2012

TAX LAWS AMENDMENT (CROSS BORDER TRANSFER PRICING) BILL 2013: MODERNISATION OF TRANSFER PRICING RULES

EXPOSURE DRAFT - EXPLANATORY MEMORANDUM

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

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Chapter 1
Cross-border transfer pricing

Outline of chapter

1.1 This Bill inserts Subdivisions 815-B, 815-C, 815-D and 815-E into the *Income Tax Assessment Act 1997* (ITAA 1997). These Subdivisions contain amendments that modernise the transfer pricing rules contained in Australia's domestic law. They ensure these rules better align with the internationally consistent transfer pricing approaches set out by the Organisation for Economic Cooperation and Development (OECD).

1.2 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.

1.3 This Schedule also:

- makes consequential amendments to the *Income Tax Assessment Act 1936* (ITAA 1936); and
- amends the *Taxation Administration Act 1953* (TAA 1953).

1.4 All legislative references are to the ITAA 1997 unless otherwise stated.

Context of amendments

1.5 Australia's transfer pricing rules seek to ensure that an appropriate return for the contribution made by Australian operations is taxable in Australia for the benefit of the community.

1.6 The appropriate return is determined by 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.

1.7 The new rules apply the arm's length principle through an analysis of the conditions that might be expected to operate in comparable circumstances between entities dealing wholly independently with one another.

1.8 In addition, where the allocation of an entity's profits to a permanent establishment is relevant in determining its tax position, the

arm's length principle ensures that this attribution is performed on the basis that permanent establishment was a distinct and separate entity dealing wholly independently with the entity of which it is a part.

1.9 The amendments ensure Australia's domestic rules are aligned with and interpreted consistently 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). Greater consistency with international standards reduces uncertainty and the risk of double taxation; it will also assist in minimising compliance and administration costs.

1.10 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 — about 50 per cent — of Australia's cross-border trade flows.

1.11 There is evidence of a growth in multinational trade over the last decade. For example, trade in highly mobile factors such as services has grown from $16.6 billion in 2002 to $37.3 billion in 2009, whilst trade in insurance products and interest flows were valued at $10.3 billion in 2002 and $27.3 billion in 2009.

1.12 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.

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

Current transfer pricing rules

1.14 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.

1.15 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, Australia's tax treaties and the OECD Guidelines (recognised as international best practice) 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 when determining whether outcomes are consistent with the arm's length principle. The OECD Guidelines' focus on the totality of arrangements allows for the consideration of a

broad range of methods to determine the arm's length outcome which include, but are not limited to, traditional transaction methods.

1.16 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. The rules also provide direct access to the OECD Guidance material in interpreting the rules and clarify how the Subdivision should interact with Division 820 of the ITAA 1997, which deals with thin capitalisation.

Summary of new law

1.17 Subdivisions 815-B, 815-C, 815-D and 815-E will modernise and relocate the transfer pricing provisions into the ITAA 1997 to ensure that a single set of rules applies to both tax treaty and non-tax treaty cases. Consistent with the approaches under Division 13, the new rules in Subdivision 815-B will apply the arm's length principle to relevant dealings between both associated and non-associated entities. Subdivision 815-C also uses the arm's length principle to attribute an entity's actual income and expenses between its parts.

1.18 Division 13 will be repealed when Subdivisions 815-B, 815-C, 815-D and 815-E are enacted. Subdivision 815-A will have no operation from the date of application of these changes. The new rules, consistent with the approach under Division 13 of the ITAA 1936, will also apply the arm's length principle to relevant cross-border dealings between both associated and non-associated entities.

1.19 That is, irrespective of whether the entities are related, the amount brought to tax in Australia in respect of non-arm's length dealings should reflect the economic contribution made by Australian operations. This will ensure that independent parties engaging in, for example, collusive behaviour or other practices where they are not dealing exclusively in their own economic interests will not circumvent the rules by reason of their non-association.

1.20 Subdivision 815-B will apply to arrangements between entities to ensure that Australia's domestic transfer pricing rules determine the arm's length conditions that would have been expected to operate had the entities been dealing with each other on a wholly independent basis. The arm's length conditions should be reflective of, and take into account, the totality of the commercial or financial relations between the entities.

1.21 Subdivision 815-C will apply to entities with permanent establishments. The Subdivision will operate to ensure that the attribution of income and expenses of the entity between its parts is reflective of an allocation that may be expected had the parts of the entity been separate

entities dealing wholly independently with each other (but constrained by the actual income and expenses of the entity of which the permanent establishment is a part).

1.22 Unlike the current transfer pricing rules in Division 13 and in Subdivision 815-A, which both rely on the Commissioner of Taxation making a determination, these provisions will be self-executing in their operation. This will bring these rules in line with the design of Australia's taxation system which generally operates on a self-assessment basis. Entities will be required to determine their overall tax position that arises from their arrangements with offshore parties on the basis of independent commercial and financial relations (or in the case of the permanent establishment of an entity, on the basis of arm's length profits) occurring between the entities (or the parts of the entity).

1.23 The transfer pricing rules will allow for consequential adjustments. Similar to current arrangements, these adjustments will be available at the discretion of the Commissioner where it is considered fair and reasonable for the adjustment to be reflected in the final tax position of the disadvantaged entity.

1.24 Subdivision 815-D sets out the type of documentation that would be relevant for an entity in self-assessing its tax position with respect to transfer pricing. Keeping documentation under these provisions is not mandatory. However, failure to prepare and keep transfer pricing documentation will mean that an entity is unable to argue that a reduced base penalty should apply on the basis of a reasonably arguable position (RAP).

1.25 De minimis thresholds will now apply to scheme shortfall amounts that arise as a result of a transfer pricing adjustment; below the threshold, scheme administrative penalties will not apply.

1.26 Subdivision 815-E sets out special rules which ensure that the main provisions apply to trusts and partnerships.

Subdivision 815-B

1.27 Subdivision 815-B modernises Division 13 as it applies to separate legal entities. It requires prescribed amounts (taxable income, loss of a particular sort and tax offsets) to be worked out by applying the internationally accepted arm's length principle.

1.28 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. This 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."

1.29 Each of Australia's comprehensive tax treaties includes an *Associated Enterprises* article based on Article 9 of the OECD Model Tax Convention and Commentaries, as adopted by the Council of the OECD and last amended on 22 July 2010 (the OECD Model Tax Convention and Commentaries).

1.30 Although the application of the arm's length principle contained in Article 9 of the OECD's Model Tax Convention and the *Associated Enterprises* article of each of Australia's tax treaties is restricted to associated enterprises, Subdivision 815-B will apply to unrelated entities that enter into non-arm's length cross-border arrangements. This is consistent with the current scope of Division 13. The purpose of this is to ensure that, irrespective of the relationship between the parties, where non-arm's length conditions operate in connection with cross-border arrangements (for example, as a result of collusive behaviour between unrelated parties) amounts are appropriately brought to tax in Australia.

1.31 The application of the Subdivision does not rely on or assume a tax avoidance motive. In this regard, the scope of Subdivision 815-B will be largely consistent with that of Division 13.

1.32 Broadly, the arm's length principle is introduced into Australia's domestic law by requiring cross-border 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. 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. That is, while differing in scope, Subdivision 815-B applies the same test of the arm's length principle as do the *Associated Enterprises* articles of Australia's tax treaties.

1.33 The arm's length conditions applicable to the commercial or financial relations between entities operating in the Australian tax jurisdiction should be determined by analysing all of the factors that are relevant to an understanding of the commercial and financial relations that exist between the entities.

1.34 Specifically, determining the arm's length conditions involves an analysis of the functions performed, the assets used or contributed, and the risks assumed/managed by the entities. From this analysis, the most appropriate and reliable transfer pricing method, or combination of methods, should be chosen, having regard to all relevant circumstances. Applying the most appropriate and reliable transfer pricing method or methods will determine the arm's length conditions that are applicable to the multinational enterprise.

1.35 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 given comparable commercial or financial relations under comparable circumstances. In effect, this uses the behaviour of parties dealing at arm's length with each other as a benchmark for the purposes of determining the arm's length conditions for an entity.

1.36 For the purposes of determining the tax outcome under the Subdivision, the arm's length principle will be interpreted so as to best achieve consistency with the internationally accepted OECD Guidelines, as well as any documents that are prescribed at a future date.

Subdivision 815-C

1.37 Subdivision 815-C deals with the attribution of profits between a permanent establishment and the entity of which it is a part. The rules confirm the relevant business activity approach (also known as the single entity approach) as the basis for attributing profits under Australia's domestic transfer pricing rules. Consistent with Australia's former Reservation on Article 7 of the OECD Model Tax Convention, the relevant business activity approach is the approach Australia has sought to adopt in its tax treaties.

1.38 The transfer pricing rules will focus on ensuring that the amount brought to tax in Australia by entities operating permanent establishments is not less than it would be if the permanent establishment were allocated a share of the entity's profits as if it 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 other parts of the entity.

1.39 Broadly, the allocation of profits between a permanent establishment and the entity of which it is a part will be 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.

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

1.41 The arm's length principle will be interpreted so as to best achieve consistency with the OECD Model Tax Convention and

Commentaries, as well as the internationally accepted OECD Guidance material, insofar as they are relevant.

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

1.42 Subdivisions 815-B and 815-C are generally aligned with the treaty transfer pricing articles (generally Articles 7 and 9) in Australia's tax treaties. Subsection 4(2) of the ITAA 1953 will continue to apply in the event of an inconsistency between Australia's international tax treaties and the rules. The Subdivisions apply where the entity gets a transfer pricing benefit in Australia. However, nothing in these Subdivisions prevents Australia's tax treaties from applying in circumstances where the outcome under a tax treaty could result in, for example, a lesser adjustment relative to a taxpayer's position under the domestic law provisions to the extent that they deal with the same subject matter.

Subdivision 815-D

1.43 Subdivision 815-D sets out the type of documentation that an entity may prepare and keep in self-assessing tax results with respect to Subdivision 815-B or 815-C. This documentation is referred to as transfer pricing documentation and, in order to satisfy the requirements of Subdivision 815-D, must be prepared before the lodgement of the relevant tax return.

1.44 While the Subdivision does not mandate the preparation and keeping of such documentation, failing to do so will disentitle an entity to the lower base penalty amount which is available to those entities whose positions are 'reasonably arguable'.

Amendments to the TAA 1953

1.45 The TAA 1953 has been amended to make sure that scheme administrative penalties apply to scheme shortfall amounts arising from the application of Subdivision 815-B or 815-C.

1.46 If the scheme shortfall amounts are equal to or less than the respective de minimis thresholds, no scheme administrative penalty will arise. A de minimis threshold applies to scheme shortfall amounts for entities that are not trusts or partnerships. There is also a separate de minimis threshold that applies to scheme shortfall amounts for trusts and for partners in a partnership.

1.47 Entities that do not prepare transfer pricing documentation in accordance with Subdivision 815-D will be deemed as not having a 'reasonably arguable' position. As such these entities will not be entitled to the lower base penalty amounts which is available to those entities whose positions are 'reasonably arguable'. However, this does not preclude the Commissioner from using his discretion to remit

administrative penalties where appropriate (currently available under the law).

Subdivision 815-E

1.48 Subdivision 815-E sets out special rules about the way that Subdivisions 815-B, 815-C and 815-D apply to trusts and partnerships. The rules ensure that the Subdivisions apply in relation to the net income of a trust or partnership in the same way as those Subdivisions apply to the taxable income of an entity other than a trust or partnership. The Subdivisions also apply to the partnership loss of a partnership in the same way as they apply to the tax loss of an entity other than a partnership.

Comparison of key features of new law and current law

New law	*Current law*
A transfer pricing adjustment may be made under Subdivision 815-B, Subdivision 815-C, or the relevant transfer pricing provisions of a tax treaty. 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. To the extent they have the same coverage as the equivalent tax treaty rules, an adjustment under Subdivision 815-B or Subdivision 815-C will give the same result as the transfer pricings provisions of a tax treaty.	A transfer pricing adjustment may be made under either Division 13, the transfer pricing provisions of a tax treaty, or Subdivision 815-A. 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.
Subdivisions 815-B and 815-C apply on a self-assessment basis.	The Commissioner must make a determination under Division 13 or Subdivision 815-A in order to give effect to a transfer pricing adjustment.

New law	***Current law***
Subdivision 815-B applies to cross-border conditions between entities whether associated or not and to entities operating in both treaty and non-treaty countries. The transfer pricing provisions of a tax treaty may apply in the event of an inconsistency with Subdivision 815-B.	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). Subdivision 815-A and the tax treaty transfer pricing provisions apply in treaty cases only, and in respect of entities to which a particular relevant transfer pricing article applies (that is, as it applies to separate entities, between associated enterprises only).
Subdivision 815-C applies to the allocation of actual income and expenses of an entity between the entity and its permanent establishment. 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. The transfer pricing provisions of a tax treaty may apply in the event of an inconsistency with Subdivision 815-C.	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. The transfer pricing provisions of a tax treaty may apply in the event of an inconsistency with Subdivision 815-A.
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.	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. 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.

New law	***Current law***
Subdivision 815-D sets out optional record keeping requirements for entities to which Subdivision 815-B or 815-C applies. 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. If the documentation as specified in the Subdivision is not kept the entity will not be able to demonstrate that they have a reasonably arguable position for the purposes of Schedule 1 to the TAA 1953.	The general record-keeping provisions of the tax law apply to the transfer pricing provisions.
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.	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.
An amendment to give effect to Subdivision 815-B or Subdivision 815-C can be made within 8 years after the day on which the Commissioner gives notice of the assessment to the entity. Some tax treaties impose specific time limits in relation to transfer pricing adjustments under the tax treaty.	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. Some tax treaties impose specific time limits in relation to transfer pricing adjustments under the tax treaty.

Chapter 2
Arm's length principle for cross-border conditions between entities

Detailed explanation of new law

Subdivision 815-B

What is the object of Subdivision 815-B?

2.1 The object of Subdivision 815-B is to ensure that the amount brought to tax in Australia from cross-border conditions between entities reflects the arm's length contribution made by Australian operations. Further, the amount should reflect the conditions that might be expected to operate between entities dealing at arm's length, by considering any connection between the entities and any other relevant circumstance. ***[Schedule 1, item 2, section 815-105(1)]***

2.2 The Subdivision seeks to achieve this outcome in a way that facilitates trade and investment through alignment with international standards. The international standard that has widespread adoption amongst Australia's trade and investment partners is the arm's length principle, the application of which is set out in the OECD Guidelines.

2.3 The Subdivision implements this principle by requiring entities that would otherwise get a tax advantage in Australia from non-arm's length cross-border conditions, to calculate their Australian tax position as though the arm's length conditions had operated. ***[Schedule 1, item 2, subsection 815-105(2)]***

Working out an entity's tax position

2.4 The new rules apply if 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. The effect of the new rules is that those 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 of an entity's taxable income, loss of a particular sort and tax offsets for an income year. ***[Schedule 1, item 2, section 815-115]***

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

Guidance material

2.6 In establishing whether the Subdivision applies to an entity for an income year, the Subdivision must be interpreted in a way that best achieves consistency with the prescribed guidance material. ***[Schedule 1, item 2, section 815-130]***

2.7 The use of OECD material in relation to this Subdivision is potentially available, in many cases, under the ordinary rules of statutory interpretation. To provide a more direct legal pathway for accessing certain guidance material, a specific rule will apply for the purposes of this Subdivision to supplement the general rules of statutory interpretation.

2.8 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.

2.9 Most of Australia's major trading and investment partners look to OECD material to ensure consistent application of transfer pricing rules. This consistency improves certainty of application of these rules for enterprises operating across borders. Further, if 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).

2.10 The OECD Guidelines, in particular, expand on the application of the 'arm's length principle' – the internationally agreed approach to dealing with transfer pricing. They contain authoritative international know-how on the application of transfer pricing rules and were described by the UK Special Commissioners as 'the best evidence of international thinking'[1] on transfer pricing'. While the OECD Council recommends that tax administrations of Member Countries follow the Guidelines in reviewing transfer prices, they are also used by non-Member administrations, as well as international tax advisers.

2.11 For income years to which this Subdivision applies any adjustment made to an entity's Australian tax position to reflect arm's length conditions, must be done consistently with the following material:

- the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations as approved by the OECD Council and last amended on 22 July 2010 (the OECD Guidelines); and

[1] *DSG Retail Limited and Others v HMRC (2009)*

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

[Schedule 1, item 2, subsection 815-130(2)]

2.12 Any reference in the OECD Guidelines to associated enterprises or related parties should be read in the context of Subdivision 815-B to be a reference to entities not dealing wholly independently with one another.

2.13 Therefore, insofar as it is relevant, the OECD Guidance material is to be used in all cases to which the Subdivision applies — 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. This is consistent with the intended operation of Division 13 — the Second Reading Speech to the Income Tax Assessment Amendment Bill 1982 that introduced Division 13 (which Subdivisions 815-B and 815-C are replacing) made reference to the work of the OECD on transfer pricing.

Regulation making power in relation to documents

2.14 A regulation making power is included to modify the list of documents set out in the law. 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. ***[Schedule 1, item 2, subsection 815-130(4)]***

2.15 Regulation making powers are included so that additional documents or parts of a document may be prescribed for the purposes of the Subdivision. 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 1, item 2, paragraph 815-130(2)(b)]***

2.16 The OECD Guidelines or other prescribed documents may also be disqualified, in whole or part, by regulation. This allows material to be removed in the event that it is no longer relevant to determining whether an entity's tax position should be adjusted to reflect arm's length conditions. ***[Schedule 1, item 2, subsection 815-130(3)]***

2.17 It may be appropriate to disqualify 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 disqualify a part of a document; this power may be used, for example, where Australia reserves its position on part of a document.

2.18 Regulations may also prescribe which documents, or parts of documents, are to be used or disqualified in specific circumstances. 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 give nonsensical results for similar arrangements in all other industries. In such cases it may be appropriate to prescribe that document to be used in interpreting the Subdivision but confined to the particular arrangements to which it best relates. Alternatively, a regulation that disqualifies a document specified under the Subdivision may prescribe the circumstances in which those documents are to be disregarded. ***[Schedule 1, item 2, subsection 815-130(4)]***

When does an entity get a transfer pricing benefit?

2.19 A transfer pricing benefit is the amount of the Australian tax advantage that an entity would receive from its non-arm's length dealings with other entities. Because these rules apply on a self-assessment basis, this tax advantage will be a notional one, as it would only be realised in the absence of the entity applying Subdivision 815-B.

2.20 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.

2.21 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 meet the cross-border requirement; and
- the actual conditions differ from the arm's length conditions; and
- if the arm's length conditions had operated instead of the actual conditions, one or more of the following would apply to the entity:
  - the amount of the entity's taxable income for the income year would be *greater*; or
  - the amount of the entity's loss of a particular sort for the income year would be *less*; or
  - the amount of the entity's tax offsets for the income year would be *less*.

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

The actual conditions must meet the cross-border requirement

2.22 The first step in determining if an entity gets a transfer pricing benefit is to determine whether the actual conditions will meet the cross-border requirement for an entity.

- The cross-border requirement will be met where the actual conditions operate between the entity and another entity, and that other entity is:
  - not an Australian resident; and
  - not a resident trust estate for the purposes of Division 6 of Part III of the ITAA 1936; and
  - not a partnership in which all of the partners are, directly or indirectly through one or more interposed partnerships, Australian residents or resident trust estates;
  - an overseas permanent establishment; or
- the actual conditions operate in connection with a business the entity carries on in an area covered by an international tax sharing treaty.

[Schedule 1, item 2, paragraph 815-120(3)(c)]

2.23 Where the cross-border requirement is satisfied, having regard to the totality of the commercial or financial relations, it will be necessary to determine if there are non-arm's length conditions operating between the entities that give rise to a more favourable Australian tax result for the relevant entity than would be the case if the arm's length conditions had operated.

Example 2.1Cross-border conditions: an entity and another entity

Aus Co is a wholly owned Australian resident subsidiary of a US resident entity (US Co). Aus Co acts as US Co's Australian distributor of goods. The cross-border requirement will be met in this scenario where conditions operate between Aus Co and US Co in connection with their commercial or financial relations.

Example 2.2 Cross-border conditions: an entity and an overseas permanent establishment

United Kingdom resident company UK Co has a permanent establishment operating in New Zealand (NZ PE). UK Co also wholly owns Aus Co, an Australian subsidiary company. Where conditions operate between Aus Co and NZ PE, in connection with the commercial or financial relations between Aus Co and UK Co, the cross-border requirement will be met.

Example 2.3 Cross-border conditions: a foreign entity with an Australian permanent establishment and another foreign entity

US Co is a resident entity of the United States, with a wholly owned UK resident subsidiary (UK Co), as well as a permanent establishment in Australia (Aus PE). Where conditions operate between UK Co and Aus PE, in connection with the commercial or financial relations between US Co and UK Co, these conditions would meet the cross-border requirement.

Application to parties that are not related

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

The actual conditions must differ from the arm's length conditions

2.25 A further requirement in determining if an entity gets a transfer pricing benefit is that 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. The relevance of the connection with the commercial and financial relations, the actual conditions and determining the arm's length conditions are discussed below (at paragraphs 2.31 to 2.91).

2.26 In order to determine whether the arm's length conditions should apply, there needs to be a difference between the arm's length conditions and the actual conditions. A difference will 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 1, item 2, subsection 815-120(2)]***

The actual conditions result in a tax advantage in Australia

2.27 Subdivision 815-B requires an assessment of what an entity's Australian tax position would be under arm's length conditions, having regard to all aspects of the commercial and financial relations that exist between it and another entity. This requires a comparison of the arm's length conditions with the actual conditions to be made. If the relevant entity would have received a transfer pricing benefit in Australia because of the operation of non-arm's length conditions, the arm's length conditions must be used to calculate the entity's taxable income, loss of a particular sort or tax offsets.

2.28 Where a change in an amount of profits or component amounts of profits (that is, revenues and expenses) would not have affected an entity's Australian tax position, the entity will not have any transfer pricing benefit. 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, it would not constitute a transfer pricing benefit.

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

2.29 An assessment of whether an entity receives a transfer pricing benefit, 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 the arm's length conditions that might be expected to operate between entities which is ascertained in accordance with the arm's length principle.

2.30 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), the entity will be deemed to have a taxable income, loss of a particular sort or tax offsets of an amount of nil (as appropriate). This will allow the relevant amount to be compared with the nil amount (or amounts). ***[Schedule 1, item 2, subsection 815-120(4)]***

What are the commercial or financial relations?

2.31 The analysis of conditions, and the question of whether or not they constitute arm's length conditions, is undertaken within the context of the commercial or financial relations that exist between entities. ***[Schedule 1, item 2, subsection 815-120(1)]***

2.32 This analysis includes taking into account the surrounding economic and commercial environment within which the entities operate. This will usually require the identification and evaluation of the economically significant elements of the multinational's value chain relevant to the Australian entity.

2.33 For the purposes of this Subdivision, all relevant aspects of the commercial and financial relationships existing between parties must be examined, irrespective of whether they are express or implied.

2.34 The concept of commercial or financial relations is intended to be broad and would take into account any connections or dealings between the entities or relevant parts of the entity that relate to or could otherwise affect the commercial or financial activities of one or all of the entities or parts of the entity. It could include one or more of the following:

- a single transaction or a series of transactions;
- an understanding, an arrangement, things to be done or not to be done, and practices, whether express or implied and whether or not legally enforceable;
- unilateral actions or mutual dealings;
- a strategy; or
- overall profit outcomes achieved by two or more entities.

It is important to clearly distinguish between the comparability of the commercial or financial relations between the entities, and the comparability of circumstances. The former relate to the conditions relevant to an understanding of the economically significant functions, assets and risks of the entity. The latter relate to factors external to the

entity, such as market characteristics or other environmental factors. The OECD Guidelines provide relevant guidance on how to perform a comparability assessment.

What are the actual conditions?

2.35 The actual conditions that operate in the commercial or financial relations between entities include, but are not limited to, the conditions which can influence, or have the potential to influence, the financial indicators measured in applying the appropriate transfer pricing method. These conditions can include, for example, the price of any transfers, the terms of the transfers, the circumstances under which the transfers took place between the entities, the margins or profits earned by one or more of them, and the division of profits between them. ***[Schedule 1, item 2, subsection 815-115(1)***

2.36 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 the value chain, the main conditions relevant might involve the price at which trading stock items are sold or the fees charged for common services such as transportation or freight.

What are the arm's length conditions?

2.37 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 1, item 2, subsection 815-125(1)]***

2.38 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.

2.39 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 determine 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.

2.40 It may also be important to consider issues such as whether independent entities operating in similar circumstances would have advanced loans with the same or similar characteristics, provided various

forms of credit support, issued shares or paid dividends and at what price and under what conditions would those transactions have occurred between independent parties dealing wholly independently with one another. Similar questions could also be asked regarding royalties or license payments and could also include decisions that may affect an entity's liquidity, such as the time at which an amount should be paid.

Entities dealing wholly independently with one another

2.41 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 this Subdivision requires an assessment of whether the conditions which operate between them would make commercial sense if the entities were dealing wholly independently of each other.

2.42 When considering whether parties have dealt with one another in a way that is wholly independent, it is necessary to ask whether the parties have dealt with each other as independent parties in comparable circumstances would normally be expected to, 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.

2.43 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].

2.44 Circumstances in which 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 dictation 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.

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

2.45 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. The entity 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 1, item 2, subsection 815-125(2)]

2.46 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.

What are 'Transfer Pricing Methods'?

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

2.48 Entities must have regard to the OECD Guidelines in working out arm's length conditions.

2.49 The various methods currently outlined in the Guidelines are set out below. Note, however, these are not the only methods that may be used. The OECD Guidelines state that 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 (CUP) method

2.50 The 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

2.51 The cost plus method provides an estimate of an independent margin by adding an appropriate cost plus mark-up to the supplier's direct and indirect 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

2.52 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

2.53 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.

2.54 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.

2.55 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

2.56 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.

2.57 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

2.58 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

2.59 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'?

2.60 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 1, item 2, paragraph 815-125(4)(a)]***

2.61 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 1, item 2, paragraph 815-125(4)(b)]***

Example 2.4 Comparability adjustments

Aus Co almost exclusively deals wholly independently with independent enterprises. Aus Co undertakes limited dealings with a non-arm's length party that operates in the same market, undertakes comparable commercial roles, undertakes no remarkable 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 the independent enterprise. 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.

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

2.63 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 that would significantly affect the value of an arrangement.

What are the factors that need to be taken into account in determining comparability?

2.64 In identifying comparable circumstances, regard must be had to all relevant factors including 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 1, item 2, subsection 815-125(3)]

2.65 In identifying the comparable circumstances, regard should be had to the OECD Guidance material. ***[Schedule 1, item 2, section 815-130]***

How do the OECD Guidelines describe these factors?

2.66 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

2.67 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.

2.68 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 will also be 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.

2.69 The risks assumed by different parties will also be 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.

2.70 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.

2.71 The functions carried out (taking into account the assets used and risks assumed) will 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

2.72 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 potential comparables need to be carefully considered. Such differences would often account, at least in part, for differences in value.

2.73 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, may be less sensitive to such differences.

2.74 In considering the specific characteristics of the property or services transferred it will be 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

2.75 Contractual terms will 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.

2.76 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.

2.77 When parties are dealing wholly independently their separate interests will usually drive 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 will be important to establish whether the economic substance of arrangements matches the contractual terms.

Economic circumstances

2.78 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 (risk thereof) 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; the date and time of transactions, and so forth.

Business strategy

2.79 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.

2.80 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).

2.81 Generally a market penetration scheme will result 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.

Relevance of economic substance

2.82 In identifying the arm's length conditions, regard must be had to the economic substance of what was actually done. ***[Schedule 1, item 2, subsection 815-125(5)]***

2.83 Although in many cases, the economic substance of what was actually done will match its legal form, where that is not the case, it is the economic substance of what was done that determines the arm's length conditions. ***[Schedule 1, item 2, subsections 815-125(5) and (8)]***

2.84 The arm's length principle is fundamentally concerned with ensuring that entities are appropriately rewarded for their economic contributions. As such, where the economic substance of the dealings between entities is not reflected by the legal form of their arrangements, it is the economic substance of what was done that is relevant in the application of the transfer pricing rules.

2.85 The economic substance of what was done is determined by examining all of the 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.

2.86 Although the economic substance of what was done by the entities must be considered in determining the arm's length conditions that would be expected to operate between them, it is not the case that the arm's length conditions must be those that would be expected to operate between independent entities doing the things that the entities in question actually did. ***[Schedule 1, item 2, subsection 815-125(6)]***

2.87 If it were the case that independent entities would not have dealt with one another in the way that the two entities did, the transfer pricing question can extend to identifying what would have instead been done by entities dealing wholly independently with one another in comparable circumstances, and the arm's length conditions that would have arisen from those dealings. In substituting actual dealings or arrangements, a necessary precondition is that independent entities would not have done what was actually done given the options that are realistically available to them - it is not of itself sufficient to propose that independent entities would have done something else.

2.88 The mere fact that independent entities have not been *observed* to have done something (or that information on such independent dealings is not available) will not of itself mean that independent entities would not have dealt with one another in the manner the entities actually did. The 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.

2.89 Although it is not necessary for the identification of arm's length conditions to be done on the basis of a characterisation of arrangements or structure that is identical in substance to what was actually done, any substituted arrangements or dealings must nevertheless be substantially similar to the economic substance of what was actually done. ***[Schedule 1, item 2, subsections 815-125(6) and (7)]***

2.90 As such, the economic substance of what was actually done informs the nature of any re-characterisation of particular dealings or

arrangements that would not have been entered into by entities dealing wholly independently with one another. This requirement imposes an additional constraint in substituting what was actually done with what independent entities would have done by requiring the substituted dealings to comport as closely as possible with the facts and economic substance of what actually happened.

2.91 If however entities dealing wholly independently with one another in comparable circumstances would not have been expected to have done anything which is, in economic substance, substantially similar to what was done by the entities then the arm's length conditions are to be identified as if what was actually done had not been done. ***[Schedule 1, item 2, subsection 815-125(7)]***

Example 2.5 Economic substance and substituted arrangements or dealings in identifying arm's length conditions

Aus Co enters into a long-term contract with its foreign resident related party, for a single fixed sum in consideration for unlimited entitlement to intellectual property rights of future research. In this case it may be appropriate to acknowledge the substance of the arrangement, that is, a transfer of intellectual property rights. It may, however, be appropriate to substitute the terms of the arrangement in their entirety (in this case the contractual terms) with contractual terms that would reasonably be expected to be entered into by parties dealing wholly independently.

In this case, if it were established that independent parties behaving commercially rationally would not have agreed to a single fixed sum, but instead would have entered into a continuing research agreement, Aus Co's arrangement with its related party may be adjusted to reflect the arrangement that independent parties behaving commercially rationally would have entered into (that is, a continuing research agreement).

Working out an entity's tax result

2.92 Once Subdivision 815-B has been applied to determine the arm's length conditions for an entity, the entity must then work out its taxable income, loss of a particular sort and tax offsets (as applicable) as though the arm's length conditions had operated. ***[Schedule 1, item 2, subsection 815-115(2)]***

2.93 That is, after determining the arm's length conditions that operate to an entity, the entity must then consider whether and how those conditions would affect its Australian tax result and any elements in the calculation of its tax result under the relevant sections of the Income Tax Assessment Acts.

2.94 Determination of the entity's tax position will include any questions that would ordinarily be considered in calculating any elements of the entity's tax position. For example, such questions may include consideration as to the source of any income (and related expenses).

2.95 One example would be where the question of source is relevant to an entity's tax position (for example, where the entity is a foreign resident). Similarly, source may be relevant in calculating the entity's Australian 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).

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

2.96 Where Division 820 applies to an entity for an income year and the entity has worked out its taxable income or loss of a particular sort to reflect arm's length conditions that are referable to its debt deductions, a special rule applies in working out the transfer pricing adjustment. The rule modifies the way in which Subdivision 815-B applies to an entity. ***[Schedule 1, item 2, subsection 815-135(1)]***

2.97 The rule preserves the role of Division 820 as the comprehensive regime in regards 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 1, item 2, subsection 815-135(2)]***

2.98 The rule maintains the administrative approach provided in Taxation Ruling TR 2010/7, which was confirmed in Subdivision 815-A. Its inclusion seeks to clarify and provide certainty on the interaction between the thin capitalisation rules and this Subdivision, on the basis that depending on the priority given to each, the tax outcomes for an entity may vary substantially.

2.99 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 calculation of a transfer pricing benefit relating to those debt deductions is modified so that only the rate may be adjusted. That is, this Subdivision would allow that rate to be adjusted to an arm's length rate, but the rate must be applied to the debt interest actually issued (and still on issue from time to time) in order to determine the amount of any transfer pricing adjustment. This ensures that this Subdivision does not defeat the operation of Division 820.

2.100 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.

2.101 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 will be 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 aligned to 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 is applied to the entity's actual amount of debt. The amount of debt deductions of the entity remaining after the arm's length rate of interest has been applied will then become the amount of debt deductions that are relevant for the purposes of Division 820.
- Finally, and after the consideration of any other part of the Act as may be necessary, Division 820 may reduce an entity's otherwise allowable debt deductions if the entity's adjusted average debt exceeds its maximum allowable debt.

2.102 Similar to Subdivision 815-A, the following examples illustrate the interaction of Subdivision 815-B and Division 820. They are intended purely 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 2.6 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%, and $200 million from an independent lender at an interest rate of 10%.

Aus Co's only debt deductions are for the interest incurred at a rate of 15% on its $200 million related party debt, and 10% 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 (i.e. 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 and 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%. In this case, Aus Co gets a transfer pricing benefit of $10 million (being the difference between an arm's length rate of 10% applied to the debt interest arising from the loan from For Co ($200 million) and the actual interest rate of 15% on the debt interest).

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

Example 2.7 Transfer pricing adjustment and no thin capitalisation adjustment

Assume the facts and circumstances are the same as in Example 2.6, 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%, 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 2.6, Aus Co determines that an arm's length interest rate of 10% is to be applied to the debt interest from For Co. As such, Aus Co gets a transfer pricing benefito of $7.5 million (being the difference between the arm's length rate of 10% applied to the debt interest from For Co ($150 million) and the actual interest rate of 15% on the debt interest).

Example 2.8 Transfer pricing adjustment and no thin capitalisation adjustment

Assume the facts and circumstances are the same as in Example 2.7, except that the entire $300 million of debt is borrowed from For Co at an interest rate of 15%. 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%.

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% 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

2.103 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 a different income year. Additional rules under Subdivision 815-B allows the Commissioner to make a consequential adjustment to ensure that taxpayers are subject to an appropriate amount of tax in Australia.

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

- the entity is required by section 815-115 to work out its taxable income, loss of a particular sort or tax offsets as if arm's length conditions had operated;
- 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 1, item 2, subsection 815-140(1)]

2.105 The disadvantaged entity may be the entity that applied Subdivision 815-B to work out its taxable income, loss of a particular sort or tax offsets, or another entity.

2.106 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 will be required. That is, the disadvantaged entity must be able to show that it would have had a smaller taxable income, greater loss of a particular sort, greater tax offsets or smaller amount of withholding tax payable. This will involve a comparison between the actual amounts and the arm's length amounts.

How will a consequential adjustment be made?

2.107 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 1, item 2, subsection 815-140(2)]

2.108 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 1, item 2, subsection 815-140(3)]***

2.109 The Commissioner must provide a copy of the determination to the disadvantaged entity. However a failure to provide a copy of the determination will not affect the validity of the determination. ***[Schedule 1, item 2, subsections 815-140(4) and 815-140(5)]***

2.110 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 1, item 2, subsection 815-140(6)]***

2.111 An entity may make a request to the Commissioner to consider making a determination that results in 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 TAA 1953. ***[Schedule 1, item 2, subsections 815-140(7) and 815-140(8)***

Example 2.9: 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 815-140(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

2.112 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.

2.113 Under Subdivision 815-B, a time limit for amending assessments is being introduced. 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 eight years of the day on which the Commissioner gives notice of the assessment to the entity. ***[Schedule 1, item 2, section 815-145]***

Chapter 3
Arm's length principle for permanent establishments

Subdivision 815-C

What is the object of 815-C?

3.1 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 as a result of the attribution of the income and expenses of an entity between its parts 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 1, item 2, section 815-205]***

3.2 In recent years the OECD revised its approach to the attribution of business profits to permanent establishments. 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. With this in mind, Subdivision 815-C reflects the approach to the attribution of profits to permanent establishments that is currently incorporated into Australia's tax treaties (the relevant business activity approach).

Working out an entity's tax position

3.3 In working out the amount of an entity's taxable income, loss of a particular sort or tax offsets, if an entity gets a transfer pricing benefit from the attribution of profits to a PE of the entity, these profits are taken to not have been so attributed. Instead, the arm's length profits are taken to have been attributed to the PE. ***[Schedule 1, item 2, subsection 815-215(1)]***

3.4 The Subdivision applies where an entity (either a foreign resident or Australian resident) receives a transfer pricing benefit as a result of the attribution of profits to a PE of the entity. The rules ensure 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 (within the confines of the entity's actual income and expenses).

Guidance material

3.5 In establishing whether an entity has attributed the arm's length profits to its PE, the Subdivision must be interpreted in a way that best

ensures consistency with the prescribed guidance material unless the contrary intention appears. ***[Schedule 1, item 2, section 815-230]***

3.6 In applying this Subdivision (including the application of section 815-215, as it applies for the purposes of this Subdivision) any adjustment made to an entity's tax result to reflect arm's length profits must be done consistently with the following guidance material:

- 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; and
- any other documents covered by subsection 815-130, which currently includes:
  - the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations as approved by the OECD Council and last amended on 22 July 2010 (the OECD Guidelines); and
  - any other documents, or part(s) of a document, prescribed by the regulations for this purpose.

[Schedule 1, item 2, section 815-230]

3.7 The rules also provide for a regulation making power which allows the OECD Model Tax Convention or any other documents prescribed for the purposes of Subdivision 815-C to be disregarded. Further, the regulation making power also provides that any documents prescribed for the purposes of Subdivision 815-B may also be disregarded. ***[Schedule 1, item 2, subsections 815-230(3) and (4)]***

3.8 The regulation making power also allows different documents or parts of documents to be prescribed for different circumstances. ***[Schedule 1, item 2, subsection 815-230(5)]***

3.9 The concepts underpinning arm's length conditions in section 815-125 have a limited relevance in attributing profits to a PE, since the starting point for the latter is confined to the actual expenditure and income of the entity. However, in determining the extent to which those amounts of actual expenditure and income are attributable to the PE, the concepts in section 815-125 and in the OECD Guidelines will often be relevant.

3.10 While the OECD Guidelines do not specifically refer to the attribution of profits to PEs, it is still relevant for many steps in this process. Areas where there will often be overlap include:

- selection of the most appropriate method of profit allocation to the PE; and

- identification of comparable activities and conditions based on the functions performed, assets used and risks assumed by the various parts of the entity.

3.11 Arm's length profits should therefore 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) by reference to the functions performed, assets used and risks assumed by the enterprise in carrying on business at or through the permanent establishment and through the rest of the enterprise.

3.12 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 tax treaty practice to adopt the functionally separate entity approach. Subdivision 815-C therefore reflects the approach to the attribution of profits to permanent establishments that is currently incorporated into Australia's tax treaties (the relevant business activity approach).

3.13 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 permanent establishments) 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 permanent establishment of an enterprise. Within the confines of the relevant business activity approach, this is the approach that adopted by Subdivision 815-C.

3.14 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 a reference to entities and their PEs not dealing with each other as distinct and separate entities.

3.15 Insofar as it is relevant, the guidance material is to be used in all cases to which the Subdivision applies — that is the guidance material is relevant in applying the Subdivision to dealings between an entity and its PE, and in both treaty and non-treaty cases.

Regulation making power in relation to documents

3.16 Consistent with Subdivision 815-B, 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. ***[Schedule 1, item 2, paragraph 815-230(2)(b) and subsections 815-230(3)-(5)]***

3.17 The OECD Model Tax Convention or other prescribed documents may also be disqualified, in whole or part, by regulation. ***[Schedule 1, item 2, subsection 815-230(3)]***

3.18 This allows material to be removed in the event that it is no longer relevant to determining whether an entity's tax position should be adjusted to reflect arm's length conditions. This might occur if the document is subsequently revised, or if an alternate model or guidance material is adopted in the future. The regulation making power may also disqualify a part of a document, which may, for example, be used where Australia reserves its position on that part of the document.

3.19 Further, a regulation making power exists that allows documents covered by section 815-130 to be disregarded for the purposes of interpreting Subdivision 815-C. ***[Schedule 1, item 2, subsection 815-230(4)]***

3.20 This would allow the OECD Transfer Pricing Guidelines, as well as any other document prescribed for the purposes of Subdivision 815-B, to be disregarded for the purposes of interpreting Subdivision 815-C. This might occur where a document has been prescribed which has no impact on the interpretation of the rules relating to permanent establishments of an entity. ***[Schedule 1, item 2, subsection 815-230(4)]***

3.21 Additional documents or parts of a document may be prescribed by regulation for the purposes of the Subdivision. 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 material. ***[Schedule 1, item 2, paragraph 815-230(2)(b)]***

3.22 As with Subdivision 815-B, regulations may also prescribe which documents, or parts of documents, are to be used or disqualified in specific circumstances. ***[Schedule 1, item 2, subsection 815-230(5)]***

3.23 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 give nonsensical results for similar arrangements in all other industries. In such cases it may be appropriate to prescribe that document to be used in interpreting the Subdivision but confined to the particular arrangements to which it best relates. Alternatively, a regulation that disqualifies a document specified under the Subdivision may prescribe the circumstances in which those documents are to be disregarded.

When does an entity get a transfer pricing benefit?

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

- the entity carries on a business at or through a PE;
- 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, one or more of the following would apply:
  - the amount of the entity's taxable income for the income year would be *greater*; or
  - the amount of the entity's loss of a particular sort for the income year would be *less;* or
  - the amount of the entity's tax offsets for the income year would be *less*.

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

The entity carries on a business at or through a PE

3.25 The first requirement in order to show that an entity has received a transfer pricing benefit under Subdivision 815-C is to determine that an entity carries on a business at or through a PE. ***[Schedule 1, item 2, subsection 815-220(1)(a)]***

The actual profits differ from the arm's length profits

3.26 A further requirement in determining if an entity gets a transfer pricing benefit is that the profits of the entity that have been attributed to the PE differ from the arm's length profits for the PE. The determination of arm's length profits is discussed below at paragraphs 3.33 to 3.38.

The actual conditions result in a tax advantage in Australia

3.27 Subdivision 815-C requires an assessment of the Australian tax position of the entity that would result based on the attribution of arm's length profits to a PE. This requires a comparison to be made between the arm's length profits with the actual profits. If a transfer pricing benefit would have been received in Australia because of the attribution of non-arm's length profits, the arm's length profits must be used to calculate the entity's taxable income, loss of a particular sort or tax offsets.

3.28 Where a change in an amount of profits or component amounts of profits (that is, expenditure or income) would not have affected an entity's Australian tax position, the entity will not have a transfer pricing benefit.

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

3.29 An assessment of whether an entity receives a transfer pricing benefit, as well as the amount of any such benefit, requires consideration of the difference between two amounts: the first being based on the actual profits that have been attributed to the PE of an entity, and the second being the arm's length profits that might be expected to be attributed to the PE of an entity.

3.30 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 had the arm's length profits been attributed to the PE), the entity will be deemed to have a taxable income, loss of a particular sort or tax offsets of an amount of nil (as appropriate). This will allow the relevant amount to be compared with the nil amount (or amounts). ***[Schedule 1, item 2, subsection 815-220(2)]***

Tax advantage in respect of cross-border dealings

3.31 Although Subdivision 815-C does not contain an express cross-border requirement, the rules will only have application where the allocation of an amount to a PE has an impact upon an entity's tax position – this can only occur in respect of cross-border dealings.

3.32 That is, the attribution of amounts to an Australian PE of an Australian resident does not affect the entity's tax position, whereas the attribution of amounts to a foreign PE of such an entity will have implications for their access to section 23AH of the ITAA 1936 or the *Business Profits* articles of a relevant treaty. Similarly, attribution of amounts to a foreign PE of a foreign resident will not affect the entity's Australian tax position, whereas attribution to an Australian PE will affect the entity's tax position (either because of the sourcing rules in our tax treaties or the equivalent deeming provision under new subsection 815-225(3)).

What are the arm's length profits?

3.33 Subdivision 815-C requires an entity to work out the arm's length profits for a PE.

3.34 The arm's length profits of a PE are worked out by allocating the actual expenditure and income of the entity between the PE and the entity of which it is a part 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; and
- 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, in relation to those that would exist if the PE was a distinct and separate entity engaged in the same or comparable activities under the same or comparable conditions, were the arm's length conditions.

[Schedule 1, item 2, subsection 815-225(1)]

3.35 Consistent with the approach adopted in Australia's domestic law and in Australia's tax treaties, the arm's length profits should 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.

3.36 For the purposes of determining the arm's length profits, the actual expenditure of an entity includes all amounts that would be allowable as deductions of the entity, including any losses or outgoings. Similarly, the actual income of an entity includes all amounts that would be assessable income of the entity. ***[Schedule 1, item 2, subsection 815-225(2)]***

3.37 The Subdivision includes a deeming rule in relation to the source of profits attributed to an Australian PE of a foreign resident. In this case, the arm's length profits attributed to this PE are taken to be attributable to Australian sources. This is consistent with the approach that is generally adopted in Australia's tax treaties. ***[Schedule 1, item 2, subsection 815-225(3)]***

3.38 In establishing whether an entity has attributed the arm's length profits to its PE, an entity must have regard to the factors mentioned in new subsection 815-125(2) and new subsection 815-125(3) as if the functions would be performed, assets would be used and risks would be borne by the PE, and the entity of which it is a PE, if the PE was a separate and distinct entity. ***[Schedule 1, item 2, paragraph 815-220(2)(c)]***

What is a 'distinct and separate' entity engaging in the 'same or comparable' activities in the 'same or comparable' circumstances?

3.39 In working out the arm's length profits, an entity must identify how much of its profits would have been attributed to the PE had the PE been a distinct and separate entity engaging in the same or comparable activities in the same or comparable circumstances. ***[Schedule 1, item 2, paragraphs 815-225(1)(a) and (b)]***

3.40 All the factors relevant to determining the arm's length conditions under Subdivision 815-B may be 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.

3.41 The same or comparable activities and circumstances mentioned 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. ***[Schedule 1, item 2, subsection 815-225(1)]***

3.42 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.

Time limits for amending assessments

3.43 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.

3.44 Under Subdivision 815-C, a time limit for amending assessments will be introduced. 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 eight years of the day on which the Commissioner gives notice of the assessment to the entity. ***[Schedule 1, item 2, section 815-235]***

Chapter 4
Record keeping requirements and penalties

Subdivision 815-D

Record Keeping and penalties

4.1 Subdivision 815-D 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 the requirements in Subdivision 815-D are required (but not sufficient) to establish a reasonably arguable position about the application of those Subdivisions.

4.2 Where an entity is able to demonstrate that its position was reasonably arguable, this will entitle them to a lower scheme shortfall amount.

4.3 Where an entity has not prepared or maintained documentation to show the application of Subdivision 815-B or 815-C, they will be unable to establish that they have a reasonably arguable position about the way they apply, and will therefore be unable to access the lower scheme penalty amount should they be liable to a shortfall penalty.

Documentation for 815-B

Records about the arm's length principle for cross-border conditions between entities

4.4 An entity may prepare and maintain transfer pricing documentation to demonstrate compliance with Subdivision 815-B when preparing the tax return for a particular income year. ***[Schedule 1, item 2, section 815-305]***

4.5 The documentation must show the way in which Subdivision 815-B was applied to the entity in relation to the income year, as well as why the application of Subdivision 815-B to the entity in that way best achieves consistency with the OECD Guidance material. ***[Schedule 1, item 2, subsection 815-305(2)]***

4.6 While an entity is not required to prepare and maintain transfer pricing documentation in accordance with the requirements of Subdivision 815-D, an entity that does not keep such records will be treated as not having a reasonably arguable position for the purposes of determining administrative penalties. ***[Schedule 1, item 2, section 815-301 and Schedule 1, item 6, section 284-180]***

4.7 Any transfer pricing documentation that is prepared by an entity should be in English, or be readily accessible and convertible into English. ***[Schedule 1, item 2, subsections 815-305(3)]***

What should be included in transfer pricing documentation cross-border conditions between entities?

4.8 Transfer pricing documentation should detail the process the entity has undertaken to satisfy itself that its taxable income, loss of a particular sort or tax offsets are worked out as if the arm's length conditions had operated. In doing so, the actual and arm's length conditions should be identified***. [Schedule 1, item 2, paragraph 815-305(4)(a)]***

4.9 Transfer pricing documentation must contain particulars about the method selected and the comparable circumstances relevant in identifying the arm's length conditions. ***[Schedule 1, item 2, paragraph 815-305(4)(b)]***

4.10 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 this process.

4.11 Transfer pricing documentation should also set out the amount (if any) by which any of the following would, apart from the application of Subdivisions 815-B, be different if the arm's length conditions, instead of the actual conditions, had operated:

- the amount of the entity's taxable income for the income year (if any);
- the amount of the entity's loss of a particular sort for the income year (if any);
- the amount of the entity's tax offsets for the income year (if any); and
- the amounts that are elements in the calculation of those amounts (unless it is not reasonable in the circumstances to do so)

[Schedule 1, item 2, paragraph 815-305(4)(c)]

4.12 Records must be prepared before the time by which the entity lodges its income tax return for the income year. ***[Schedule 1, item 2, subsection 815-305(5)]***

Documentation for 815-C

Records about the arm's length principle for PEs

4.13 An entity may prepare and maintain transfer pricing documentation to demonstrate compliance with Subdivision 815-C when

preparing the tax return for a particular income year. ***[Schedule 1, item 2, subsection 815-310(2)(a)]***

4.14 The documentation must also show why the application of Subdivision 815-C to the entity in that way best achieves consistency with the documents covered by section 815-230. ***[Schedule 1, item 2, paragraph 815-310(2)(b)]***

4.15 While an entity, or the agent of an entity, is not required to prepare and maintain transfer pricing documentation in accordance with the requirements of Subdivision 815-D, an entity or agent that does not keep such records will be treated as not having a reasonably arguable position for the purposes of determining administrative penalties. ***[Schedule 1, item 2, section 815-301 and Schedule 1, item 6, section 284-180]***

4.16 Any transfer pricing documentation that is prepared by an entity or an agent of the entity should be in English, or be readily accessible and convertible into English. ***[Schedule 1, item 2, subsection 815-310(3)]***

What should be included in transfer pricing documentation for permanent establishments?

4.17 Transfer pricing documentation should detail the process the entity has undertaken to satisfy itself that its taxable income, loss of a particular sort or tax offsets are worked out as if arm's length profits had been attributed to the PE. In doing so, the actual and arm's length profits should be identified. ***[Schedule 1, item 2, paragraph 815-310(4)(a)]***

4.18 Transfer pricing documentation must contain particulars about the things that are relevant to working out the arm's length profits, including the activities and circumstances that are assumed as a result of attributing arm's length profits. 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 circumstances to be used in this process. ***[Schedule 1, item 2, paragraph 815-310(4)(b)]***

4.19 Transfer pricing documentation should also set out the amount (if any) by which the following would, apart from the application of Subdivisions 815-C, be different if the arm's length conditions, instead of the actual conditions, had operated:

- the amount of the entity's taxable income for the income year (if any);
- the amount of the entity's loss of a particular sort for the income year (if any);
- that amount of the entity's tax offsets for the income year (if any); and

- the amounts that are elements in the calculation of those amounts (unless it is not reasonable in the circumstances to do so)

[Schedule 1, item 2, paragraph 815-310(4)(c)]

4.20 Records must be prepared before the time by which the entity lodges its income tax return for the income year. ***[Schedule 1, item 2, paragraph 815-310(5)]***

What penalties apply to adjustments made under the Subdivisions?

4.21 The administrative penalty provisions provided in Subdivision 284-C in Schedule 1 to the TAA 1953 will apply to the additional amount of tax payable due to the Commissioner amending an assessment for an income year to give effect to Subdivision 815-B or 815-C. This additional amount is also referred to as the scheme shortfall amount. ***[Schedule 1, item 4, subsection 284-145(2B) of Schedule 1 to the TAA 1953; Schedule 1, item 5, subsection 284-150(2A) of Schedule 1 to the TAA 1953]***

4.22 De minimis thresholds will ensure that only scheme shortfall amounts that are above the stipulated thresholds will be subject to the administrative penalty applicable to schemes.

4.23 For a scheme shortfall amount of an entity (that is not a trust or a partnership), no penalty under subsection 284-145(2B) will be payable where the scheme shortfall amount is equal to or less than the greater of following amounts:

- $10,000;
- 1% of income tax payable by the taxpayer for the income year, worked out on the basis of the tax return.

[Schedule 1, item 6, subsection 284-165(1) of Schedule 1 to the TAA 1953]

4.24 For a scheme shortfall amount arising from applying Subdivision 815-B or 815-C to a trust, no penalty will be payable where the trust would have had a greater net income, or a lesser tax loss, that is equal to or less than the greater of the following amounts:

- $20,000;
- 2% of the trust's net income (if any) for the income year worked out on the basis of the trust's income tax return

[Schedule 1, item 6, subsection 284-165(2) of Schedule 1 to the TAA 1953]

4.25 For a scheme shortfall amount arising from applying Subdivision 815-B or 815-C to a partnership, no penalty will be payable

where the partnership would have had a greater net income, or a lesser tax loss, that is equal to or less than the greater of the following amounts:

- $20,000;
- 2% of the partnership's net income (if any) for that year worked out on the basis of the partnership's income tax return.

[Schedule 1, item 6, subsection 284-165(3) of Schedule 1 to the TAA 1953]

Transfer pricing documentation and penalties

4.26 Where a taxpayer is subject to a scheme shortfall amount under subsection 284-145(2B), and that taxpayer has not prepared transfer pricing documentation in accordance with Subdivision 815-D, the taxpayer will be deemed to not have a reasonably arguable position. As such, the taxpayer would not be entitled to the lower base penalty amount available to positions that are 'reasonably arguable'. ***[Schedule 1, item 7, section 284-180 of Schedule 1 to the TAA 1953]***

4.27 However it should be noted that where the scheme shortfall amount is under the threshold amount for a penalty arising from the application of the arm's length principle, the taxpayer will not be subject to a scheme administrative penalty, regardless of whether transfer pricing documentation has been prepared in accordance with Subdivision 815-D. ***[Schedule 1, item 6, section 284-165 of Schedule 1 to the TAA 1953]***

Subdivision 815-E

4.28 Special rules are included under Subdivision 815-E to ensure that Subdivisions 815-B, 815-C and 815-D apply appropriately to trusts and partnerships. These rules relate to differences in terminology and do not change the substantive effect of the Subdivisions. ***[Schedule 1, item 2, section 815-401]***

4.29 Subdivisions 815-B, 815-C and 815-D apply in relation to the net income of an entity that is a trust or partnership in the same way that those Subdivisions apply in relation to the taxable income of an entity other than a trust or partnership. ***[Schedule 1, item 2, section 815-405 and subsection 815-410(1)].***

4.30 Further, Subdivisions 815-B, 815-C and 815-D apply in relation to a partnership loss of a partnership in the same way that those Subdivisions apply in relation to the tax loss of an entity other than a partnership. ***[Schedule 1, item 2, subsection 815-410(2)]***