TR 1999/D16 - Income tax: international transfer pricing - transfer pricing and profit reallocation adjustments, relief from double taxation and the Mutual Agreement Procedure

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Draft Taxation Ruling

Income tax: international transfer pricing – transfer pricing and profit reallocation adjustments, relief from double taxation and the Mutual Agreement Procedure

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Preamble

Draft Taxation Rulings (DTRs) represent the preliminary, though considered, views of the Australian Taxation Office. DTRs may not be relied on by taxation officers, taxpayers and practitioners. It is only final Taxation Rulings that represent authoritative statements by the Australian Taxation Office of its stance on the particular matters covered in the Ruling.

What this Ruling is about

Class of person/arrangement

1. This Ruling applies to taxpayers who wish to seek relief from international double taxation arising from an increased liability to tax due to a transfer pricing or profit reallocation adjustment by the Australian Taxation Office (ATO) or by a foreign tax administration. This Ruling applies only to companies.

Issues discussed in this Ruling

2. This Ruling outlines mechanisms in the income tax law and ATO practice that deal with relief from double taxation arising from a primary international transfer pricing or profit reallocation adjustment made by either the ATO or a foreign tax administration. The mechanisms are in the *Income Tax Assessment Act 1936* [1]('the Act' or 'the 1936 Act'), *Income Tax Assessment Act 1997* ('the 1997 Act') and Australia's comprehensive double tax agreements ('DTAs') (included as schedules to the *International Tax Agreements Act 1953* ('the Agreements Act')). Relief from double taxation in these circumstances is referred to in this Ruling as 'correlative relief' or 'correlative adjustment.' It is also referred to as 'corresponding adjustment' in *Transfer Pricing Guidelines for Multinational*

[1] All subsequent legislative references are to the *Income Tax Assessment Act 1936* unless otherwise indicated.

Enterprises and Tax Administrations, published in July 1995 ('the 1995 OECD Transfer Pricing Report').

3. This Ruling uses Australia's modern DTAs (for example, the Vietnamese agreement - schedule 38 of the Agreements Act) as the basis for discussion and provides analysis of any major variations in particular treaties. References are also made to the *OECD Model Tax Convention on Income and on Capital*, updated as of 1 November 1997 ('the OECD Model Tax Convention').

Date of effect

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

Contents list

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Ruling and explanations

PART 1: INTERNATIONAL DOUBLE TAXATION

TYPES OF INTERNATIONAL DOUBLE TAXATION

1.1 Two types of international double taxation are generally recognised:

(a) economic double taxation; and

(b) juridical double taxation.

1.2 **Economic** double taxation occurs where two companies resident in different countries (e.g., two separate legal entities, i.e., a parent company resident in one country and a subsidiary company resident in another) are effectively taxed on the same income, without either country providing relief for the tax imposed by the other. This double taxation may arise where, as a consequence of non-arm's length dealings, the profits of one company are upwardly adjusted increasing the tax payable in the country of residence of that company (a primary **transfer pricing** adjustment), without a corresponding downward adjustment to the tax payable by the associated company in the other country. The **Associated Enterprises** Article in each of Australia's DTAs provides for primary transfer pricing adjustments (e.g., Article 9(1) of the Vietnamese agreement). Most of these DTAs also provide a mechanism for relief from resulting economic double taxation (e.g., Article 9(3) the Vietnamese agreement).

1.3 Detailed discussion of economic double taxation is contained in Part 2 of this Ruling.

1.4 **Juridical** double taxation occurs where a company pays tax on the same income in two different countries (e.g., where a single legal entity has, for example, a head office in its country of residence and a permanent establishment in another country), without either country providing relief for tax imposed by the other. This double taxation may arise where the profits that are taken to have arisen from the company's operations in one country are upwardly adjusted to increase the tax payable in that country (a primary **profit reallocation** adjustment) without a corresponding downward adjustment to the company's profits from its operations in the other country. The **Business Profits** Article and the Methods for Elimination of Double Taxation Article in each of Australia's DTAs provides for both

primary profit reallocation adjustments and relief from resultant double taxation (e.g., Article 7(2) and Article 23 respectively of the Vietnamese agreement).

1.5 Detailed discussion of juridical double taxation is contained in Part 3 of this Ruling.

1.6 Each of Australia's DTAs contains a **Mutual Agreement Procedure** ('MAP') Article that provides, amongst other things, for the resolution of cases where a taxpayer is faced with international double taxation. Double taxation is usually regarded as 'taxation not in accordance' with the DTA (e.g., Article 24 of the Vietnamese agreement). The MAP Article enables the competent authorities of both countries to consult with each other with a view to resolving double taxation, but does not compel agreement. Paragraph 26 of the Commentary on Article 25 of the OECD Model Tax Convention states:

> 'Paragraph 2 no doubt entails a duty to negotiate; but as far as reaching mutual agreement through the procedure is concerned, the competent authorities are under a duty merely to use their best endeavours and not to achieve a result …'

1.7 Discussion of the MAP principles and procedures is contained in Part 4 of this Ruling.

1.8 Transfer pricing adjustments usually involve the imposition of penalties and/or interest. Each of Australia's DTAs specifically excludes penalty or interest relating to tax from the definition of 'tax' (e.g., Article 3(1)(g) of the Vietnamese agreement), thereby preventing such amounts from being eligible for double tax relief under a DTA.

No double tax agreement

1.9 Where either the ATO or the tax administration of another country makes a transfer pricing or profit reallocation adjustment and no relevant DTA exists, no country to country procedures are in place. Accordingly, any relief from resulting double taxation can only be provided under the domestic tax provisions of Australia or the foreign country.

Adjustment by foreign tax administration

1.10 Where economic double taxation arises from a foreign tax administration transfer pricing adjustment increasing the profits of an associated foreign company (i.e., an associate of a resident company), there are no provisions under Australian domestic tax law permitting:

(a) the income which has been derived by the resident company to be treated as not derived; or

(b) a deduction to be allowed to the resident company where no expenditure has been incurred.

1.11 Neither will the foreign tax credit system apply to provide relief from double taxation in these circumstances because the tests in paragraphs 160AF(1) (a) and (b) will not be satisfied. The Australian resident company has not paid, nor was it personally liable for the extra tax chargeable on the adjusted profits of the associated foreign company (those adjusted profits having already been returned by it as Australian source income for Australian tax purposes).

1.12 Similarly, the adjusted profits are not exempt under section 23AJ where they are deemed by the foreign tax administration to be a dividend paid by the foreign company to an associated Australian resident company. The section 23AJ exemption requires the amount to be a 'dividend' for the purposes of Australian tax law and the recharacterisation by a foreign tax administration is ineffective for this purpose.

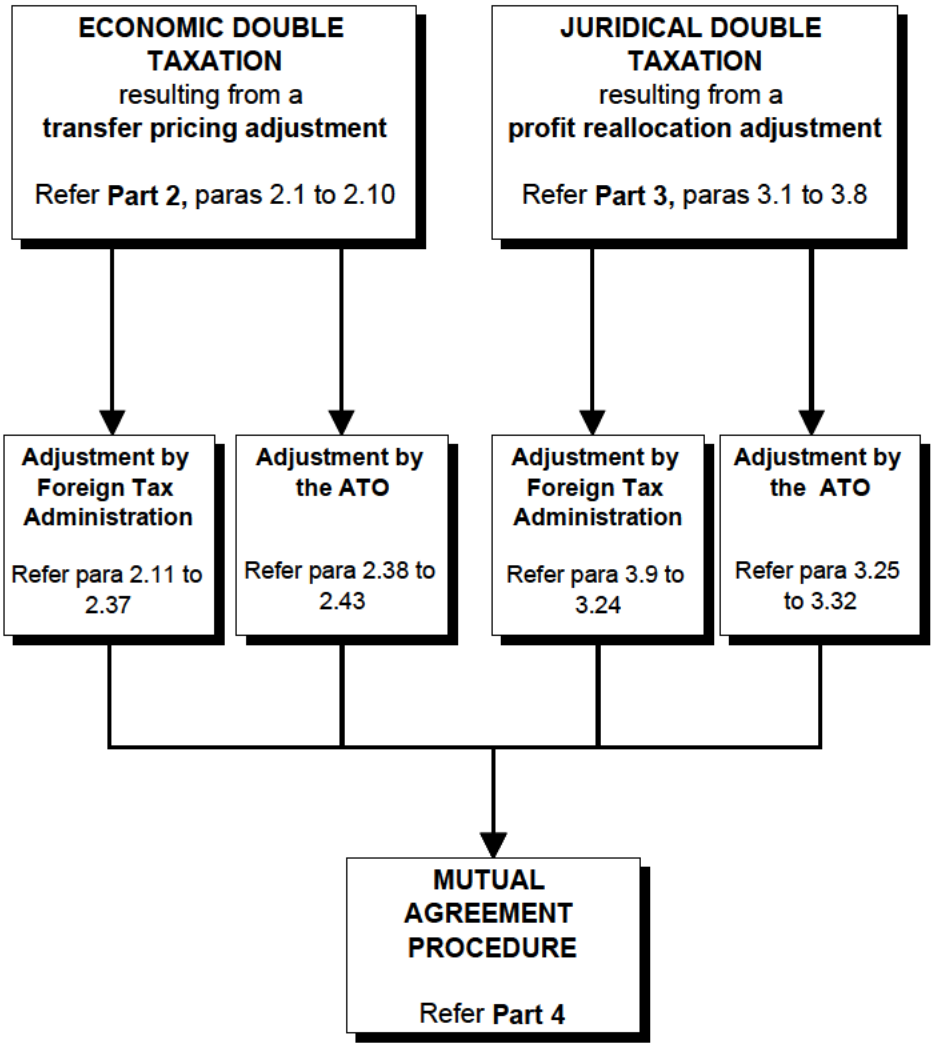
1.13 Similarly, where juridical double taxation arises for a resident company that is subject to a profit reallocation adjustment made by a foreign tax administration, the income which has been subject to double taxation will not qualify for exemption under section 23AH or relief by way of a foreign tax credit under subsection 160AF(1) where the income is not properly sourced as foreign income for Australian tax purposes.

1.14 A non-resident company subject to this type of adjustment will continue to be subject to tax in Australia on income properly sourced in Australia and expenses will not be deductible where they are attributable to income that is not properly sourced in Australia.

1.15 The remaining Parts of this Ruling address situations where there is a DTA between Australia and the other country.

Using this Ruling

1.16 This Ruling has been designed so that taxpayers need not read it in its entirety in order to determine the principles and procedures relevant to their particular case. This approach recognises that double taxation may arise in several mutually exclusive circumstances and that the treatment will vary accordingly. The following chart provides a 'roadmap' to guide taxpayers to those parts of the Ruling relevant to their circumstances. All taxpayers using this Ruling should refer to Part 4 for discussion of the principles and procedures relating to MAP.



PART 2: ECONOMIC DOUBLE TAXATION

INTRODUCTION

2.1 Most of Australia's DTAs provide for a correlative adjustment to be made to relieve economic double taxation arising from an adjustment to the profits of an associated company under the Associated Enterprises Article. The MAP Article in these DTAs may also be used to facilitate agreement between tax treaty partner countries on the application of the Associated Enterprises Article in transfer pricing adjustment cases.

DTAs without economic double tax relief provision

2.2 Australia's DTAs with Germany, Switzerland and Italy do not have a provision specifically directed at the relief from economic double taxation.

2.3 In the absence of a provision in a DTA specifically directed at the relief of economic double taxation (such as Article 9(3) of the Vietnamese agreement, and Article 9(2) of the OECD Model Tax Convention), the ATO does not consider that tax treaty partner countries have an obligation to provide relief from economic double taxation. In these circumstances, the operation of the MAP Article is limited to resolving taxation not in accordance with the DTA and does not extend to the provision of relief from economic double taxation. Nevertheless, the Australian competent authority will exchange information with the other competent authority. This may assist to resolve economic double taxation where the tax treaty partner country has a different view of its obligations under the DTA or has domestic provisions to relieve economic double taxation. Exchanges of information will be undertaken in accordance with **the Exchange of Information** Article in the relevant DTA (e.g., Article 25 of the Vietnamese agreement, Article 26 of the OECD Model Tax Convention).

DTAs with economic double tax relief provision

2.4 Obligations to relieve economic double taxation in Australia's DTAs may be found in either the:

(a) Associated Enterprises Article (e.g., Article 9(3) of the Vietnamese agreement); or

(b) Methods for Elimination of Double Taxation Article (e.g., Article 17 of the Japanese agreement).

2.5 Provisions in the Associated Enterprises Article generally require an 'appropriate adjustment to the amount of tax charged' to be made where a tax treaty partner country makes a primary transfer pricing adjustment to an associated foreign company.

2.6 Provisions in the Methods for Elimination of Double Taxation Article provide for relief to be given by way of a credit to the resident company for the additional tax paid by the associated foreign company as a result of a transfer pricing adjustment.

2.7 The existence and location of economic double tax relief provisions in Australia's DTAs are set out in the following table:

Country	Year **signed**	**Economic double tax relief provision type**	Article Number
United Kingdom	1967	Credit	19(4)
United States	1982	Appropriate adjustment	9(2)
Canada	1980	Appropriate adjustment	9(3)
New Zealand	1995	Appropriate adjustment	9(3)
New Zealand	1972	Credit	18
Singapore	1989 Protocol	Appropriate adjustment	6(3)
Japan	1969	Credit	17(4)
Germany	1972	None	
Netherlands	1976	Appropriate adjustment	9(2)
France	1976	Appropriate adjustment	8(3)
Belgium	1977	Appropriate adjustment	9(3)
Philippines	1979	Appropriate adjustment	9(3)
Switzerland	1980	None	
Malaysia	1980	Credit	23(4)
Sweden	1981	Appropriate adjustment	9(3)
Denmark	1981	Appropriate adjustment	9(3)
Ireland	1983	Appropriate adjustment	10(4)
Italy	1982	None	
Korea	1982	Appropriate adjustment	9(5)
Norway	1982	Appropriate adjustment	9(3)
Malta	1984	Appropriate adjustment	9(3)
Finland	1984	Appropriate adjustment	9(3)
Austria	1986	Appropriate adjustment	9(3)
China	1988	Appropriate adjustment	9(3)
PNG	1989	Appropriate adjustment	9(3)
Thailand	1989	Appropriate adjustment	9(3)
Sri Lanka	1989	Appropriate adjustment	9(3)
Fiji	1990	Appropriate adjustment	9(4)
Hungary	1990	Appropriate adjustment	9(3)
Kiribati	1991	Appropriate adjustment	9(3)
India	1991	Appropriate adjustment	9(3)
Poland	1991	Appropriate adjustment	9(3)
Indonesia	1992	Appropriate adjustment	9(3)
Vietnam	1992	Appropriate adjustment	9(3)
Spain	1992	Appropriate adjustment	9(3)
Czech Republic	1995	Appropriate adjustment	9(3)
Taipei	1996	Appropriate adjustment	9(3)
South Africa*	1999	Appropriate adjustment	9(3)
Slovak Republic*	1999	Appropriate adjustment	9(3)
Argentine Republic**	1999	Appropriate adjustment	9(3)
OECD Model Tax Convention		Appropriate adjustment	9(2)

*Royal Assent was given on 11 November 1999. The DTA will enter into force on the exchange of diplomatic notes. It is likely to enter into force by end of 1999 and to commence domestic law effect on 1 January/1 June 2000 depending upon type of taxes.

** Royal Assent was given on 11 November 1999. The DTA will enter into force on the exchange of diplomatic notes. It is likely to enter into force in year 2000 and to commence domestic law effect on 1 January/1 June 2001 depending upon type of taxes (but retrospective application in respect of tax on income, profits or gains from the operation of aircraft on or after 27 September 1988).

2.8 The obligation to provide relief from economic double taxation arises only where the primary transfer pricing adjustment is made in accordance with the relevant DTA, i.e., by the application of the arm's length principle. Therefore, the question of whether a correlative adjustment will be made by the ATO will depend upon Australia agreeing with the adjustment made by the tax treaty partner country, both in principle and in amount. Paragraphs 73 and 74 of the Commentary to Article 9 of the OECD Model Tax Convention makes it clear that this is the result intended. Paragraph 151 of the 1995 OECD Transfer Pricing Report states:

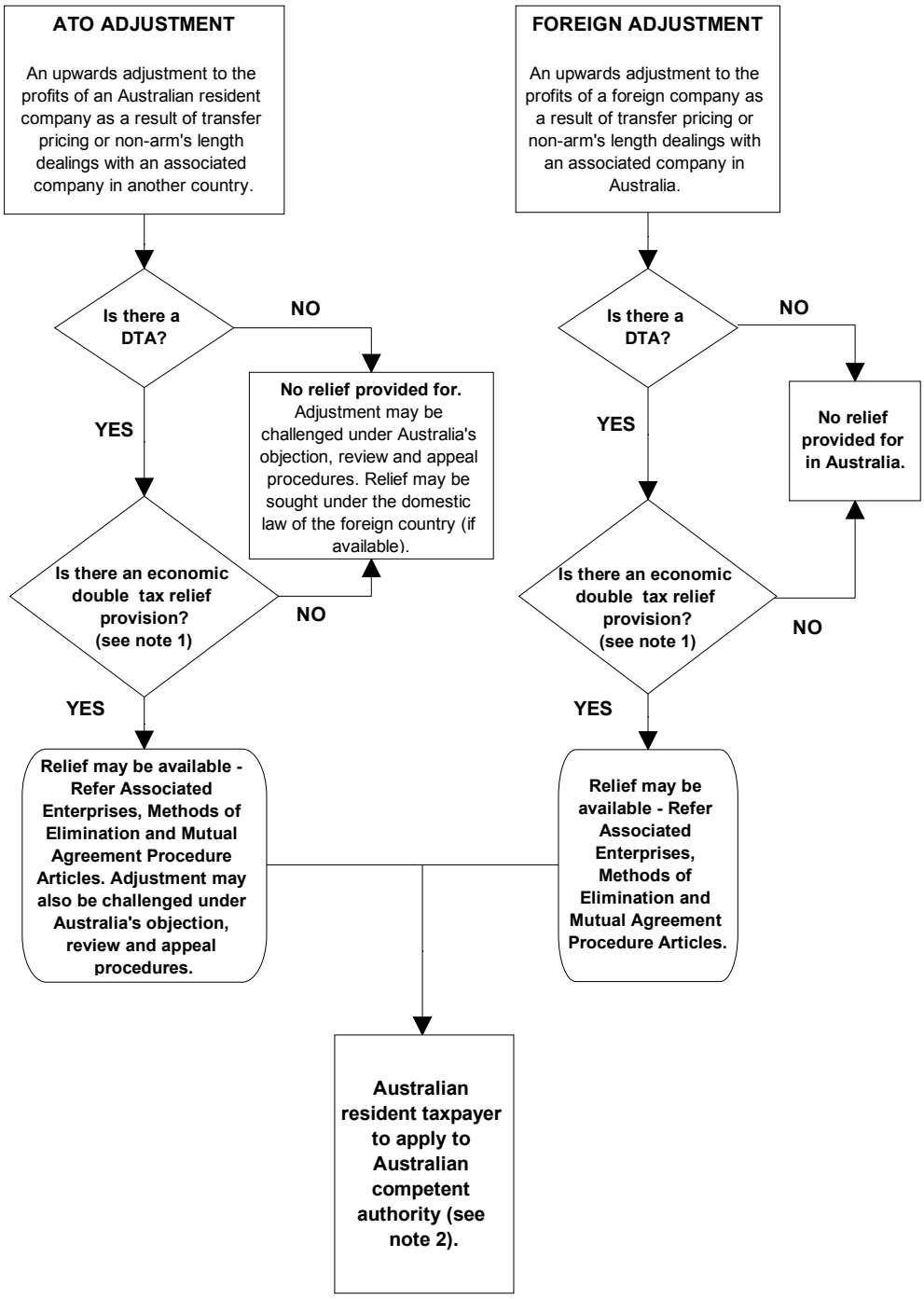
> 'Corresponding adjustments are not mandatory, mirroring the rule that tax administrations are not required to reach agreement under the mutual agreement procedure. Under Article 9(2), a tax administration should make a corresponding adjustment only in so far as it considers the primary adjustment to be justified both in principle and in amount.'

2.9 The provisions in some of Australia's DTAs specifically state that the obligation to relieve economic double taxation arises where the primary adjustment is made 'according to the provisions of paragraph (1)' (e.g., Article 9(3) of the Finnish agreement) or 'by virtue of paragraph (1)' (e.g., Article 9(2) of the United States convention) of the Associated Enterprises Article. It is arguable that these provisions are more limited than others and that economic double tax relief would not be available for a primary transfer pricing adjustment made by recourse to domestic law. Such recourse to domestic law may be either the means by which the DTA is given effect or permitted in certain circumstances under another paragraph of the Article (e.g., Article 9(2) of the Finnish agreement and Article 9(3) of the United States convention). The ATO does not accept this narrow view and considers that a primary transfer pricing adjustment made by recourse to domestic law will, nevertheless, be an adjustment made in accordance with paragraph 1, provided it is consistent with the principles stated in that Article.

Flowchart

2.10 Below is a flowchart of the legislative framework for evaluating requests for relief from economic double taxation arising from a transfer pricing adjustment.

ECONOMIC DOUBLE TAXATION



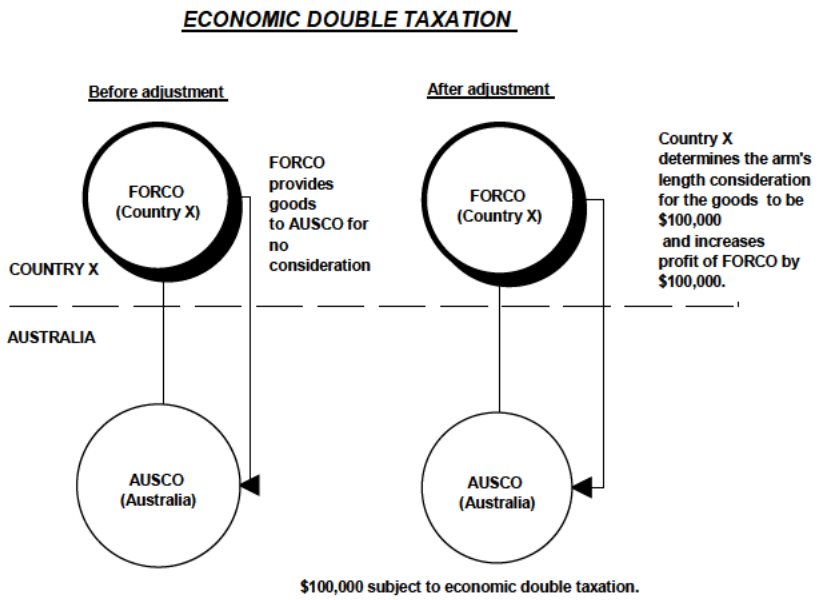
Note 1 : DTAs which do not have a provision providing for relief from economic double taxation are those with Germany, Switzerland and Italy.

Note 2: Under the UK agreement, a case may be presented to the competent authority of either country.

ADJUSTMENT BY FOREIGN TAX ADMINISTRATION

2.11 Discussion of the economic double tax relief mechanisms is based on the following example:

> Forco is a company resident in a tax treaty partner country (Country X) and provides goods for no consideration to its wholly owned subsidiary, Ausco, a company resident in Australia. Country X subjects Forco to audit and increases the profits of Forco by $100,000 on the basis that if Forco and Ausco had been dealing on an arm's length basis, Ausco would have paid Forco $100,000 for the goods.



2.12 Economic double taxation would result until:

(a) the ATO agrees that $100,000 reflects an arm's length consideration and reduces the tax payable by Ausco accordingly; or

(b) the tax administration of Country X is convinced that its adjustment is incorrect and accordingly reduces the additional tax payable by Forco (e.g., through domestic review processes in Country X); or

(c) an agreement is reached between both competent authorities (e.g., under the MAP Article of a relevant DTA).

'Appropriate adjustment' relief

2.13 Where the ATO agrees with the foreign country primary transfer pricing adjustment both in principle and amount, the 'appropriate adjustment' relief provision in a relevant DTA requires the ATO to '… make an appropriate adjustment to the amount of tax charged …' on the profits of the resident company. The adjustment will be made to reduce the tax that would otherwise be payable on the taxable income of the resident company.

2.14 The reduction in the tax payable by the resident company will be effected by a credit under Division 19 of Part III of the Act. Division 19 contains general machinery provisions dealing with the administration of double tax relief and the granting of credits. The Division governs credits allowable 'under or by virtue' of:

(a) Division 18, 18A or 18B; or

(b) the Agreements Act.

2.15 In this context (e.g., Article 9(3) of the Vietnamese agreement), the amount of credit allowable under the Agreements Act will be that amount considered by the Australian competent authority to be the 'appropriate' amount. Other provisions of the relevant DTA and domestic tax law will be taken into account in ascertaining that amount.

2.16 When the amount of an appropriate adjustment is determined by the competent authority (in consultation with the other competent authority if necessary) as the credit allowable under the Agreements Act, the resident company will be treated as having made a claim under subsection 160AI(1) for a credit for that amount. The Commissioner is required under subsection 160AI(3) to advise the resident company in writing of the determination of the credit.

2.17 Other provisions of Division 19 will apply including section 160AK that deals with amendment of determinations and section 160AL that provides objection rights against a determination made by the Commissioner.

2.18 Economic double taxation arising from a transfer pricing adjustment is a special case where the obligation to provide relief arises solely from the DTA. This situation may be contrasted with credits arising under the general foreign tax credit system in Division 18. This Division deals with foreign source income derived by Australian residents and generally addresses juridical double taxation by providing relief for tax imposed by the source country.

2.19 The credit provided by the ATO will be of an amount considered appropriate in the circumstances to relieve the economic double taxation. The following scenarios illustrate how the amount of an appropriate adjustment will be calculated:

(a) **Goods acquired by Australian resident company for less than the arm's length price.** Using the example outlined in paragraph 2.11 as a basis, assume Forco has paid an extra $50,000 tax in Country X where the tax rate is 50 per cent. On the basis that Ausco's taxable income would have been $100,000 less had it provided the arm's length consideration for the goods, the appropriate correlative adjustment would be a $36,000 reduction in Ausco's tax payable where the Australian tax rate is 36 per cent.

(b) **Goods supplied by Australian resident company for more than the arm's length price.** Assume Ausco supplied goods to Forco for $400,000 and the tax administration of Country X determines that the arm's length consideration for the goods is $200,000. Country X increases Forco's taxable profits by $200,000 as Forco would not have been entitled to a deduction for this amount if it had dealt on an arm's length basis. Forco has paid an extra $100,000 tax in Country X where the tax rate is 50 per cent. On the basis that Ausco's taxable income would have been $200,000 less had it supplied the goods for arm's length consideration, the appropriate correlative adjustment would be a $72,000 reduction in Ausco's tax payable where the Australian tax rate is 36 per cent.

(c) **Extent of relief where source country taxing rights exist.** If an interest free loan instead of goods had been provided by Forco to Ausco, and Country X made a primary transfer pricing adjustment to increase Forco's income by an arm's length interest amount of $100,000 the appropriate amount of relief to be provided by Australia would be reduced by $10,000 to $26,000. The reduction of $10,000 represents Forco's liability to interest withholding tax that would have arisen under section 128B (i.e., 10 per cent of $100,000 interest payable) if the dealings had been undertaken on an arm's length basis. Ausco would have been required to deduct and forward that amount to the ATO under sections 221YL and 221YN of the Act and would not have been entitled to a deduction for the interest payment until the withholding tax was paid (section 221YRA(1)).

2.20 In relation to (c) above, there will be no need in many cases to reduce the appropriate adjustment to take into account source country taxing rights as interest withholding tax may have been actually paid. This would be the case where Ausco subsequently made a payment of

interest to Forco in a manner that resulted in a liability to withholding tax and that amount of withholding tax was paid. In these circumstances the appropriate adjustment would continue to be $36,000. As explained in paragraphs 2.32 to 2.35 below, the Australian resident taxpayer is advised to seek the approval of the ATO or request the consideration of the competent authority prior to making any payment.

'Credit' relief provisions

2.21 Australia has four DTAs (the United Kingdom, 1972 New Zealand, Japanese and Malaysian agreements) that specifically provide for a credit to relieve economic double taxation arising from a transfer pricing adjustment. These provisions require Australia to give a credit to the resident company for the extra tax chargeable on the amount of adjusted profits of the associated foreign company.

2.22 These credit provisions apply subject to the domestic laws of the tax treaty partner country that is obliged to provide the credit (e.g., Article 19(2)(a) of the United Kingdom agreement).

2.23 Australia's domestic foreign tax credit system is contained in Division 18 of the Act. An entitlement to a credit for foreign taxes under subsection 160AF(1) depends upon two factors:

(a) the resident taxpayer's assessable income including foreign income for the year of income (paragraph 160AF(1)(a)); and

(b) the payment by the taxpayer of foreign tax in respect of the foreign income, being tax for which the taxpayer was personally liable (paragraph 160AF(1)(b)).

2.24 The amount of adjusted profits is deemed by the DTA to be foreign source income of the resident company and this ensures that the conditions generally recognised for the allowance of a foreign tax credit are satisfied (i.e., those in (a) above). However, neither the DTA nor subsection 6AB(3) of the Act deems, in these circumstances, the foreign tax to have been paid by the taxpayer or that the taxpayer is personally liable for the foreign tax (i.e., those in (b) above). These additional requirements arose when Division 18 was introduced, replacing sections 14 and 15 of the Agreements Act, from the 1987-88 income year. It is therefore arguable that no relief from economic double taxation can be provided under the four DTAs because the threshold conditions in Division 18 are not satisfied. However, this is not the view of the ATO.

2.25 To ensure that the spirit and objective of the economic double tax credit relief provision are given effect, the reference in the DTA provisions to domestic taxation will be taken to refer to specific

mechanisms and rules and not to threshold conditions in the domestic foreign tax credit provisions. No change in the availability of a credit for foreign tax under a credit economic double taxation relief provision was intended by the repeal of sections 14 and 15 of the Agreements Act and their replacement by Division 18 of the Act. The obligation to provide credit relief under the DTA will therefore, in the circumstances, take precedence over paragraph 160AF(1)(b). This approach is supported by subsection 4(2) of the Agreements Act.

2.26 Apart from the threshold conditions, the specific rules governing credits for foreign taxes apply, such as the carry forward and transfer of foreign tax credits, the foreign tax credit limit and the calculation of the limit by classes of income.

Losses

2.27 The stated aims of DTAs are to avoid double taxation and prevent fiscal evasion. The language of both the appropriate adjustment and credit double tax relief provisions are aimed at providing a measure of relief from **actual double taxation**. This approach may, in some circumstances, mean that the parties' position will not be fully restored to that which would have existed if the dealings had been undertaken on an arm's length basis.

2.28 The appropriate adjustment provision requires tax to be charged on the same profits by the two countries before an obligation to make an appropriate adjustment arises. The ATO considers that the expressions 'charged to tax' and 'taxed accordingly' used in the context of the rest of the provision requires liabilities to tax to actually exist or arise in both jurisdictions in respect of the adjusted profit. Similarly the credit provision requires tax to be paid in both countries before the obligation to provide relief arises.

2.29 This means that actual double taxation does not arise while one or both of the associated companies are in a loss position. However, double taxation may actually arise at a later stage when the company/ies return to profit. Accordingly, relief may be provided at that time.

2.30 The following example illustrates how relief can be granted for double taxation arising subsequent to a transfer pricing adjustment:

> **Year 1** - assume, in relation to the example in paragraph 2.11, that Forco has a loss of $300,000 prior to the transfer pricing adjustment. This adjustment results in a reduction of Forco's carry forward loss to $200,000. No relief could be made to Ausco in that year.
>
> **Year 2** - Forco returns a profit of $300,000 the following year (offset by $200,000 carry forward loss) and pays tax on

$100,000. Relief of $36,000 can now be provided to Ausco (being tax on $100,000 where the tax rate is 36 per cent).

2.31 Similarly, where the Australian resident company is in a loss position, relief cannot be given until it returns to a profit position in a later year. The Australian competent authority will keep the case open for a reasonable period of time to enable the appropriate correlative relief to be given for subsequently arising economic double taxation. Domestic rules governing the carry forward and transfer of foreign tax credits within a company group will apply:

(a) for the 1989-90 and prior years, domestic foreign tax credit provisions did not permit the carrying forward of excess credits, but did permit certain transfers of credits within a wholly owned company group; and

(b) from the 1990-91 year, rules permit the carrying forward of foreign tax credits.

Retrospective adjustment or repatriation

2.32 The ATO is aware of a number of cases where Australian resident companies have sought to relieve economic double taxation by claiming deductions under section 8-1 of the 1997 Act (subsection 51(1) of the 1936 Act) for subsequent voluntary payments purporting to represent a retrospective adjustment to dealings previously undertaken with an associated foreign company.

2.33 For example, assume the same facts as set out in paragraph 2.19(c) of this Ruling, with the subject loan provided by Forco to Ausco in 1992 and the audit by the foreign tax administration in Country X conducted during the year ended 30 June 1995. In an attempt to relieve the resultant economic double taxation, Ausco voluntarily pays an additional $100,000 to Forco during the year ended 30 June 1995 and claims a deduction under subsection 51(1) of the 1936 Act in its income tax return for that year.

2.34 If the resident company decides to pay the arm's length price as determined by the foreign tax administration without first seeking the approval of the ATO or requesting the consideration of the competent authority, it is at risk of:

(a) the payment not being properly deductible under section 8-1 of the 1997 Act (subsection 51(1) of the 1936 Act); and

(b) the price not being acceptable as the correct arm's length price

with consequent liability to amendment and penalties.

2.35 The ATO considers that relief from double taxation is to be appropriately sought by presentation of a case to the competent authority (refer to Part 4 of this Ruling) for resolution under the economic double tax relief provision and MAP Article of the relevant DTA.

Deemed dividend

2.36 Relief by way of an exemption under section 23AJ is not available to an Australian resident company in circumstances where the foreign tax administration treats the profits shifted to be a 'deemed dividend'. These circumstances arise where a foreign tax administration considers that profits have been transferred to a company resident in Australia (using the example in paragraph 2.11, by Forco providing goods to Ausco for no consideration but where Forco is a subsidiary of Austco), and accordingly increases the consideration receivable in that country (resulting in economic double taxation), and also deems for its purposes the increased consideration to be a 'dividend' paid by the foreign company to the Australian resident company.

2.37 The section 23AJ exemption only applies to dividends for the purposes of the domestic law. This means that a section 23AJ exemption cannot be claimed for income received by a resident company which is a 'deemed dividend' under the law of another country but not under Australian law.

ADJUSTMENT BY THE ATO

2.38 Where the primary transfer pricing adjustment is made by the ATO, the role of the Australian competent authority initially will be to demonstrate to the competent authority of the tax treaty partner country that the ATO adjustment is in accordance with the DTA and that relief from any resultant double taxation should accordingly be provided by that country.

2.39 The mechanism to be used in a tax treaty partner country to relieve economic double taxation under either an 'appropriate adjustment' or 'credit' type provision of the relevant DTA is a matter for the tax administration of that country to determine in accordance with its taxation laws.

Losses

2.40 The ATO view on relief from economic double taxation where one or both associated companies are in a loss position is set out at paragraphs 2.27 to 2.31 above. Some tax treaty partner countries may

arrive at a different interpretation of a relevant DTA or may have provisions in their domestic law that enable a different approach to be taken, e.g., restoring income and deductions to what they would have been had the dealings been undertaken on an arm's length basis in the first place.

2.41 To enable the tax treaty partner country to give effect to a relevant DTA in accordance with its domestic law, the Australian competent authority will exchange information about the ATO transfer pricing adjustment. This exchange will be made under the Exchange of Information Article of a relevant DTA.

Source country taxing rights - withholding taxes

2.42 The ATO view on the provision of economic double tax relief where source country taxing rights exist is outlined at paragraphs 2.19(c) and 2.20 above. The basis upon which the foreign tax administration will calculate the appropriate amount of tax relief and the mechanisms for the provision of relief from economic double taxation in equivalent circumstances are matters for determination by that administration.

2.43 Where the source country taxation has actually been paid, e.g., where interest is paid giving rise to a liability and payment of withholding tax by an Australian resident company (equivalent circumstances to those outlined in paragraphs 2.19(c) and 2.20 above), a credit would be available under section 160AF for the foreign tax properly payable and paid.

PART 3: JURIDICAL DOUBLE TAXATION

INTRODUCTION

3.1 Many countries, including Australia and most other OECD member countries, levy income tax on:

(a) the worldwide income of resident taxpayers; and

(b) the income derived by non-resident taxpayers from domestic sources.

It is common practice for countries to include mechanisms in their domestic law to relieve juridical double taxation suffered by residents arising from source country taxation in another country. These mechanisms provide for either an exemption for foreign source income or a credit for foreign taxes paid.

3.2 Generally, Australia's DTAs permit the country in which an Australian resident taxpayer carries on business through a permanent establishment to tax the profits 'attributable to the permanent establishment' (e.g., Article 7(1) of the Vietnamese agreement; Article 7(1) of the OECD Model Tax Convention). These profits are deemed to be income from sources in that country (e.g., Article 22(1) of the Vietnamese agreement).

3.3 There are some notable differences in the Business Profits Article of some of Australia's DTAs:

(a) the 1972 New Zealand agreement (that applies up to the income year ended 30 June 1995) applies a 'force of attraction' principle that permits the source country to tax the whole of the profits of the enterprise sourced in that country regardless of whether or not those profits are attributable to the permanent establishment (see Article 5(1)).

(b) some of Australia's DTAs permit the country of source to tax, in addition to profits attributable to a permanent establishment in that country, certain profits attributable to:

- the sales in that country of goods or merchandise of the same or similar kind as those sold through the permanent establishment; and
- other business activities carried on in that country of the same or similar kind as those carried on through the permanent establishment.

(See the Business Profits Article of the Fijian, Indian, Indonesian, Kiribati, Papua New Guinean, Philippines, Sri Lankan and Thai agreements.)

3.4 References in this section of the Ruling to 'profits attributable to a permanent establishment' should be understood as encompassing the variations outlined in paragraph 3.3 above.

3.5 Where a tax treaty partner country exercises the right to tax the profits of the taxpayer on a source basis in accordance with the Business Profits Article, the country of residence of the taxpayer must provide relief from the resultant double taxation. The obligation to provide relief is contained in the Methods for Elimination of Double Taxation Article (e.g., Article 23 of the Vietnamese agreement).

3.6 The Business Profits Article also requires tax treaty partner countries to apply the same principle in attributing profits to a permanent establishment, i.e., 'there **shall in each Contracting State** be attributed to that permanent establishment the profits which it

might be expected to make if it were a distinct and separate enterprise …' [emphasis added] (e.g., Article 7(2) of the Vietnamese agreement). The mutual application of this principle ensures:

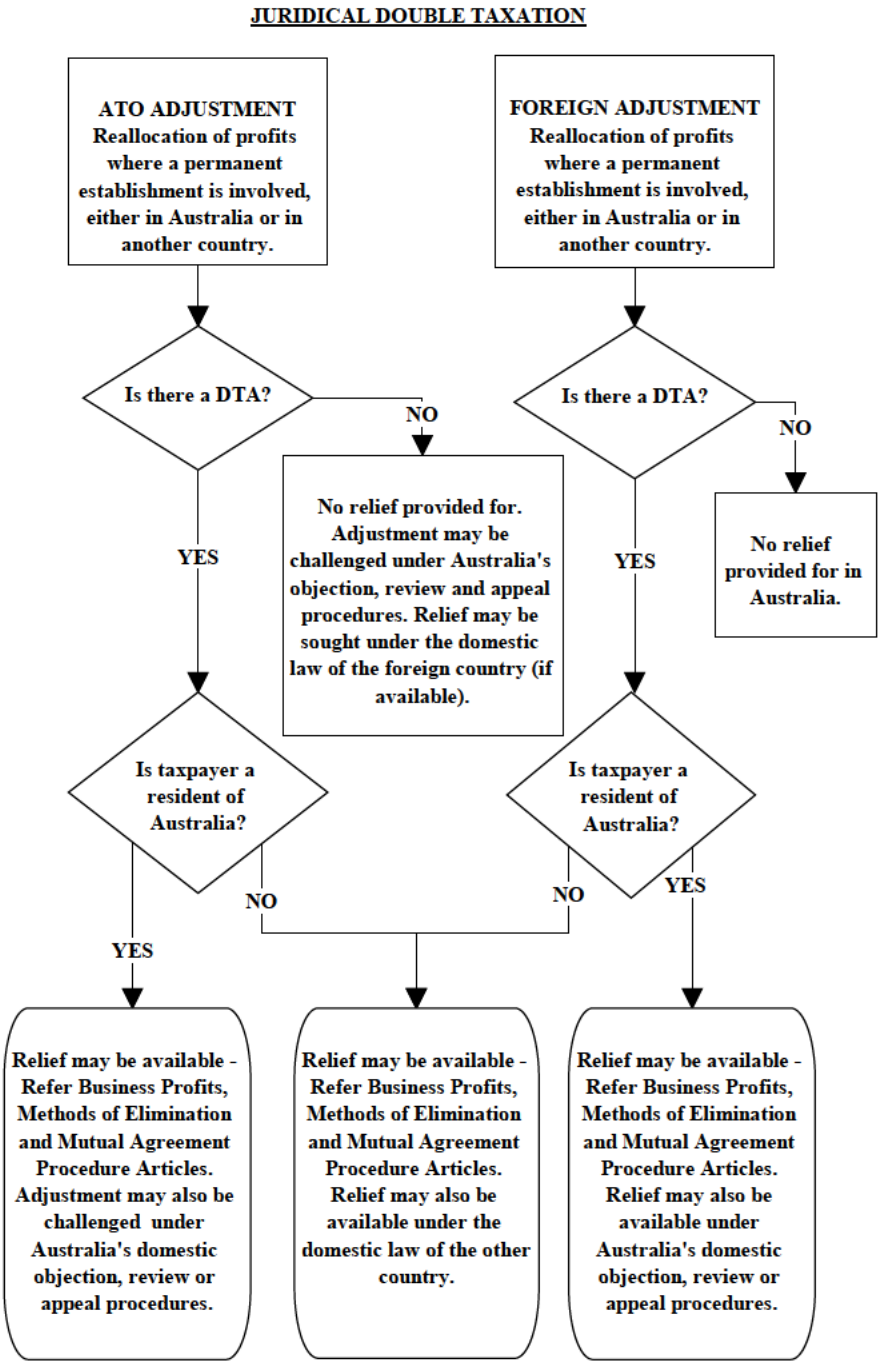
(a) the appropriate exercise of source country taxing rights; and

(b) the provision of appropriate relief by the country of residence.

3.7 The MAP Article in all of Australia's DTAs can be used to facilitate agreement where tax treaty partner countries differ on profit allocations under the Business Profits Article, i.e., where a taxpayer considers that it has been taxed not in accordance with a relevant DTA. However, as outlined in paragraph 1.6 above, the MAP Article does not compel agreement.

Flowchart

3.8 Below is a flowchart of the legislative framework for evaluating requests for relief from juridical double taxation arising from a profit reallocation adjustment.



ADJUSTMENT BY FOREIGN TAX ADMINISTRATION

3.9 The tax administration of a tax treaty partner country may make a profit reallocation adjustment to:

(a) an Australian resident company carrying on (or claiming to be carrying on) business through a

permanent establishment in the tax treaty partner country; or

(b) a company resident in the tax treaty partner country carrying on (or claiming to be carrying on) business through a permanent establishment in Australia.

Australian resident taxpayer

3.10 For example, a tax treaty partner country may in relation to an Australian resident company:

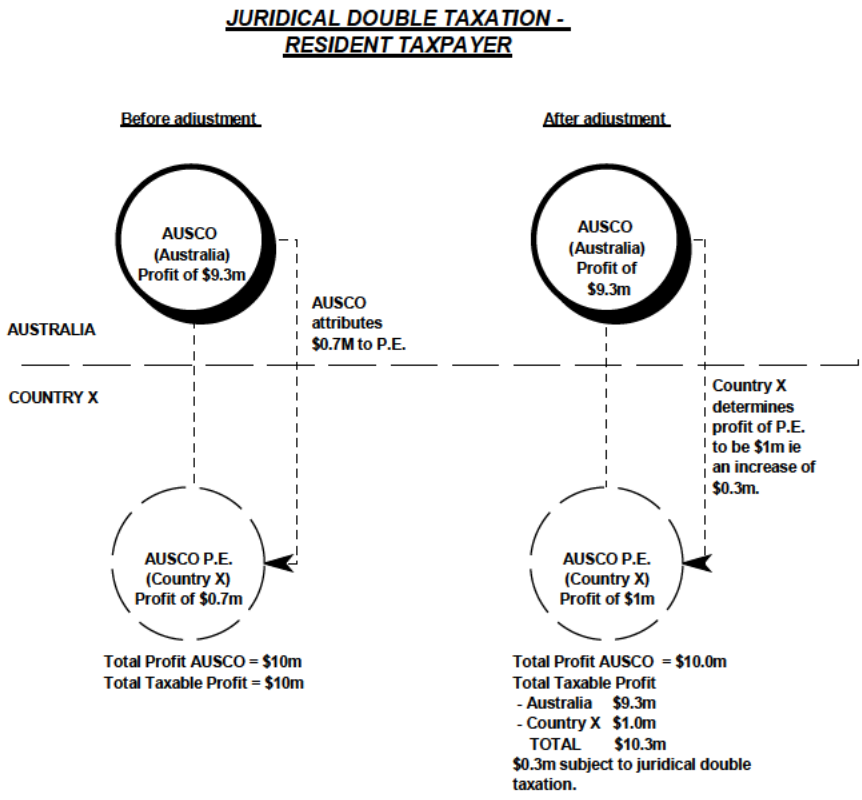
(a) make a profit reallocation adjustment upon a factual finding that a permanent establishment of the company existed or did not exist in that country, where the company previously maintained the converse; or

(b) adjust the amount of profits considered to be attributable to a permanent establishment of the company in that country.

3.11 Ultimately the ATO will provide relief from juridical double taxation only to the extent that it agrees both in principle and amount with the profit reallocation adjustment made by the tax treaty partner country.

3.12 Discussion of the juridical double tax relief mechanisms is based on the following example:

> Ausco is an Australian resident company subject to tax in Australia on its worldwide income. Ausco carries on business in Country X through a permanent establishment. Country X is not a listed country for the purposes of Part X of the Act (if so, see paragraph 3.28 below). Ausco lodges in both Australia and Country X, returning a profit for tax purposes of $10 million in Australia, of which $0.7 million is attributable to the permanent establishment in Country X. The tax administration of Country X subsequently audits the permanent establishment, and determines that non-arm's length dealings between the Australian head office and the permanent establishment have resulted in an understatement of the profits attributable to the permanent establishment. Country X's tax administration concludes that the profits of the permanent establishment should have been $1 million instead of $0.7 million and deems those profits to have been derived from sources in that country. Country X accordingly reallocates an additional $0.3 million of Ausco's profits to the permanent establishment (making a total of $1 million attributable to it) and imposes additional tax on Ausco.



3.13 Juridical double taxation would result until:

(a) the ATO agrees that the profit attributable to the permanent establishment in Country X should have been $1 million and allows a credit for the additional foreign taxes paid; or

(b) the tax administration of Country X is convinced that its adjustment is incorrect and accordingly reduces the additional tax payable (e.g., through domestic review processes in Country X); or

(c) an agreement is reached between both competent authorities (e.g., under the MAP Article of a relevant DTA).

3.14 Australia's domestic tax provisions that give effect to the obligation to provide relief from double taxation under the Methods for Elimination of Double Taxation Article in DTAs consist of:

(a) for the 1986-87 and prior income years - an exemption under previous paragraph 23(q) or a credit for foreign tax (former sections 12, 13, 14 and 15 of the Agreements Act);

(b) for the 1987-88 to 1989-90 income years - a credit under the general foreign tax credit system contained in Divisions 18 and 19 of Part III of the Act; and

(c) for the 1990-91 and subsequent income years - a credit under the general foreign tax credit system as in (b) above; or, where applicable, an exemption under section 23AH.

Operation of the foreign tax credit system - years ended 30 June 1988 and subsequent years

3.15 Under the provisions of Division 18 of the Act an entitlement to a credit for foreign tax arises where:

(a) the assessable income of a resident taxpayer includes foreign income; and

(b) the taxpayer has paid foreign tax in respect of the foreign income, being tax for which it was personally liable.

3.16 'Foreign income' is defined in subsection 6AB(1) to mean income derived from sources in a foreign country. References to 'sources in a foreign country' are to be interpreted according to Australian law. The DTAs deem the profits attributable to a permanent establishment in the other country to have a foreign source (i.e., a source in the tax treaty partner country) (e.g., Article 22(2) of the Vietnamese agreement). While, by reason of subsection 4(2) of the Agreements Act, DTAs deemed source rules have precedence over domestic law source rules, the deemed source rules in the DTAs only apply where, in Australia's view, the tax treaty partner country is exercising a taxing right in accordance with the treaty.

3.17 Accordingly, where the ATO considers that a tax treaty partner country has imposed tax in contravention of a DTA, Australia is not under any obligation to provide a credit for the additional foreign taxes paid under domestic law. This approach is generally reflected in paragraphs 32 to 41 of Taxation Ruling IT 2527.

Operation of certain exemptions - year ended 30 June 1991 and subsequent years

3.18 For the year ended 30 June 1991 and subsequent years, section 23AH of the Act provides that resident companies with certain foreign branch income derived in a listed country are entitled to an exemption from tax on that income. (As from 1 July 1997, different rules for exemption apply to branch income derived in a broad-exemption listed country and in a limited- exemption listed country.)

3.19 To qualify for the exemption provided by section 23AH, the branch income (in addition to other qualifying conditions) has to constitute foreign income which is defined in subsection 23AH(12) to include:

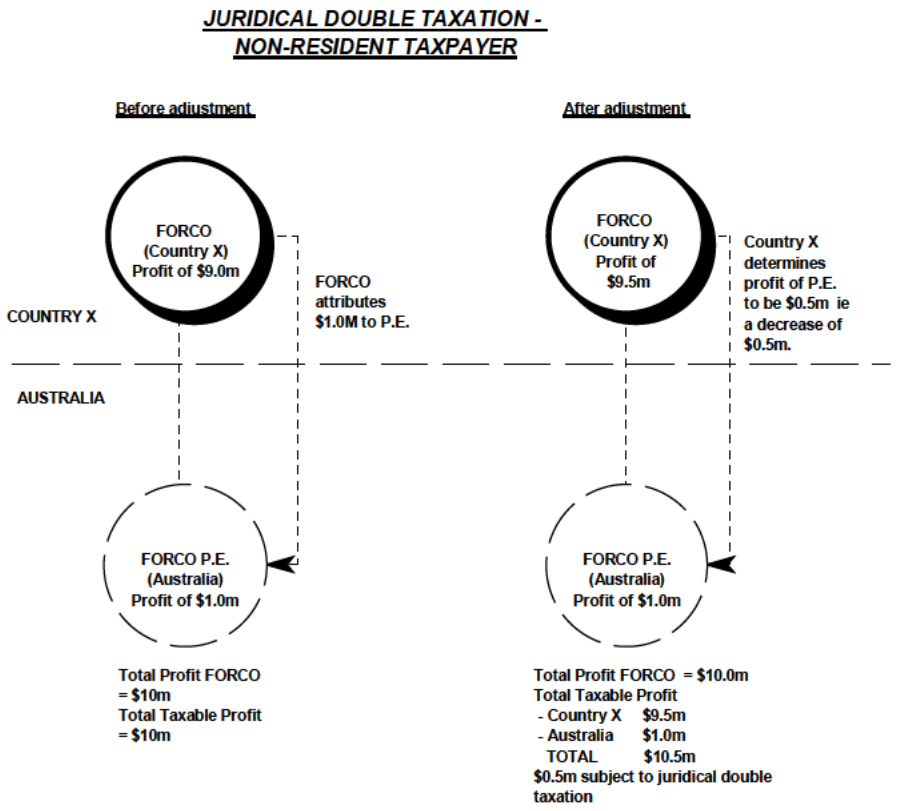
> 'an amount that:
>
> (a) apart from this section, would be included in assessable income under a provision of this Act other than Part IIIA; and
>
> (b) is derived from sources in a foreign country.'

3.20 Where the ATO regards the reallocated profits as properly attributable to the permanent establishment, so that under the deemed source rules in the DTAs (e.g., Article 22(2) of the Vietnamese agreement) they are regarded as having a foreign source, for domestic law purposes also the exemption under section 23AH will be available (subject to other qualifying conditions being met).

3.21 Where, in the ATO's view, the tax treaty partner country is taxing the resident company in contravention of the Business Profits Article, the exemption under section 23AH does not apply for the reasons explained in paragraphs 3.16 to 3.17 above.

Non-resident taxpayer

3.22 Juridical double taxation may occur where a non-resident taxpayer that carries a business through a permanent establishment in Australia is subject to an adjustment by a foreign tax administration. An example would be where a foreign company (Forco) is resident in Country X, lodges tax returns in both countries and declares profits for tax purposes of $10 million of which $1 million is attributable to the permanent establishment in Australia. The tax administration of Country X then subjects Forco to audit and determines that non-arm's length dealings between the foreign head office and the permanent establishment have resulted in an overstatement of the profits attributable to the permanent establishment. The profits of the permanent establishment in Australia are accordingly reduced to $0.5 million. Assuming Country X has a unilateral foreign tax credit system it would then disallow credits for Australian taxes paid on $0.5 million, (or if it had an exemption system, Country X would reduce the amount of Forco's exempt income to $0.5 million).



3.23 Juridical double taxation would result until:

(a) the ATO agrees that the profits of the permanent establishment should have been $0.5 million and reduces the Australian sourced profits of the taxpayer from $1 million to $0.5 million; or

(b) the tax administration of Country X is convinced that its adjustment is incorrect and accordingly reduces the additional tax payable by Forco (e.g., through domestic review processes in country X); or

(c) an agreement is reached between both competent authorities (e.g., under the MAP Article of a relevant DTA).

3.24 A correlative adjustment will be made by the ATO to relieve juridical double taxation only where the ATO regards the reallocated profits as not attributable to the permanent establishment. In those circumstances, because the reallocated profits are deemed by the Source of Income Article (e.g., Article 22(2) of the Vietnamese agreement) to be derived from sources in the other country, the (reduced) profits that are attributable to the permanent establishment in Australia will be reflected in a reduction in the taxable income of

the non-resident taxpayer. Subsection 3(2) of the Agreements Act provides that a reference in an agreement to profits of an activity or business is to be read, where the context so permits, as a reference to taxable income derived from that activity or business. This provision recognises that, for domestic law purposes, tax is levied on taxable income rather than on profits. Depending upon the circumstances of the profit reallocation adjustment, this may mean a reduction in the assessable income considered derived from sources in Australia, or an increase in the expenses considered to be incurred in the derivation of income from Australian sources.

ADJUSTMENT BY THE ATO

3.25 The ATO may make a profit reallocation adjustment to either:

(a) an Australian resident company with a permanent establishment in a tax treaty partner country; or

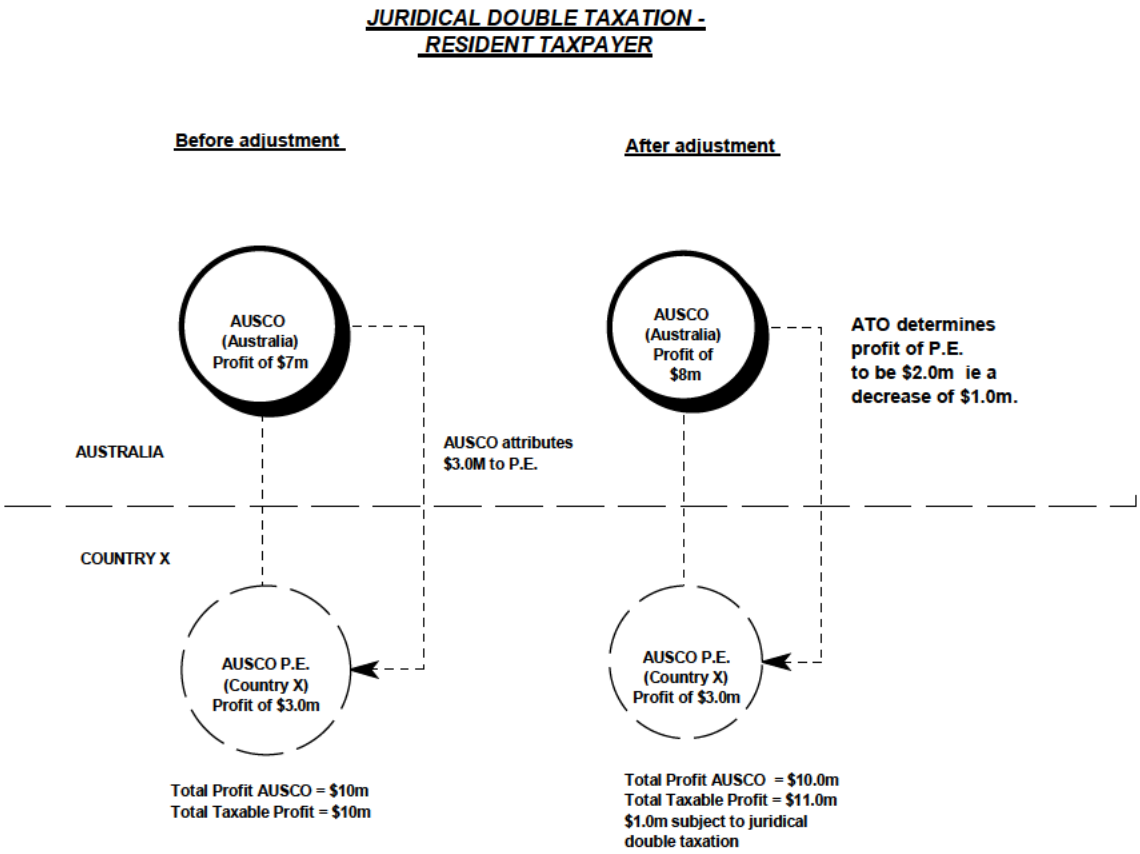
(b) a non-resident company with a permanent establishment in Australia.

3.26 Where the profit reallocation adjustment is made by the ATO, the primary role of the Australian competent authority will be to demonstrate to the competent authority of the tax treaty partner country that the ATO adjustment is in accordance with the DTA so that relief from any resultant double taxation will be provided by the tax treaty partner country.

Australian resident taxpayer

3.27 Juridical double taxation may arise where the ATO reduces the amount of profits of a resident taxpayer attributable to carrying on business through a permanent establishment in the tax treaty partner country. For example, Ausco is an Australian resident company that is taxed in Australia on its worldwide income. Ausco carries on business through a permanent establishment in Country X (not a listed country under Part X of the Act). Ausco lodges income tax returns in both Australia and Country X, declaring profits for Australian tax purposes of $10 million, of which $3 million is considered attributable to the permanent establishment and which is derived from sources in Country X. Country X taxes Ausco on the $3 million. The ATO then undertakes an audit of Ausco and considers that the profits attributable to the permanent establishment were overstated because of non-arm's length dealings between the head office and the permanent establishment. The ATO concludes that the profits attributable to the permanent establishment and derived from sources in Country X are $2 million instead of $3 million as returned in Ausco's Australian income tax return. The ATO accordingly makes a profit reallocation

adjustment reducing Ausco's income derived from foreign sources from $3 million to $2 million. This results in a reduction in credits for foreign taxes paid under Division 18 of the Act.



3.28 Where Country X is a listed country (either a broad-exemption listed country or a limited-exemption listed country) for the purposes of Part X of the Act, the profit reallocation adjustment will result in a reduction in the amount of income exempt from tax under section 23AH.

3.29 The resultant juridical double taxation may be relieved by:

(a) the tax administration of Country X agreeing with the ATO reallocation and reducing its taxes accordingly; or

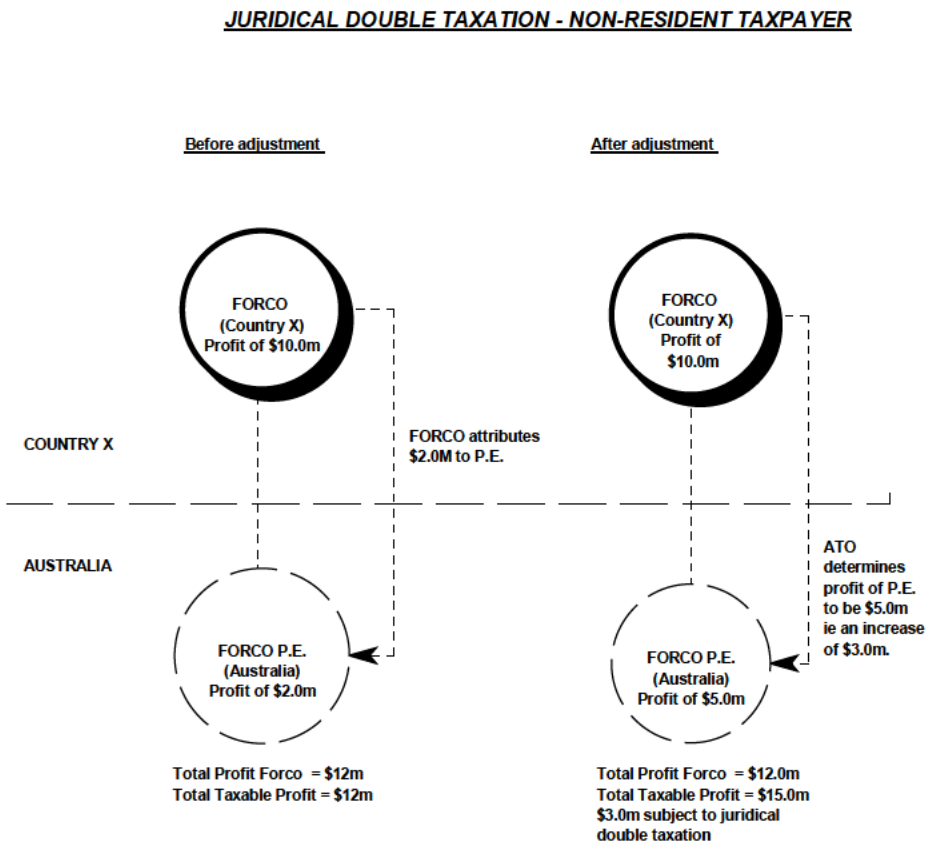
(b) domestic objection, review or appeal processes in Australia finding the ATO adjustment to be incorrect; or

(c) the reaching of an agreement between both competent authorities (e.g., under the MAP Article of a relevant DTA).

Non-resident taxpayer

3.30 Juridical double taxation may arise where the ATO increases the amount of profits considered attributable to the business carried on by a non-resident taxpayer through a permanent establishment in Australia. For example, Forco, a company resident in a tax treaty partner country (Country X) carries on business through a permanent establishment in Australia. Forco declares profits of $12 million, of which $2 million are considered attributable to the permanent establishment in Australia. Forco returns a taxable income of $2 million for Australian tax purposes. The laws of Country X may either provide for an exemption of the profits attributable to the permanent establishment in Australia or tax the worldwide profits of Forco with a credit or deduction given for the Australian taxes paid.

3.31 The ATO undertakes an audit of Forco and considers that the profits attributable to the permanent establishment in Australia were understated because of non-arm's length dealings between the head office and the permanent establishment. The ATO concludes that the profits attributable to the permanent establishment in Australia should be $5 million instead of $2 million as returned in Forco's Australian income tax return. The ATO accordingly makes a profit reallocation adjustment, increasing Forco's Australian taxable income from $2 million to $5 million.



3.32 The resultant juridical double taxation may be relieved by:

(a) the tax administration of Country X agreeing with the ATO reallocation and reducing its taxes accordingly (e.g., by way of a credit for Australian tax paid or an exemption for Australian sourced profits); or

(b) domestic objection, review or appeal processes in Australia finding the ATO adjustment to be incorrect; or

(c) the reaching of an agreement between both competent authorities (e.g., under the MAP Article of a relevant DTA).

PART 4: MUTUAL AGREEMENT PROCEDURE

GENERAL

Taxation not in accordance with DTA

4.1 All of Australia's DTAs have a MAP Article the terms of which usually enable a taxpayer to initiate the procedure where it is considered that the actions of the competent authority of one or both

of the countries concerned '… result or will result for the person in taxation not in accordance with this Agreement …' (e.g., Article 24(1) of the Vietnamese agreement). Taxation not in accordance with a DTA can arise from a variety of actions, including transfer pricing and profit reallocation adjustments, e.g., source country taxation of dependent personal services in contravention of the Dependent Personal Service Article of a relevant DTA (e.g., Article 15 of the Vietnamese agreement). However, this Ruling deals with the operation of the MAP Article only where there has been a transfer pricing or profit reallocation adjustment.

4.2 The operation of the MAP Article in several of Australia's DTAs is limited to double taxation cases in contravention of the DTA (e.g., the Singaporean, Japanese and New Zealand (1972) agreements).

Stages of MAP

4.3 There are two stages to MAP outlined in the Commentary to Article 25 of the OECD Model Tax Convention. The first stage involves the taxpayer and the competent authority of its country of residence. The second stage involves the competent authorities of both countries endeavouring to resolve the case.

4.4 The first stage has three elements:

(a) the presentation of a case by the taxpayer to the competent authority;

(b) consideration by the competent authority that the case presented is justified; and, if so

(c) consideration by the competent authority whether it is able to arrive at a satisfactory solution itself.

4.5 Where resolution of the case cannot be achieved at Stage 1, the competent authority has an obligation to endeavour to resolve the case by mutual agreement with the competent authority of the tax treaty partner country (Stage 2). These stages are discussed in more detail at paragraphs 4.6 to 4.26 below.

STAGE 1

Presentation of case

4.6 Apart from the United Kingdom agreement, the MAP Article in Australia's DTAs provides for the taxpayer to present its case to the competent authority of the country of which it is a resident. The United Kingdom agreement permits the taxpayer to present its case to the competent authority of either country. References to the competent authority in this Ruling are to be read as meaning the

competent authority of either country for the purpose of the United Kingdom agreement.

4.7 The address of the Australian competent authority for presenting a case is:

The Competent Authority
International Tax Division
Australian Taxation Office
P.O. Box 900
CIVIC SQUARE ACT 2608.

4.8 When presenting a case to the Australian competent authority, the taxpayer should include the following information:

(a) the basis upon which it has formed the opinion that the actions of one or both of the tax treaty partner countries result or will result for that taxpayer in taxation not in accordance with the relevant DTA;

(b) full details of the relevant transactions and the parties to the transactions as well as the actions relied upon; including the identification of the tax treaty partner country involved, how the actions affect the tax liability of the taxpayer and the associated foreign company (where relevant), and particulars of the taxation that does not accord with the relevant DTA; and

(c) how the taxpayer would like the problem resolved, including provisions of the domestic tax law and the DTA applicable to the resolution of the case.

4.9 Where a non-resident taxpayer presents a case to the competent authority of a tax treaty partner country in anticipation of Australia providing relief from double taxation, it is suggested that a copy of the case presented be provided at the same time to the Australian competent authority. The provision of a copy at this time may:

(a) assist with resolution of the case in the quickest possible time by enabling the Australian competent authority to undertake preliminary analysis of the case;

(b) ensure that both competent authorities are satisfied that the case has been presented within the time limits specified in a relevant DTA; and

(c) ensure that the requirements for presentation of a case to the competent authority have been satisfied.

Time limit for presentation of case

4.10 The MAP Article in most of Australia's DTAs permits a taxpayer to present a case to the competent authority within three years from the first notification to the taxpayer of the actions giving rise to taxation not in accordance with the DTA. The following table sets out the relevant time limits in Australia's DTAs.

Time limits for presentation of case under Australian DTAs

COUNTRY	Time Limit	COUNTRY	Time Limit
United Kingdom	None	Malta	3 years
United States	3 years	Finland	3 years
Canada	None	Austria	3 years
New Zealand	3 years	China	3 years
New Zealand (1972)	None	Papua New Guinea	3 years
Singapore	None	Thailand	3 years
Japan	None	Sri Lanka	3 years
Germany	None	Fiji	3 years
Netherlands	3 years	Hungary	3 years
France	None	Kiribati	3 years
Belgium	3 years	India	3 years
Philippines	2 years	Poland	3 years
Switzerland	None	Indonesia	3 years
Malaysia	2 years	Vietnam	3 years
Sweden	3 years	Spain	3 years
Denmark	3 years	Czech Republic	4 years
Ireland	3 years	Taipei	3 years
Italy	2 years	South Africa*	3 years
Korea	3 years	Slovak Republic*	4 years
Norway	3 years	Argentine Republic*	3 years

* See notes accompanying chart under paragraph 2.7 above.

4.11 For the purpose of applying this time limit, the first notification of action giving rise to taxation not in accordance with the DTA is usually the relevant notice of assessment issued by the ATO or the equivalent notification of a tax liability from a tax treaty partner country. This view accords with paragraph 18 of the Commentary to Article 25 of the OECD Model Tax Convention which considers that the first notification should be interpreted in the way most favourable to the taxpayer. It is, however, recognised that a case may be presented and considered by the competent authorities before such notification is issued.

Case justified

4.12 The competent authority upon being presented with a case by a taxpayer must consider whether the case is justified, i.e., that the taxpayer has reasonable grounds upon which to seek competent

authority consideration. The action complained of must be directed specifically at the taxpayer.

4.13 The Australian competent authority could be expected to consider a case justified where the taxpayer has received notification in writing (e.g., a position paper or a notice of assessment or equivalent notice) from either the ATO or the tax administration of a tax treaty partner country of a proposed transfer pricing or profit reallocation adjustment. This notification would need to reflect that an examination or audit of the taxpayer's affairs was significantly advanced in this regard (i.e., not just a mere possibility), and include details of what is to be adjusted, the amount involved and the basis of calculation.

4.14 Actions that the Australian competent authority is unlikely to consider sufficient to justify a case include:

(a) the mere existence of an audit or an examination of the affairs of the taxpayer or associated foreign company;

(b) requests from the ATO or a tax treaty partner country for an exchange of information about the dealings between the Australian resident company and an associated foreign company;

(c) discussions between the taxpayer and a tax treaty partner country about the amount and source of profits considered attributable to the permanent establishment under the Business Profits Article;

(d) discussions between an associated foreign company and a tax treaty partner country concerning non-arm's length dealings between the taxpayer and the associated foreign company; or

(e) an ATO Taxation Ruling (e.g., a Ruling which is a 'public ruling' for the purposes of Part IVAAA of the *Taxation Administration Act 1953*) or a tax treaty partner country ruling or policy of a general nature that the taxpayer believes could be applied to it and, if so, may result in taxation not in accordance with the DTA.

4.15 The issues raised by a Ruling or policy will usually be of general application and not be related to any particular taxpayer. However, such items of a general nature may be brought to the attention of the competent authority who may seek to resolve any difficulties or doubts about the interpretation or application of the DTA with the other competent authority under the appropriate provision of the MAP Article (e.g., Article 24(3) of the Vietnamese agreement, Article 25(3) of the OECD Model Tax Convention).

Solution by competent authority presented with case

4.16 The Australian Competent Authority will consider whether it is able to arrive at an appropriate solution itself. However, in the ATO experience, transfer pricing and profit reallocation cases have not been capable of solution in this manner.

STAGE 2

4.17 The second stage commences with the competent authority who has been presented with the case approaching the other competent authority. Paragraph 26 of the Commentary to Article 25 of the OECD Model Tax Convention recognises that this stage imposes on the competent authorities a duty to negotiate and to use their best endeavours to resolve a case (see paragraph 1.6 above).

4.18 Where the primary transfer pricing or profit reallocation adjustment is made by a tax treaty partner country, it can be expected that the Australian competent authority will seek to resolve the case by reaching a mutual understanding as to:

(a) the principles embodied in the DTA;

(b) the facts of the particular case; and

(c) how those principles should be applied to the facts of the case in a way which does not result in unrelieved double taxation.

4.19 Where the primary adjustment is made by the ATO, the main role of the Australian competent authority will be to demonstrate to the other competent authority that the ATO transfer pricing or profit reallocation adjustment is in accordance with the DTA and therefore, relief from any resultant double tax should be provided by the tax treaty partner country.

Year of adjustment

4.20 Where the ATO provides relief from double taxation it will as a matter of practice adjust the tax payable for the year of income corresponding to the period that the profits have been adjusted or reallocated by the tax treaty partner country. For example, assume an adjustment is made by a tax treaty partner country to increase the profits of the associated foreign company in relation to non-arm's length dealings with the resident company in April 1995. Appropriate relief will be provided against tax payable for the income year ended 30 June 1995. Where the primary adjustment relates to dealings undertaken during the whole of a year, e.g., the year ended 31 December 1995, relief will be provided against tax payable for the years ended 30 June 1995 and 1996.

4.21 Where the resident taxpayer is in a tax loss position in the year to which the primary adjustment relates, a correlative adjustment may be made to the income tax payable in a subsequent year (see paragraphs 2.27 to 2.31 above). The ATO practice in relation to the year in which relief is provided will be appropriate to the facts of each case, and the nature and timing of the relevant adjustments.

4.22 Where a tax treaty partner country is providing relief from double taxation in response to an ATO primary adjustment, the method of the adjustment and the year to which it relates are matters to be determined by the tax administration of that country.

Competent authority communications

4.23 Communications between the competent authorities will usually be through an exchange of position papers. Information provided by the resident taxpayer will be taken into account in the preparation of Australian position papers.

4.24 Where a case involves significant issues upon which agreement cannot be reached through the exchange of position papers, the competent authorities may meet for negotiations. The taxpayer does not have a right to be present at such negotiations between competent authorities. However, where both competent authorities agree, the taxpayer may present its case to the competent authorities jointly. Where the competent authority of a tax treaty partner country does not agree to a joint presentation, the taxpayer will nevertheless be given an opportunity to present its case to the Australian competent authority.

4.25 The Australian competent authority will endeavour to ensure that communications are undertaken on a timely basis to facilitate resolution of cases as quickly as possible. Taxpayers will be kept informed of progress by the ATO.

4.26 Exchanges of information between competent authorities are undertaken under the Exchange of Information Article of the relevant DTA (e.g., Article 25 of the Vietnamese agreement; Article 26 of the OECD Model Tax Convention) and will be subject to the secrecy provisions of that Article.

TIME LIMIT FOR RESOLUTION OF CASES

4.27 Specific provisions in a DTA dealing with time limits for implementation of competent authority agreement under a MAP article take precedence over the normal domestic law time limits that would otherwise apply to the provision of relief from double taxation. Most of Australia's DTAs include a provision in the MAP Article (e.g., the last sentence in Article 24(2) of the Vietnamese agreement),

that states that '… the solution so reached shall be implemented notwithstanding any time limits in the national laws of the Contracting States'. This means that the taxpayer can ensure, by presenting a case to the competent authority under the MAP Article, that the mere expiration of domestic time limits does not preclude the granting of relief.

4.28 There are some notable variations in some of Australia's DTAs. The Malaysian agreement provides that there is no time limit for implementation of relief only where the case is presented to the competent authority within 6 years of the tax year in question (Article 24(2)). The Irish agreement provides that the solution may be implemented within 7 years from presentation of the case to the competent authority (Article 26(2)).

4.29 Specific time limits in DTAs take precedence because of the operation of subsection 4(2) of the Agreements Act.

Economic double taxation

4.30 In effect, there is no time limit on the provision of relief from economic double taxation even for DTAs where the MAP article does not specifically address domestic time limits (DTAs with the United Kingdom, Canada, New Zealand (1972), Singapore, Japan, Germany, France, Belgium, Philippines, Switzerland, Italy, Thailand and Fiji). This is because the domestic provisions do not apply a time limit. Both the 'appropriate adjustment' and 'credit relief' provisions are given effect by a credit and the time limit imposed on amendment of a credit determination does not apply where the amendment of a determination is made 'in consequence of an adjustment, credit or refund of Australian tax or foreign tax' (subsection 160AK(2)).

Juridical double taxation

4.31 For those DTAs where the MAP Article does not specifically address domestic time limits (listed at paragraph 4.30 above) the domestic time limits that govern the granting of correlative relief from juridical double taxation are as follows:

(a) As outlined in paragraph 4.30 above in relation to economic double taxation, subsection 160AK(2) also applies to effectively remove time limits on the provision of relief of juridical double taxation provided by way of a credit. This means that a correlative adjustment can be made at any time in relation to a resident taxpayer with a permanent establishment in a tax treaty partner country (that is not a listed country

under Part X) and section 23AH does not apply to exempt the income; and

(b) the time limits in section 170 apply where a correlative adjustment is provided by an amended assessment, e.g., to increase the amount of income exempt under section 23AH as a result of a profit reallocation adjustment made by a tax treaty partner country (that is a listed country under Part X) to the profits attributable to the permanent establishment of an Australian resident taxpayer in that country.

4.32 Where a correlative adjustment is effected by way of an amended assessment, subsection 170(9B) of the 1936 Act may apply. This in effect permits the amendment at any time of an assessment for the purpose of giving effect to a 'prescribed provision' or a 'relevant provision'.

4.33 'Relevant provision' is defined in subsection 170(14) of the Act as meaning 'paragraph (3) of Article 5 or paragraph (1) of Article 7 of the United Kingdom agreement or a provision of any other DTA that corresponds with either of those paragraphs'. Article 5(3) of the United Kingdom agreement is the Business Profits Article that governs the calculation of the profits attributable to a permanent establishment and provides for both:

(a) a primary profit reallocation adjustment; and

(b) a correlative adjustment to relieve the resultant double taxation.

4.34 Both types of adjustments are effected under Australian domestic provisions by amending the taxpayer's assessment at any time under subsection 170(9B).

4.35 Subsection 170(9C) limits the application of subsection 170(9B) to situations where the DTA provisions corresponding to Article 5(3) of the United Kingdom agreement have not previously been applied in relation to the same subject matter in making or amending an assessment in relation to the year of income (see paragraph 36 of TR1999/8).

ATO ADJUSTMENT - INTERACTION BETWEEN MUTUAL AGREEMENT PROCEDURE AND DOMESTIC REVIEW RIGHTS

4.36 The MAP Article in Australia's DTAs provides taxpayers with an avenue for review in addition to the objection, review and appeal rights that are available in Australian domestic law.

4.37 The ATO will consider concurrently a case presented to the competent authority and the objection lodged by the taxpayer under

domestic provisions against the relevant assessment or amended assessment. The domestic provisions governing objections, review or appeals are contained in Part V of the Act in relation to 1991-92 and prior income tax years and in Part IVC of the *Taxation Administration Act 1953* in relation to 1992-93 and subsequent income tax years.

Objection decisions

4.38 Competent authority consideration under a MAP Article will cease where a decision to wholly allow an objection is made since there will no longer be taxation that is not in accordance with the DTA.

Where competent authority agreement is reached

4.39 An appropriate solution arrived at by both competent authorities may result in the ATO either:

(a) restoring the taxpayer's original tax position by withdrawing the primary adjustment; or

(b) reducing the primary adjustment with the agreement of the taxpayer.

4.40 Where (b) of paragraph 4.39 above applies, the taxpayer is required, under the Code of Settlement Practice, to record the terms of the agreement in writing and, where an objection decision has not been made, advise the ATO of the withdrawal of the objection. Where an objection decision has been made or will be made to reflect the agreement between the competent authorities, the taxpayer has to agree that it will not seek review of the decision by the Administrative Appeals Tribunal or appeal to the Federal Court against the decision.

4.41 Where an assessment/amended assessment challenged by the taxpayer involves a number of issues (e.g., a transfer pricing adjustment in relation to an interest free loan and a profit reallocation adjustment between the head office and its foreign branch), a settlement agreement entered into by a taxpayer with the ATO may be limited to those issues resolved by the competent authorities. This means that the taxpayer may still proceed with domestic review and appeal rights in relation to the issues unresolved through MAP.

Where taxpayer does not agree with competent authority agreement

4.42 Where competent authorities have reached agreement but the taxpayer does not agree with the implementation of the agreement, the taxpayer can continue to seek tax relief using its domestic objection review and appeal rights. The competent authorities generally will not communicate further on the matter.

Where competent authority agreement has not been reached

4.43 Where competent authorities have not agreed on an appropriate solution to the case by the time an objection decision is made, the taxpayer has a right to apply to the Administrative Appeals Tribunal (AAT) for a review of the decision or appeal to the Federal Court against the decision if dissatisfied with the objection decision (refer section 14ZZ of the *Tax Administration Act 1953*). The continuation of competent authority endeavours under the MAP Article during the review and appeal stages will be considered on a case by case basis. It may, in certain circumstances, be inappropriate to continue competent authority endeavours after an application has been made to the Administrative Appeals Tribunal for a review of an objection decision or an appeal to the Federal Court against the objection decision has been lodged.

4.44 Taxpayers should take into account the possibility that competent authority endeavours may cease at the review and appeal stages when considering their right under section 14ZYA of the *Tax Administration Act 1953* to require the Commissioner to make an objection decision within 60 days. A notice to the Commissioner under section 14ZYA may lead to insufficient time being available to the competent authorities to reach agreement to resolve the case and the taxpayer may have to rely only on its domestic review and appeal rights (or any rights available under the laws of the tax treaty partner country).

4.45 The ATO is required to take action to give effect to a decision of the AAT or an order of the Federal Court which is either wholly or partially in the taxpayer's favour (refer to sections 14ZZL and 14ZZQ of the *Tax Administration Act 1953*). Once a decision of the AAT or an order of the Federal Court has been made, the Australian competent authority will abide by that decision or order. The subsequent endeavours of the Australian competent authority will be limited to demonstrating to the competent authority of the tax treaty partner country that the ATO transfer pricing or profit reallocation adjustment is in accordance with the DTA, as a matter of principle and amount, and that relief should be provided by that country.

INTERACTION BETWEEN MUTUAL AGREEMENT PROCEDURE AND REVIEW RIGHTS IN THE TAX TREATY PARTNER COUNTRY

4.46 It is the ATO view that the MAP Article provides a problem resolution process which is in addition to any objection, review and appeal rights that may be available to a resident taxpayer or its

associated foreign company under the respective laws of both treaty partner countries.

4.47 The successful exercise of review and appeal rights in the tax treaty partner country may give rise to the result that there is no longer any taxation which is contrary to the DTA. Under these circumstances, it would be inappropriate for the taxpayer to obtain any correlative relief in Australia.

4.48 Depending upon the circumstances of each case, the provision of any correlative adjustment by the ATO will be conditional upon either:

(a) the resident taxpayer and any associated foreign company having exhausted or rescinded objection, review and appeal rights in the tax treaty partner country; or

(b) the resident taxpayer in a transfer pricing adjustment case agreeing to advise the Australian competent authority should objection, review and appeal rights be exercised by the foreign associated company in the tax treaty partner country; or

(c) the resident taxpayer in a profit reallocation case agreeing to advise the Australian competent authority should objection, review and appeal rights be exercised in the tax treaty partner country.

4.49 In relation to the situations outlined under (b) or (c) in paragraph 4.48 above, the issue of any amended assessment or the provision of a credit for foreign taxes paid will be deferred until such time as the review and appeal rights in the tax treaty partner country have lapsed or are subsequently rescinded or exhausted.

PAYMENT OF TAX DURING MUTUAL AGREEMENT PROCEDURE

4.50 In respect of a case which has been presented to the competent authority, a taxpayer may apply for an extension of time to pay tax under section 206 of the Act. Each request for an extension of time to pay tax under such circumstances will be decided on its merits. The factors which will be taken into account may include:

(a) whether the assessment is disputed, e.g., whether the taxpayer has lodged a notice of objection or is preparing such a notice for lodgment and whether the objection has been dealt with by the ATO (*Ahern v. Deputy Commissioner of Taxation* 83 ATC 4698; *Nestle Australia Limited v. Federal Commissioner of Taxation* 87 ATC 4409 at 4419);

(b) where the assessment is disputed by the taxpayer, whether the ATO considers that the dispute is genuine and that arguable questions of fact or law are involved (*Ahern v. Deputy Federal Commissioner of Taxation* 83 ATC 4698; *ARM Constructions Pty Limited & Ors v. DFC of T* 86 ATC 4213);

(c) the size of the tax liability, including whether hardship would result from having to pay such a sum by the due date for payment (*Ahern v. Deputy Federal Commissioner of Taxation* 83 ATC 4698; *Nestle Australia Limited v. FC of T* 87 ATC 4409);

(d) the capacity of the taxpayer to discharge the tax liability;

(e) the risks to the revenue, e.g., whether any other liability to Australian tax remains unpaid after its due date;

(f) whether the taxpayer has already discharged its tax liabilities in relation to the profit reallocation adjustment in the tax treaty partner country. To enable this factor to be considered the taxpayer should provide such a confirmation from the foreign tax administration; and

(g) any other relevant factors.

4.51 Deferral of recovery action for MAP cases may be subject to:

(a) review on a periodic basis, e.g., every six months;

(b) a requirement for partial payment or payments over a period of time;

(c) the taxpayer's timely cooperation in providing information to facilitate competent authority processes and determination of the objection lodged;

(d) the provision of security by the taxpayer; or

(e) some other arrangement to minimise the risks to the revenue.

Additional tax for late payment

4.52 The deferral of recovery action for a case presented under a MAP Article of a relevant DTA will generally subject the taxpayer to the payment of penalty for unpaid tax under section 207 and penalty interest on unpaid tax under section 207A, calculated from the original due date for payment under the assessment or amended assessment of tax.

4.53 As stated in paragraph 1.8 above, no relief is available in respect of any penalty or interest paid as these are not 'taxes' as defined in Australia's DTAs.

PAYMENT OF INTEREST ON CORRELATIVE ADJUSTMENTS

General history

4.54 In certain circumstances correlative adjustments may give rise to overpayments of tax upon which interest may be payable under the *Taxation (Interest on Overpayments and Early Payments) Act 1983* (the Overpayments Act).

4.55 Amendments were made to the Overpayments Act in 1994 that generally widened the circumstances under which interest is paid to taxpayers who overpay their income tax and provide for interest to be paid to taxpayers who pay their income tax early. This applies to interest payable in relation to assessments (including amended assessments) and credits made on or after 1 July 1994 for the 1993-94 income year and subsequent years.

4.56 However, overpayments arising from the provision of correlative relief by the ATO may not qualify for interest in certain circumstances or may qualify for a limited amount of interest (see paragraphs 4.59 and 4.60 below). The limitation and denial of interest in certain circumstances where correlative relief is provided apply in relation to any year where correlative relief is provided on or after 1 July 1994 (see paragraphs 4.60 and 4.61 below).

Payment of interest

1984-85 income year and prior years

4.57 Subject to the limitation and exception outlined below in paragraphs 4.60 and 4.61 respectively, interest on overpaid tax is payable where a credit amended assessment is issued as a result of an objection, review or appeal. The interest is payable only from 14 February 1983.

1985-86 to 1992-93 income years inclusive

4.58 Subject to the limitation and exception outlined in paragraphs 4.60 and 4.61 below respectively, interest is payable where correlative relief is provided by way of a credit amendment to the assessment. However, credits for foreign taxes do not give rise to an overpayment of tax upon which interest is payable.

1993-94 income year and subsequent years

4.59 Subject to the limitation and exception outlined in paragraphs 4.60 and 4.61 below respectively, interest will be payable on overpayments of tax arising from the provision of correlative relief, whether by way of an assessment (i.e., 'decision to which this Act applies' as defined in subsection 3(1) of the Overpayments Act) or a credit for foreign taxes (i.e., 'income tax crediting amount' as defined in subsection 3(1) of the Overpayments Act) made on or after 1 July 1994 in respect of the 1993-94 or subsequent income year.

Limitation on amount of interest paid

4.60 Where interest is payable on an overpayment of tax that has arisen from the provision of correlative relief, sections 8J and 11 of the Overpayments Act provide that the amount of interest payable is limited to the least of the following amounts:

(a) the amount of interest payable under the Overpayments Act; or

(b) the amount of interest charged by the foreign country making the transfer pricing or profit reallocation adjustment; or

(c) the amount of correlative relief being provided.

This limitation applies to any year where correlative relief is provided on or after 1 July 1994.

No interest payable

4.61 Subsection 9(1A) and paragraph (b) of the definition of the 'income tax crediting amount' in subsection 3(1) of the Overpayments Act provide that interest will not be paid on overpayments arising from the provision of correlative relief unless the law of the foreign country making the transfer pricing or profit reallocation adjustment requires the payment of interest on that adjustment and that the interest is paid by the time correlative relief is provided. This provision applies to correlative relief provided on or after 1 July 1994.

4.62 The Explanatory Memorandum to the 1994 amendments to the Overpayments Act explains that to pay interest on overpayments arising from the provision of correlative relief where the country making the transfer pricing or profit reallocation adjustment does not impose interest 'would result in a windfall gain for a taxpayer or MNE (multinational enterprise) [group] where the taxpayer or MNE [group] viewed as an economic unit has not overpaid its global tax obligations. This would place taxpayers or MNEs who engage in international

profit shifting through transfer pricing in a better position than those who do not'.

4.63 Section 3A of the Overpayments Act provides for provisions of DTAs or the manner of operation of provisions of DTAs to be prescribed by regulation for the purposes of identifying overpayments of tax which 'provide correlative relief' (see Regulations 5-8 inclusive of the *Taxation (Interest on Overpayments and Early Payments) Regulations.*

ADVANCE PRICING ARRANGEMENTS

4.64 In order to avoid juridical or economic double taxation arising in future years, taxpayers may wish to consider seeking an Advance Pricing Arrangement in accordance with Taxation Ruling TR 95/23.

DIALOGUE WITH COMPETENT AUTHORITY

4.65 The procedures outlined above do not limit the opportunities of taxpayers discussing their international operations with the ATO.

Your comments

8. We invite you to comment on this Draft Taxation Ruling. We are allowing 7 weeks for comments before we finalise the Ruling. If you want your comments to be considered, please provide them to us within this period.

Comments by:	11 February 1999
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IT 2527; TR 95/23

Subject references:

- arm's length principle
- competent authority
- correlative adjustment/relief
- double tax agreements
- economic double taxation
- exchange of information
- juridical double taxation
- mutual agreement procedure
- penalties
- profit reallocation
- transfer pricing

Legislative references:

- ITAA 97 8-1
- ITAA 36 6AB(1)
- ITAA 36 6AB(3)
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- ITAA 36 128B
- ITAA 36 Pt III, Div 18
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- ITAA 36 160AF(1)(b)
- ITAA 36 Pt III, Div 18A
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- ITAA 36 Pt III, Div 19
- ITAA 36 160AI(1)
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- TAA 1953 14ZZQ

Case references:

- Ahern v. Deputy Federal Commissioner of Taxation 83 ATC 4698
- ARM Constructions Pty Limited & Ors v. DFC of T 86 ATC 4213
- Nestle Australia Limited v. Federal Commissioner of Taxation 87 ATC 4409

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