TR 2014/6EC - Compendium

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Ruling Compendium – TR 2014/6

This is a compendium of responses to the issues raised by external parties to Draft Taxation Ruling TR 2014/D3 *Income tax: transfer pricing – the application of section 815-130 of the Income Tax Assessment Act 1997.*

This compendium of comments has been edited to maintain the anonymity of entities that commented on the Draft ruling.

Summary of issues raised and responses

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1	Paragraph 45. We submit that one cannot merely 'disregard' the transaction in its entirety as recognition must be given to the actual conditions, namely: the sale transaction and its attendant consequences (presumably recognition of assessable income and/or a capital gain in relation to the sale and, possibly, royalty payments for the right to use licenced IP etcetera.). Paragraphs 45 and 131-135 are not necessarily appropriate situations in which transactions should be ignored entirely.	The examples described at paragraphs 45 and 131-135 of the Draft Ruling are consistent with the proposition expressed at paragraph 1.34 of the 2010 OECD Transfer Pricing Guidelines for Multinational and Tax Administrations (2010 OECD TP Guidelines) that 'Independent enterprises, when evaluating the terms of a potential transaction, will compare the transaction to the other options realistically available to them, and they will only enter into the transaction if they see no alternative that is clearly more attractive.' The more attractive option might be to not enter into the transaction or arrangement (see paragraph 9.61 of the 2010 OECD TP Guidelines). Where subsection 815-130(4) applies so that the identification of the arm's length conditions must be based upon that absence of commercial or financial relations, the effect is that such relations in connection with which the actual conditions operate are disregarded and the arm's length condition that nothing would have occurred is substituted in their place. Subdivision 815-B takes precedence over other provisions of *the Income Tax Assessment Act 1936* and the *Income Tax Assessment Act 1997*, unless a limitation is expressly provided in the Subdivision (refer to section 815-110). Depending on the circumstances, it may be the case that the Commissioner would make a determination under section 815-145 to provide a consequential adjustment to a disadvantaged entity.
2	At paragraph 103, the statement that the purchaser of the IP '… would be rewarded only for its re-invoicing activities and reimbursement activities.' This (like the foregoing example) is clearly incorrect. The purchaser of the IP should receive an arm's length return for its ownership (a question of fact)	The example has been replaced.

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	thereof. The example should be reviewed as, on the facts, a transfer pricing benefit may not arise for the Australian entity.	
3.	The Draft Ruling suggests that the basic tenet of the interaction of these two terms is the difference that exists between *'prima facie features or legal characteristics of the dealings between entities'* and *'economic substance' of the actual transactions, arrangements or other such relations between the entities'.* This appears to be inconsistent with the manner in which these terms are used more widely in interpreting other tax issues where it is applied to non-conformity between the legal documents and what is actually occurring between the parties. *'*Economic substance' is the term used in accounting to describe the overall reality of the financial statements of an entity. The definition at paragraph 78 describes the facts relevant to determining the substance (for the purposes of s.815-130) of commercial and financial relations (CFRs) of which the conduct of the entities is merely one aspect. While we have no specific issue with the contextual overlay of having substance requiring *'making a difference in terms of the economic benefits and outgoings…'* or *'produce an effect that is proportionate to the economic risk and rewards…'* (paragraph 80), it is our view that the term *'economic substance'* is inappropriate in that it broadens the scope of the first exception beyond what may be reasonably inferred from the words of the legislation in the way in which it is used to describe substance by contradistinction to form. Instead, we consider that the Draft Ruling should just refer to the substance of the CFRs that exist.	The meaning of 'substance' for the purposes of section 815-130 depends on the object of Subdivision 815-B and the context in which the term is used. The meaning of substance is explained at paragraph 3.84 of the Explanatory Memorandum, which states: ' … The substance of the commercial or financial relations describes the economic reality or essence of those dealings. …' Paragraph 3.95 of the EM explains that the '…first exception is based on the approach taken under the OECD Guidelines in relation to economic substance (see for example paragraphs 1.65, 9.169 and 9.183 of the OECD Guidelines). …' The Commissioner considers that this meaning of 'substance' for the purposes of section 815-130 (that it describes the economic reality or essence of the commercial or financial relations), best achieves consistency with the documents covered by section 815-135 of the ITAA 1997.
5	Although the matters in paragraphs 81 – 83 may in some	The Commissioner considers that each of the factors identified in paragraph 83

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	circumstances be connected to transactions that lack substance, they are more generally relevant to consideration of the General Anti-Avoidance Rule, Part IVA, than an examination of substance in a transfer pricing context. This seems to be out of line with the intended operation of the transfer pricing provisions and is more relevant to instances of deliberate structuring to avoid tax. Again, it is noted that transfer pricing is not seen, generally, as a vehicle for deliberate tax avoidance, particularly as the Draft Ruling notes that it is intended that the basic rule will prevail in most cases. The manner in which the practical application of exception 1 is described contemplates a much broader range of relevant factors for economic substance. These go beyond what is required from 815-130(2) and introduces subjective notions (such as making 'commercial sense') that are beyond the intent of the law and the OECD TP Guidelines. Ascertaining economic substance should not go beyond confirmation of the actual CFRs following their own form. Paragraph 83 over-reaches in parts, whether CFRs provide a commercially realistic return is a pricing matter.	could, either alone or together, be relevant in determining the substance of the commercial or financial relations for the purposes of section 815-130. The determination of 'substance' for these purposes is far more than just a consideration of the legal rights and obligations created (that is, 'legal substance'). The Commissioner also considers that whether the commercial or financial relations make 'commercial sense' is a relevant aspect that should be taken into account in examining the substance of those relations. At paragraph 9.166 of the 2010 OECD TP Guidelines, it is contended that 'in examining the risk allocation between associated enterprises and its transfer pricing consequences, it is important to review not only the contractual terms but also whether the associated enterprises conform to the contractual allocation of risks and whether the contractual terms provide for an arm's length allocation of risks. In evaluating the latter, two important factors that come into play are whether there is evidence from comparable uncontrolled transactions of a comparable allocation of risks and, in the absence of such evidence, whether the risk allocation makes commercial sense (and in particular whether the risk is allocated to the party that has greater control over it).'
6	Paragraph 85 should also be reviewed as it is not consistent with paragraph 2.33 of the OECD TP Guidelines on which it purports to be based. It is not relevant, for purposes of determining whether the Australian subsidiary obtained a transfer pricing benefit, whether a payment made by the conduit is received by the parent company in a tax exempt form. What is relevant for such a purpose is that it must be shown that some part of the price received by the conduit from the Australian taxpayer does not belong to the conduit and that it may belong to the Australian taxpayer.	The application of section 815-130 in the example is not dependent on whether the payment made by the conduit is received by the parent in a tax exempt form. What is relevant is whether the form of the commercial or financial relations is inconsistent with the economic substance of those relations. However, it may be the case that the tripartite relations are relevant for the purposes of the 'basic rule' and that multiple transfer pricing benefits may arise.

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7	Paragraph 27 appears to be consistent with the requirement in the OECD TP Guidelines that reconstruction is 'exceptional' (paragraph 1.65). However, this threshold condition which equates with the 'rare' or 'unusual' circumstances (see paragraphs 9.168 of the OECD TP Guidelines) appears to be lost in the treatment provided within other sections of the Draft Ruling. In particular, the Draft Ruling fails to provide the appropriate level of emphasis on 'exceptionality' to ensure its conformity with the OECD TP Guidelines, and instead it implies a much broader requirement in considering the potential application of the exceptions. Among other issues, we submit that this is well beyond the scope of reconstruction under the OECD TP Guidelines and places a burden on taxpayers well beyond a level that can be considered reasonable or practical. It is our view that the Draft Ruling should therefore expressly adopt the language used in the OECD TP Guidelines and require guidance and consideration as to whether the arrangements are truly exceptional in the sense contemplated. Paragraph 27 suggests the Commissioner's views are that the exceptions to the basic rule may be applied more widely and with greater regularity than the position stated in the OECD guidelines and is broader than Parliament's intent. Paragraph 1.64 et al of the OECD TP Guidelines makes patently clear that other than in exceptional circumstances, actual transactions of a taxpayer should not be disregarded. The statement at paragraph 27 should be made upfront in the discussion on the basic rule and reiterated in the exceptions. Without clearly addressing the requirement that 'arm's length pricing cannot reliably be determined for that transaction or arrangement', the current drafting of TR 2014/D3 implies that the exceptions considered at s 815-130 (3) and (4) can be	The exceptions contained in subsections 815-130(2) to 815-130(4) of Subdivision 815-B operate automatically. There is no discretion with their application. In particular, section 815-130 neither requires nor contemplates the existence of any other 'exceptional circumstances', nor any subjective analysis in this regard, before subsections 815-130(2) to 815-130(4) inclusive apply. Rather, the exceptional circumstances required for their operation are strictly defined within these subsections. The Commissioner considers that the application of subsections 815-130(2) to 815-130(4) in these circumstances best achieves consistency with the 2010 OECD TP Guidelines.

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	more widely applied than is actually considered under the OECD Guidelines. This brings about greater uncertainty for taxpayers, increased compliance costs and is inconsistent with government initiatives on reduction of red tape. Prior to paragraph 87, it would assist if reference is made to the OECD guidelines in relation to the non-recognition as set out in paragraph 3.94 of the Explanatory Memorandum (EM). This will provide context to both the ATO and taxpayers that the exceptions should only be used in exceptional circumstances as set out in paragraph 9.168 of the OECD TP Guidelines.	
8.	In Example 4 (starting at paragraph 122), the ATO refers to the fact that the taxpayer 'consistently returns tax losses' as relevant to demonstrating the arm's length conditions are different. This appears to be inconsistent with the recognition in cases (albeit in the context of Division 13) that losses may have nothing to do with the CFRs between the related parties, and rather be the result of economic conditions, poor sales performance, etcetera. see *Re Roche Products Pty Ltd v Commissioner of Taxation* [2008] AATA 639 at paragraph 185. Accordingly, the reference to losses in that paragraph should indicate the need to understand if there are other reasons for losses being incurred. In Example 4, there is a presumption that sustained losses are not an arm's length condition. They are only an indicator of potential risk. To apply section 815-130 in such circumstances, the onus is on the Commissioner to identify and quantify the benefit to a group of a loss-making subsidiary.	This example (now Example 7) indicates that the reason for the losses being incurred is that the marketing activities are undertaken by the Australian importer/distributor at its own cost and without appropriate reward for that function. The relevance of sustained losses is explained at paragraph 1.70 of the 2010 OECD TP Guidelines, which states: > … an independent enterprise would not be prepared to tolerate losses that continue indefinitely. An independent enterprise that experiences recurring losses will eventually cease to undertake business on such terms. In contrast, an associated enterprise that realizes losses may remain in business if the business is beneficial to the MNE group as a whole.
9.	In paragraph 124, there is a footnote (60) referencing the 'Revised Discussion Draft on Transfer Pricing Aspects of	This reference has been removed.

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	Intangibles – 30 July 2013'. This is not relevant guidance for the purposes of s.815-135. Accordingly, the reference should be removed.	
10.	In addition to our general observations relating to the nature of examples in the Draft Ruling, we also have concerns that the content of some examples do not properly assist taxpayers to understand the operation of the new laws. In particular, we draw attention to the example of the application of s.815-130(2) in relation to the incorporation, by an Australian company, of an offshore subsidiary as a distribution and invoicing centre (paragraph 103). This arrangement changes with the assignment of an intangible to the entity, but upon examination the conditions are reconstructed to reflect the substance of the arrangement such that the subsidiary is rewarded only for its re-invoicing and reimbursement functions. The outcome in this example is too simplistic for the conditions established and is silent on the consequences for the IP transfer itself, and whether (and if so, how) these may be addressed by s.815-145. It also fails to discuss the flow-on consequences of the use of a trademark by the subsidiary now it is (deemed to be) back in the hands of the Australian entity, the change in the risk/reward structure of the subsidiary and how service charges might now be applied. Again, these issues can all be considered consequential to the reconstruction of the existing conditions. The example also raises a wider question of when, if at all, the ATO considers that it may reconstruct one transaction, but leave another related (but legally separate) transaction intact because of the requirement in s.815-120 that there be positive adjustments to taxable income. If such a position were to be adopted it would likely lead to the application of the Mutual Agreement Provision, where a tax treaty exists, at additional cost to taxpayers.	The Commissioner recognises that section 815-145 could have application to enable consequential adjustments to be made in appropriate circumstances. However, the application of section 815-145 is beyond the scope of this ruling.

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11.	Some of the explanatory appendices (refer paragraphs 83 to 85 on the explanatory appendix in TR 2014/D3) include a lengthy list of additional ATO expectations for TP documentation to achieve a RAP. Moreover, paragraph 85 suggests that the ATO would require documentation to also provide information on 'structures, operations and flows of funds' involving group entities that are not party to the international arrangement under review.	The Commissioner will issue separate guidance products dealing with documentation and penalties.
12.	Perhaps more problematic, by setting out such exhaustive lists of documentation expectations without adequate guidance of the circumstances under which this list may be significantly culled, there would be ample scope for the ATO to argue that the taxpayer has not achieved a RAP. It is presumably difficult to obtain a RAP in circumstances where the substance of the transaction is inconsistent with its form (that is, exception 1 under 815-130) or where the transaction would never have been entered into (that is, exception 3 under 815-130). Guidance on this expectation would help to ensure that taxpayers address and prioritise these matters in preparing their documentation.	Draft Taxation Ruling TR 2014/D3 doesn't set out documentation expectations. The Commissioner will issue separate guidance products dealing with documentation and penalties. What is now paragraph 106 of Taxation Ruling TR 2014/6 states the factors that could be used. This does not mean that, in the facts and circumstances of a particular case, every factor will apply.
13.	We have serious concerns with the stated object of Subdivision 815-B in paragraph 7 of the ruling. The quote is, in fact, not consistent with the arm's length principle and is not the object of Subdivision 815-B. The object of the Subdivision is to ensure taxation is based on a level of profit that reflects the economic activity attributable to the Australian taxpayer calculated in accordance with the arm's length principle. The economic activity attributable to Australia is a far wider concept and includes a range of matters not relevant to determining the arm's length profit of the taxpayer. The Subdivision is only concerned with levying tax on a taxpayer relevant to its functionality, including assets used by	We have revised this paragraph of the ruling.

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	it and risks assumed by it. To illustrate this point further, the economic activity attributable to Australia could include Australian residents using ecommerce to purchase product on-line from a (offshore) global web site. Such activity typically has no relevance to an Australian taxpayer. It may do so depending on the functionality of the taxpayer for example, marketing activity on behalf of the global site or providing a link from its own website. The Subdivision is concerned with the appropriate reward for the functions performed by the taxpayer; not the economic value of the Australian residents purchasing online from the global site.	
14.	Paragraph 111 footnote 51. The second condition for the application of the second exception is not outlined or applied in the Draft Ruling. Given 815-135(2)(a), the additional condition should be imported as a condition of the application of 815-130(3) - also consistent with 1.11 of the OECD TP Guidelines which recognises that MNE members face different commercial circumstances than independent enterprises. Or, if the Commissioner does not agree with the above, the ruling should state this. Beyond a limited reference at paragraph 35, TR 2014/D3 does not explicitly address the practical implications of this language from the OECD Guidelines and, in particular, how a requirement that the structure of the actual transaction 'practically impedes' the determination of an arm's length price in order for the transaction to be re-characterised.	The additional condition of the second exception outlined at paragraph 1.65 of the 2010 OECD TP Guidelines, that 'the actual structure practically impedes the tax administration from determining an appropriate transfer price', is not a condition of the application of subsection 815-130(3) or subsection 815-130(4). The Commissioner considers that, in circumstances which permit subsections 815-130(3) or 815-130(4) to operate (for example, where it is concluded that independent parties dealing at arm's length with each other would not have entered into the actual commercial or financial relations), the actual structure adopted by the taxpayer impedes the identification of the arm's length conditions. The operation of subsections 815-130(3) or 815-130(4) to resolve this impediment, by disregarding the actual commercial or financial relations and identifying the arm's length conditions based on what independent parties would, or wouldn't, have done instead, best achieves consistency with the 2010 OECD TP Guidelines.
15.	TR 2014/D3 does not currently provide taxpayers with a clear delineation as to when the Commissioner will seek to 're-price' under the Basic Rule under s 815-130(1), or seek to apply the Exceptions. This is observed in a number of sections throughout	A new example (Example 2) to explain when subsection 815-130(1) applies is included in the final Taxation Ruling. The Commissioner notes that, in real world situations, the adjustment of the price condition to reflect adjustments for differences between the controlled transaction and a comparable uncontrolled transaction could be perceived as simply being a

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	TR2014/D3, including Example 4 (paragraphs 122 to 125). In this example, there is a clear opportunity for the taxpayer or Commissioner to eliminate the perceived transfer pricing benefit through an adjustment in product pricing rather than by 're-characterising' the transaction. Importantly, a pricing adjustment would also achieve consistency with the OECD Guidelines by considering the *'transaction actually undertaken by the associated enterprises'.* This inconsistency in interpretation is also observed in paragraphs 74 to 86 where an extensive (though inconclusive) list of factors that may indicate where a lack of substance may arise. This is because many of the factors observed, particularly those relating to risk or the use of financial intermediaries which could potentially be managed through an adjustment in pricing, rather than the application of the Exceptions.	pricing adjustment or it could be perceived as re-characterisation of the actual transaction.
16.	Should it be determined that one of the exceptions apply, the Draft Ruling provides no practical guidance regarding how to give effect to the re-characterisation. This has flow-on effects in terms of interactions with other aspects of the tax law and increased uncertainty for taxpayers. It is necessary to consider the implications on the overall transaction of replacing the actual conditions with arm's length ones. Use broad, rather than strict comparability to avoid inappropriate re-characterisation other than in exceptional circumstances.	Some of the examples have been revised to demonstrate how particular provisions of Subdivision 815-B operate to determine the effect that the Subdivision has on an entity. These adjustments attempt to strike a balance between addressing the need specified in the submissions and the scope of the ruling.
17.	TR 2014/D3 does not adequately address the threshold that will be required to demonstrate that an independent party would not have entered into particular arrangements. Paragraphs 33 to 45, 111 to 117 and 116 to 130, provide some guidance but provides no particular insight as to how a taxpayer can practically seek to demonstrate that its position is or is not supportable beyond theoretical economic constructs, resulting in somewhat loose interpretation to the	The level of transfer pricing analysis required to identify the arm's length conditions for the purposes of the operation of Subdivision 815-B is consistent with the operation of the generally accepted arm's length principle and the guidance set out in the 2010 OECD TP Guidelines. If entities structure and characterise their cross border commercial or financial relations in a manner where the form and substance of the relations is not inconsistent, then the provisions of subsection 815-130(2) will not apply. Further, if

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	threshold that would need to apply in having to demonstrate that the arrangements would not have been entered into by independent parties. Example 4 referred to and a request that a high threshold exists be specifically acknowledged in the ruling.	entities enter into cross border commercial or financial relations that would be entered into by independent entities operating wholly independently in comparable circumstances then, equally, subsections 815-130(3) and 815-130(4) would not usually apply. For example, paragraph 9.172 of the 2010 OECD TP Guidelines states that: 'Where reliable data show that comparable uncontrolled transactions exist, it cannot be argued that such transactions between associated enterprises would lack commercial rationality. The existence of comparables data evidencing arm's length pricing for an associated enterprise arrangement demonstrates that it is commercially rational for independent enterprises in comparable circumstances.' However, the existence of comparables data evidencing arm's length pricing for a controlled transaction cannot not totally rule out the potential application of subsections 815-130(3) or 815-130(4). This is because the application of the arm's length principle is based on the notion that independent entities will not enter into a transaction if they see an alternative that is clearly more attractive having regard to all options that are realistically available to them (see paragraph 9.175 of the 2010 OECD TP Guidelines). This could include the option of doing nothing (for example, continuing to conduct the function or assume the risk itself).
18.	The position in relation to the application of section 815–130 in respect of thinly capitalised entities is unclear and potentially contradictory. The ruling should state the various approaches to determining the rates set out in TR 2010/7 continue to be available. • Paragraph 31. Additional facts have been inserted compared with paragraph 1.65 of the OE CD TP guidelines. Statement read zero interest rate not in the OECD TP guidelines. The example is too simplistic when read in the context of TR 92/11 and the OECD guidelines. If the interest rate is 0% to transfer pricing purposes, this outcome is contrary to TR 2010/7. Remove paragraph 31 or state that it is not relevant in the context of Australian law or say it	Partly disagree. Given that section 815-140 codifies what is in TR 2010/7 and there is no equivalent provision in Division 13, it would not be appropriate to refer to TR 2010/7 in TR 2014/D3. The example at paragraph 31 has been removed (in response to requests made in some submissions received).

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	is only relevant for establishing the arm's-length conditions. • Paragraph 31. The example does not go far enough. In what circumstances will the ATO take a position that debt is in substance equity? This needs to be specified. A subsidiary's inability to source third party funding is not necessarily determinative of the debt equity characterisation. The parent will generally be best placed to appreciate the profit earning potential of the subsidiary as a result of arm's-length third party may well agree to provide the requisite loan funding. A number of other factors are relevant and should be included in the ruling in relation to whether or not alone is so exceptional as to warrant reconstruction. These factors are addressed in TR 92/11. The ruling should state that the element of the debt treated as notional equity would be treated as interest-free for the purposes of identifying the arm's-length conditions. Include details of the factors the ATO can expect taxpayers to consider in evaluating whether debt should be treated as notional equity. An example involving a high risk greenfield business with no track record or apparent source of cash flow and inadequate assets could be used. Paragraphs 53 to 60. The result at paragraph 58 that subsection 815–130(3) applies, appears to be at odds with the statement in example 3.16 in the explanatory memorandum that 'alternatively structured arrangements do not need to be considered in this case'.	
19.	TR 2014/D3 does not state that section 815–140 overrides the otherwise potential operation of section 815–130 where	Disagree. The interaction is made clear.

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	subsection 815–140(1) applies, that is where Division 820 applies to the taxpayer and the arm's-length conditions affect costs that are debt deductions in relation to debt interests.	
20.	Given what occurs in other countries and in other international anti-avoidance regimes a de minimus threshold of $2 million in debt deductions is proposed before the provisions apply by way of amendment to the law or adopting at an administrative practice.	This is a policy matter and beyond the scope of the Ruling.
21.	Include an example as follows: An Australian taxpayer purchases products from both related parties and third parties outside Australia. The prices and/or margins on related party products compare favourably to those on the third party sourced product. The Australian entity is effectively a price taker from both related and third parties. Despite the ability to benchmark the prices or gross margins, restrain taxpayer still makes an operating loss. Previously, the CUP or resale price methods would have been adopted. Which subsection of 815–130 applies?	The Taxation Ruling contains an example where there is a loss making entity.
22.	Include examples in relation to areas that are known to give rise to issues such as business restructures, financial arrangements and technology licensing arrangements. Examples should be built from a base case that would justify application of the basic rule. Key characteristics relevant to triggering each exception type are added separately and defined. Each example defines the transfer pricing benefit that is determined to exist. Any consequential adjustments are to be clearly defined. The content of some examples do not properly assist taxpayers to understand the operation of the new laws. For example, paragraph 103. The outcome is too simplistic for the conditions established. In place of the examples used in the ruling, we submit it would be more appropriate to outline key transfer pricing	More examples have been added.

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	issues dealing with 'substance', for example in relation to risk structuring, transactions: • with no real underlying risk; • where the entity with legal responsibility has no practical functional control; or • with an entity that has legal responsibility for the risk but does not have the financial capacity to absorb a risk event.	
23.	Paragraph 111. Requiring taxpayers to work out an interest rate as though arm's-length conditions had operated places additional compliance burdens on companies by requiring them to work out an arm's-length amount of debt with little or no guidance as to how that should be done.	Refer to TR 2010/7 for such guidance.
24.	Taxpayers would benefit from guidance on whether they are expected to document a section 815–140 analysis for inbound interest-bearing loans that are not material in the context of the overall business. Proposal made to have a de minimus threshold where, if debt deductions are less than $2 million, it is not necessary for the arm's length debt amount to be determined. The interest rate would be cut by on the basis of the actual debt amount in place.	Such matters go to the risk assessment of the entity in the particular facts and circumstances. There will be a separate guidance product dealing with documentation. De minimus threshold proposals are matters of policy and beyond the scope of the ruling.
25.	Paragraph 56. The final sentence should be reviewed. It is not appropriate to add a caveat to the effect that the price of the loan may need to be less than the market rate in order to produce an outcome that would make commercial sense for both For Co and Aus Co. The ATO's approach here raises how this approach is consistent with the application of the arm's-length standard. If the transaction is priced appropriately, but still fails the ATO view of profitability then why should taxpayers concern themselves with the arm's-length nature of the transaction?	The statement at paragraph 56 is drawn from TR 2010/7. In the context of the concession provided by section 815-140, that the arm's length interest rate will be applied to the actual amount of debt even if that amount is not the arm's length amount (for example, the amount that the borrower could borrow from an independent lender), the so called 'caveat' is necessary to highlight to taxpayers that the transaction still has to be one that independent parties dealing with each other independently would have entered into. The requirement that the dealing makes commercial sense for the borrower is consistent with the 2010 OECD TP Guidelines.

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	Also, what of other conditions such as gearing levels that may be relevant? It may be argued that the pricing of the transaction may be more relevant than the bottom-line result, at least in the shorter term.	
26.	The Draft Ruling should address the question of whether the Commissioner can support an amended assessment on the basis of using more than one counterfactual for the purposes of paragraph 815–130(3)(b).	The Commissioner could, if he chose to do so, support an amended assessment on alternate applications of section 815-130. There could be situations, for example, where adjustments to the actual price condition to identify the arm's length conditions under the 'basic rule' in subsection 815-130(1) could be supported by the application of subsection 815-130(2), if necessary. Similarly, situations which trigger the operation of subsection 815-130(2) might well be suited to the operation of subsection 815-130(3) as an alternate basis to identify the arm's length conditions. Whether or not the Commissioner would use one or more of the exceptions as an alternate basis will depend on the actual circumstances, but it is expected this would be an unusual situation. If considered appropriate (see also below), some wording that reflects the principles stated above could be included in the ruling.
27.	The Draft Ruling should address how the Commissioner would administer the documentation rules and the penalty provisions where an amended assessment is made on the basis of more than one counterfactual.	There will be a separate guidance product dealing with documentation. Internal note: This issue has not been dealt with expressly in those documents. In relation to documentation, there are no special rules for this type of scenario in ascertaining whether an entity has met section 284-255. In relation to penalties, the use of alternative bases of assessment does not affect imposition of penalty considerations, which rest on the adjustments made rather than the basis by which the arm's length conditions have been identified.
28.	Guidance is needed on if and how section 815–130 applies to arrangements entered into before Subdivision 815–B has effect. Division 815 applies to arrangements entered into before 29 June 2013 as it finds them and section 815–130 cannot operate to reconstruct past transactions. Regarding paragraphs 39 to 41, does the ATO consider it	Subdivision 815-B applies to arrangements entered into before 29 June 2013 where they have effect in income years commencing on or after that date in relation to income tax. In relation to withholding tax, it applies to income derived or taken to be derived in the income years specified above.

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	has a power to look in 2014 at the transfer that occurred in 2011 as if it were a continuing research agreement? If yes, the ruling should also explain how the reconstruction provisions apply in such situations. How does the ATO propose to deal with the following: • the proceeds of sale of the IP received • what return will the Australian taxpayer earned on these IP rights from 2011 to 2014 given it has not actually exploited these IP rights in any other way?	
29.	If the ATO view is that section 815–130 can apply to arrangements entered into before Subdivision 815–B took effect, then the taxpayer would not be able to satisfy the recordkeeping requirements and be deemed not to have a reasonably arguable position. To have penalties imposed at a minimum of 25% is a harsh and oppressive outcome.	There will be separate guidance product dealing with documentation and penalties.
30.	The reference to economic substance in TR 2014/D3 departs from the same concept in Division 974 in relation to the extensive list of factors the commissioner considers relevant to the consideration of the substance of a financing arrangement in a transfer pricing context. For example, if the rights and obligations arising out of a financing arrangement make commercial sense, if there is a net economic result or objective from the financing arrangement, or if the arrangements are highly structured and involve unnecessary steps. Such matters enquiring to the commercial intent of the arrangements and could give rise to contradictory characterisations on the same financing arrangement. The ruling should have a clear outline of the interaction between the transfer pricing law and Division 974 and the ordering in which they would apply.	The Taxation Ruling explains the ATO view on the operation of section 815-130. It is beyond the scope of the ruling that it should explain every interaction with other provisions of the Income Tax law. In any event, the meaning of the term for transfer pricing purposes reflects the applicable object, context and purpose. It does not mean that factors will be the same as those for the purposes of the term in Division 974.

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31.	Paragraph 38. The statement that taxpayers are required to keep appropriate records to evidence the application of this section 815–130 should be clarified so that such recordkeeping requisites are separate and distinct from Subdivision 284–E documentation requirements for the purposes of securing a RAP.	There will be separate guidance products dealing with documentation and penalties. In any event, documentation requirements in relation to the application of section 815-130 are not separate and distinct from the Subdivision 284-E requirements; rather they are part of them.
32.	In what situations will the ATO utilise the new rules as an integrity measure in terms of the interaction between an entity's overall profitability and withholding tax obligations – where selective allocations of expenses are made to achieve a more favourable withholding tax outcome while maintaining profitability.	This is considered to be beyond the scope of the Taxation Ruling. However, the point is noted and the need to address the point can be considered going forward.
33.	This provision should be very tightly constrained given the impracticality of pricing a non–event. The ruling gives no guidance as to how to determine the transfer prices for the hypothetical 'no change' circumstances. There is an air of unreality about the application of this exception. How is it possible to price an entire function when it no longer existed? Will the Commissioner invoke the third exception in situations involving sales, marketing or production functions? If not, providing guidance to this effect would allay concerns.	The potential operation of subsection 815-130(4) is explained in the Taxation Ruling. In relation to the last point, the third exception can apply where the condition in the subsection has been satisfied and will depend on the facts and circumstances of the particular case. As a result, it is not possible to make such a broad-brush statement.
34.	Some guidance would assist on how to undertake an analysis where the third exception applies.	This is demonstrated in the examples. The analysis to be undertaken is consistent with the guidance set out in the 2010 OECD TP Guidelines.
35.	The ATO should acknowledge that the third exception will lead to unrelieved economic double taxation.	If it does, these issues may be dealt with under MAP.
36.	To be of benefit to taxpayers in the middle market, TR 2014/D3 will need to: 1. outline the transactions that the ATO is concerned about and set out the characteristics of those	The Taxation Ruling cannot be this prescriptive. The outcome of the current 'Simplification Project' may address some of these concerns.

Issue No.	Issue raised	ATO Response/Action taken
	transactions that will attract ATO attention; 2. tell taxpayers when they need to check whether the circumstances of the transaction are exceptional enough to warrant testing under the reconstruction power; 3. provide bright line tests (if a transaction meets both 1 and 2 above) to enable taxpayers to readily determine if exceptional circumstances exist to require them to use the reconstruction power; 4. make it clear that unless a transaction meets both one and two above, there is no need for them to do anything other than apply what is described in the Draft Ruling is the basic rule. TR 2014/D3 neither: 1. Recognises the compliance burden middle market taxpayers will face in self assessing whether they have received a transfer pricing benefit; nor 2. Provides practical guidance in the form of examples that can be used by middle market taxpayers and their advisers as to acceptable approaches that could be taken to meet the requirements of the ATO.	
37.	There needs to be some specific acknowledgement, with supporting examples that transactions will within the members of the SME group are fairly which are fairly simple and which have pricing which is on reasonably arm's-length terms should not be reconstructed.	The outcome of the current 'Simplification Project' may address some of these concerns.
38.	There needs to be some sort of realistic materiality threshold applied in the final ruling. The Draft Ruling is so broad that in practice SMEs will not know whether all of their transactions will be reconstructed or not.	The outcome of the current 'Simplification Project' may address some of these concerns.