TR 94/14 - Income tax: application of Division 13 of Part III (international profit shifting) - some basic concepts underlying the operation of Division 13 and some circumstances in which section 136AD will be applied

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Taxation Ruling

Income tax: application of Division 13 of Part III (international profit shifting) - some basic concepts underlying the operation of Division 13 and some circumstances in which section 136AD will be applied

other Rulings on this topic

TR 92/11

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*This Ruling, to the extent that it is capable of being a 'public ruling' in terms of Part IVAAA of the **Taxation Administration Act 1953**, is a public ruling for the purposes of that Part. Taxation Ruling TR 92/1 explains when a Ruling is a public ruling and how it is binding on the Commissioner.*

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What this Ruling is about

1. This Ruling is the first in a series of Rulings/Determinations which will provide guidelines on the operation of Division 13 of Part III ("Division 13") of the *Income Tax Assessment Act 1936* ("the ITAA") and the Associated Enterprises and Business Profits Articles of Australia's double taxation agreements.

2. This Ruling provides guidelines on:

- some of the basic concepts underlying the operation of Division 13; and
- some of the circumstances in which section 136AD of Division 13 will be applied resulting in an arm's length consideration being deemed in respect of transfers of property under international agreements between separate legal entities.

3. In broad terms, this Ruling provides guidance to taxpayers and ATO staff, based on the principles contained within Division 13, to assist them to price, for tax purposes, their international dealings, particularly any international dealings between related parties so that the right amount of Australian income tax and withholding tax is payable. In providing these guidelines, it is not being suggested that taxpayers must adopt the principles contained within Division 13 for

any purpose unconnected with the calculation of their taxation liabilities. Apart from the taxation implications, the legal rights and obligations of the parties to such international dealings between non-arm's-length parties will be unaffected.

4. The guidelines provided in this Ruling are relevant to the supply and acquisition of all forms of "property". They apply primarily to goods and other tangible assets, and only discuss in broad terms:

(a) the treatment of service fees, management fees, administration fees, interest and other expense allocation issues; and

(b) the treatment of transfers of technology, trademarks and other intangible assets and their royalty income flows,

which will be the subject of more detailed later Rulings.

5. In considering the guidelines provided in this Ruling, on the application of Division 13, the terms of any relevant double taxation agreement must also be considered. The interaction of Division 13 and double taxation agreements will be the subject of later Rulings **(also see paragraphs 184 - 186)**.

6. It is not the purpose of this Ruling to deal with matters already explained in TR 92/11 ("Application of the Division 13 transfer pricing provisions to loan arrangements and credit balances").

7. This Ruling is stated in relation to dealings between separate legal entities, with a particular focus on dealings between companies, and does not address dealings between different parts of the same legal entity (e.g. branch offices, divisions and permanent establishments of a single legal entity). While the main focus of the Ruling is in respect of companies, the same principles apply where individuals, partnerships and trusts engage in dealings with separate legal entities. Where the word "associate" has been used in examples in the Ruling, this has been done for ease of explanation and should not be interpreted as implying that Division 13 cannot be applied unless companies are associated in some way **(see also paragraphs 274 - 283)**.

8. In providing these guidelines, there is no intention of laying down any conditions to restrict officers in the exercise of any discretion. Each case must be decided on its merits.

Date of effect

9. This Ruling sets out the current practice of the Australian Taxation Office and is generally not concerned with a change in interpretation. It therefore applies to years commencing both before

and after its date of issue. However, this Ruling does not apply to the extent that it conflicts with the terms of a settlement of a dispute agreed to before the date of issue of this Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

Ruling

History behind the introduction of Division 13 and adoption within it of the "arm's length principle"

10. The legislative purpose behind Division 13 is to ensure Australia can counter "non-arm's length transfer pricing" or "international profit shifting" arrangements in order to protect the Australian revenue. It provides a mechanism by which Australia adopts the internationally accepted "arm's length principle" for taxation purposes as the basis for ensuring that Australia receives its fair share of tax by adjusting profits by reference to the conditions which would have existed between independent parties under comparable circumstances **(paragraphs 154 - 157).**

11. Application of the arm's length principle requires that members of multinational enterprises ("MNEs") be treated as operating as separate entities rather than as inseparable parts of a single unified business ("the separate entity approach") **(paragraph 158)**.

12. The application of the arm's length principle for the purposes of Division 13 would have regard to: the economic value added by the functions performed, the assets and skills used, and the degree and nature of any business or financial risks involved, in the process of deriving income; in the same manner as independent parties would. It should result in prices being charged or paid for the supply or acquisition of goods and services, or assets of a capital nature, that would have been charged or paid between unrelated entities for comparable products under comparable circumstances **(paragraphs 159 - 168)**.

The role and structure of Division 13 as it applies to separate legal entities

13. Division 13 is structured to achieve its legislative purpose in respect of non-arm's length dealings between separate legal entities by focussing on basic mechanisms through which Australia may be deprived of its fair share of tax through international profit shifting, whether deliberate or not. It covers:

(a) the underpricing of goods, services or other property supplied by companies;

(b) the overpricing of goods, services and other property acquired by companies; and

(c) the inappropriate allocation of global, headquarters or other expenses against Australian income

(paragraphs 169 - 171).

14. Unless specific provisions have been made (as in the case of offshore banking) dealings between branches of the same entity or between a branch and its head office are not recognised under Australian general law or taxation law since under the general law an entity cannot deal with itself or make a profit out of itself. This is reflected in the concept of an "international agreement" on which section 136AD is based and in the specific reference in paragraph (b) of subsections 136AD(1), (2) and (3) to "two or more parties" **(paragraph 172)**.

15. Where international dealings between different parts of the same entity are concerned, section 136AE of Division 13 allows for the proper allocation of the appropriate part of the income, profits and expenses between the Australian and foreign operations **(paragraph 173)**.

16. The effect of making adjustments under Division 13 is that amounts that otherwise would not be derived under section 25 can be included in assessable income in accordance with the arm's length principle. Division 13 enables such amounts to be determined as having an Australian source or a foreign source, as appropriate. It also enables a determination of the extent to which expenses properly relate to the derivation of Australian income and the extent to which they relate to the derivation of foreign income **(paragraphs 174 - 176 and 412 - 419)**.

17. The application of Division 13 will result in the adjustment for taxation purposes of the actual consideration to an arm's length consideration. The actual terms, conditions and prices agreed upon between the parties is not affected for any other purpose **(paragraphs 174 - 178)**.

The interaction between Division 13 and Australia's Double Taxation Agreements

18. In considering the application of Division 13, the terms of any relevant double taxation agreement must be considered.
The Commissioner may apply the provisions of Division 13 and/or the treaty provisions. In the event of any inconsistency, the treaty provisions will prevail unless the treaty itself gives precedence to the domestic law **(paragraphs 184 - 186).**

The interaction between subsection 51(1) and Division 13

19. It may not be necessary to consider the application of Division 13 for the purpose of denying or reducing a deduction under subsection 51(1) of the ITAA, in respect of an acquisition of property under an international agreement, where the deduction, or the relevant part of it, is not allowable under subsection 51(1) because it:

(a) was not incurred for the purpose of producing the assessable income of the taxpayer - but for some other purpose;

(b) is properly regarded as being incurred in producing the income of another party; or

(c) was incurred in relation to the gaining or production of exempt income

(paragraphs 187 - 199).

20. Where the operation of section 51 is not clear cut, consideration would need to be given to whether a determination should be made under section 136AD:

(a) as an alternative basis upon which to support an adjustment under subsection 51(1); or

(b) to remedy the effect of profit shifting from Australia resulting from non-arm's length transfer pricing,

where the preconditions for application of section 136AD have been met **(paragraphs 188 - 203)**.

21. Even where expenditure is not deductible under subsection 51(1) because it is incurred in deriving exempt income, Division 13 may still have to be applied to increase the amount of any exempt income where it would reduce a carry forward loss and where the preconditions for its application have been satisfied **(paragraphs 197 - 199)**.

22. Where expenditure is otherwise deductible under subsection 51(1), Division 13 can apply to allow an adjustment to be made to the amount of that expenditure where the conditions for the application of the Division have been satisfied **(paragraphs 200 - 203)**.

Outline of the basic concepts

23. Section 136AD deems the consideration, in respect of the supply or acquisition of property, to be equal to the arm's length consideration, for "all purposes of the application of [the ITAA]" in relation to a taxpayer, if all the following conditions have been satisfied:

(a) the "taxpayer" has either "supplied or acquired property" under an "international agreement";

(b) the Commissioner is satisfied that, in respect of "the agreement", any "two or more of the parties were not dealing with each other at arm's length" in relation to the supply or acquisition of property;

(c) the "consideration" in respect of the supply or acquisition of property was not the "arm's length consideration", or no consideration was received or receivable; and

(d) the Commissioner determines that the relevant subsection should apply to the taxpayer in relation to the supply or acquisition of property.

(paragraphs 204 - 206)

24. Section 136AD of Division 13 may be applied to any form of cross-border dealing, where the dealing and the relevant consideration are not at arm's length. This is achieved through the use of the following terms, expressions and concepts, all of which have been given extended meanings for the purposes of the Division:

(a) "supply" and "acquire" **(paragraphs 214 - 216)**;

(b) "supply of property" and "acquisition of "property" **(paragraphs 217 - 222)**;

(c) "property" **(paragraphs 223 - 238)**;

(d) "services" **(paragraphs 229 - 237)**;

(e) "agreement" **(paragraphs 239 - 266)**; and

(f) "international agreement" **(paragraphs 267 - 272).**

The meaning of "taxpayer" for the purposes of Division 13

25. The scope of Division 13 is subject to the doctrine of territorial limitation. A "taxpayer" has to be read as a person or persons:

(a) whose income or profits or gains of a capital nature are relevant in the context of ascertaining Australian taxation liabilities (e.g. income tax or withholding tax) or losses; or

(b) who is, or is deemed by law to be, an Australian resident (including a company) or someone who has sufficient economic connection with Australia such that the person has derived Australian sourced income; or

(c) who would have derived income that would have been liable to Australian tax or relevant to the calculation of

carry-forward losses had the dealings by the person being at arm's length

(paragraphs 211 - 213).

Supply or acquisition of property

26. The word "acquire" in the context of Division 13, includes an agreement to acquire and covers things not yet in existence as capable of being acquired **(paragraphs 214 - 216)**.

27. The expressions "supply of property" and "acquisition of property" include:

(a) sales, purchases, transfers and assignments of property;

(b) leasing, hiring, hire purchase of property;

(c) the supplying or obtaining of services generally;

(d) a gift of property from one company to another or the provision of services free of charge;

(e) the provision of property to, or the obtaining of property from, a joint venture;

(f) an exchange of property (including an exchange of property for services) as part of a barter or countertrade arrangement;

(g) the conferring of any economic or commercial advantage or benefit by way of credit, loan or guarantee facilities;

(h) any transfer of technology or knowledge of any economic or commercial advantage between companies;

(i) the granting of exclusive marketing rights in a particular geographical area in respect of a product or service;

(j) dealings in respect of property which is not yet in existence; and

(k) an arrangement for a loan in which the terms of the loan are clearly established, including agreement for the payment of interest, and in respect of which the parties to the arrangement either fail to pay or fail to demand payment of the agreed interest

(paragraphs 214 - 219).

28. The supply or acquisition of property "in connection with an agreement" extends the range of matters to which Division 13 applies and includes back to back deals, side deals or collateral arrangements, and the indirect supply or acquisition of property through associates, interposed entities or third parties **(paragraph 220)**.

29. In the context of Division 13, there must be a relevant connection between the supply or acquisition of property and an "international agreement" must exist. "A taxpayer" has to be either a supplier or acquirer of property, but "the taxpayer" need not be the only party to supply or acquire property in connection with the "agreement". Nor is there any requirement for "the taxpayer" to be a party to the "agreement" in a formal sense **(paragraphs 221 - 222)**.

The meaning of the term "property"

30. In the context of Division 13, the term "property", when used in conjunction with the terms "supply" and "acquire", means that the expressions "supply of property" and "acquisition of property" can refer to both the supply or acquisition of a discrete item of property and the supply or acquisition of a number of items of property **(paragraphs 223 - 228)**.

The term "property" includes "services"

31. The word "benefit" contained in the definition of "services" encompasses anything that would bestow an economic or commercial advantage which an independent entity might reasonably be expected to pay for, or to obtain consideration for supplying. That is, something that would assist a company's profitability or net worth by enhancing, assisting or improving the company's income production, profit making, the quality of its products, or which could result in a reduction of expenses or otherwise facilitate the operations of the company. A benefit (in the relevant sense) has to be reasonably capable of being identified and valued and may be regarded as something of economic or commercial value which an independent entity might reasonably expect to pay for, or to obtain consideration for supplying **(paragraphs 229 - 237).**

32. The breadth of the terms used in the definition of "services", means that Division 13 could potentially apply to arrangements between companies relating to the use of, or the right to use, any copyright, patent, design or model, plan, secret formula or process, trade-mark, or the supply or acquisition of scientific, technical, industrial or commercial knowledge or information. The supply of commercial knowledge would include the use of marketing skills on behalf of another entity and information would include the provision of market or fashion trend information to another entity **(paragraphs 229 - 237)**.

33. "Services" includes the provision of insurance cover, the guarantee of a loan and a commitment to lend money **(paragraph 237)**.

34. In the context of Division 13, the term "property" includes:

(a) trading stock;

(b) work in progress and other business inputs;

(c) futures contracts, hedging agreements and forward sale and purchase agreements;

(d) cash and foreign exchange;

(e) options, including the property in respect of which the option is given;

(f) the provision of finance (whether by loan, the provision of credit or an advance or the purchase of commercial paper), including the terms of any such provision;

(g) debts, including the factoring and forgiveness of debts;

(h) financial products, including newly developed and developing financial products;

(i) leases and licences, including the terms upon which a lease or licence is made;

(j) hire-purchase agreements, including the terms of any such agreement;

(k) the transport of any property or personnel;

(l) service, management and administration fees;

(m) the provision of services such as administration, management, marketing, sales or distribution services by head offices or companies within a group of companies to other companies within the group;

(n) intangible assets including their development and use and their royalty income flows;

(o) gifts of money or plant and equipment;

(p) the manufacturing or processing of goods or materials belonging to someone else

(paragraphs 223 - 238).

What is an "agreement" for the purposes of Division 13?

35. The term "agreement" is broad enough to include situations where parties other than those directly involved with the supply or acquisition of property are somehow involved or can influence the outcome of the dealings between the parties directly involved **(paragraph 239 - 241)**.

36. The word agreement contained within the expression "agreement" is closest in nature to that of a contract between parties but is not limited to its strict legal sense in Division 13. It can include agreements:

(a) that are unilateral, in the sense that one party can provide a benefit to another without obtaining any consideration;

(b) where one party is acting under dictation; or

(c) which are legally unenforceable

(paragraphs 242 - 244).

37. An arrangement (and therefore an "agreement") would exist if the facts showed a course of dealing between the parties, even though no formal agreement had been entered into and no legally enforceable relationship was intended **(paragraphs 245 - 247)**.

38. The word transaction is not limited to a single act or step but includes a series of acts or steps **(paragraphs 248 - 249).**

39. The term understanding includes situations where the relevant parties have a common view regarding the maintenance of a particular state of affairs or the adoption of a course of conduct - whether or not the state of affairs or course of conduct has been unilaterally created or involves some element of mutual obligation **(paragraphs 250 - 252)**.

40. The word scheme is used in the neutral sense of a plan or system in the context of which property is supplied or acquired. It is not used in the sense of a tax avoidance scheme and does not require the demonstration of a purpose or object of avoiding Australian tax, though that may well be the effect of a particular scheme **(paragraphs 253 - 255)**.

41. Few, if any, non-arm's length dealings between companies would be unable to be brought within the operation of Division 13 where independent parties could reasonably have been expected to have sought greater remuneration or paid a lower cost in those circumstances, there was evidence of the underpayment of Australian income tax or withholding tax as a result of those dealings and the other preconditions for the application of Division 13 have been satisfied **(paragraph 256)**.

42. An "agreement" may in some cases constitute only a single step, one contract, or one arrangement. In other cases, an "agreement" may comprise a number of steps, two or more contracts, two or more arrangements or some combination of these which together form a broader "agreement" **(paragraph 257)**.

43. Where only a part of the "agreement" involves the supply or acquisition of property, this part will not be viewed in isolation but in

the context of the broader arrangement, understanding or scheme **(paragraphs 258 - 259)**.

44. The provisions of Division 13 can be applied to a particular transaction forming one part of a broader arrangement, understanding or scheme or to a scheme within a larger scheme. However, due consideration would have to be given to the existence of any broader agreement, taking account of the legislative purpose behind Division 13 **(paragraph 260)**.

45. Evidence of a course of conduct or a pattern of trading between companies may be relied upon as evidence of the formation of an "agreement" or its existence and its basic terms even though there may be no evidence to show when, where by whom or in what particular words such "agreement" was made **(paragraphs 261 - 262)**.

46. Where evidence of a course of conduct or a pattern of trading between companies exists, and that pattern of trading is not consistent with the arm's length principle and results in the underpayment of Australian income tax or withholding tax, it could be expected that Division 13 will be applied where all its preconditions for application have been satisfied **(paragraph 263)**.

47. More than one specific transaction may be covered by an "agreement" and regard would have to be given to other factors which would indicate what independent parties dealing at arm's length with each other might reasonably be expected to have done in comparable circumstances **(paragraphs 264 - 265)**.

48. Where a company is involved in two or more separate and distinct "agreements", and each "agreement" is entire in itself and unrelated to any other "agreement", Division 13 would have to be considered in the context of each or any of these separate and distinct "agreements" **(paragraph 266)**.

Provision of property under an "international agreement"

49. The existence of an "international agreement" is essential to the operation of section 136AD. An "international agreement" can in very broad terms be described as dealings between separate legal entities involving the supply or acquisition of property across international borders. The table at paragraph 272 lists all the basic combinations covered by the concept of an "international agreement". However, regard must also be had to the possible existence of "back to back" deals, side deals or other collateral arrangements, which may involve interposed entities and may have the effect that, in the context of broader "agreements", onshore dealings may be covered by the concept, as well as dealings between offshore parties **(paragraphs 267 - 272)**.

Not dealing with each other at arm's length

50. In the context of Division 13, the expression "any connection between" is not dependent upon the existence of control or share ownership. Without limiting the scope of the expression, it would include:

(a) a direct or indirect shareholding in one company by another company;

(b) the common ownership of companies even though there may be no direct or indirect shareholding between the subsidiaries;

(c) the ability of one company to obtain an interest in another company through:

(i) an existing option agreement;

(ii) the fact that convertible notes are held;

(iii) the ownership of convertible preference shares;

(d) the existence of common directors;

(e) the existence of common executives; and

(f) involvement in a cartel

(paragraphs 273 - 277).

51. Without in any way limiting the width of the expression "any other relevant circumstances," in the context of Division 13 the expression would include, for example, the existence of:

(a) a market sharing agreement or agreement not to enter a particular market;

(b) any back to back or collateral arrangements or side deals; and

(c) an income sharing agreement that does not properly reflect the contributions of the parties

(paragraphs 278 - 283).

52. Paragraph (b) of subsections 136AD(1) - (3) focuses on the type of dealing between the parties rather than merely on the relationship between them. Hence, the presence or absence of such matters as those listed in paragraph 50 above will not necessarily be determinative of whether or not any of the parties to an "agreement" were dealing at arm's length with each other **(paragraphs 277 and 284 - 286)**.

53. It will be relevant to consider whether the outcome of dealings between the relevant parties is a matter of real bargaining, in terms of the consideration that passed between them as a consequence of their dealings, and the overall manner and effect of what the parties did, for the purposes of determining whether or not they were dealing at arm's length with each other **(paragraphs 284 - 289)**.

54. The use of the concept of "arm's-length consideration" in Division 13 is modelled on the arm's length principle. This principle is in turn modelled on notions of comparison and predication about what independent parties dealing at arm's length either did or might reasonably be expected to have done in the taxpayer's circumstances. This necessarily involves consideration be given to the outcome of the dealing. It is not confined to an examination of process, though process is also relevant **(paragraph 289)**.

55. Real bargaining between related parties could be expected to be achieved where the conditions in which the bargaining is undertaken are similar to those that would exist between unrelated parties dealing at arm's length. The view has been expressed by the OECD that conditions for arm's length dealings are sometimes fulfilled by members of company groups where "the members have a considerable amount of autonomy so that they can and often indeed do bargain with each other in a manner similar to that of independent entities". We would go further and add that where such conditions do exist, failure by the members to exercise that autonomy and operate as separate profit centres, would be unlikely to lead to a result that is consistent with the arm's length principle **(paragraph 290)**.

56. Relevant factors in determining whether the relevant parties were dealing at arm's length with each other would include those matters referred to in paragraphs 291 and 292 **(paragraphs 291 - 292).**

57. The fact that the parties to an "agreement" are under common control raises an issue of whether the parties were not dealing at arm's length with each other. However, other factors such as pricing and the terms and conditions of the "agreement" may be enough to overcome this concern, if they show that the "agreement" was concluded on the basis of arm's length dealing, i.e. on rates available on the open market to the world at large and the normal terms of trade available to those parties in the relevant market were adopted. The Commissioner needs to be satisfied that all aspects of the relevant agreement can be explained by reference to ordinary commercial dealings and real bargaining, and that there is nothing that can be explained only by reference to a special relationship between the parties that indicates acquiescence or a facade **(paragraphs 284 - 297)**.

58. A strong market position may enable one entity to negotiate from a position of strength, such that the parties with whom it deals cannot negotiate their desired outcomes. Where this results from the particular dynamics of the market it does not justify a conclusion that there was an absence of real bargaining **(paragraph 298)**.

59. In order to show that real bargaining occurred in respect of dealings between related parties, it would be expected that the parties would have brought into existence during the negotiation phase the type of documentation independent parties dealing at arm's length would have used in comparable circumstances **(paragraph 299)**.

60. The documentation and information held by taxpayers needs to be sufficient to enable an effective assessment of compliance with the arm's length principle **(paragraph 299)**.

61. The mere fact that any two or more of the parties to an agreement are associated or are "connected" will not necessarily be determinative in concluding that they were not dealing at arm's length with each other **(paragraphs 300 - 302)**.

The meaning of consideration received or receivable, or given or agreed to be given

62. The word "consideration", in the context of Division 13, should be construed as a reference to anything of value that actually passes between the parties, or that was agreed to pass as payment for the supply or acquisition of property **(paragraphs 303 - 306)**.

63. In view of the context in which the word "consideration" appears in Division 13, claims that:

(a) a parent company receives immediate and adequate compensation in the form of an increase in the value of the shares it holds in a subsidiary;

(b) a parent company is likely to receive an increased flow of dividends from a non-resident subsidiary, the likely increase being adequate compensation; or

(c) a non-resident subsidiary is in the practice of paying dividends approximately equal to its after tax profits, and consequently, there has therefore been no profit shifting,

will not be accepted as forming any part of the "consideration received or receivable" by a parent company for "property" supplied to the subsidiary **(paragraphs 306 - 309)**.

Arm's length consideration

64. The arm's length consideration should be consistent with the consideration that would arise as a result of real bargaining between independent parties **(paragraphs 310 - 313)**.

65. The incurring of expenditure is not a measure of, or a substitute for, the arm's length consideration. The quantum of the expenditure incurred is but one factor (and in some cases a very important factor) to take into account in ascertaining the arm's length consideration **(paragraph 314)**.

66. Implicit in the concept of the "arm's length principle" and of the expression "arm's length consideration" used in Division 13 is the notion that independent parties who were dealing at arm's length would each compare the options realistically available to them and seek to maximise the overall value of their respective entities from the economic resources available to or obtainable by them. In this regard, all the matters referred to in paragraph 315 would be relevant.**(paragraphs 315 - 316)**.

67. The matters in paragraph 315 are also relevant in terms of paragraphs 136AA(3)(c) and (d) in determining the consideration that might reasonably be expected to have been set by independent parties dealing at arm's length with each other, regardless of the methodology that is sought to be applied **(paragraphs 315 - 316)**.

68. The appropriate arm's length consideration should reflect commercial and market realities, would have regard to the nature of competition and the nature of business (ie. what it means to compete and what it means to carry on business) whereby it would generally be expected that entities would seek to:

(a) maximise the consideration received in respect of the supply of property;

(b) minimise the consideration to be given in respect of the acquisition of property; and

(c) be adequately rewarded for the activities carried out so as to be commercially viable

(paragraphs 317 - 318).

69. The generalisation in paragraph 68 needs to be tempered with a recognition that, for legitimate commercial reasons, companies may sometimes reduce prices to gain market share or move surplus stocks or secure reliable long term distribution outlets. In such cases regard should also be had to paragraphs 139 - 141 below,**(paragraphs 317 - 318)**.

70. The ATO accepts that it could not reasonably be expected that a company would achieve the same level of profit margin in countries

where there is government intervention through pricing controls or other price regulation mechanisms that are impacting on company profits as the company would achieve in an unregulated market. This assumes that there is reliable evidence that the market price would be higher if such controls or regulatory mechanisms were not in place **(paragraph 319)**.

71. The views that members of company groups need only:

(a) cover their variable costs and make some contribution to fixed costs; or

(b) return a profit, however marginal, from their activities,

are not accepted. The "arm's length principle" and the expression "arm's length consideration" are not predicated on the basis of whether variable costs may or may not have been covered or whether any particular level of profits has been attained but rather are based on an objective determination of the consideration that might reasonably be expected to have arisen had the parties to the dealings been independent parties dealing at arm's length **(paragraph 320).**

72. If the way an "agreement" was entered into or was priced can only be explained by reference to some special relationship not able to be explained by reference to normal commercial dealings, the "agreement" will not be consistent with the "arm's length principle" if the outcome is not an arm's length price **(paragraph 321)**.

73. Determining the relevant arm's length consideration involves a practical weighing of the functions performed or to be performed, the assets and skills used or available for use, the degree and nature of risks involved and/or to be rewarded, the business strategies being pursued and the market and economic context in which the relevant parties are operating **(paragraph 322).**

74. The determination of the arm's length consideration involves an element of judgment and is not a precise science. Accordingly, taxpayers and ATO auditors need to approach cases with a degree of flexibility and commonsense, having regard to business and market realities. There will often be a range of comparable prices and taxpayers and ATO auditors need to establish the most appropriate point in the range having regard to the facts and circumstances of the particular case **(paragraph 323)**.

75. The view that because certain arrangements are common between companies in multinational groups, they should be regarded as arm's length arrangements, is not accepted. Nor is it accepted that a particular dealing is on an arm's length basis simply because it is an arrangement that can only be entered into between related parties. The fact that arm's length parties would not have entered into similar arrangements will often confirm the non-arm's length nature of the

dealings between the parties, though highly vertically integrated industries, transfers and licences of valuable intangibles and dealings in unique or highly differentiated products require further analysis **(paragraph 324)**.

76. Where related parties revise or renegotiate existing contracts or arrangements, the likely absence of a divergence of interest between the parties means that close examination will need to be given to the changed circumstances leading to the revision or renegotiation in order to be satisfied that the approach taken and outcome achieved by the related parties is consistent with what arm's length parties might reasonably be expected to have done in comparable circumstances **(paragraph 325)**.

77. A finding reached for the purposes of paragraph (b) of subsections 136AD(1) - (3), that any two or more of the parties to an "agreement" were not dealing at arm's length with each other, will not necessarily be determinative in concluding that the consideration received or receivable or given or agreed to be given for the purposes of paragraph (c) of subsections 136AD(1) - (3) was not an arm's length consideration **(paragraph 326)**.

78. Where it can be concluded that, even though there was an absence of real bargaining, an arm's length consideration was received or receivable or given or agreed to be given, as the case may be, then paragraph (c) of subsections 136AD(1) - (3) will not be satisfied and section 136AD will have no application. This conclusion does not apply to transactions like re-invoicing where no economic value is added and for which independent parties would be prepared to pay **(paragraph 327)**.

The Commissioner may deem an amount to be the arm's length consideration

79. Where for any reason (including an insufficiency of information available to the Commissioner), it is not possible or not practicable for the arm's length consideration in respect of the supply or acquisition of property to be ascertained, subsection 136AD(4) allows the Commissioner to determine an "amount" - which is then deemed, for the purposes of section 136AD, to be the arm's length consideration in respect of the supply or acquisition of property. Where the subsection is applied, the Commissioner would still need to make the relevant determination under paragraph (d) of subsections 136AD(1), (2) or (3) for Division 13 to operate **(paragraphs 328 - 334)**.

80. Subsection 136AD(4) may be applied in cases such as those involving vertically integrated industries where an arm's length consideration does not exist in respect of the goods, services

(including intangibles) or work in progress transferred. It may also be applied in cases involving unique or highly differentiated products or services, although consideration would need to be given to whether comparable products or services exist; and to the degree of difference in respect of near comparable products or services to see whether adjustments could be made to produce a valid comparison **(paragraphs 335 - 336)**.

81. Subsection 136AD(4) may be used to deem an "amount" to be the arm's length consideration where, after careful consideration of whether comparables are reasonably available, it is concluded that it would not be administratively practicable to determine the arm's length consideration **(paragraph 337)**.

82. Subsection 136AD(4) is silent as to the manner in which the relevant "amount" is to be determined. The determination of the relevant "amount" needs to be approached in a manner which, in all the circumstances of the case, would lead to a fair result that is as consistent as practicable with the arm's length principle as internationally accepted **(paragraphs 338 - 340)**.

83. The amount determined by the Commissioner under subsection 136AD(4) needs to be supported by sufficient relevant information to demonstrate that an informed and reasonable decision has been reached in the circumstances of the case **(paragraphs 339 - 340)**.

84. Given the purpose, policy and wording of Division 13, the view is not accepted that section 136AD should not be applied in the case of dealings between members of company groups where it would not be possible to arrive at an arm's length consideration because similar dealings would not occur between unrelated parties **(paragraph 341)**.

85. In situations involving dealings between related parties which may not occur between unrelated parties, the role of the Division is to consider the underlying economic and commercial reality of the situation. Regard would be had to the economic functions performed or to be performed, the assets and skills used or available for use and the degree and nature of risks involved and/or to be rewarded in respect of the various parties to the dealing. Some of the other factors listed in paragraph 315 may also be useful in this regard. In this way, a reasonable reflex can be obtained of the economic value of the contribution made by the activities carried on in Australia which can then provide a basis for comparison with the actual pricing of the inputs and outputs by the relevant company in its dealings with other entities **(paragraph 342)**.

What methodologies can be used to ascertain an arm's length consideration?

86. Division 13 does not prescribe any particular methodology for the purpose of ascertaining an arm's length consideration. Nor does it prescribe a preference for the order in which particular arm's length methodologies should be used. The Commissioner would generally seek to use methods that have been given international endorsement and to adopt the method that is the most appropriate or best suited to the circumstances of each particular case **(paragraphs 343 - 367)**.

87. In determining the most appropriate method, companies and ATO auditors should bear in mind that:

(a) the Commissioner is under no obligation to accept the particular method chosen by companies unless, on an objective analysis, it produces the most accurate calculation of the arm's length consideration in the particular case. Companies should be mindful of this and can reduce the risk of disputation by being able to demonstrate that their choice of method is the most appropriate for their circumstances (in this regard, reference should be made to paragraphs 376 - 377 on documentation);

(b) choosing the most appropriate method would take into account relevant market and business factors, the functions performed or to be performed, the assets and skills used or available for use and the degree and nature of risks involved and/or to be rewarded in respect of the various parties to the dealing;

(c) a result that is fair, in the sense referred to in *Mobil Oil Australia Pty Ltd v. FC of T* (1963) 113 CLR 475, does not mean the result that produces the most favourable taxation outcome for the company or the company group of which it may be a member - or necessarily the result that produces the highest amount of Australian tax;

(d) a result that is fair must consider the policy and objects underlying Division 13 and recognise that Australia should not be denied its fair share of tax based on the economic value it has contributed, measured by reference to the arm's length principle; and

(e) the most appropriate method will be the one that produces the highest practicable degree of comparability, recognising though that there will be unique situations and cases involving valuable intangibles where it is not practicable to apply methods based on a high degree of direct comparability

(paragraph 344).

88. The ATO accepts the comparable price method (CUP), the resale price method and the cost plus method as acceptable methodologies for the purposes of determining the arm's length consideration (or an amount for the purposes of subsection 136AD(4)) under Division 13. The method to be adopted in the circumstances of the particular case (the most appropriate method) should be the one that produces the highest degree of comparability **(paragraphs 346 - 348).**

89. In relation to the CUP method, the word "comparable" means the "same as, similar to or analogous". Even though identical dealings do not exist, there may be comparables. Care needs to be taken to ensure that the comparable chosen is as close as practicable to the dealings under review **(paragraph 353)**.

90. While the CUP method involves close product similarity, its application also requires a consideration of all other factors relevant to comparability. For example, a business strategy based on price competition would be relevant. Similarly, the marketing of an identical or closely similar product under a brand name could have a material effect on comparability **(paragraph 354)**.

91. It is recognised that in practice it is often extremely difficult to ascertain an arm's length consideration under the CUP method. This is particularly true where the property involved is unique or highly differentiated, intangible property is involved, services are provided or received, markets are isolated or where, as in the case of transfers of work in progress in highly vertically integrated businesses, there is little or no comparability with dealings of unrelated parties **(paragraph 355)**.

92. The ATO considers that the CUP method can still have application even where there are differences between the dealing being reviewed and the dealings of the parties considered to be comparable, provided those differences are capable of quantification on some reasonable basis and adjustments can be made to produce a valid comparison. Thus, an adjusted comparable uncontrolled price ("an adjusted CUP") could be acceptable as the arm's length consideration against which actual prices can be benchmarked. However, given that an element of judgment is involved in making adjustments, where the differences are significant other methods may need to be considered because such major adjustments may not result in a true comparable **(paragraphs 353 - 357)**.

93. In seeking to find an adjusted CUP, regard should be had to factors which, although not directly measurable (such as the presence or absence of a tariff, credit terms or delivery terms) are sufficiently quantifiable to make the choice of the CUP method a more accurate

measure of an arm's length consideration than the result produced by some other method. Such factors might include:

(a) whether intangibles are included (e.g. patents, copyrights, trademarks);

(b) geographic market place;

(c) level of market penetration;

(d) the provision of guarantees or after sales service;

(e) differences in functionality or the quality of functionality;

(f) the degree of physical similarity of product;

(g) volumes of sales or purchases (if volume has an effect on price) and the relevant terms of trade;

(h) whether services are provided with the goods sold;

(i) the duration of the relevant agreement and whether continuity of supply is important;

(j) whether the timing of the agreement affects the price; and

(k) whether any government regulation impacts on transfers or the price that can be charged.

(paragraph 358).

94. Unlike the CUP method, the resale price method does not require the same close physical similarity with the property sold, or that services provided be as closely comparable with those provided by the comparable arm's length seller. A lack of close physical similarity is not necessarily indicative of dissimilar mark-up percentages. A comparison is made between the mark-up charged by comparable arm's length resellers and the mark-up charged by the relevant company. Where comparable arm's length resellers cannot be identified, an appropriate profit mark-up may be determinable by reference to the functions performed or to be performed, the assets and skills used or available for use and the degree and nature of risks involved and/or to be rewarded in respect of the company reselling the relevant property or services **(paragraphs 359 - 360)**.

95. The resale price method is best suited to cases where there is a high degree of similarity of process between what the taxpayer does and the activities of independent parties engaged in comparable uncontrolled dealings. The resale price method is generally a more reliable measure where there is little useable evidence of comparable uncontrolled sales, where the property or services sold are not used in a manufacturing process of the reseller, or the reseller does not add substantially to the value of the product, e.g. where the reseller, being

merely a distributor, sells the product or service to an independent third party **(paragraph 361)**.

96. Where the non-arm's length reseller adds substantial value to the property (e.g. where the products are further processed through manufacture or are incorporated as components of a more complicated product so that the identity of the original products is lost or transformed or the taxpayer establishes, builds up or maintains a valuable trademark in the relevant market largely through its own expense and endeavour), a portion of the resale price is attributable to this effort. This addition would need to be assessed and accounted for, making it more difficult to establish an arm's length consideration and consequently, more difficult to apply this method **(paragraph 362)**.

97. In applying the cost plus method the profit mark-up is ideally determined by reference to the profit mark-up earned by the same supplier in a comparable dealing with an independent party. If there are no comparable sales by the non-arm's length supplier to arm's length parties, the profit mark-up is generally determined by reference to the profit mark-up earned by a comparable arm's length party in a comparable dealing with an independent party **(paragraph 363)**.

98. The cost plus method is generally a more reliable measure where components or unfinished goods are subject to additional manufacturing, assembly, addition of trade marks, etc prior to distribution, provided the process does not involve high value intangibles (sometimes unique) **(paragraphs 364 - 365)**.

99. There may be situations, including but not confined to those dealing with intangibles, where CUP, resale price and cost plus methods are inadequate in approximating a satisfactory arm's length outcome. This leads to the need to have regard to other methods such as profit methods, and to develop methods that have regard to commercial and economic reality, the merits of each case, and the standard of the arm's length principle. That is not to say that companies and the ATO ought to depart from the first three methods referred to above merely because it is easier or administratively convenient. A profit method, as with any other method should be used where it is the most appropriate method because it produces the highest practicable degree of comparability in the circumstances of the particular case **(paragraphs 366)**.

100. Where the CUP, resale price or cost plus methods are inappropriate on their own in a given case, having regard to commercial and economic realities and the nature of the company's business, products and markets, for the purposes of determining the arm's length consideration (or an amount for the purposes of subsection 136AD(4)) under Division 13, we will accept the use of:

(a) a mixture of the above three methods; or

(b) some other method (e.g. a profit split or profit comparison method) or a mixture of methods:

that is likely to lead to a result that is as consistent as practicable with the arm's length principle as internationally accepted **(paragraph 367)**.

Documentation

101. Division 13 imposes obligations on taxpayers to use best endeavours to lodge correct tax returns and to pay the right amount of tax based on the economic value added in the respective jurisdictions (calculated in accordance with the arm's length principle). Other provisions impose general obligations on taxpayers to lodge accurate returns. Taxpayers are advised to create and keep contemporaneous records in order to demonstrate that their international dealings comply with the arm's length principle. However, records created during the setting of transfer prices and used in preparing tax returns are required by section 262A to be retained. It is not accepted that taxpayers need not address the question of whether their pricing policies comply with the arm's length principle until they are subject to audit by the ATO **(paragraphs 368 - 371)**.

102. The ATO will seek to rely as much as possible on documentation that should be created in the ordinary course of business. However, in order to satisfy the arm's length principle taxpayers who deal with related parties need to do an analysis in accordance with the principles set out in this Ruling. In this regard we will limit requirements to the minimum necessary to ensure compliance with the arm's length principle **(paragraphs 372 - 373)**.

103. For the purposes of ascertaining the most appropriate method for determining the arm's length consideration in respect of the supply or acquisition of property under an international agreement and also for determining whether resort may need to be made to subsection 136AD(4), we will ask companies:

(a) what methodology they are using;

(b) the reasons why they consider their choice of methodology to be the most appropriate to the relevant international agreement(s) and to their particular circumstances; and

(c) how and why they chose the particular price as a result of applying their chosen methodology

(paragraph 374).

104. In testing a taxpayer's methodology and in those cases where no particular methodology has been chosen by companies to set their international transfer prices in relation to the supply or acquisition of property under an international agreement, we will be asking their opinion as to:

(a) which products, goods or services, etc, if any, they consider to be most comparable to the products, goods or services being investigated;

(b) who their major competitors are;

(c) which of their competitors they consider to be most comparable to them; and

(d) what they consider to be the most appropriate methodology to use in their particular circumstances.

This information will be considered in determining whether resort may need to be made to subsection 136AD(4) **(paragraph 375)**.

105. In undertaking an analysis of whether the consideration for the supply or acquisition of property under international agreements represented an arm's length consideration, we will ask companies to provide relevant documentation created when the dealing was being contemplated and at the time the arrangement was entered into. Where there is inadequate contemporaneous documentation of non-arm's length international dealings, it is clearly more difficult for companies to convince us that the dealings took place on an arm's length basis. However, companies will be given the opportunity to explain their business circumstances and pricing policies **(paragraph 376)**.

106. We will ask companies under audit to provide relevant documents, explanatory material and other information which the company has or to which the company could reasonably be expected to have access. The nature of the documentation likely to be sought would include relevant pricing policies, product profitabilities, relevant market information (such as sales forecasts and market characteristics), the profit contributions of each party, and an analysis of the functions, assets, skills and the degree and nature of the risks involved for the various parties **(paragraph 377)**.

107. Where international agreements are being contemplated by companies in the same multinational group, the risk of the Commissioner seeking to make an adjustment under of Division 13 can be considerably reduced where the companies involved:

(a) establish the economic justification prior to the arrangement being entered into;

(b) satisfy themselves that the consideration is an arm's length consideration;

(c) have the necessary contemporaneous documentation to support the matters referred to in (a) and (b) above and the assessment of market conditions at the time the pricing decisions were made;

(d) provide reasons why the chosen methodology is appropriate to their circumstances. However, companies would not be required to undertake an intricate analysis of other methodologies but should have a sound basis for using the selected methodology;

(e) establish a systematic arm's length process for setting international transfer prices and consistently follow the process they have established; . and

(f) conclude an advance pricing agreement with the ATO, in appropriate cases

(paragraphs 378 - 381 and 385 - 386).

108. Where contemporaneous documentation does not exist, companies should review their pricing policies against the principles set out in this Ruling and satisfy themselves that they accord with the arm's length principle and that dealings with related parties have been carried out on that basis. Documentary evidence that such reviews have been done should reduce the risk of disputation to the extent that the review properly addresses the requirements of the arm's length principle. However, for the future, companies would be well advised to maintain contemporaneous documentation **(paragraph 382)**.

109. Where a company finds on review that its pricing policies do not comply with the arm's length principle, the company should request an amended assessment under subsection 170(1). Assessments amended in this way will not be treated as involving the exercise of the Commissioner's discretion under Division 13 and therefore will not activate section 225 penalties. Normal procedures regarding voluntary disclosures would apply **(paragraph 383)**.

110. Division 13 is seen as imposing an obligation on taxpayers to conform to the arm's length principle for tax purposes in respect of international dealings. Accordingly, it is expected that companies will take reasonable care to ensure that when preparing their tax returns they properly review the data available to them and address the question of whether the amounts of income and deductions included in their tax returns have been calculated according to the arm's length principle. Where companies have not used arm's length consideration in the ordinary course of their day to day dealings with non-arm's

length parties, an adjustment should be made for tax purposes at the time of preparation of their tax returns **(paragraph 384 - 385)**.

Access to relevant information

111. Where a company has been tardy or unco-operative in providing all the relevant information from Australian or overseas sources, formal requests should be made under section 264A and/or the relevant double taxation agreement for information held offshore to enable the audit to be completed within a reasonable time frame **(paragraph 387 - 388)**.

112. The fact that section 263 or section 264 have already been used or might be used in the future does not prevent the use of section 264A notices, or the exchange of information provisions under double taxation agreements, though ATO auditors should take care to avoid unnecessary duplication. However, on occasions auditors may need to verify information if there is reason to believe that the information provided may be inaccurate, misleading or incomplete **(paragraph 388).**

113. We will seek such information as will establish how transfer prices were set in respect of dealings between related parties at an early stage of an audit. Where such information is either not held or able to be obtained by a company operating in Australia but could reasonably be expected to be held by the company's foreign parent or some other offshore related entity, ATO auditors should consider whether an offshore information notice under section 264A and/or a request to a foreign tax administration under a double tax agreement should issue with a view to obtaining such information **(paragraph 389)**.

The Commissioner has a discretion whether or not to apply section 136AD

114. In exercising the discretion in paragraph (d) of subsections 136AD(1), (2) and (3) the Commissioner must take into account all relevant facts and circumstances as they existed at the time the international agreement was made in forming a view as to whether the amount of consideration in an international agreement needs to be adjusted. It would also be relevant to consider subsequent events to the extent that they are relevant to testing purpose or assist in determining the true nature of any agreement by comparing the conduct of the parties and the stated terms of the agreement. The Commissioner must not consider irrelevant circumstances **(paragraphs 390 - 391)**.

115. In particular the Commissioner needs to be satisfied that the various preconditions in subsections 136AD(1), (2), or (3) are met as

the case may be. Consideration also needs to be given to whether the exercise of the discretion, or a failure to exercise it, would be consistent with the policy underlying Division 13 **(paragraph 392).**

116. It would also be relevant to consider whether there is any evidence of the taxpayer's purpose since this would also be a relevant factor. However, this would need to be weighed with other factors, including the effect on the Australian revenue of the use of non-arm's length consideration, against the wording and legislative purpose of section 136AD **(paragraph 393)**.

117. Having regard to the legislative intent, where paragraphs (a), (b) and (c) of subsections 136AD(1) - (3) have been satisfied, then, in the absence of sound reasons to the contrary, it could be expected that the discretion in paragraph (d) of the relevant subsection would be exercised where the Australian revenue has been disadvantaged **(paragraph 394)**.

118. Where the discretion under paragraph (d) of subsections 136AD(1), (2) or (3) is exercised, a formal determination should be made to that effect **(paragraph 395)**.

Does a tax avoidance purpose need to exist before Division 13 can apply?

119. It is the view of the ATO that the Commissioner does not have to identify a tax avoidance purpose in order to invoke the discretion in paragraph (d) of subsections 136AD(1), (2) and (3). Cases where there is a tax avoidance purpose are clearly intended to be countered by Division 13 where the use of non-arm's length consideration results in an underpayment of Australian tax. But it does not follow that the absence of a tax avoidance purpose renders the Commissioner's discretion inoperative **(paragraphs 401 - 407)**.

120. Where a tax avoidance purpose exists in relation to a matter being considered in the context of Division 13, then Part IVA may also have application, where the particular requirements of Part IVA are satisfied **(paragraph 408)**.

121. Penalties are imposed under section 225 of the ITAA, where Division 13 has been applied, notwithstanding the absence of a tax avoidance purpose. The existence of a tax avoidance purpose is, however, a factor to consider in the imposition of such penalties **(paragraph 409)**.

Higher tax rates in foreign countries in themselves do not suggest an absence of profit shifting

122. The view that profits are not shifted overseas where foreign nominal or effective company tax rates are comparable to the prevailing company tax rate in Australia, and hence that Division 13 should not be applied in such cases, is not accepted because it ignores the need to protect Australia's legitimate taxing rights **(paragraphs 410 - 411)**.

The source of income

123. In determining the source or sources of income or the extent to which expenditure was incurred in deriving income for the purposes of section 136AE, regard would be had, amongst other things, to:

(a) the nature and extent of any relevant business activities;

(b) the place or places at which the business is carried on;

(c) the functions performed in each country, the assets and skills employed in each country and the risks and responsibilities borne by the various entities;

(d) the economic value added to the relevant property in each location;

(e) the application of common law rules relating to source;

(f) the degree of connection between each amount of expenditure and the income derived in each jurisdiction;

(g) other circumstances relevant to a particular company and "agreement"; and

(h) the operation of any source rules in any applicable double tax agreement.

(paragraphs 412 - 419).

124. The inclusion of the words "as to the extent to which" in relation to the Commissioner's determination of the source of income have the effect that the Commissioner can make that determination in relation to a part of the arm's length consideration that has been deemed to have been received or receivable **(paragraphs 414 - 416)**.

125. Regard must also be had to the operation of any source rules contained within Australia's double tax agreements. In that regard, the determination of source may differ depending on the type of income involved **(paragraph 417)**.

Transfers of property including trading stock and other goods and services

126. Subsection 136AD(1) could generally be expected to apply where a person carrying on business in Australia sells property overseas at a reduced price in a non-arm's length dealing, unless there was cogent evidence that the consideration received or receivable was, in reality, the arm's length consideration **(paragraph 420)**.

127. Where the consideration is, prima facie, less than the arm's length consideration, companies would be expected to:

(a) have ascertained what an arm's length consideration might reasonably be expected to be in respect of the relevant supply of property; and

(b) be able to supply the necessary contemporaneous documentation or - in the case of past dealings where contemporaneous documentation was not kept - a reasoned case based on all the facts and circumstances that then applied to support the transfer prices that have been adopted. For the future, companies should maintain sufficient contemporaneous documentation to enable tax returns to be prepared having regard to the arm's length principle

(paragraph 421).

128. Where a foreign parent company directs its Australian associated company what the price will be for the acquisition of property, to be exported from Australia, it cannot be said that the parties are dealing at arm's length with each other as there is no real bargaining between the parties in respect of the acquisition of property. Subsection 136AD(1) could therefore normally be expected to apply to such cases where the other requirements of the subsection are satisfied **(paragraph 423)**.

129. It is not accepted that independent parties dealing at arm's length would supply goods free of charge except in very narrow circumstances. We would require *very convincing proof* that such circumstances have arisen before accepting a nil or reduced payment between associated enterprises as being equivalent to the arm's length consideration **(paragraphs 424 - 425)**.

130. Subsection 136AD(3) could generally be expected to apply where profits have been shifted out of Australia by a person carrying on business in Australia purchasing property from overseas at an inflated price in a non-arm's length dealing **(paragraph 426)**.

131. In cases where the consideration given or agreed to be given for purchases is, prima facie, more than the arm's length consideration, companies would be expected to meet the criteria stated in paragraph

127 above to support contentions that the transfer prices adopted represent the arm's length consideration **(paragraph 427)**.

132. Where a foreign parent company advises its Australian associated company what the price will be for property to be imported into Australia, or has directed the return that the Australian associated company is to make, it could not be said that the parties were dealing at arm's length with each other as there has been no real bargaining. Subsection 136AD(3) could therefore normally be expected to apply to such cases where the other requirements of the subsection are satisfied **(paragraph 428)**.

133. Where non-resident companies have incurred expenditure on behalf of, or provided services to, their Australian associates and have charged amounts which exceed the value of the economic benefits obtained by the Australian associate, subsection 136AD(3) could normally be expected to apply to reduce the consideration to an arm's length consideration (which in some cases may be the cost and in some other cases may be a nil amount - as would be the case with shareholder costs). Regard should also be had to the possible disallowance of expenditure not complying with the requirements of subsection 51(1) **(paragraph 429)**.

134. Where doubt exists about the financial capacity of an associated entity to pay an arm's length consideration, it would generally not be acceptable for companies to simply reduce the purchase price or to indefinitely defer demands for payment without some form of compensation or security being provided to the supplier of the goods. The nature of any compensation or security to be provided would need to be consistent with what independent parties dealing at arm's length with each other would agree to if faced with similar circumstances **(paragraphs 430 - 431)**.

135. Where a range of "property" (not including intangible property or services) is supplied or acquired under a broadly based (or "umbrella") agreement covering one or more product lines, on occasions referred to as a "basket of goods", and there are genuine commercial reasons for selling some products at less than the market price - or even supply them free - in order to make a higher overall profit on its sales of products to the same buyer, the ATO would generally not make an adjustment under Division 13 provided independent parties dealing at arm's length might reasonably have been expected to have entered into a comparable "agreement". In cases of transfers of goods between associated entities, it would be relevant to consider, inter alia:

(a) the price eventually realised upon resale to an independent party;

(b) the overall profit made on a "basket of goods" with the total profit that could be made on the basis of individual product sales; and

(c) whether the business strategy resulted in any deferral or avoidance of tax

(paragraphs 432 - 438).

Effects on the value of opening and closing trading stock where an adjustment is made under subsection 136AD(3)

136. Where a determination made under subsection 136AD(3) has the effect of reducing the actual consideration in respect of the acquisition of trading stock, to an arm's length consideration given or agreed to be given, there may also be a need to revise the value of closing stock on hand at the end of the financial year (depending on the method of accounting for trading stock), as any determination made under section 136AD applies for all purposes of the ITAA. Such purposes would include any effect on closing trading stock values at the end of the relevant year of income, as well as the opening stock values in the succeeding year of income. There may also be a continued flow-on effect for later years **(paragraphs 439 - 440)**.

Existence of a business purpose insufficient in itself to avoid Division 13

137. The existence of a business purpose is not in itself sufficient to preclude the making of a determination under section 136AD where the conditions for its application are met **(paragraphs 441 - 444)**;

"Start up", "market penetration and "obsolete stock prices"

138. Where Australian producer/wholesaling companies reduce or discount the price at which property is supplied to foreign marketing/distribution associates and the price reduction or discount is for the purpose of increasing market share, establishing a new market in the foreign country, introducing its products into an existing market in the foreign country or to clear surplus or obsolete stock, then, whether Division 13 will apply in such cases will depend on the facts and circumstances of each case and in particular on:

(a) the discounted prices being charged for only a limited period, in accordance with a genuine business strategy and with the specific objective of improving the profits of the Australian producer in the longer term;

(b) the research and analysis undertaken at the time to support the business strategy;

(c) the market conditions prevailing at the time;

(d) the market impact of any price discount strategies and the financial and taxation consequences for the parties involved; and

(e) regard being given to what independent parties dealing at arm's length might reasonably have been expected to have done in comparable circumstances

(paragraphs 445 - 451).

139. Where goods are sold to an independent distributor at discounted prices to increase the distributor's profit and thereby entice the distributor to become tied to the supplier's products, or at least provide a reliable competitive outlet for the goods, Division 13 would not normally be applied in such a case unless there is evidence of some back to back or collateral arrangement or side deal **(paragraph 452)**.

140. Where goods are sold to a related party distributor, and the related party has a high level of independence, operates as a truly separate profit centre with authority (which it exercises) to deal with third party suppliers, and adopts arrangements similar to those used by independent distributors in that market, Division 13 would not normally be applied unless the particular case exhibits other abnormal features that are inconsistent with independent dealing **(paragraphs 445 - 453)**.

141. On occasions, foreign producer companies selling goods through an associated marketing/distribution entity in Australia may wish to establish a new market in Australia, increase market share, introduce its products into an established Australian market, or to clear surplus or obsolete stock and therefore direct that lower prices be charged to unrelated Australian buyers, without at the same time decreasing the prices charged to their Australian distributor. The pricing of such arrangements would generally only be acceptable for tax purposes where:

(a) the discounted prices were charged for only a limited period, in accordance with a genuine business strategy and with the specific objective of improving the profits of both the foreign producer and Australian marketing entity in the longer term;

(b) they reflected the respective contributions of the producing and marketing/distribution entities in terms of: the nature of functions performed; the assets and skills

used; and the degree and nature of any business or financial risks involved; and

(c) regard had been given to what independent parties dealing at arm's length might reasonably have been expected to have done in comparable circumstances

(paragraphs 445 - 449 and 454 - 457).

The treatment of joint venture arrangements

142. The provision of property to a joint venture falls within paragraph (b) of the definition of "supply" in subsection 136AA(1) **(paragraphs 458 - 461)**.

143. Where property is supplied to or acquired from a joint venture, it will be the value of that property which will be relevant for the purposes of Division 13 **(paragraph 462)**.

144. Subsections 136AD(1), (2) or (3) may be applied to either or both of the supply or acquisition of property having regard to the value of the contribution to the joint venture, the product sharing agreement and the division of output between the joint venturers **(paragraph 463)**.

145. Where property is supplied to a joint venture under an "international agreement", subsection 136AD(1) could normally be expected to apply to any of the joint venturers who were not dealing at arm's length with each other and where the consideration in respect of the supply of property was less than an arm's length consideration. Similarly, subsection 136AD(2) may be expected to apply where no consideration was received in respect of the supply of property **(paragraph 464)**.

146. The output or product of a joint venture obtained by each joint venturer would fall within paragraph (b) of the definition of "acquire" in subsection 136AA(1). Where property is obtained from a joint venture under an international agreement, subsection 136AD(3) could normally be expected to apply to any of the joint venturers who were not dealing at arm's length with each other and where the consideration in respect of the acquisition of property was more than an arm's length consideration **(paragraph 465)**.

147. The fact that the joint venturers may have agreed upon the value to be ascribed to the property provided by each of the joint venturers or to the share of the product of the joint venture obtained by each of the joint venturers does not automatically mean that such agreed values represent the arm's length consideration in respect of the supply or acquisition of the relevant property **(paragraph 466)**.

148. In ascertaining the arm's length consideration in respect of property provided to or obtained from a joint venture, regard should be had to the matters referred to in paragraph 467 **(paragraph 467)**.

The treatment of barter and countertrade arrangements

149. In respect of arrangements where a company issues shares in itself in exchange for property, the general principles espoused in this Ruling would apply **(paragraphs 468 - 470)**.

150. Section 136AD could be expected to apply to barter and countertrade arrangements involving the supply or acquisition of property under international agreements where the parties to the barter or countertrade arrangement were not dealing at arm's length with each other and the value of the consideration is not arm's length in respect of the relevant supply or acquisition **(paragraphs 468 - 472)**.

151. In barter arrangements under international agreements, there is both a supply and acquisition of property (by virtue of the word "exchange" in paragraph (a) of the definitions of "supply" and "acquisition" in subsection 136AA(1)). Both sides of any barter or countertrade arrangement should be benchmarked against arm's length prices to ensure that the consideration received or given respectively is equivalent to the value of what is being supplied or acquired **(paragraph 473)**.

152. For the purposes of ascertaining the arm's length consideration that might reasonably be expected to have been agreed in respect of the supply and acquisition of property under a barter arrangement, we will accept as indicative of an arm's length consideration:

(a) the cash price and terms which the company would normally have obtained from an independent party dealing with the company at arm's length for the supply of the property; and

(b) the cash price and terms which the company would normally have expected to have agreed to with an independent party dealing with the company at arm's length for the acquisition of the property

(paragraph 474).

153. The fact that the parties to a barter arrangement may have agreed upon the value to be ascribed to the property contributed by each of them, does not automatically mean that such agreed values represent the arm's length consideration in respect of the supply or acquisition of the relevant property. It will be the arm's length consideration which will be relevant for a range of purposes including

depreciation, trading stock valuation and capital gains calculations **(paragraph 475)**.

Explanations

History behind the introduction of Division 13 and adoption within it of the "arm's length principle"

154. The legislative purpose behind Division 13 is to ensure Australia can counter "non-arm's length transfer pricing" or "international profit shifting" arrangements in order to protect the Australian revenue. Expressed another way, Division 13 provides a mechanism by which Australia can ensure that it receives its fair share of tax based on the economic value added by activities carried on in Australia or involving the use of Australian assets, infrastructure and skills, and measured by reference to the internationally accepted arm's length principle. It covers cases where there has been an undercharging in respect of property or services supplied or an overcharging for property or services acquired, regardless of whether any resulting shortfall in Australian tax is due to deliberate tax avoidance or merely due to the adoption of an incorrect pricing method for taxation purposes (whether through misunderstanding, carelessness, recklessness or miscalculation or the inappropriate use of a methodology).

155. The current Division 13 (sections 136AA - 136AG) was introduced into the ITAA by the *Income Tax Assessment Amendment Act 1982* to overcome deficiencies in the application of the former Division 13 (section 136), exposed by the decision of the Full High Court in *FC of T v. Commonwealth Aluminium Corporation Ltd,* (1980) 143 CLR 646 and other potential deficiencies (as described in the Explanatory Memorandum to the *Income Tax Assessment Amendment Act 1982* ("Explanatory Memorandum") at pages 3-4).

156. Unlike the former section 136, the operation of Division 13 does not require that the dealings be between companies under common "control" or "share ownership" (Explanatory Memorandum at page 3). Division 13 applies equally to Australian and foreign owned entities. It adopts the internationally accepted "arm's length principle" for taxation purposes as the basis for determining whether Australia has been denied its fair share of tax.

157. The "arm's length principle" is stated in Article 9(1) of the 1977 Organisation for Economic Co-operation and Development ("OECD") Model Double Taxation Convention on Income and on Capital and more recently in Article 9(1) of the 1992 OECD Model Tax Convention on Income and Capital. It provides:

> "[When] conditions are made or imposed between ... [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."

158. The arm's length principle is predicated on the basis of adjusting profits by reference to the conditions which would have existed between independent parties under comparable circumstances. Application of the arm's length principle requires that members of multinational enterprises ("MNEs") be treated as operating as separate entities rather than as inseparable parts of a single unified business ("the separate entity approach"). This accords with their legal status as separate entities. Because the separate entity approach treats the members of MNEs as if they were independent entities, attention is focused on the nature of the dealings between those members.

159. In practical terms - and in the absence of "back to back" deals, side deals or other collateral arrangements - the application of the "arm's length principle" should result in prices being charged or paid for the supply or acquisition of goods and services, or assets of a capital nature, that would have been charged or paid between unrelated entities for comparable products under comparable circumstances. In setting the price to be charged, independent entities would have regard to the functions they had to perform, the assets and skills they had to use and the degree and nature of any business or financial risks involved in the process of deriving their income. Similarly, in deciding how much to pay for goods, services or other property, an independent entity would also consider these issues.

160. MNEs often integrate their activities so as to obtain a competitive advantage or cost reduction. Notwithstanding this legitimate objective and the fact that such arrangements may present unique situations, dealings between the various parts of MNEs and with associates and others must also have regard to the legitimate interests of the nations in which they operate who:

> "need to determine the proper level of taxable profits of the affiliated enterprises operating within their respective jurisdictions".
>
> [paragraph 3 of the 1979 Report of the OECD Committee on Fiscal Affairs, titled "Transfer Pricing and Multinational Enterprises" ("the 1979 OECD Report")].

161. In other cases, valuable intangibles are used by one or more parties operating together in an international context.

162. An analysis of functions, assets and risks will assist the allocation of income and expenses in all the above cases and is consistent with what independent enterprises would do in order to set prices.

163. Notwithstanding the fact that global manufacturing and trading often presents unique situations that do not occur between independent enterprises, it is generally accepted by tax authorities around the world that the arm's length principle has application to these cases and is the best approach to the determination of fair shares of revenue between countries in respect of dealings and financial relations between associated entities.

164. For the purposes of Division 13, the arm's length principle is reflected in subsections 136AD(1), (2) and (3) through the requirements for "not dealing at arm's length with each other" and "arm's length consideration" in relation to "international agreements". The "arm's length principle" also underlies the allocation of profits and expenses for tax purposes in each of Australia's comprehensive double taxation agreements.

165. In a speech to the Australian Mining Industry Council on 25 March 1983 ("the 1983 Speech"), the then Second Commissioner of Taxation, Mr Boucher said:

> "(Division 13) state(s) the basic principle to be applied - the arm's length principle - in a way that (section 136) never did. ... (T)he new law in large measure represents a statutory expression of a principle that had been found by interpretation to exist in section 136. That is put in a few words by the Taxation Board of Review in the celebrated 1963 oil industry case when it said -
>
> > ".... the independent arm's length test prescribed .... (in the U.K. tax treaty) .... is not materially different from the fair market value test, which in our opinion, is the primary but not the exclusive yardstick to be applied in making determinations under section 136."."

[Note: The reference to the "1963 oil industry case" is a reference to Case N69, [1962] 13 TBRD (NS) 270; 11 CTBR (NS) Case 53].

166. In other words, the arm's length principle tries to reflect the characteristics of supply and demand and competition in an open market and uses the behaviour of independent entities as a guide. It poses the question: what would a reasonable business person do in the circumstances of the taxpayer in order to protect and advance their own economic interest?

167. It follows from the very nature of the arm's length principle that comparability is central to its operation. Tax authorities try, by various methodologies, to compare what the related entities have done to what independent entities have done or would have done in comparable circumstances. This can be done directly by the use of comparable uncontrolled prices or less directly by the use of "cost plus" or "resale price" methodologies which focus on profit margins. Where these methodologies are inapplicable or not practicable, other indirect methods such as profit splits and profit comparisons, which also involve comparisons with rates of return for comparable activities, should be considered. All of these methodologies are considered by the ATO as compatible with the arm's length principle. This is not to suggest that taxpayers and ATO auditors need to exhaustively explore each methodology in some sort of hierarchy before a selection is made. These methodologies are discussed further below and will be the subject of a separate detailed Ruling.

168. The methodology that on the basis of the facts and circumstances of the case will produce the highest degree of comparability (between what the related entities have done and what independent entities have done or might reasonably be expected to do in comparable circumstances) is the one that should be used. It should be noted in this regard that in some cases indirect methodologies may have to be used if there are no reasonably reliable direct comparables. The matters listed in paragraph 344 also need to be borne in mind.

The role and structure of Division 13 as it applies to separate legal entities.

169. Where non-arm's length dealings between separate legal entities occur across international borders, questions often arise as to the proper allocation of income, profits and expenses between the respective tax jurisdictions. Putting to one side the operation of Australia's double tax agreements (see paragraphs 184 - 186 below), Division 13 has the role of ensuring that Australia is not deprived of its fair share of tax as a consequence of international profit shifting. As stated by Mr Boucher in his 1983 Speech:

> "this particular area of the legislation is designed so that it may, as necessary, have application to all possible forms of profit shifting."

170. Division 13 is structured to achieve its legislative purpose by focussing on basic mechanisms through which underpayment of Australian tax may occur, whether deliberate or not. It covers:

(a) the underpricing of goods, services or other property supplied by companies;

(b) the overpricing of goods, services and other property acquired by companies; and

(c) the inappropriate allocation of global, headquarters or other expenses against Australian income.

171. Division 13 codifies this approach by using the concept of the supply or acquisition of property under an "international agreement", coupled with a statutory power in the Commissioner to adjust cases of underpricing and overpricing back to the arm's length consideration in order to protect the Australian revenue.

172. Special statutory rules in respect of permanent establishments (branch offices) are necessary to ensure that Australia gets its fair share of tax because Australia's domestic legislation adopts the "single entity approach". That is, dealings between branches of the same enterprise or between a branch and its head office are not recognised under Australian general law or taxation law since an entity cannot deal with itself or make a profit out of itself, although specific statutory provisions have been made for offshore banking. This is a fundamental principle reflected in the concept of an "international agreement" on which section 136AD is based and in the specific reference in paragraph (b) of subsections 136AD(1), (2) and (3) to "two or more parties".

173. This approach differs from the practice in most other OECD countries where a branch office of a company is treated (at least for taxation purposes) as a separate legal entity. Where international dealings between different parts of the same entity are concerned, the issues to be addressed for Australian taxation purposes are those of properly allocating the appropriate part of the income, profits and expenses between the Australian and foreign operations. In these cases, section 136AE is the relevant provision to consider (see paragraphs 412 - 419).

174. Division 13 does not operate as a stand-alone assessing provision. It operates in conjunction with other provisions of the ITAA to produce the effect that in relevant cases, income or assessable income is increased, deductions or losses are reduced so that the right amount of Australian income tax and withholding tax is payable.

175. The adjusted consideration under the relevant "international agreement" becomes the relevant component of assessable income (including capital gains) or the amount of allowable deduction as the case may be. For example, an increase in the consideration for goods sold will have the effect that the gross sales income for the purposes of section 25 is correspondingly increased. Adjustments under Division 13 which affect the amount of exempt income may in turn affect the amount of any carry-forward losses.

176. The effect of making adjustments under Division 13 is that amounts that otherwise would not be derived under section 25 can be included in assessable income in accordance with the arm's length principle. Division 13 enables such amounts to be determined as having an Australian source or a foreign source, as appropriate. It also enables a determination of the extent to which expenses properly relate to the derivation of Australian income and the extent to which they relate to the derivation of foreign income (also see paragraphs 412 - 419).

177. Where a determination has been made under Division 13, provision is also made for compensating (consequential) adjustments where the conditions of section 136AF are met. The application of section 136AF will be discussed in detail in a later Ruling.

178. While application of Division 13 will result in the adjustment of the actual consideration to an arm's length consideration, it must be emphasised that any such adjustment only applies "for taxation purposes". That is, the actual terms, conditions and prices agreed upon between the parties in relation to the supply or acquisition of the relevant "property" is not affected for any other purpose.

Division 13 has a broad scope

179. In order to achieve its policy objective, Division 13 has been drafted in broad terms. Subsection 136AB(1) gives it priority over every provision of the ITAA other than Part IVA. In this regard subsection 136AB(1) provides that nothing in the provisions of the ITAA (other than provisions contained within Division 13 itself) shall limit the operation of the Division. For example, the fact that transfer prices may have the effect that profits are shifted out of Australia notwithstanding the provisions of sections 25 and 51, Division 13 enables a reallocation of the amount properly attributable to Australia by allowing the adjustment of the actual consideration for sales and acquisitions as appropriate.

180. Where its provisions are applied, Division 13 can result in adjustments being made to, inter alia:

(a) assessable income and/or allowable deductions;

(b) income subject to withholding taxes, including income from dividends, interest and royalties liable to tax under section 128B;

(c) exempt income;

(d) the cost of acquisitions and value of disposals, for depreciation purposes;

(e) receipts or losses of a capital nature affecting any liability to capital gains tax; and

(f) other matters for which the ITAA makes special provision, including:

(i) capital costs for special provisions which allow for a full, or partial, capital deduction (e.g. Divisions 10B and 10D of Part III);

(ii) costs for specific deduction provisions (e.g. research and development);

(iii) expenditure subject to recoupment provisions; and

(iv) income subject to special provisions which can affect the calculation of taxable income (e.g. Division 12 of Part III).

181. Any adjustment made as a result of the application of sections 136AD and/or 136AE (the operative provisions of Division 13) applies to the relevant taxpayer *"for all purposes of the ITAA"*. This will result in not only the underlying consideration in respect of the supply or acquisition of property being adjusted to an arm's length consideration but will also have flow-on consequences for the taxpayer where that consideration is also relevant to the operation of other provisions of the ITAA. For example:

(a) the value of opening and closing trading stock under section 28 (see paragraphs 439 - 440);

(b) bad debts under subsection 51(1) or section 63; and

(c) carried forward losses under sections 79D, 79E or 80.

182. The Commissioner will not, however, apply sections 51 and 63 in respect of bad debts in a way that undermines the legislative purpose behind Division 13. It would be absurd and illogical for the flow-on consequences to operate in such a manner. For example, an increase under section 136AD in the sale price charged by an Australian company will produce sales income (for taxation purposes) higher than the actual sales income resulting from the prices actually charged. Companies have to comply with the preconditions for write off. In particular, the increase in the sales income for Australian tax purposes will not be regarded as a debt unless it is recognised by the other party as legally owing to the company with the Australian tax liability. This may present problems for taxpayers because the other party may have difficulty showing additional consideration being received for its assumption of the additional liability; past consideration is no consideration.

183. The ATO will agree to an appropriate adjustment under section 136AF where it is fair and reasonable to do so, in conjunction with

sections 51 or 63 as appropriate. In such circumstances any amount to be written off as a bad debt would have to be calculated on the basis of the full amount of the relevant sales income after the application of Division 13, and not just the increase occasioned by Division 13, unless the amount actually agreed has already been paid in full.

The interaction between Division 13 and Australia's Double Taxation Agreements

184. In considering the application of Division 13, the terms of any relevant double taxation agreement must be considered. Australia's double taxation agreements, which appear as schedules to the *Income Tax (International Agreements) Act 1953 ("the IT(IA)A")*, contain their own provisions to deal with profit shifting arrangements in certain circumstances. These provisions, like the domestic non-arm's length transfer pricing provisions, are based on the arm's length principle.

185. Section 4 of the *IT(IA)A* provides that the ITAA is incorporated and shall be read as one with the *IT(IA)A*. The provisions of the *IT(IA)A* have precedence in the case of any inconsistency, notwithstanding anything contained in the ITAA (other than section 160AO or Part IVA) or in any Act imposing Australian tax.

186. There should be no fundamental inconsistency between the results under Division 13 and the relevant provisions of the double taxation agreements since both are based on the arm's length principle, though due regard has to had to the precise wording of the relevant provision(s) being applied. Accordingly, the Commissioner may apply the provisions of Division 13 and/or the treaty provisions. However, in the event of any inconsistency, the treaty provisions will prevail unless the treaty itself gives precedence to the domestic law. A detailed discussion of the interaction between certain provisions of Australia's double taxation agreements and Division 13 will be dealt with in later Rulings.

The interaction between subsection 51(1) and Division 13

187. Cases may arise, which involve the acquisition of property under an international agreement, where subsection 51(1) can be relied upon to deny a deduction in respect of that portion of expenditure which, while incurred by the taxpayer, was either:

(a) not incurred for the purpose of producing the assessable income of the taxpayer but for some other purpose;

(b) properly regarded as being incurred in producing the income of another party; or

(c) incurred in relation to the gaining or production of exempt income.

188. Where the operation of section 51 is not clear cut, consideration would need to be given to whether a determination could be made under section 136AD, as an alternative basis upon which to support an adjustment under subsection 51(1), or to remedy the effect of profit shifting from Australia resulting from non-arm's length transfer pricing where the preconditions for application of section 136AD have been met.

Expenditure incurred not for the purpose of producing the assessable income of a taxpayer but for some other purpose

189. If the proper conclusion to be drawn from all the facts and circumstances is that certain expenditure (or part of it) was not incurred for the purpose of gaining or producing assessable income of the Australian taxpayer, or is otherwise not allowable under subsection 51(1), then the appropriate result is that the expenditure (or relevant part) should be disallowed as a tax deduction under subsection 51(1). Such a case would not normally give rise to an application of Division 13.

190. There will be cases where Division 13 will apply even though expenditure is not deductible under subsection 51(1); e.g. where Division 13 is relied on to increase exempt income and thereby in certain circumstances reduce carry forward losses. Division 13 may, however, be invoked as an alternative basis for disallowing a deduction under subsection 51(1) where there is some doubt about the operation of subsection 51(1), in the particular circumstances, and/or if the facts indicate profit shifting has occurred through the use of non-arm's length transfer pricing.

191. It is well established that the words "to the extent to which" in subsection 51(1), make it clear that the subsection contemplates apportionment: *Fletcher & Ors v. FC of T* (1991) 173 CLR 1 at 16; *Ronpibon Tin NL and Tongkah Compound NL v. FC of T,* (1949) 78 CLR 47 at 59; *Ure v. FC of T* 81 ATC 4100; 11 ATR 484. In *Ronpibon Tin NL and Tongkah Compound NL v. FC of T* (ibid), Latham CJ, Rich, Dixon, McTiernan and Webb JJ, in their joint judgment stated that there were at least two kinds of outgoings which require apportionment for the purposes of the subsection:

> "One kind consists in undivided items of expenditure in respect of things or services of which distinct and severable parts are devoted to gaining or producing assessable income and distinct and severable parts to some other cause. In such cases it may be possible to divide the expenditure in accordance with the

> applications which have been made of the things or services. The other kind of apportionable items consists in those involving a single outlay or charge which serves both objects indifferently."

192. As was also pointed out by their Honours, what is an appropriate apportionment in such cases is essentially a question of fact. The following passages from *Fletcher & Ors v. FC of T* (1991) 173 CLR 1 at 18/19 are relevant in this regard:

> "Even in a case where some assessable income is derived as a result of the outgoing, the disproportion between the detriment of the outgoing and the benefit of the income may give rise to a need to resolve the problem of characterisation of the outgoing for the purposes of the subsection by a weighing of the various aspects of the whole set of circumstances, including direct and indirect objects and advantages which the taxpayer sought in making the outgoing. Where that is so, it is a "commonsense" or "practical" weighing of all the factors which must provide the ultimate answer."

And later:

> "If, however, that consideration reveals that the disproportion between outgoing and relevant assessable income is essentially to be explained by reference to the independent pursuit of some other objective and that part only of the outgoing can be characterised by reference to the actual or expected production of assessable income, *apportionment of the outgoing between the pursuit of assessable income and the pursuit of that other objective will be necessary*." (emphasis added)

193. Subsection 51(1) could reasonably be expected to apply to apportion a claim for a deduction where after a "practical weighing of all the factors" the conclusion is reached that a company had some other objective or purpose in addition to the pursuit of assessable income. Such situations might include:

(a) a cost sharing arrangement between an Australian company and a non-resident company, in respect of which, the cost allocated to the Australian associate for the provision of services allegedly provided to it by the non-resident company, are disproportionately high compared to the level of services actually provided or the benefits actually obtained; and

(b) the importation of goods by an Australian associate of a non-resident company where the cost of acquisition of the goods cannot be reconciled with normal commercial

prices that could reasonably be expected in the circumstances of the particular case.

Expenditure incurred on behalf of another

194. Instances have come to light in the course of audits in which Australian companies have incurred expenditure on behalf of or provided services to their foreign associates without receiving arm's length consideration. In these cases, the Australian companies have claimed tax deductions for the expenditure. It is often the case that the incurring of such expenditure has not been formally recognised in documentation between the respective companies. In some cases, such expenditure would not be deductible under subsection 51(1) since it may be properly regarded as being incurred in producing the income of another party *(Hooker Rex Pty Ltd v. FC of T* (1988) 19 ATR 1241 at 1253 and 1262; 88 ATC 4392 at 4404 and 4411), or perhaps, incurred in deriving exempt income (e.g. section 23AJ) (see below).

195. Division 13 may however be invoked as an alternative basis for disallowing a deduction under subsection 51(1) where there is some doubt about the operation of subsection 51(1), in the particular circumstances, and/or if the facts indicate profit shifting has occurred through the use of non-arm's length transfer pricing.

196. Where the expenditure is deductible under subsection 51(1), subsections 136AD(1) or (2) could normally be expected to apply where the preconditions for application of the relevant provision have been met. The result would be that an arm's length consideration (which in some cases may be at cost) would be deemed to be received by the Australian company.

Expenditure incurred in relation to the gaining or production of exempt income

197. Subsection 51(1) also provides that expenditure incurred in deriving exempt income shall not be an allowable deduction. In particular, no deductions would be allowed under subsection 51(1) in connection with:

(a) foreign branch profits derived by Australian companies where the profits are exempt under section 23AH;

(b) non-portfolio dividends from foreign countries where the dividends are exempt under section 23AJ; and

(c) income other than dividends that is exempt under the former paragraph 23(q).

198. Division 13 may however be invoked as an alternative basis for disallowing a deduction under subsection 51(1) where there is some doubt about the operation of subsection 51(1), in the particular circumstances, and/or if the facts indicate profit shifting has occurred through the use of non-arm's length transfer pricing.

199. It should be noted that even though expenditure may not be deductible under subsection 51(1) if it is incurred in deriving exempt income, Division 13 can still apply to increase the amount of exempt income where the preconditions have been satisfied. For example it can be applied in cases where the Australian taxpayer has deductible carry forward losses which the law requires be reduced by any increase in exempt income.

Expenditure otherwise deductible under subsection 51(1)

200. It is also a long established principle underlying the operation of subsection 51(1) that:

> "it is not for the Court or the Commissioner to say how much a taxpayer ought to spend in obtaining his income, but only how much he has spent": (*Ronpibon Tin NL and Tongkah Compound NL v. FC of T* (1949) 78 CLR 47 at 60).

This is not a prohibition on the Commissioner ever looking beyond the amount spent; the prohibition applies only when it is demonstrated that the expenditure was really incurred for the purpose of obtaining assessable income.

201. However, it needs to be recognised that in appropriate cases Division 13 can apply to disallow a deduction that would be otherwise allowable under section 51 where the preconditions of section 136AD have been met.

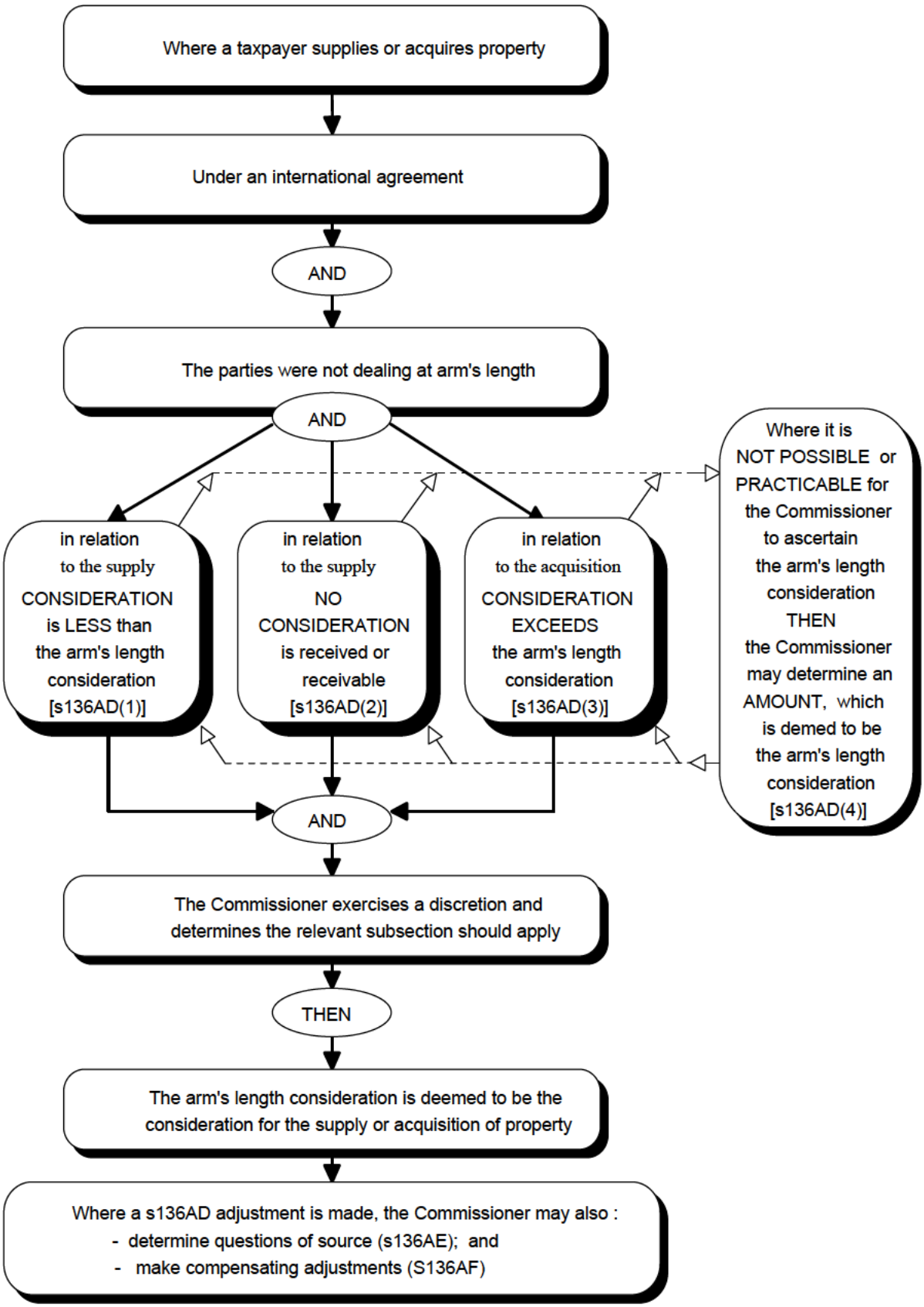
202. Section 31C of the ITAA has been introduced to overcome arrangements relating to the acquisition of trading stock at inflated prices following adverse decisions on subsection 51(1) in *Cecil Bros Pty Ltd v. FC of T* (1964) 111 CLR 430; *Isherwood & Dreyfuss Pty Ltd v. FC of T* 78 ATC 4311; 8 ATR 735 (decision affirmed on appeal by Full Federal Court 79 ATC 4031; 9 ATR 473). Much of the difficulty faced by the Commissioner in these cases is arguably due to the very nature of trading stock.

203. The subsequent enactment of Division 13 also makes provision to overcome non-arm's length transfer pricing arrangements involving expenditure which would otherwise be deductible under subsection 51(1) - including arrangements to purchase trading stock at inflated prices under an "international agreement". Division 13 contains a specific provision (subsection 136AB(2)), which states that the

operation of section 31C is to be disregarded whenever the Division is applied.

Flowchart of Division - for separate legal entities

204. The basic structure of Division 13 and the preconditions for its application to dealings between separate legal entities are shown in the following flowchart (see next page).


Where a taxpayer supplies or acquires property
Under an international agreement
AND
The parties were not dealing at arm's length
AND
in relation to the supply CONSIDERATION is LESS than the arm's length consideration [s136AD(1)]
in relation to the supply NO CONSIDERATION is received or receivable [s136AD(2)]
in relation to the acquisition CONSIDERATION EXCEEDS the arm's length consideration [s136AD(3)]
Where it is NOT POSSIBLE or PRACTICABLE for the Commissioner to ascertain the arm's length consideration THEN the Commissioner may determine an AMOUNT, which is demed to be the arm's length consideration [s136AD(4)]
AND
The Commissioner exercises a discretion and determines the relevant subsection should apply
THEN
The arm's length consideration is deemed to be the consideration for the supply or acquisition of property
Where a s136AD adjustment is made, the Commissioner may also :
- determine questions of source (s136AE); and
- make compensating adjustments (S136AF)

Outline of the basic concepts

205. In broad terms, and as the above diagram indicates, the legislation provides that the following conditions must all be satisfied before an adjustment can be made under section 136AD:

(a) a "taxpayer" **(see paragraphs 211 - 213)** must have either "supplied or acquired property" **(see paragraphs 214 - 222)** under an "international agreement" **(see paragraphs 267 - 272)**;

(b) the Commissioner must be satisfied that, in respect of "the agreement" **(see paragraphs 239 - 266)**, any "two or more of the parties were not dealing with each other at arm's length" **(see paragraphs 273 - 302)** in relation to the supply or acquisition of property;

(c) the "consideration" **(see paragraphs 303 - 309)** in respect of the supply or acquisition of property was not the "arm's length consideration" **(see paragraphs 310 - 327)** or no consideration was received or receivable; and

(d) the Commissioner determines that the relevant subsection should apply to the taxpayer in relation to the supply or acquisition of property **(see paragraphs 390 - 395)**.

206. Where all the above conditions are satisfied, the legislation deems the consideration in respect of the supply or acquisition of property to be equal to the arm's length consideration **(see paragraphs 396 - 400)** for "all purposes of the application of the ITAA" in relation to the taxpayer **(see paragraphs 181 - 183)**.

207. Where it is not possible or practicable for the Commissioner to ascertain the arm's length consideration, subsection 136AD(4) allows the Commissioner to determine an amount which is deemed to be the arm's length consideration in respect of the supply or acquisition of property **(see paragraphs 328 - 342)**.

208. In addition, subsection 136AD(2) (i.e. in situations where no consideration is received or receivable in respect of the supply of property) also contains a mechanism to enable the time of derivation of the deemed arm's length consideration to be determined **(see paragraphs 398 - 400)**.

209. Where section 136AD has been applied, and a question arises as to the source of any adjustment, or the allocation of any expenditure between Australian sourced income and other income, the Commissioner may also determine these questions under subsections 136AE (1) - (3) **(see paragraphs 412 - 419)**.

210. The Commissioner is also authorised under section 136AF to make such compensating consequential adjustments as are fair and

reasonable. Consequential adjustments will be discussed in more detail in a later Ruling.

The meaning of "taxpayer" for the purposes of Division 13

211. Subsections 136AD(1) - (3) focus on "a taxpayer". The term "taxpayer" is defined for the purposes of Division 13 in subsection 136AA(1). The effect of this definition is to extend the meaning of the term "taxpayer" found in subsection 6(1) of the ITAA to include a partnership and a taxpayer in the capacity of a trustee. Paragraph (a) of subsections 136AD(1) - (3), makes no distinction between resident and non-resident taxpayers.

212. The provisions of Division 13 apply with equal force to Australian owned and foreign owned companies.

213. The scope of Division 13, while extensive, is still subject to the doctrine of territorial limitation which requires that there be a relevant connection with Australia. Therefore, the definition of "taxpayer" has to be read as relating to a person or persons whose income or profits or gains of a capital nature are relevant in the context of ascertaining Australian taxation liabilities (e.g. income tax or withholding tax) or losses. In other words, a "taxpayer" has to be someone who is, or is deemed by law to be, an Australian resident (including a company) or someone who has sufficient economic connection with Australia such that the person has derived Australian sourced income. It also includes a person (whether a resident or not) who would have derived income that would have been liable to Australian tax or relevant to the calculation of carry-forward losses had the dealings by the person being at arm's length.

Supply or acquisition of property

214. The terms "supply" and "acquire" are both defined in subsection 136AA(1) to encompass the ordinary meaning of the words (which would include such things as sales, purchases, transfers and assignments), as well as leasing, hiring, hire purchase and exchange of property. Additionally, the term "supply" includes situations where something is provided, granted or conferred and the term "acquire" includes situations where something is obtained, gained or received.

215. In *Allina Pty Ltd v. FC of T* 1991 ATC 4195; (1990) 21 ATR 638, the Full Federal Court considered the meaning of the word acquire in the context of paragraph 160ZH(9)(a) of the ITAA and said:

> ""To acquire", according to its ordinary and natural meaning, connotes in our view to obtain, gain or get

> something. The first meaning given in the Oxford English Dictionary, 2nd ed (1989), is: "1. To gain, obtain or get as one's own, to gain the ownership of (by one's own exertions or qualities)." The second meaning is: "2. To receive, or get as one's own (without reference to the manner), to come into possession of." The Macquarie Dictionary gives a similar definition. There must be something in existence that can be obtained or gained; but the word is apt to encompass the case where one person creates an asset which at the same time comes into the possession of or is obtained by another person."

216. The Full Federal Court was considering acquisitions of assets. In the context of Division 13, the word "acquire" has to be construed against the background that "property" is defined to include "services". Clearly then, it is apt to cover things not yet in existence as capable of being acquired. Transactions in commodity or financial futures and in respect of future production or future research are examples of this. This interpretation is reinforced by the fact that "acquire" also includes an agreement to acquire.

217. Given the breadth of subject matter encompassed by the term "property" (discussed in paragraphs 223 - 238 below), the expression "supply of property" is therefore wide enough to cover the case where a benefit is conferred by one company on another, such as in respect of permitting access to or use of industrial or intellectual property. Similarly, the expression "acquisition of property" is wide enough to include the case where one of the companies within the group provides a particular service (e.g. communications and reporting through central computer facilities or management services) to some or all of the companies within the group.

218. The breadth of the expressions "supply of property" and "acquisition of property" are a clear indication of the legislative intent to cover all forms of dealings between companies. The expressions are wide enough to include, for example:

(a) a gift of property from one company to another or the provision of services free of charge;

(b) the provision of property to or the obtaining of property from a joint venture;

(c) an exchange of property (including an exchange of property for services) as part of a barter or countertrade arrangement;

(d) the conferring of any economic or commercial advantage or benefit by way of credit, loan or guarantee facilities;

(e) any transfer of technology or knowledge of any economic or commercial advantage between companies; and

(f) the granting of exclusive marketing rights in a particular geographical area in respect of a unique or highly differentiated or patented product or service.

219. Paragraph 136AA(3)(a) provides that "a reference to the supply or acquisition of property includes a reference to agreeing to supply or acquire property". Accordingly, "property" would include property which is not yet in existence (eg. next year's production). The expressions "supply of property" or "acquisition of property" would be wide enough therefore to include an arrangement for a loan in which the terms of the loan are clearly established, including agreement for the payment of interest, and in respect of which the parties to the arrangement either fail to pay or fail to demand payment of the agreed interest. The provision of the principal amount of the loan would constitute the supply of property even where the terms of the loan do not provide for the payment of interest. An agreement to pay interest would constitute an agreement to supply property and would therefore fall within the expanded meaning of the expression "supply of property".

220. Paragraph 136AA(3)(e) states that "a reference to the supply or acquisition of property under an agreement includes a reference to the supply or acquisition of property *in connection with* an agreement." (emphasis added). The Explanatory Memorandum at page 63 states that paragraph 136AA(3)(e) "is a safeguarding measure to ensure that a supply or acquisition of property that is technically not made under an agreement, but nevertheless occurs in connection with the agreement, is to be brought within the scope of the Division." The provision is designed to extend the range of matters to which Division 13 applies and would include back to back deals (see the example at paragraph 279), side deals or collateral arrangements (see example at paragraph 282) and the supply or acquisition of property by an associate to or from a third party (see example at paragraph 274).

221. The expression "in connection with" was considered by Nourse J in *Emery v. IRC* (1981) STC 150 at p171, where reference was made to the decision of McFarlane J in *Re Nanaimo Community Hotel Ltd* [1944] 4 DLR 638 at 639:

> "One of the very generally accepted meanings of "connexion" is "relation between things one of which is bound up with or involved in another"; or again, "having to do with". The words include matters occurring prior to as well as subsequent to or consequent upon so long as they are related to the principal thing. The phrase

> "having to do with" perhaps gives as good a suggestion of the meaning as could be had."

222. It is clear there must be a relevant connection between the supply or acquisition of property and an "international agreement" and that "a taxpayer" has to be either a supplier or acquirer of property, but "the taxpayer" need not be the only party to supply or acquire property in connection with the "agreement". Nor is there any requirement for "the taxpayer" to be a party to the "agreement" in a formal sense. The expression "in connection with" includes the indirect supply or acquisition of property through interposed entities within the operation of Division 13.

The meaning of the term "property"

223. For the purposes of Division 13, the term "property" is defined in subsection 136AA(1) in considerably broader terms than the common law definition, including such things as:

(a) a chose in action;

(b) any estate, interest, right or power, whether at law or in equity, in or over property;

(c) any right to receive income; and

(d) services.

The expressions "right to receive income" (see paragraph 228 below) and "services" (see paragraphs 229 - 237 below) are also defined in subsection 136AA(1).

224. Decided cases which dealt with the term "property" in the context of the ITAA provide some guidance as to how it might be interpreted for the purposes of Division 13. In *FC of T v. Miranda*, 76 ATC 4180 at 4189; 6 ATR 367 at 377, Rath J in considering the meaning to be given to the term "property" in paragraph 26(a) of the ITAA, saw no reason to restrict its meaning. His Honour referred to *Stroud's Judicial Dictionary* (3rd. ed., vol.3 p. 2340) where the term "property" is defined as the generic term for all that a person has dominion over. His Honour referred to *Stroud's* quotation of Langdale MR in *Jones v. Skinner* 5 LJ Ch 90 where he said:

> "'Property' is the most comprehensive of all terms which can be used, inasmuch as it is indicative and descriptive of every possible interest that a party can have."

225. In ordinary usage, the word "property" is used both as a singular term (i.e. to describe a single discrete item of property) and as a collective term (i.e. to describe a collection of items of property). When used in conjunction with the terms "supply" and "acquire", the expressions "supply of property" and "acquisition of property"

(discussed in paragraphs 214 - 222) can refer to both the supply or acquisition of a discrete item of property and the supply or acquisition of a number of items of property (e.g. a "basket of goods" as referred to in paragraph 432).

"Property" includes choses in action

226. The ordinary meaning of property clearly includes all forms of tangible property, and intangible property such as copyrights, patents and trademarks. For the purposes of Division 13, the meaning of the term "property" has been expanded to include choses in action, i.e. rights enforceable in law or equity. A chose in action means a thing recoverable by action as opposed to a thing which is enjoyed by possession (refer to *Halsbury's Laws of England* 4th ed, vol 6, para 1). This is the classical distinction between enforceable rights and property (in its ordinary sense). Examples of choses in action would be debts, contractual rights or rights to sue for breach of copyright, patent, negligence or trespass. It could be argued that there are elements of overlap between choses in action and the ordinary meaning of property.

"Property" includes rights or powers in or over property

227. Paragraph (b) of the definition of "property" covers a range of rights or powers in or over property. For example, a lease would be covered, as would the equitable interest under a contract of purchase. Again, there are overlaps with the ordinary meaning of property. The definition also covers powers of appointment or waiver and the power to licence or permit the use of or access to any property.

"Property" includes any right to receive income

228. Rights to receive income are expressly included in the definition of property but regard would have to be had to the provisions of section 102A of the ITAA and the principles developed in *Norman v. FC of T* (1963) 109 CLR 9, *Shepherd v. FC of T* (1965) 113 CLR 385 and *Myer v. FC of T* (1987) 163 CLR 199 in relation to whether and, if so, how a taxpayer can effectively transfer such a right for tax purposes.

The term "property" includes "services"

229. The inclusion of "services" represents a significant extension of the ordinary meaning of the term "property". The term "services" itself, is defined broadly in subsection 136AA(1), to embrace not only the ordinary meaning, but also rights, benefits, privileges or facilities generally.

"Services" includes benefits

230. "Services" includes "benefits". The word "benefit" is intended to encompass anything that would bestow an economic or commercial advantage; that is, something that, in the context of this Ruling, would assist a company's profitability or net worth by enhancing, assisting or improving the company's income production, profit making, the quality of its products, or which could result in a reduction of expenses or otherwise facilitate the operations of the company.

231. The ordinary meaning given to the word benefit in the *Macquarie Dictionary* is "anything that is for the good of a person or thing; to gain advantage" and in the *Shorter Oxford English Dictionary* as "advantage, profit, good".

232. A simple example of a benefit would be the receipt of money (regardless of whether in a lump sum or otherwise) by one entity from another in circumstances in which there was no obligation for the payment to be made, such as with a gift. Another example would be where a company is granted terms of trade (as distinct from the value of the underlying property) more favourable than those ordinarily available in the relevant market, e.g.:

(a) terms of payment for goods supplied being either without penalty for late payment or no provision for payment of interest on overdue amounts, or payment not due until 180 days after supply where the industry norm for payment terms is COD; or

(b) the liability for warranty claims being solely the responsibility of the distributing entity where usually there would be recourse to the manufacturing entity in respect of such claims.

233. In the context of Division 13, a benefit may be regarded as something of economic or commercial value which an independent entity might reasonably expect to pay for, or to obtain consideration for supplying. In this regard it needs to be borne in mind that circumstances will vary and the issue is whether the dealings are reasonable in terms of the arm's length principle. It follows that a benefit has to be reasonably capable of being identified and valued.

"Services" includes privileges

234. The *Macquarie Dictionary* defines privilege as including "a right or immunity enjoyed by a person or persons beyond the common advantages of others: a prerogative, advantage, or opportunity enjoyed by anyone in a favoured position (as distinct from a right)". There is thus a large degree of overlap between a benefit and a privilege. An example of a privilege would be the situation which arises where an associated company, which is a non-resident for Australian tax purposes, has much of the work associated with its operations performed by staff of its parent company located in Australia. The provision of commercial or technological information, equipment and other facilities of the parent company not available to the wider community or competitors, or the provision of services by senior or junior staff, would each constitute a privilege or benefit provided to the non-resident associate.

"Services" includes the conferring of rights, benefits or privileges for which consideration is payable in the form of a royalty

235. By virtue of sub-paragraph (a)(iii) of the definition in subsection 136AA(1), "services" includes the conferring of rights, benefits or privileges for which consideration is payable in the form of a royalty, tribute, levy or similar exaction. The term "royalty" is defined in subsection 6(1) of the ITAA and has itself been given an extended meaning. The breadth given to these terms means that Division 13 could potentially apply to arrangements between companies relating to the use of, or the right to use, any copyright, patent, design or model, plan, secret formula or process, trade-mark, or the supply or acquisition of scientific, technical, industrial or commercial knowledge or information. The above reference to the supply of commercial knowledge would include, for example, the possession and use of marketing skills on behalf of another entity and the reference to information would include, for example, the provision of market trend information to another entity.

236. In a particular case, regard may need to be had to the definition of royalty in any relevant double taxation agreement.

237. The definition of "services" also includes agreements of insurance and agreements for or in relation to the lending of moneys (paragraphs (c) and (d) of the definition). It would therefore include the provision of insurance cover, the guarantee of a loan and a commitment to lend money. TR 92/11 addresses the application of Division 13 to loan arrangements and credit balances.

Other things covered by the term "property"

238. The term "property" also includes:

(a) trading stock;

(b) work in progress and other business inputs;

(c) futures contracts, hedging agreements and forward sale and purchase agreements;

(d) cash and foreign exchange;

(e) options, including the property in respect of which the option is given;

(f) the provision of finance (whether by loan, the provision of credit or an advance or the purchase of commercial paper), including the terms of any such provision;

(g) debts, including the factoring and forgiveness of debts;

(h) financial products, including newly developed and developing financial products;

(i) leases and licences, including the terms upon which a lease or licence is made;

(j) hire-purchase agreements, including the terms of any such agreement;

(k) the transport of any property or personnel;

(l) service, management and administration fees;

(m) the provision of services such as administration, management, marketing, sales or distribution services by head offices or companies within a group of companies to other companies within the group;

(n) intangible assets including their development and use and their royalty income flows;

(o) gifts of money or plant and equipment; and

(p) the manufacturing, processing or refining of goods or materials belonging to someone else.

What is an "agreement" for the purposes of Division 13?

239. The term "agreement" is central to the meaning of the expression "international agreement" (discussed in paragraphs 267 - 272) which is used in section 136AD. "Agreement" is defined broadly to mean "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".

240. The broad drafting of Division 13 reflects the legislative intention of being able to address those situations where parties, other than those directly involved with the supply or acquisition of property, are somehow involved or can influence the outcome of the dealings between the parties directly involved in the supply or acquisition of the relevant property (see also the example at paragraphs 279 - 281).

241. Although not having been the subject of judicial consideration in the context of Division 13, courts have considered the term "agreement" and similar terms in other provisions of the ITAA. Expressions and terms found within the definition of "agreement" have also been judicially considered.

The meaning of agreement

242. The word agreement is closest in nature to that of a contract between parties and was considered in *Re Symon, Public Trustee v. Symon* [1944] SASR 102 at 110 where Mayo J said that:

> "'Agreement' signifies primarily a contract, that is, a legally binding arrangement between two or more persons, by which rights are acquired by one or more acts or forbearances on the part of the other or others."

243. However, "agreement" is not limited to its strict legal sense in Division 13. It can be unilateral, in the sense that one party can provide a benefit to another without obtaining any consideration (subsection 136AD(2)). Again, one party could be acting under dictation, e.g. a subsidiary following the directions of the parent company, such that there may not be any notion of agreement as understood by contract law.

244. Moreover, an agreement as defined in Division 13 can be legally unenforceable.

The meaning of arrangement

245. The word arrangement has been described as something less than a binding contract or agreement, something in the nature of an understanding between two or more persons (*Newton v. FC of T*, (1958) 98 CLR 1 at 7; *FC of T v. Lutovi Investments Pty Ltd*, (1978) 140 CLR 434 at 466). An arrangement may be informal as well as unenforceable and the parties to it may be free to withdraw from it or to act inconsistently with it, notwithstanding their adoption of it (*FC of T v. Lutovi Investments Pty Ltd* (ibid)). In other words, in the context of Division 13, an arrangement (and therefore an "agreement")

would exist if the facts showed a course of dealing between the parties, even though no formal agreement had been entered into and no legally enforceable relationship was intended.

246. In *Top Performance Motors Pty Ltd v. Ira Berk (Queensland) Pty Ltd* (1975) 5 ALR 465 at 469; (1975) 24 FLR 286 at 291, the Full Court of the Australian Industrial Court in considering the meaning of the word "arrangement" appearing in section 45 of the *Trade Practices Act 1974*, referred to the decision of the Privy Council in *Newton v. FC of T* (supra) and to the judgment of Diplock LJ in *British Slag Ltd v. Registrar of Restrictive Trading Agreements* [1963] 2 All ER 807 at 819 and said that:

> "an arrangement of the kind contemplated in s.45 is conditional upon a meeting of the minds of the parties to the arrangement in which one of them is understood, by the other or others, and intends to be so understood, as undertaking, in the role of a reasonable and conscientious man, to regard himself as being in some degree under a duty, moral or legal, to conduct himself in some particular way, at any rate so long as the other party or parties conducted themselves in the way contemplated by the arrangement." (per Smithers J)

247. In respect of arrangements which are not enforceable at law, Cross J in *British Slag Ltd v. Registrar of Restrictive Trading Agreements* [1962] 3 All ER 247 at 255 (referred to by Diplock LJ in the Court of Appeal on appeal) said that:

> "all that is required to constitute an arrangement not enforceable in law is that the parties to it shall have communicated with one another in some way and that as a result of the communication each has intentionally aroused in the other an expectation that he will act in a certain way."

The meaning of transaction

248. The word transaction has been described as "a comprehensive word which includes any dealings with property": *Barron (Inspector of Taxes) v. Littman* [1953] AC 96 at 113; (1952) 2 All ER 548 at 555 and "In its ordinary sense it is understood to mean the doing or performing of some matter of business between two or more persons": *R v. Canavan and Busby* [1970] 3 OR 353 at 356 by the Ontario Court of Appeal.

249. The word transaction, in its ordinary sense, is not limited to a single act or step but includes a series of acts or steps: *Birks v C of T* (1953) 10 ATD 266 at 270 per Kitto J, *Robertson v. IRC* [1959]

NZLR 492 at 499. Both of the foregoing cases were relied on by the Full High Court in *Palmer v C of T* (WA) (1976 -1977) 136 CLR 406 in interpreting the word transaction.

The meaning of understanding

250. The word understanding is of very wide import and was considered in *Top Performance Motors Pty Ltd v. Ira Berk (Queensland) Pty Ltd* (supra) in the context of section 45 of the Trade Practices Act 1974. In that case, Smithers J stated that:

> "It seems to me also that an understanding must involve the meeting of two minds. Where the minds of the parties are at one that a proposed transaction between them proceeds on the basis of the maintenance of a particular state of affairs or the adoption of a course of conduct, it would seem that there would be an understanding within the meaning of the Act."

251. This passage was cited by Fisher J in *TPC v. Nicholas Enterprises* (1979) 26 ALR 609 at 629. Fisher J, however, then went on to hold that it was a necessary ingredient of an understanding that there be an element of mutual commitment between the other parties to the understanding. When the case went on appeal to the Full Federal Court, *Morphett Arms Hotel Pty Ltd v TPC* (1979-80) 30 ALR 88 at 91-92, Bowen CJ who delivered the judgment of the court, qualified his general agreement with the reasons of Fisher J when he said, in obiter, that:

> "As at present advised, it seems to me that one could have an understanding between two or more persons restricted to the conduct which one of them will pursue without any element of mutual obligation, in so far as the other party or parties to the understanding are concerned."

This is an example of a situation where the Commissioner could conclude that there may be a unilateral agreement.

252. For the purposes of Division 13, the term "understanding" will be read as including situations where the relevant parties have a common view regarding the maintenance of a particular state of affairs or the adoption of a course of conduct - whether or not the state of affairs or course of conduct has been unilaterally created or involves some element of mutual obligation.

The meaning of scheme

253. In *Investment and Merchant Finance Corporation Ltd v. FC of T,* (1970) 120 CLR 177 at 188-89, Windeyer J said, in respect of the interpretation of the word scheme which appeared in the former paragraph 26(a), that:

> "A scheme presupposes some programme of action, a series of steps all directed to an end result. Similarly an undertaking is an enterprise directed to an end result. Each word connotes activities that are co-ordinated by plan and purpose - that whatever is done under the scheme or pursuant to the undertaking is done as a means to an end. *There may, in one sense, be several transactions, but they are related because all directed to the attainment of the one end, profit*." (emphasis added)

254. In *XCO Pty Ltd v. FC of T,* (1971) 124 CLR 343 at 349, Gibbs J, when also discussing the word "scheme" in the context of the former paragraph 26(a) said:

> "A taxpayer can, within sec.26(a), carry out a scheme, notwithstanding that what he does is done for the purposes of a larger scheme to which others are parties."

255. The above statements are considered relevant to the application of the word "scheme" contained within the definition of the term "agreement" in subsection 136AA(1). The word "scheme" is used in the neutral sense of a plan or system in the context of which property is supplied or acquired. It is not used in the sense of a tax avoidance scheme and does not require the demonstration of a *purpose or object* of avoiding Australian tax, though that may well be the *effect* of a particular scheme (see also paragraphs 401 - 408).

256. When the meanings of the individual words in the definition of "agreement" are considered it can be appreciated that few, if any, non-arms length dealings between companies would be unable to be brought within the operation of Division 13 if an independent party could reasonably have been expected to have sought greater remuneration or paid a lower cost in those circumstances and if there was evidence of the underpayment of Australian tax as a result of those dealings. The other preconditions for the application of Division 13 would also need to be satisfied.

Determining the scope of an "agreement"

257. An "agreement" may in some cases constitute only a single step, one contract, or one arrangement, for example, the supply of a single shipment of particular goods. In other cases, an "agreement" may comprise a number of steps, two or more contracts, two or more

arrangements or some combination of these which together form a broader "agreement"; for example, a contract between related parties for the supply of property being entered into on the understanding that a contract for the acquisition of the same property will subsequently be entered into between the first purchaser and another related party. It is a long-established principle of legal construction that all related transactions need to be considered together in order to properly determine the true nature of an arrangement (e.g. *FC of T v. Myer Emporium Ltd* (1987) 163 CLR 199 at 216).

258. Where only a part of the "agreement" involves the supply or acquisition of property, this part will not be viewed in isolation but in the context of the broader arrangement, understanding or scheme. It is only when all connected steps are viewed in their proper context that the true nature, extent and effects of an "agreement" can be determined.

259. For example, an agreement between related parties for the sale of particular property may be entered into on the basis that the property will be on-sold to another related party. Each agreement might adopt a different pricing method that, taken in isolation, would appear to be an arm's length consideration. However, taken together as an intended preordained, integrated series of steps, it may be clear that the party on-selling was bound to lose money because of the way the separate agreements were priced. It is considered that Division 13 would have application to either or both of the agreements (In this regard, see *FC of T v. Ball*, 82 ATC 4701; 13 ATR 746, decision affirmed by High Court in *Estate of Ball v. FC of T*, 84 ATC 4920; 15 ATR 1296).

260. That is not to say that the provisions of Division 13 cannot be applied to a particular transaction forming one part of a broader arrangement, understanding or scheme or to a scheme within a larger scheme as was the case in *XCO Pty Ltd v. FC of T* (supra). However, due consideration would have to be given to the existence of any broader agreement, but also taking account of the legislative purpose behind Division 13.

Evidence of a course of conduct

261. Evidence of a course of conduct or a pattern of trading between companies may be relied upon as evidence of the formation of an "agreement" or its existence and its basic terms even though there may be no evidence to show when, where by whom or in what particular words such "agreement" was made, (*Brogden v. Metropolitan Railway Co.* (1877) 2 App. Cas. 666 at 680, 686; *Lahey v. Canavan* [1970] Qd. R. 224 at 230; *Goodwin v. Temple* [1957] St. R. Q. 376 at 384-387). The same approach is also applicable to variations to existing

"agreements" (*Bowman v. Durham Holdings Pty Ltd* (1973) 131 CLR 8 at 17-20; *Winks v. W.H. Heck & Sons Pty Ltd* [1986] 1 Qd. R. 226 at 238).

262. A course of conduct or a pattern of trading between companies may also constitute an admission receivable into evidence against a company if such conduct or trading discloses an intention to affirm or acknowledge the existence of an "agreement": (*Lustre Hosiery Ltd v. York* (1935) 54 CLR 134 at 143-144; *Grey v. Australian Motorists & General Insurance Co.* [1976] 1 NSWLR 669 at 684-685).

263. Where, having regard to paragraphs 261 - 262 evidence of a course of conduct or a pattern of trading between companies exists, and that pattern of trading is not consistent with the arm's length principle and results in the underpayment of Australian income tax or withholding tax, it could be expected that Division 13 will be applied where all its preconditions for application have been satisfied.

Division 13 is "agreement" based and is not limited to considering specific transactions

264. It has been suggested that in applying Division 13 regard can only be had to a specific transaction when deciding whether the parties were dealing at arm's length in relation to a supply or acquisition of property and whether the consideration given (if any) was an arm's length consideration.

265. "Transaction" is a sub-set of "agreement" and (as discussed in paragraphs 248 - 249 above) a range of lower level transactions can fall within a broader transaction. Whilst section 136AD clearly allows for the application of the Division in relation to each supply or acquisition of property under an international agreement, more than one specific transaction may be covered by an "agreement" and regard would have to be given to other factors which would indicate what independent parties dealing at arm's length with each other might reasonably be expected to have done in comparable circumstances.

On occasions, companies may be involved in more than one separate and distinct "agreement"

266. There may also be occasions where a company may be involved in two or more separate and distinct "agreements", each "agreement" being entire in itself and unrelated to any other "agreement". Each of these separate and distinct "agreements" may involve one or more steps, one or more contracts, one or more arrangements or some combination of these. These individual and unrelated "agreements" could be between the same parties or between different parties. Whether more than one separate and distinct "agreement" exists, will

depend ultimately on the facts in each particular case. Where this is so, the application of Division 13 would have to be considered in the context of each or any of these separate and distinct "agreements".

Provision of property under an "international agreement"

267. The existence of an "international agreement" is essential to the operation of section 136AD. An "international agreement" can in very broad terms be described as dealings between separate legal entities involving the supply or acquisition of property across international borders. Taxation Ruling TR 92/11 discusses the supply and acquisition of property under an "international agreement" in relation to loans and credit balances.

268. A basic design feature of Division 13 is that where dealings are limited to those between a branch office (permanent establishment) and its head office (regardless of whether the entity is a resident or a non-resident), there is no "international agreement" since any dealings are within the same entity. This outcome reflects the fact that Australia's domestic law (which adopts the single entity approach) does not recognise intra-entity transactions. Such transactions have therefore been excluded from the scope of section 136AD through the use of the concept of an "international agreement" and the requirement that there be at least two parties who are not dealing with each other at arm's length.

269. Division 13 contains special provisions in subsections 136AE(4) - (6) covering dealings between different parts of the same entity. These provisions, which give the Commissioner power to allocate the income, profits and expenses between Australian and overseas operations, will be the subject of a later Ruling.

270. Another basic design feature for section 136AD to apply is that there must be a cross border dealing. The section does not apply where all the relevant dealings are wholly within Australia. However, regard must also be had to the possible existence of "back to back" deals, side deals or other collateral arrangements, like the examples in paragraphs 274, 279 and 282 below which have the effect of shifting profits out of Australia.

271. The expressions "a business carried on" in paragraph 136AC(a) and "carrying on a business" in paragraph 136AC(b) have their ordinary meanings for the purpose of Division 13. The body of law which has developed in respect of the similar expression in subsection 51(1) would provide assistance in their interpretation.

272. The following table lists all the basic combinations covered by the concept of an "international agreement". However, regard must also be had to the possible existence of "back to back" deals, side

deals or other collateral arrangements, which may involve interposed entities and may have the effect that, in the context of broader "agreements", onshore dealings may be covered by the concept, as well as dealings between offshore parties. (for table see next page)

WHAT QUALIFIES AS AN INTERNATIONAL AGREEMENT?

supply or acquisition by / supply to or acquisition from	**Resident company operating onshore**	**NR company operating onshore through a PE**	**NR company operating onshore but not through a PE**	**Resident company operating offshore**	**NR company operating offshore**
Resident company operating onshore	No [1] [totally domestic]	No [1] [exception to 136AC(a)]	Yes 136AC(a)	Yes 136AC(b)	Yes 136AC(a)
NR company operating onshore through a PE	No [1] [exception to 136AC(a)]	No [1] [exception to 136AC(a)]	Yes 136AC(a)	Yes 136AC(b)	Yes 136AC(a)
NR company operating onshore but not through a PE	Yes 136AC(a)	Yes 136AC(a)	Yes 136AC(a)	Yes 136AC(a) and (b)	Yes 136AC(a)
Resident company operating offshore through a PE	Yes 136AC(b)	Yes 136AC(b)	Yes 136AC(a) and (b)	Yes 136AC(b)	Yes 136AC(a) and (b)
NR company operating offshore	Yes 136AC(a)	Yes 136AC(a)	Yes 136AC(a)	Yes 136AC(a) and (b)	Yes [2] 136AC(a)

NOTES TO TABLE:

"NR" stands for non-resident as defined in subsection 6(1) of the ITAA

"PE" stands for permanent establishment as defined in subsection 136AA(1) of the ITAA

1 Subject to the exceptions referred to in paragraph 272 in relation to back to back deals, side deals or other collateral arrangements.

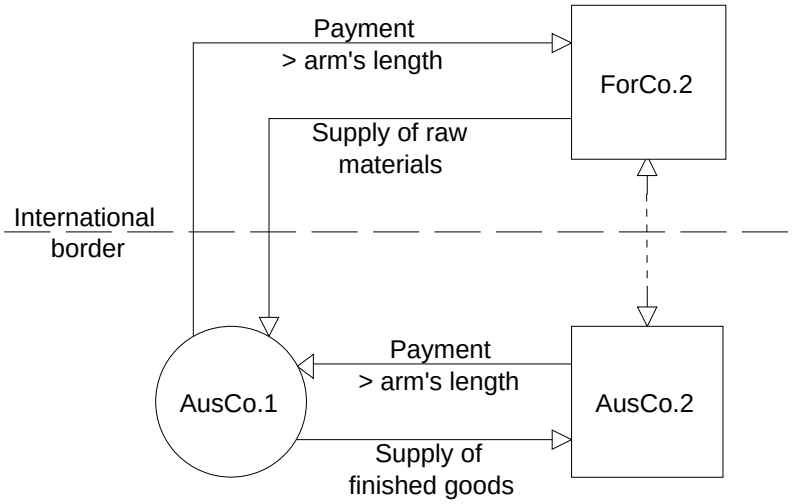
2 However such company is unlikely to be a "taxpayer" for the purposes of Division 13 (see paragraphs 211 - 213), unless the accruals legislation applies and regard must also be had to the exceptions referred to in note 1 above.

Not dealing with each other at arm's length

273. One of the principal requirements in subsections 136AD(1), (2) and (3) before Division 13 can be applied, is that the Commissioner must be satisfied that the parties to the agreement or any two or more of those parties were not dealing at arm's length with each other (paragraph (b) of subsections 136AD(1) - (3)). In addressing this issue, regard is to be had to "any connection between any 2 or more of the parties to the agreement or to any other relevant circumstances". The expressions "any connection between" or "any other relevant circumstances" are expressions of the widest import.

The meaning of "any connection between"

274. The expression "any connection between" is not dependent upon the existence of control or share ownership although cases in which non-arm's length transfer pricing does occur are normally found where one of the parties controls the other, or they are under common control. Instances where dealings between unrelated parties are on non-arm's length terms can also arise. This aspect of unrelated parties not dealing at arm's length was discussed by Mr Boucher in his 1983 Speech. In this address, the following example was given of a situation in which section 136AD would have application:



> "Another illustration of the point that non-arm's length dealings can operate outside the area of dealings between affiliates is provided by a case we have experienced in practice. A company in Australia bought a raw material from an independent supplier overseas. It paid an inflated price but was prepared to do so because it sold the finished product, at a correspondingly inflated price, to an Australian affiliate of the overseas supplier. The purchase by the interposed company would be open to attack under Division 13."

275. This comment needs qualification. Aus Co. 1 would be subject to a possible adjustment under Division 13 if, for example, there was tax deferral or tax rate arbitrage on a year to year basis. For example, the raw materials could be paid for in Year 1 and the income derived in Year 2 when tax rates had decreased.

276. The example also gives rise to the need to consider the overall arrangement and consideration would have to be given to whether Division 13 should be applied to Aus Co. 2. Where similar situations are encountered in practice, paragraph (b) of the relevant subsection (subsection 136AD(1), (2) or (3)) would be satisfied and section 136AD could be expected to apply.

277. In the context of Division 13, the expression "any connection between", is not dependent upon the existence of control or share ownership. Without limiting the scope of the expression, it would include, for example:

(a) a direct or indirect shareholding in one company by another company;

(b) the common ownership of companies even though there may be no direct or indirect shareholding between the subsidiaries;

(c) the ability of one company to obtain an interest in another company through:

(i) an existing option agreement;

(ii) the fact that convertible notes are held;

(iii) the ownership of convertible preference shares;

(d) the existence of common directors;

(e) the existence of common executives; and

(f) involvement in a cartel.

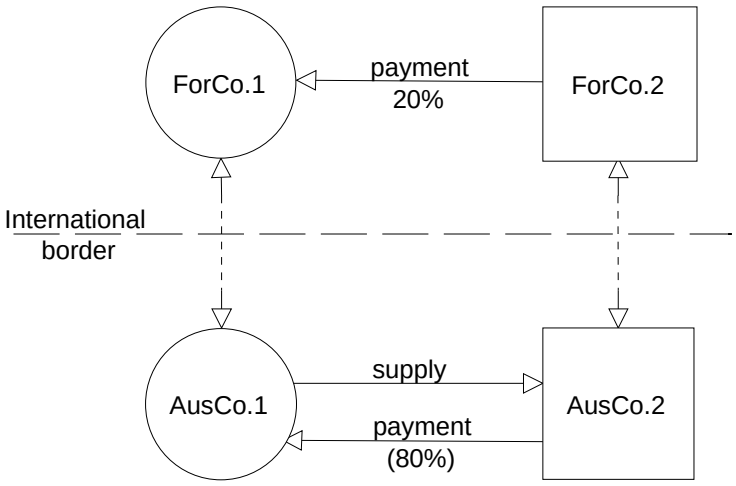
The meaning of "any other relevant circumstances"

278. The expression "any other relevant circumstances" is similarly a very wide expression. The question of what are relevant circumstances will depend on the facts in each particular case. The Explanatory Memorandum gives the following example at page 66:

> "there can be cases where formally unrelated parties to an agreement do not deal with one another on an arm's length basis, viewed simply in relation to a particular supply or acquisition of property. This could be the case where the particular transaction which reduces a taxpayer's Australian income is offset by benefits under

another seemingly unrelated agreement, which may accrue abroad, and perhaps to an associate of the taxpayer."

279. The example contained within the Explanatory Memorandum and referred to in the previous paragraph can be illustrated in the following diagram:



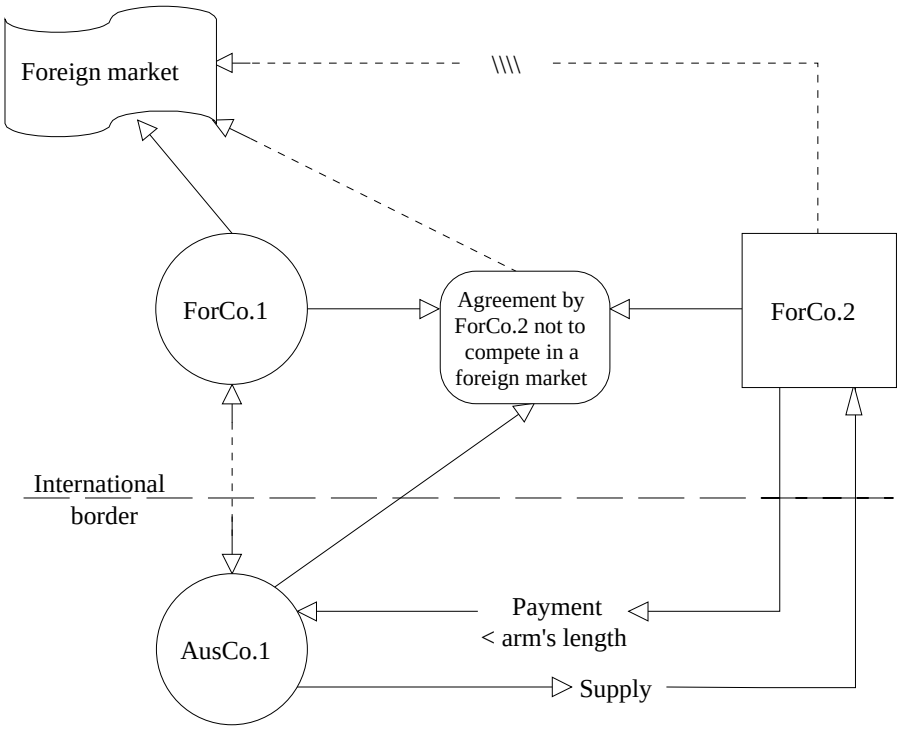
Two unassociated company groups comprising AusCo.1 and ForCo.1 in one group and AusCo.2 and ForCo.2 in the other group have agreed that AusCo.1 will receive 80% of the arm's length consideration from AusCo.2 in respect of the supply of property in Australia, while AusCo.1's offshore associate, ForCo.1, will receive the balance of 20% of the arm's length consideration from ForCo.2.

280. This example provides a good illustration of the width of Division 13 by showing that it can embrace what at first glance appears to be a totally domestic arrangement. In this example, a non-resident has supplied property (the payment by ForCo.2 to ForCo.1 either with or without other property being transferred between them) which gives the "agreement" (being the agreement between the two unassociated company groups) its international flavour and renders the "agreement" an "international agreement". This results in paragraph (a) of subsection 136AD(1) being satisfied. On the facts as presented, paragraphs (b) and (c) of subsection 136AD(1) are also satisfied and in such circumstances, it could be expected that the Commissioner would exercise the discretion in paragraph (d) of subsection 136AD(1) as the Australian revenue has suffered as a consequence of the non-arm's length dealing.

281. This example also serves to illustrate the point made in paragraph 240 above as to why the legislation has adopted the notion of an "agreement" and was not restricted to only those dealings which involve the direct supply or acquisition of property to or from a non-resident. In this example, Division 13 requires that the consideration received by AusCo.1 be adjusted upwards to the arm's length

consideration for the property it supplied to AusCo.2. This can be done by considering both sides of the back to back arrangement together. Consideration should also be given to whether prosecution action is warranted.

282. In the 1983 Speech, Mr Boucher also gave an example of a situation to which the Division would apply as a result of "any other relevant circumstances" even though there might not be "any connection" between two or more of the parties. He said:



In this example, ForCo.1 and AusCo.1 are associated. No association exists between AusCo.1 and ForCo.2.

> "(Consider) a deal between a company in Australia that is a member of one group with a company overseas that is a member of another, quite unrelated group. The particular transaction could be one that results in the company in Australia receiving less for its exports than the relevant price on the open market. Why, it might be asked, should the company here do that. The answer could be that there are other, completely off-shore, deals between members of the two company groups that, in one way or another, redress for each group as a whole the income imbalance resulting from the reduced export price to the company in Australia. There might, for example, be such an off-shore agreement not to compete in a particular market.
>
> Whatever might be said about the arm's length nature of the set of deals between each of the two groups

> considered as a whole, the export transaction itself is not one carried out at arm's length and Division 13 is there to redress the revenue imbalance for Australia that would otherwise exist."

283. Without in any way limiting the width of the expression "any other relevant circumstances", in the context of Division 13 the expression would include, for example, the existence of:

(a) a market sharing agreement or agreement not to enter a particular market;

(b) any back to back or collateral arrangements or side deals; and

(c) an income sharing agreement that does not properly reflect the contributions of the parties.

The meaning of "not dealing at arm's length with each other"

284. The expression "not dealing at arm's length with each other", is not defined, though it is used in a number of provisions throughout the ITAA. In *Barnsdall v. FC of T,* 88 ATC 4565; (1988) 19 ATR 1352, Davies J, in considering the expression "not dealing with each other at arm's length" in the context of subsection 26AAA(4), held that:

> "(the) term should not be read as if the words "dealing with" were not present. The Commissioner is required to be satisfied not merely of a connection between a taxpayer and the person to whom the taxpayer transferred, but also of the fact that they were not dealing with each other at arm's length. A finding as to a connection between the parties is simply a step in the course of reasoning and will not be determinative unless it leads to the ultimate conclusion."

This interpretation was also agreed with by Hill J in *The Trustee for the Estate of the late AW Furse No 5 Will Trust v. FC of T,* 91 ATC 4007; 21 ATR 1123.

285. Given the similarity in wording between the expressions "not dealing with each other at arm's length" in subsection 26AAA(4) and "not dealing at arm's length with each other" in paragraph (b) of subsections 136AD(1) - (3), and the fact that in both contexts the Commissioner has to have regard to any connection between the taxpayers or any other relevant circumstances, the above statement of Davies J is considered equally applicable to the interpretation of the expression "not dealing at arm's length with each other" in Division 13.

286. The legislative formula in paragraph (b) of subsections 136AD(1) - (3) focuses on the type of dealing between the parties rather than merely on the relationship between them. Hence, the presence or absence of such matters as those listed in paragraph 277 above will not necessarily be determinative of whether or not any of the parties to an "agreement" were dealing at arm's length with each other.

287. In *The Trustee for the Estate of the late AW Furse No 5 Will Trust v. FC of T* (supra), Hill J, in relation to the expression "not dealing with each other at arm's length" in subsection 102AG(3) of the ITAA, said that:

> "What is required in determining whether parties dealt with each other in respect of a particular dealing at arm's length is an assessment whether in respect of that dealing they dealt with each other as arm's length parties would normally do, so that the *outcome* of their dealing is a matter of real bargaining." (emphasis added)

288. It will therefore be relevant to also consider whether the outcome of dealings between the relevant parties is a matter of real bargaining, in terms of the consideration that passed between them as a consequence of their dealings and the overall manner and effect of what the parties did, for the purpose of being satisfied as to whether or not any two or more of the parties to the "agreement" were dealing at arm's length with each other. There is thus some degree of overlap between the tests in paragraphs (b) and (c) of subsections 136AD(1) - (3).

289. The use of the concept of "arm's length consideration" in Division 13 is modelled on the arm's length principle. This principle is in turn modelled on notions of comparison and predication about what independent parties dealing at arm's length either did or might reasonably be expected to have done in the taxpayer's circumstances. It is therefore relevant to consider whether any comparative analysis was done and to what extent the taxpayer relied on it. Again, this necessarily involves consideration be given to the outcome of the dealing. It is not confined to an examination of process, though process is also relevant.

290. Real bargaining between related parties could be expected to be achieved where the conditions in which the bargaining is undertaken are similar to those that would exist between unrelated parties dealing at arm's length. The view is expressed in paragraph 2 of the 1979 OECD Report that conditions for arm's length dealings are sometimes fulfilled by members of company groups where "the members have a considerable amount of autonomy so that they can and often indeed do bargain with each other in a manner similar to that of independent

entities". We would go further and add that where such conditions do exist, failure by the members to exercise that autonomy and operate as separate profit centres, would be unlikely to lead to a result that is consistent with the arm's length principle.

291. Listed below are some factors (by no means exhaustive) which, if shown to exist, would lend support to arguments that conditions for real bargaining between related parties were similar to those existing between unrelated parties dealing with each other at arm's length (although, none of them in isolation would be conclusive of those arguments in their own right):

(a) members of company groups being allowed to acquire property (and services) from unrelated parties where the consideration would be lower;

(b) members of company groups being allowed to supply property to unrelated parties where the consideration would be higher;

(c) each entity having its own profit and cost responsibility and user pays principles applying in relation to goods and services provided between the entities; and

(d) manager remuneration is either significantly or wholly related to the economic performance of the individual entity - and there is no scope for rewarding performance detrimental to the individual entity (but which is of overall advantage to the group).

292. The weight to be given to the above factors will depend on the particular case and individual factors taken in isolation would not be conclusive. Moreover, it needs to be acknowledged that the absence of some or all of the factors in (a) to (d) does not necessarily lead to the conclusion that the parties were not dealing at arm's length. The weight to be given to these factors would also depend on the nature and the extent of the documentation that the company has to support its contentions. In this regard, reference should be made to the comments at paragraphs 299 and 368 - 385.

293. On the other hand, real bargaining between related parties would not usually be expected to be achieved where:

(a) the same directors, officers, or representatives handled the negotiations on behalf of all the related parties; or

(b) where one party may have directed the negotiations or determined the outcome of the dealings for the related parties.

294. In the Canadian case of *Minister of National Revenue v. Merritt & Another* 69 DTC 5159, referred to with approval by Davies J in *Barnsdall v FC of T* (ibid), Cattanach J said at pp 5165-5166:

> "where the 'mind' by which the bargaining is directed on behalf of one party to a contract is the same 'mind' that directs the bargaining on behalf of the other party, it cannot be said that the parties are dealing at arm's length. In other words where the evidence reveals that the *same* person was 'dictating' the 'terms of the bargain' on behalf of *both* parties, it cannot be said that the parties were dealing at arm's length."

295. Davies J stated that this case and other Canadian cases to which he referred in his judgment, looked primarily to the relationship between the parties and to matters of influence and control. He did not disagree with the analysis of Cattanach J. but accepted that there may be transactions between related parties in which the parties deal with each other at arm's length.

296. The fact that the parties to an "agreement" are under common control raises an issue of whether the parties were not dealing at arms length with each other. However, as suggested in the cases referred to above, other factors such as pricing and the terms and conditions of the "agreement" may be enough to overcome this concern, if they show that the "agreement" was concluded on the basis of arm's length dealing, i.e. on rates available on the open market to the world at large and the normal terms of trade available to those parties in the relevant market were adopted.

297. In other words, the Commissioner needs to be satisfied that all aspects of the relevant agreement can be explained by reference to ordinary commercial dealings and real bargaining, and that there is nothing that can be explained only by reference to a special relationship between the parties that indicates acquiescence or a facade.

298. It needs to be recognised that a strong market position may enable one entity to negotiate from a position of strength, such that the parties with whom it deals cannot negotiate their desired outcomes. Where this results from the particular dynamics of the market it does not, on its own, justify a conclusion that there was an absence of real bargaining.

299. In order to show that real bargaining occurred in respect of dealings between related parties, it would be expected that the parties would have brought into existence *during the negotiation phase*, the type of documentation independent parties dealing at arm's length would have used in comparable circumstances and would have addressed compliance with the arm's length principle. The

documentation and information held by taxpayers needs to be sufficient to enable an effective assessment of compliance with the arm's length principle. This view is reflected in paragraph 25 of the 1979 OECD Report. This information, together with documents in respect of any subsequent variations of contracts or arrangements, would be the best evidence for a taxpayer to be able to establish that the relevant dealing was on arm's length terms. Regard would also have to be had to the matters in paragraphs 326 and 327. The nature of the documentation we would expect to be held and we will be seeking from companies will be addressed in more detail in a later Ruling.

300. The mere fact that any two or more of the parties to an agreement are associated or are "connected" in the sense referred to in paragraph 274 above, will not necessarily be determinative in concluding that they were not dealing at arm's length with each other (*The Trustee for the Estate of the late AW Furse No 5 Will Trust v. FC of T* (supra)). If, after reviewing all the relevant facts (and bearing in mind that the outcome of the dealing must be consistent with real bargaining), it is clear that the parties to the relevant "agreement" were dealing with each other on an arm's length basis in respect of the supply or acquisition of property, then paragraph (b) of subsections 136AD(1) - (3) will not be satisfied and section 136AD will have no application to the relevant supply or acquisition of property (see the Explanatory Memorandum at page 63).

301. It has been suggested that the ATO, by insisting on the need for arm's length dealing and the adoption of arm's length consideration, is telling taxpayers how to run their businesses. This is not the case. Division 13 is concerned solely with the taxation consequences of cross-border dealings. It states a number of factors to which the Commissioner must have regard before the discretion in Division 13 can be exercised. In particular, an objective assessment is required of whether the parties were dealing at arm's length and whether they used the arm's length consideration. It then empowers the Commissioner, having properly considered all relevant factors, to make an adjustment where appropriate so that for taxation purposes the correct arm's length amounts of income and deductions are used.

302. Accordingly, it is a matter of applying Division 13, consistently with international practice and convention, in accordance with the arm's length principle as reflected in its wording.

The meaning of consideration received or receivable, or given or agreed to be given

303. Other than paragraph 136AA(3)(b) providing that a reference to consideration includes property supplied or acquired as consideration, and a reference to the amount of any such consideration as being a reference to the value of the property, the term "consideration" is not defined in either Division 13 or in section 6 of the ITAA. Accordingly, the word "consideration" has its ordinary meaning in the context in which it appears. *The Macquarie Dictionary* defines "consideration" as:

> "**5.** Law. in a contract, or other legal transaction, the promise by which some right or benefit accrues to one party, in return for which the party who receives the benefit promises or conveys something to the other."

304. A general principle of contract law is that "whilst consideration need not be adequate it must be of value" *(Halsbury's Laws of England*). In *Thomas v. Thomas* (1842) 2 QB 851 at p859, Patteson J said:

> "Consideration means something which is of value in the eye of the law, moving from the plaintiff ... ".

And in *Currie v. Misa* (1875) LR 10 Exch 153 at 162:

> "A valuable consideration, in the sense of the law, may consist either in some right, interest, profit, or benefit accruing to one party, or some forbearance, detriment, loss or responsibility given, suffered or undertaken by the other".

305. The foregoing discussion has focussed on a meaning to be given to the word "consideration" in the law of contract. However, the interpretation of a word appearing in a statute should not be divorced from its context (*Cooper Brookes (Wollongong) Pty Ltd v. FC of T* (1981) 147 CLR 297). In this regard, it should be noted that the references to "consideration" appearing in paragraphs 136AD(1) - (3) are in the context of *the amount* of the consideration which "was received or receivable by the taxpayer" and "the taxpayer gave or agreed to give " in respect of the supply or acquisition (or that there was no consideration) and not simply to "consideration".

306. This context indicates that the reference to "consideration" should be construed as a reference to anything of value that actually passes between the parties, or that was agreed to pass as payment for the supply or acquisition of property. This is reinforced by the fact that the term "agreement" encompasses informal arrangements, understandings and schemes. Further weight is given to this interpretation when regard is had to the way the word "consideration"

is used in paragraphs 136AA(3)(c) and (d) in the context of defining the expression "arm's length consideration" for the purposes of the Division and to the use of the expression "the amount of that consideration" appearing in paragraphs 136AD(1)(c) and (3)(c).

307. Representations have been made that an adjustment to income should not be made in respect of property supplied by a resident parent company to a non-resident subsidiary because:

(a) the parent company receives immediate and adequate compensation in the form of an increase in the value of the shares it holds in the subsidiary;

(b) the parent company is likely to receive an increased flow of dividends from the non-resident subsidiary, the likely increase being adequate compensation; or

(c) the non-resident subsidiary is in the practice of paying dividends approximately equal to its after tax profits, and consequently, there has therefore been no profit shifting.

308. These propositions are not accepted because they do not pay sufficient regard to the fact that the companies are separate legal persons. Nor do they properly address the tax effect and, if accepted, would make Division 13 inapplicable to non-arm's length dealings between a resident parent company and a non-resident subsidiary despite the clear intention of the legislation, expressed in its terms and confirmed in the Explanatory Memorandum and the Second Reading Speech. Such propositions are based on a meaning of the term "consideration" which is inconsistent with the notion of the supply or acquisition of property under an international agreement between two or more separate legal entities and the requirement for arm's length consideration to be used in such dealings.

309. Where, for example, an arm's length supplier of property would have received regular payments for the property supplied over a period of time, the Australian revenue would lose if assessable income is to be recognised only if and when dividends are actually distributed. In this regard, it does not matter whether the potential dividends would be assessable or exempt.

Arm's length consideration

310. Paragraphs 136AD(1)(c) and (3)(c) when read with the definitions of arm's length consideration in paragraphs 136AA(3)(c) and (d) *require a comparison to be made between*:

(a) the consideration that was:

(i) received or receivable in respect of the supply of property (subsection 136AD(1)(c)); or

(ii) given or agreed to be given in respect of the acquisition of property (subsection 136AD(3)(c)); and

(b) the arm's length consideration in respect of the supply or acquisition.

Where the consideration was less than or more than might reasonably be expected to have been received or given, as the case may be, in an arm's length dealing, then paragraph (c) of the relevant subsection would be satisfied.

311. In the case of subsection 136AD(2), no comparison with an arm's length consideration needs to be made in order for paragraph (c) of the subsection to be satisfied. The relevant test in paragraph 136AD(2)(c) is satisfied if no consideration (in the sense referred to in paragraphs 305 - 306) was received or receivable in respect of the supply of property.

312. The expression "arm's length consideration" is defined in paragraphs (c) and (d) of subsection 136AA(3) as the consideration that might reasonably be expected to have been:

(a) received or receivable in respect of the supply; or

(b) given or agreed to be given in respect of the acquisition,

if the property had been supplied or acquired, as the case may be, under an agreement between independent parties dealing at arm's length with each other in relation to the supply or acquisition.

Arm's length consideration reflects commercial and market realities and the nature of business

313. An important aspect of an arm's length consideration is that it should be consistent with the consideration that would arise as a result of real bargaining between independent parties.

314. It should also be borne in mind that the incurring of expenditure is not a measure of, or a substitute for, the arm's length consideration. The quantum of the expenditure incurred is but one factor (and in some cases a very important factor) to take into account in ascertaining the arm's length consideration.

315. Implicit in the concept of the "arm's length principle" and of the expression "arm's length consideration" used in Division 13 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. Optimal use of economic resources would take into account such matters (non exhaustive) as:

(a) the functions performed or to be performed, the assets and skills used or available for use and the degree and nature of the risks involved and/or to be rewarded;

(b) the short term and long term business strategies of the entity, including such things as:

(i) corporate and group goals;

(ii) actual and desired market share; and

(iii) management of business and market risks;

(c) the nature of the markets in which the entity was operating or seeking to operate, including such things as:

(i) the ease of entry and exit;

(ii) the degree of competition (i.e. are there many competitors, is the competition between them intense, does the market tend towards an oligopoly, monopoly or monopsony) and the strength of the negotiating position of the respective parties (see paragraph 298);

(iii) the relative shares of the market enjoyed by the company and its competitors;

(iv) the existence of and potential for substitute products;

(v) the price sensitivity of relevant products and the market;

(vi) the availability and supply of raw materials and other inputs;

(vii) the availability and stability of distribution outlets;

(d) the rate of technological change; and

(e) external constraints (e.g. environmental and business regulation, general economic conditions, the business/investment regime and the political climate).

All of these matters are relevant to an examination of comparability.

316. However, all of the matters set out in paragraph 315 are relevant in terms of paragraphs 136AA(3)(c) and (d) in determining the consideration that might reasonably be expected to have been set by independent parties dealing at arm's length with each other. These

matters are considered relevant regardless of the methodology that is sought to be applied.

317. The appropriate arm's length consideration would then reflect commercial and market realities, and would have regard to the nature of competition and the nature of business whereby it would generally be expected that entities would seek to:

(a) maximise the consideration received in respect of the supply of property;

(b) minimise the consideration to be given in respect of the acquisition of property; and

(c) be adequately rewarded for the activities carried out so as to be commercially viable. (The contribution of loss makers to the overall group profitability should be compensated.)

318. This generalisation needs to be tempered with a recognition that, for legitimate commercial reasons, companies may sometimes reduce prices to gain market share or move surplus stocks or secure reliable long term distribution outlets. Regard should also be had to paragraphs 445 - 457 below.

319. The ATO accepts that it could not reasonably be expected that a company would achieve the same level of profit margin in countries where there is government intervention through pricing controls or other price regulation mechanisms that are impacting on company profits as the company would achieve in an unregulated market. This, of course, assumes that there is reliable evidence that the market price would be higher if such controls or regulatory mechanisms were not in place.

320. It has been suggested, amongst other things, that adoption of the "arm's length principle" implies that members of company groups need only:

(a) cover their variable costs and make some contribution to fixed costs; or

(b) return a profit, however marginal, from their activities (i.e. that it is sufficient to avoid the operation of Division 13 provided some amount of profit is returned as assessable income after all costs associated with the relevant activities have been covered).

These views are not accepted. The "arm's length principle" and the expression "arm's length consideration" are not predicated on the basis of whether variable costs may or may not have been covered or whether any particular level of profits has been attained but rather are based on an objective determination of the consideration that might

reasonably be expected to have arisen had the parties to the dealings been independent parties dealing at arm's length.

321. If the way the "agreement" was entered into or was priced can only be explained by reference to some special relationship not able to be explained by reference to normal commercial dealings, then the "agreement" will not be consistent with the "arm's length principle" if the outcome is not an arm's length price.

322. Determining the relevant arm's length consideration involves a practical weighing of the functions performed or to be performed, the assets and skills used or available for use, the degree and nature of risks involved and/or to be rewarded, the business strategies being pursued, and the market and economic context in which the relevant parties are operating. In saying this, it is acknowledged that there will often be a range of comparable prices and taxpayers and ATO auditors need to establish the most appropriate point in the range having regard to the facts and circumstances of the particular case. Ranges will be the subject of a more detailed discussion in a later Ruling.

323. It also needs to be recognised that the determination of the arm's length consideration involves an element of judgment and that the exercise is not a precise science. Accordingly, taxpayers and ATO auditors need to approach cases with a degree of flexibility and commonsense, having regard to business and market realities.

324. The view that because certain arrangements are common between companies in multinational groups, they should be regarded as arm's length arrangements, is also not accepted. Nor should it be concluded that a particular dealing is on an arm's length basis simply because it is an arrangement that can only be entered into between related parties. The fact that arm's length parties would not have entered into similar arrangements will often confirm the non-arm's length nature of the dealings between the parties, though highly vertically integrated industries, transfers and licences of valuable intangibles and dealings in unique or highly differentiated products require further analysis. A detailed discussion on the methodologies that we would consider acceptable when seeking to ascertain an appropriate arm's length consideration in such circumstances will be dealt with in a later Ruling.

325. Where related parties revise or renegotiate existing contracts or arrangements, the likely absence of a divergence of interest between the parties means that close examination will need to be given to the changed circumstances leading to the revision or renegotiation. This needs to be done in order to be satisfied that the approach taken and outcome achieved by the related parties is consistent with what arm's length parties might reasonably be expected to have done in comparable circumstances.

326. A finding reached by the Commissioner for the purposes of paragraph (b) of subsections 136AD(1) - (3) that any two or more of the parties to an "agreement" were not dealing at arm's length with each other will not necessarily be determinative in concluding that the consideration received or receivable or given or agreed to be given for the purposes of paragraph (c) of subsections 136AD(1) - (3) was not an arm's length consideration.

327. The fact that any two or more of the parties to an "agreement" were not dealing at arm's length with each other might often infer that the consideration was not an arm's length consideration. This does not, however, mean that any such inference is irrefutable. If, after reviewing all the relevant facts, it can be concluded that, even though there was an absence of real bargaining, an arm's length consideration was received or receivable or given or agreed to be given, as the case may be, then paragraph (c) of subsections 136AD(1) - (3) will not be satisfied and section 136AD will have no application. This conclusion does not apply to transactions like re-invoicing where no economic value is added and for which independent parties would not be prepared to pay.

The Commissioner may deem an amount to be the arm's length consideration (subsection 136AD(4))

328. The policy underlying subsection 136AD(4) is to address situations in which it would not be practicable or possible to determine the arm's length consideration. In the 1983 Speech, Mr Boucher stated that:

> "There are situations, recognised in every one of Australia's comprehensive tax treaties, where it may not be practicable to apply the arm's length principle. Section 136 was apt for such cases, because the Commissioner could generally fix as a taxable income such part of the taxpayer's receipts as he determined. Sub-section 136AD(4) of the new law covers the situations I refer to."

329. Subsection 136AD(4) achieves this policy aim by allowing the Commissioner to determine *"an amount" which is then deemed, for the purposes of section 136AD, to be the arm's length consideration* in respect of the supply or acquisition of property. This amount is then used in the application of subsections 136AD(1) - (3).

330. This deemed amount is then relevant:

(a) for ascertaining whether the consideration which passed in respect of the supply or acquisition of property was less than or more than the arm's length consideration

(paragraph (c) of subsection 136AD(1) or subsection 136AD(3)); and

(b) as representing the consideration which is deemed to have passed, in respect of the supply or acquisition of property, where a determination is made to apply any of subsections 136AD(1) - (3).

331. The manner in which subsection 136AD(4) operates is different to that in subsections 136AD(1) - (3). Subsection 136AD(4) operates in conjunction with and through the other provisions of section 136AD. The application of subsection 136AD(4) on its own results in an amount being deemed to be the arm's length consideration in respect of the relevant supply or acquisition of property. Subsection 136AD(4), on its own, does nothing with this deemed amount. It is only when this deemed amount is used for the purposes of subsections 136AD(1) - (3) that the consideration for the supply or acquisition of property which passed between the relevant parties is adjusted to the arm's length consideration. This interpretation is supported by the introductory words of the subsection which state, "For the purposes of this section, ...".

332. In this regard, subsection 136AD(4) merely states:

> "... 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 Commissioner can determine an amount.

It should be noted, however, that where subsection 136AD(4) is applied, the Commissioner would still need to make the relevant determination under paragraph (d) of subsections 136AD(1), (2) or (3) for Division 13 to operate.

333. The circumstances in which it may not be possible or practicable for the Commissioner to determine the arm's length consideration in respect of the supply or acquisition of property will depend on the facts of each case. The Explanatory Memorandum at page 68 gives the following examples of situations in which subsection 136AD(4) would have application:

(a) the industry is so controlled and structured that there are no comparable arm's length dealings in relation to property of the same kind;

(b) there are no comparable dealings in the same quantities as that supplied or acquired under the agreement; or

(c) though comparable dealings exist, details of them are held back from or otherwise are not available to the Commissioner.

334. The examples in the Explanatory Memorandum are seen as relevant to cases where CUP would ordinarily be the best method but for some reason cannot be applied. Being examples, they are not seen as exhaustive. Nor is the passage seen as precluding the use of other arm's length methodologies such as cost plus, resale price and profit methods where they are the most appropriate methods.

335. Resort to subsection 136AD(4) may well be necessary in cases of vertically integrated industries where an arm's length consideration does not exist in respect of the goods, services (including intangibles) or work in progress transferred. It may also be applied in cases involving unique or highly differentiated products or services, although careful consideration would need to be given to whether comparable products or services exist; and to the degree of difference in respect of near comparable products or services to see whether adjustments could be made to produce a valid comparison.

336. Alternatives and substitutes need to be considered in order to properly determine the relevant market for the purposes of the analysis of comparables.

337. Subsection 136AD(4) may be used to deem "an amount" to be the arm's length consideration where, after careful consideration of whether comparables are reasonably available, it is concluded that it would not be administratively practicable to determine the arm's length consideration.

338. Subsection 136AD(4) is silent as to the manner in which the relevant "amount" is to be determined. However, the determination of the relevant "amount" (which is then deemed to be the arm's length consideration) needs to be approached in a manner which, in all the circumstances of the case, would lead to a fair result that is as consistent as practicable with the arm's length principle as internationally accepted. As Kitto J said in *Mobil Oil Australia Pty Ltd v. FC of T* (1963) 113 CLR 475 at 504 (in the context of the review function of the now replaced Taxation Boards of Review):

> "What is fair in a given situation depends upon the circumstances."

339. The amount determined by the Commissioner under subsection 136AD(4) needs to be supported by sufficient relevant information to demonstrate that an informed and reasonable decision has been reached in the circumstances of the case. It is not a matter of the Commissioner substituting his own commercial judgement for that made by the company at the time the transaction was entered into.

340. The statements made in the preceding paragraphs on the role of subsection 136AD(4) and how it will be administered are consistent with the view expressed in paragraph 46 of the 1979 OECD Report that:

> "It has to be recognised that an arm's length price will in many cases not be precisely ascertainable and that in such circumstances it will be necessary to seek for a reasonable approximation to it."

Division 13 can apply even where independent parties would not enter such agreements

341. Representations have been made that, in the case of some dealings between members of company groups, it would not be possible to arrive at an arm's length consideration because, for example, the industry is so vertically integrated. In these situations, so it is argued, similar dealings would not occur between unrelated parties and thus Division 13 should not apply. While it is acknowledged that company groups are able to enter into a greater variety of dealings and arrangements than can unrelated entities (a point which is recognised in the 1979 OECD Report at paragraphs 24 and 38), the argument that Division 13 should not be applied in these cases is not accepted. If this view was to be accepted, Division 13 would be rendered inapplicable to a large number of international dealings with the consequence that significant opportunities for international profit shifting would not be addressed. Division 13 was intended to cover all international dealings which had the capacity to adversely affect the Australian revenue and has been deliberately drafted in the broadest possible terms so as to achieve this policy aim.

342. Where the application of Division 13 is contemplated in situations involving types of dealings between related parties which may not occur between unrelated parties, the role of the Division is to consider the underlying economic and commercial reality of the situation. Regard would be had to the economic functions performed or to be performed, the assets and skills used or available for use and the degree and nature of risks involved and/or to be rewarded in respect of the various parties to the dealing. Some of the factors listed in paragraph 315 may also be useful in this regard. In this way, a reasonable reflex can be obtained of the economic value of the contribution made by the activities carried on in Australia which can then provide a basis for comparison with the actual pricing of the inputs and outputs by the relevant company in its dealings with other entities.

What methodologies can be used to ascertain an arm's length consideration?

343. Division 13 does not prescribe any particular methodology for the purpose of ascertaining an arm's length consideration. Nor does it prescribe a preference for the order in which particular arm's length methodologies should be used. Given that there is no prescribed legislative preference, the Commissioner would generally seek to use methods that have been given international endorsement and to adopt the method that is the most appropriate or best suited to the circumstances of each particular case.

344. In determining the most appropriate method, companies and ATO auditors should bear in mind that:

(a) the Commissioner is under no obligation to accept the particular method chosen by companies unless, on an objective analysis, it produces the most accurate calculation of the arm's length consideration in the particular case. Companies should be mindful of this and can reduce the risk of disputation by being able to demonstrate that their choice of method is the most appropriate for their circumstances (in this regard, reference should be made to paragraphs 378 - 385 on documentation);

(b) choosing the most appropriate method would take into account relevant market and business factors, the functions performed or to be performed, the assets and skills used or available for use and the degree and nature of risks involved and/or to be rewarded in respect of the various parties to the dealing;

(c) a result that is fair, in the sense referred to in *Mobil Oil Australia Pty Ltd v. FC of T* (supra), does not mean the result that produces the most favourable taxation outcome for the company or the company group of which it may be a member - or necessarily the result that produces the highest amount of Australian tax;

(d) a result that is fair must consider the policy and objects underlying Division 13 and recognise that Australia should not be denied its fair share of tax based on the economic value it has contributed, measured by reference to the arm's length principle; and

(e) the most appropriate method will be the one that produces the highest practicable degree of comparability, recognising though that there will be unique situations and cases involving valuable intangibles where it is not

practicable to apply methods based on a high degree of direct comparability.

345. The following comments provide a general outline of methodologies which would be relevant for the purposes of Division 13. A more detailed discussion will be included in a later Ruling on Methodologies.

346. Various internationally accepted methods exist to determine an appropriate arm's length consideration. Many of these methods are referred to in the 1979 OECD Report. In the 1983 Speech, Mr Boucher stated that the 1979 OECD Report:

> "(while not) an interpretation of Division 13 as enacted by the Australian Parliament (is) so authoritative on the international scene as to represent something to which we in Australia do pay close regard".

347. The principal methods referred to in the 1979 OECD Report are:

(a) the comparable uncontrolled price method ("the CUP method");

(b) the resale price method;

(c) the cost plus method; and

(d) any other method which is found to be acceptable.

348. The ATO accepts the CUP method, the resale price method and the cost plus method as acceptable methodologies for the purposes of determining the arm's length consideration (or an amount for the purposes of subsection 136AD(4)) under Division 13. Other methodologies (such as those referred to in paragraph 367) are also acceptable. The method to be adopted in the circumstances of the particular case (the most appropriate method) should be the one that produces the highest degree of comparability.

349. The 1979 OECD Report at paragraphs 13 - 14 and 70 - 74 provides some discussion on certain other generic methods which have found varying degrees of favour within the international community. These other methods include comparable profits and various "global" methods of profit allocation (including predetermined formula methods and various yield methods). While these methodologies (which include profit splits and profit comparisons) are less direct ways of applying the arm's length principle - by focussing on rate of return and the process by which profits and expenses are allocated - they are also accepted by the ATO as being consistent with the arm's length principle and most appropriate for cases where a more direct comparability on price or profit margin is not possible or practicable. In that sense they are methods of last resort. This is not

to say that there needs to be an exhaustive search for direct comparables before these methods can be applied.

350. If after reasonable analysis of the facts and circumstances direct comparables or price or profit margin cannot be identified, other methods need to be considered and the most appropriate method selected. This will involve two stages of analysis since Division 13 requires the overall result achieved by such methodologies to be adjusted to the level of the particular international agreement and the arm's length consideration. For example, the application of a profit split or profit comparison - in cases where one or other of these is the most appropriate method - may produce an overall adjustment which needs to be apportioned across all relevant international agreements to produce the appropriate arm's length consideration.

351. It is necessary to bear in mind the cautionary tone expressed in paragraph 5 of the 1979 OECD Report and referred to in Mr Boucher's 1983 Speech, in which it was said:

> "What is set out in the main body of the report must necessarily be regarded, however, as only a general guide setting out principles that may be relevant and appropriate to apply in most cases to the different circumstances arising. The report does not and cannot lay down rules that are appropriate to every aspect of every case: it is an essential feature of the problem that it is always necessary to have regard to the particular facts of each case."

In this regard, the further comments made in paragraph 46 of the 1979 OECD Report and referred to at paragraph 340 above should also be kept in mind.

352. A detailed explanation of the more widely known methods used for ascertaining an arm's length consideration and of various circumstances in which these methods could be employed will be dealt with in a later Ruling. The purpose of discussing some matters relevant to particular methodologies in this Ruling is simply to provide broad directional guidance as to how the Commissioner would generally seek to ascertain an arm's length consideration for the purposes of section 136AD.

The CUP method

353. Broadly, the CUP method endeavours to ascertain an arm's length consideration by attempting to identify comparable transfers of property between unrelated parties in comparable markets and setting the relevant transfer price by reference to such comparable dealings. In this regard, the word "comparable" means "the same as, similar to or analogous". Even though identical dealings do not exist, there may

be comparables. Care needs to be taken to ensure that the comparable chosen is as close as practicable to the dealings under review.

354. While the CUP method involves close product similarity, its application also requires a consideration of all other factors relevant to comparability. For example, a business strategy based on price competition would be relevant. Similarly, the marketing of an identical or closely similar product under a brand name could have a material effect on comparability.

355. It is recognised that in practice it is often extremely difficult to ascertain an arm's length consideration under the CUP method. This is particularly true where the property involved is unique or highly differentiated, intangible property is involved, services are provided or received, markets are isolated or where, as in the case of transfers of work in progress in highly vertically integrated businesses, there is little or no comparability with dealings of unrelated parties.

356. The ATO considers that the CUP method can still have application even where there are differences between the dealing being reviewed and the dealings of the parties considered to be comparable, provided those differences are capable of quantification on some reasonable basis and adjustments can be made to produce a valid comparison (see also paragraph 46 of the 1979 OECD Report). Thus, an adjusted comparable uncontrolled price ("an adjusted CUP") could be acceptable as the arm's length consideration against which actual prices can be benchmarked. However, given that an element of judgment is involved in making adjustments, where the differences are significant other methods may need to be considered because such major adjustments may not result in a true comparable.

357. This position is consistent with the view expressed in paragraph 51 of the 1979 OECD Report which states that:

> "a useful comparison may still be possible so long as appropriate adjustments can be reasonably made to the uncontrolled price to take account of the differences. Similarly it may be possible to derive some help from sales of substitute goods though much will depend on the circumstances."

358. In seeking to find an adjusted CUP, regard should be had to factors which, although not directly measurable (such as the presence or absence of a tariff, credit terms or delivery terms) are sufficiently quantifiable to make the choice of the CUP method a more accurate measure of an arm's length consideration than the result produced by some other method. Such factors might include:

(a) whether intangibles are included (e.g. patents, copyrights, trademarks);

(b) geographic market place;

(c) level of market penetration;

(d) the provision of guarantees or after sales service;

(e) differences in functionality or the quality of functionality;

(f) the degree of physical similarity of product;

(g) volumes of sales or purchases (if volume has an effect on price) and the relevant terms of trade;

(h) whether services are provided with the goods sold;

(i) the duration of the relevant agreement and whether continuity of supply is important;

(j) whether the timing of the agreement affects the price; and

(k) whether any government regulation impacts on transfers or the price that can be charged.

The resale price method

359. The resale price method is based on the price at which a property or services acquired by a taxpayer is resold to an arm's length buyer. The selling price is then reduced by an appropriate mark-up to cover the taxpayer's costs and a profit margin. The balance remaining can be regarded as the arm's length consideration for the original acquisition. The matters at issue then become the determination of an appropriate mark-up and the identification of a comparable arm's length reseller.

360. Unlike the CUP method, the resale price method does not require the same close physical similarity with the property sold, or that services provided be as closely comparable with those provided by the comparable arm's length seller. A lack of close physical similarity is not necessarily indicative of dissimilar mark-up percentages. A comparison is made between the mark-up charged by comparable arm's length resellers and the mark-up charged by the relevant company. Where comparable arm's length resellers cannot be identified, an appropriate profit mark-up may be determinable by reference to the functions performed or to be performed, the assets and skills used or available for use and the degree and nature of risks involved and/or to be rewarded in respect of the company reselling the relevant property or services.

361. The resale price method is best suited to cases where there is a high degree of similarity of process between what the taxpayer does and the activities of independent parties engaged in comparable uncontrolled dealings. The resale price method is generally a more reliable measure where there is little usable evidence of comparable

uncontrolled sales, where the property or services sold are not used in a manufacturing process of the reseller, or the reseller does not add substantially to the value of the product, e.g. where the reseller, being merely a distributor, sells the product or service to an independent third party.

362. Where the non-arm's length reseller adds substantial value to the property (e.g. where the products are further processed through manufacture or are incorporated as components of a more complicated product so that the identity of the original products is lost or transformed or the taxpayer establishes, builds up or maintains a valuable trademark in the relevant market largely through its own expense and endeavour), a portion of the resale price is attributable to this effort. This addition would need to be assessed and accounted for, making it more difficult to establish an arm's length consideration and consequently, more difficult to apply this method.

The cost plus method

363. The cost plus method requires the estimation of an arm's length consideration by adding an appropriate profit mark-up to the supplier's cost. The profit mark-up is ideally determined by reference to the profit mark-up earned by the same supplier in a comparable dealing with an independent party. Some difficulty arises in applying this method to account for the differences in functions, price and cost when the non-arm's length supplier does not sell comparable property to independent parties in arm's length dealings. Where transactions are very interrelated it may be that they cannot be evaluated on a separate basis. These difficulties will be discussed in detail in a later Ruling. If there are no comparable sales by the non-arm's length supplier to arm's length parties, the profit mark-up is generally determined by reference to the profit mark-up earned by a comparable arm's length party in a comparable dealing with an independent party.

364. The cost plus method is generally a more reliable measure where components or unfinished goods are subject to additional manufacturing, assembly, addition of trade marks, etc prior to distribution, provided the process does not involve high value intangibles (sometimes unique or highly differentiated).

365. In considering whether the cost plus method is the most appropriate method to use in a particular case, regard should be had to the problems identified in the 1979 OECD Report associated with the use of this method (at paragraphs 64 - 69) and to the statement at paragraph 63 of the same report which says that:

> "Whilst it is true that an enterprise has to cover its costs over a period of time to remain in business, its costs do

not usually help much in forming an opinion of the appropriate profit in specific cases."

Other methods which may be appropriate

366. There may be situations, including but not confined to those dealing with intangibles, where CUP, resale price and cost plus methods are inadequate in approximating a satisfactory arm's length outcome. This leads to the need to have regard to other methods such as profit methods, and to develop methods that have regard to commercial and economic reality, the merits of each case, and the standard of the arm's length principle. That is not to say that companies and the ATO ought to depart from the first three methods referred to above merely because it is easier or administratively convenient. A profit method, as with any other method should be used where it is the most appropriate method because it produces the highest practicable degree of comparability in the circumstances of the particular case.

367. Where the CUP, resale price or cost plus methods are inappropriate on their own in a given case, having regard to commercial and economic realities and the nature of the company's business, products and markets, for the purposes of determining the arm's length consideration (or an amount for the purposes of subsection 136AD(4)) under Division 13, we will accept the use of:

(a) a mixture of the above three methods; or

(b) some other method (e.g. a profit split or profit comparison method) or a mixture of methods:

that is likely to lead to a result that is as consistent as practicable with the arm's length principle as internationally accepted.

Documentation

368. The purpose of this part of the Ruling is to cover the broad issues in relation to the types and extent of documentation taxpayers need to keep in relation to their transfer prices. A more detailed discussion will be the subject of a later Ruling. The starting point in considering documentation is that section 262A requires taxpayers: "[to] keep records that record all transactions and other acts engaged in by the person that are relevant for any purpose of [the Income Tax Assessment Act]". In particular the section requires taxpayers to keep:

(a) any documents that are relevant for the purpose of ascertaining the person's income and expenditure; and

(b) documents containing particulars of any election, estimate, determination or calculation made by the person under that Act and, in the case of an estimate, determination or calculation, particulars showing the basis on which and the method by which the estimate, determination or calculation was made.

369. The section goes on to say that the records must be kept in the English language or so as to enable the records to be readily accessible and convertible into writing in the English language, and that they must be kept in such a way as to enable the person's liability to tax under the Act to be readily ascertained. The basic requirement is that those records be maintained for 5 years or until the completion of the transactions or acts to which those records relate, whichever is the later.

370. In addition there are practical reasons why, in terms of Division 13, taxpayers would be well advised to keep contemporaneous documentation. Division 13 imposes obligations on taxpayers to use best endeavours to lodge correct tax returns and to pay the right amount of tax based on the economic value added in the respective jurisdictions (calculated in accordance with the arm's length principle). It does not seem possible for taxpayers to comply with these expectations if, at the time of lodging tax returns, they do not address the question of whether their dealings comply with the arm's length principle. Other provisions impose general obligations on taxpayers to lodge accurate returns.

371 In order to effectively do this, it seems to us that taxpayers need to keep sufficient contemporaneous records to enable this evaluation to be done. While section 262A only requires those records created during the setting of transfer prices and used in the preparing of tax returns to be retained, taxpayers are nevertheless advised to keep contemporaneous documentation in order to demonstrate that their international dealings comply with the arm’s length principle. It is not accepted that taxpayers need not address the question of whether their pricing policies comply with the arm's length principle until they are subject to audit by the ATO. It also needs to be remembered that sections 14ZZK and 14ZZO of the Taxation Administration Act provide that the ultimate onus of proof in the event of disputation rests with the taxpayer.

372. If taxpayers have not maintained appropriate records the process of checking compliance with the arm's length principle becomes far more difficult and ATO auditors are forced to rely on less evidence on which to apply a methodology, thus requiring a greater degree of judgment.

373. In terms of administrative approach, the ATO will seek to rely as much as possible on documentation that should be created in the ordinary course of business. However, in order to satisfy the arm's length principle taxpayers who deal with related parties need to do an analysis in accordance with the principles set out in this Ruling. In this regard we will limit requirements to the minimum necessary to ensure compliance with the arm's length principle.

374. In seeking to ascertain the most appropriate method for determining the arm's length consideration in respect of the supply or acquisition of property under an international agreement and also for determining whether resort may need to be made to subsection 136AD(4), we will ask companies:

(a) what methodology they are using;

(b) the reasons why they consider their choice of methodology to be the most appropriate to the relevant international agreement(s) and to their particular circumstances; and

(c) how and why they chose the particular price as a result of applying their chosen methodology.

375. In testing a taxpayer's methodology and in those cases where no particular methodology has been chosen by companies to set their international transfer prices in relation to the supply or acquisition of property under an international agreement, we will be asking their opinion as to:

(a) which products, goods or services, etc, if any, they consider to be most comparable to the products, goods or services being investigated;

(b) who their major competitors are;

(c) which of their competitors they consider to be most comparable to them; and

(d) what they consider to be the most appropriate methodology to use in their particular circumstances.

This information will be considered in determining whether resort may need to be made to subsection 136AD(4).

The use of contemporaneous documentation

376. In undertaking an analysis of whether the consideration for the supply or acquisition of property under international agreements represented an arm's length consideration, we will be asking companies, inter alia, to provide us with relevant documentation created when the dealing was being contemplated and at the time the arrangement was entered into. Where there is inadequate contemporaneous documentation of non-arm's length international dealings, it is clearly more difficult for companies to convince us that the dealings took place on an arm's length basis. This view has also been expressed in the 1979 OECD Report at paragraph 25 where it is stated that:

> "If the transactions are not adequately evidenced by contemporary documents it is clearly more difficult for the (multinational company group) to convince the tax authorities that they took place in the form and manner claimed or that the transactions compare properly with particular transactions between unrelated parties."

However, companies will be given ample opportunity to explain their business circumstances and pricing policies.

377. It would not be unreasonable to expect companies under audit to provide relevant documents, explanatory material and other information which the company has or to which the company could reasonably be expected to have access. The nature of the documentation likely to be sought would include relevant pricing policies, product profitabilities, relevant market information (such as sales forecasts and market characteristics), the profit contributions of each party, and an analysis of the functions, assets, skills and the degree and nature of the risks involved for the various parties. (Regard should also be had to the discussion on "Access to relevant information" in paragraphs 387 - 389.)

Ways companies can reduce the possibility of disputation

378. Where international agreements are being contemplated by companies in the same multinational group, the risk of the Commissioner seeking to make an adjustment under of Division 13 can be considerably reduced where the companies involved:

(a) establish the economic justification prior to the arrangement being entered into;

(b) satisfy themselves that the consideration is an arm's length consideration; and

(c) have the necessary contemporaneous documentation to support the matters referred to in (a) and (b) above and

> the assessment of market conditions at the time the pricing decisions were made.

379. The position outlined above is consistent with the views expressed in the 1979 OECD Report, where it is stated that:

> "In such instances tax authorities would have to determine what is the underlying reality behind an arrangement in considering what the appropriate arm's length price would be." (paragraph 24)

380. Companies can also reduce the risk of disputation over their choice of methodology for the particular international agreement(s) if they are able to provide reasons why the chosen methodology is appropriate to their circumstances. However, companies would not be required to undertake an intricate analysis of other methodologies but should have a sound basis for using the selected methodology.

381. Companies can similarly reduce the likelihood of disputation where they establish a systematic arm's length process for setting international transfer prices and consistently follow the process they have established. Where companies have only occasional related-party dealings, they may have many transactions with unrelated parties against which they can benchmark their prices.

382. In the event that contemporaneous documentation does not exist, companies should review their pricing policies against the principles set out in this Ruling and satisfy themselves that they accord with the arm's length principle and that dealings with related parties have been carried out on that basis. Documentary evidence that such reviews have been done should reduce the risk of disputation to the extent that the review properly addresses the requirements of the arm's length principle. However, for the future, companies would be well advised to maintain contemporaneous documentation.

383. Where a company finds on review that its pricing policies do not comply with the arm's length principle, the company should request an amended assessment under subsection 170(1). Assessments amended in this way will not be treated as involving the exercise of the Commissioner's discretion under Division 13 and therefore will not activate section 225 penalties. Normal procedures regarding voluntary disclosures would apply.

384. Division 13 is seen as imposing an obligation on taxpayers to conform to the arm's length principle for tax purposes in respect of international dealings. Accordingly, it is expected that companies will take reasonable care to ensure that when preparing their tax returns they properly review the data available to them and address the question of whether the amounts of income and deductions included in their tax returns have been calculated according to the arm's length principle. Where companies have not used arm's length consideration

in the ordinary course of their day to day dealings with non-arm's length parties, an adjustment should be made for tax purposes at the time of preparation of their tax returns.

385. While the above suggestions, if adopted in good faith, are likely to lead to reduced disputation with the Commissioner, it must still be emphasised that in the event of disputation, the onus of proof ultimately rests with taxpayers by virtue of sections 14ZZK and 14ZZO of the *Taxation Administration Act 1953*. A more detailed discussion on the nature and extent of relevant documentation will be the subject of a later Ruling.

Advance Pricing Agreements

386. Companies may also wish to consider the merits of entering into an Advance Pricing Agreement ("APA") on a unilateral basis with the ATO, or on a bilateral basis with the ATO and the tax authority of a foreign country with which Australia has concluded a double tax agreement. An APA provides greater certainty for both the taxpayer and the revenue authorities concerned, minimises the likelihood of a dispute, and more effectively reduces the potential for double taxation by allowing the parties to address and resolve international transfer pricing issues on a prospective basis which reflects arm's length principles. A later Ruling will provide more detailed procedures.

Access to relevant information

387. In seeking to establish the relevant facts associated with arrangements to which section 136AD may have application, including joint venture arrangements and barter and countertrade arrangements, relevant information will be sought from the parties involved both informally and formally (where necessary) under sections 263, 264 and 264A.

388. In respect of offshore information notices under section 264A, and the exchange of information provisions of double taxation agreements, ATO auditors need to exercise judgment as to whether informal approaches will enable all the relevant information to be obtained in a reasonable timeframe. Where this is not the case, for example where the taxpayer has been tardy or unco-operative in providing all the relevant information from Australian or overseas sources, formal requests should be made under section 264A and/or the relevant double taxation agreement for information held offshore to enable the audit to be completed within a reasonable timeframe. The fact that section 263 or section 264 have already been used or might be used in the future does not prevent the use of section 264A notices, or the exchange of information provisions under double

taxation agreements, though ATO auditors should take care to avoid unnecessary duplication. However, on occasions auditors may need to verify information if there is reason to believe that the information provided may be inaccurate, misleading or incomplete.

389. The basis upon which prices are established between related parties in respect of transfers of property is central to the issue of whether or not the consideration represents an arm's length consideration. Taxpayers can therefore expect that such information will be sought by us at an early stage of an audit. Where such information is either not held or able to be obtained by a company operating in Australia but could reasonably be expected to be held by the company's foreign parent or some other offshore related entity, ATO auditors should consider whether an offshore information notice under section 264A and/or a request under a double taxation agreement should be issued with a view to obtaining such information. Additional guidelines in respect of the use of the access provisions in the context of Division 13 will be provided in a later Ruling.

The Commissioner has a discretion whether or not to apply section 136AD

390. The exercise of the discretion to make adjustments under Division 13 is neither automatic nor mandatory. Long established case law such as *Sharpe v. Wakefield & Others* (1891) AC 73, demonstrates that an exercise of a discretion of this type must be:

> "according to the rules of reason and justice, not to private opinion; according to law, and not humour. It is to be not arbitrary, vague and fanciful, but legal and regular."

391. The Commissioner must take into account all relevant facts and circumstances as they existed at the time the international agreement was made in forming a view as to whether the amount of consideration in an international agreement needs to be adjusted. It would also be relevant to consider subsequent events to the extent that they are relevant to testing purpose or assist in determining the true nature of any agreement by comparing the conduct of the parties and the stated terms of the agreement. Irrelevant circumstances should be excluded from consideration.

392. In particular the Commissioner needs to be satisfied that the various preconditions in subsections 136AD(1), (2), or (3) are met as the case may be. Consideration also needs to be given to whether the exercise of the discretion, or a failure to exercise it, would be consistent with the policy underlying Division 13 (*Cooper Brookes (Wollongong) Pty Ltd v. FC of T* (1981) 147 CLR 297; section 15AA

of the *Acts Interpretation Act 1901*). The Explanatory Memorandum, at page 66, states that the intention behind the granting of the discretion is to:

> "enable the Commissioner to have regard to whether the use of non-arm's length prices has resulted in a shifting of taxable income from Australia."

393. It would also be relevant to consider whether there is any evidence of the taxpayer's purpose since this would also be a relevant factor. However, this would need to be weighed with other factors, including the effect on the Australian revenue of the use of non-arm's length consideration, against the wording and legislative purpose of section 136AD.

394. Having regard to the legislative intent, where paragraphs (a), (b) and (c) of subsections 136AD(1) - (3) have been satisfied, then, in the absence of sound reasons to the contrary, it could be expected that the discretion in paragraph (d) of the relevant subsection would be exercised where the Australian revenue has been disadvantaged.

395. Where the discretion under paragraph (d) of subsections 136AD(1), (2) or (3) is exercised, a formal determination should be made to that effect (see also paragraph 416(a) below regarding the need to cover the determination of the source of the amount by which the actual consideration is deemed to have been increased). The nature and process of making determinations will be discussed in more detail in a later Ruling.

The arm's length consideration determined under section 136AD replaces the actual consideration

396. Where all of paragraphs (a), (b), (c) and (d) of subsection 136AD(1) or (3) have been satisfied, then the actual consideration is deemed to be adjusted to the arm's length consideration for all purposes of the application of the ITAA (i.e for tax purposes). Similarly, where all the paragraphs of subsection 136AD(2) have been met, then consideration equal to the arm's length consideration in respect of the supply is deemed to have been received for all purposes of the application of the ITAA (i.e for tax purposes). Subsection 136AD(2) also provides a mechanism for determining the time at which the arm's length consideration is deemed to have been received and receivable by the taxpayer (discussed at paragraph 398 below).

397. The above result, whereby the actual consideration (or the absence of consideration) is adjusted to the arm's length consideration, is consistent with the internationally recognised "arm's length principle".

The time of receipt of the arm's length consideration for the purposes of subsection 136AD(2)

398. Where subsection 136AD(2) is applied to deem an arm's length consideration in respect of the supply of property, in circumstances where no consideration had been received or receivable, it is also necessary to ascertain the point in time when the deemed consideration is received or receivable so that normal rules regarding the timing of derivation of income can be applied. The legislation provides that the time the arm's length consideration will be deemed to have been received or receivable shall be:

(a) at the time when the property was supplied; or

(b) as the case requires, any of the property was first supplied; or

(c) at such later time or times as the Commissioner considers appropriate.

399. The use of the expression "any of the property" in conjunction with the expression "was first supplied" referred to in paragraph 398(b) above, indicates that there will be occasions when it would be appropriate, in accordance with normal terms of trade, to regard payment for property to be supplied to have been made in full, or at least receivable, when the first shipment is supplied. This is notwithstanding the fact that some of the property to be supplied under the "agreement" will not be supplied until a later point or points in time or that the property (such as with the provision of some services) is being supplied on a continuous basis, for example over the whole of a year of income.

400. The reference to "such later time or times" in subsection 136AD(2), referred to in paragraph 398(c) above, would cover cases where, for example, the terms of trade normally provided for payment within a certain period after the property is supplied or payment by instalments over a number of years.

Does a tax avoidance purpose need to exist before Division 13 can apply?

401. It has frequently been suggested that a tax avoidance purpose needs to be identified before a determination can be made under Division 13. Proponents of this view have referred to the following passage from the Second Reading Speech on the *Income Tax Assessment Amendment Bill 1982* ("the Second Reading Speech") being the Bill which introduced Division 13. This passage declares that the objective of the Division is to address all international arrangements that result in a loss to the Australian revenue even where

the arrangement was not entered into primarily for tax avoidance purposes:

> "the proposed measures are not limited in scope to arrangements that have a dominant tax avoidance purpose. In that regard, it is important to recognise that an arrangement to shift profits out of Australia may be entered into for a complex mixture of tax and other reasons. However, as I mentioned in my earlier statement to the House on this matter, *the fact that tax saving is not a key purpose of a particular arrangement or transaction is no reason why we, as a nation, should not be in a position to counteract any loss to the Australian revenue inherent in it."* (emphasis added)

402. That statement is reinforced by the terms of Division 13 and other parts of the Second Reading Speech, and it is important to note in this regard that nowhere in section 136AD is there to be found a requirement for the existence of a tax avoidance purpose, nor any implied requirement that a tax avoidance purpose is to be identified. In this regard the drafting of Division 13 can be contrasted with that of Part IVA.

403. The suggestion that the Commissioner is nonetheless required to identify a tax avoidance purpose is not accepted. As stated by the then Treasurer elsewhere in the Second Reading Speech, the introduction of Division 13 completes:

> "a package of general measures that are designed to render ineffectual arrangements that have the purpose *or effect* of avoiding Australian tax." (emphasis added)

404. It is accepted that in considering whether to exercise the discretion in sections 136AD(1), (2) or (3) the Commissioner should consider the taxpayer's purpose. However this would not be determinative on its own, given the policy underlying Division 13 and its wording.

405. As stated in paragraphs 154 - 178, Division 13 is concerned with ensuring that transfers of property under "international agreements" (which have the potential to adversely affect the Australian revenue) are subjected to Australian taxation on a basis that is consistent with the arm's length principle.

406. The above view is consistent with the position expressed in the 1979 OECD Report, where at paragraph 3 it says:

> "It is important to bear in mind, moreover, that the need to adjust the actual price to an arm's length price, in order to arrive at a proper level of taxable profits, arises

> irrespective of any contractual obligation undertaken by the parties to pay a particular price *or of any intention of the parties to minimise tax.* Hence, the consideration of transfer pricing problems should not be confused with the consideration of problems of tax fraud or tax avoidance, even though transfer pricing policies may be used for such purposes." (emphasis added)

407. It is the view of the ATO that the Commissioner does not have to identify a tax avoidance purpose in order to invoke the discretion in paragraph (d) of subsections 136AD(1), (2) and (3). Cases where there is a tax avoidance purpose are clearly intended to be countered by Division 13 where the use of non-arm's length consideration results in an underpayment of Australian tax. But it does not follow that the absence of a tax avoidance purpose renders the Commissioner's discretion inoperative. This view is reinforced by section 225 which clearly envisages the application of Division 13 in non-tax-avoidance cases, and it is consistent with the legislative intent.

408. Where a tax avoidance purpose does exist in relation to a matter being considered in the context of Division 13, then Part IVA may also have application, where the particular requirements of Part IVA are satisfied. The interaction between Division 13 and Part IVA will be dealt with in a later Ruling.

409. Section 225 imposes a penalty where Division 13 has been applied, notwithstanding the absence of a tax avoidance purpose. The existence of a tax avoidance purpose results in a higher statutory penalty. Additional guidelines to those in IT 2311 and TR 92/11 in relation to penalties in Division 13 cases will be provided in a later Ruling.

Higher tax rates in foreign countries in themselves do not suggest an absence of profit shifting

410. Arguments have been put to us that we should accept that profits would not be shifted overseas where foreign nominal or effective company tax rates are comparable to the prevailing company tax rate in Australia. It has been urged that Division 13 should not be applied in these cases. This argument is not accepted because it ignores the fact that the main objective of Division 13, as was stated in the Second Reading Speech, is to ensure that Australia receives its fair share of tax in accordance with the arm's length principle as internationally accepted.

411. International profit shifting may seek to take advantage of:

(a) differences in effective tax rates as a result of concessions and tax preferences;

(b) timing differences with respect to the imposition and payment of tax; and

(c) other advantages that flow from paying tax in one jurisdiction rather than another (e.g. foreign tax credits, franking credits, etc).

In other words, while tax rates may be comparable there may be advantages in paying tax in a country other than Australia and it is therefore not accepted that profits would not be shifted overseas in these cases.

The source of income

412. In general terms, section 25 of the ITAA operates to establish a liability to Australian income tax in respect of income derived:

(a) by Australian residents - from all sources; and

(b) by non-residents - from sources in Australia.

Having regard to the fact that Division 13 changes the tax effect of actual dealings, a special rule is required to determine the source of any additional income or profits arising as a result of the operation of the Division. Similarly, because Division 13 can operate to reduce expenditure, there is a need to have a special rule to enable the nexus between income and expenditure to be determined.

413. Section 136AE provides for the determination of the geographical source of income and the allocation of related expenses in cases in which:

(a) section 136AD *has been* applied to deem an arm's length consideration as having been received or receivable or given or agreed to be given in respect of the supply or acquisition of property under an international agreement (subsections 136AE(1), (2) or (3)); or

(b) section 136AD does not apply - where the circumstances involve the allocation of income and or expenses within the one entity (e.g. between a permanent establishment and its head office or between two permanent establishments of the same entity) (subsections 136AE(4), (5) or (6)).

414. Where section 136AE is applied, the relevant income or expenditure is deemed for all the purposes of the ITAA to have been derived or to have been incurred in deriving income:

(a) from a particular source or from such sources; and

(b) in such proportions,

as the Commissioner determines. Subsection 136AE(1) applies to individuals and companies, subsection 136AE(2) to partnerships and subsection 136AE(3) to trusts. Cases involving subsections 136AE(4) to (6) (see paragraph 413(b) above) will be addressed in a later Ruling.

415. Where section 136AD has been applied (see paragraph 413(a)), a question may arise whether, and if so, as to the extent to which:

(a) income consisting of the arm's length consideration deemed to have been received or receivable for property supplied has a source in Australia or in another country; or

(b) the arm's length consideration deemed to have been given or agreed to be given for property acquired was expenditure incurred in deriving income from sources in or out of Australia.

416. Such questions might arise, for example, in the following circumstances:

(a) An Australian company charges a foreign associate $250,000 for goods or services provided to it by the Australian company. After investigation, a determination is made under subsection 136AD(1) and $450,000 is deemed as the arm's length consideration in respect of the supply of the property. Other than for the operation of Division 13, the $200,000 would not have been derived by the Australian company. If a question arose as to the source of the additional $200,000 deemed consideration, the Commissioner is able to determine the source of that income under sub-paragraph 136AE(1)(b)(i).

Views may differ as to whether there is a question of source as to the additional $200,000 "deemed" consideration. On one view, the question of source is determined by the source of the actual consideration of $250,000. On the other view, it could be argued that the source of the additional $200,000 is a separate question given that this amount would not have been included in assessable income under section 25, but for the application of Division 13. Given this divergence of views, auditors should address their minds to the question of source of the additional $200,000 and determine the appropriate source of this amount in any determination made. The inclusion of the words "as to the extent to which" in relation to the Commissioner's determination of the source of income have the effect that the Commissioner can make that determination in relation to

a part of the arm's length consideration that has been deemed to have been received or receivable;

(b) An Australian company does not charge a foreign associate for the goods or services provided to it or for the use of intangible property belonging to the Australian company. After investigation, a determination is made under subsection 136AD(2) and $500,000 is deemed as the arm's length consideration in respect of the supply of the property. As no amount of income has been derived by the Australian company for the purposes of subsection 25(1) (apart from the operation of Division 13), the question would arise as to the source of the deemed income (sub-paragraph 136AE(1)(b)(i)). By the operation of subsection 136AE(1), the Commissioner is able to determine the source of that income;

(c) An Australian associate of a foreign company group is invoiced by a foreign associate for an amount of $10,000,000 being for the acquisition of motor vehicle parts. After investigation, a determination is made under subsection 136AD(3) and an arm's length consideration of $7,500,000 is deemed in respect of the acquisition of the property. The amount of $7,500,000 will therefore represent the deduction allowable to the Australian company under subsection 51(1). In this respect it is difficult to see how a question would arise under section 136AE, since the disallowance of part of the deduction for stock does not involve a reallocation of expenses.

However, a question might arise as to the nature of the balance of the expenditure that the Australian associate company has been charged for, being the amount of $2,500,000. As subsection 136AE(1) makes a reference to "that consideration", which in the context of the subsection is a reference to the deemed arm's length consideration, it would appear that subsection 136AE(1) can have no application to the amount of $2,500,000. How the overcharged disallowed amount of $2,500,000 is to be treated falls within the realm of secondary adjustments which are to be dealt with in a later Ruling.

417. In each of the above examples, regard must be had to the operation of any source rules contained within Australia's double taxation agreements. In that regard, the determination of source may differ depending on the type of income involved. If for example, an Australian entity undercharges an overseas associate for trading stock supplied directly from Australia, the amount undercharged would be deemed to be income sourced in Australia. On the other hand, if an

Australian entity supplied technology to an associate resident in a country with which Australia has a double tax agreement, the income would be royalty income and treated as sourced in the overseas country pursuant to the source rule contained in the relevant double tax agreement. The determination of source would also have to have regard to whether Division 13 is being applied directly to an Australian company or is being applied under Australia's accruals tax rules.

418. In the application of subsections 136AE(1) to (3), subsection 136AE(7) requires amongst other things that regard shall be given to:

(a) the nature and extent of any relevant business activities and the place or places at which the business is carried on (paragraph 136AE(7)(a)); and

(b) such other matters *as the Commissioner considers relevant* (paragraph 136AE(7)(c)).

419. Accordingly, the issues that we would consider in determining the source or sources of income or the extent to which expenditure was incurred in deriving income would include:

(a) the nature and extent of any relevant business activities;

(b) the place or places at which the business is carried on;

(c) the functions performed in each country, the assets and skills employed in each country and the risks and responsibilities borne by the various entities;

(d) the economic value added to the relevant property in each location;

(e) the application of common law rules relating to source (though the application of Division 13 often presupposes that these rules have been effectively circumvented or that section 25 does not apply);

(f) the degree of connection between each amount of expenditure and the income derived in each jurisdiction;

(g) other circumstances relevant to a particular company and "agreement"; and

(h) the operation of any source rules in any applicable double taxation agreement.

Transfers of property including trading stock and other goods and services

420. Subsection 136AD(1) could generally be expected to apply where a person carrying on business in Australia sells property (e.g.

trading stock) overseas at a reduced price in a non-arm's length dealing, unless there was cogent evidence that the consideration received or receivable was, in reality, the arm's length consideration.

421. In cases where the consideration is, prima facie, less than the arm's length consideration, companies would be expected to:

(a) have ascertained what an arm's length consideration might reasonably be expected to be in respect of the relevant supply of property; and

(b) be able to supply the necessary contemporaneous documentation or - in the case of past dealings where contemporaneous documentation was not kept - a reasoned case based on all the facts and circumstances that then applied to support the transfer prices that have been adopted. For the future, companies should maintain sufficient contemporaneous documentation to enable tax returns to be prepared having regard to the arm's length principle.

422. A more detailed discussion on the nature and extent of the documentation that we would expect to be held to support contentions put to us that an arm's length consideration was received or receivable will be dealt with in a later Ruling (see also paragraphs 368 - 377 above).

423. We have found cases where a foreign parent company has sent a facsimile or telex message to its Australian associated company stipulating what the price for the acquisition of property, to be exported from Australia, will be. Again, it cannot be said that the parties are dealing at arm's length with each other as there is no real bargaining between the parties in respect of the acquisition of property. Subsection 136AD(1) could therefore normally be expected to apply to such cases where the other requirements of the subsection are satisfied. Regard should also be had to the matters in paragraphs 326 and 327.

424. Paragraph 40 of the 1979 OECD Report states that "The question has to be considered whether, in an arm's length situation, goods might be supplied for no payment or an unusually low payment, or might be supplied at a price producing less than the usual profit or even a loss". It then goes on to make the following comments in respect of the question raised:

(a) It would not be unusual for an independent enterprise to do this (i.e. to sell at a loss or at no cost) if the goods were samples or advertising offers, but associated enterprises are not likely to be in a parallel situation;

(b) The question is more likely to arise in connection with goods sold to an associate in financial difficulties when some or all of the payment might be waived;

(c) It would be very exceptional for this to occur in transactions between independent enterprises, though the possibility cannot be wholly discounted (for example a supplier might to some extent be prepared to waive payment by an independent customer *in temporary difficulties* in order to preserve a potentially valuable outlet for his goods); and

(d) Tax authorities could properly require *very convincing proof* that this situation would arise before accepting a nil or reduced payment between associated enterprises as equivalent to the arm's length price. Payment might be deferred in such circumstances in the arm's length situation but this would normally affect the price or be compensated for under a credit arrangement of some sort.

(emphasis added)

425. Our view is in line with these remarks. It is not accepted that independent parties dealing at arm's length would supply goods free of charge except in the very narrow circumstances and under the same sorts of conditions as referred to in paragraph 40 of the 1979 OECD Report.

426. Subsection 136AD(3) could generally be expected to apply where the other preconditions of Division 13 have been satisfied and profits have been shifted out of Australia by a person carrying on business in Australia purchasing property (e.g. trading stock) from overseas at an inflated price (refer to the Explanatory Memorandum at page 68).

427. In cases where the consideration given or agreed to be given for purchases is, prima facie, more than the arm's length consideration, companies would be expected to meet the same criteria as identified in paragraph 421 to support contentions that the transfer prices adopted represent an arm's length consideration. A more detailed discussion on the nature and extent of the documentation that we would expect to be held to support contentions put to us that an arm's length consideration was given or agreed to be given will be dealt with in a later Ruling.

428. There have been some cases where foreign parent companies have sent advice to their Australian associated company stipulating what the price for the property, to be imported into Australia, will be. In other cases, the foreign parent company has directed the return that the Australian associated company is to make. In such cases, it could not be said that the parties were dealing at arm's length with each

other as there has been no real bargaining between the parties in respect of the acquisition of property by the Australian associated company. Subsection 136AD(3) could therefore normally be expected to apply to such cases where the other requirements of the subsection are satisfied. Regard should also be had to the matters in paragraphs 326 and 327.

429. Additionally, instances have also come to light in the course of audits where non-resident companies which have incurred expenditure on behalf of, or provided services to, their Australian associates have charged amounts which exceed the value of the economic benefits obtained by the Australian associate. In such cases, subsection 136AD(3) could normally be expected to apply to reduce the consideration in respect of the charge levied on the Australian associate to an arm's length consideration (which in some cases may be the cost, and in some other cases may be a nil amount - as would be the case with shareholder costs). Regard should also be had to the possible disallowance of expenditure not complying with the requirements of subsection 51(1). These matters will be discussed in a later Ruling.

Where doubt exists about the financial capacity of an associate to pay for purchases

430. Where doubt exists about the financial capacity of an associated entity to pay an arm's length consideration, alternative arrangements such as those referred to in paragraph 40 of the 1979 OECD Report would be considered acceptable where these would be consistent with what independent parties dealing at arm's length would enter into if confronted with similar circumstances. It would generally not be acceptable for companies to simply reduce the purchase price or to indefinitely defer demands for payment without some form of compensation or security being provided to the supplier of the goods.

431. The nature of any compensation or security to be provided would depend on the facts of each case and again would need to be consistent with what independent parties dealing at arm's length with each other would agree to if faced with similar circumstances. In this respect, a distinction can be drawn between a company experiencing temporary cash flow difficulties, for which few if any alternative financial arrangements would be likely to be made and a company which may be facing insolvency. In dealings between related parties, the nature and extent of any financial support or guarantees that have been provided in the past by associated entities in respect of dealings with independent parties or other related parties or which might reasonably be expected to be provided would also be relevant to consider. TR 92/11 provides more detail as to how deferral of

demands for payment for balances due between related parties (e.g. by suppliers of goods) could attract the application of section 136AD.

Pricing of 'Baskets of goods'

432. A "basket of goods" could be described as the supply or acquisition of a range of "property" (not including intangible property or services) under a broadly based (or "umbrella") agreement covering one or more product lines. In the usual situation, a more streamlined pricing policy is applied which seeks to avoid treating each good or product within the "basket" as a discrete item having a unique price. Examples of such streamlined pricing policies could include common profit margin mark-ups applied to product lines or across all goods contained within the "basket".

433. An issue which sometimes arises is whether we would require an individual price to be ascertained in respect of each discrete item contained within a "basket of goods" or whether we would accept a more streamlined pricing policy as representing the arm's length consideration in respect of the supply or acquisition of property. Our view is that neither paragraphs (b) or (c) of subsections 136AD(1), (2) and (3) (being the relevant paragraphs in this instance) require, as a matter of practical application, the arm's length consideration in respect of discrete goods contained within a "basket of goods" to be determined, rather than accepting in appropriate cases, the adoption of a more streamlined pricing policy. The question for the purposes of section 136AD is: What would be the arm's length consideration in respect of the supply or acquisition of an equivalent "basket of goods" under a comparable "agreement" between independent parties dealing at arm's length?

434. The further question has been put to us whether we agree with the statement in paragraph 41 of the 1979 OECD Report in respect of the pricing of discrete goods comprised within a "basket of goods". It is stated in paragraph 41 that "It may be reasonable in some circumstances to analyse the transfer prices for product lines or other groupings rather than to ascertain an arm's length price for each individual product or sale. An enterprise may find it necessary to sell some products at less than the market price or even supply them free in order to make a higher profit on its sales of products overall to the same buyer."

435. We expect that companies already know and would be able to demonstrate what it cost them to purchase or to produce each discrete good or product line. The view expressed in paragraph 41 of the 1979 OECD Report is that it may be reasonable in some circumstances for an enterprise to sell *some* products at less than the market price or supply them free in order to make *a higher profit* on its sales of products overall *to the same buyer*. In some cases, it may be thought

desirable from a marketing point of view to have a full range of certain products, even though some are not expected to make money. Two aspects of the OECD statement must be emphasised. First, it only applies to some products (and given the examples used in paragraph 41 of the 1979 OECD Report, these products would be ancillary to the major product lines). Secondly, it only applies where the decision to sell some products at less than market price or cost (or even free) is to make higher profits than would otherwise have been obtained. Where the evidence shows that higher overall profits in Australia were in fact realised as a consequence of following the business strategy, it could be expected that the arrangements would be acceptable to us provided independent parties dealing at arm's length might reasonably have been expected to have entered into a comparable agreement.

436. This is not to say Division 13 would not be applied in a situation where a particular item in a "basket of goods" has been priced below the arm's length amount and, having regard to the particular product and its market, the pricing cannot be explained by the business strategy. The conduct of the parties also needs to be examined to determine if it is consistent with the professed business strategy.

437. It is also stated in paragraph 41 of the 1979 OECD Report that:

> "an unusually low or high price would, however, have to be examined closely and substantiated by cogent evidence, and the prices realised on resale by the buyer could be relevant."

We would go further and say that in respect of transfers of "baskets of goods" between associated entities, the price eventually realised upon resale to an independent party would be a relevant factor in examining the nature of the business strategy and in determining whether it was capable of achieving its purpose, and whether it was in fact implemented. It would be equally relevant to compare the overall profit made on a "basket of goods" with the total profit that could be made on the basis of individual product sales and whether the business strategy resulted in any deferral or avoidance of Australian tax.

438. There is a view expressed by some practitioners that the concept of a "basket of goods" should be applied more broadly. This issue will be addressed in a later Ruling on Methodologies.

Effects on the value of opening and closing trading stock where an adjustment is made under subsection 136AD(3)

439. Where a determination is made under subsection 136AD(3), the deemed arm's length consideration applies for all purposes of the

application of the ITAA. In respect of property which is trading stock, the deemed arm's length consideration will affect not only the deduction allowable under subsection 51(1) in respect of the acquisition of the trading stock, but may also affect the value of any relevant trading stock still on hand at the end of a year of income. These additional consequences may also affect the calculation of the taxable income or loss of a company where a Division 13 determination has been made. An example will illustrate one of the possible situations which could arise.

440. Assume as in example (c) in paragraph 416(c) that a Division 13 determination is made to reduce purchases of $10,000,000 to $7,500,000. Assume also:

(i) in its tax return, $4,000,000 worth of motor vehicle parts are recorded by the Australian associate as still on hand at the end of the year of income (cost price being used for the purposes of subsection 31(1));

(ii) that (for the purpose of this example) the effect of the determination can be apportioned on a straight line basis between the stock on hand and the stock which has been sold. i.e. the value of any of the overpriced stock still on hand will be 25% ($1,000,000) less than the value of stock on hand recorded by the Australian associate ($7,500,000 / $10,000,000 x $4,000,000 = $3,000,000, a reduction of $1,000,000);

(iii) an amount of $12,000,000 was included by the Australian associate in its assessable income under subsection 28(2) (being the excess of the value of the trading stock on hand at the end of the year of income over the value of the trading stock on hand at the beginning of the year of income). This figure of $12,000,000 includes the $4,000,000 representing the overpriced stock still on hand.

In this situation, the amount to be included in the assessable income of the Australian associate under subsection 28(2) would be reduced by $1,000,000 in accordance with step (ii) above to $11,000,000. The revised amount of $11,000,000 would then form the value of the opening stock on hand for the purposes of the succeeding year of income under section 29. This may also have a continued flow-on effect for later years.

Existence of a business purpose insufficient in itself to avoid Division 13

441. An Australian entity may have a business purpose for supplying property at no consideration or less than an arm's length consideration or, alternatively, acquiring property for more than an arm's length consideration from an offshore subsidiary. However, that in itself is not adequate to take the dealings outside the ambit of Division 13.

442. For example, an Australian parent company may provide goods for sale at little or no charge to an offshore subsidiary to enable it to accumulate profits for reinvestment. Where this is the purpose of the provision of the goods, subsection 136AD(1) or (2) could be expected to apply to attribute an arm's length consideration in respect of the supply of the goods by the Australian parent even though there was a business purpose to the dealings.

443. Similarly, a non-resident company in dealings with an Australian subsidiary may have a business purpose for supplying property at more than an arm's length consideration or acquiring property for no consideration or less than an arm's length consideration. Again, that in itself is not adequate to take the arrangement outside the ambit of Division 13.

444. For example, a non-resident parent company may have an urgent need for funds and impose terms for payment of goods in advance of their supply, which would not be encountered were the parties to the agreement independent parties dealing at arm's length with each other (such terms might include the payment of a deposit in excess of that which arm's length parties would have agreed to). Even where this is the purpose for the advance payment (i.e. in essence a disguised loan), subsection 136AD(1) or (2) could be expected to apply with the result that an arm's length consideration will be deemed by way of the interest that might reasonably have been expected to have been received by the Australian subsidiary in respect of the advance payment.

"Start up", "market penetration" and "obsolete stock prices"

445. As indicated in the 1983 Speech, Mr Boucher said that:

> "A company endeavouring to break into a market may, for a period, undercut its competitors in that market. When the circumstances are enquired into, that might be found to be an arm's length price. So too, where a company has surplus stocks that it must unload for a price lower than could apply in a balanced market."

446. Paragraph 43 of the 1979 OECD Report makes the following relevant comments in respect of specially low prices charged by producing entities to associated marketing entities:

(a) that in general specially low prices may be expected to be charged *for a limited period only, with the specific objective of improving the profits of the producer in the long term*; (emphasis added)

(b) that producers may not be alone in this kind of activity and that both producing and marketing entities may combine in such an operation, splitting the risk and sharing the profitable outcome, if any, in some way between them; and

(c) that tax authorities could in principle accept such low prices charged between associated enterprises as arm's length prices *but only if independent enterprises could be expected to have fixed the prices in the same manner in comparable circumstances*. (emphasis added)

The matters raised in paragraphs 315 - 317 above would also need to be considered.

447. While we are in broad agreement with these views, it needs to be recognised that they consider the issue of specially low prices arising out of "start up", "market penetration" or "obsolete stock prices" mainly from the point of view of the producing or manufacturing entity. The role of related party marketing or distribution entities in any such business strategy is only lightly discussed and the ultimate effect, if any, on prices charged to arm's length consumers in the relevant market is not referred to at all. In our view, such additional matters would also be relevant for the purposes of assessing comparability with what independent parties dealing at arm's length might reasonably have been expected to have done in comparable circumstances. Such matters are referred to in more detail below.

448. It has been suggested that the 1979 OECD Report may be too narrow in the context of current global marketing techniques and competition. We agree that a reasonable period of time needs to be allowed to enable genuine business strategies to take effect. What is a reasonable timeframe will depend on the facts and circumstances of the case. However, regard could be had to the sorts of business strategies generally being pursued in the particular market and the characteristics of the market (including all of the features listed at paragraph 315(c)). We would want to be satisfied, though, that there was a reasonable basis for the view that greater profits would be obtained in the foreseeable future. Where prices are set such that losses are being incurred beyond a reasonable period and no strong indication exists that profitable operations will return or commence in the near future, a transfer pricing adjustment may be appropriate, particularly where comparable data over several years shows that the

losses have been incurred for a period longer than that affecting comparable independent parties.

449. It would also generally not be accepted that a business strategy of sacrificing some level of price or profit in order to increase market share is something an independent party would do while there was a level of unmet demand in the relevant market.

Goods leaving Australia

450. It has been argued that subsection 136AD(1) should not be applied where Australian producing/wholesaling companies reduce or discount the price at which property is supplied to foreign marketing/distribution associates where the price reduction or discount is for the purpose of increasing market share, establishing a new market in the foreign country, introducing its products into an existing market in the foreign country or to clear surplus or obsolete stock.

451. Whether Division 13 would be applied in cases where property is supplied to a foreign associate at discounted prices, will depend on the facts and circumstances of each case and in particular on:

(a) the discounted prices being charged for only a limited period, in accordance with a genuine business strategy and with the specific objective of improving the profits of the Australian producer in the longer term;

(b) the research and analysis undertaken at the time to support the business strategy;

(c) the market conditions prevailing at the time;

(d) the market impact of any price discount strategies and the financial and taxation consequences for the parties involved; and

(e) regard being given to what independent parties dealing at arm's length might reasonably have been expected to have done in comparable circumstances.

It would also be expected that companies would continually monitor the particular market or markets in which the discounted goods are being sold.

452. There may be cases where goods are sold to an independent distributor at discounted prices to increase the distributor's profit and thereby entice the distributor to become tied to the supplier's products, or at least provide a reliable competitive outlet for the goods. Division 13 would not be applied in such a case unless there is evidence of some back to back or collateral arrangement or side deal.

453. It is somewhat more difficult to reach a similar conclusion in relation to a related party distributor, but if the related party has a high level of independence (see paragraph 291), operates as a truly separate profit centre with authority (which it exercises) to deal with third party suppliers, and adopts arrangements similar to those used by independent distributors in that market, Division 13 would, in general, not be applied unless the particular case exhibits other abnormal features that are inconsistent with independent dealing.

Goods entering Australia

454. The comments made in paragraph 43 of the 1979 OECD Report (referred to in paragraph 446), while of more general application, are relevant to the situation where a transferor company directs an associated company to charge a reduced price to unrelated parties yet at the same time fails to reduce the transfer price of the underlying goods or services that it charges to its associate. Where independent parties dealing at arm's length with each other would not have entered into a similar arrangement, then subsection 136AD(3) could be expected to be applied.

455. For example, foreign producer companies selling goods through an associated marketing/distribution entity in Australia, may wish to establish a new market in Australia, increase market share, introduce its products into an established Australian market or to clear surplus or obsolete stock. Accordingly, they may direct that lower prices be charged by the Australian distributor to unrelated Australian buyers, without decreasing the prices charged to their Australian distributor. The pricing of such arrangements would generally only be acceptable for taxation purposes where:

(a) the discounted prices were charged for only a limited period, in accordance with a genuine business strategy and with the specific objective of improving the profits of both the foreign producer and Australian marketing entity in the longer term;

(b) they reflected the respective contributions of the producing and marketing/distribution entities in terms of: the nature of functions performed; the assets and skills used; and the degree and nature of any business or financial risks involved; and

(c) regard had been given to what independent parties dealing at arm's length might reasonably have been expected to have done in comparable circumstances.

456. In these cases, for taxation purposes, it would be expected that discounted retail prices in Australia would generally result in a

reduction in the wholesale prices of the goods or services being charged to the Australian distributor, and that the marketing entity is properly rewarded for its efforts - taking account of market realities - if an adjustment under subsection 136AD(3) is to be averted.

457. In cases where prices to related marketing/distribution companies are high relative to prevailing market selling prices and particular market strategies, companies would be expected to provide information on the issues identified in paragraphs 451 - 453 that would support contentions that the price charged by the foreign company to its Australian associate in respect of the property acquired by the Australian associate is arm's length.

The treatment of joint venture arrangements

458. The following discussion is included to reflect the fact that separate legal entities can have dealings with each other in the context of an unincorporated joint venture. In those cases each individual entity within the joint venture will be subject to Division 13 where all the pre-conditions of application are satisfied, unless the arrangement is a partnership for the purposes of the ITAA - in which case Division 13 applies as appropriate to the partnership.

459. A joint venture is an unincorporated contractual association, other than a partnership or a trust, between two or more parties to undertake a specific business project in which the joint venturers meet the costs of the project and receive a share of any resulting output (see the definitions of "joint venture" in Accounting Standards Review Board Approved Accounting Standard, ASRB 1006 and the Statement of Accounting Standards, AAS 19). The establishment of a joint venture does not create a separate legal entity. Often a joint venture, as defined in the accounting standards, will fall within the definition of the word "partnership" in subsection 6(1) of the ITAA. It is not the purpose of this Ruling to discuss such situations.

460. The term joint venture has also been found to include references to "joint venture companies" which are not joint ventures, in the sense referred to in the accounting standards, but special purpose companies incorporated to carry out a specific business purpose.
The incorporation of a company to carry out a specific business purpose creates a new legal entity. This section of the Ruling is directed towards joint ventures in the sense referred to in the accounting standards. Joint venture companies, being separate legal entities, would be treated no differently to any other separate legal entity to which Division 13 may have application.

461. In joint venture arrangements, it is common for some or all of the parties to the joint venture to provide property instead of or in addition to finance. While legal title to property may not transfer

(though equitable interests or other equitable rights may be created), it is clear that making property available confers a benefit on the other joint venturers. Using the Division 13 concepts, the property provided could include, inter alia, plant and equipment, rights, services and/or the making available of intangible assets (such as processes or patents) for use by the joint venture. The provision of property to a joint venture in these circumstances clearly falls within paragraph (b) of the definition of "supply" in subsection 136AA(1).

462. Paragraph 136AA(3)(b) provides that a reference in Division 13 to "consideration" includes a reference to property supplied or acquired as consideration and a reference to the amount of any such consideration is a reference to the value of the property. Accordingly, where property is supplied to or acquired from a joint venture, it will be the value of that property which will be relevant for the purposes of the Division.

463. In many joint venture arrangements, the "consideration" for the supply of property to the joint venture may be a share of the proceeds of the joint venture (i.e the product produced by the joint venture). For example, two mining companies may agree to jointly develop a lease with a view to each of them obtaining 50% of the coal. Each is free to independently market the coal or use it in production etc. In such cases, subsections 136AD(1), (2) or (3) may be applied to either or both of the supply or acquisition of property having regard to the value of the contribution to the joint venture, the product sharing agreement and the division of output between the joint venturers.

464. Where property is supplied to a joint venture under an international agreement, subsection 136AD(1) could normally be expected to apply to any of the joint venturers who were not dealing at arm's length with each other and where the consideration in respect of the supply of property was less than an arm's length consideration. Similarly, subsection 136AD(2) may be expected to apply where no consideration was received in respect of the supply of property. While, on the face of it, it might be expected that the real risk of non-arm's length dealing would occur in joint ventures between related parties, there is still the possibility of back to back and collateral arrangements between unrelated parties. Accordingly, these principles are stated in relation to joint ventures generally.

465. The output or product of a joint venture obtained by each joint venturer would also clearly fall within paragraph (b) of the definition of "acquire" in subsection 136AA(1). The property obtained might, for example, include minerals, partly finished goods or finished goods. Where property is obtained from a joint venture under an international agreement, subsection 136AD(3) could normally be expected to apply to any of the joint venturers who were not dealing at arm's length with

each other and where the consideration in respect of the acquisition of property was more than an arm's length consideration.

466. The fact that the joint venturers may have agreed upon the value to be ascribed to the property provided by each of the joint venturers or to the share of the product of the joint venture obtained by each of the joint venturers does not automatically mean that such agreed values represent the arm's length consideration in respect of the supply or acquisition of the relevant property. The facts of each case will be relevant when trying to ascertain the value (and product share) that independent parties dealing at arm's length would have allocated to the supply or acquisition of the relevant property by each of the joint venturers.

467. In ascertaining the arm's length consideration in respect of property provided to or obtained from a joint venture, regard should be had, inter alia, to such matters as:

(a) the terms of the joint venture agreement;

(b) the relevant interests in the joint venture of the individual joint venturers;

(c) the value of the property provided to the joint venture by the other joint venturers, whether in money or in property (including services) or both;

(d) the value of the property obtained from the joint venture by each of the joint venturers (such as minerals, partly finished goods or finished goods);

(e) the functions performed, the assets and skills employed and the risks and responsibilities borne by each of the joint venturers;

(f) any broader "agreement" which may exist; and

(g) any agreement as to the disposition of assets upon cessation of the joint venture.

The treatment of barter and countertrade arrangements

468. It needs to be recognised that separate legal entities can engage in barter and countertrade arrangements amongst themselves on a cross-border basis. This part of the Ruling considers how Division 13 applies in these situations where the pre-conditions of its operations are met.

469. For the purposes of this Ruling, barter and countertrade arrangements will have the same meanings as given in paragraphs 2 and 3 of Taxation Ruling IT 2668. Paragraph 2 of IT 2668 states that:

> "In its simplest form, bartering involves the direct exchange of goods or services for other goods or services without reference to money or a money value."

470. In respect of arrangements where a company issues shares in itself in exchange for property, the general principles espoused in this Ruling would apply.

471. Taxation Ruling IT 2668 covers the income tax implications of barter and countertrade arrangements, other than the application of Division 13. Paragraph 7 of IT 2668 states that the essential principle is that these dealings are assessable and deductible only to the same extent as similar cash or credit dealings. Similarly, timing principles for the derivation of income and the incurring of expenditure that apply to cash or credit dealings apply equally to barter and countertrade arrangements.

472. Section 136AD could be expected to apply to barter and countertrade arrangements involving the supply or acquisition of property under international agreements where the parties to the barter or countertrade arrangement were not dealing at arm's length with each other and the value of the consideration is not arm's length in respect of the relevant supply or acquisition. The effect of subsection 136AA(3) is to convert consideration "in specie" into the money value of the property supplied or acquired.

473. In barter arrangements under international agreements, there is both a supply and acquisition of property (by virtue of the word "exchange" in paragraph (a) of the definitions of "supply" and "acquisition" in subsection 136AA(1)). Both sides of any barter or countertrade arrangement should be benchmarked against arm's length prices to ensure that the consideration received or given respectively is equivalent to the value of what is being supplied or acquired.

474. For the purposes of ascertaining the arm's length consideration that might reasonably be expected to have been agreed in respect of the supply and acquisition of property under a barter arrangement, we will accept as indicative of an arm's length consideration:

(a) the cash price and terms which the company would normally have obtained from an independent party dealing with the company at arm's length for the supply of the property (see also paragraph 15 of IT 2668); and

(b) the cash price and terms which the company would normally have expected to have agreed to with an independent party dealing with the company at arm's length for the acquisition of the property.

475. The fact that the parties to a barter arrangement may have agreed upon the value to be ascribed to the property contributed by each of them, does not automatically mean that such agreed values represent the arm's length consideration in respect of the supply or acquisition of the relevant property. The facts of each case will be relevant when trying to ascertain the arm's length consideration in respect of the relevant property exchanged by each of the parties to the barter arrangement. The arm's length consideration will be relevant for a range of purposes including depreciation, trading stock valuation and capital gains calculations.

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