LCR 2018/6 - Diverted profits tax

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Generated on: 21 November 2026, 03:12:21 AM

Page status: **not legally binding**

Diverted profits tax

Relying on this Ruling

The 'Specific issues for guidance' section of this publication (paragraphs 10 to 50) is a public ruling for the purposes of the Taxation Administration Act 1953.

This Ruling describes how the Commissioner will apply the law as amended by Schedule 1 to the Treasury Laws Amendment (Combating Multinational Tax Avoidance) Act 2017 to entities that rely on this Ruling in good faith.

To the extent that it is a public ruling, if you rely on this Ruling in good faith, you will not have to pay any underpaid tax, penalties or interest in respect of matters covered by that section in the Ruling if it does not correctly state how a relevant provision applies to you.

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What this Ruling is about

1. This Ruling addresses Schedule 1 to the *Treasury Laws Amendment (Combating Multinational Tax Avoidance) Act 2017* (the Act), which introduces a diverted profits tax (DPT) for significant global entities. This Ruling is provided to assist you with understanding the law.

Date of effect

2. The 'Specific issues for guidance' section (paragraphs 10 to 50) of this Ruling is a public ruling, effective from 1 July 2017 for those who rely on it in good faith.

Outline of the law

3. The DPT is designed to ensure that significant global entities do not reduce the amount of Australian tax they pay by diverting profits offshore through arrangements with related parties.

4. Schedule 1 to the Act amends Part IVA of the *Income Tax Assessment Act 1936* (ITAA 1936)[1] by inserting sections 177H to 177R. There are also consequential amendments to the *Income Tax Assessment Act 1997* (ITAA 1997) and the *Taxation Administration Act 1953* (TAA).

5. The objects of the DPT provisions are set out in section 177H and are as follows:

- to ensure that the Australian tax payable by significant global entities properly reflects the economic substance of the activities that those entities carry on in Australia (paragraph 177H(1)(a))
- to prevent those entities from reducing the amount of Australian tax they pay by diverting profits offshore through contrived arrangements between related parties (paragraph 177H(1)(b)), and
- in addition, to encourage those entities to provide sufficient information to the Commissioner to allow for the timely resolution of disputes about Australian tax (subsection 177H(2)).[2]

6. Where the DPT applies, the Commissioner may make an assessment of the taxpayer's liability to diverted profits tax. The tax is imposed at the rate of 40% on the diverted profit and is due and payable at the end of 21 days after the Commissioner gives the relevant taxpayer notice of the assessment.[3]

[1] All legislative references in this Ruling are to the ITAA 1936 unless otherwise indicated.
[2] Subsection 177H(2) makes it clear that Division 145 of Schedule 1 to the TAA is also relevant to achieving this object.
[3] Section 177P; section 4 of the *Diverted Profits Tax Act 2017*. For assessments of the amount of the tax see Divisions 145 and 155 of Schedule 1 to the TAA 1953.

7. For the DPT to apply, the following criteria must be satisfied:

- the relevant taxpayer has obtained, or would but for section 177F obtain, a tax benefit (the DPT tax benefit) in connection with a scheme in a year of income (paragraph 177J(1)(a))[4]
- it would be concluded, having regard to the matters in subsection 177J(2), that a person who entered into or carried out the scheme or any part of the scheme did so for a principal purpose of, or for more than one principal purpose that includes a purpose of:
  - enabling the relevant taxpayer to obtain a tax benefit, or both to obtain a tax benefit and to reduce one or more of the relevant taxpayer's foreign tax liabilities, in connection with the scheme, or
  - enabling the relevant taxpayer and another taxpayer (or other taxpayers) each to obtain a tax benefit, or both to obtain a tax benefit and to reduce one or more of their foreign tax liabilities, in connection with the scheme (paragraph 177J(1)(b))
- the relevant taxpayer is a significant global entity for the relevant year of income (paragraph 177J(1)(c))
- a foreign entity is an associate of the relevant taxpayer at any time in the relevant year of income (paragraph 177J(1)(d))
- the foreign entity entered into or carried out the scheme or any part of the scheme, or is otherwise connected with the scheme or any part of the scheme (paragraph 177J(1)(e))
- the relevant taxpayer is not an entity listed in paragraph 177J(1)(f) (paragraph 177J(1)(f)), and
- it is reasonable to conclude that none of sections 177K ($25 million income test), 177L (sufficient foreign tax test) and 177M (sufficient economic substance test) apply in relation to the relevant taxpayer, in relation to the DPT tax benefit (paragraph 177J(1)(g)).

8. These criteria, which must be satisfied in order for the DPT to apply, include the principal purpose test in paragraph 177J(1)(b). The principal purpose test is the central provision around which the DPT operates. Consequently, while the DPT provisions are not provisions of last resort, consistent with the operation of Part IVA generally, it is expected that the DPT will be applied in limited circumstances.

9. The revised explanatory memorandum to the Treasury Laws Amendment (Combating Multinational Tax Avoidance) Bill 2017 (EM) contains a detailed outline of the DPT provisions (with paragraphs 1.9 to 1.15 of the EM providing a summary of the law).

[4] The guidance provided to tax officers in Law Administration Practice Statement PSLA 2005/24 *Application of General Anti-Avoidance Rules* in relation to the application of Part IVA, including the requirement for the taxpayer to obtain a tax benefit in connection with the scheme and the identification of that tax benefit being made by reference to a relevant alternative postulate, is relevant in this context.

Specific issues for guidance

Principal purpose test

Consistency with the test in the multinational anti-avoidance legislation (MAAL)

10. The principal purpose test in paragraph 177J(1)(b) is essentially mirrored in paragraph 177DA(1)(b) for the purposes of the MAAL provisions except that the list of matters to which regard must be had is different. Therefore the views expressed at paragraphs 11 to 16 in Law Companion Ruling LCR 2015/2 *Section 177DA of the Income Tax Assessment Act 1936: schemes that limit a taxable presence in Australia* are relevant to the interpretation of the phrase '…for a principal purpose of, or for more than one principal purpose that includes a purpose of…' in paragraph 177J(1)(b).

Consideration of the eleven matters

11. In applying the principal purpose test, subsection 177J(2) requires regard be had to the eight matters listed in subsection 177D(2) and the three additional matters listed in paragraphs 177J(2)(b) (the scheme's quantifiable non-tax financial benefits), 177J(2)(c) (the scheme's foreign tax results), and 177J(2)(d) (the amount of the tax benefit mentioned in paragraph 177J(1)(b)).[5]

12. Consistent with the application of Part IVA generally, regard must be had to all of the eleven matters referred to in subsection 177J(2) in applying the principal purpose test.

13. Although it is necessary to have regard to all of the matters in subsection 177J(2) in applying the principal purpose test, not all of the matters will be relevant in every case and some may be more relevant than others. As with the application of Part IVA generally, regard may be had to the matters individually or globally and it is not essential in reaching a conclusion as to purpose that each matter should indicate the requisite purpose.[6]

Quantifiable non-tax financial benefits

14. Paragraph 1.52 of the EM states that the significance of the quantifiable non-tax financial benefits which have resulted, will result, or may reasonably be expected to result from the scheme relates to the amount of those benefits relative to the tax benefit. The EM also explains that if the scheme produces significant quantifiable non-tax financial benefits (in comparison to the amount of the tax benefit and, where relevant, the reduction in liability to foreign tax), this may provide a strong indication that the scheme was not entered into or carried out for a principal purpose of obtaining a tax benefit. However, this factor must be considered and given appropriate weight alongside the other factors which taken together may lead to a different conclusion.

15. Consistent with the approach to considering the matters outlined in paragraphs 177D(2)(e), (f) and (g), this matter requires identifying the consequences that may reasonably be expected to result from the scheme, not just changes that have resulted or will result from the scheme. Quantification of the non-tax financial benefits that will or may reasonably be expected to result from the scheme will generally be based on the outcomes that were anticipated at the time of entry into the scheme, provided that those outcomes were based on reasonable commercial assumptions.[7]

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[5] Paragraph 1.90 of the EM provides that the facts and circumstances surrounding the use of foreign tax losses, foreign tax credits or other foreign tax attributes may be taken into account in considering the principal purpose test.

[6] *Federal Commissioner of Taxation v. Consolidated Press Holdings Ltd* [2001] HCA 32 at 94; 207 CLR 235 at 263; 179 ALR 625 at 643; 2001 ATC 4343 at 4360; 47 ATR 229 at 246; *Peabody v. Federal Commissioner of Taxation* (1993) 40 FCR 531 at 543; 112 ALR 247 at 258; 93 ATC 4104 at 4113-4114; 25 ATR 32 at 42.

[7] Refer to paragraph 1.54 of the EM.

The amount of the tax benefit mentioned in paragraph 177J(1)(b)

16. In applying the principal purpose test, paragraph 177J(2)(d) requires regard to be had to the amount of the tax benefit mentioned in paragraph 177J(1)(b).

17. Paragraph 177J(1)(b) refers to a tax benefit obtained by the relevant taxpayer (subparagraph 177J(1)(b)(i)) and it also refers to a tax benefit obtained by another taxpayer or other taxpayers (subparagraph 177J(1)(b)(ii)).

18. Where the scheme involves an entity (or entities) other than the relevant taxpayer obtaining a tax benefit, the amount of the tax benefit referred to in paragraph 177J(2)(d) includes the tax benefit(s) obtained by the other taxpayer (or taxpayers), in addition to the tax benefit obtained by the relevant taxpayer.

19. This may be relevant, for example, when considering the relative significance of the quantifiable non-tax financial benefits that have resulted, will result, or may reasonably be expected to result from the scheme. That is, their significance should be considered in relation to the tax benefit(s) covered by paragraph 177J(1)(b).

20. Any modification made to the amount of the DPT tax benefit under subsection 177J(5) (where the thin capitalisation provisions apply) or subsection 177J(6A) (where the associate foreign entity is a controlled foreign company) does not affect the amount of the tax benefit mentioned in paragraph 177J(1)(b).

Sufficient foreign tax test

Foreign tax liability: determination of amount

21. The foreign tax liability is determined by quantifying the total of the increases in the amount of foreign income tax that is liable to be paid or that is reasonably expected to be liable to be paid as a result of the scheme. This requires that a legally enforceable obligation to pay the tax has arisen, or may reasonably be expected to arise.

22. The increases in liability for foreign income tax (however those increases arise) must result, or reasonably be expected to result from the scheme, and the increases must arise or reasonably be expected to arise in a foreign tax period that corresponds to the income year in which the DPT tax benefit is obtained.

23. The 'increases in liability for foreign income tax' are determined by quantifying the increases of each relevant entity's liability for foreign income tax as a result of the scheme. An entity's liability for foreign income tax is the foreign income tax[8] that is or may reasonably be expected to be imposed and payable in the relevant foreign jurisdiction(s).

Foreign tax liability: recognised entities – groups of entities

24. The calculation of the foreign tax liability may require the Commissioner to consider tax liable to be paid by an entity on behalf of or in place of the relevant foreign entity. This may include tax liable to be paid by a head entity or a single taxpayer for a group of entities within a particular jurisdiction.

25. Where the scheme involves fiscally transparent or flow-through entities (such as partnerships or trusts), the increases in liability for foreign income tax may include the liabilities of members of those entities for the purposes of calculating the foreign tax liability. For example, a scheme could involve a partnership making distributions of foreign income to its partners. In such a case, any related foreign income tax liabilities of the partners may be considered for the purposes of determining the foreign tax liability (provided they are covered by subsection 177L(5)).

[8] As defined in section 770-15 of the ITAA 1997.

Meaning of foreign income tax

26. The term 'foreign income tax' is defined in section 770-15 of the ITAA 1997 as a tax on income, profits or gains (of a revenue or capital nature) or any other tax that is subject to a double tax agreement.

27. The definition of foreign income tax is intended to cover taxes that are substantially equivalent to Australian income tax. The tax must be imposed by a law other than an Australian Commonwealth, state or territory law. The foreign law may be at the level of a national or sub-national government. The ATO has issued a list of foreign taxes imposed by Australia's major trading partners (see ATO's *Guide to foreign income tax offset rules 2018*) for which a foreign income tax offset may be available. While not exhaustive, this list may provide guidance in determining the taxes that would qualify as foreign income tax for the purposes of the sufficient foreign tax test.

Reduced Australian tax liability: interaction with the thin capitalisation rules

28. The rule in subsection 177J(5) modifies the way in which the amount of the DPT tax benefit is worked out. The modification preserves the role of the thin capitalisation rules in Division 820 of the ITAA 1997 as a comprehensive regime with respect to an entity's level of debt.[9]

29. For entities that are subject to the thin capitalisation rules, the modification allows the Commissioner to adjust the return on a debt interest to a rate that would have applied had the scheme not been entered into or carried out, but the rate must be applied to the amount of debt actually issued (and still on issue from time to time) in determining the amount of the DPT tax benefit.

30. Therefore, by applying the rate to the debt interest actually issued in determining the amount of the DPT tax benefit, the DPT will not alter the debt levels used to fund Australian operations that are allowed under the thin capitalisation rules. This ensures that the DPT does not defeat the object of the thin capitalisation rules.

31. The thin capitalisation modification changes what would otherwise be the amount of the DPT tax benefit. The modification may affect the taxpayer's liability to diverted profits tax under section 177P and the sufficient foreign tax test.

Foreign tax liability: recognition of losses and foreign credits

32. Paragraphs 1.89 and 1.90 of the EM explain that even though a foreign associate is resident in a jurisdiction with a comparable tax rate to Australia's corporate tax rate, a reduced or nil amount of foreign tax could be liable to be paid during all or some of the years to which the scheme relates, due to the availability of a foreign tax loss, foreign tax credit or other foreign tax attributes. These paragraphs of the EM confirm that it is the actual foreign tax liability payable (after a reduction for foreign tax losses, foreign tax credits or other foreign tax attributes) in the period commensurate with the income year in which the DPT tax benefit is obtained, which is the relevant measure for the sufficient foreign tax test.[10]

[9] In this respect, subsection 177J(5) applies in a similar way to the way that section 815-140 of the ITAA 1997 applies in the context of the transfer pricing rules.

[10] Paragraph 1.91 of the EM explains that the facts and circumstances surrounding the use of those foreign tax losses, foreign tax credits or other foreign tax attributes may be taken into account in considering the principal purpose test.

33. Other foreign tax attributes which may be taken into account in determining whether the total of the increases in liability for foreign income tax is at least 80% of the reduced Australian tax liability include:

- any refunds that may be received for tax paid (or tax that will be paid at some point in the future)
- the operation of any tax relief in the foreign jurisdiction
- any law in the foreign jurisdiction that allows income of the kind received in connection with the scheme to be exempt from or otherwise not subject to tax, and
- any law in the foreign jurisdiction that allows deferral of a tax liability.

34. Tax may be treated as refunded to the extent that a refund of tax, or a credit for tax, is made, or is reasonably expected to be made in the future, to any relevant entity, directly or indirectly in respect of the foreign tax payable.

35. This may extend to any refunds or credits to an entity (that meets subsection 177L(5)) that is a shareholder, beneficiary, partner, or other equity holder in another entity. For example, the Commissioner may obtain information that the global value chain involves a structure whereby a foreign entity is held by a holding company in a different foreign jurisdiction. Under this structure, the shareholders of the holding company may be able to claim a refund on the tax assessed to the foreign entity. After taking into account the refund of taxes, the sufficient foreign tax test may not be satisfied.

Sufficient economic substance test

36. The sufficient economic substance test in section 177M is an exception to the application of the DPT. The test is satisfied where the profit made as a result of the scheme by each relevant entity[11] reasonably reflects the economic substance of the entity's activities in connection with the scheme. In determining whether section 177M is satisfied, it is necessary to first identify the relevant entity's activities in connection with the scheme and ascertain the economic substance of those activities. It can then be determined whether the profit made by the entity in respect of those activities represents a reasonable reward in respect of those activities. The term 'profit' in section 177M is used in a more general sense than 'taxable income'.

Concept of economic substance

37. The term 'economic substance' describes the economic reality or essence of the relevant activities. It is determined by examining all of the relevant facts and circumstances, such as the conduct of the parties, the economic and commercial context of the relevant activities, and the object and the effect of those activities from a practical and business point of view. Subsection 177M(4) also requires regard to be had to the assets used, the functions performed and the risks assumed in relation to the activities. This encompasses an examination of an entity's activities in the context of a wider transaction or arrangement.

[11] See subsection 177M(2).

Relevance of the OECD Guidelines

38. Subsection 177M(4) requires regard to be had to the 2010 OECD Transfer Pricing Guidelines (OECD Guidelines) and other documents covered by section 815-135 of the ITAA 1997[12], to the extent that they are relevant to the matters mentioned in paragraph 177M(4)(a) or to any other aspect of the determination.[13]

39. The OECD Guidelines (read together with the 2015 OECD Report) require the accurate delineation of actual transactions between associated enterprises, which typically includes a 'broad-based understanding of the industry sector in which the MNE group operates…and of the factors affecting the performance of any business operating in that sector.'[14] Examples of such factors include 'business strategies, markets, products, [the group's] supply chain, and the key functions performed, material assets used, and important risks assumed.'[15] Where relevant, the sufficient economic substance test utilises the same concepts in considering transactions or arrangements involving associated entities (to determine whether the profits made by those entities reasonably reflect the economic substance of their activities in connection with the scheme). Therefore a functional analysis is used in delineating the actual transaction by determining whether any contractual agreement governing the transaction reflects its economic substance, having regard to the conduct of the parties and the functions performed, assets used and risks assumed by them.

Profit must reasonably reflect the economic substance of the entity's activities

40. It is a question of fact whether the profit made by an entity as a result of a scheme reasonably reflects the entity's activities in connection with the scheme.

41. In determining whether the profit made by any entity reasonably reflects the economic substance of the entity's activities, it is necessary to have regard to:

- the relative economic significance of the functions performed by the entity in connection with the scheme (including their frequency, nature and value), and
- the entity's relative contribution within the context of the overall value chain, to generating the total profit made as a result of the scheme.

42. In applying the test, it is the economic substance of the entity's activities in connection with the scheme that is relevant, not the overall economic substance of the entity itself. Entities may have multiple operations and business lines interacting across multiple jurisdictions. The focus will be on the quantum of the profit made relative to the economic substance of the entity's activities undertaken in connection with the scheme. For example, as set out in paragraph 1.111 of the EM, an entity may have significant operations and employees, but the actual activities and functions undertaken by those employees in connection with the scheme may be small relative to the profit made by that entity in connection with the scheme.

[12] These documents include the Aligning Transfer Pricing Outcomes with Value Creation, Action 8-10 – 2015 Final Reports, of the Organisation for Economic Cooperation and Development, published on 5 October 2015 (2015 OECD Report).

[13] This could include consideration of the wider question as to whether the profit made by an entity reasonably reflects the economic substance of the entity's activities in connection with the scheme – refer to paragraph 1.108 of the EM.

[14] OECD Guidelines (subject to the 2015 OECD Report) at paragraph 1.34.

[15] OECD Guidelines (subject to the 2015 OECD Report) at paragraph 1.34.

43. Whereas the $25 million income and sufficient foreign tax tests (in sections 177K and 177L) are considered with respect to the income year in which the DPT tax benefit is obtained by the relevant taxpayer, the sufficient economic substance test is not so confined. For example, where a taxpayer obtains a DPT tax benefit in the 2017–18 income year in connection with a scheme that commenced in the 2015–16 income year, it is necessary, in applying the sufficient economic substance test, to have regard to the profit made by each relevant entity as a result of the scheme commencing from the 2015–16 income year onwards.

44. For the purposes of the DPT, it will be necessary to examine the functions, assets and risks not only of the relevant Australian taxpayer, but also other entities connected to the scheme. All entities that are a party to or connected with the scheme are tested for sufficient economic substance unless the entity's role in the scheme is minor or ancillary.[16]

45. The economic substance test may not be satisfied where, for example:

- the entity's role in the scheme does not make commercial sense
- the scheme as a whole does not make commercial sense
- the scheme does not produce a real economic effect because the transactions under the scheme are self-cancelling, offsetting or circular, or
- the entity's role is primarily explicable by the tax consequences which arise as a result of the scheme, for example re-invoicing schemes, outsourcing arrangements, sale and leaseback arrangements, sale and licence back arrangements, and arrangements involving interposed or fiscally transparent entities.

46. In determining whether the profit made as a result of the scheme by each relevant entity reasonably reflects the economic substance of the entity's activities in connection with the scheme, it will be necessary to consider the constituent elements of the profit including the income and related expenses arising from the entity's activities, with reference to the functions performed, assets used and risks assumed by the entity.

47. In determining whether a risk assumed under a contract by an entity has economic substance, it is relevant to consider whether the entity to which the risk is allocated has:

- the functional capability to assume and manage that risk, by having personnel who are both capable of performing, and actually perform, the 'risk control functions' involving making decisions to take on the risk and whether and how to manage the risk, and
- the financial capacity to assume that risk.[17]

48. For example, the control functions in respect of the economically significant risks in relation to internally developed intellectual property (IP) are those related to the development, enhancement, maintenance, protection and exploitation of the IP. An entity that acts simply as the legal owner of IP but does not perform any of these control functions by actively exercising decision making related to taking on and managing these risks is not ultimately entitled to any portion of the return derived from exploitation of the IP (other than arm's length compensation, if any, for holding title).[18]

[16] Paragraphs 1.104 and 1.105 of the EM discuss matters relevant to deciding whether an entity's role in the scheme is minor or ancillary.
[17] OECD Guidelines (subject to the 2015 OECD Report) at paragraphs 1.60–1.67.
[18] OECD Guidelines (subject to the 2015 OECD Report) at paragraph 6.42.

49. This is illustrated by Example 1.12 in the EM, in which a newly incorporated entity in a foreign jurisdiction (Foreign IP Co) purchases and holds IP rights. The example concludes that the amount of product sales income derived from exploiting the IP rights that is attributed to Foreign IP Co does not reasonably reflect the functions undertaken and risks actively managed by it, and therefore does not reasonably reflect the economic substance of its activities in connection with the scheme.

50. It is not expected that in all cases the passive holding of an asset will, of itself, indicate a lack of economic substance. It is a question of fact and degree in each case having regard to all the relevant circumstances including the broader setting in which the arrangement took place. The assessment of whether an entity's profit reasonably reflects the economic substance of its activities is not a narrow inquiry, but can examine the wider circumstances of the scheme. The mere passive holding of an asset may indicate a lack of economic substance if the arrangement in question does not accord with well understood commercial behaviour or is contrary to the taxpayer's own separate commercial and economic interests.

Additional matters

Other ATO guidance

51. We have other guidance about the DPT to provide taxpayers that could be impacted by the measure with greater certainty.

52. This guidance includes Practical Compliance Guideline PCG 2018/5 *Diverted profits tax* which addresses what we consider are the relative risks associated with particular arrangements and structures in the context of the DPT.

53. This guidance has been provided to assist those taxpayers in determining the level of engagement that we would generally expect from them and outlines what they can expect from us based on the risk of the arrangement.

Administrative matters

54. We have established an administrative framework to support the introduction of the DPT. This includes Law Administration Practice Statement PS LA 2017/2 *Diverted profits tax assessments* which provides a set of internal processes aimed at addressing when a DPT assessment may be made by the Commissioner including:

- the escalation and sign off processes that apply in order to make a DPT assessment
- the role of the General Anti-Avoidance Rules Panel in the DPT assessment and review process, and
- a process map to outline and support our administrative procedures.

Commissioner of Taxation
26 September 2018

References

ATOlaw topic(s)	Tax integrity measures ~~ Part IVA ~~ Other
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	TAA 1953 TAA 1953 Div 145 Sch 1 TAA 1953 Div 155 Sch 1 Diverted Profits Tax Act 2017 Diverted Profits Tax Act 2017 4 Treasury Laws Amendment (Combating Multinational Tax Avoidance) Act 2017
Related Rulings/Determinations	
Case references	Federal Commissioner of Taxation v. Consolidated Press Holdings Ltd [2001] HCA 32; 207 CLR 235; 179 ALR 625; 2001 ATC 4343; 47 ATR 229 Peabody v. Federal Commissioner of Taxation (1993) 40 FCR 531; 112 ALR 247; 93 ATC 4104 at 4113-4114; 25 ATR
Other references	Guide to foreign income tax offset rules 2018 2010 OECD Transfer Pricing Guidelines 2015 OECD Report Revised Explanatory Memorandum to the Treasury Laws Amendment (Combating Multinational Tax Avoidance) Bill 2017 PCG 2018/5 PSLA 2005/24 PSLA 2017/2
ATO references	1-AN371U0
ISSN	2209-1300
BSL	PGI

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