TRANSFER PRICING

MEMORANDUM OF ADVICE

Introduction

1. We have been of requested to advise the Commissioner of Taxation in relation to three areas of taxation law where transfer pricing provisions, or their equivalent, can enable the Commissioner to substitute arm's length prices for those adopted by the parties to the transaction. The first area is the transfer pricing provisions of Div 13 of Pt III of the *Income Tax Assessment Act* 1936 (**the 1936 Act**). The second area is the thin capitalisation provisions of Div 820 of Pt 4-5 of the *Income Tax Assessment Act* 1997 (**the 1997 Act**) and their effect on the arm's length consideration to be attributed to debt funding for the purposes of Div 13. The third area is the 'associated enterprises articles' in Australia's double tax treaties.

2. The specific problem with which the Commissioner is concerned has been expressed as follows:

> '... certain taxpayers [which are part of an international corporate structure or arrangement] may be claiming excessive amounts of interest expense. Cases have been identified where the interest charges are being based on the increased financial and credit risk presented by thinly capitalised structures that exceed the amount of debt funding levels typically seen in other independent participants in the relevant industry but fall within the safe harbour debt amounts allowed by the thin capitalisation rules in Division 820 of the 1997 Act. ...'[1]

[1] The extract is set out at p 1 of a paper prepared by Mr Jim Kilaly for the purposes of this Advice.

3. In this Advice we propose to focus on the issue stated in the above extract. We will also address the specific questions raised in our brief, albeit in the context of our consideration of the issue raised in the extract. If there is any matter that we have not addressed by adopting this approach our instructor can raise that matter with us.

Division 820 (in the 1997 Act) and Div 13 (in the 1936 Act)

(a) The thin capitalisation provisions of Div 820

4. Division 820 sets out thin capitalisation rules that apply to foreign related entities. We propose to focus on the rules that apply to an entity which is an Australian subsidiary of a foreign parent and is classified as an 'inward investment vehicle (general)' for the purposes of Div 820: see item 1 of the table in s 820-185(2) and subdiv 820-C.

5. Division 820 operates to limit the level of debt funding for income tax purposes. It achieves that outcome by disallowing all or part of each 'debt deduction' of the entity if its adjusted average debt (worked out by applying the method statement in s 820-185(3)) exceeds its 'maximum allowable debt': ss 820-185(1) and 820-220.

6. The term 'debt deduction' is defined in s 820-40 as a cost of a specified kind incurred by an entity in relation to debt interest (as defined under the debt and equity rules in Div 974 of Pt 6-1 of the 1997 Act). The specified kind of costs includes, relevantly, interest: s 820-40(1)(a)(i). The cost must be one which 'the entity can, apart from this Division, deduct ... from its assessable income': s 820-40(1)(b).

7. The 'maximum allowable debt' is defined in s 820-190 as the greater of two amounts, being the 'safe harbour debt amount' and the 'arm's length debt amount'. The 'safe harbour debt amount' for an 'inward investment vehicle (general)' is established by the method statement in s 820-195, which considers the entity's assets, liabilities and equity. The 'arm's length debt amount' is a notional amount calculated in accordance with s 820-215(1), which considers what the entity's debt capital would be after

having regard to the factual assumptions and relevant factors set out in ss 820-215(2) and (3).

8. In the result, the safe harbour debt amount permits a level of debt funding for income tax purposes which exceeds the arm's length debt amount. It therefore represents a departure from the usual principle of valuing related party dealings at arm's length values for income tax purposes. The explanation for the departure is that Parliament was seeking to achieve a balance between protection of the Australian tax base and the compliance costs associated with a calculation based on an arm's length debt test. The Explanatory Memorandum (**the Div 820 EM**)[2] in respect of Div 820 states:

> '11.11 ... The most appropriate method of assessing whether in fact the Australian operations of a multinational entity are sufficiently capitalised is by the application of an arm's length test. Such a test requires the analysis of the assets, liabilities and cash flow of the Australian operations of the entity to ascertain if the level of debt of the operation is in fact commercially justifiable for an independent entity. <u>After significant consultation with industry representatives, it was recognised that the application of this test may be quite onerous leading to an increase in compliance costs. To reduce the compliance burden, a safe harbour approach was adopted as the rule of general application. The safe harbour allows sufficient protection of the Australian tax base to be provided whilst simultaneously minimising compliance costs.</u>' (emphasis added)

9. Division 820 is a comprehensive regime for the determination of the appropriate level of debt funding to be allowed for income tax purposes in respect of the entities that fall within it. We set out some passages from the Div 820 EM which support that view of the Division:

> '1.19 Whether an entity's debt funding is excessive or not will be determined by comparing the amount of debt, or equity in the case of ADIs [ie an authorised deposit-taking institution for the purposes of the *Banking*

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2 The Div 820 EM was in respect of the *New Business Tax System (Thin Capitalisation) Bill* 2001, which introduced Div 820.

Act 1959] used to finance the Australian business or investment with the maximum allowable amount of debt, or minimum equity requirement, specified in the legislation.

… …

1.76 The thin capitalisation rules collectively make up a comprehensive regime. They are specifically directed at debt deductions which, broadly, relate to interest and other costs of borrowing. These features of the regime show that it is intended to cover the whole subject matter to which the thin capitalisation rules apply.

… …

2.30 Although entities will be required to calculate their maximum allowable debt level, they will not be required to do so under both the safe harbour and the arm's length tests. They will have the option to choose either one of these tests. However, since the first of these is a safe harbour amount, the second will normally only be determined where the entity's adjusted average debt is greater than the safe harbour debt amount. If the entity's adjusted average debt capital is less than the safe harbour amount there is no need to calculate the arm's length amount. Additionally, an entity that fails the safe harbour debt test could choose not to calculate the arm's length debt amount and have debt deductions disallowed on the basis of the safe harbour debt amount.

… …

10.9 The arm's length debt amount can replace the safe harbour debt amount as an entity's maximum allowable debt for a period ...'

10. When introducing Div 820, Parliament recognised that in a given situation both Div 820 and Div 13 may apply. Parliament can be taken to have accepted that one situation where that can arise is where the maximum allowable debt of an entity exceeds the arm's length debt amount by reason of the safe harbour debt amount. The Div 820 EM, for example, acknowledges that:

> '1.74 Some cases will attract the operation of the thin capitalisation rules and the transfer pricing rules in Division 13 of Part III of the ITAA 1936 and comparable provisions of DTA's [ie double tax treaties].'

11. In Div 820, Parliament has established a statutory departure from the arm's length principles embodied in Div 13 by permitting a level of debt funding at the safe harbour debt amount which may differ from the arm's length amount.

(b) The transfer pricing provisions of Div 13

12. Division 13 is concerned with the consideration for a supply or acquisition of property under an international agreement. Under Div 13, consideration equal to the arm's length consideration may be substituted by the Commissioner for the actual consideration given or agreed to be given in respect of the supply or acquisition: ss 136AD(1)-(3).

13. Section 136AD(3) is the operative provision in the case of an acquisition of property. Sections 136AD(1) and (2) are the provisions that apply in the case of a supply of property. Section 136AD(3) provides:

> 'Where:
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> (a) a taxpayer has acquired property under an international agreement;
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> (b) the Commissioner, having regard to any connection between any 2 or more of the parties to the agreement or to any other relevant circumstances, is satisfied that the parties to the agreement, or any 2 or more of those parties, were not dealing at arm's length with each other in relation to the acquisition;
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> (c) the taxpayer gave or agreed to give consideration in respect of the acquisition and the amount of that consideration exceeded the arm's length consideration in respect of the acquisition; and
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> (d) the Commissioner determines that this subsection should apply in relation to the taxpayer in relation to the acquisition,
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> then, <u>for all purposes of the application of this Act in relation to the taxpayer</u>, consideration equal to the arm's length consideration in respect of the

> acquisition shall be deemed to be the consideration given or agreed to be given by the taxpayer in respect of the acquisition.' (emphasis added)

14. The pre-conditions for the application of s 136AD(3) are:
    - an international agreement;
    - the agreement is entered into between parties who were not dealing at arm's length with each other;
    - the agreement is one under which property was acquired; and
    - the consideration for the acquisition is for more than the arm's length consideration.

15. The terms 'international agreement', 'property', 'acquire' and 'arm's length consideration' are all defined in Div 13: ss 136AA(1), (3) and s 136AC. It is sufficient to observe that, where a foreign parent lends money to an Australian subsidiary, the Australian subsidiary acquires property under an international agreement for the purposes of Div 13.[3]

16. The application of s 136AD(3) will result in consideration equal to the arm's length consideration being deemed for income tax purposes to be the consideration in respect of the acquisition. The adjusted consideration becomes the amount of the consideration 'for all purposes of the application of this Act'[4]. Section 136AD(3) is not a stand alone provision but, rather, operates in conjunction with other provisions of the income tax legislation, such as the general deduction provision contained in s 8-1 of the 1997 Act.

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3 The term 'acquire' includes 'obtain, gain or receive'. The term 'property' includes 'services' which includes 'the rights, benefits, privileges or facilities that are, or are to be, provided, granted or conferred under: ... an agreement for or in relation to the lending of moneys': s 136AA(1). The term 'international agreement' includes an agreement where 'a non-resident supplied ... property under the agreement otherwise than in connection with a business carried on in Australia by the non-resident at or through a permanent establishment of the non-resident in Australia': s 136AC(a). The term 'agreement' means 'any agreement, arrangement, transaction, understanding or scheme, whether formal or informal, whether express or implied and whether or not enforceable, or intended to be enforceable, by legal proceedings'. The term 'supply' includes 'provide, grant or confer': s 136AA(1).

4 The term 'this Act' includes the 1997 Act: s 6(1), 1936 Act.

17. Division 13 also allows for the case where it may not be possible or practicable for the Commissioner to ascertain the arm’s length consideration. Such a situation might arise, for example, where on the objective facts and circumstances it is concluded that independent parties would not have entered into the particular transaction. Section 136AD(4) provides:

> ‘(4) For the purposes of this section, where, for any reason (including an insufficiency of information available to the Commissioner), it is not possible or not practicable for the Commissioner to ascertain the arm's length consideration in respect of the supply or acquisition of property, the arm's length consideration in respect of the supply or acquisition shall be deemed to be such amount as the Commissioner determines.’

18. Section 136AD(4) operates in conjunction with, and through, relevantly, s 136AD(3). The application of section 136AD(4) will result in an amount determined by the Commissioner being deemed to be the arm’s length consideration for the purposes of s 136AD(3).

(c) The arm’s length consideration under Div 13

19. Determining the arm’s length consideration in respect of a relevant acquisition is the critical step under s 136AD(3). The task required by s 136AD(3)(c) is to determine whether the consideration given or agreed to be given in respect of the acquisition exceeded the arm’s length consideration in respect of the acquisition.

20. The term ‘arm’s length consideration’ is defined in s 136AA(3)(d), which provides that:

> ‘a reference to the arm’s length consideration in respect of the acquisition of property is a reference to the consideration that might reasonably be expected to have been given or agreed to be given in respect of the acquisition if the property had been acquired under an agreement between independent parties dealing at arm’s length with each other in relation to the acquisition;’.[5]

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5 A similar definition is given in the context of a supply of property: s 136AA(3)(c).

21. The definition is expressed in terms of the amount that would have been given in respect of the acquisition if the property had been acquired under an agreement between independent parties dealing at arm's length with each other in relation to the acquisition. The effect of the definition is to substitute a hypothetical transaction for the actual transaction, albeit that the hypothetical transaction is in respect of the 'property' acquired under the actual transaction.[6]

22. The rights, benefits, privileges or facilities that are, or are to be, provided, granted or conferred under an agreement for or in relation to the lending of moneys are 'property' for the purposes of Division 13: see the s 136AA(1) definitions of 'property' and 'services'. A loan is a simple contract where the lender agrees to pay a sum of money to the borrower in consideration of a promise by the borrower to repay the money to the lender, either upon demand or on a fixed date. The promise may or may not be coupled with a promise to pay interest on the money. As Lowe J put it, in a judgment delivered on his behalf and on behalf of Gavan Duffy and Martin JJ, in *Ferguson v O'Neill*[7]:

> 'Lend' in its ordinary meaning in our view imports an obligation on the borrower to repay ...'

23. Section 136AD(3)(c) is concerned with the consideration in respect of the acquisition. Where the promise to repay is coupled with a promise to pay interest, the task required by s 136AD(3)(c) is to determine whether the interest exceeded the amount of interest that would have been given or agreed to be given if the loan had been acquired under an agreement between independent parties dealing at arm's length with each other in relation to the acquisition.

24. The structure of s 136AD(3), in focussing upon the consideration in respect of *the* acquisition, does not permit a restructuring of the aspects of the acquisition that do not

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6 A similar situation arises under s 136AD(4), where the Commissioner may determine an amount which becomes the arm's length consideration in respect of the acquisition for the purposes of s 136AD(3). Again, the deemed amount is in respect of the 'property' acquired under the actual transaction.

7 [1943] VLR 30 at 32.

bear directly upon the consideration given or agreed to be given. For example, it does not provide for determining a lower interest rate that might have been charged in an arm’s length transaction if the borrowing entity had a different funding structure. Also, it does not permit the taking apart of the actual transaction, or its contractual terms, to eliminate those aspects which made the transaction a non-arm’s length dealing. While those aspects may enable a determination that there has been a non-arm’s length dealing to which s 136AD(3) is to apply (see s 136AD(3)(b)), they are not factors mentioned in the definition of ‘arm’s length consideration’ in s 136AA(3)(d), which is concerned with the ‘consideration’ payable if the ‘property’ had been acquired in an arm’s length dealing. Put simply, Div 13 does not enable the Commissioner to reconstruct the relevant acquisition by removing the elements, apart from the consideration, that enabled him to be satisfied it was not an arm’s length transaction.

25. For the reasons given above, the proper application of s 136AD(3) requires that the deemed arm’s length interest rate is to be determined on the basis of the actual loan which was provided, but assuming a hypothetical agreement between independent parties dealing at arm’s length to pay the arm’s length consideration for that loan. That is not to say that the characteristics of the parties to and the structure of the actual transaction are irrelevant. Money is fungible. The loan is made to a particular borrower whose characteristics and risk structure can affect the deemed arm’s length interest, whether determined under s 136AD(3) or (4), to be attributed to the loan made to it. If there is no appropriate arm’s length surrogate for the particular transaction then the answer to that problem lies in the broad power given to the Commissioner to ascertain the arm’s length consideration under s 136AD(4), rather than to seek to reconstruct the transaction under s 136AD(3). Although the breadth of the power conferred under s 136AD(4) enables the Commissioner to consider a broad range of factors, it is inappropriate to speculate on the factors to which the Commissioner may have regard in the absence of a particular factual scenario. However, we observe that the range of factors to be considered is only limited by the purpose of s 136AD(4), namely the determination of the arm’s length consideration in the circumstances that attracted the operation of s 136AD(4).

26. Other provisions of the income tax legislation, namely those set out in Div 820, address the deemed level of debt funding of the borrower for income tax purposes. A consequence of this approach by the legislature is that whether the arm's length interest on the loan (as determined under Div 13) might be greater than the interest which would have applied if the amount of the loan was reduced (in line with Div 820 if the level of debt funding exceeded the maximum allowable debt) is not a factor that is addressed in Div 13, which takes the loan, save for the consideration, as it finds it. In that regard it is significant that s 136AD(3) provides that the arm's length consideration shall be deemed to be the consideration 'for all purposes of the application of this Act', which, as explained above, includes Div 820 of the 1997 Act. There is no equivalent provision in Div 820.

(d) Summary

27. In summary, Divs 13 and 820 have different functions. Division 13 is applied to determine the deemed consideration for the actual loan that was entered into. Division 820 is applied to determine the level of debt funding which is permitted and to disallow the deductions that the entity may claim apart from Div 820 (eg under s 8-1 after applying Div 13), to the extent that the actual level of debt funding exceeds the level permitted under Div 820. It follows that Div 820 can operate to reduce the amount otherwise deductible as the arm's length consideration under Div 13, by only allowing the consideration determined under Div 13 to be deducted in respect of the maximum allowable debt. The scheme does not provide for the arm's length consideration under Div 13 to be determined in respect of the maximum allowable debt determined under Div 820. That outcome is not necessarily anomalous as the Divisions deal with different subject matters and do not provide for a restructuring of the loan under Div 13 for the purposes of determining the arm's length consideration. Further, as explained above, Div 820 permits a level of debt funding which exceeds the arm's length debt amount and, to that extent, departs from arm's length value principles. Nonetheless, the Commissioner has asked us to specifically consider whether the later enactment of Div 820 might implicitly limit the circumstances in which Div 13 can operate.

(e) Has the operation of Div 13 been altered by the later enactment of Div 820?

28. We have been provided with copies of submissions received by the Commissioner in response to two documents. The documents are:

(a) Draft Taxation Determination TD 2007/D20 headed ‘Income tax: where there is no excess debt under Division 820 of the *Income Tax Assessment Act 1997* can the transfer pricing provisions apply to adjust the pricing of costs that may become debt deductions, for example, interest and guarantee fees?’; and

(b) a discussion paper headed ‘Intra-group finance guarantees and loans - Application of Australia’s transfer pricing and thin capitalisation rules’.

29. A number of the submissions were made to the effect that the requirements for an arm’s length gearing for transfer pricing purposes contradicts the legislative intent and policy objective of the safe harbour rules in Div 820. An example is provided in the submission, dated 29 August 2008, by the Corporate Tax Association in response to the discussion paper:

> ‘In pricing the actual debt level by reference to a notional and highly subjective arm’s length debt amount or capital structure, the Tax Office is attempting to do what was explicitly rejected by the Government when it introduced Division 820. The EM, at par 11.11, recognises that an arm’s length test that takes into account the cash flow, assets and liabilities of the borrower’s Australian operations (in other words, an arm’s length capital structure) would be the best way to determine “whether in fact the Australian operations of a multinational entity are sufficiently capitalised”. However, in order to reduce the compliance burden imposed by such a test, the EM explains that the safe harbour approach would provide “sufficient protection of the Australian tax base ... while simultaneously minimising compliance costs”.
>
> ...
>
> It seems inconceivable that, in providing a safe harbour for the **level** of debt under Division 820, because it wanted to relieve taxpayers of the compliance burden associated with having to determine an arm’s length capital structure, Parliament would have intended for that burden to be imposed on taxpayers in working out the **price** of the debt.’

30. We have already outlined why we view Div 820 as a comprehensive regime for the determination of the appropriate level of debt funding and why, as part of that regime, Parliament has given taxpayers the opportunity to adopt a safe harbour debt amount which is greater than the arm's length debt amount. The significance of those matters is that it becomes difficult to argue that the outcome under Div 820 must necessarily be applied to Div 13, which is concerned with an arm's length consideration. Further, as explained above, the outcome under Div 13, but not Div 820, is applicable to the taxpayer for all of the purposes of the application of the 1936 and 1997 Acts.[8] For essentially the same reasons we do not regard Div 820 as authorising a reconstruction of the debt structure under Div 13, which is concerned with the arm's length consideration within the actual structure employed and only provides for a substituted arm's length consideration under ss 136AD(3) or (4) for the loan made within that structure.[9]

31. In our opinion, the existence of a separate and comprehensive regime for determining the permitted level of debt funding, which itself permits an entity to have a level of debt funding at a safe harbour debt amount that is greater than the arm's length amount, strengthens, rather than weakens, the view that it is not part of the function of Div 13 to treat the outcome under Div 820 as a matter that is to be taken into account under Div 13.

The associated enterprises articles in Australia's double tax treaties

(a) Introduction

32. The associated enterprises articles operate more broadly than Divs 13 and 820 and therefore may provide greater latitude for the Commissioner in addressing the income

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8 See s 136AD(3).

9 This conclusion does not have the consequence of limiting the range of factors to which the Commissioner may have regard under s 136AD(4). However, as pointed out earlier in this Advice, those factors need to be considered in the context of the particular factual scenario that attracted the operation of s 136AD(4).

tax consequences of non-arm’s length dealings. For ease of reference, we propose to focus on Art 9 of the Swiss treaty as an example of those articles.

33. The Swiss treaty is Sch 15 of the *International Tax Agreements Act* 1953 (**the Agreements Act**). The full title is: ‘Agreement between Australia and Switzerland for the avoidance of double taxation with respect to taxes on income’. There is also a protocol. Both were signed on 28 February 1980.

34. Article 9 provides:

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

35. The application of Art 9 is conditioned upon:

(a) the participation by an enterprise, directly or indirectly, in the management, control or capital of an enterprise of the other country, or the existence of the same persons who participate, directly or indirectly, in the management, control or capital of both enterprises;

(b) the existence of conditions between the two enterprises in their commercial or financial relations which differ from those which might be expected to operate between independent enterprises dealing wholly independently with one another; and

(c) the ascertainment of profits which, but for those conditions, might have been expected to accrue to one of the enterprises, but, by reason of those conditions, have not so accrued.

36. The consequence of the conditions being satisfied is that the profits which, but for those conditions, might have been expected to accrue may be included in the profits of the enterprise and taxed accordingly.

37. In the application of Art 9, the reference to 'profits' is to be read as a reference to 'taxable income'. Section 3(2) of the Agreements Act provides:

> 'For the purposes of this Act and the Assessment Act, a reference in an agreement to profits of an activity or business shall, in relation to Australian tax, be read, where the context so permits, as a reference to taxable income derived from that activity or business.'

38. The protocol is also relevant. It provides in item (3):

> 'With reference to Articles 7 and 9, where the information available to the competent authority of one of the Contracting States is inadequate to determine the profits of an enterprise on which tax may be imposed in that State in accordance with Article 7 or Article 9 of the Agreement, nothing in those Articles shall affect the application of any law of that State relating to the determination of the tax liability of an enterprise in special circumstances, provided that that law shall be applied, so far as the information available to the competent authority permits, in accordance with the principles of those Articles.'

39. The terms of item (3) reflect the right reserved by Australia to apply, relevantly, Div 13. Clause 18 of the OECD Commentary on Art 9 of the Model Tax Convention explains that:

> '*Australia* reserves the right to propose a provision to the effect that, if the information available to the competent authority of a Contracting State is

> inadequate to determine the profits to be attributed to an enterprise, the competent authority may apply to that enterprise for that purpose the provisions of the taxation law of that State, subject to the qualification that such law will be applied, as far as the information available to the competent authority permits, in accordance with the principles of this Article.'

40. While it appears that the reservation is intended to deal with the case where the information available is inadequate, it is not always so expressed. For example, while the Singapore treaty[10] includes a reservation it is not confined to an information deficiency. Article 6(2) of the Singapore treaty provides:

> 'Nothing in this Article shall affect the application of any law of a Contracting State relating to the determination of the tax liability of a person, including determinations in cases where the information available to the competent authority of that State is inadequate to determine the income to be attributed to an enterprise, provided that that law shall be applied, so far as it is practicable to do so, consistently with the principles of this Article.'

41. The Singapore treaty also contains a further provision which provides for adjustments where amounts are taxed in both States. Article 6(3) provides:

> 'Where profits on which an enterprise of one of the Contracting States has been charged to tax in that State are also included, by virtue of paragraph (1) or (2), in the profits of an enterprise of the other Contracting State and charged to tax in that other State, and the profits so included are profits which might have been expected to have accrued to that enterprise of the other State if the conditions operative between the enterprises had been those which might have been expected to have operated between independent enterprises dealing wholly independently with one another, then the first-mentioned State shall make an appropriate adjustment to the amount of tax charged on those profits in the first-mentioned State. In determining such an adjustment, due regard shall be had to the other provisions of this Agreement and for this purpose the

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[10] Schedule 5 of the Agreements Act.

> competent authorities of the Contracting States shall if necessary consult each other.'

(b) Can the associated enterprises articles be relied on as a separate source of power to make an assessment?

42. The question of whether the associated enterprises articles provide the Commissioner with a separate source of power to assess independently of Divs 13 and 820 is complex.

(i) The case law

43. A number of cases have expressed the view that a double tax treaty merely allocates between the treaty parties the right to tax a particular item. A recent example of this view was in *Roche Products Pty Limited v Commissioner of Taxation* [2008] AATA 639 (22 July 2008) where Downes J, President, stated:[11]

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

See also *McDermott Industries (Aust) Pty Ltd v Commissioner of Taxation* (2005) 142 FCR 134 at [2]; *Commissioner of Taxation v Lamesa Holdings BV* (1997) 77 FCR 597 at 600-1; *Chong v Commissioner of Taxation* (2000) 101 FCR 134 at [26]; *GE Capital Finance Pty Ltd v Federal Commissioner of Taxation* (2007) 159 FCR 473 at [36], [37]. In the most recent case on this issue, *Undershaft (No 1) Limited v Commissioner of Taxation* [2009] FCA 41 (3 February 2009) at [45], [46], Lindgren J cited, inter

11 At [191].

alia, *Chong* and re-iterated that the double tax treaty does not give the contracting State a power to tax, or oblige it to tax but, rather, avoids the potential for double taxation by restricting one contracting State's taxing power.

44. It is clear that, if income tax is to be assessed by the exercise of power under the associated enterprises article, there needs to be a legislative conferral of that power. In order to meet the requirements of s 55 of the Constitution,[12] at least two pieces of legislation need to be enacted to give effect to any tax - a taxing Act which imposes the tax and a further Act(s) which sets out the rules for calculation of the tax and for assessing tax (and any other relevant matters). In accordance with this requirement the *Income Tax Act* 1986 imposes income tax at the rates declared by the *Income Tax Rates Act* 1986: see s 5(1). By s 4, the Income Tax Act incorporates the Assessment Act:

> 'The Assessment Act is incorporated and shall be read as one with this Act.'

45. The effect of the incorporation of an assessment Act with a taxing Act was explained by Dawson J in *Northern Suburbs General Cemetery Reserve Trust v Commonwealth* (1993) 176 CLR 555 at 595-6:

> 'The precise effect of incorporating an assessment Act with a taxing Act appears not to have been the subject of actual decision, but it has generally been accepted that the result is that, if the incorporation means that the taxing Act deals with matters other than the imposition of taxation, then the incorporation is ineffectual by reason of s. 55 [of the Constitution] (save to the extent that the assessment Act deals with the imposition of taxation), leaving the assessment Act otherwise to remain in existence and to operate separately. This mechanism is a convenient means of avoiding the difficulty which might otherwise arise should the legislature misconceive where the line is to be drawn between a law dealing with the imposition of taxation and a law simply dealing with taxation. ...'

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12 Section 55 provides that laws imposing taxation shall deal only with the imposition of taxation and with one subject of taxation only.

46. The Agreements Act does not purport to impose taxation. Section 4(1) of the Agreements Act incorporates the Assessment Act[13] but nothing is said in s 4(1) about incorporating the Income Tax Act (ie the taxing Act). Section 4 provides:

> '4(1) Subject to subsection (2), the Assessment Act is incorporated and shall be read as one with this Act.[14]
>
> 4(2) The provisions of this Act have effect notwithstanding anything inconsistent with those provisions contained in the Assessment Act (other than Part IVA of that Act) or in an Act imposing Australian tax.'[15]

47. A further link to the Assessment Act is provided, taking the Swiss treaty as an example, by s 11E of the Agreements Act under which the provisions of the Swiss treaty, so far as they affect Australian tax, are given the force of law. Section 11E provides:

> 'Subject to this Act, on and after the date of entry into force of the Swiss agreement, the provisions of the agreement, so far as those provisions affect Australian tax, have, and shall be deemed to have had, the force of law-
>
> (a) …
>
> (b) in relation to tax other than withholding tax – in respect of income of the year of income that commenced on 1 July 1979 and of a subsequent year of income in relation to which the agreement remains effective.'

48. The operation of s 4(1) was considered by Middleton J in *GE Capital Finance Pty Ltd v Commissioner of Taxation*.[16] The Commissioner had argued that the incorporation led to a modification of the operation of the Assessment Act: at [39]. His Honour rejected this approach and considered that s 4(1) has the consequence, as a matter of a

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13 Defined in s 3(1) to mean the 1936 Act or the 1997 Act.

14 Including the schedules thereto. By s 13(2) of the *Acts Interpretation Act* 1901, every schedule to an Act is deemed to form part of the Act. Also, by reason of s 10 of that Act (subject to any contrary intention), the incorporation is of the Assessment Act as amended from time to time.

15 'Australian tax' is defined in s 3(1) to mean, relevantly, income tax imposed as such by an Act.

16 (2007) 159 FCR 473.

drafting technique, of incorporating the text of the Assessment Act into the Agreements Act. Middleton J stated:

> 'In view of the respondent's submissions, it is necessary to consider the effect of s 4(1). By the operation of s 4(1), the Agreements Act incorporates the Assessment Act subject to s 4(2). However, each Act retains its own identity and the imposition of the relevant tax is still imposed by and at the rates declared by the *Income Tax (Dividends, Interest and Royalties Withholding Tax) Act 1974* (Cth) and the *Income Tax Rates Act 1986* (Cth) by reference to the Assessment Act. The incorporation has the consequence, as a matter of a drafting technique, of incorporating the text of the Assessment Act into the Agreements Act. As Lockhart J said in *Amalgamated Television Services Pty Ltd v Australian Broadcasting Tribunal* (1984) 1 FCR 409 at 413:
>
> > It is not uncommon to find in an Act a provision that an earlier Act is incorporated and shall be read as one with the later Act. The effect of such a provision is to transpose the earlier into the later Act or to write every provision of the earlier Act into the later Act as if they had been actually printed into it. It is a rule of construction of statutes; but it cannot be used in effect to amend the provisions of the earlier Act which is to be read as one with the later Act. Sometimes an Act provides that it is incorporated and shall be read as one with an earlier Act. The effect is the same namely, to transpose the later into the earlier Act. ...'

See also at [41]-[42].

49. A different approach was taken in *Case N69* (1962) 13 TBRD 270, especially at 284, which concerned the former Div 13[17] and the associated enterprises article. In that

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17 The former Division 13 was headed 'Australian Business Controlled Abroad' and comprised section 136. It read:

> *'Where any business carried on in Australia –*
>
> *(a) is controlled principally by non-residents;*
>
> *(b) is carried on by a company a majority of the shares in which is held by or on behalf of non-residents; or*
>
> *(c) is carried on by a company which holds or on behalf of which other persons hold a majority of the shares in a non-resident company,*
>
> *and it appears to the Commissioner that the business produces either no taxable income or less than the amount of taxable income which might be expected to arise from that business,*

case, the Board of Review regarded s 4(2) of the Agreements Act as requiring an associated enterprises article to be applied to the extent it was inconsistent with s 136 of the 1936 Act.

50. In summary, by enacting ss 4(1) and 11E of the Agreements Act, the legislature probably intended to confer a power to assess in reliance upon the associated enterprise articles in Australia's double tax treaties. However, in *GE Capital Finance*, Middleton J concluded that the legislature failed to achieve that outcome because the Agreements Act was not incorporated into, and was not to be read as part of, the relevant taxing Act.

(ii) The 1982 amended assessment and penalty provisions

51. However, the authorities cited above failed to consider certain amendments made to the 1936 Act at the time of the introduction of Div 13 in 1982, which provide for the Commissioner to have a separate source of power to amend an assessment in reliance upon the associated enterprises article.

a. Section 170(9B) and (9C)

52. Section 170 of the 1936 Act confers on the Commissioner a general power to amend assessments subject to the conditions and limitations set out in the section. When the current Div 13 was inserted in place of the former Div 13, s 170(9B) was inserted to confer the associated power to amend assessments. It provides:

> 'Subject to subsection (9C), nothing in this section prevents the amendment, at any time, of an assessment for the purpose of giving effect to a prescribed provision or a relevant provision.'

53. The terms 'prescribed provision' and 'relevant provision' are defined in s 170(14). Section 136AD is a prescribed provision, while the associated enterprises article is a relevant provision. The definition of 'relevant provision' reads:

> *the person carrying on the business in Australia shall, notwithstanding any other provision of this Act, be liable to pay income tax on a taxable income of such amount of the total receipts (whether cash or credit) of the business as the Commissioner determines.'*

> ‘**relevant provision** means:
>
> (a) a provision of a double tax agreement that attributes to a permanent establishment or to an enterprise the profits it might be expected to derive if it were independent and dealing at arm’s length; or
>
> ...’[18]

54. The effect of the definitions is that, by s 170(9B) (subject to s 170(9C)), the Commissioner, relevantly, has power to at any time amend an assessment:

- for the purpose of giving effect to section 136AD, being a prescribed provision; or
- for the purpose of giving effect to the associated enterprises article, being a relevant provision.

55. Section 170(9B) demonstrates a clear legislative intention, at least from 1982, that the Commissioner may, in amending an assessment, rely upon either s 136AD or the associated enterprises article as conferring upon him, as a separate power, a power to amend an assessment. Put another way, the sub-section can be taken to have incorporated the associated enterprises article into the Assessment Act by empowering the Commissioner to amend an assessment in reliance upon the article. Although the amending provisions do not expressly state that ‘the relevant provision’ (ie the associated enterprises article) has been incorporated into the Assessment Act, as was stated by Willes J in *Chorlton v Lings*[19]:

> ‘It is quite clear that whatever the language used necessarily or even naturally implies is expressed thereby.’

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18 When first introduced, the definition read:

> *‘‘**relevant provision**’’ means paragraph (3) of Article 5 or paragraph (1) of Article 7 of the United Kingdom agreement or a provision of any double taxation agreement that corresponds with either of those paragraphs;’*

Article 7(1) of the United Kingdom agreement was the associated enterprises article.

The definition was replaced from 20 May 2002 although its terms were practically the same. The above definition applies from 5 December 2003.

19 (1868) LR 4 CP 374 at 387.

In our view, the language used in ss 170(9B) and (9C) necessarily and naturally implies that, as an amended assessment may be made under the Assessment Act in reliance on the associated enterprises article, that article is incorporated into the Assessment Act.

56. It follows that by enacting ss 170(9B) and (9C) (which we refer to below) the legislature appears to have overcome the problem identified by Middleton J in *GE Capital Finance,* because the Assessment Act (as amended from time to time)[20] has been incorporated into the relevant taxing Act (here, the Income Tax Act). That, in our view, is the consequence of the amending provisions having incorporated the associated enterprises article into the Assessment Act for the purposes of an amended assessment.

57. Section 170(9B) is subject to s 170(9C), which provides:

> 'Subsection (9B) does not authorize the Commissioner, for the purpose of giving effect to a prescribed provision or a relevant provision, to amend an assessment made in relation to a taxpayer in relation to a year of income where:
>
> (a) in a case where the purpose of amendment is to give effect to the prescribed provision in relation to the supply or acquisition of property - the prescribed provision has been previously applied, in relation to that supply or acquisition, in making or amending an assessment in relation to the taxpayer in relation to the year of income; or
>
> (b) in any other case - the prescribed provision or the relevant provision, as the case may be, has been previously applied, in relation to the same subject matter, in making or amending an assessment in relation to the taxpayer in relation to the year of income.'

58. Section 170(9C) limits the power conferred by s 170(9B). The limitation is that s 170(9B) does not authorise the amendment of an assessment where:

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20 See s 10 of the *Acts Interpretation Act* 1901 (Cth) (referred to above).

- the purpose of the amendment is to give effect to s 136AD in relation to, relevantly, the acquisition of property and s 136AD has been previously applied in relation to that acquisition in making or amending an assessment; or
- s 136AD or the associated enterprises article has been previously applied in relation to the same subject matter in making or amending an assessment.

59. Section 170(9C), in referring to a previous application of s 136AD or the associated enterprises article in making an assessment, demonstrates that, at least from 1982, the legislature has enacted these provisions on the basis that the Commissioner may rely upon either s 136AD or the associated enterprises article as separate sources of power to make an assessment. We add that a power to amend an assessment in reliance on s 136AD or the associated enterprises article implies that there exists a power to assess in reliance on those provisions. In that regard, we again refer to the principle of construction in *Chorlton v Lings*[21] that whatever the language naturally or necessarily implies can be taken as expressed thereby. Conferral of a power to amend an assessment (which is an assessment) on a particular basis naturally and necessarily implies a power to assess on that basis, particularly where it has been concluded that the particular basis for the amendment has been incorporated into the Assessment Act.[22]

60. The view we have expressed is strongly supported by the Explanatory Memorandum to ss 170(9B) and (9C) (**the s 170(9B) EM**). [23] According to the s 170(9B) EM, under the former Division 13 adjustments were made by way of an original special assessment and there was no time limit on the making of such an assessment. In effect, ss 170(9B) and (9C) were introduced to maintain that position, albeit by amended assessments, in the context of the current Div 13.

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21 (1868) LR 4 CP 374 at 387.

22 The amendment of an assessment involves changes in the process of assessment by which the liability to tax has been calculated. The amended assessment is not something extraneous to the assessment. Rather, the assessment henceforth exists as altered or added to. See *Meredith v Commissioner of Taxation* (2002) 125 FCR 308 at [45]; *Cadbury-Fry-Pascall Pty Ltd v Federal Commissioner of Taxation* (1944) 70 CLR 362 per Latham CJ at 381; *Federal Commissioner of Taxation v S Hoffnung & Company Limited* (1928) 42 CLR 39 per Isaccs J at 54.

23 The Explanatory Memorandum to *Income Tax Assessment Amendment Bill* 1982.

61. The s 170(9B) EM not only explains the reason for enacting ss 170(9B) and (9C), but also refers to the associated enterprises article as a separate source of power to amend as assessment:

> ‘**International tax avoidance (Clauses 19 and 21-23)**
>
> ...
>
> Where [Div 13] has been applied to increase a taxpayer's liability to income tax by adjusting assessable income or allowable deductions, an amount of additional tax will also be payable. The additional tax will be 10 per cent per annum of the difference between the tax payable upon the application of Division 13 and the tax calculated on the basis that the particulars in the taxpayer's return had been accepted as correct insofar as those particulars were relevant to the operation of the Division. <u>Where a taxpayer's tax liability is increased under corresponding provisions of a double taxation agreement in circumstances where, but for the agreement, the Division would have applied to the same effect, the additional tax will also be payable.</u>
>
> ...’ (emphasis added)

62. And later in relation to the amendment of assessments:

> ‘**Clause 21: Amendment of assessments**
>
> ...
>
> Under existing Division 13, there is no time limit on the making of an assessment under that Division by the Commissioner to overcome profit shifting arrangements. Clause 19 of the Bill will continue that policy in relation to the revised Division 13. However, the technical means by which this is achieved will be changed. Under existing section 136, necessary adjustments to taxable income are made by way of an original special assessment, even where an assessment has already been made under general provisions of the Act. In contrast, adjustments under the revised Division, in cases where an assessment has already been made under general provisions, will be by way of amendment of that assessment and thus subject to the rules for amendment of assessments contained in section 170. An amendment of section 170 is thus required for the effect of the present law to be maintained.

Paragraph (a) of sub-clause 21(1) will insert in section 170 of the Principal Act two new sub-sections - sub-sections 170(9B) and (9C) - dealing specifically with the Commissioner's powers to amend an assessment to deal with cases involving international profit shifting arrangements.

New sub-section 170(9B), which will apply subject to proposed sub-section (9C), will, in effect, preserve the power which the Commissioner has in relation to existing section 136, by authorising the amendment of an assessment at any time to apply the anti-profit shifting provisions of revised Division 13. <u>The sub-section also contains a corresponding power of amendment where a matching provision of a double taxation agreement is applied instead of Division 13.</u> These provisions are respectively designated as a "prescribed provision" or as a "relevant provision" and are defined in proposed new sub-section 170(14).

Proposed sub-section 170(9C) will limit the authority to amend an assessment contained in sub-section 170(9B). <u>It is to the effect that, once the revised Division - or the corresponding provisions in a double taxation agreement - have been applied in relation to a particular subject matter - whether in an original or an amended assessment - no further amendment to apply those same provisions to the same subject matter can be made under the authority of sub-section 170(9B).</u> In other words, once a prescribed provision or a relevant provision has been applied in relation to a particular subject matter, any further amendment of an assessment to apply that provision in relation to that subject matter can only be made in accordance with the general amendment powers of section 170 that are outlined above.

In their practical effect, proposed sub-sections 170(9B) and (9C) will clarify the powers of the Commissioner to amend an assessment where a provision of a double taxation agreement that deals with profit shifting may be applicable. Sub-section 4(2) of the Income Tax (International Agreements) Act 1953 provides that the provisions of that Act are to have effect notwithstanding anything inconsistent with those provisions contained in the Principal Act. <u>Technically, therefore, the provisions of a double taxation agreement that deal with profit shifting, either under a "business profits" article (e.g., Article 5 of the Australia/U.K. agreement), or an "associated enterprises" article (e.g.,</u>

Article 7 of that agreement), may have to be applied instead of Division 13. Where the profit shifting provisions of a double taxation agreement are to apply in these circumstances, sub-sections 170(9B) and (9C) confer the same specific powers of amendment of an assessment as are to be provided in relation to revised Division 13.

...' (emphasis added)

b. Associated amendments to the penalty provisions

63. At the same time, new penalty provisions were inserted into the 1936 Act to apply where the application of a prescribed provision, relevantly s 136AD, was taken into account in calculating the tax assessable to a taxpayer: ss 226(2B)-(2F). Section 226(2C) dealt with the case where, relevantly, s 136AD was not applied by reason of the Agreements Act (then called by a different name) and provided for a different calculation of additional tax. It read in part:

'Where-

(a) for the purpose of making an assessment, the Commissioner has calculated the tax that, but for this sub-section, is assessable to a taxpayer in relation to a year of income; and

(b) in calculating the tax assessable to the taxpayer, a prescribed provision was not applied in a particular case by reason of the *Income Tax (International Agreements) Act* 1953,

the Commissioner shall determine the following amounts:

...'

64. The s 170(9B) EM explained the operation of s 226(2C) as:

'**Clause 23: Additional tax in certain cases**

...

Sub-section 226(2C) applies for purposes of sub-section (2D) and provides for the calculation of additional tax on two bases. In effect, additional tax of 10 per cent per annum is to be calculated, on the basis set out in sub-section (2B), by reference to the tax that would have been assessed if Division 13 had been applied (paragraph (c)) and by reference to the tax that has been assessed upon the application of the provision of the double taxation agreement that has displaced the application of Division 13 (paragraph (d)).'

65. A new Part VII of the 1936 Act dealing with penalty tax was inserted by *Taxation Laws Amendment Act* 1984 and s 225(2) was expressed in similar terms to s 226(2C). It read in part:

'Where:

(a) for the purpose of making an assessment or arising out of the consideration of an objection, the Commissioner has calculated the tax that is assessable to a taxpayer in relation to a year of income; and

(b) in calculating the tax assessable to the taxpayer, a prescribed provision was not applied in a particular case by reason of the *Income Tax Agreements Act 1953*;

the Commissioner shall determine the following amounts:

...'

66. The s 170(9B) EM and the Explanatory Memorandum to the 1984 penalty provisions make it clear that the associated enterprises article may apply instead of Div 13. We set out below relevant extracts from the more recent 1984 Explanatory Memorandum:

'***Section 225 : Penalty tax where Division 13 of Part III applies***

...

Proposed new section 225 will replace these existing sub-sections and provide for the imposition of additional tax (at an increased level) <u>where Division 13 or a corresponding provision of a double taxation agreement has been applied either on assessment or in considering an objection against an assessment. Penalty tax will be imposed where the application has resulted in an increase in the amount of tax assessable to the taxpayer or, where no tax was previously assessable, in an amount of tax now being payable.</u>

...

<u>In determining the increase in tax attributable to the application of Division 13 or of a corresponding double taxation agreement provision</u>, and on which the

25% per annum or 200% additional tax is based, it is necessary first to calculate a base amount of tax: The base amount of tax for this purpose will, broadly, be the tax that would be payable if the taxpayer were to be assessed as having the taxable income revealed by the taxpayer's return. The tax payable as the result of the application of Division 13 or of the relevant agreement provision having been calculated, the additional tax - in cases where the profit shifting arrangements are not connected with blatant tax avoidance arrangements - will be 25% per annum of the difference between that amount and the base amount, calculated from the last day allowed for furnishing the return to the date of assessment. Where tax would not have been assessable to the taxpayer but for the application of Division 13, or of a relevant agreement provision, the additional tax will be 25% per annum for the abovementioned period or 200% flat, as the case may be, of the tax payable.

...

By new sub-section 225(2) (replacing existing sub-section 226(2C)), additional tax is to be imposed where a prescribed provision has not applied because of the Income Tax (International Agreements) Act 1953 - that is, where by virtue of sub-section 4(2) of that Act (under which the provisions of that Act have effect notwithstanding anything inconsistent therewith in the Principal Act) the provisions of a double taxation agreement dealing with profit shifting have applied instead of a prescribed provision. (Paragraph 2 of Article 7 and paragraph 1 of Article 9 of the Australia/USA Convention, and corresponding articles in other agreements, are such agreement provisions).

In effect, additional tax of 25% per annum or 200% flat is to be calculated on the basis set out in sub-section 225(1), by reference to the tax that would have been assessed if Division 13 had been applied (paragraph (c)) and by reference to the tax that has been assessed upon the application of the provision of the double taxation agreement that has displaced the application of Division 13 (paragraph (d)).

...’ (emphasis added)

c. Other statements in the 1982 Explanatory Memorandum

67. Other statements made in the s 170(9B) EM relating to the introduction of Div 13 also suggest that there were two separate sources of power to assess and to amend an assessment:

> ‘**International tax avoidance (Clauses 19 and 21-23)**
>
> ...
>
> <u>There can be situations, for which both existing section 136 and each of the double taxation agreements make provision, where it is not feasible to ascertain the arm’s length consideration that is to be taken as a benchmark. This can happen where the nature of the industry is such that relevant arm’s length dealings do not exist, or where information about arm’s length dealings is not available to the taxation authorities. The new provisions will, in relation to such situations, enable appropriate re-construction of Australian taxable income arising in international transactions.</u>
>
> ...
>
> <u>Reflecting the position that exists in relation to existing section 136, an assessment may be amended to give effect to the revised Division at any time, so long as the Division has not previously been applied in relation to the same subject matter. Where a double taxation agreement provision operates to reallocate profits, amendment of assessments will be authorised on the same basis. An assessment may also be amended at any time for the purpose of making a compensating adjustment in favour of a taxpayer.</u>
>
> ...’ (emphasis added)

68. And further:

> ‘**Clause 19: International agreements and determination of source of certain income**
>
> ...
>
> **Section 136AB: Operation of Division**
>
> ...

> It is not proposed that Division 13 will override the Income Tax (International Agreements) Act 1953. <u>The double taxation agreements which appear as Schedules to that Act contain their own provisions to deal with profit shifting arrangements which occur in an agreement context</u>, and these provisions are based on application of the arm's length principle.
>
> ...' (our emphasis)

d. Conclusion

69. We have set out the relevant amending provisions and the associated extracts from the relevant Explanatory Memoranda at some length as, in our view, they demonstrate that the legislature has incorporated the associated enterprises article into the Assessment Act, at least for the purposes of an amended assessment. Sections 170(9B) and (9C) and the amendments to the penalty provisions in ss 226(2B) – (2F), and later in s 225(2), plainly have that consequence.

70. Put another way, to construe the operation of the relevant provisions as not having the consequence of incorporation of the associated enterprises article into the Assessment Act would be contrary to the well established rules of statutory construction of giving effect to, rather than defeating or frustrating, the object and intention of the relevant legislative provisions: see, for example, *Project Blue Sky v ABA* (1998) 194 CLR 355 at [69], [70]; *Cooper Brookes (Wollongong) Pty Ltd v Commissioner of Taxation* (Cth) (1981) 147 CLR 297 at 311, 321 and *MacAlister v The Queen* (1990) 169 CLR, 324 at 330. The High Court has also reiterated the role of 'logic and common sense in matters of statutory construction': see *Collector of Customs v Agfa-Gevaert Ltd* (1996) 186 CLR 389, 402. Further, s 15AB of the *Acts Interpretation Act* 1901 entitles the Court to consider the Explanatory Memoranda in construing the relevant legislative provisions.

71. As Lord Diplock observed in 'The Court as Legislators[24]

> 'if … the Courts can identify the target of Parliamentary legislation their proper function is to see that it is hit: not merely to record that it has been missed.'

72. Although the position is not as clear with the power to assess, essentially for the same reasons there can be no rational explanation for incorporation of the associated enterprises article only for the power to amend and not for the power to assess. Plainly, the implicit intention in the enactment of the relevant amending provisions is the incorporation of the associated enterprises article into the Assessment Act for the purposes of both assessment and the amendment of an assessment. That intention is made explicit in the extracts of the Explanatory Memoranda to which we have referred.

73. It follows from the foregoing discussion that it is our view that the associated enterprises article has been incorporated into the Assessment Act as a basis for assessment and may therefore be relied upon by the Commissioner as a separate source of power to amend an assessment and also, probably, to issue an assessment. Plainly, that has significant tax consequences as the associated enterprises article confers a broader power of reconstruction in respect of a transaction than Div 13 and Div 820. As the Assessment Act has been incorporated into the relevant taxing Act, the gap seen to exist in that regard in the authorities to which we have referred has been removed as from 1982. We finally turn to briefly consider the breadth of the associated enterprises article.

(c) The breath of the associated enterprises article

74. Division 13 and the associated enterprises article deal with the same general subject matter, namely amounts which might have been expected to accrue if parties had been dealing at arm's length. In the case of Div 13, the focus is on dealings or transactions.

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[24] The Lawyer and Justice (1978) at 274.

In the case of the associated enterprises article, it is on the relationship between the two enterprises.

75. Although the provisions of the two regimes do not precisely correspond, they are comparable. Each regime applies to a wide range of transactions. The primary principle in each case is that where parties are not dealing with each other at arm's length the Commissioner has power, but is under no duty, to attribute an arm's length consideration.

76. The power to make adjustments under the associated enterprises article appears to be broader than the power which exists under Div 13. In particular, the power is conditioned on the existence of conditions which operate between the two enterprises in their commercial or financial relations which differ from those which might be expected to operate between independent enterprises dealing wholly independently with one another.

77. It is difficult to comment on the application of the associated enterprises article in the abstract. However, in our opinion, it is open to the Commissioner in applying the associated enterprises article to eliminate those aspects of the commercial and financial relations which resulted in profits which, but for those relations, might have been expected to accrue, but by reason of the relations have not so accrued. The notion of 'relations' is of such width that the associated enterprises article appears to give considerable latitude in addressing non-arm's length dealings. Finally, we observe that there is a potential tension between the breadth of the arm's length approach in the associated enterprises article and the safe harbour allowance in Div 820.

Conclusion

78. Divisions 13 and 820 have different functions. Division 13 is applied to determine the deemed consideration for the actual loan that was entered into. Division 820 is applied to determine the level of debt funding which is permitted and, to the extent the permitted level is exceeded, to disallow the deductions that the entity may claim apart from Div 820. The arm's length interest on the loan that is determined under Div 13

may be greater than the interest that would be payable on the loan amount reduced under Division 820 (eg where the level of actual debt funding exceeds the maximum allowable debt). However, that is not a factor that can authorise a reconstruction of the loan under Div 13, which takes the loan, save for the consideration, as it finds it. That consequence might be ameliorated to some extent if s 136(AD(4) applies, but that needs to be considered in the context of the particular factual scenario that attracts the operation of s 136AD.

79. The associated enterprises article is couched in terms that are broader than Div 13 and may in a given situation provide greater latitude for the Commissioner to address the income tax consequences of non-arm's length dealings by reconstructing the relevant transaction to make it accord with the surrogate arm's length transaction. It is, however, difficult to comment on this aspect of the matter in the abstract. Ultimately it will be necessary for the Commissioner to consider the application of Div 13, the associated enterprises article and Div 820 in relation to the particular facts involved in each case and to make a determination as to how to proceed, including as to which of the provisions are to be relied upon.

80. Although it is our view that the associated enterprises article has been incorporated into the Assessment Act and, as a consequence, into the Income Tax Act, there is merit in removing any doubt about the matter by consideration being given to enacting legislation that confirms that outcome.

Dated: 11 May 2009

Ron Merkel

Diana Harding