TR 2014/D3 - Income tax: transfer pricing - the application of section 815-130 of the Income Tax Assessment Act 1997

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Draft Taxation Ruling

Income tax: transfer pricing – the application of section 815-130 of the *Income Tax Assessment Act 1997*

Contents	Para
What this Ruling is about	**1**
Background	**3**
PROPOSED LEGALLY BINDING SECTION:	
Ruling	**18**
Date of effect	**61**
NOT LEGALLY BINDING SECTION:	
Appendix 1:	
Explanation	**62**
Appendix 2:	
Your comments	**136**
Appendix 3:	
Detailed contents list	**138**

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What this Ruling is about

1. This draft ruling provides the Commissioner's views about the application of section 815-130 of the *Income Tax Assessment Act 1997* (ITAA 1997),[1] which specifies the relevance of the actual commercial or financial relations to the identification of the *arm's length conditions. The identification of these conditions is relevant to ascertaining whether an entity gets a *transfer pricing benefit from the actual conditions which operate between the entity and another entity in connection with their cross border dealings.

2. In doing so, the draft ruling discusses the meaning of the terms used in section 815-130 and its interaction with other parts of Subdivision 815-B.

[1] All legislative references in this draft ruling are to the *Income Tax Assessment Act 1997* unless stated otherwise.

Background

3. Subdivision 815-B of the ITAA 1997 was introduced by the *Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Act 2013* (Act No. 101, 2013), which inserted Subdivisions 815-B, 815-C and 815-D into the ITAA 1997 and Subdivision 284-E into Schedule 1 to the *Taxation Administration Act 1953* (TAA 1953), and also repealed Division 13 and subsections 170(9B) and (9C) of the *Income Tax Assessment Act 1936* (ITAA 1936), with effect from 29 June 2013.[2] These new Subdivisions ensure that Australia's transfer pricing rules better align with the arm's length principle and the internationally consistent transfer pricing approaches as set out by the Organisation for Economic Cooperation and Development (OECD).[3]

The arm's length principle and the OECD

4. 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*. Paragraph 1 of Article 9 states that:

> [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.

5. Paragraph 1.7 of the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration, as approved by the Council of the Organisation for Economic Cooperation and Development last amended on 22 July 2010 (the 2010 OECD TP Guidelines) provides that:

> Paragraph 1 of Article 9 of the OECD Model Tax Convention … introduces the need for:
>
> - A comparison between conditions (including prices, but not only prices) made or imposed between associated enterprises and those which would be made between independent enterprises …; and
> - A determination of the profits which would have accrued at arm's length ….

[2] Section 815-15 of the *Income Tax (Transitional Provisions) Act 1997* provides that Subdivisions 815-B, 815-C and 815-D of the ITAA 1997 apply to income years starting on or after the earlier of 1 July 2013 and the day the *Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Act 2013* received Royal Assent (being 29 June 2013).

[3] See paragraphs 2.1, 2.5. 2.16 and 3.2 of the Explanatory Memorandum to Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013 (EM) which accompanied the *Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Act 2013*.

6. The 2010 OECD TP Guidelines specify two exceptions to the policy of recognising the transaction or arrangement as actually undertaken and structured, being where:

- the economic substance of the transaction or arrangement differs from its form, or
- independent enterprises behaving in a commercially rational manner in comparable circumstances would not have characterised or structured the transaction or arrangement as the associated enterprises have and arm's length pricing cannot reliably be determined for that transaction or arrangement.[4]

Object of Subdivision 815-B

7. Consistent with Article 9 of the OECD Model Tax Convention and the 2010 OECD TP Guidelines, the object of Subdivision 815-B is to ensure that Australia receives an appropriate share of tax from multinational firms, with such taxation based on a level of profits that reflects the economic activity attributable to Australia and calculated in accordance with the internationally accepted arm's length principle.[5]

8. Unlike both former Division 13 of the ITAA 1936 and Subdivision 815-A of the ITAA 1997,[6] Subdivision 815-B is self-executing in its operation.[7] This means that the Subdivision applies on a self-assessment basis and does not require the Commissioner to make a determination.[8]

Structure of Subdivision 815-B

9. Subdivision 815-B addresses the adoption of non-arm's length structures, arrangements and dealings, through which an entity may get a *transfer pricing benefit, using a two-step process.

10. Firstly, section 815-130 of Subdivision 815-B requires that the identification of the arm's length conditions must be based on certain commercial or financial relations as specified in subsections 815-130(1) to 815-130(4).

11. Secondly, subsection 815-115(1) provides that, if an entity gets a transfer pricing benefit from the actual conditions that operate between the entity and another entity in connection with their commercial or financial relations:

(a) those conditions are taken not to operate, and

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[4] See paragraphs 1.64-1.66, 9.161, 9.164, 9.168-9.169 and 9.183-9.185 of the 2010 OECD TP Guidelines.
[5] Also, see section 815-101, subsection 815-105(1) and paragraph 3.1 of the EM.
[6] Subsection 815-1(2) of the *Income Tax (Transitional Provisions) Act 1997* provides that Subdivision 815-A of the ITAA 1997 does not apply to an income year to which Subdivisions 815-B and 815-C of that Act apply.
[7] See paragraphs 2.17 and 3.29 of the EM.
[8] See paragraphs 2.13-2.20 of the EM.

(b) instead, the arm's length conditions are taken to operate.

12. The operation of subsection 815-115(1) thereby requires the existence of a transfer pricing benefit and a connection between the obtaining of that transfer pricing benefit and the 'conditions that operate between the entity and another entity in connection with their commercial or financial relations'.

Meaning of arm's length conditions

13. Central to the operation of Subdivision 815-B is the identification of the arm's length conditions which, in relation to conditions that operate between an entity and another entity, are the conditions that might be expected to operate between independent entities dealing wholly independently with one another in comparable circumstances (see subsection 815-125(1)).

When an entity gets a transfer pricing benefit

14. An entity gets a transfer pricing benefit for the purposes of Subdivision 815-B if the cross border[9] 'actual conditions' that operate between the entity and another entity in connection with their commercial or financial relations differ from the arm's length conditions and, had the arm's length conditions operated instead, one or more of the following would apply:

- the amount of the entity's taxable income for an income year would be greater
- the amount of the entity's loss of a particular sort for an income year would be less
- the amount of the entity's tax offsets for an income year would be less
- an amount of withholding tax payable in respect of interest or royalties would be greater. [10]

15. Subsection 815-120(2) provides that there is taken to be a difference between the actual conditions and the arm's length conditions if:

(a) an actual condition exists that is not one of the arm's length conditions, or

(b) a condition does not exist in the actual conditions but is one of the arm's length conditions.

[9] See the 'cross border test' in subsection 815-120(3).
[10] See subsection 815-120(1) and paragraphs 3.11, 3.37-3.38 and 3.47-3.48 of the EM**.**

Relevance of actual commercial of financial relations

16. A key feature of Subdivision 815-B, which is the subject of this draft ruling, is that it sets out when and to what extent the actual commercial or financial relations are relevant to the identification of the arm's length conditions; see section 815-130 of Subdivision 815-B. This ensures that the identification of the arm's length conditions is based on an appropriate framework which has regard to the form and substance of the actual commercial and financial relations and to what independent entities dealing wholly independently with one another in comparable circumstances would have done.

Guidance in section 815-135

17. Notably, for the purposes of determining the effect Subdivision 815-B has in relation to an entity, the arm's length conditions should be identified so as best to achieve consistency with the 2010 OECD TP Guidelines; see section 815-135 of Subdivision 815-B.

Ruling

Relevance of actual commercial or financial relations in the identification of the arm's length conditions

18. Subsection 815-130(1) of Subdivision 815-B provides the 'basic rule' for the way in which the arm's length conditions are to be identified, based on the commercial or financial relations in connection with which the actual conditions operate. Subsections 815-130(2) to (4) then provide exceptions to that rule depending on whether the form and substance of those relations is consistent, or on what independent entities dealing wholly independently with one another in comparable circumstances would have done, or would not have done.

19. The operation of the 'basic rule', the exceptions to that rule, the meaning of the terms in section 815-130 and its interaction with other parts of Subdivision 815-B are discussed below.

The 'basic rule'

20. The 'basic rule' requires that the identification of the arm's length conditions must be based on the commercial or financial relations in connection with which the actual conditions operate, having regard to both the form and substance of those relations.

21. The term 'commercial or financial relations' is broad and describes the totality of the arrangements between the entities. However, for the purposes of subsection 815-130(1), the identification of the arm's length conditions is based only on 'the commercial and financial relations in connection with which the actual conditions operate'.

22. The 'actual conditions that operate' between the entity and another entity in connection with their commercial or financial relations are the things which ultimately affect each entities' economic or financial position. These conditions need not be explicit contractual terms and can also include the price paid for the sale or purchase of goods or services, the terms of an agreement that have an economic impact on the margin of profits earned by one or both the entities, or a division of profits between the entities. Furthermore, it is implicit in the structure of Subdivision 815-B that, for the purposes of section 815-130, the actual conditions must satisfy the cross border test in subsection 815-120(3).

23. The expression 'in connection with', in the phrase 'commercial or financial relations in connection with which the actual conditions operate', requires that there be a nexus between those conditions and the commercial or financial relations between the entities. While conditions that directly result from the commercial or financial relations are clearly within the scope of the provision, the expression 'in connection with' is broad enough to cover conditions that have a less direct or immediate connection. Accordingly, cross border conditions arising out of the structures put in place by a multinational group would fall within the scope of Subdivision 815-B where those conditions relate to or affect the commercial or financial relations between one entity and another and produce a transfer pricing benefit.

24. The 'form' of the commercial or financial relations describes the prima facie features or legal characteristics of the dealings between entities. This would generally be evident from the documented contractual terms of transactions, arrangements or other relations between the entities that define explicitly or implicitly how the responsibilities, risks and benefits are to be divided between all parties. The terms of a transaction or arrangement may also be found in other correspondence between the parties.

25. In some cases the commercial and financial relations will not have been documented (or not fully documented). In those cases, the form of those relations will need to be determined by reference to all the facts and circumstances, including the behaviours of the entities in relation to each other, the legal and funding structures that have been put in place, the roles allocated to the entities, the transactions or arrangements that occur within those structures and pursuant to the allocated roles, and the economic and financial impacts produced for the relevant entities by those structures, roles and transactions as reflected in their business records. The relevance of such relations will be identified based on their connection with the actual (cross border) conditions that operate between the entities.

26. The 'substance' of the commercial or financial relations is the 'economic substance'[11] of the actual transactions, arrangements or other such relations between the entities. This is determined by examining all of the relevant facts and circumstances, such as the economic and commercial context and economic reality of the commercial or financial relations, the object and economic and financial effects of those relations from a practical and business point of view on each of the entities, and the conduct of the parties, including functions performed, assets used and risks assumed by them. Hence, the actual structure, appearance and characterisation of the commercial or financial relations, including the legal rights and obligations created, are not decisive in the identification of the arm's length conditions under the 'basic rule'.

27. In most cases, it is expected that the identification of the arm's length conditions will be able to be accomplished by applying the 'basic rule' and determining the arm's length contribution made by the Australian operations based upon the form and substance of the actual commercial or financial relations.

The first exception to the 'basic rule' – where the 'form' of the actual commercial or financial relations is inconsistent with the 'substance' of those relations

28. Subsection 815-130(2) provides an exception to the 'basic rule' to disregard the form of the actual commercial and financial relations[12] to the extent that it is inconsistent with the substance of those relations.

29. The effect of this rule is that some aspects of the actual commercial or financial relations are altered or disregarded and the identification of the arm's length conditions is based only on the modified commercial or financial relations that fully and accurately reflect the economic substance of those relations.

30. Whether the form and substance of the actual commercial or financial relations are inconsistent will be a question of fact having regard to all relevant factors, including the actual structure adopted by the entities, the conduct of the entities, the true characterisation of the relations, the legal rights and obligations created, any flows of funds between entities (including circular flows), the overall economic consequences (including exposure to economic risks and rewards and actual transfers of wealth) and their effects on the net economic positions of entities. The cases to which subsection 815-130(2) is directed are those where the inconsistency between form and substance would yield a distorted outcome in the identification of the arm's length conditions that would undermine the object of the Subdivision if the inconsistency was not addressed.

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[11] For the purposes of determining the effect Subdivision 815-B has in relation to an entity, the identification of the arm's length conditions based on this meaning of 'substance' best achieves consistency with the documents covered by both section 815-135 and the EM.

[12] Being the commercial or financial relations in connection with which the actual conditions operate.

31. The 2010 OECD TP Guidelines[13] identify one situation where this exception could apply. This is the provision of financial accommodation to an associated entity in the form of interest bearing debt when, having regard to the economic circumstances of the borrowing entity, the legal rights created and the conduct of the entities in relation to the loan including the advance of funds, it would not be expected to be structured this way. Depending on the facts and circumstances, the loan could be characterised in accordance with its economic substance; with the result that it is regarded as a subscription of equity and the interest rate would be zero for the purpose of identifying the arm's length conditions. If this inconsistency was not addressed, the interest rate applied would be higher than would be the case if the financial relations were modified to reflect their economic substance. (Note that subsection 815-140 contains a special rule on how Subdivision 815-B interacts with the thin capitalisation provisions in Division 820 – see paragraphs 49 to 60 of this draft ruling.)

32. The effect of this exception applying is that the economic substance of the actual commercial or financial relations is ultimately relevant and decisive in the identification of the arm's length conditions.

The second exception – where independent entities would have entered into other commercial or financial relations which differ in 'substance' from the actual commercial or financial relations

33. Subsection 815-130(3) provides a second exception to the 'basic rule' where it is concluded that independent entities dealing wholly independently with one another in comparable circumstances, would not have entered into the actual commercial or financial relations, but would have entered into other such relations which differ in substance. In this circumstance, the identification of the arm's length conditions must be based on those other commercial or financial relations that independent entities would instead have entered into. Implicit in this requirement is that regard must be had to the substance of the actual conditions that were made or imposed between the entities in their commercial or financial relations and hypothesising what independent entities behaving in a commercially rational manner would have done in comparable circumstances.

34. The requirement that independent entities 'would' have entered into other commercial or financial relations doesn't mean that actual third party transactions or arrangements that exactly replicate those modified relations must be identified. Where exact real world comparables are unavailable, it will be sufficient to identify what independent entities would have done by reference to alternatively structured transactions or arrangements that most closely reflect the substance of the modified relations, provided appropriate adjustments for any material differences can reliably be made.

[13] Refer to paragraph 1.65 of the 2010 OECD TP Guidelines.

35. The application of subsection 815-130(3) also requires that the other commercial or financial relations must differ in substance from the actual commercial or financial relations. However, this doesn't mean they must be entirely different. The other commercial or financial relations acceptable to independent entities dealing wholly independently with one another could both retain and reject elements of the actual relations and would include any additional elements on which independent entities would insist.

36. It can be seen that the relevant question is whether the actual commercial or financial relations adopted by the entities differ from those which would have been adopted by independent entities dealing wholly independently with one another in comparable circumstances, having regard to their own best commercial and economic interests and the arm's length options realistically available to them.

37. Whether these inferences can be drawn will depend on the facts and circumstances having regard to all relevant factors,[14] including comparability analysis[15] and whether the actual or other commercial or financial relations make commercial sense for independent entities in all of the circumstances of the dealings.

38. Where the circumstances are such that this exception applies, the commercial or financial relations actually undertaken by the entities are disregarded to the extent they differ from the relations that would be adopted by independent entities and the identification of the arm's length conditions must be based on the other commercial or financial relations; to reflect what independent entities acting in a commercially rational manner would have done had the actual commercial or financial relations been structured in accordance with the economic and commercial reality of independent parties dealing at arm's length.

39. A situation where this exception could apply would be a sale under a long-term contract, for a lump sum payment, of unlimited entitlement to the intellectual property rights arising as a result of future research for the term of the contract. Here, having regard to all relevant factors, it could be the case that it would reasonably be concluded that independent entities dealing wholly independently with one another in comparable circumstances would not have entered into the actual commercial or financial relations, and hence the contract, for the sale of intellectual property rights on those terms.

[14] See subsection 815-130(5), which provides that subsections 815-125(3) and 815-125(4) apply for the purposes of section 815-130.
[15] Guidance on the comparability analysis is found in Chapters I and III of the 2010 OECD TP Guidelines.

40. The lump sum payment for the transfer of intellectual property could be considered not to be commercially rational for two reasons. Firstly, valuation difficulties exist at the time of the transaction because the intellectual property rights do not yet exist. It would be virtually impossible to set a price for the property rights agreed to have been sold. Secondly, the static pricing mechanism (lump sum) used in such an arrangement would likely be unacceptable to both an arm's length transferor and an arm's length transferee.

41. In this case it would be appropriate to conform the terms of that transfer in their entirety (and not simply by reference to pricing) to the commercial or financial relations that would have been entered into had the transfer of property been the subject of a transaction involving independent entities dealing wholly independently with one another. Thus, in the case described above, it might be appropriate to adjust the terms of the agreement in a commercially rational manner as a continuing research agreement, and identify the arm's length conditions on that basis.[16]

The third exception – where independent entities would not have entered into commercial or financial relations

42. Subsection 815-130(4) provides a third exception to the 'basic rule' where it can be concluded that independent entities dealing wholly independently with one another in comparable circumstances would not have entered into the actual commercial or financial relations. In this case, the identification of the arm's length conditions is to be based on that absence of commercial or financial relations; therefore on the premise that independent entities would have maintained their existing positions and done nothing in the circumstances.

43. Whether these inferences can be drawn will be a matter of fact having regard to all relevant factors,[17] including comparability analysis and whether, having regard to their own economic interests, independent entities dealing wholly independently with one another would have entered into commercial or financial relations.

[16] This example is taken from paragraph 1.65 of the 2010 OECD TP Guidelines. See also paragraphs 6.28-6.35 and 9.87-9.88 of the 2010 OECD TP Guidelines.
[17] See subsection 815-130(5), which provides that subsections 815-125(3) and 815-125(4) apply for the purposes of section 815-130.

44. Where the circumstances are such that this exception applies, the actual commercial or financial relations are disregarded for the purposes of identifying the arm's length conditions. In addition, the arm's length conditions, being the conditions that might be expected to operate between independent entities dealing wholly independently with one another in comparable circumstances, are to be identified based on the conclusion that independent entities dealing wholly independently with one another in comparable circumstances would not have entered into any commercial or financial relations where these conditions are made or imposed between them. That is, the arm's length conditions are to be identified based on the parties not entering into such relations, with the result that the arm's length condition is that nothing would have occurred.

45. A situation where this exception could apply would be the sale of unlimited entitlement to the intellectual property rights identified above where instead, having regard to all relevant factors, it is concluded that independent entities dealing wholly independently with one another in comparable circumstances would not have entered into the contract for the use of the intellectual property on those terms, nor any other commercial or financial relations. In this situation, the identification of the arm's length conditions must be based upon that absence of commercial or financial relations. That is, the actual conditions are disregarded and the arm's length condition that nothing would have occurred is substituted in their place. The effect of this is that the taxpayer is treated as taking the option of not entering into the transaction or arrangement.

Interaction of sections 815-130 and 815-120

46. An entity will get a transfer pricing benefit if all of the requirements of subsection 815-120(1) are satisfied including, had the arm's length conditions operated instead of the actual conditions, that one or more of the following would apply (paragraph 815-120(1)(c)):

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

47. For the purpose of working out when an entity gets a transfer pricing benefit (subsection 815-120(1)), the actual conditions which operated between the entities will differ from the arm's length conditions if they are not the same. A difference will also be taken to exist if 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 (subsection 815-120(2)).

48. For these reasons, the exceptions to the basic rule under subsections 815-130(2) to 815-130(4) will have effect with regard to the object of Subdivision 815-B[18] only if their operation would result in an entity being treated as getting a transfer pricing benefit. They will not apply to enable an entity to get a transfer pricing benefit.

Interaction of sections 815-130 and 815-140

49. Section 815-140 modifies the way in which an entity that gets a transfer pricing benefit works out its taxable income or tax loss for an income year, if the thin capitalisation provisions in Division 820 apply to the entity and the operation of the arm's length conditions involves applying a rate to a debt interest to work out costs that are debt deductions[19] of the entity. This provision requires that the rate is worked out on the basis that arm's length conditions operated and that arm's length rate is then applied to the debt interest actually issued by the entity; instead of the debt interest that would have been issued had the arm's length conditions operated. In some cases, Division 820 may apply to further reduce debt deductions if the entity has not complied with the relevant statutory threshold for debt and equity funding.

50. Section 815-130 is concerned with the relevance of the actual commercial or financial relations to the identification of the arm's length conditions. This purpose is not affected by the operation section 815-140, which operates only after any arm's length conditions relevant to determining and applying a rate to a debt interest are identified.

51. This means that, whatever effect the operation of section 815-130 has upon the identification of arm's length conditions, including where they affect costs which are worked out by applying a rate to a debt interest (such as applying a rate of interest to a loan amount, or applying a rate to the amount of debt covered by a finance guarantee), those arm's length conditions prevail for the purposes of determining the arm's length rate under Subdivision 815-B. Section 815-140 merely operates to modify the way the way in which an entity to which section 815-115 applies works out its taxable income or tax loss, by requiring that the arm's length rate is applied to the debt interest actually issued, rather than to the amount of debt that the tested entity would have had if the arm's length conditions operated.

52. The following example is intended purely to illustrate the interaction of section 815-130 with the operation of section 815-140. It is not intended to suggest that a particular method for pricing of debt must be applied to the circumstances of a particular case.

[18] See section 815-105.
[19] See section 820-40.

Example 1 - transfer pricing adjustment and thin capitalisation

53. Aus Co is an Australian resident subsidiary company of For Co, the parent company. Being an industrial company and not an Authorised Deposit-taking Institution (ADI), Aus Co is an 'inward investment vehicle (general)' for the purposes of Subdivision 820-C.

54. For an income year, Aus Co has:

- a 'safe harbour debt amount', determined in accordance with section 820-195, of $300m
- 'adjusted average debt', determined in accordance with subsection 820-185(3), of $300m is borrowed from For Co at an interest rate of 15%, and
- equity of $100m.

55. Aus Co's only debt deductions are for the interest incurred at a rate of 15% on its $300m debt, meaning that it has $45m of debt deductions for the income year.

56. Aus Co doesn't have borrowings from independent parties that could be used as a comparable. However, the available data as to market reference rates for a borrowing of that size and the credit standing that the capital markets would give Aus Co might be able to be used in determining a market rate of interest for the loan from For Co, where Aus Co's credit standing would allow it to borrow $300m from independent lenders. This might, in turn, be used to determine the arm's length consideration for the loan, provided this price produces an outcome that makes commercial sense for For Co and Aus Co in all of the circumstances.

57. The analysis may show that the loan from For Co might not reasonably be expected to exist between independent parties dealing at arm's length, for instance because the relatively high cost of the loan produces an outcome for Aus Co, in terms of the profitability, viability or competitiveness of its business, that does not make commercial sense for it. Assume that, in this scenario, after considering all arm's length pricing methods and taking account of all the necessary elements of comparability, it is not possible to ascertain the arm's length consideration in respect of the relevant acquisition, there being no evidence that similar arrangements would have been entered into between unrelated parties.

58. Assume also that the information available to the taxpayer in this particular case supports a conclusion that the closest arm's length scenario (at which a loan might reasonably be expected to exist between independent parties dealing at arm's length) is a loan of $250m at 10%, provided a further $50m of equity is raised. In accordance with subsection 815-130(3), the arm's length conditions are identified based on this scenario, including an arm's length interest amount of $25m ($250m at 10%) and an arm's length amount of debt of $250m.

59. The taxpayer works out that it would get a transfer pricing benefit if it claimed the entire $45m of debt deductions as deductible in working out its taxable income for the income year. In accordance with section 815-140, the taxpayer applies the rate of 10% to the actual debt amount of $300m to calculate debt deductions of $30m.

60. On this basis, Subdivision 815-B would operate to deny $15m of Aus Co's $45m deductions for interest, leaving a total amount of debt deductions to be considered for the purposes of Division 820 of $30m. Section 820-220 would not operate to deny any of that $30m because Aus Co does not exceed the 'safe harbour debt amount'.

Date of effect

61. When the final Ruling is issued, it is proposed to apply to income years commencing on or after 29 June 2013 in relation to income tax. In relation to withholding tax, it is proposed to apply to income derived or taken to be derived in the income years specified above. However, the Ruling will not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 75 to 76 of Taxation Ruling TR 2006/10).

Commissioner of Taxation

16 April 2014

Appendix 1 – Explanation

This Appendix is provided as information to help you understand how the Commissioner's preliminary view has been reached. It does not form part of the proposed binding public ruling.

Section 815-130 relevance of actual commercial or financial relations

62. The meaning of the various terms in section 815-130 dealing with the relevance of the actual commercial or financial relations to the identification of the arm's length conditions and its operation are explained below.

Basic rule in subsection 815-130(1)

63. The 'basic rule' in subsection 815-130(1) of Subdivision 815--B requires that the identification of the arm's length conditions must be based on the commercial or financial relations in connection with which the actual conditions operate, having regard to both the form and substance of those relations.[20] In most cases, it is expected that the object of Subdivision 815-B, 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, can be satisfied by applying this rule.

Commercial and financial relations

64. The commercial or financial relations referred to in the 'basic rule' are those in connection with which the actual conditions operate. These relations are the actual commercial or financial relations for the purposes of section 815-B.[21]

65. The 'commercial and financial relations' are the totality of arrangements related to the interactions of two entities (the context in which each of the actual conditions arise). This includes any connection or dealings between the entities that relate to or could otherwise affect the commercial or financial activities of one of the entities.[22]

66. This includes, but is not limited to, one or more of:

- a single transaction or a series of transactions
- a practice, understanding, arrangement, thing to be done or not be done, whether express or implied and whether or not legally enforceable
- the options realistically available to each entity

[20] The arm's length conditions are the conditions that might be expected to operate between independent entities dealing wholly independently with one another in comparable circumstances (subsection 815-125(1)).
[21] See paragraph 3.83 of the EM.
[22] Refer to paragraphs 3.40–3.41 of the EM.

- unilateral actions or mutual dealings
- a strategy, or
- overall profit outcomes achieved by the entities.[23]

67. The concept of commercial or financial relations is very broad, encompassing the surrounding economic and commercial environment within which the entities operate, together with an evaluation of the economically significant elements of the Australian entity. It also takes into account any connections or dealings between entities, whether legally enforceable or not and irrespective of whether they are express or implied, and includes strategies and overall profit outcomes.

68. However, the commercial or financial relations that are relevant for the purposes of subsection 815-130(1) are those 'in connection with which the actual conditions operate'. The expression 'in connection with' must be interpreted in accordance with the intent of the relevant statute.24 In *Hatfield v. Health Insurance Commission* (1987) 15 FCR 487, at page 491, Davies J stated that:

> 'Expressions such as 'relating to', 'in relation to', 'in connection with' and 'in respect of' are commonly found in legislation but invariably raise problems of statutory interpretation. They are terms that fluctuate in operation from statute to statute ... The terms may have a very wide operation but they do not usually carry the widest possible ambit, for they are subject to the context in which they are used, to the words with which they are associated and to the object or purpose of the statutory provision in which they appear.'

69. This passage was approved by the Full Federal Court in *Burswood Management Ltd v. Attorney-General* (1990) 23 FCR 144. At page 146 their Honours concluded that reference to reported cases is of little assistance in determining the meaning of the words 'in connection with', because they take their meaning from the particular statute in which they appear.

70. When read together with the words 'with which the actual conditions operate' (in paragraph 815-130(1)(a)), the expression 'in connection with' indicates that the requisite connection of the 'commercial or financial relations' with the 'actual conditions' is that those relations relate to or affect the actual conditions that arise from the commercial or financial activities of one of the entities.

71. Accordingly, consistent with the purpose of subsection 815-130(1) to limit the identification of the arm's length conditions based on the commercial or financial relations in connection with which the actual conditions operate, in some cases the relevant commercial or financial relations could be confined to certain aspects of a broader set of relations. In such cases, the comparison of form and substance of the commercial or financial relations relates to that confined subset of the broader relations.

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[23] Refer to paragraph 3.42 of the EM.
[24] See the discussion about the expression 'in connection with' at paragraphs 348-353 of Miscellaneous Taxation Ruling MT 2006/1.

Actual Conditions

72. The 'actual conditions' operating in connection with the commercial or financial relations of two entities are the things that ultimately affect each entity's economic or financial positions.[25] Conditions need not be explicit contractual terms, but can include the price paid for the sale or purchase of goods or services, terms of an agreement that have an economic impact (such as the allocation of an expense), the margin of profits earned by one or both the entities, or a division of profits between the entities.[26]

'Form' for the purposes of section 815-130

73. The 'form' of the commercial or financial relations describes the prima facie features or legal characteristics of the dealings between entities,[27] that is of the legal relationship that has lawfully been set up.

'Substance' for the purposes of section 815-130

74. The 'substance' of the commercial or financial relations describes the economic or commercial substance, or economic reality or essence of those relations.[28]

75. Paragraphs 1.65, 9.169 and 9.183 of the 2010 OECD TP Guidelines each refer to the substance of a transaction or arrangement as being the 'economic substance'.[29] In particular, paragraph 9.170 of the 2010 OECD TP Guidelines states that:

> 9.170 The economic substance of a transaction or arrangement is determined by examining all of the facts and circumstances, such as the economic and commercial context of the transaction or arrangement, its object and effect from a practical and business point of view, and the conduct of the parties, including the functions performed, assets used and risks assumed by them.

76. Accordingly, determining the economic substance of the commercial or financial relations includes a consideration of whether:

- the parties have correctly characterised[30] the transaction or arrangement in their contracts or agreements[31]

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[25] See paragraph 1.33 of the 2010 OECD TP Guidelines.
[26] Refer to paragraph 3.43 of the EM.
[27] Refer to paragraph 3.84 of the EM.
[28] As distinct from only the legal effect, being the legal rights and obligations created by the commercial or financial relations.
[29] Paragraphs 3.94–3.95 of the EM provide that 'substance' in section 815-130 is equivalent to the term 'economic substance' as used in the 2010 OECD TP Guidelines.
[30] Isaacs J in *Curtis* v. *Perth and Fremantle Bottle Exchange Co Limited* (1914) 18 CLR 17 at 25 said:
Where parties enter into a bargain with one another whereby certain rights and obligations are created, they cannot by a mere consensual label alter the inherent character of the relations they have actually called into existence. Many cases have

- an entity has done what it purported to do and/or whether it has borne the risk as evidenced by the contract or agreement,[32] and
- the parties have followed the terms and conditions of the contracts or agreements.[33]

77. For example, entities cannot conceal the true economic substance of their commercial or financial relations by characterising them based on a form or structure that is different from the true economic effect of the legal rights and obligations actually assumed by them. Likewise, the choice of language used in documenting their commercial or financial relations cannot overcome the economic substance or effect of those commercial or financial relations.

78. For the purposes of section 815-130, the 'substance' of the commercial or financial relations is determined by examining all relevant facts and circumstances, including:

- the economic and commercial context and economic reality of any arrangements entered into
- their object and effect from a practical and business point of view
- the conduct of the entities, and
- the economic functions performed, assets used and risks assumed by the entities.[34]

79. From the above, the Commissioner considers that the determination of substance in section 815-130 necessitates a consideration of the economic, commercial, financial and true legal[35] consequences of the actual commercial or financial relations. Substance in section 815-130 essentially requires a consideration of the economic and commercial substance of the legal rights and obligations created.

arisen where Courts have disregarded such labels, because in law they were wrong, and have looked beneath them to the real substance.

[31] See paragraphs 1.65, 7.18 and 9.133 of the 2010 OECD TP Guidelines.

[32] See paragraph 1.48–1.49 of the 2010 OECD TP Guidelines. See also paragraphs 3.74, 7.18, 9.12 and 9.165 of the 2010 OECD TP Guidelines.

[33] See paragraphs 1.53, 9.12, 9.104 and footnote 13 to paragraph 9.168 of the 2010 OECD TP Guidelines.

[34] Refer to paragraph 3.84 of the EM. Note also paragraphs 1.53, 9.13, 9.34, 9.55, 9.108, 9.165, footnote 13 to paragraph 9.168, 9.170 and 9.189 of the 2010 OECD TP Guidelines.

[35] Consideration of the legal consequences will include the legal rights and obligations that are created by the commercial or financial relations.

80. To have substance for the purposes of subsection 815-130(1), the commercial or financial relations should:

- make a difference in terms of economic benefits and outgoings, exposure to economic liabilities, funds flows, financial outcomes and the creation or addition of economic or commercial value; such that they permanently and commensurately affect the net economic position of the parties to those relations, and thereby
- produce an effect that is proportionate to the economic risks and rewards, and economic contributions made and/or economic burdens borne by each of the parties.

81. Where there is no commercial justification or economic reality, net economic result or objective economic effect from the commercial or financial relations – that is such relations do not vary control or change the flow of economic benefits, such that a party's economic position is unchanged – there may prima facie be no substance to the transaction, arrangement or other dealings.

82. For example, if funds begin and end with the same entity, or if there is some form of indemnity or reimbursement received, recoupment made, or self-cancelling transaction undertaken in a particular arrangement, the entity will likely be considered not to have made an economic outlay or to have incurred any economic loss, because it will not have suffered any economic detriment. Here, the substance of such commercial or financial relations may be that the taxpayer is left in materially the same economic position.

How to determine the 'substance' of the commercial or financial relations for the purposes of section 815-130

83. The Commissioner considers that the following factors could be considered in determining the 'substance' of the commercial or financial relations for the purposes of section 815-130:

- the commercial reality of the rights and obligations arising under the actual commercial or financial relations, as opposed to the legal form – and whether those rights and obligations are in conformity with reasonable commercial practices or dealings; having commercial purpose, character or rationale
- whether the relations make commercial and financial sense in all of the circumstances – that is, do they provide a commercially realistic return for the functions performed, assets used and risks assumed or managed in the relevant business activities, and are not contrary to the commercial interests of the parties

- whether a purported participant to an arrangement lacks the financial capacity to assume the share of a risk assigned to it contractually[36]
- intentional set-offs where a taxpayer holds offsetting positions that largely reduce or eliminate the economic risk of a transaction or arrangement[37]
- whether there is any real economic risk, that is, a market determined risk of a loss, for example, an exposure to economic loss of the amount invested – or whether an apparent financial outlay is largely protected from risk and is reasonably expected to be returned
- whether the commercial or financial relations involve only fleeting or economically inconsequential investments, or offsetting divestments, that are inconsistent with the economic benefits and burdens of ownership
- where there is no net economic result or objective economic effect from a transaction or arrangement – that is, the commercial or financial relations do not vary control or change the flow of economic benefits, such that a party's economic position is unchanged
- in some cases, the accounting treatment of a transaction or arrangement may assist in the determination of 'substance'. An entity may have adopted a 'substance over form' approach for accounting purposes. Where the accounting treatment reflects the economic and commercial substance or effect of a transaction or arrangement, this may be relevant in determining the 'substance' of the commercial or financial relations
- a transaction or arrangement which on its face results in a loss, or an 'artificial' or 'paper' or 'fictional' loss as distinct from a genuine 'economic' loss
- whether the commercial or financial relations are highly structured and/or include unnecessary steps (for example, inserted steps that have no independent economic significance or commercial purpose)
- a pre-ordained series of transactions or, a single composite transaction, or a single continuous operation; integrated and mutually dependent steps

[36] See paragraphs 9.20 and 9.29-9.33 of the 2010 OECD TP Guidelines.
[37] Paragraph 3.13 of the 2010 OECD TP Guidelines explains intentional set-offs as occurring when one associated enterprise has provided a benefit to another associated enterprise within the group that is balanced to some degree by different benefits received from that enterprise in return.

- a series of circular[38] cash flows making no commercial sense, round trip financing, complex interrelated arrangements; reimbursement agreements, self-cancelling series of transactions
- the interposition or use of conduits or intermediaries; for example, back-to-back loans or other arrangements that are economically equivalent, including for transactions or arrangements in or through tax shelter countries.

84. These factors alone or together may not be determinative of the true economic substance of the commercial or financial relations in connection with which the actual conditions operate, but where they are present in such relations they should be taken into consideration in that determination.

85. In some cases, in determining the substance of the commercial or financial relations between two entities, it will be appropriate to have regard to structures, operations and flows of funds involving more than those entities; for example where a foreign parent company requires an Australian subsidiary to enter non-arm's length dealings with a company in a tax haven that is operating as a conduit, potentially enabling the nature of the income flows the haven entity receives to be converted and remitted on to the parent in a tax exempt form. In such a case it may be that the tripartite relations are relevant for the purposes of the 'basic rule' and that multiple transfer pricing benefits will arise.

86. In this regard, paragraphs 2.33 and 3.9 of the 2010 OECD TP Guidelines provide that:

> 2.33 In a case where there is a chain of distribution of goods through an intermediate company, it may be relevant for tax administrations to look not only at the resale price of goods that have been purchased from the intermediate company but also at the price that such company pays to its own supplier and the functions that the intermediate company undertakes. … If it cannot be demonstrated that the intermediate company either bears a real risk or performs an economic function in the chain that has increased the value of the goods, then any element in the price that is claimed to be attributable to the activities of the intermediate company would reasonably be attributed elsewhere in the MNE group …
>
> 3.9 Ideally, in order to arrive at the most precise approximation of arm's length conditions, the arm's length principle should be applied on a transaction-by-transaction basis. However, there are often situations where separate transactions are so closely linked or continuous that they cannot be evaluated adequately on a separate basis. … A further example would be the routing of a transaction through another associated enterprise; it may be more appropriate to consider the transaction of which the routing is a part in its entirety, rather than consider the individual transactions on a separate basis.

[38] Circularity in this context refers to movements of money which conceal the fact that there is little or no underlying economic activity and/or which leave the taxpayer in essentially the same financial position as before.

The exceptions to the basic rule

87. The 'basic rule', that the identification of the arm's length conditions must be based on the commercial or financial relations having regard to both the form and substance of those relations, is disregarded if one of the exceptions at subsections 815-130(2)–(4) applies. The effect of one of these exceptions applying is to either modify or disregard the operation of the 'basic rule'.

88. The EM explains that:

> 3.92 There are three exceptions to the 'basic rule' for identifying arm's length conditions. Where these exceptions apply, actual commercial or financial relations in connection with which the actual conditions operate are disregarded for the purposes of identifying arm's length conditions. Specific rules for each exception then provide the alternative means of identifying arm's length conditions. As with the basic rule, the exceptions continue to constrain the way in which the arm's length conditions must be identified. …
>
> 3.95 The first exception is based on the approach taken under the OECD Guidelines in relation to economic substance (see for example paragraphs 1.65, 9.169 and 9.183 of the OECD Guidelines). In this regard, paragraph 9.183 of the OECD Guidelines states:
>
> > 'Under the first circumstance of paragraph 1.65, where the economic substance of a transaction differs from its form, the tax administration may disregard the parties' characterisation of the transaction and re-characterise it in accordance with its substance.'
>
> 3.96 The second and third exceptions are based on the approach taken under the OECD Guidelines in relation to the non-recognition and alternative characterisation of certain arrangements (see for example paragraphs 1.65, 1.66, 9.61, 9.175, 9.169 and 9.185 of the OECD Guidelines). In this regard, paragraph 1.66 of the OECD Guidelines states:
>
> > 'Article 9 would thus allow an adjustment of conditions to reflect those which the parties would have attained had the transaction been structured in accordance with the economic and commercial reality of parties dealing at arm's length.'

89. The Commissioner considers that subsections 815-130(2) to (4) are consistent with the exceptional circumstances discussed in the 2010 OECD TP Guidelines in the context of the non-recognition and alternative characterisation of certain arrangements or transactions.[39]

90. Because specific rules within each exception provide a different basis to be used in identifying the arm's length conditions[40], the Commissioner also considers that the exceptions to the basic rule are mutually exclusive of each other.

91. The use of the word 'despite' in subsections 815-130(2) to (4) means that entities must determine whether the circumstances described in one of those subsections apply and, as a result, whether the 'basic rule' in subsection 815-130(1) is disregarded in part (where subsection 815-130(2) applies), or in full (where either subsection 815-130(3) or subsection 815-130(4) applies).

Subsection 815-130(2) – 'substance' prevails over 'form'

92. The examination of a controlled transaction would ordinarily be based on the transaction actually undertaken by the entities as it has been structured by them, using the most reliable and appropriate methods, having regard to all relevant factors, so as to best achieve consistency with the 2010 OECD TP Guidelines.[41]

93. However, consistent with the 2010 OECD TP Guidelines, there may be circumstances in which it is appropriate to disregard all or part of the actual commercial or financial relations in the course of identifying the arm's length conditions. One such circumstance is where the economic substance of a transaction differs from its form. In this situation, subsection 815-130(2) has the effect of modifying the 'basic rule' by directing that the form[42] of the commercial or financial relations must be disregarded to the extent that it is inconsistent with the substance of those relations. This means that, to the extent of the inconsistency between form and substance, taxpayers must have regard to the economic and commercial substance of the commercial or financial relations[43] in identifying the arm's length conditions.

[39] See paragraph 3.94 of the EM.
[40] See paragraph 3.92 of the EM.
[41] Refer to subsection 815-125(2), subsection 815-135(1) and also paragraphs 1.48-1.49, 1.52-1.53, 1.64, 8.14, 9.11-9.14, 9.30, 9.34, 9.50, 9.60, 9.104, 9.118, 9.155, 9.159, 9.161, 9.164-9.166 and 9.168 of the 2010 OECD TP Guidelines.
[42] See above at paragraphs 24-25.
[43] See above at paragraphs 26 and 28-32.

94. As previously mentioned, the need to identify the arm's length conditions based on 'substance' requires a consideration of the economic and commercial substance or economic equivalent based upon the economic effect of the commercial or financial relations. In essence, subsection 815-130(2) places 'substance over form'[44] (that is, subordinates legal form to the economic and commercial substance), where these are inconsistent.

95. Paragraph 1.65 of the 2010 OECD TP Guidelines explains that:

> 1.65. … there are two particular circumstances in which it may, exceptionally, be both appropriate and legitimate for a tax administration to consider disregarding the structure adopted by a taxpayer in entering into a controlled transaction. The first circumstance arises where the economic substance of a transaction differs from its form. In such a case the tax administration may disregard the parties' characterisation of the transaction and re-characterise it in accordance with its substance. …

96. Paragraph 3.97 of the EM is consistent with paragraphs 1.65, 9.169 and 9.183 of the 2010 OECD TP Guidelines, stating that:

> 3.97 In cases where the form and substance of the actual commercial or financial relations of the entities differ, the form is disregarded to the extent of the inconsistency with the substance.

97. So as to best achieve the consistency with the 2010 OECD TP Guidelines, the Commissioner considers that in interpreting the term 'inconsistent' in subsection 815-130(2), it is sufficient that the form of the commercial or financial relations differs from the substance of those relations to the extent the differences would or do yield a different economic result.

Example 2 – form and substance not consistent

98. Assume a scenario where the Australian manufacturer ('Aus Co') of consumer goods sells these goods through offshore controlled distribution companies. The product is well recognised and attracts a premium in all markets compared to its competitors. Aus Co is the legal owner and developer of the trademark and the related goodwill giving rise to that premium.

[44] With regard to substance over form, the OECD Glossary of Tax Terms defines the 'substance over form doctrine' as the:

- Doctrine which allows the tax authorities to ignore the legal form of an arrangement and to look to its actual substance in order to prevent artificial structures from being used for tax avoidance purposes.

99. The Australian manufacturer incorporates a wholly owned subsidiary ('For Co') in a jurisdiction close to a number of Aus Co's major markets to act as a super distributor and invoicing centre. Aus Co continues to ship its product directly to the offshore distribution companies, but title to the product passes to For Co on a 'flash title' basis, and For Co then reinvoices the offshore distribution companies. Prior to establishing For Co, the in-country distribution companies had operated as basic buy-sell businesses. Marketing plans were developed and implemented under close supervision by Aus Co and all in country advertising and marketing expenditure was reimbursed by Aus Co.

100. Under the new arrangement, Aus Co has assigned the trademarks to For Co for consideration considered by Aus Co to be arm's length. Further, under a new intercompany agreement, For Co agrees to pay Aus Co for ongoing development and maintenance of all advertising and marketing programs together with product research and development. In addition, reimbursement of the in-country advertising and marketing expenditure is now provided by For Co. For Co has only two staff and For Co's balance sheet primarily comprises receivables and payables connected to the invoicing activities.

101. For Co pays Aus Co for the consumer goods on a cost-plus basis. According to the legal form of the intercompany agreements, For Co is now entitled to all of the income related to the intangibles on the basis that such income is attributable to goodwill created through the advertising costs now borne by For Co.

102. Based on the results of a comprehensive economic functional analysis, it is apparent that the substance of the commercial or financial relations between Aus Co and For Co is not consistent with their legal form. In particular, Aus Co continues to undertake all of the economically significant activities and assumes the economically significant risks in relation to the design, production and sale of the consumer goods. Further, For Co does not have the resources to manage or control the activities and risks it has been assigned. In these circumstances, For Co has no economic claim to income derived from the exploitation of goodwill or any other intangible, with respect to the consumer goods. It performs no functions other than invoicing and reimbursement bears no risk and, in substance, bears no costs related to the development, enhancement, maintenance or protection of intangibles.[45]

103. In this case, subsection 815-130(2) would apply and the arm's length conditions would be identified based on the analysis of the economically significant activities performed (and risks assumed) by the associated enterprises. Here, For Co would be rewarded only for its re-invoicing and reimbursement activities.

[45] See also paragraphs 2.31, 2.33 and 3.9 of the 2010 OECD TP Guidelines and paragraph 2.74(2) (c) of Taxation Ruling TR 97/20 where this issue is discussed.

Subsection 815-130(3) - Identification of the arm's length conditions based on other commercial or financial relations

104. Subsection 815-130(3) provides an exception to the 'basic rule' where:

- independent entities dealing wholly independently with one another in comparable circumstances would not have entered into the actual commercial or financial relations, and
- such entities would have entered into other commercial or financial relations, and
- those other commercial or financial relations differ in substance from the actual commercial or financial relations.[46]

105. In these circumstances, the identification of the arm's length conditions must be based on the other commercial or financial relations.

106. Subsection 815-130(3) is based on the second circumstance described in paragraphs 1.65–1.66 of the 2010 OECD TP Guidelines,[47] which states in part:

> 1.65. … The second circumstance arises where … the arrangements made in relation to the transaction, viewed in their totality, differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner and the actual structure practically impedes the tax administration from determining an appropriate transfer price. …
>
> 1.66. … Article 9 would thus allow an adjustment of conditions to reflect those which the parties would have attained had the transaction been structured in accordance with the economic and commercial reality of parties transacting at arm's length. …

107. The situation where independent parties dealing at arm's length would not have entered into the actual transaction or arrangement existed in the ECJ case of *Lankhorst-Hohorst GmbH v. Finanzamt Steinfurt* (Case C-324/00), where the court noted that the loan would not have been made between parties acting at arm's length:

> Having regard to the over-indebtedness of Lankhorst-Hohorst and its inability to provide security, it could not in fact have obtained a similar loan from a third party …

108. In such a scenario, it would be reasonable to have regard to whether an alternatively structured transaction would have occurred between independent entities dealing in comparable circumstances, such as a different loan, or a combination of a loan and an equity injection.

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[46] See also paragraph 3.99 of the EM.
[47] See subsection 3.96 of the EM. Also, the subsection is consistent with some of the discussion in paragraphs 9.169, 9.171, 9.175-9.176, 9.184 and 9.185 of the 2010 OECD TP Guidelines.

109. For the purposes of subsection 815-130(3), in identifying 'comparable circumstances', regard must be had to all relevant factors, including those stated in subsection 815-125(3).

110. Comparable means the same, similar or analogous. However, for the purpose of subsection 815-130(3), circumstances are comparable if, to the extent that the circumstances differ from the actual circumstances, the difference does not materially affect a condition that is relevant to the transfer pricing method (or combination of methods) used to identify the arm's length conditions, or a reasonably accurate adjustment can be made to eliminate the effect of the difference on a condition that is relevant to the method.[48]

Determining whether subsection 815-130(3) applies

111. The Commissioner considers that determining whether each of the requirements in subsection 815-130(3) are met will be a question of fact having regard to all relevant factors,[49] including comparability analysis[50] and whether, having regard to their own economic interests, independent entities dealing wholly independent with one another would have entered into the actual commercial or financial relations or other such relations.[51]

112. Implicit in the concept of the 'arm's length principle' is the notion that independent parties when evaluating the terms of a potential deal would compare the deal to the other options realistically available to them and would enter into the deal only if there was no alternative clearly of greater commercial advantage to the individual entity. It could therefore be said that independent parties who were dealing at arm's length would each seek to maximise the overall value of their respective entities from the economic resources available to or obtainable by them.[52]

113. The answer will depend on a survey of the commercial and financial relations and the conditions adopted by independent entities dealing wholly independently with one another in comparable circumstances. Central to the identification of the relevant arm's length conditions is a systematic and careful analysis of the comparability factors listed in subsection 815-125(3).

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[48] See subsection 815-130(5) and subsection 815-125(4).
[49] See subsection 815-130(5), which provides that subsections 815-125(3) and 815-125(4) apply for the purposes of section 815-130.
[50] Guidance on the comparability analysis is found in Chapters I and III of the 2010 OECD TP Guidelines.
[51] This is consistent with paragraphs 1.65-1.66, 9.61, 9.169, 9.171, 9.175-9.176 and 9.184-9.185 of the 2010 OECD TP Guidelines. See also paragraph 3.96 of the EM.
[52] See paragraph 1.34 of the 2010 OECD TP Guidelines.

114. This will involve an examination of whether the actual commercial or financial relations make economic and commercial sense for the parties by reference to the actual conditions adopted and a comparison with the conditions that that would have existed[53] between independent parties in comparable circumstances.

115. It is expected that the processes applied in undertaking this examination will be consistent with the guidance for applying the arm's length principle set out in Section D of Chapter 1 of the 2010 OECD TP Guidelines.

116. It is not of itself sufficient to infer that independent entities might have dealt with one another in an alternative manner. Moreover, the mere fact that actual independent entities have not been observed to deal with one another in a particular way (or that information on such independent dealings is not available) will not necessarily mean that independent entities would not have entered into the commercial or financial relations that the entities actually did.[54]

117. It may be the case that it can be hypothesised on a rational basis that the actual commercial and financial relations, even though unique, are commercially rational and best serve the separate commercial and economic interests of the tested entity having regard to the options realistically available to it; including the option of not entering the tested relations if independent entities would not have done so.[55]

Example 3 – identify the arm's length conditions based on other commercial or financial relations

118. An Australian manufacturer (the taxpayer) sells goods to a controlled distributor located in another country. Under the terms of the arrangement the distributor agrees, for a fee equal to 1% of gross sales, to accept all of the manufacturing warranty risk associated with the goods.

119. However, based on the results of a comprehensive economic functional analysis, the controlled distributor does not have the financial capacity to bear the manufacturing warranty risk, nor any ability to control or mitigate it.[56] Further, market based evidence indicates that manufacturing entities dealing wholly independently with distributors in comparable circumstances do not to assign the warranty risk to the distributor. Rather, the market based evidence indicates that manufacturing entities in comparable circumstances are responsible for the manufacturing warranty risk.

[53] It is inappropriate to be prescriptive in discussing what these conditions would be, particularly as this depends upon facts and circumstances and the availability of data on comparable uncontrolled transactions or arrangements.
[54] See paragraph 3.101 of the EM.
[55] Refer again to paragraph 3.101 of the EM.
[56] See paragraphs 9.20 and 9.29-9.33 of the 2010 OECD TP Guidelines.

120. The information and analysis leads to a conclusion that entities dealing wholly independently with one another in comparable circumstances would not have entered into the actual commercial or financial relations, but they would have entered into other relations whereby the manufacturer retains the warranty risk.

121. In these circumstances, the taxpayer must identify the arm's length conditions based on the other commercial or financial relations. This would result in elimination of the actual conditions concerning the assignment of the manufacturing warranty risk and determination of the arm's length condition(s) on that basis.

Example 4 – identify the arm's length conditions based on other commercial or financial relations

122. An Australian importer/distributor, the taxpayer, is a subsidiary member of a global group. The Australian subsidiary buys certain products from group companies overseas, and sells them to unrelated end-users in Australia. Over the years, the Australian subsidiary has undertaken market development activities at its own expense and risk, and enhanced the value of the global group's brand name, with the strategy of building its market share in Australia. These marketing activities have significantly eroded the profitability of the subsidiary such that, from its incorporation, the taxpayer consistently returns tax losses.[57]

123. Having regard to what independent entities dealing wholly independently in comparable circumstances do, it is concluded that such entities would not enter into the actual commercial or financial relations. To the contrary, having regard to what a real or hypothetical independent entity would do in comparable circumstances, taking into account its own economic circumstances and best interests, an independent entity would want its contribution to market development expenditure to be reflected in the economic contribution made by the Australian operations of the global group; for example by way of a price rebate for trading stock purchased from the owner of the brand name, and the net cost of goods sold to the Australian subsidiary of the products would be set accordingly.[58]

[57] Paragraph 1.70 of the 2010 OECD TP Guidelines states that:
… an independent enterprise would not be prepared to tolerate losses that continue indefinitely. An independent enterprise that experiences recurring losses will eventually cease to undertake business on such terms. In contrast, an associated enterprise that realizes losses may remain in business if the business is beneficial to the MNE group as a whole.

[58] See paragraphs 1.62 and 6.36-6.38 of the 2010 OECD TP Guidelines.

124. Alternatively, instead of seeking a price rebate for the goods it acquired, an independent entity dealing wholly independently in comparable circumstances would have sought separate compensation for the special costs and risks incurred in acting for the long-term benefit of the Group.[59] For example, an independent distributor might be expected to obtain an arm's length share of the intangible-related returns from the owner of the trademark or related intangibles or some other benefits.[60]

125. In these circumstances, having regard to the application of subsection 815-130(3), the Australian subsidiary should disregard the actual financial or commercial relations and identify the arm's length conditions based on other commercial or financial relations that independent entities dealing wholly independently with one another in comparable circumstances would have entered into.

Identification of the arm's length conditions based on the absence of commercial or financial relations – subsection 815-130(4) of Subdivision 815-B

126. Implicit in the concept of the arm's length principle is the notion that an independent entity would not enter into a transaction if it sees an alternative option that is realistically available and clearly more attractive[61] – including the option not to enter into any commercial or financial relations.[62]

127. The exception provided in subsection 815-130(4) applies where it can be concluded that independent entities dealing wholly independently with one another in comparable circumstances would take the option not to enter into the actual commercial or financial relations, nor any other commercial or financial relations. In this circumstance, the identification of the arm's length conditions must be based on the absence of commercial or financial relations between the entities involved[63] – that is, there is an explicit supposition that there are no commercial or financial relations.

128. Thus, if independent entities dealing wholly independently with one another in comparable circumstances would not be expected to have done anything, subsection 815-130(4) provides that the arm's length conditions are to be identified as if what was actually done had not been done. It follows that the actual conditions connected with the commercial or financial relations are completely disregarded in identifying the arm's length conditions and the overriding condition is that nothing has occurred.[64]

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[59] A similar approach under former Division 13 of the ITAA 1936 is outlined at paragraph 5.33 of Taxation Ruling TR 98/11.
[60] See paragraph 1.47 of the 2010 OECD TP Guidelines. See also paragraphs 94-96 of the Revised Discussion Draft on Transfer Pricing Aspects of Intangibles 30 July 2013.
[61] See paragraph 1.34 of the 2010 OECD TP Guidelines.
[62] See paragraphs 84, 94 and 137-138 of Taxation Ruling TR 2011/1 where the option of not entering into commercial or financial relations was also considered.
[63] The proposition inherent in this subsection is echoed in paragraphs 9.59, 9.61 and 9.175-9.176 of the 2010 OECD TP Guidelines.
[64] See paragraph 3.105 of the EM.

129. Whether the requirements in subsection 815-130(4) are met will involve the same examination as that explained above at paragraphs 111 to 117 in relation to the operation of subsection 815-30(3).

130. Importantly, any arm's length conditions that are identified under this exception are still subject to the general transfer pricing benefit requirements set out under section 815-120, meaning that this exception does not apply if disregarding the commercial or financial relations would result in the entity obtaining an Australian tax advantage (for example, an actual payment to the entity could not be disregarded under this exception).[65] As such, application of this exclusion is limited to disregarding positive actions of an entity that give rise to a transfer pricing benefit. One example of this would be where the actual commercial or financial relations result in an expense being borne by an entity that would simply not have been borne by an independent entity in comparable circumstances. In such instances, the non-recognition of the expense would result in the entity not being able to claim a deduction.[66]

Example 5 – identify the arm's length conditions based on an absence of commercial or financial relations

131. Assume the scenario set out in Example 2. In addition, For Co is required by legal agreement between Aus Co and For Co to manage and mitigate late payment risk on the part of the third party customers. In legal form, this arrangement is presented as a debt-factoring arrangement. Payment terms with third party customers are for payment in full within 30 days. For Co is contractually required to transfer payment to Aus Co on immediate receipt from third party customers. For management and mitigation of this 'late payment' risk, Aus Co will pay For Co a fee equal to 2% of gross sales.

132. Following a comprehensive economic functional analysis, the key terms of the actual commercial or financial relations do not make commercial sense for the parties such that, independent parties dealing wholly independently with one another in comparable circumstances, would not have entered into the arrangement. In particular, the evidence indicates that there is no possibility of late payment risk. As part of the economic functional analysis, it is discovered that Aus Co and For Co do not transact with third party customers unless the customers can demonstrate the existence of a binding third party guarantee. As such, the evidence indicates there is no risk of late payment of sales invoices. Furthermore, as previously noted, For Co through its financial and operational structure has no ability to control or mitigate the risk.

[65] See paragraph 3.106 of the EM.
[66] The Commissioner has taken a similar approach previously. See for example. paragraphs 180 and 197 of TR 2004/1 in the context of cost contribution arrangements and also paragraphs 94 and 137-138 of TR 2011/1 in the context of business restructuring.

133. This leads to the conclusion that independent entities dealing wholly independently with one another in comparable circumstances would not have entered into any commercial or financial relations.

134. In these circumstances, the identification of the arm's length conditions will be based upon that absence of commercial or financial relations. That is, the actual conditions are disregarded and no arm's length conditions are substituted in their place.

135. The effect is that, under subsection 815-130(4), the taxpayer is treated as taking the option of not entering into the transaction or arrangement which is annihilated.

Appendix 2 – Your comments

136. You are invited to comment on this draft Ruling, including the proposed date of effect. Please forward your comments to the contact officer by the due date.

137. A compendium of comments is prepared for the consideration of the relevant Rulings Panel or relevant tax officers. An edited version (names and identifying information removed) of the compendium of comments will also be prepared to:

- provide responses to persons providing comments; and
- be published on the ATO website at www.ato.gov.au.

Please advise if you do not want your comments included in the edited version of the compendium.

Due date:	**30 May 2014**
Contact officer:	**Andrew Peake**
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Appendix 3 – Detailed contents list

138. The following is a detailed contents list for this Ruling:

	Paragraph
What this Ruling is about	**1**
Background	**3**
The arm's length principle and the OECD	4
Object of Subdivision 815-B	7
Structure of Subdivision 815-B	9
Meaning of arm's length conditions	13
When an entity gets a transfer pricing benefit in section 815-120	14
Relevance of actual commercial of financial relations	16
Guidance in section 815-135	17
Ruling	**18**
Relevance of actual commercial or financial relations in the identification of the arm's length conditions	18
The 'basic rule'	20
The first exception to the 'basic rule' – where the 'form' of the actual commercial or financial relations is inconsistent with the 'substance' of those relations	28
The second exception – where independent entities would have entered into other commercial or financial relations which differ in 'substance' from the actual commercial or financial relations	33
The third exception – where independent entities would not have entered into commercial or financial relations	42
Interaction of sections 815-130 and 815-120	46
Interaction of sections 815-130 and 815-140	49
Example 1 - transfer pricing adjustment and thin capitalisation	53
Date of effect	**61**
Appendix 1 – Explanation	**62**
Section 815-130 relevance of actual commercial or financial relations	62
Basic rule in subsection 815-130(1)	63
Commercial and financial relations	64
Actual Conditions	72
'Form' for the purposes of section 815-130	73
'Substance' for the purposes of section 815-130	74

How to determine the 'substance' of the commercial or financial relations for the purposes of section 815-130 83

The exceptions to the basic rule 87

Subsection 815-130(2) – 'substance' prevails over 'form' 92

Example 2 – form and substance not consistent 98

Subsection 815-130(3) – identification of the arm's length conditions based on other commercial or financial relations 104

Determining whether subsection 815-130(3) applies 111

Example 3 – identify the arm's length conditions based on other commercial or financial relations 118

Example 4 – identify the arm's length conditions based on other commercial or financial relations 122

Identification of the arm's length conditions based on the absence of commercial or financial relations – subsection 815-130(4) of Subdivision 815-B 126

Example 5 – identify the arm's length conditions based on an absence of commercial or financial relations 131

Appendix 2 – Your comments **136**

Appendix 3 – Detailed contents list **138**

References

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

MT 2006/1; TR 97/20; TR 98/11; TR 2004/1; TR 2006/10; TR 2011/1

Subject references:

- actual conditions
- arm's length conditions
- arm's length principle
- arm's length profits
- comparable circumstances
- cross-border test
- multinational enterprise
- Organisation for Economic Co-operation & Development
- tax treaties
- transfer pricing

Legislative references:

- ITAA 1936
- ITAA 1936 Div 13
- ITAA 1936 170(9B)
- ITAA 1936 170(9C)
- ITAA 1997
- ITAA 1997 Subdiv 815-A
- ITAA 1997 Subdiv 815-B
- ITAA 1997 Subdiv 815-C
- ITAA 1997 Subdiv 815-D
- ITAA 1997 815-105
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- ITAA 1997 815-115(1)
- ITAA 1997 815-120
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- Hatfield v. Health Insurance Commission (1987) 15 FCR 487; 77 ALR 103
- Lankhorst-Hohorst GmbH v. Finanzamt Steinfurt (Case C-324/00)

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- The Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration, as approved by the Council of the Organisation for Economic Cooperation and Development last amended on 22 July 2010

- OECD Glossary of Tax Terms
- OECD Model Tax Convention on Income and on Capital
- Revised Discussion Draft on Transfer Pricing Aspects of Intangibles 30 July 2013

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