) and insert them in the definition of 'reasonably arguable threshold'.

6.20 The relevant thresholds are the greater of:

- \$10,000 or 1 per cent of income tax payable, or minerals resource rent tax (MRRT) payable by an entity for the income year; and

- \$20,000 or 2 per cent of an entity's net income for an income year, where the entity is a trust or partnership.

*[Schedule 2, items 45 to 48]*

6.21 The definition of reasonably arguable threshold allows any future changes to the general thresholds under section 284-90 of Schedule 1 to the TAA 1953 to apply automatically for the purposes of determining administrative penalties in relation to transfer pricing adjustments.

### **Records for Subdivision 815-B and 815-C**

6.22 Subdivision 284-E of Schedule 1 to the TAA 1953 sets out requirements in respect of documents related to the application of Subdivisions 815-B and 815-C.

6.23 Where an entity has treated Subdivision 815-B or 815-C as applying or not applying to a matter in a certain way (or made a statement about the way those Subdivisions apply to a matter), and the entity does not have records that meet the requirements of Subdivision 284-E, the entity cannot have a reasonably arguable position in respect of that matter. *[Schedule 2, item 7, section 284-250 in Schedule 1 to the TAA 1953]*

6.24 In order to meet the documentation requirements of Subdivision 284-E, the records must be prepared before the time the entity lodges its income tax return for the income year, and either be in English or be readily accessible and convertible into English. *[Schedule 2, item 7, paragraphs 284-255(1)(a) and (b) in Schedule 1 to the TAA 1953]*

6.25 It is intended that an entity only maintain and prepare documentation in respect of those conditions that are both material and relevant to the application of Subdivision 815-B and 815-C to them. In this regard, a condition is material if it impacts upon the entity's Australian tax position, and is ultimately relevant where it is subject to an adjustment by the Commissioner.

6.26 Because compliance with the documentation rules is not mandatory, it is expected that in determining whether certain conditions are material or relevant an entity will undertake a risk assessment of its cross-border dealings and prepare and maintain transfer pricing documentation in respect of those matters which could be the subject of dispute with the Commissioner.

6.27 Where an entity has prepared and maintained transfer pricing documentation in respect of a matter that is the subject of a scheme shortfall amount, the entity is entitled to establish that it had a reasonably

arguable position in respect of that matter (and therefore is eligible for a lower administrative penalty). Conversely, in the event that an entity does not have any documentation in respect of the matter which is ultimately disputed by the Commissioner and results in a scheme shortfall amount, the entity is unable to claim a reasonably arguable position in respect of that matter.

6.28 To the extent that an entity considers that transfer pricing documentation should be prepared and maintained in respect of certain matters, the documentation must explain the way in which the relevant Subdivision was applied to the matter, and why the application in that way best achieved consistency with the relevant guidance material. *[Schedule 2, item 7, paragraphs 284-255(1)(c) and (d) in Schedule 1 to the TAA 1953]*

6.29 The records must also contain information in respect of the relevant arm's length conditions, as well as particulars about the method selected and the comparable circumstances relevant in identifying the arm's length conditions. *[Schedule 2, item 7, paragraphs 284-255(2)(a) and (b) in Schedule 1 to the TAA 1953]*

6.30 As such, transfer pricing documentation should also contain an explanation of all the steps that are undertaken in identifying which method should be selected, and the comparable conditions used in that process.

6.31 In cases where the records explain the application of the transfer pricing rules to a matter (as opposed to the non-application of the rules), the records must also explain the result of the application of the relevant Subdivision and contrast this result with the outcome that would have been achieved in the absence of the Subdivision being applied (for example, the entity's tax result under arm's length conditions relative to actual conditions). *[Schedule 2, item 7, paragraph 284-255(2)(c) in Schedule 1 to the TAA 1953]*

6.32 In cases where the records relate to the application of Subdivision 815-B, the records must also explain the actual conditions that are relevant to the matter in question. *[Schedule 2, item 7, paragraph 284-255(2)(d) in Schedule 1 to the TAA 1953]*

6.33 In cases where the records relate to the application of Subdivision 815-C, the records must also explain the actual profits and arm's length profits attributed to the permanent establishment that are relevant to the matter, as well as the particulars of the activities and circumstances of the permanent establishment that were assumed as the result of the entity being deemed to be a separate and distinct entity. *[Schedule 2, item 7, paragraph 284 255(2)(e) in Schedule 1 to the TAA 1953]*

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## **Chapter 7**

### **Other amendments**

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#### **Consequential amendments**

##### *What is the effect on the Controlled Foreign Company provisions?*

7.1 Section 400 of Part X of the *Income Tax Assessment Act 1936* (ITAA 1936) is repealed by these amendments. Subsection 400(aa) is re-written to ensure the Controlled Foreign Company (CFC) rules continue to operate as intended when calculating the attributable income of an eligible CFC. This section specifies that for an eligible CFC the cross-border test is not satisfied where the eligible CFC and the other entity (provided it is also a CFC) are residents of the same listed country (disregarding the residency test in section 383 of the ITAA 1936).  
*[Schedule 2, item 18, section 400]*

7.2 Former subsection 400(a) is not re-written because it is not required. The residency assumption under section 383 means that a CFC is treated as an Australian resident and the cross-border test satisfied in the same way for that CFC as it is for any other resident entity. It would be expected that in most cases the cross-border test would be satisfied for the CFC because it would operate through an overseas permanent establishment.

7.3 Former subsection 400(b) is not rewritten because it has no practical effect in the context of the new rules. That subsection related to consequential amendments for entities as the result of the notional application of Division 13 of the ITAA 1936 (Division 13) to a CFC in working out its attributable income. In the event that an entity is actually disadvantaged by the application of the new transfer pricing rules, they are entitled to request a consequential adjustment under those rules.

7.4 Amendments also modify the gross turnover calculation provisions in the CFC rules to reflect the change in the transfer pricing rules from operating on the basis of the Commissioner of Taxation (Commissioner) making a determination under section 136AD of the ITAA 1936, to the new rules operating on a self-assessment basis.  
*[Schedule 2, item 19, subsection 434(3)]*

##### *What is the effect on the transferor trust rules?*

7.5 Consequential amendments also repeal section 102AAZA, which modified the way Division 13 applied in the notional application of Division 13 to the trustee of a trust in calculating the net income of the

trust under the transferor trust rules. [*Schedule 2, item 9, section 102AAZA in Schedule 1 to the TAA 1953*]

7.6 Former subsection 102AAZA(a) is not re-written because it is not required. The residency assumption for the trustee that applies in the ordinary calculation of the net income of a non-resident trust estate will mean that the trustee is treated as an Australian resident. The cross-border test is satisfied in respect of the trustee in the same way that it is for any other resident entity.

7.7 Former subsection 102AAZA(b) is not rewritten because it is not required for the provisions relating to consequential adjustments under Subdivision 815-B. That subsection related to consequential amendments for entities as the result of the notional application of Division 13 to a trustee in calculating its net income under Division 13. In the event that an entity is actually disadvantaged by the notional application of the new transfer pricing rules, it is entitled to request a consequential adjustment under those rules.

#### ***Amendment Period***

7.8 Consequential amendments also repeal various provisions in Part IV of the ITAA 1936 as a result of the removal of the unlimited amendment period available to the Commissioner to give effect to any transfer pricing adjustment. [*Schedule 2, items 12 to 16, subsection 170(9B), table item 4 in subsection 170(10), subsection 170(9C), definition of 'double taxation agreement' in subsection 170(14), definition of 'prescribed provision' in subsection 170(14), definition of 'relevant provision' in subsection 170(14)*]

7.9 However, unlimited amendment periods continue to apply to consequential adjustments made under subsection 815-145(2). [*Schedule 2, item 2, subsection 815-150(2)*]

#### ***Administrative Penalties***

7.10 A note is also included in provisions dealing with determining when a matter is 'reasonably arguable' which directs taxpayers to Subdivision 284-E of Schedule 1 to the *Tax Administration Act 1953* (TAA 1953). This Subdivision sets out the requirements for transfer pricing documentation [*Schedule 2, item 44, note at end of subsection 284-15(1) in Schedule 1 to the TAA 1953*]

7.11 A further amendment updates provisions that apply administrative penalties to scheme shortfall amounts to ensure they may also be applied where a liability to an administrative penalty arises under subsection 284-145(2A) in Schedule 1 to the TAA 1953 from 1 July 2012. This amendment resolves an issue in calculating the penalty amount for adjustments under Subdivision 815-A. The change does not adversely

affect taxpayers because Subdivision 815-A makes clear provision for penalties to apply in this way. *[Schedule 2, item 58, subsection 284-160(b) in Schedule 1 to the TAA 1953]*

### **Other amendments**

7.12 As a result of Schedule 2 modernising the transfer pricing rules and replacing Division 13, many consequential amendments arise, where sections currently contain references to Division 13, or to terms used in that Division. *[Schedule 2, items 8, 10, 30, 31, 33, 35, subsection 6(1) definition of ‘international tax sharing treaty’, note in subsection 160ZZW(2), paragraph 802-35(1)(c), paragraph 802-35(2)(c), subsection 815-40(2), subparagraph 842-250(1)(c)(ii)]*

7.13 Further consequential amendments repeal provisions that are no longer necessary as a consequence of the repeal of Division 13. *[Schedule 2, items 11, 13, 17, 24 to 29, subsection 160ZZW(5), table item 24 in subsection 170(10), subsection 389(a), notes 1 and 2 in section 70-20, notes 1 and 2 in section 355-400, note in section 420-20, note in section 420-30]*

7.14 Amendments also reflect changes to references that have resulted from the inclusion of additional Subdivisions within Division 815. *[Schedule 2, items 32 and 34, note in section 815-10, note in section 820-30]*

7.15 Amendments also update the checklist in sections 10-5 and 12-5 to reflect the changes that resulted from the repeal of Division 13 and the inclusion of the transfer pricing rules into the *Income Tax Assessment Act 1997*. *[Schedule 2, items 20 to 23, table item headed ‘avoidance of tax’ in section 10-5, table item headed ‘trading stock’ in section 10-5, table item headed ‘tax avoidance schemes’ in section 12-5, table item headed ‘transfer pricing’ in section 12-5]*

7.16 Amendments also insert new definitions into the dictionary for an ‘area covered by an international tax sharing treaty’, ‘arm’s length conditions’, ‘arm’s length profits’, ‘international tax sharing treaty’, ‘PE’, ‘reasonably arguable threshold’ and ‘residence article’, while the definition of ‘transfer pricing benefit’ has been updated to incorporate amendments resulting from the modernisation of the transfer pricing rules. *[Schedule 2, items 36 to 43, subsection 995-1(1)]*

7.17 In updating the IMR income provision to account for the repeal of Division 13, a further technical amendment is also made to this provision with the insertion of the words ‘that is resident in a country’ to ensure that the provision applies only to entities that are residents of countries that have not entered into an international agreement with Australia which contains a business profits article. *[Schedule 2, item 35, subparagraph 842-250(1)(c)(ii)]*

7.18 Minor technical amendments also ensure that dictionary definitions apply and that the appropriate entity is identified. *[Schedule 2, items 55 to 57, subparagraph 815-35(1)(b)(ii), subparagraph 815-35(2)(b)(ii), subsection 815-35(10)]*

### **Application provisions**

7.19 The amendments made by Schedule 2 apply:

- in respect of tax other than withholding tax — to income years starting on or after the earlier of:
  - 1 July 2013; and
  - the day this Bill receives Royal Assent.
- in respect of withholding tax — in relation to income derived, or taken to be derived, in income years starting on or after the earlier of the above two dates.

*[Schedule 2, items 50 and 54]*

7.20 The amendment made by item 58 (which applies a base penalty to scheme shortfall amounts) applies to income years commencing on or after 1 July 2012. *[Schedule 2, item 59]*

7.21 Amendments to the *Income Tax (Transitional Provisions) Act 1997* reflect changes that have resulted from the inclusion of the additional Subdivisions within Division 815. In particular, the amendments clarify that Subdivision 815-A does not apply to an income year to which Subdivisions 815-B and 815-C apply. *[Schedule 2, items 51 to 53]*

## **STATEMENT OF COMPATIBILITY WITH HUMAN RIGHTS**

### **Prepared in accordance with Part 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011***

#### **Modernisation of the Transfer Pricing Rules**

7.22 This Schedule is compatible with the human rights and freedoms recognised or declared in the international instruments listed in section 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011*.

## Overview

7.23 Schedule 2 to this Bill inserts Subdivisions 815-B, 815-C and 815-D into the *Income Tax Assessment Act 1997* and Subdivision 284-E into Schedule 1 to the *Taxation Administration Act 1953*. These amendments are designed to modernise the transfer pricing rules contained in Australia's domestic rules.

7.24 The amendments provide a set of consistent rules that apply to both tax treaty and non-treaty cases, ensuring greater alignment between outcomes for international arrangements involving Australia and other jurisdictions irrespective of whether they are part of Australia's treaty network.

7.25 The amendments also contain specific rules relating to transfer pricing documentation.

7.26 This measure applies for income years commencing on or after the earlier of:

- 1 July 2013; and
- the day this Bill receives Royal Assent.

7.27 In respect of withholding tax, this measure applies in relation to income derived, or taken to be derived, in income years commencing on or after the earlier of the above two dates.

## Human rights implications

7.28 The Schedule does not engage any of the applicable rights or freedoms.

## Conclusion

7.29 This Schedule is compatible with human rights as it does not raise any human rights issues.

## Assistant Treasurer, the Hon David Bradbury



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