PCG 2018/D2 (Finalised) - Diverted profits tax

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There is a Compendium for this document: **PCG 2018/5EC** .
This document has been finalised by PCG 2018/5.

Generated on: 25 November 2026, 03:43:17 AM

Diverted profits tax

Relying on this draft Guideline

This Practical Compliance Guideline is a draft for consultation purposes only. When the final Guideline issues, it will have the following preamble:

This Practical Compliance Guideline sets out a practical administration approach to assist taxpayers in complying with relevant tax laws. Provided you follow this guideline in good faith, the Commissioner will administer the law in accordance with this approach.

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What this draft Guideline is about

1. This draft Practical Compliance Guideline sets out our client engagement framework for the diverted profits tax (DPT). It also outlines our approach to risk assessment and compliance activity when the DPT is identified as a potential area of concern.

2. You can use this draft Guideline to:

   (a) determine the level of engagement that we would generally expect from you based on our assessment of the risk of your arrangement, and the types of products that may be used to provide you with further certainty

(b) determine the engagement that you can expect from us based on our assessment of the risk of your arrangement, where that risk is identified in the course of our ordinary compliance activity, and

(c) understand our approach to the sufficient economic substance test (SES test) in section 177M of the *Income Tax Assessment Act 1936* (ITAA 1936).

3. We would generally expect you to undertake your own assessment of the risk of an arrangement in the first instance. You can assess the risk of your arrangement having regard to the framing questions outlined below. The framing questions serve to provide you with a general guide of the types of matters we may consider relevant in assessing risk and undertaking compliance activity.

4. We have received feedback that affected taxpayers are likely to assess the risk of their arrangements by reference to the SES test before considering other aspects of the DPT. In recognition of this, we have provided guidance on what we consider to be high and low risk scenarios in relation to the SES test. These scenarios are examples only and this draft Guideline can be used to assess the risk of other arrangements under the DPT.

Structure of this draft Guideline

5. This draft Guideline is structured as follows:

(a) Background to the DPT

(b) Our compliance approach

(c) Our DPT client engagement framework

(d) Our framing questions for assessing risk

(e) Other guidance products relevant to assessing risk

(f) Documentation relevant to assessing risk and compliance activity, and

(g) High and low risk scenarios for the SES test.

Background to the DPT

6. The DPT is designed to ensure that significant global entities pay tax in Australia that properly reflects the economic substance of their activities in Australia and that they do not reduce the amount of tax they pay by diverting profits offshore through arrangements with related parties. The measure is also intended to encourage taxpayers to provide information to the Commissioner to allow for the more timely resolution of tax disputes.

7. The DPT applies to DPT tax benefits obtained in income years commencing on or after 1 July 2017, even if the scheme commenced before that time. Where the DPT applies, the Commissioner may give an assessment to the taxpayer imposing tax at a rate of 40% on the diverted profit.

8. An outline of our views on the relevant law is set out in draft Law Companion Guideline LCG 2017/D7 *Diverted profits tax*. This draft Guideline should be read in conjunction with LCG 2017/D7.

Date of effect

9. When finalised, this draft Guideline will apply both before and after its date of issue.

Our compliance approach

10. We expect that a DPT risk will usually be identified in the course of our ordinary compliance activity. Our decision-making process in relation to compliance activity is guided by the circumstances of the particular case, however we will generally prioritise our resources to address arrangements that we consider pose the highest risk.

11. Once a DPT risk is identified, our compliance approach may include ongoing monitoring of the risk or active consideration as part of a review. As part of our examination, we will consider information available to us and may request further information from you as outlined in the documentation section of this draft Guideline. Even where we consider a DPT risk to be low, we may continue to monitor your arrangement having regard to any additional information that becomes available.

12. Where we have advised you that we will consider the application of the DPT during the course of a review, and have collected information regarding the DPT, we will seek to communicate our findings to you at the end of the review. This communication will not provide a risk rating in respect of the arrangement but will instead outline our proposed compliance approach going forward. We will discuss our proposed compliance approach with you which may include informing you that we have decided not to dedicate further compliance resources to the matter.

13. At the end of a review, we may decide that the matter needs to be escalated to audit. During an audit, we will closely examine the risk and seek to obtain more detailed information in respect of the arrangement. We will seek to work cooperatively and in a transparent manner with you during the course of any audit.

14. In some cases we may identify other treatment strategies where there is an identified DPT risk which is not able to be resolved during the course of a review, and is not considered to be suitable for audit. This may include a recommendation to seek an advanced pricing arrangement (APA) or a private ruling. This is discussed in further detail in paragraphs 15–18 of this draft Guideline.

Our DPT client engagement framework

15. If you consider that there is a potential DPT risk associated with your arrangement, we expect you to engage with us. Our DPT client engagement framework, which is set out at Appendix 1 of this draft Guideline, outlines how to do this.

16. If, after considering the framework, you determine that no further engagement is required, then we do not expect you to initiate any further engagement with us in respect of your arrangement. Generally, if you have undertaken this assessment appropriately, it is unlikely in these circumstances that we will devote compliance resources to review your arrangement (other than to review the appropriateness of your determination under the framework as part of our ordinary compliance activities).

17. If, however, your arrangement requires further engagement with the ATO, the main avenues of engagement are:

(a) seeking entry to the APA program

(b) applying for a private ruling, and

(c) contacting the DPT specialist team.

18. As early as possible in the process, we will assist you to determine the product that is most appropriate to your circumstances.

APA program

19. The APA program can provide certainty with respect to the application of the DPT to covered transactions for an agreed period. An APA may be an appropriate product in particular circumstances as it involves a thorough examination of the covered transactions.

20. As the DPT forms part of Part IVA of the ITAA 1936, its potential application is treated as a collateral issue. Where possible, we will seek to deal with the potential application of the DPT concurrently with transfer pricing issues as part of the development of the APA.

21. Where it is not possible to address and resolve a DPT risk through a proposed APA, it is unlikely that we will proceed with the APA and the matter may be referred internally for further consideration.

22. APA's may be treated differently depending upon whether the APA application was submitted and/or entered into prior to 4 April 2017, the date on which the DPT was enacted.

APA applications submitted on or after 4 April 2017

23. Where an APA application is received on or after 4 April 2017, and subsequently the taxpayer enters into an APA, the covered transactions will be considered to be low risk for the purposes of the DPT for the period of the APA.

24. In this context, low risk means that, to the extent that the critical assumptions of the APA are not breached, we will generally not apply compliance resources to review the potential application of the DPT to the covered transactions. This compliance approach is limited to specified DPT tax benefits which may arise in relation to covered transactions.

25. If you wish to obtain further assurance relating to the DPT, you can request that a standard DPT clause be inserted into the APA. Such a request should be made during the early engagement stage. Where such clauses are requested, we may need to make further enquiries relating to the potential application of the DPT.

26. The standard DPT clause provides written assurance to the taxpayer that, in relation to the covered transactions under an APA, the Commissioner will not seek to apply the DPT for the income years covered by the APA. However, this is subject to critical assumptions not being breached; the absence of certain omissions and false or misleading statements; and the relevant DPT tax benefit being a 'covered DPT tax benefit.' A covered DPT tax benefit, for the purposes of the standard clause, is a tax benefit referred to in subparagraphs 177C(1)(a), (b) and (ba) of the ITAA 1936.

27. At the request of a taxpayer, we will determine whether to extend the standard clause to include a DPT tax benefit that arises from a tax benefit referred to in paragraphs 177C(1)(bb), (bbaa), (bba) and/or (bc) of the ITAA 1936. Taxpayers may be required to provide further information to enable us to make a decision in relation to any such request.

APA applications submitted prior to 4 April 2017

28. Generally, no assurance relating to the DPT is provided to a taxpayer by an APA entered into prior to 4 April 2017.

29. However, where an APA application was received prior to 4 April 2017 and the taxpayer enters into an APA with the ATO after 4 April 2017, the covered transactions will be considered low risk for the purposes of the DPT for the period of the APA.

30. Whilst a standard DPT clause can be requested for these APA's, we will consider the insertion of such a clause on a case-by-case basis.

Consideration of the DPT during the monitoring compliance stage

31. In reviewing a lodged Annual Compliance Report (ACR), we may consider the application of the DPT in relation to transactions covered by the APA if the taxpayer has not complied with the terms of the APA and/or a critical assumption has been breached.

32. For instance, if the reporting results are outside the agreed ranges, we may consider whether the transaction gives rise to a DPT tax benefit. In these circumstances, we will either inform the competent authority of our relevant treaty partner(s) (in the case of a bilateral or multilateral APA) or the taxpayer (in the case of a unilateral APA) to discuss how to treat the breach and where appropriate, it may be necessary to revise, modify, suspend or cancel the APA.

33. A broader enquiry into the potential application of the DPT may also be undertaken as part of an ACR review. The circumstances in which this may occur will be determined on a case-by-case basis but may include where the APA is not covered by a standard DPT clause. Any potential DPT issue arising outside the covered transactions of the APA, which cannot be resolved, may be escalated for further compliance activity.

34. An APA renewal request will undergo the same steps as an initial application and the DPT will be addressed in the course of considering any such request. It is important that a taxpayer discloses any material changes to the roles of the entities in the global value chain and any material changes in dealings to which the DPT may apply.

Private rulings

35. Taxpayers may lodge a request for a private ruling on the application of the DPT in relation to a particular arrangement. A private ruling may be appropriate where a taxpayer requires a greater level of certainty in relation to the application of the law to an arrangement. However, it should be noted a taxpayer will only get a greater level of certainty if the arrangement being ruled upon is the arrangement actually carried out, and all the relevant facts are disclosed by the taxpayer as part of the arrangement.

DPT matters appropriate for a private ruling

36. We consider that the following questions of law may be dealt with by a private ruling on the application of the DPT:

(a) whether the relevant taxpayer is a significant global entity (SGE)

(b) whether the relevant taxpayer has obtained a DPT tax benefit

(c) whether it would be concluded that a scheme was entered into or carried out for a principal purpose of obtaining a tax benefit

(d) whether the $25 million income test applies in relation to the relevant taxpayer, in relation to a DPT tax benefit, and

(e) whether the sufficient foreign tax test applies in relation to the relevant taxpayer, in relation to a DPT tax benefit.

37. In circumstances where it is not possible or appropriate for the Commissioner to make a ruling in relation to the DPT, the taxpayer may be encouraged to seek entry into the APA program or deal with the matter in some other way.

Contacting the DPT specialist team

38. The ATO has a dedicated team responsible for the DPT. If you have a general enquiry regarding the DPT engagement strategy, you may contact us at divertedprofitstax@ato.gov.au

Other matters – settlements

39. If there is a risk that the DPT may apply to an arrangement covered by a proposed settlement, we will generally seek to resolve the matter before proceeding with the settlement. Depending on the circumstances, we may include a clause relating to the DPT in the settlement deed.

40. Similarly, at the taxpayer's request, we may include a clause covering the application of the DPT in a multinational anti-avoidance law (MAAL) settlement. The inclusion and content of such a clause will depend on the circumstances of the particular case.

Our framing questions for assessing risk

41. You can assess the risk of your arrangement having regard to the framing questions outlined below. The framing questions are indicative of the matters we are likely to consider when assessing the risk that the DPT applies to an arrangement. The framing questions are separated into a number of categories although there may in a particular case be significant overlap in relation to these categories.

42. The list of framing questions is a general guide only and should not be taken as an exhaustive list of the kinds of matters we may take into account. We may consider additional matters depending on the circumstances of the particular case.

Preliminary framing questions

43. In conducting a preliminary assessment of risk we will generally ask the following questions:

(a) Is the taxpayer an SGE?

(b) Is the taxpayer over the $25 million income threshold?

(c) Does the taxpayer have any international related party dealings?

44. If any of these questions are answered in the negative then we are unlikely to consider the potential application of the DPT further (other than to test or confirm the conclusion reached and monitor any future arrangements).

Transaction-specific framing questions

45. In assessing the risk of a particular arrangement we may ask a number of transaction-specific framing questions if the taxpayer is otherwise within the scope of the DPT. These questions are likely to focus on whether the arrangement involves:

(a) the transfer or effective transfer of valuable intangible assets offshore

(b) the transfer or effective transfer and/or centralisation of functions and/or risks offshore

(c) a significant transfer of value relative to overall profitability

(d) the mischaracterisation of payments (for example, service fees rather than royalties)

(e) the use of hybrid entities and/or instruments

(f) back-to-back or flow-through arrangements

(g) the booking of profit offshore in a manner disproportionate to staff headcount and/or capability, or

(h) any other features that are unusual having regard to the nature of the relevant business operations.

Framing questions relevant to the SES test

46. In assessing whether an arrangement satisfies the SES test, we are likely to ask the following kinds of questions:

(a) Is there a genuine commercial rationale for the arrangement under consideration and does the arrangement achieve that end?

(b) Are there any changes that could be expected to result from the arrangement in the relevant business operations that have not so resulted?

(c) Is the legal form and documentation consistent with the economic substance of the arrangement?

(d) Is there evidence of market conduct that resembles the arrangement?

(e) Are there any aspects of the arrangement that would not be expected to be seen between parties dealing at arm's length?

(f) Where the transaction involves the centralisation of business assets, functions and/or risks, is centralisation common in the relevant industry?

(g) Where the arrangement involves the transfer of valuable intangible assets offshore, is there a corresponding change in the functional profile of the relevant entities and does the recipient entity possess the competencies necessary to manage the assets?

(h) Where the arrangement involves the transfer of functions offshore, is there a corresponding change in the functional profile of the relevant entities and does the recipient entity possess the competencies necessary to perform the functions?

(i) Where the arrangement involves the transfer of economically significant risks offshore, is there a corresponding change in the functional profile of the entities and does the recipient entity possess the competencies necessary to manage the contractually assumed risks?

(j) In relation to the economically significant risks identified in (i), do the relevant entities exercise actual control over these risks and perform control functions and risk mitigation functions?

(k) Do the relevant entities have the financial capacity to assume the risks and are they exposed to the upside or downside of risk outcomes?

(l) Are there entities that commercially bear economically significant risks as a result of the arrangement where those risks do not align with their contractual assumption of risks?

(m) Are there entities that have assumed economically significant risks under the arrangement where the consequences of those risks are already known or reasonably knowable?

Framing questions relevant to the principal purpose test

47. A number of the questions outlined in paragraph 46 of this draft Guideline will be relevant to the application of the principal purpose test. In addition to these questions, we may ask the following:

(a) Is there a more straightforward way that the commercial objectives of the arrangement could be achieved?

(b) Are there other ways (for example, more convenient, commercial or cost-effective ways) to achieve the same commercial end?

(c) Were any alternatives to the arrangement considered, and if so, why were they rejected?

(d) Are the entities' roles explicable by commercial reasons or is the role of any entity in the arrangement explicable solely or principally by tax reasons?

(e) What are the commercial reasons and rationale for setting up in each jurisdiction involved?

(f) Is the arrangement more complex or does it contain more steps than is necessary to achieve the commercial objectives?

(g) What are the quantifiable non-tax financial benefits of the arrangement?

Other guidance products relevant to assessing risk

48. We consider the following guidance products relevant in assessing DPT risk:

(a) Practical Compliance Guideline PCG 2017/1 *ATO compliance approach to transfer pricing issues related to centralised operating models involving procurement, marketing, sales and distribution functions*, and

(b) Practical Compliance Guideline PCG 2017/4 *ATO compliance approach to taxation issues associated with cross-border related party financing arrangements and related transactions*.

49. If your arrangement is in the green zone under PCG 2017/1 or PCG 2017/4[1], there is no expectation that you will be required to separately engage with us in relation to the DPT. Practically, this means we will generally only dedicate compliance resources to review your arrangement in accordance with the relevant guideline.

50. Similarly, if your arrangement is in the white zone under PCG 2017/1 or PCG 2017/4, we will generally only undertake compliance activity to the extent stipulated in the relevant guideline.

[1] Where you have multiple financing arrangements, PCG 2017/4 provides that your risk zone for an income year will reflect that of your highest risk financing arrangement.

51. Our approach to assessing risk in such cases is limited to the types of arrangements outlined in the specified guidelines and may not be followed if any of the conditions stipulated in the relevant guideline are not satisfied.

Guidance products relevant in the context of captive insurance arrangements

52. When considering the application of the DPT in the context of captive insurance arrangements, we will have regard, among other relevant matters, to existing ATO advice and guidance on these arrangements. Specifically, we will have regard to Taxation Ruling TR 96/2 *Income tax: taxation implications of arrangements known as financial insurance and financial reinsurance* and Law Administration Practice Statement PS LA 2007/8 *Treatment of non-resident captive insurance arrangements.*

Documentation relevant to assessing risk and compliance activity

53. There are no specific record-keeping requirements under the DPT. Taxpayers will need to keep appropriate records of their arrangements and transactions in the normal way. In order to aid taxpayers to do this, we have outlined in paragraphs 55–65 of this draft Guideline the kinds of documentation we may take into account when considering the application of the DPT as part of our risk assessment and compliance processes.

54. The documentation outlined in this draft Guideline is intended as a general guide only and should not be taken as an exhaustive list of the kinds of documentation we may take into account. The relevance of particular documentation will turn on the circumstances of the arrangement in question.

General

55. In considering the application of the DPT, we will have regard to information in our possession, including but not limited to:

(a) lodged Australian income tax returns

(b) international dealings schedules (IDS)

(c) Australian notices of assessment

(d) Country-by-Country reporting data exchanged automatically or by exchange of information request

(e) information obtained from foreign jurisdictions through exchange of information processes

(f) other information provided previously under another compliance product, and

(g) other relevant information from third party sources.

56. To further assist us in considering the application of the DPT, you may provide the following information:

(a) a general submission outlining your views about the application of DPT, for example, the basis for satisfying any exemptions

(b) IDS working papers

(c) annual reports or general purpose financial statements

(d) contemporaneous transfer pricing documentation, and

(e) intercompany agreements and relevant company policies regarding such dealings.

57. Where you have chosen to use a simplified transfer pricing record keeping option, we will have regard to the record-keeping obligations outlined in Practical Compliance Guideline PCG 2017/2 *Simplified Transfer Pricing Record Keeping Options*.

Principal purpose test

58. In considering the application of the principal purpose test, we may have regard to the following kinds of source documents:

(a) presentations and other papers prepared in relation to the arrangement and circulated to the taxpayer's management team and board of directors

(b) minutes of board and other meetings at which the arrangement was considered, and

(c) internal cost-benefit analyses – this could include quantifiable productivity gains, cost savings, synergistic benefits, location specific benefits, reduction of non-income tax costs, provision of government incentives and any other relevant costs and benefits associated with the arrangement.

Sufficient foreign tax test

59. In considering the application of the sufficient foreign tax test, we may have regard to the following kinds of documents:

(a) foreign income tax returns

(b) foreign notices of assessment (or equivalent)

(c) foreign tax receipts/notices of refund (or equivalent)

(d) foreign tax instalment notices and running balance accounts (or equivalent)

(e) general ledger entries and other accounting documentation

(f) any advice or valuation obtained in relation to the potential tax consequences of proposed structures and/or transactions

(g) any approvals of tax holidays or other reductions in tax, and

(h) correspondence from foreign revenue agencies.

SES test

60. In considering the application of the SES test, we may have regard to the following kinds of documents:

(a) global value chain information including details of each entity and the activities each entity performs

(b) source documents which form part of, evidence or relate to the arrangement including agreements between relevant entities

(c) commercial, regulatory and tax advice obtained in connection with the arrangement

(d) transfer pricing documentation including functional analyses for entities connected to the arrangement and analysis on the appropriateness of the transfer pricing method adopted having regard to the outcomes under multiple transfer pricing methods

(e) source documents demonstrating that the relevant entities are undertaking functions, using assets and assuming risks in accordance with the functional analyses supplied (for example, approvals, correspondence, meeting minutes, reports, specifications and written directions demonstrating that entrepreneurial entities are overseeing and/or performing key functions and making key decisions in accordance with the functional analyses supplied)

(f) details about staff numbers, key personnel, including their job titles, descriptions, and responsibilities

(g) valuation reports, working papers and related documentation where assets, functions and/or risks are transferred offshore in connection with the arrangement

(h) details of any changes to the transfer pricing policy in the relevant period, including the rationale for any such changes (for example, reports documenting functional analyses for relevant entities, correspondence exchanged between key decision makers regarding the benefits of certain structures, and actuarial reports of cost modelling)

(i) details of any changes to intercompany agreements and company policies in the relevant period, and

(j) evidence of actual cash flows in accordance with the arrangement.

61. The documents that will be relevant in a particular case will depend on the circumstances of the case including the nature of the arrangement and the relevant industry sector. We provide below some further guidance in relation to specific kinds of arrangements.

Related party financing arrangements

62. In the context of related party financing arrangements and related transactions, paragraph 65 of PCG 2017/4 provides examples of the kind of documentation that may be relevant in relation to the relevant risk indicators.

Procurement, marketing, sales and distribution hubs

63. The framing questions listed at paragraphs 111–113 of PCG 2017/1 may assist taxpayers in preparing the identifying relevant documents in relation to procurement, marketing, sales and distribution hubs.

Intellectual property arrangements

64. For intellectual property (IP) arrangements, we will pay close attention to intercompany agreements and company policies relating to the development, enhancement, maintenance, protection and exploitation of the relevant intangible assets. Source documents evidencing that the relevant entities are operating in accordance with intercompany agreements, company policies, transfer pricing documentation and other information supplied for the relevant period are likely to assist us in considering the application of the SES test.

65. We may also have regard to the following kinds of documents:

(a) source documents demonstrating that the relevant entities are undertaking functions, using assets and assuming risks in accordance with representations made by the taxpayer (for example, approvals, correspondence, meeting minutes, reports, specifications and written directions demonstrating that entrepreneurial entities are overseeing and/or performing key functions and making key decisions in accordance with transfer pricing documentation and any functional analyses supplied)

(b) full details of the intangible assets associated with the scheme including the name and nature of the asset (for example, patent), a detailed description of the asset, registration details of the asset as relevant to entities' domestic and offshore business, full details of all intercompany agreements and policies associated with the asset, full details regarding the contribution of relevant entities to the development, enhancement, maintenance, protection and exploitation of the asset, and any changes to this information over the course of the review period, and

(c) contemporaneous valuation reports, working papers and associated documentation where intangible assets and relevant functions have been transferred offshore.

High and low risk scenarios for the SES test

66. The SES test is met where it is reasonable to conclude that the profit made as a result of a scheme by each relevant entity reasonably reflects the economic substance of the entity's activities in connection with the scheme. The following scenarios are provided to illustrate some of the matters we will consider in assessing risk in relation to the SES test.

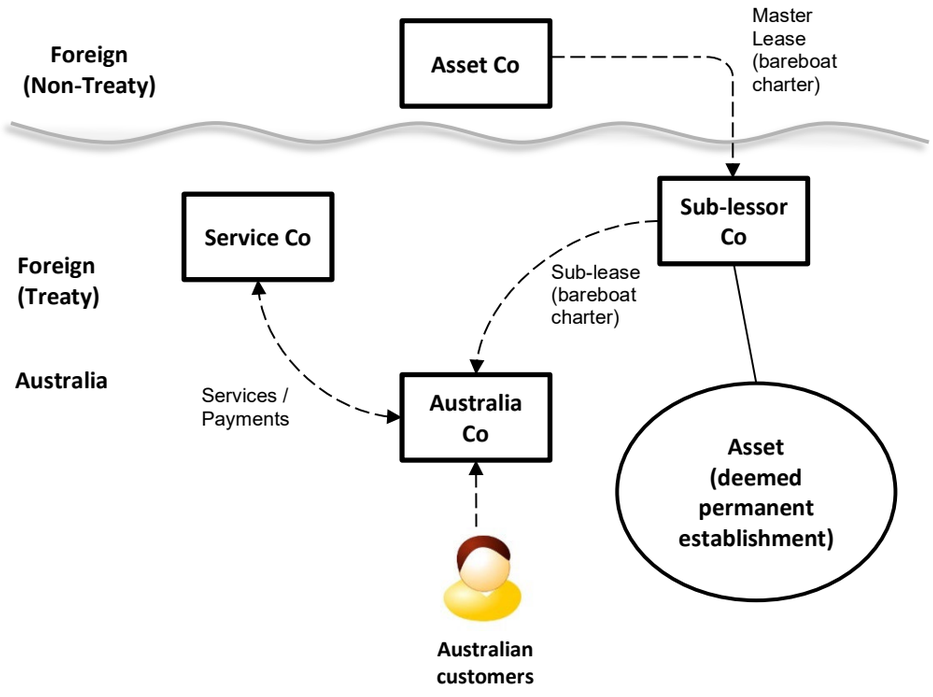
67. The scenarios below are both high and low risk scenarios. The high risk scenarios highlight the circumstances in which we consider it is likely the SES test will not be met. The low risk scenarios highlight the circumstances in which we consider it is likely the SES test will be satisfied, such that the DPT will not apply.

68. To assess whether your arrangement is high or low risk, you will need to exercise judgment having regard to the guidance provided in this draft Guideline. For an arrangement to be considered low risk it must be reasonable to conclude that the profit made by each relevant entity as a result of the scheme reasonably reflects the economic substance of the entity's activities in connection with the scheme.

69. Generally we will accept, based on an assessment of sufficient information and documentation, a profit level that falls within a range of acceptable results. This could include a range determined by reference to an appropriate transfer pricing method or by other means. The appropriate method will depend on the circumstances of the particular case.

70. Importantly, the scenarios set out below highlight our approach to risk assessment in relation to the SES test. While some of the scenarios are considered low risk in the context of the SES test, a low risk assessment will not necessarily preclude the application of other tax provisions, such as the transfer pricing rules and other anti-avoidance rules.

Scenario 1: lease in lease out arrangement – high risk



Background

71. *Australia Co is a wholly owned subsidiary of a global parent entity engaged in the operation of oil drilling rigs. Asset Co and Sub-lessor Co are also members of the global group.*

72. *Asset Co is the legal owner of a drilling rig and provides the requisite finance and insurance for the asset. Asset Co is a resident of a country that does not have a tax treaty with Australia. Sub-lessor Co is resident of a country that has a tax treaty with Australia.*

73. *Asset Co leases the rig to Sub-lessor Co under the Master Lease for $300 million per annum.*

74. *Sub-lessor Co sub-leases the rig to Australia Co on substantially the same terms for the same period for $350 million per annum under a sub-lease arrangement.*

75. *Australia Co utilises the rig in the conduct of its business. As part of the conduct of its business, Australia Co is responsible for identifying and liaising with third party customers; the marketing and scheduling of the rig; managing its outsourced contractors; and managing operational, environmental and utilisation risks associated with the rig.*

76. *The sub-lease contract between Sub-lessor Co and Australia Co mirrors the terms of the Master Lease agreement and there are no inherent risks borne by Sub-lessor Co. Accordingly, risks are shared between Asset Co and Australia Co.*

77. *After taking into account the costs associated with the running of its business, Australia Co makes a return commensurate with its functional profile.*

78. *Service Co is a foreign related party of Australia Co and undertakes various technical, crewing and other services related to the operation of the rig on behalf of Australia Co. Service Co employs staff with the requisite skills to perform the obligations under the contracts.*

79. *The interposition of Sub-lessor Co results in a reduction or exclusion from Asset Co's liability to pay royalty withholding tax on the lease payment. This is a consequence of the Double Tax Agreement in force between Australia and the foreign country in which Sub-lessor Co is a tax resident.*

80. *There is a substantial equipment permanent establishment (PE) of Sub-lessor Co in Australia. However, Sub-lessor Co does not perform any additional functions that would result in Sub-lessor Co being considered to be carrying on a business through a PE in Australia (pursuant to subsection 6(1) of the ITAA 1936) and the relevant treaty does not deem the PE to be carrying on a business. As such, no Australian royalty withholding tax could apply between the lease payment made by Sub-lessor Co to Asset Co.*

SES analysis

81. *Based on the information available to us, the profit made as a result of the scheme by Australia Co and Service Co reasonably reflects the economic substance of the entity's activities in connection with the scheme.*

82. *Notwithstanding Sub-lessor Co being party to the sub-lease agreement with Australia Co, it does not undertake any active functions in respect of the sub-lease. No independent consideration or negotiation is undertaken by Sub-lessor Co to determine the relevant terms and conditions of the sub-lease nor does Sub-lessor Co actively engage in managing any inherent risks from the underlying agreement (for example, defaulting payments).*

83. *Based on the information available to us, the profit made as a result of the scheme by Sub-lessor Co ($50 million) does not reasonably reflect the economic substance of Sub-lessor Co's activities in connection with the scheme.*

84. *Asset Co, as the Master Lease holder, is responsible for the acquisition and financing of the rig, and the ongoing insurance of the rig with external providers. A functional analysis determines that Asset Co should have received $350m for its economic activities in connection with the scheme.*

85. *Based on the information available to us, the profit made by Asset Co as a result of the scheme does not reasonably reflect the economic substance of Asset Co's activities in connection with the scheme.*

Scenario 2: lease in lease out arrangement – low risk

86. *Assume the following modifications to the facts of Scenario 1 in paragraphs 71-85 of this draft Guideline.*

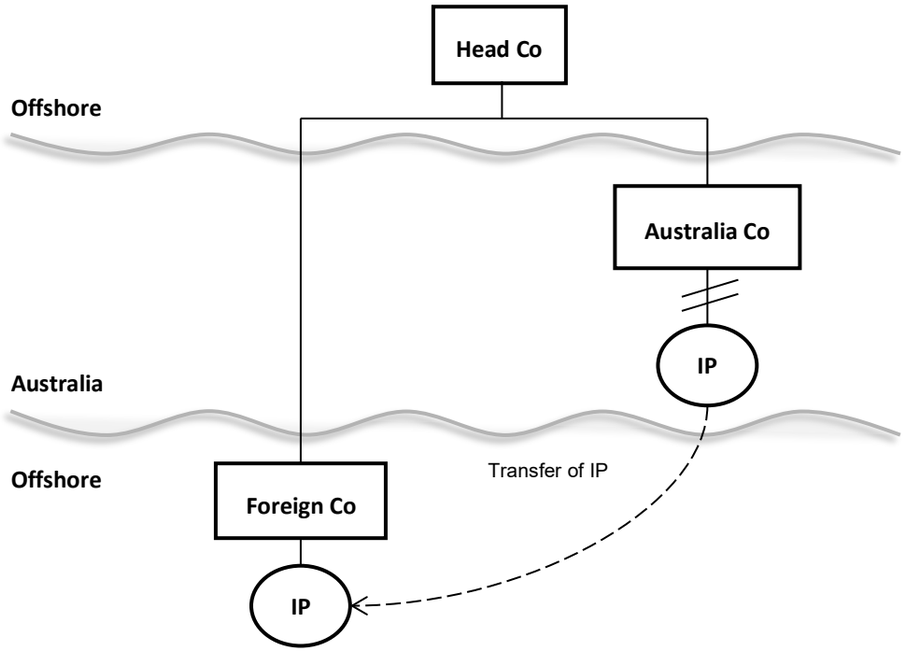
87. *Sub-lessor Co is the central leasing entity for the global group and is responsible for the sub-lease of rigs to related party operating entities in various regions of the world (including the Mediterranean, Africa and South America). Sub-lessor Co is responsible for global marketing and scheduling of the rigs; managing outsourced contractors; adhering to local government reporting and compliance obligations in the country of Sub-lessor Co. Sub-lessor Co also bears utilisation risk in relation to the vessel and its financial performance is a function of its ability to optimise utilisation of the asset during the period of the head lease.*

88. *Sub-lessor Co enters into a Master Lease agreement with Asset Co under arm's length terms. Sub-lessor Co then sub-leases the rig to Australia Co after negotiating the terms and conditions of the lease for $350 million per annum under a sub-lease arrangement. Australia Co utilises the asset in the conduct of its oil drilling business.*

89. *In this modified scenario, Sub-lessor Co is able to demonstrate that it carries out significant functions and bears actual risk in its role as sub-lessor. After taking into account the costs associated with the running of its business, Australia Co makes a return commensurate with its functional profile and Asset Co is remunerated in accordance with the financial and economic risks borne in respect of the rig.*

90. *Based on the information available to us, it is reasonable to conclude that the profits made by Australia Co, Asset Co and Sub-lessor Co reasonably reflect the economic substance of their activities in connection with the scheme.*

Scenario 3: intangibles migration (pharmaceutical) – high risk



Background

91. *Australia Co is part of a global pharmaceutical group. The group's core business is the development and commercialisation of pharmaceutical products. The group derives the bulk of its income from the sale of medicinal drugs. The development and manufacture of the drugs requires the group to exploit a range of IP assets.*

92. *On 1 July 2017, the group restructured. Prior to the restructure, Australia Co was the legal and beneficial owner of the IP associated with medicinal drug #16 (MD16), including registered trademarks, patents, know-how and processes. Australia Co performed all functions associated with developing, enhancing, maintaining, protecting and exploiting MD16. This involved funding and managing the development of the drug over a 10 year period including:*

- *(a) employing highly skilled staff in Australia*
- *(b) designing, controlling and funding research*
- *(c) undertaking testing and quality control for early phase pre-human testing and clinical trials*
- *(d) centrally managing and funding clinical trials*
- *(e) conducting research and development (R&D) projects associated with improvement of the drug and enhancements to the delivery and administration of the drug*
- *(f) developing a manufacturing process for the active ingredient, and*
- *(g) managing compliance with relevant regulatory requirements.*

93. *On 1 July 2017, at the final stage of clinical trials and prior to commercialisation, Australia Co and Foreign Co entered into an agreement which legally transferred the ownership of all the existing registered IP relating to MD16 to Foreign Co. This included exclusive rights to utilise the registered IP for the manufacturing, distribution, marketing, and commercialisation process. The trademarks for the product were also permanently assigned to Foreign Co. Foreign Co is the legal owner of the IP for MD16 post 1 July 2017.*

94. *At the time the registered IP was transferred, Foreign Co employed a small number of staff who had very little experience in the development and commercialisation of pharmaceutical products.*

95. *Following the disposal, a manufacturing contract was entered into between Foreign Co and a third party manufacturer to produce MD16 for the purpose of global sales. Evidence available to us indicates that Australia Co undertakes functions related to the manufacture and commercialisation of MD16 for the global market including:*

(a) set-up and maintenance of the third party manufacturing processes, and

(b) oversight of testing and quality assurance of the drug.

96. *Australia Co also continues to perform functions associated with developing, enhancing, maintaining, protecting and exploiting MD16 including:*

(a) design of drug packaging including content

(b) coordination of the marketing program for the drug, and

(c) managing legal protection.

97. *Australia Co is remunerated on a cost plus basis for the services provided to Foreign Co. Foreign Co is responsible for payment to the third party manufacturer for the production of the drug and receives all income from global sales of the drug.*

98. *The effect of the arrangement is to move ownership of the IP offshore and the subsequent profits arising from the global sales of the drug.*

SES analysis

99. *We take the view that an independent entity in circumstances comparable to Australia Co would not have entered into the arrangement as it involves Australia Co disposing of valuable IP while continuing to undertake the main functions in connection with the commercialisation of the IP. If the transfer of the IP had not taken place, Australia Co would have derived the income from global sales of the drug.*

100. *At the time of the disposal of the IP, the drug was fully developed and ready for commercialisation. Following the disposal, Foreign Co enjoys legal and beneficial ownership of the IP and derives a majority of the profits from its exploitation.*

101. *The form of the transaction allocates all risks that come with owning the IP to Foreign Co, as the purchaser. However, as set out above, Australia Co continues to bear relevant risks associated with the exploitation of the IP. The functions required to exploit the drug, including the legal protection of the IP, management of the third party manufacturing contract and distribution of the drug, continue to be performed by Australia Co.*

102. *On this basis we take the view that the profit made by Foreign Co and Australia Co as a result of the scheme does not reasonably reflect the economic substance of their activities in connection with the scheme.*

Scenario 4: intangibles migration (pharmaceutical) – low risk

103. *Assume the following modifications to the facts of Scenario 3 in paragraphs 91–102 of this draft Guideline.*

104. *Australia Co determines that it does not have the requisite skills and resources to successfully commercialise MD16. In addition to the transfer of the registered IP rights in respect of MD16 to Foreign Co, the following are also transferred to Foreign Co from Australia Co:*

(a) the manufacturing know-how and process manuals for MD16

(b) marketing and trade intangibles associated with MD16 such as key contracts with suppliers

(c) customer contracts and customer lists, and

(d) regulatory compliance plans, draft approval applications and other supporting materials.

105. *Further, a number of key employees of Australia Co involved in the decision making and management of the MD16 project were also relocated to Foreign Co. Foreign Co also employed additional personnel locally who are qualified and skilled in the development and commercialisation of pharmaceutical products.*

106. *Foreign Co provided market value compensation to Australia Co in relation to the transfer of the registered IP, associated business assets and other intangibles.*

107. *Australia Co made a gain on the disposal on the registered IP which it included in its assessable income. The R&D integrity rules applied to the relevant parts of this gain.*

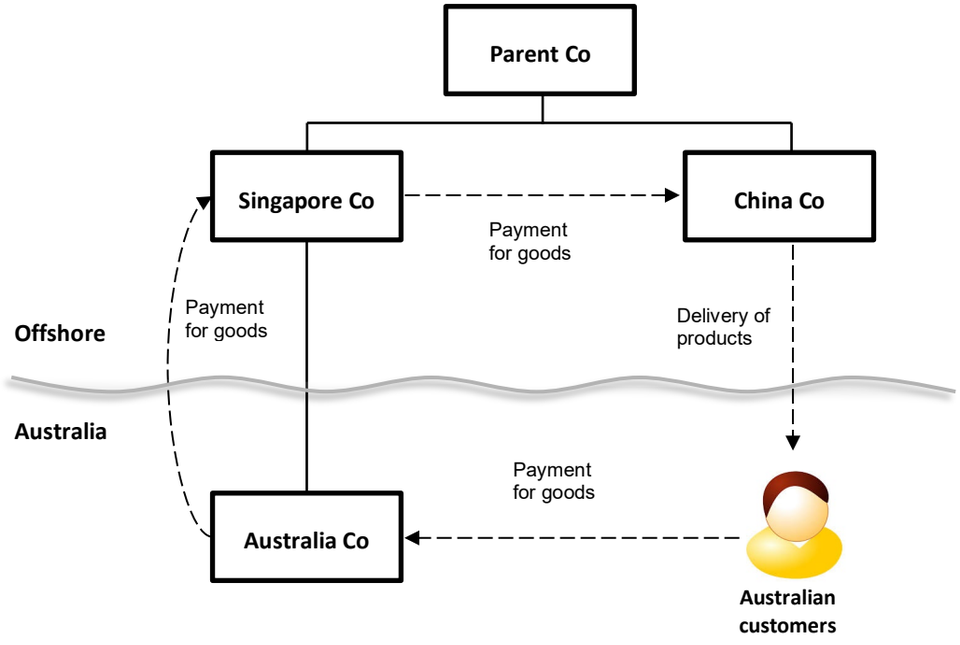
108. *After the transfer of the MD16 business, Australia Co continued to perform various functions to develop, enhance and protect the MD16 IP under an agreement with Foreign Co to provide contract R&D and other support services. These functions were only performed for a short transitional period following the transfer of the business to Foreign Co and were performed under the direction of Foreign Co staff. Australia Co was remunerated by Foreign Co for these services in accordance with arm's length principles.*

109. *After the transition period, Australia Co provided limited contract R&D services in relation to the MD16 at the direction of Foreign Co and was remunerated accordingly.*

110. *Foreign Co employees are responsible for the planning and design of the manufacturing process for MD16. Foreign Co also bears the relevant risks associated with the exploitation of the IP, including risks associated with the manufacturing and distribution of the MD16 product. Furthermore, Foreign Co has the financial capacity to bear the costs of managing and mitigating these risks as well as assuming any potential losses.*

111. *Foreign Co is entitled to the profits from the global sales of the MD16 products as a result of the functions and risks assumed by Foreign Co. In these circumstances, it is reasonable to conclude that the profits made by Foreign Co and Australia Co as a result of the scheme reasonably reflect the economic substance of their activities in connection with the scheme.*

Scenario 5: limited risk distributor – high risk



Background

112. *Parent Co, Australia Co, Singapore Co and China Co are members of a global group which designs, manufactures and markets electrical appliances.*

113. *China Co owns the group's manufacturing facilities and is responsible for:*

- *(a) manufacturing of the products*
- *(b) undertaking testing and quality control*
- *(c) assembling and packaging the products*
- *(d) organising delivery of finished goods to Australian customers*
- *(e) undertaking all stages of production scheduling, including planning supply and capacity, and*
- *(f) managing selection of suppliers and raw materials.*

114. *Singapore Co is the initial purchaser of the finished goods and distributes the goods in the Asia-Pacific region. Singapore Co buys the goods from China Co at a percentage mark up on cost. Singapore Co further subcontracts to Australia Co for distribution to Australian customers. Singapore Co does not take physical possession of products and does not make any changes to the products.*

115. *There are 2,000 employees in Singapore Co who perform centralised ordering and invoicing, human resources, logistics and sales and distribution functions for various countries in the Asia-Pacific region. Information available to us suggests that Singapore Co performs ordering functions for Australian sales based on instructions from Australia Co. We do not have any evidence that Singapore Co employees undertake any relevant functions in relation to the generation of Australian sales.*

116. *The terms of the contractual agreement between Australia Co and Singapore Co provide that Australia Co is a limited risk distributor and that Australia Co's purchase price is set in order to achieve a particular targeted adjusted operating margin of 2%. As set out in the distribution agreement between Australia Co and Singapore Co, Australia Co's main responsibilities as a limited risk distributor are the provision of routine sales and marketing support functions, and the delivery of administrative services.*

117. *Pursuant to this agreement, Australia Co is the contracting party in all agreements entered into with Australian customers and these customers only have recourse to Australia Co. As a result, the evidence suggests that Australia Co assumes the relevant risks including inventory risk, market risk, customer credit risk, and warranty and product liability risk.*

118. *Australia Co employs over 500 personnel who perform a variety of functions including:*

- *(a) researching, developing and implementing local sales and marketing strategies, including promotional and marketing activities*
- *(b) sales forecasting and demand planning*
- *(c) order management, for example, determining purchasing volumes and then sending the orders to Singapore Co for processing*
- *(d) maintaining and strengthening existing client relationships and seeking new opportunities, and*
- *(e) negotiating discounts with resellers.*

119. *In examining the arrangement between Singapore Co and Australia Co, we review information provided by the taxpayer as well as publicly available information, Country-by-Country reports and information obtained under exchange of information processes.*

120. *To further understand the arrangement, we seek to conduct functional analyses of Australia Co and Singapore Co and issue a number of requests for information (RFIs) to obtain additional information about their roles and functions. Australia Co is not forthcoming in engaging with us, consistently requests lengthy extensions of time to respond and provides incomplete responses to the RFIs.*

121. *As a result, we rely on the available information to complete our review. This information suggests that over the years, Australia Co has undertaken market development activities which enhanced the value of the global group's brand name, with the strategy of building the group's market share in Australia.*

SES analysis

122. *On the available evidence, we take the view that the profits made by Australia Co and Singapore Co do not reasonably reflect the economic substance of their activities in connection with the scheme. Australia Co is the contracting party in all agreements entered into in the Australian market and it has an obligation to provide the products to customers. Australia Co's staff perform, economically significant functions including developing and implementing local marketing and promotional strategies which are a crucial driver for the global group's success in all relevant markets, including Australia. Australia Co's activities capture market share, generate value creation in Australia and contribute to the building of the global brand.*

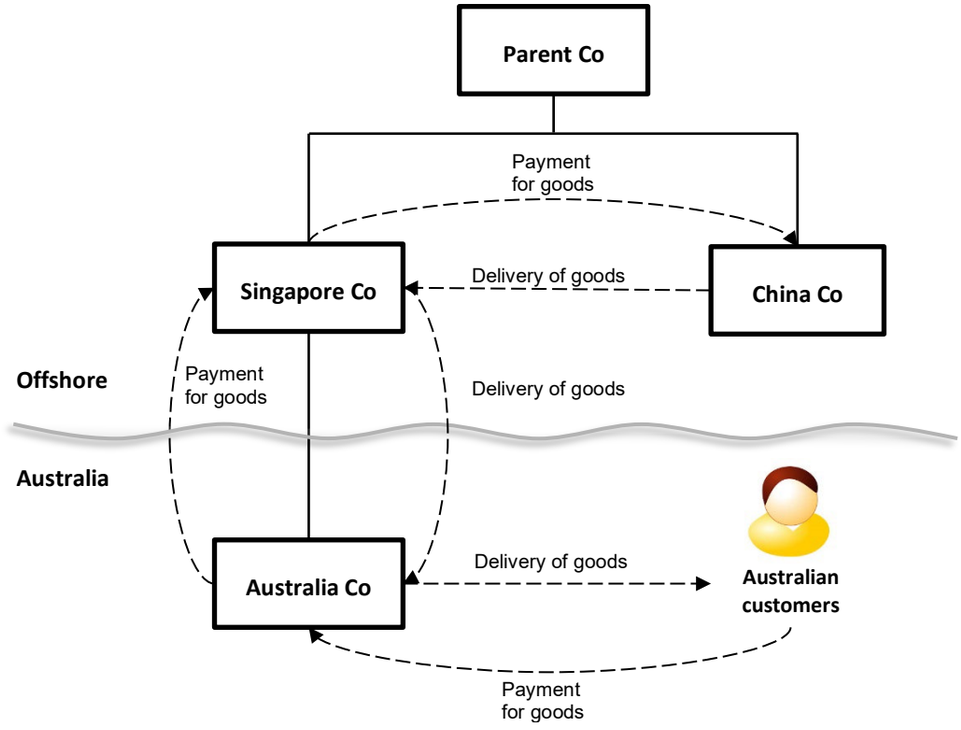
123. *Furthermore, Australia Co bears market, inventory, warranty and customer credit risk. Australia Co undertakes functions and assumes risks that are consistent with the functional characterisation of a fully-fledged distributor rather than a limited risk distributor. Australia Co's characterisation as a limited risk distributor does not align with its actual roles and responsibilities. On this basis, the profit made by Australia Co as a result of the scheme does not reasonably reflect the economic substance of its activities in connection with the scheme.*

124. *Although there are a large number of employees in Singapore Co who are performing sales, marketing and distribution functions, these activities relate to sales made in the Asia-Pacific region excluding Australia. It is the activities performed by Singapore Co that relate directly to Australian sales that are relevant when considering the appropriate level of profit derived by Singapore Co for the purposes of the sufficient economic substance test. Available evidence demonstrates that Singapore Co has a limited, non-value adding role in relation to the sales made to Australian customers.*

125. *Singapore Co purchases products from China Co but does not take physical possession of the products. The purchases and delivery are based on Australia Co's instructions. Singapore Co relies heavily on Australia Co to perform key functions and Singapore Co's functions add value only to sales made in regions other than Australia. Therefore, the profit made by Singapore Co as a result of the scheme does not reasonably reflect the economic substance of its activities in connection with the scheme.*

Scenario 6: limited risk distributor – low risk

Background



126. *Assume the following modifications to the facts of Scenario 5 in paragraphs 112–125 of this draft Guideline.*

127. *Singapore Co takes physical possession of the products from China Co in order to perform quality checks on the products to ensure they adhere to the relevant industry safety standards and regulations. As the group's distributor for the Asia Pacific region, Singapore Co is also responsible for all significant decision-making activities referrable to the sales of the product to Australian customers.*

128. *Australia Co has a separate agreement with Singapore Co which provides that Singapore Co is responsible for and assumes the economically significant risks that relate to the sale of goods to Australian customers. These risks include inventory risk, customer credit risk, and warranty and product liability risk. Singapore Co has exercised control over these risks through the performance of functions such as quality control and inventory management. Singapore Co also has the financial capacity to assume these risks. In the past it has been required to pay for warranty and product liability claims and to bear the cost of customer bad debts.*

129. *Of the 2,000 plus employees in Singapore Co, over 500 employees undertake economically significant functions in relation to the generation of Australian sales, including:*

- *(a) researching, developing, directing and managing local sales and marketing strategies, including promotional and marketing activities*
- *(b) sales forecasting, demand planning and order management*
- *(c) coordinating manufacturing, logistics, sales and distribution functions*
- *(d) product development, ongoing product monitoring and commercialisation*
- *(e) maintaining and strengthening existing client relationships and seeking new opportunities, and*
- *(f) negotiating discounts with resellers.*

130. *The taxpayer is able to demonstrate that the distribution agreement between Australia Co and Singapore Co is an accurate representation of Australia Co's main responsibilities as a limited risk distributor – that is, the provision of routine sales and limited marketing support functions, as well as the delivery of routine administrative services. Australia Co employs 50 personnel in carrying out these functions. Australia Co's purchase price is set in order to achieve a targeted adjusted operating margin that appropriately reflects its significant economic contribution to the transaction. Based on the functional and comparability analysis the margin is higher than the return in Scenario 5.*

131. *Further to the functional analyses of Australia Co and Singapore Co, evidence available to us confirms that Singapore Co's role in directing and managing sales and market development activities in Australia has enhanced the value of the global group's brand name and increased the group's market share.*

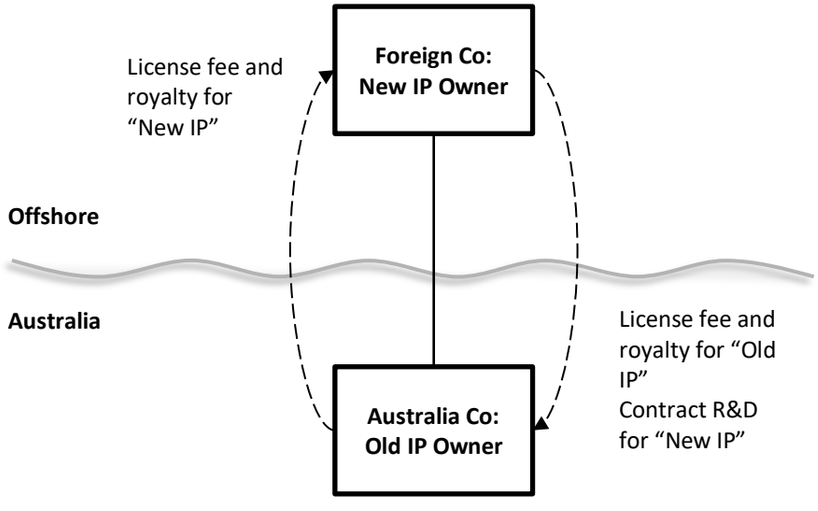
SES analysis

132. *On the available evidence, it is reasonable to conclude that the taxpayer satisfies the SES test. While Australia Co maintains its role in providing routine sales, limited marketing support functions and routine administrative services, Singapore Co's staff perform economically significant functions in generating Australian sales – such as developing and implementing local marketing and promotional strategies which are a crucial driver for the global group's success in all relevant markets, including Australia. Singapore Co's activities capture market share, generate value creation in Australia and contribute to the building of the global brand. Singapore Co also assumes the relevant risks associated with the distribution of the products in Australia.*

133. *Evidence available to us confirms Australia Co's characterisation as a limited risk distributor. Having regard to its functional profile, it is reasonable to conclude that the profit made by Australia Co as a result of the scheme reasonably reflects the economic substance of its activities in connection with the scheme.*

134. *Furthermore, in considering the activities performed by Singapore Co in relation to the generation of Australian sales, it is clear that Singapore Co possesses actual decision-making responsibilities in directing sales and marketing strategies as well as managing and controlling the implementation of market development activities in Australia. With its product development and client management functions also reflected by the capability of its staff, it is evident that Singapore Co performs key functions in adding value specifically to the generation of sales in Australia. It is therefore reasonable to conclude that the profit made by Singapore Co reasonably reflects the economic substance of its activities in connection with the scheme.*

Scenario 7: intangibles migration (run up run down) – high risk



Background

135. *Foreign Co is the parent company of a global group. Australia Co is a wholly owned subsidiary of Foreign Co and the holding company for the group's Australian operations. The group derives income from the sale of goods and associated services. The distribution of goods and the provision of associated services require the group to exploit IP assets including copyrights, patents and trademarks.*

136. *On 1 July 2017 the group restructures. Prior to the restructure, Australia Co was the legal and beneficial owner of group IP (the old IP) and performed all functions associated with developing, enhancing, maintaining, protecting and exploiting the old IP. Australia received income from global customer sales on behalf of the group. From 1 July 2017, Australia Co licences the old IP to Foreign Co to allow Foreign Co to produce future versions of goods using the old IP. After entering into this agreement, Australia Co becomes a sales agent of Foreign Co in relation to sales of the goods to Australian customers. Under the licensing agreement, Foreign Co also becomes the legal owner of group IP developed post 1 July 2017 (the new IP).*

137. *The evidence available to us suggests that the development of the new IP is wholly reliant on the enhancement and exploitation of the old IP so that the old IP forms the platform upon which the new IP is developed. Australia Co has a central role in the development of the new IP during the period following entry into the licensing arrangement, but is only engaged by Foreign Co on a contract R&D basis in respect of this work. Foreign Co pays licence fees to Australia Co on arm's length terms for the use of the old IP and remunerates Australia Co on a cost plus basis for providing contract R&D services associated with new IP. The amount of licence fees paid by Foreign Co to Australia Co declines over a short timeframe as the new IP is developed. Licence fees are no longer payable after the goods associated with the new IP are released to market.*

138. *Following this, key personnel are relocated offshore and Australia Co starts to provide limited R&D support to Foreign Co. It distributes goods to Australian customers only and is remunerated by Foreign Co on a cost plus basis. Foreign Co employs the key personnel and starts to perform the majority of functions associated with developing, enhancing, maintaining, protecting and exploiting the new IP. For example:*

- *(a) Foreign Co performs functions integral to the ongoing development of the new IP such as designing and controlling research programs*
- *(b) Foreign Co undertakes strategic decision making in respect of the commercialisation of the new IP and takes protective action where IP rights are infringed*
- *(c) Foreign Co coordinates offshore sales and marketing strategies on behalf of the group, and*
- *(d) Foreign Co provides technical support to customers.*

139. *These functions are a key aspect of the group's business model and vital to the success of the business globally. Foreign Co also sells and distributes the goods to offshore customers and receives income from global group sales. Foreign Co enters into new global agreements with third parties as the existing agreements with Australia Co expire.*

140. *The effect of these arrangements is to move ownership and development of group IP offshore.*

SES analysis

141. *On the available evidence, we take the view that the profits made by Foreign Co and Australia Co do not reasonably reflect the economic substance of their activities in connection with the scheme.*

142. *Foreign Co enjoys legal and beneficial ownership of the new IP and derives a majority of group profits from the exploitation of the new IP, either through royalties from the use of the new IP by other group companies or directly through the manufacture and sale of products incorporating the new IP. This is mainly achieved via the modification and exploitation of the old IP, despite the absence of a legal form disposal of the old IP by Australia Co to Foreign Co.*

143. *Based on the evidence available, it is also considered that in the period following the entry into the licensing agreement, Foreign Co did not have the capacity to undertake these further R&D activities as it did not have the expertise, know-how or qualified staff to do so and only paid Australia Co for the provision of 'limited R&D' services. While key personnel are eventually transferred to Foreign Co, it is considered that the economic substance of the activities undertaken by these employees after the transfer did not significantly contribute to the*

development of the new IP. On this basis, the profit made by Foreign Co as a result of the scheme does not reasonably reflect the economic substance of its activities in connection with the scheme.

144. *Additionally, it is considered that the level of profit made by Australia Co is indicative of a sales agent with no responsibility for long term product or market development, and does not reflect Australia Co's contribution towards the development, enhancement, maintenance and protection of the new IP during the period following entry into the licensing arrangement. As the key R&D specialists and know-how in relation to the old IP remained in Australia during this period, Australia Co's role was not merely of a contract R&D provider but rather Australia Co played a key role in the development of the new IP, including the making of key decisions during the R&D process. As a result, the profit made by Australia Co does not reasonably reflect the economic substance of its activities in connection with the scheme.*

Scenario 8: intangible migration (run up run down) – low risk

145. *Assume the following modifications to the facts of Scenario 7 in paragraphs 135–144 of this draft Guideline.*

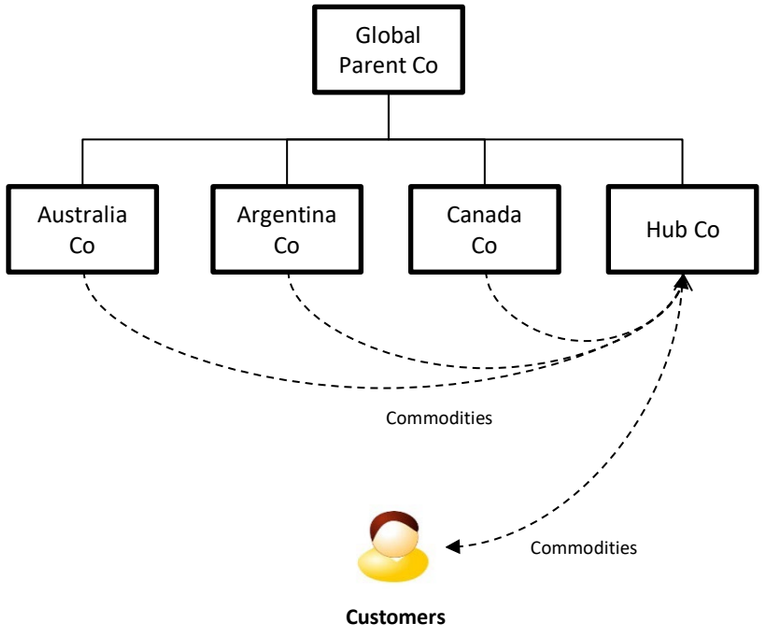
146. *Foreign Co is the primary R&D entity of the global group and accordingly has staff with the necessary skills, experience and capability to provide the relevant R&D services to further develop and enhance group IP.*

147. *The strategic decision was made for Australia Co to sell the IP to Foreign Co.*

148. *Under this alternative arrangement, Australia Co received market value consideration for the disposal of the IP from Foreign Co in accordance with arm's length principles. Australia Co made a gain on the disposal of the registered IP which is included in its assessable income. The R&D integrity rules applied to the relevant parts of this gain.*

149. *Going forward, Foreign Co is entitled to the profits from the global sales of goods associated with the old and new IP as a result of the functions and risks assumed by Foreign Co. On this basis, it is reasonable to conclude that the profits made by Foreign Co and Australia Co as a result of the scheme reasonably reflect the economic substance of their activities in connection with the scheme.*

Scenario 9: marketing hub – high risk



Background

150. *Australia Co, Hub Co, Argentina Co and Canada Co are all members of a global group. The global group generates income primarily through selling commodities both in the Asia Pacific and Atlantic markets.*

151. *Australia Co, Argentina Co and Canada Co carry out mining, processing, inland transport and port activities for commodities in their respective jurisdictions. Australia Co, Argentina Co and Canada Co also undertake exploration activity to provide long term reliable supply and maintain product brand.*

152. *Australia Co provides commodities for the Asia Pacific market whereas the Atlantic market commodities are sourced from Canada Co and Argentina Co.*

153. *Under the group's arrangements, Australia Co, Argentina Co and Canada Co exclusively sell all their production (on Free on Board terms) to Hub Co, which then on-sells the commodities immediately to third party customers (on Free on Board terms) in the two regional markets.*

154. *Due to Hub Co's participation in the sales market, it collects 'sales-side' market intelligence for the two distinct markets to assist in the identification of, and marketing to, potential customers (technical specification to price sensitivity, volume to price sensitivity, the customer's stockpile levels, demand cycles, sales by competitors, et cetera).*

155. *Under the this arrangement, Australia Co, Argentina Co and Canada Co use the 'sales-side' market intelligence to assist them in their production planning. In addition, in order to secure sales, Hub Co is also dependent on the technical and production information gathered by Australia Co, Argentina Co and Canada Co in relation to their commodities as customers utilise this information to inform their purchase decisions. Accordingly, Hub Co is highly dependent on Australia Co, Argentina Co and Canada Co to provide technical marketing assistance to allow it to secure the sale of the commodities to third parties.*

156. *Australia Co, Argentina Co and Canada Co provide Hub Co with ongoing 'production-side' market intelligence (forecast production schedules, port loading delays, changes in product quality, production/quality of competitors, et cetera) and a feedback channel to their operating assets to allow Hub Co to most effectively sell its commodities.*

157. *Hub Co also receives information from group personnel located in the jurisdictions of the customers, who provide real time information of market conditions and customer contact in those regions.*

158. *Physically, Australia Co, Argentina Co and Canada Co hold the commodities in port stockpiles until sold. Hub Co does not alter the commodities, or take physical possession.*

159. *Australia Co, Canada Co and Argentina Co sell commodities to Hub Co at a discount relative to their respective regional index price which allows Hub Co to generate profits on the sale of the commodities to third party customers.*

160. *Australia Co employs staff who perform the following activities:*

- *(a) exploration, development, and maintenance of mining rights*
- *(b) design and implementation of production plans, including development of new production techniques*
- *(c) mining activities (including support activities such as managing contractors)*
- *(d) mine maintenance to deliver volumes as agreed with customers*
- *(e) operation of mine to port infrastructure*
- *(f) technical activity in relation to the commodities, including specification testing, efficient stockpiling at the port and efficient ship loading*
- *(g) collating market conditions and intelligence from the producer side, and*
- *(h) developing business strategies for the production and sales of the commodities to third party customers.*

161. *Canada Co and Argentina Co undertake similar functions in relation to their local markets.*

162. *The taxpayer has provided documentation that stipulates that Hub Co assumes the following risks:*

(a) accounts receivable late payment risk, and

(b) market risk.

163. *Hub Co employs staff who undertake the following activities:*

(a) market analysis and contract negotiation

(b) provision of technical and other information from Australia Co, Argentina Co and Canada Co to customers

(c) managing accounts receivable and accounts payable, and

(d) invoicing and other administrative tasks.

SES analysis

164. *On the available evidence, we take the view that the profits made by Australia Co and Hub Co do not reasonably reflect the economic substance of their activities in connection with the scheme.*

165. *While Hub Co performs marketing activities and other administrative functions, we do not consider that these activities reasonably reflect the level of profits that it is receiving given that Australia Co, Canada Co and Argentina Co (as well as the personnel located in the local jurisdictions of the customers) provide key functions to Hub Co to allow it to secure its third party contracts.*

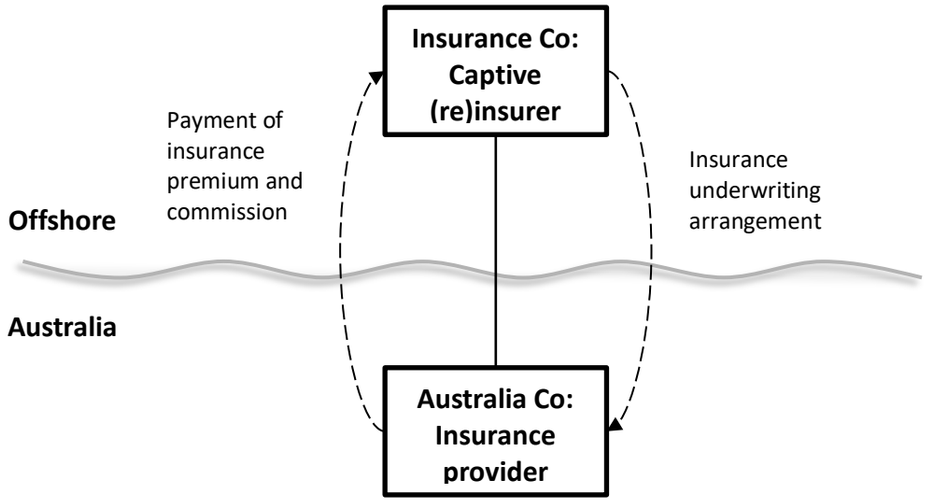
166. *Based on the functional analyses undertaken by us, Australia Co staff are responsible for ensuring planning, production and technical marketing of the commodities as well as collating local market intelligence. Australia Co undertakes significant activities in relation to the production, scheduling and specifications of the commodities which are important to the group's third party customers. Key value chain decisions and management functions are undertaken by Australia Co in relation to the Asia Pacific sales and Hub Co does not undertake the activities required to obtain its third party contracts or to satisfy its contractual obligations, and relies on the functions and decision-making activities of its related parties in order to fulfil its obligations.*

167. *Further, as inventory is mined and transported to stockpiles at port and held until requested by customers, most of the market risk is still held by Australia Co. Hub Co bears limited market risk as the commodities are not sold to Hub Co unless the commodities are needed to fulfil a sale agreement with a customer. Hub Co does not have full control over the sales in relation to the supply, delivery or scheduling of the commodities as these are all dependent on Australia Co's functions.*

168. *Although Hub Co legally assumes accounts receivable late payment risk, based on the information available to us, Hub Co does not have the ability to manage and control any of its exposure to this risk and does not have the financial capacity to bear the risks apart from the ability to call on the financial resources of its parent.*

169. *Therefore, the profits made by Australia Co and Hub Co as a result of the scheme do not reasonably reflect the economic substance of their activities in connection with the scheme.*

Scenario 10: insurance arrangement – low risk[2]



170. *Insurance Co is the captive insurance entity of a global group and is a resident in Bermuda. Insurance Co is authorised and registered to conduct an insurance business in Bermuda and is recognised as an insurance entity by the Australian Prudential Regulation Authority (APRA).*

171. *Insurance Co enters into reinsurance arrangements with Australia Co which provides insurance services to third parties within Australia. Insurance Co is an associate of Australia Co. The arrangements between Insurance Co and Australia Co do not include financial insurance or financial reinsurance.*

172. *Insurance Co employs staff located in Bermuda, who carry out underwriting, manage and control Insurance Co's arrangements with Australia Co and manage Insurance Co's assets and investments. These employees have the requisite skills to undertake these activities.*

173. *There is a genuine transfer of significant insurance risk to Insurance Co from Australia Co. Insurance Co assumes the insurance risks under the insurance cover provided.*

174. *Australia Co undertakes any reinsurance of its insurance risk exposure on arm's length terms and in a way which is consistent with its business model and commercial risk appetite.*

175. *An insurance premium (net of commission receivable where relevant) that is struck on arm's length terms is paid by Australia Co to Insurance Co in accordance with Australia Co's insurance needs.*

176. *Insurance Co has the capacity to pay and indeed does pay out any insurance claims made by Australia Co.*

177. *Costs incurred by Insurance Co are priced on arm's length terms, and there is no evidence of biased allocation of costs between the relevant insured risks and its other business.*

178. *Insurance Co undertakes any retrocession*[3] *of the reinsured risk to other reinsurers on arm's length terms and in a way which is consistent with its own business model and commercial risk appetite.*

[2] This scenario draws upon the guidance contained in PS LA 2007/8.

[3] Retrocession involves reinsurance of a reinsured risk by one reinsurance company with another. In this scenario, Insurance Co (the reinsurance company) may wish to manage its risk exposure under the risks it has reinsured with Australia Co by 'ceding' (reinsuring) part of that risk under a retrocession (reinsurance) arrangement with another reinsurance company.

179. *Insurance Co holds a level of capital in its investment portfolio which corresponds to the liability that it manages. Capital reserve levels and measurement of accounting liabilities in the captive reflect the commercial nature of the relevant risks.*

180. *On the available evidence, we consider that the profits made by Australia Co and Insurance Co reasonably reflect the economic substance of their activities in connection with the scheme (which is limited to the underwriting arrangement between Australia Co and Insurance Co).*

Commissioner of Taxation
7 February 2018

Your comments

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

Due date: **9 March 2018**

Contact officer details have been removed following publication of the final guideline.

References

ATOlaw topic(s)	Tax integrity measures ~~ Part IVA ~~ Other
Legislative references	ITAA 1936 ITAA 1936 Pt IVA ITAA 1936 6(1) ITAA 1936 177C(1)(a) ITAA 1936 177C(1)(b) ITAA 1936 177C(1)(ba) ITAA 1936 177C(1)(bb) ITAA 1936 177C(1)(bba) ITAA 1936 177C(1)(bbaa) ITAA 1936 177C(1)(bc) ITAA 1936 177M
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Other references	PS LA 2007/8
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Appendix 1 – DPT client engagement framework

