# *TR 95/D31 - Income tax: international transfer pricing - correlative adjustments to relieve double taxation arising from an adjustment by a foreign tax administration*

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# Draft Taxation Ruling

Income tax: international transfer pricing - correlative adjustments to relieve double taxation arising from an adjustment by a foreign tax administration

**other Rulings on this topic**

**CITCM 864; IT 2527; IT 2597; TR 95/D22; TR 95/23**

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*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 which 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 is intended for taxpayers who wish to seek relief in Australia from international double taxation arising from an increased liability to foreign tax due to a transfer pricing or profit reallocation adjustment by a foreign tax administration.

### Issues discussed in this Ruling

2. This Ruling outlines the mechanisms in the *Income Tax Assessment Act 1936* (ITAA) and Australia's comprehensive double tax agreements (DTAs) included as schedules to the *International Tax Agreements Act 1953* (the Agreements Act) by which relief may be granted from double taxation arising as a result of an international transfer pricing or profit reallocation adjustment made by a foreign tax administration. This is known as 'correlative relief' or a 'correlative adjustment'.

3. This Ruling outlines the circumstances in which such a correlative adjustment may be made by the Australian Taxation Office (ATO).

4. This Ruling also provides practical guidance to taxpayers seeking relief from international double taxation arising from transfer pricing or profit reallocation adjustments made by a foreign tax administration.

5. The Ruling relates to companies. Different rules may be applicable to other entities such as individuals and trusts.

6. The Ruling does not deal with international double taxation cases other than those which have arisen because of a transfer pricing, profit reallocation or similar type adjustment.

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

8. This ruling uses Australia's modern DTAs as the basis for discussion. However, where the provisions of a particular DTA differ substantially from our modern agreements, reference will be made to those differences. Australia's agreement with Vietnam (Schedule 38 of the Agreements Act) is an example of a modern agreement and this DTA will be used for discussion purposes in this Ruling.

9. Because DTAs differ in their terms, each relevant DTA should be considered in light of its actual terms when applying this Ruling.

10. A glossary of terms commonly used in this Ruling is provided at paragraph 12.

# Date of effect

11. This Ruling sets out the current practice of the Australian Taxation Office and is generally not concerned with a change in interpretation. It therefore applies to years commencing both before and after its date of issue. However, this Ruling does not apply to the extent that it conflicts with the terms of a settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

# Glossary

12. With the exception of definitions marked '*' the definitions used here are from the 1995 Report to the OECD Committee on Fiscal Affairs, 'Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations' (the 1995 OECD Report).

**Arm's length principle**

The international standard that OECD Members have agreed should be used for determining transfer prices for tax purposes. It is set forth in

Article 9 of the OECD Model Tax Convention on Income and on Capital (the OECD Model Tax Convention) as follows:

> '[where] conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would but for those conditions have accrued to one of the enterprises, but by reason of those conditions have not so accrued, may be included in the profits of that enterprise and taxed accordingly.'

**Associated enterprises**

Two enterprises are associated enterprises with respect to each other if one of the enterprises meets the conditions of Article 9, subparagraphs 1(a) or 1(b) of the OECD Model Tax Convention with respect to the other enterprise.

**Double tax agreements***

Particular double tax agreements (DTAs) cited in this Ruling have the same meaning as described in subsection 3(1) of the Agreements Act.

**Enterprise***

A person with legal identity, ie. a separate legal entity such as an individual, a trust or a company, organised for commercial purposes.

In the context of this Ruling, 'enterprise' is used as a reference to 'enterprise of a Contracting State' as used in the OECD Model Tax Convention and defined in Article 3, subparagraph 1(c) to mean an enterprise carried on by a resident of a Contracting State. Article 4 of the OECD Model Tax Convention provides for the term a 'resident of a Contracting State' to mean any person who, under the laws of that State, is liable to tax therein by reason of domicile, residence, etc.

**Economic double taxation***

Where two associated enterprises (e.g., two company members of a group of companies) are each taxed on the same income by two or more tax administrations in different countries.

**Juridical double taxation***

Where a single enterprise (e.g., a company) is taxed on the same income by two or more tax administrations in different countries.

**Multinational enterprise group (MNE group)***

A group of associated enterprises with a company resident in Australia and associated enterprises resident in another country or other countries.

**Multinational enterprise (MNE)***

An enterprise that is part of a MNE group.

**Profit reallocation adjustment***

An adjustment by a tax administration to increase a taxpayer's liability to tax in that country by the reallocation of profits (including income and expense components) between parts of an enterprise. The Business Profits Article (Article 7) of the OECD Model Tax Convention provides that:

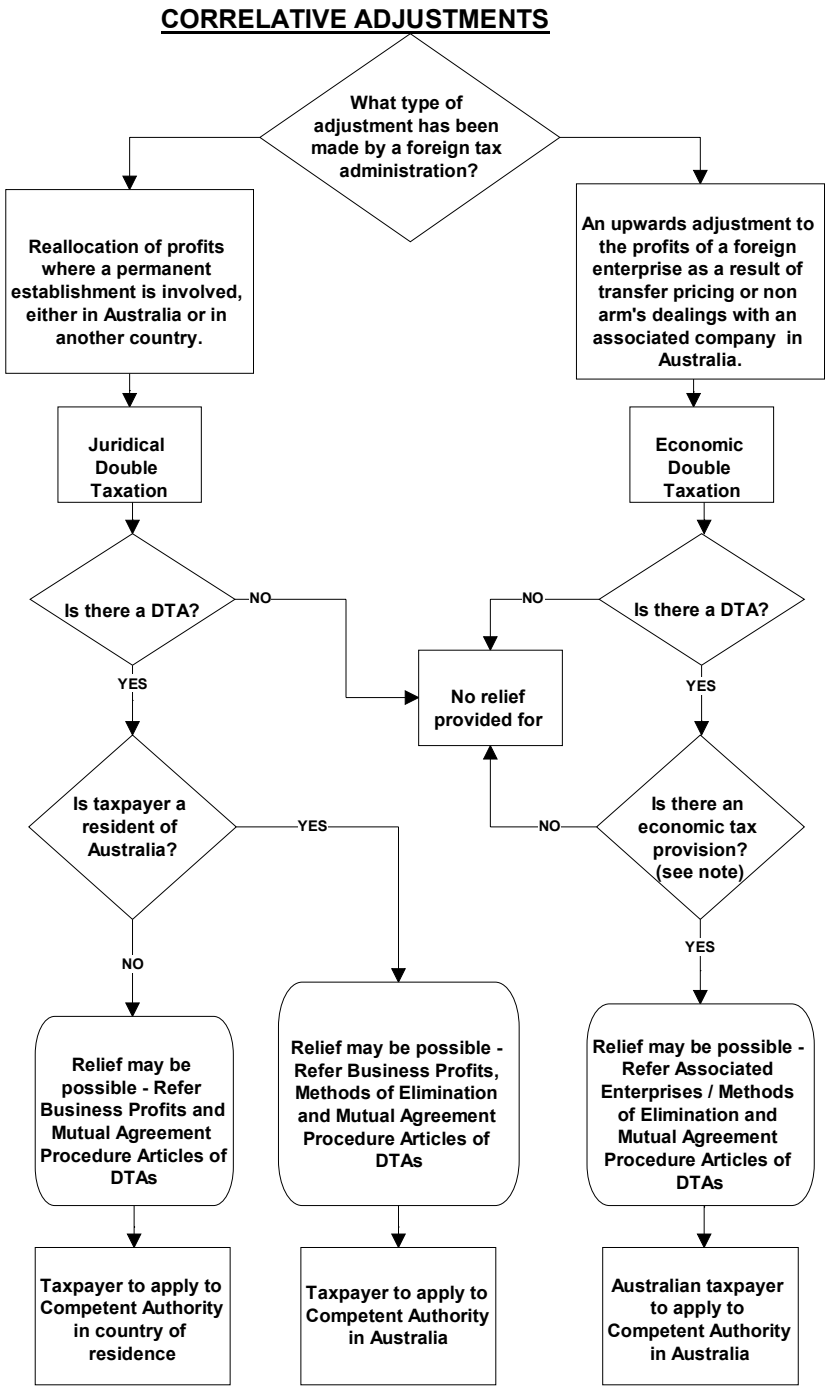
> 'where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment.'

**Transfer pricing adjustment***

An adjustment by a tax administration to increase the profits of an enterprise which are subject to tax in that country to correct understatements of profits arising from international dealings between associated enterprises being undertaken not in accordance with the arm's length principle, e.g., an adjustment made in accordance with Article 9(1) of the OECD Model Tax Convention.

# Flowchart

13. Below is a flow chart which diagrammatically depicts the legislative framework which will be used by the ATO to evaluate requests by Australian taxpayers for correlative relief from double taxation arising from a transfer pricing or profit reallocation adjustment made by the tax administration of another country.




Note: DTAs which do not have a provision covering economic double taxation are those with Germany, Switzerland and Italy

# Ruling

**Juridical double taxation - resident taxpayer**

14. Generally, juridical double taxation may arise where a tax administration of another country increases the proportion of profits of a taxpayer company resident in Australia which are considered to be derived from sources in that other country, where those profits have also been taxed in Australia **(see paragraphs 94 to 100)**.

***No double tax agreement***

15. Double taxation arising from the tax administration of another country making a profit reallocation adjustment and changing the source of income derived by a company resident in Australia will not generally qualify for foreign tax credit relief under subsection 160AF(1) of the ITAA. Subsection 6AB(1) of the ITAA defines foreign income as income derived from sources in a foreign country or countries according to ordinary concepts of source of income (see Taxation Ruling IT 2597, paragraph 27). The mere fact that the tax administration of another country considers income to have a source in that country does not alter the source of the income for Australian tax purposes. Similarly, such income will not qualify for exemption under section 23AH of the ITAA as it would not be foreign income for Australian tax purposes **(see paragraphs 101 to 103)**.

16. In the absence of a DTA between Australia and the country making the profit reallocation adjustment, the ATO will not be communicating with a foreign tax administration on the matter **(see paragraph 104)**.

***Double tax agreement applies***

17. Where a tax administration of a tax treaty partner country reallocates profits of a taxpayer company resident in Australia in accordance with the Business Profits Article of a relevant DTA (e.g., Article 7 of the Vietnamese agreement) mechanisms are provided in the DTAs which are designed to avoid or resolve any resultant juridical double taxation **(see paragraph 105)**.

18. Australia's DTAs generally allocate taxing rights between tax treaty partner countries in respect of business profits on the basis that the country of residence of a taxpayer retains the right to levy tax on the taxpayer's worldwide profits. A further taxing right is permitted to be exercised by the other country in certain circumstances, generally where the taxpayer carries on business through a permanent establishment in that other country. Australia's DTAs generally permit

the country in which the taxpayer carries on business through a permanent establishment to tax the profits 'attributable to the permanent establishment' and deems those profits to have a source in that country **(see paragraph 106)**.

19. This approach is modified as follows:

(a) the 1972 DTA with New Zealand (which applies up to the income year ended 30 June 1995) applies a 'force of attraction' principle which permits New Zealand to tax the whole of the profits of the Australian enterprise from sources within New Zealand whether or not those profits are attributable to the permanent establishment (Article 5(1) of the 1972 New Zealand agreement);

(b) the Business Profits Articles in Australia's DTAs with Fiji, India, Indonesia, Kiribati, Papua New Guinea, Philippines, Sri Lanka and Thailand permits those countries to tax, in addition to profits attributable to a permanent establishment in those countries, certain profits of an Australian enterprise attributable to:

(i) the sales in those countries of goods or merchandise of the same or similar kind as those sold through the permanent establishment; and

(ii) other business activities carried on in those countries of the same or similar kind as those carried on through the permanent establishment;

**(see paragraphs 107 and 108)**.

20. It is only where the other country exercises the right to tax the profits of the Australian resident taxpayer on a source basis in accordance with the Business Profits Article that Australia is obliged to provide relief from the resultant double taxation. Relief from juridical double taxation is generally provided for in the Methods for Elimination of Double Taxation Article in DTAs (e.g., Article 23 of the Vietnamese agreement) **(see paragraph 109)**.

21. The mechanisms by which effect is given to the Methods for Elimination of Double Taxation Articles in DTAs consist of:

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

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

**(see paragraph 110)**.

22. Ultimately, the question of whether a correlative adjustment will be made by the ATO to relieve juridical double taxation will depend upon the ATO agreeing with the profit reallocation adjustment made by the tax administration of the tax treaty partner country. For the purposes of considering whether a correlative adjustment is to be made, the ATO will apply the same principles as it would apply when making an upward profit reallocation adjustment. The Mutual Agreement Procedure Article in Australia's DTAs exists to facilitate agreement where the taxpayer considers that there is taxation not in accordance with the relevant DTA (**see paragraphs 111 to 113)**.

***Mutual agreement procedure***

23. Resident taxpayers may, under the Mutual Agreement Procedure Articles of DTAs (e.g., Article 24 of the Vietnamese agreement), present a case to the Australian competent authority where they are, or are likely to be, subjected to taxation not in accordance with a relevant DTA. The United Kingdom agreement provides that the taxpayer may present its case to the competent authority of either country **(see paragraph 114)**.

24. A resident taxpayer seeking a correlative adjustment in relation to the following circumstances should present its case to the Australian competent authority under the Mutual Agreement Procedure Article of the relevant DTA:

(a) a reallocation or proposal to reallocate profits which results or will result in an increase in the amount of profits regarded by the tax administration of a tax treaty partner country as being attributable to a permanent establishment of the taxpayer in that country (or attributable to certain other income which may be taxed by the country of source - refer paragraph 19 above); or

(b) a determination or proposed determination by a tax administration of a tax treaty partner country that a permanent establishment of the taxpayer exists in that country which results in or will result in the taxation of an amount of profits being attributable to that permanent establishment where the taxpayer has previously had its tax obligations determined on the basis that no permanent establishment existed in that country;

**(see paragraph 115)**.

*Tax not in accordance with DTA*

25. Double taxation is not generally necessary for there to be considered 'taxation not in accordance' with a DTA. However, several of Australia's DTAs limit the application of the Mutual Agreement Procedure Article to double taxation cases **(see paragraphs 116 and 117)**.

*Time limit for presentation of case*

26. An assessment notice or similar notification from the tax administration of a tax treaty partner country will be regarded by the ATO as the first notification of the action giving rise to taxation not in accordance with the DTA for the purposes of applying the time period (generally 3 years) within which taxpayers must present their case for competent authority consideration under the Mutual Agreement Procedure Article (e.g., last sentence of Article 24(1) of the Vietnamese agreement) **(see paragraphs 118 and 119)**.

*When domestic time limits apply*

27. As a general principle, normal domestic law time limits apply to the provision of relief from double taxation unless those limits are specifically overridden by the terms of a relevant DTA. Most of Australia's DTAs include such a provision in the Mutual Agreement Procedure Article (e.g., last sentence in Article 24(2) of the Vietnamese agreement). This means that the taxpayer can ensure, by presenting a case under the Mutual Agreement Procedure Article, that the mere expiration of domestic time limits does not preclude relief from double taxation being granted **(see paragraph 120)**.

28. The Malaysian agreement overrides domestic time limits only where the case is presented to the competent authority within 6 years of the tax year in question. The Irish agreement sets a specific limit of 7 years from the presentation of the case to the competent authority **(see paragraph 120)**.

29. Subsection 4(2) of the Agreements Act gives precedence to provisions of the Agreements Act, which includes the provisions in DTAs to override or substitute domestic time limits, notwithstanding anything inconsistent in the ITAA **(see paragraph 121)**.

30. DTAs which do not have provisions specifically overriding domestic time limits are those with the United Kingdom, United States (1953), Canada, New Zealand (1972), Singapore, Japan, Germany,

France, Belgium, Philippines, Switzerland, Italy, Thailand and Fiji **(see paragraph 122)**.

31. For those DTAs which do not override the domestic time limits, the statutory time limits applicable under the ITAA apply:

(a) time limits in section 170 of the ITAA will apply where a correlative adjustment is to be provided by an amended assessment, eg. to increase the amount of income exempt under section 23AH. Where an amended assessment is permitted by subsection 170(9B) it may be made at any time; and

(b) time limits in Division 19 (e.g., subsection 160AK(2)) of the ITAA will apply where a correlative adjustment is to be provided by a foreign tax credit;

**(see paragraphs 123 to 127)**.

*Requirements for presentation of case*

32. To present a case under the Mutual Agreement Procedure Article a taxpayer has to consider that the action of one or both of the tax treaty partner countries result or will result for that person (i.e., a company in the context of this Ruling) in taxation not in accordance with the DTA. Mutual Agreement Procedure Articles impose an obligation upon the competent authorities of the tax treaty partner countries to endeavour to resolve a case presented by a taxpayer where:

(a) the claim appears to be justified; and

(b) the competent authority of the country of residence is not able to arrive at an appropriate solution;

**(see paragraph 128)**.

33. For a claim to be considered justified by the ATO for the purposes of the Mutual Agreement Procedure Article, the action complained of needs to be directed specifically at the taxpayer **(see paragraph 129)**.

34. Actions which the ATO will regard as sufficient to place an obligation upon the competent authority to endeavour to resolve the case will include:

(a) advice in writing from a tax treaty partner country to the taxpayer advising that they are proposing to tax the taxpayer on a basis different to that upon which the taxpayer has been taxed in Australia; or

(b) an assessment or similar notification of a tax liability indicating that the taxpayer has been taxed, in relation to its permanent establishment in the other country, on a basis different to that upon which it has been taxed in Australia;

**(see paragraphs 130 to 134)**.

35. In deciding whether or not a correlative adjustment is to be made by the ATO, or whether endeavours to resolve the case with the competent authority of the tax treaty partner country should be made, the Australian competent authority's own opinion will be formed as to whether taxation contrary to the particular DTA results or will result. A correlative adjustment to relieve double taxation arising out of a profit reallocation adjustment made by a tax treaty partner country will only be made by the ATO if the Australian competent authority is satisfied that the adjustment is in accordance with the principles embodied in the relevant DTA and where mechanisms providing for relief are available, either under the relevant DTA or domestic law **(see paragraphs 135 to 138)**.

*Year of adjustment*

36. Where a correlative adjustment is to be made by the ATO, the adjustment will be made in relation to the year of income corresponding to that adjusted by the tax treaty partner country (subject to time limits as discussed in paragraphs 27 to 31 above) **(see paragraph 139)**.

*Foreign domestic appeal rights*

37. The Mutual Agreement Procedure Articles provide a problem resolution process which is **in addition** to that which may be available to a taxpayer under domestic law, e.g., objection, review and appeal rights both in the tax treaty partner country and Australia. Depending upon the circumstances of each case, the making of a correlative adjustment by the ATO will be conditional upon either:

(a) the taxpayer having exhausted or rescinded its objection, review and appeal rights in the tax treaty partner country; or

(b) the taxpayer and the tax treaty partner country agreeing to advise the Australian competent authority should domestic appeal rights be exercised in that country;

**(see paragraph 140)**.

38. However, in the latter scenario, the issue of an amended assessment or the providing of a credit for foreign taxes paid to give effect to the agreed correlative adjustment will be deferred until such time as the foreign appeal rights lapse or are subsequently rescinded or exhausted **(see paragraphs 141 and 142)**.

*Competent authority communications*

39. The Australian competent authority will advise by correspondence the competent authority of the relevant tax treaty partner country when it accepts a case presented by a resident taxpayer. In processing cases under the Mutual Agreement Procedure Article, communications between the competent authorities will usually be through the exchange of position papers. Information provided by the resident taxpayer will be taken into account in the preparation of Australian position papers and in the consideration of position papers from the other competent authority **(see paragraphs 143 to 145)**.

40. Exchanges of information between competent authorities will be undertaken pursuant to the Exchange of Information Article of the relevant DTA (e.g., Article 25 of the Vietnamese agreement) and subject to the secrecy provisions of that Article **(see paragraph 146)**.

*No resolution of case*

41. Where an Australian resident company:

(a) has not presented its case to the Australian competent authority under the Mutual Agreement Procedure article of a relevant DTA; or

(b) where the competent authorities have failed in their endeavours to resolve the case with a view to avoiding the taxation contrary to the DTA;

the taxing by the other country of the profits of the Australian resident company will, in the view of the ATO, be in contravention of the DTA. In these cases, Australia is not obliged by the DTA to make a correlative adjustment and double tax relief may not be available under domestic law **(see paragraph 147)**.

***Domestic law***

42. Where, in the view of the ATO, a tax treaty partner country has taxed profits of a company resident in Australia contrary to the

relevant DTA, relief from any resultant double taxation will generally not be available under the DTA or the ITAA **(see paragraph 148)**.

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

43. The provisions in the DTAs which deem income attributable to a permanent establishment to be derived from sources in the tax treaty partner country do not operate where, in the opinion of the ATO, the tax treaty partner country is taxing the Australian resident taxpayer in contravention of the Business Profits Article of the relevant DTA. This means that a credit under the provisions of Division 18 of the ITAA will be allowed only where the foreign tax paid is in respect of foreign income according to ordinary concepts **(see paragraphs 149 to 154)**.

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

44. As explained in the preceding paragraph, the provisions in the DTAs which deem income attributable to a permanent establishment to be derived from sources in the tax treaty partner country do not operate where, in the opinion of the ATO, the tax treaty partner country is taxing the Australian resident taxpayer in contravention of the Business Profits Article of a relevant DTA. This means that the exemption provided by subsection 23AH(2) of the ITAA for certain foreign branch income of an Australian resident company will be available only where the income is derived from foreign sources according to ordinary concepts **(see paragraphs 155 and 156)**.

**Juridical double taxation - non-resident taxpayer**

45. Generally, juridical double taxation may arise where a tax administration of another country decreases the proportion of profits considered to be derived from sources in Australia by a company taxpayer resident in that other country **(see paragraphs 157 and 158)**.

***No double tax agreement***

46. The mere fact that the tax administration of another country considers income to have a source in that country does not alter the source of income for Australian tax purposes. The ordinary concepts of source of income generally apply for the purpose of determining assessable income of a non-resident taxpayer. A correlative adjustment to relieve juridical double taxation arising from a foreign

profit reallocation adjustment will therefore generally not be available. Australian law will be applied in determining the amount of the taxable income of a non-resident company for the purposes of the ITAA, i.e. to calculate assessable income derived from Australian sources and allowable deductions **(see paragraph 159)**.

### *Double tax agreement applies*

47. The question of whether a correlative adjustment will be made by the ATO to relieve juridical double taxation arising from a profit reallocation adjustment by a tax treaty partner country, being the country of residence of the taxpayer, will depend upon the ATO agreeing with the adjustment. The ATO will apply the same principles as it would apply when making an upward profit reallocation adjustment when considering whether it agrees with the adjustment. To the extent to which the ATO agrees with a profit reallocation adjustment which decreases the profits attributable to a permanent establishment in Australia of the non-resident taxpayer, the Business Profits Article of a relevant DTA will operate to reduce the taxpayer's taxable income. This reduction will correlate to the increase in profits considered to have been derived from non-Australian sources by the tax treaty partner country **(see paragraphs 160 to 162)**.

### *Mutual agreement procedure*

48. Non-resident taxpayers may, under the Mutual Agreement Procedure Articles of DTAs (e.g., Article 24 of the Vietnamese agreement), present a case to the competent authority of the country of which they are a resident where they are, or are likely to be, subjected to taxation not in accordance with a relevant DTA (except for the United Kingdom agreement which provides for the request to be made to either competent authority) **(see paragraph 163)**.

49. A non-resident taxpayer seeking a correlative adjustment in relation to the following circumstances should, in the first instance, present its case under the Mutual Agreement Procedure Article of the relevant DTA to the competent authority of the country of which it is a resident:

(a) where a profit reallocation adjustment is made or proposed by a tax treaty partner country to reduce the amount of profits considered attributable to the permanent establishment of the taxpayer in Australia (or attributable to certain other income which may be taxed in Australia); or

(b) where a tax treaty partner country determines or proposes to determine that no permanent establishment exists in Australia where the taxpayer has previously had its tax obligations determined on the basis that permanent establishment existed in Australia and that an amount of profits were attributable to that permanent establishment;

**(see paragraph 164)**.

*Presentation of case*

50. The ATO will be satisfied that a case has been presented within the time periods permitted in the Mutual Agreement Procedure Article of a relevant DTA where the taxpayer provides to the Australian competent authority, within the permitted time period, details of the case presented to the foreign competent authority **(see paragraph 165)**.

*When domestic time limits apply*

51. Specific provisions in DTAs which deal with time limits for making correlative adjustments and the application of domestic time limits are explained at paragraphs 27 to 31 above. Juridical double taxation suffered by a non-resident company taxpayer which has arisen from a profit reallocation adjustment by a tax treaty partner is provided by assessment (including an amended assessment) as neither the DTAs nor the general foreign tax credit system provides for credits to be given for foreign taxes paid by non-resident company taxpayers. The time limits explained in paragraph 31 in relation to amended assessments apply also to non-resident company taxpayers **(see paragraph 166)**.

*Year of adjustment*

52. Where a correlative adjustment is to be made by the ATO, the adjustment will be made in relation to the year of income corresponding to that adjusted by the tax treaty partner country (subject to time limits discussed in paragraph 51 above) **(see paragraph 167)**.

*Foreign domestic appeal rights*

53. Paragraphs 37 and 38 in relation to resident taxpayer's apply also to non-resident taxpayers **(see paragraph 168)**.

*Competent authority communications*

54. After the Australian competent authority receives advice from the competent authority of the country of which the taxpayer is a resident, communications between competent authorities will generally be the same as outlined in paragraphs 39 and 40 above in relation to resident taxpayers **(see paragraphs 169 and 170)**.

**Economic double taxation**

55. Economic double taxation may arise within a MNE group where a foreign tax administration, for tax purposes, upwardly adjusts the profits of an enterprise resident in that country as a result of transfer pricing or non-arm's length dealings with an associated entity resident in Australia **(see paragraphs 171 to 174)**.

***No double tax agreement***

56. Relief for economic double tax arising from a transfer pricing adjustment made by a foreign tax administration will not generally be available under domestic law **(see paragraphs 175 to 177)**.

***Deemed dividend***

57. Where a foreign tax administration considers that profits have been transferred to a company resident in Australia, for example where an excessive amount has been paid to an Australian resident company, and the foreign tax administration accordingly reduces the deduction claimed in that country for the excess (resulting in economic double tax), and also deems the excess to be a 'dividend' paid by the foreign company to the Australian resident company for its tax purposes, relief by way of a section 23AJ of the ITAA exemption for the 'deemed dividend' is not available **(see paragraphs 178 and 179)**.

***Double tax agreement applies***

58. The Associated Enterprises Article determines on an arm's length basis the profits of an enterprise which then may be taxed in accordance with the Business Profits Article. Most of Australia's DTAs have a provision which provides for a correlative adjustment to relieve any economic double taxation arising from an adjustment to profits of an enterprise under the Associated Enterprises Article, ie. a transfer pricing adjustment **(see paragraphs 180 and 181)**.

59. There are basically two types of provisions in Australia's DTAs specifically designed to provide relief from economic double taxation:

(a) credit provision - contained in the Methods for Elimination of Double Taxation Articles of DTAs; or

(b) appropriate adjustment provision - contained in the Associated Enterprises Articles of DTAs;

**(see paragraphs 182 to 184)**.

60. Relief under an economic double tax relief provision of a DTA will be available for transfer pricing adjustments made by a tax treaty partner country where the adjustment is in accordance with the DTA. The principles to be applied by the ATO in considering whether a correlative adjustment is to be made will be the same principles which the ATO applies when making a transfer pricing adjustment. These principles are outlined in Draft Taxation Ruling TR 95/D22. However, where an adjustment made under the domestic law of a tax treaty partner country is not in accordance with the relevant DTA, e.g., the adjustment goes beyond the scope of the Associated Enterprises Article, then the economic double tax relief provision in the DTA has no application. Double tax relief would not generally be available for such adjustments **(see paragraphs 185 and 186)**.

### *No economic double tax provision in DTA*

61. In the absence of a provision in a DTA specifically directed at the problem of economic double taxation, the ATO considers that the tax treaty partner countries are not under an obligation to avoid economic double taxation and, in those circumstances, the Mutual Agreement Procedure Article does not apply to assist in the resolution of economic double taxation cases. Australia's DTAs with Germany, Italy and Switzerland have no economic double tax provision **(see paragraphs 187 and 188)**.

### *Credit provisions*

62. Australia's DTAs with the United Kingdom, New Zealand (1972), Japan and Malaysia provide for a credit to relieve economic double taxation arising from a tax treaty partner country transfer pricing adjustment. These credit provisions are found in the Methods for Elimination of Double Taxation Articles and apply generally subject to the domestic laws of the tax treaty partner countries in relation to credits for foreign taxes. The provision deems the adjusted amount to have a foreign source and also deems the amount to be income of the Australian entity and provides that Australia is to give credit relief to the company resident in Australian for the extra tax

chargeable to the associated enterprise on the adjusted amount of profits **(see paragraphs 189 to 191)**.

63. The ATO considers that the credit provision of the DTA should be interpreted in a manner which deems all the threshold tests for an entitlement to a foreign tax credit under subsection 160AF(1) to be satisfied **(see paragraph 202)**.

64. Where a resident is entitled to a credit under subsection 160AF(1), a credit for the foreign tax paid by the associated enterprise is authorised to the extent of the amount of Australian tax payable on the deemed foreign income **(see paragraphs 198 to 200).**

*Losses*

65. Where the foreign associated company is still in a loss situation after a transfer pricing adjustment by a tax treaty partner country, no correlative adjustment can be made. There is no additional foreign tax or foreign income to give rise to a credit **(see paragraph 201)**.

66. Where the Australian resident company is in a loss situation but the foreign associated enterprise is in a profit situation and pays additional foreign tax as a result of a foreign transfer pricing adjustment, the correlative adjustment position will be governed by the domestic rules applicable to the carry forward and transfer of credits within a company group of credits for foreign taxes **(see paragraph 202)**.

*Adjustment for withholding taxes*

67. Where source country taxation would have been imposed by Australia in accordance with the relevant DTA on the adjusted profits, the amount of correlative adjustment credit will be reduced by the amount of withholding tax that would have applied if the dealings had been undertaken on an arm's length basis **(see paragraphs 203 and 204)**.

### *Appropriate adjustment provisions*

68. Australia's DTAs (other than those identified in paragraph 61 above which have no economic double tax relief provision and those in paragraph 62 above which have a 'credit provision') have what is known as an 'appropriate adjustment' provision to relieve economic double taxation resulting from a transfer pricing adjustment by a tax treaty partner country, e.g., Article 9(3) of the Vietnamese agreement **(see paragraph 205)**.

69. Appropriate adjustment provisions impose an obligation upon Australia to 'make an appropriate adjustment to the amount of tax charged' on profits of a resident taxpayer, where those profits have also been taxed by a tax treaty partner country in accordance with arm's length principles of the Associated Enterprises Article. A correlative adjustment will only be made where Australia agrees that the tax treaty partner adjustment is in accordance with the DTA **(see paragraphs 206 to 208)**.

*Secondary adjustment - withholding taxes*

70. Where source country taxing rights (e.g., interest or royalty withholding taxes) would have been exercised by Australia in accordance with the DTA if the dealings subject to the transfer pricing adjustment had been undertaken in accordance with arm's length principles, the 'appropriate adjustment to the amount of tax charged' will be calculated taking into account the amount of withholding taxes which would have otherwise been imposed, i.e., the amount of correlative adjustment will be reduced by the amount of withholding taxes which would have been payable. Where withholding taxes have actually been paid in relation to the adjusted profits, no reduction to the amount of correlative adjustment will be made **(see paragraphs 209 to 213)**.

*Losses*

71. 'Appropriate adjustment' provisions require the profits subject to the transfer pricing adjustment to have been 'charged to tax' in both Australia and the tax treaty partner country. Where no additional tax has been charged by the tax treaty partner country as a result of a transfer pricing adjustment, the 'appropriate adjustment' provisions (e.g., Article 9(3) of the Vietnamese agreement) have no application. Nor will the 'appropriate adjustment' provision apply where additional tax has been charged to the foreign associated company, but the Australian resident company is in a loss position **(see paragraphs 214 and 215)**.

***Mutual agreement procedure***

*Taxation not in accordance with DTA*

72. The Mutual Agreement Procedure Article in DTAs provide for a company to present its case to the competent authority of the country of which it is a resident where the action of that country or the tax treaty partner country or both countries result or will result for the

company in taxation not in accordance with the DTA **(see paragraphs 216 to 218)**.

73. The ATO considers that taxation not in accordance with a DTA results or will result for an Australian resident company taxpayer where economic double taxation would arise unless a correlative adjustment is made by the ATO in accordance with a provision of a DTA (e.g., Article 9(3) of the Vietnamese agreement). In this case the resident company taxpayer has a right to, and should, present its case to the Australian competent authority **(see paragraphs 219 to 222)**.

*Time limit for presentation of case*

74. Similar to the situation in relation to juridical double taxation (see paragraph 26 above), the first notification of the action giving rise to taxation not in accordance with the DTA for the purposes of the time limit (generally 3 years) within which taxpayers must present their case under a Mutual Agreement Procedure Article will be the assessment notice or similar notification of a tax liability provided by the tax treaty partner country to the foreign associated enterprise in relation to the transfer pricing adjustment **(see paragraph 223)**.

*When domestic time limits apply*

75. As explained in relation to juridical double taxation (paragraphs 27 to 29 above), domestic time limits are specifically overridden by the terms of the Mutual Agreement Procedure Articles in many of Australia's DTAs. However, the following DTAs do not operate in a manner which permits relief from economic double taxation at any time:

(a) the Malaysian agreement and the Irish agreement have special arrangements (see paragraph 27 above) and the Canadian agreement replaces the domestic time limits with a 6 year period (Articles 9(3) and (4) of the Canadian agreement);

(b) DTAs with Singapore, France, Belgium, Philippines, Thailand and Fiji do not specifically override time limits in the Mutual Agreement Procedure Article, but the terms of the 'appropriate adjustment' provision in these DTAs is capable of being interpreted in a manner which in effect overrides domestic time limits (subject to a reciprocal interpretation by the tax treaty partner country); and

(c) the 'credit provisions' in the DTAs with the United Kingdom, New Zealand (1972) and Japan are subject to domestic time limits;

**(see paragraphs 224 to 227)**.

*Requirements for presentation of case*

76. To present a case under the Mutual Agreement Procedure Article a taxpayer has to consider that the action of one or both of the tax treaty partner countries results or will result for that person (i.e., a company in the context of this Ruling) in taxation not in accordance with the DTA. Mutual Agreement Procedure Articles impose an obligation upon the competent authorities of the tax treaty partner countries to endeavour to resolve a case presented by a taxpayer where:

(a) the claim appears to be justified; and

(b) the competent authority of the country of resident is not able to arrive at an appropriate solution;

**(see paragraph 228)**.

77. For a claim to be considered justified by the ATO for the purposes of the Mutual Agreement Procedure Article, the action complained of needs to be directed specifically at the taxpayer **(see paragraph 229)**.

78. Actions which the ATO will regard as sufficient to place an obligation upon the competent authority to endeavour to resolve the case will include:

(a) advice in writing to the associated foreign enterprise from a tax treaty partner country proposing to tax that enterprise on profits; or

(b) an assessment or similar notification of an additional tax liability to the associated foreign enterprise in relation to profits;

where the Australian resident company taxpayer has been taxed on those profits in Australia **(see paragraphs 230 to 233)**.

79. In deciding whether or not a correlative adjustment is to be made by the ATO, or whether endeavours to resolve the case with the competent authority of the tax treaty partner country should be made, the Australian competent authority will form its own opinion as to whether taxation contrary to the particular DTA results or will result. A correlative adjustment to relieve double taxation arising out of a transfer pricing adjustment made by a tax treaty partner country will be made by the ATO if the Australian competent authority is satisfied that the adjustment is in accordance with the arm's length principles embodied in the relevant DTA and where mechanisms providing for relief are provided in the DTA (**see paragraphs 234 to 237)**.

*Year of adjustment*

80. Where a correlative adjustment is to be made by Australia, the adjustment will be made in relation to the year of income corresponding to that adjusted by the tax treaty partner country (subject to time limits as discussed in paragraph 75 above) **(see paragraph 238)**.

*Foreign domestic appeal rights*

81. The Mutual Agreement Procedure Articles provide a problem resolution process which is **in addition** to that which may be available to the Australian resident company taxpayer and the foreign associated enterprise under domestic law, e.g., objection, review or appeal rights both in Australia and the tax treaty partner country. Depending upon the circumstances of each case, the making of a correlative adjustment by the ATO to relieve economic double tax will be conditional upon either:

(a) the foreign associated enterprise having exhausted or rescinded its objection, review or appeal rights in the tax treaty partner country; or

(b) the foreign associated enterprise and the tax treaty partner country agreeing to advise the Australian competent authority should domestic objection, review or appeal rights be exercised in that country;

**(see paragraph 239)**.

82. However, in the latter scenario, the issue of an amended assessment or the providing of a credit for foreign taxes paid to give effect to an agreed correlative adjustment will be deferred until such time as the foreign appeal rights lapse or are subsequently rescinded or exhausted **(see paragraph 240)**.

*Competent authority communications*

83. Competent authority communications for economic double taxation cases will be the same as that outlined in paragraphs 39 and 40 above in relation to communications for juridical double taxation cases **(see paragraph 241)**.

*No resolution of case*

84. Where the Australian resident company:

(a) has not sought relief from economic double tax under a provision of the relevant DTA (i.e., either a 'credit' or 'appropriate adjustment' provision) and presented its case to the competent authority under the Mutual Agreement Procedure article of a relevant DTA; or

(b) where the competent authorities have failed to resolve the case with a view to avoiding the taxation contrary to the DTA;

the taxing by the other country of the profits of the associated foreign enterprise in relation to its dealings with the Australian resident company will, in the ATO's view, be in contravention of the DTA. In this case, the ATO is not obliged by the DTA to make a correlative adjustment and relief for economic double taxation will generally not be available under domestic law **(see paragraphs 242 and 243)**.

**Retrospective adjustment or repatriation**

85. The ATO is aware of a number of cases where Australian resident companies have sought to relieve economic double taxation by claiming deductions under subsection 51(1) for voluntary payments made some years after the dealings which have been subject to the transfer pricing adjustment by the other country were undertaken. A subsequent payment representing a retrospective variation to the purchase price of goods previously provided, which is made merely for the purposes of relieving economic double taxation, would, in the ATO's view, have a connection so tenuous with the derivation of assessable income so as to take it outside the range of relationships between expenditure and assessable income that would attract deductibility (*FC of T v. Manchester Unity IOOF* 94 ATC 4235 per French J at 4255). The ATO is therefore of the view that voluntary payments made in the circumstances and for the purposes outlined above are not deductible under subsection 51(1) of the ITAA **(see paragraphs 244 to 247)**.

86. In addition to such a payment not being considered an allowable deduction under subsection 51(1), such a payment may also be considered not to be in accordance with the arm's length principles embodied in Division 13 and the Associated Enterprises Article of the DTAs **(see paragraphs 248 and 249)**.

**Payment of interest on correlative adjustments**

87. 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) **(see paragraphs 250 to 252)**.

### *Payment of interest*

88. Generally, 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 income year and subsequent years **(see paragraph 253)**.

89. For years of income prior to the 1993/94 year credits for foreign taxes do not give rise to an overpayment of tax upon which interest is payable **(see paragraph 254)**.

90. For the 1985-86 to 1993-94 years of income, interest may be payable in certain circumstances where correlative relief is provided by way of an assessment, including an amended assessment. However, for years prior to the 1985-86 year, the payment of interest is limited to cases arising as a result of a successful objection, review or appeal and is payable only from 14 February 1983**(see paragraph 255)**.

91. All payments of interest on overpayments arising from the provision of correlative relief will be subject to the limitations outlined in paragraph 92 below and certain overpayments outlined in paragraph 93 below may not qualify for any interest **(see paragraph 256)**.

### *Limitations on amount of interest paid*

92. Where interest is payable on an overpayment of tax which have 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 lesser of:

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

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

(b) the amount of correlative relief being provided;

**(see paragraph 257)**.

***No interest payable***

93. Subsection 9(1A) and paragraph (b) of the definition of '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 **(see paragraphs 258 to 260)**.

# Explanations

94. International double taxation in a transfer pricing or profit allocation context may arise because:

(a) tax administrations of different countries reach different findings as to facts, e.g., what constitutes a arm's length price for a particular international transaction;

(b) of differences between the tax laws of the countries, e.g., different statutory methods for the calculation of an arm's length price for international related party dealings; or

(c) a combination of these factors.

95. The OECD has provided guidelines on transfer pricing methodologies and the operation of the Business Profits and Associated Enterprises Articles of the OECD Model, being the considered view of many tax experts familiar with transfer pricing and profit allocation. In relation to the application of Australia's domestic law and DTAs, it needs to be recognised that OECD Reports do not have as high a status in international law as an aid to interpretation as a document evidencing the intention of the Contracting States or the Commentary to the OECD Model Tax Convention. Nevertheless, the 1995 OECD Report is seen as an important, influential document that reflects agreement amongst member countries and should be followed where relevant and in the absence of any intention to the contrary in the domestic law or the DTAs.

96. In the context of this Ruling, two types of international double taxation are generally recognised:

(a) **juridical** double taxation - which occurs where the same income of a taxpayer (i.e., the one legal entity) is taxed by tax administrations in different countries. This may be considered to be the conventional form of double taxation. (See *Commissioner of Taxes v. Luttrell* [1949] NZLR 823 where Finlay J at 846 stated in relation to the meaning of double taxation: '[i]t does not mean that the same money

may not be taxed twice in the hands of different taxpayers. What it does mean is that the same person should not pay tax twice on the same money.'); and

(b) **economic** double taxation - which occurs where, for example, two companies (i.e., two separate legal entities) of the same group of companies or economic unit are each taxed on the same income by tax administrations in different countries. This type of double taxation has become more prevalent with an increase in the use of MNE groups, being an economic unit, undertaking global trade and investment.

97. Juridical double taxation generally arises, so far as concerns a DTA, in relation to the Business Profits Article (e.g., Article 7 of the Vietnamese agreement). Economic double taxation, on the other hand, generally arises in relation to the Associated Enterprises Article (e.g., Article 9 of the Vietnamese agreement).

**Juridical double taxation - resident taxpayer**

98. Many countries, including Australia and most other OECD member countries base the income tax liability of resident taxpayers on the worldwide income of the taxpayer. It is common practice for such countries under their domestic law to relieve juridical double taxation by providing either exemptions for foreign source income or by providing credits for foreign taxes paid. However, difficulties may arise in certain circumstances. In the context of transfer pricing and profit allocation difficulties are often experienced after a foreign tax administration examines, then adjusts, for tax purposes:

(a) a factual finding that a permanent establishment of an Australian resident company taxpayer exists in the foreign country (where the company has previously maintained that no permanent establishment exists);

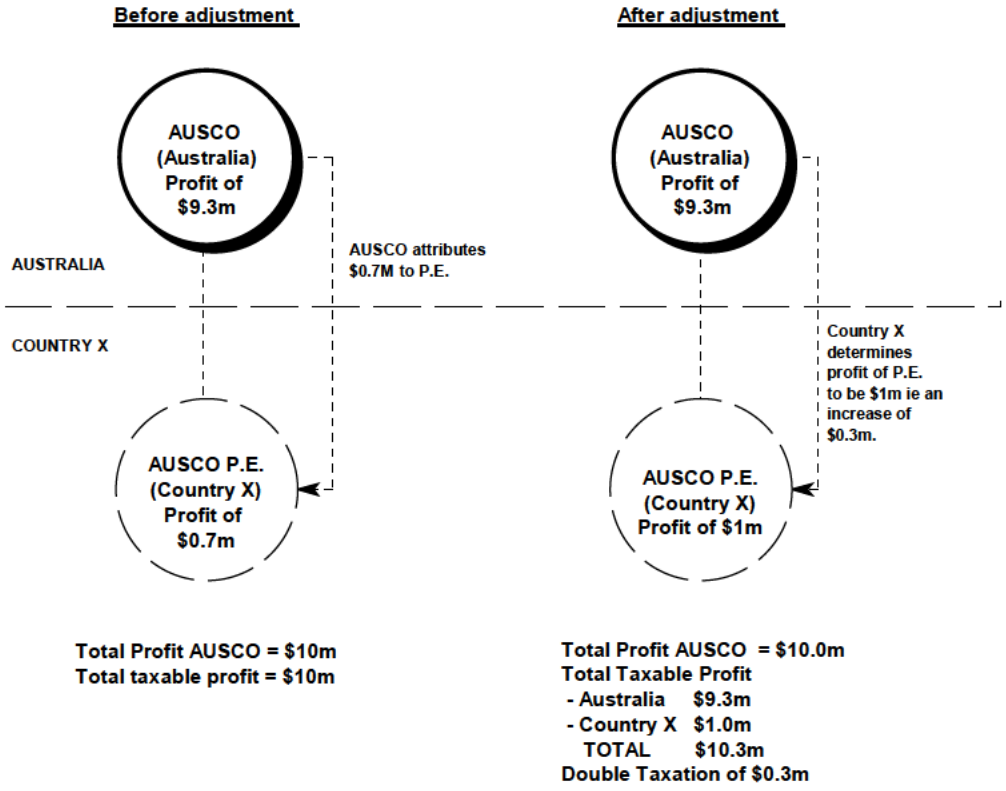
(b) the amount of income derived by the taxpayer which is considered to be attributable to the permanent establishment in the foreign country; or

(c) the source of the income derived by the taxpayer.

99. By way of example, an Australian resident company (Ausco) is taxed in Australia on its worldwide income. Ausco has a permanent establishment in country X (not a listed country for the purposes of Part X of the ITAA). Ausco lodges income tax returns in both Australia and country X, declaring a profit for tax purposes of $10 million, of which $0.7 million is attributable to its permanent establishment and sourced in country X. Assume that the tax

administration of country X then subjects Ausco's permanent establishment to an examination or audit, and determines that non-arm's length dealings between Ausco's Australian head office and its permanent establishment resulted in an understatement of the profit attributable to the permanent establishment. The tax administration of country X regards those profits to be from sources in country X. It concludes that profits of the permanent establishment should have been $1 million instead of $0.7 million. In this case, country X accordingly reallocates and additional $0.3 million of Ausco's profits to the permanent establishment (making a total of $1 million attributable to the permanent establishment) and imposes additional tax on Ausco.

***JURIDICAL DOUBLE TAXATION - RESIDENT TAXPAYER***




100. Juridical double taxation would result until such time as:

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

(b) the tax administration of country X is convinced that its adjustment is incorrect and withdraws its adjustment; or

(c) the two tax administrations reach some agreement between (a) and (b).

***No double tax agreement***

101. Where, as in the above example, the adjusting foreign country has no DTA with Australia, relief from double tax will not generally be available under our domestic law.

102. The income which has been subject to double taxation will not qualify for foreign tax credit relief under subsection 160AF(1) as it will not be foreign income as defined in subsection 6AB(1). Paragraph 27 of Taxation Ruling IT 2597 points out that subsection 6AB(1) provides that foreign income is income derived from sources in a foreign country or countries according to ordinary concepts of source of income. The mere fact that the tax administration of another country considers the income to have a source in its country does not alter the source of the income for Australian tax purposes according to ordinary concepts of source.

103. Similarly, the income which has been subject to double taxation will not qualify for exemption under section 23AH as it would not be foreign income for Australian tax purposes.

104. In the absence of a DTA between Australia and the adjusting country, the ATO will not be communicating with the foreign tax administration on the matter.

***Double tax agreement applies***

105. Where a reallocation of profit is made by the tax administration of a tax treaty partner country in accordance with the Business Profits Article of a relevant DTA (e.g., Article 7 of the Vietnamese agreement) mechanisms are provided which are designed to avoid or resolve any resultant juridical double taxation.

106. The generally accepted scheme of DTAs is the allocation of taxing rights between tax treaty partner countries in respect of business profits on the basis that the country of residence of a taxpayer retains the right to levy tax on the taxpayer's worldwide profits. A further taxing right is permitted to be exercised by the other country in certain circumstances, generally where the taxpayer carries on business through a permanent establishment in that other country.

107. Generally, Australia's DTAs permit the country in which the taxpayer carries on business through a permanent establishment to tax

the profits 'attributable to the permanent establishment' and deems those profits to have a source in that country. However, Australia's 1972 DTA with New Zealand (which applies up to the income year ended 30 June 1995) differs in that it applies what is known as a 'force of attraction' principle which permits New Zealand to tax the whole of the profits of the enterprise from sources within New Zealand whether or not those profits are attributable to the permanent establishment (see Article 5(1) of the 1972 New Zealand agreement).

108. Some of Australia's DTAs also permit the country of source to tax, in addition to profits attributable to a permanent establishment in that country, certain profits attributable:

(a) to the sales in that country of goods or merchandise of the same or similar kind as those sold through the permanent establishment; and

(b) to 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, Article 7, of Australia's DTAs with Fiji, India, Indonesia, Kiribati, Papua New Guinea, Philippines, Sri Lanka and Thailand.

109. It is only where the other country exercises the right to tax the profits of the taxpayer on a source basis in accordance with the Business Profits Article that the country of residence of the taxpayer is obliged to provide relief from the resultant double taxation. Relief from juridical double taxation is generally provided for in the Methods for Elimination of Double Taxation Article in DTAs (e.g., Article 23 of the Vietnamese agreement).

110. The mechanisms by which effect is given to the Methods for Elimination of Double Taxation Articles in DTAs consist of:

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

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

111. Ultimately the question of whether a correlative adjustment will be made by the ATO to relieve juridical double taxation arising from a profit reallocation will depend upon Australia agreeing with the

adjustment made by the tax treaty partner country. For the purposes of considering whether a correlative adjustment is to be made, the ATO will apply the same principles as it would apply when making an upward profit reallocation adjustment. Agreement will need to extend to the question of the existence of the permanent establishment and the calculation of the profits properly attributable to that permanent establishment (and any other profits which the DTA permits to be taxed on a source basis - refer paragraph 108 above).

112. The Business Profits Article of Australia's DTAs provides that '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...' (e.g., Article 7(2) of the Vietnamese agreement). That profit is then deemed to be sourced in the country where the permanent establishment exists. If both countries apply the same rules in determining the profit allocation and agree on the facts, the terms of this provision require the making of a correlative adjustment. However, neither country is bound to accept the other country's determination of the profit allocation.

113. The Mutual Agreement Procedure article in Australia's DTAs exists to facilitate agreement on these issues where there is taxation not in accordance with the relevant DTA, i.e., juridical double taxation.

### *Mutual agreement procedure*

114. Resident taxpayers generally become aware of the potential for juridical double taxation or taxation not in accordance with a relevant DTA when a tax treaty partner country proposes to:

(a) re-allocate profits (income or expenses) resulting in an increase in the amount of profits regarded by the tax administration of that country as being attributable to a permanent establishment in that country; or

(b) determine that a permanent establishment exists in that country and tax an amount of profits attributable to that permanent establishment where the taxpayer has previously had its tax obligations determined on the basis that no permanent establishment existed in that country.

115. Where a correlative adjustment is sought, resident taxpayers should present their case under the Mutual Agreement Procedure Article of the relevant DTA to the Australian competent authority. Mutual Agreement Procedure Articles generally provide for the taxpayer to present its case to the competent authority of the country in which they are resident, where taxation not in accordance with the DTA has resulted or is likely to result from the action of one or both of

the tax treaty partner countries concerned, e.g., Article 24 of the Vietnamese agreement. The DTA with the United Kingdom provides that a case may be presented to the competent authority of either country. The address of the Australian competent authority is:

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

*Tax not in accordance with DTA*

116. The Mutual Agreement Procedure Article generally requires that the taxpayer consider that the action of one or both of the countries concerned '...result or will result for the person in taxation not in accordance with this Agreement...' (Article 24(1) of the Vietnamese agreement). Double taxation is not necessary for there to be considered 'taxation not in accordance' with a DTA. However, several of Australia's DTAs limit the application of the Mutual Agreement Procedure Article to double taxation cases, e.g., the agreements with United States (1953), New Zealand (1972), Singapore and Japan.

117. It should also be noted that the Mutual Agreement Procedure Article may apply to cases other than double tax cases arising from a transfer pricing or profit reallocation adjustment, e.g., source country taxation of dependent personal services in contravention of the Dependent Personal Services Article of the relevant DTA. This Ruling, however, only addresses the operation of the Mutual Agreement Procedure Article in relation to 'taxation not in accordance' with a DTA as a result of a transfer pricing or profit reallocation adjustment.

*Time limit for presentation of case*

118. Mutual Agreement Procedure Articles in DTAs generally provide that the taxpayer must present its case to the competent authority within 3 years from the first notification of the action giving rise to taxation not in accordance with the DTA (e.g., last sentence of Article 24(1) of the Vietnamese agreement).

119. For the purposes of applying this time limit to a resident taxpayer subject to a profit reallocation adjustment by a country with which a DTA has been concluded, the first notification of the action giving rise to taxation not in accordance with the DTA will be the assessment notice or similar notification of a tax liability from that tax administration which relates to the adjustment to the profits attributed to the permanent establishment in that country. However, the taxpayer

may present its case prior to this stage (refer paragraphs 128 to 133 below).

*When domestic time limits apply*

120. As a general principle, normal domestic law time limits apply to the provision of relief from double taxation unless those limits are specifically overridden by the terms of a relevant DTA. Most of Australia's DTAs include such a provision in the Mutual Agreement Procedure Article, e.g., the last sentence in Article 24(2) of the Vietnamese agreement which states that '[t]he 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 Mutual Agreement Procedure Article, that the mere expiration of domestic time limits does not preclude relief from being granted. Note that the Malaysian agreement specifically overrides domestic time limits only where the case is presented to the competent authority within 6 years of the tax year in question. The Irish agreement does not generally override domestic time limits, but sets a specific limit of 7 years from presentation of the case to the competent authority.

121. Specific time limits in DTAs override domestic time limits because of the operation of subsection 4(2) of the Agreements Act which, in this instance, gives precedence to provisions of the Agreements Act (including the DTAs) notwithstanding anything inconsistent in the ITAA.

122. DTAs which do not have a provision specifically overriding domestic time limits are those with the United Kingdom, United States (1953), Canada, New Zealand (1972), Singapore, Japan, Germany, France, Belgium, Philippines, Switzerland, Italy, Thailand and Fiji.

123. For those DTAs which do not override the domestic time limits, the statutory time limits applicable under the ITAA apply:

(a) time limits in section 170 of the ITAA will apply where a correlative adjustment is to be provided by an amended assessment, e.g., to increase the amount of income exempt under section 23AH; and

(b) time limits in Division 19 (e.g., subsection 160AK(2)) of the ITAA will apply where a correlative adjustment is to be provided by a foreign tax credit.

124. Where a correlative adjustment is to be provided by an amended assessment, subsection 170(9B) may apply which 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'.

125. 'Relevant provision' is defined in subsection 170(14) as paragraph (3) of Article 5 of the United Kingdom agreement or a provision of any other DTA that corresponds with this paragraph. Article 5(3) of the United Kingdom agreement is the Business Profits Article provision which governs the calculation in each state of the profits attributable to a permanent establishment and states:

> 'Where an enterprise of one of the territories carries on trade or business in the other territory through a permanent establishment situated therein, there shall be attributed to that permanent establishment the industrial or commercial profits which it might be expected to derive in that other territory if it were an independent enterprise engaged in the same or similar activities and its dealings, with the enterprise of which it is a permanent establishment were dealings at arm's length with that enterprise or an independent enterprise; and the profits so attributed shall be deemed to be income derived from sources in that other territory.'

126. As this provision may be used for both increasing a taxpayer's liability to tax in the country in which the permanent establishment exits and for providing a correlative adjustment to relieve juridical double tax by the taxpayer's country of residence (refer paragraph 112 above) it would permit, in the ATO's view, an amendment at any time to allow correlative relief from juridical double taxation which is effected through an amended assessment.

127. Note that subsection 170(9C) limits the application of subsection 170(9B) in the circumstances outlined above to situations where DTA provisions corresponding to Article 5(3) of the United Kingdom agreement have not previously been applied to the same subject matter in making an assessment or amending an assessment in relation to the year of income.

*Requirements for presentation of case*

128. The Commentary to the Mutual Agreement Procedure (Article 25) of the OECD Model Tax Convention outlines two stages of the procedure. The first stage relates to the presentation of a case by the taxpayer to the competent authority of the country of which they are resident where the conditions outlined in paragraph (1) of Article 25 are satisfied. These conditions are where a resident considers that the action of one or both of the tax treaty partner countries result or will result for that person (i.e., company in the context of this Ruling) in taxation not in accordance with the DTA. This first stage continues with the competent authority considering under paragraph (2)of Article 25:

(a) whether the claim appears to be justified; and

(b) whether the competent authority is able to arrive at an appropriate solution.

129. For a claim to be considered justified for the purposes of paragraphs (1) and (2) of Article 25 the action complained of needs to be directed specifically at the taxpayer.

130. Actions directed specifically at a taxpayer which are considered by the ATO to result or likely to result in taxation not in accordance with an agreement will include:

(a) advice in writing from a tax treaty partner country to a taxpayer that they are proposing to tax the taxpayer on a basis different to that upon which the taxpayer has been taxed in Australia, including details about the amount of profits to be attributed to a permanent establishment in that other country and the basis upon which such a calculation has been made; or

(b) an assessment or similar notification of a tax liability indicating that the taxpayer has been taxed, in relation to its permanent establishment in the tax treaty partner country, on a basis different to that upon which it has been taxed in Australia.

131. Actions which are not considered to justify competent authority resolution include;

(a) the existence of an audit or an examination of the taxpayer's activities in a tax treaty partner country;

(b) requests from a tax treaty partner country for information about the taxpayer's activities carried on in the that country; or

(c) discussions with a tax treaty partner country about the amount and source of profits considered attributable to the permanent establishment and whether an amount is in accordance with the Business Profits Article.

132. However, such actions may in time develop to a stage which would justify competent authority consideration. Action of the tax treaty partner country which results or will result for the person in taxation not in accordance with the DTA must be more than a mere possibility - it needs to be more probable than not - to warrant competent authority consideration.

133. When presenting a case to the competent authority, a taxpayer should provide the following information:

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

(b) full details of the action relied upon, including identification of the tax treaty partner country involved, how the action affects the taxpayer's liability to tax, what is the taxation not in accordance with the relevant DTA; and

(c) how the taxpayer wants the problem resolved, including the provisions of the domestic tax law and the DTA which would effect resolution.

134. The second stage of the Mutual Agreement Procedure, as recognised in the Commentary to the OECD Model Tax Convention, involves the competent authority endeavouring to resolve the case with the competent authority of the tax treaty partner country where the taxation complained of is due wholly or in part to measures taken in the other country.

135. In deciding whether or not a correlative adjustment is to be made by the ATO, or whether endeavours to resolve the case with the competent authority of the tax treaty partner country should be made, the Australian competent authority will form its own opinion as to whether taxation contrary to the particular DTA results or will result. A correlative adjustment to relieve double taxation arising out of a transfer pricing or profit reallocation adjustment made by a tax treaty partner country will only be made by the ATO if the Australian competent authority is satisfied that the adjustment is in accordance with the relevant DTA and where mechanisms providing for relief are available, either under the relevant DTA or domestic law.

136. Where a tax treaty partner country makes a transfer pricing or profit reallocation adjustment contrary to the principles in the relevant DTA, it can be expected that the Australian competent authority will correspond and exchange information with the tax treaty partner country to try and resolve the case by reaching a mutual understanding as to principles embodied in the DTA and how they apply to the facts of a particular case.

137. A tax treaty partner country ruling or policy of a general nature which the taxpayer believes could be applied to them and, if so, may result in taxation not in accordance with the agreement would not be sufficient to warrant competent authority consideration under these paragraphs (i.e., paragraphs (1) and (2)of the Mutual Agreement Procedure Article).

138. However, such items of a general nature may be brought to the attention of the competent authority who may decide to endeavour to resolve any difficulties or doubts about the application of the agreement with the competent authority of the tax treaty partner country under paragraph (3) of the Mutual Agreement Procedure Article. Such a resolution will usually be of general application and not related to any particular taxpayer.

*Year of adjustment*

139. Where a correlative adjustment is to be made by Australia, the adjustment will be made in relation to the year of income corresponding to that adjusted by the tax treaty partner country. For example, an adjustment is made by a tax treaty partner country to increase the profits considered attributable to a permanent establishment in that country during the year ended 31 December 1992. Appropriate relief will be provided to the taxpayer in its Australian income tax assessments for the years ended 30 June 1992 and 1993 (assuming the taxpayer does not have a substituted accounting period). The provision of relief is, of course, subject to time limits as discussed in paragraphs 120 to 127 above.

*Foreign domestic appeal rights*

140. The Mutual Agreement Procedure Articles provide a problem resolution process which is **in addition** to that which may be available to a taxpayer under domestic law, e.g., objection, review and appeal rights both in the tax treaty partner country and the country of residence. Depending upon the circumstances of each case, the making of a correlative adjustment by Australia will be conditional upon either:

(a) the taxpayer having exhausted or rescinded its objection, review and appeal rights in the tax treaty partner country; or

(b) the taxpayer and the tax treaty partner country agreeing to advise the Australian competent authority should domestic appeal rights be exercised in that country.

141. However, in the latter scenario, the issue of an amended assessment or a credit for foreign taxes paid will be deferred until such time as the foreign appeal rights have lapsed or are subsequently rescinded or exhausted.

142. The successful exercise of domestic review processes in the tax treaty partner country may result in there no longer being taxation which is contrary to the DTA. It would be inappropriate for a taxpayer

to obtain correlative relief in Australia and also to proceed with litigation against the tax treaty partner country adjustment for which correlative relief has been granted.

*Competent authority communications*

143. The Australian competent authority will advise by correspondence the competent authority of the relevant tax treaty partner country when it accepts a case presented by a resident taxpayer. In processing cases under the Mutual Agreement Procedure Article, communications between the competent authorities will usually be through the exchange of position papers. Information provided by the resident taxpayer will be taken into account in the preparation of Australian position papers and consideration of position papers from the other competent authority.

144. 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. Taxpayers do not have a right to be present at such negotiations between competent authorities. However, where both competent authorities agree, taxpayers may be allowed to present their case to the competent authorities jointly. In the event of the competent authority of a tax treaty partner country not agreeing to a joint presentation, the taxpayer will nevertheless have an opportunity to present its case to the Australian competent authority.

145. The Australian competent authority will endeavour to ensure 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 either by correspondence or telephone contact.

146. Exchanges of information between competent authorities will be undertaken pursuant to the Exchange of Information Article of the relevant DTA (e.g., Article 25 of the Vietnamese agreement) and subject to the secrecy provisions of that Article.

*No resolution of case*

147. Where an Australian resident company:

(a) has not presented its case to the Australian competent authority under the Mutual Agreement Procedure article of a relevant DTA; or

(b) where the competent authorities have failed to resolve the case with a view to avoiding the taxation contrary to the DTA;

the taxing by the other country of the profits of the Australian resident company will, in the view of the ATO, be in contravention of the DTA. In this case, Australia is not obliged by the DTA to make a correlative adjustment and double tax relief may not be available under domestic law.

***Domestic law***

148. Where a tax treaty partner country has taxed profits of a company resident in Australia contrary, in the view of the ATO, to the relevant DTA, relief from any resultant double taxation will not be available under the DTA or the ITAA.

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

149. Income tax imposed by a tax treaty partner country in contravention of a Business Profits article of a DTA would not qualify for a credit under the provisions of Division 18 of the ITAA, as it would not be foreign tax paid in respect of foreign income.

150. This is because a taxpayer's entitlement to a credit for foreign taxes paid arises under subsection 160AF(1) of the ITAA. Paragraph 160AF(1)(a) requires that the assessable income of a resident taxpayer include foreign income.

151. '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' is to be normally interpreted according to ordinary concepts of source of income. The provisions in DTAs which deem a foreign source (i.e., a source in the tax treaty partner country) for profits attributable to a permanent establishment in the other country do not apply in these circumstances as the profits are not considered by Australia to be properly attributable to the permanent establishment in the foreign country.

152. Paragraph 160AF(1)(b) requires that the taxpayer must have paid the foreign tax in respect of the foreign income, being tax for which the taxpayer was personally liable. The foreign tax cannot be in respect of foreign income if the income does not have a foreign source.

153. This approach is reflected in paragraphs 32 to 41 of Taxation Ruling IT 2527. Those paragraphs generally specify that a foreign tax

credit will only be allowed under the foreign tax credit system in the case of income derived by a resident taxpayer from a tax treaty partner country to the extent of the relevant limit (where applicable) on the rate of tax that the treaty partner is entitled to impose under the relevant DTA. No tax is entitled to be imposed under a relevant DTA in respect of business profits unless the profits are attributable to a permanent establishment in that country (except for the DTAs identified in paragraph 108 above which extend source country taxing rights to certain profits similar to those attributable to a permanent establishment).

154. The foreign source income deeming provisions in the DTAs (e.g., Article 22(2) of the Vietnamese agreement) which, by reason of subsection 4(2) of the Agreements Act, have precedence over the ITAA will not apply where the tax treaty partner country is exercising a taxing right in contravention of the DTA. Therefore, where in the view of the ATO a tax treaty partner country imposes tax in contravention of a DTA, the question of Australia being obliged by its domestic law provisions to provide a credit for foreign taxes paid only arises where the income has a foreign source under ordinary concepts.

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

155. For the year ended 30 June 1991 and subsequent years, section 23AH of the ITAA provides that resident companies with certain foreign branch income derived from foreign sources became entitled to an exemption from tax on that income instead of a credit for foreign taxes. Basically, subsection 23AH(2) exempts foreign branch income of a resident company where:

(a) the taxpayer derives assessable income from sources in a foreign country (other than capital gains and losses) in carrying on a business in a listed country at or through a permanent establishment of the taxpayer in the listed country;

(b) the foreign income is not eligible designated concession income in relation to a listed country, i.e., within the meaning in Part X, i.e., generally income that is not taxed or is taxed at reduced rates; and

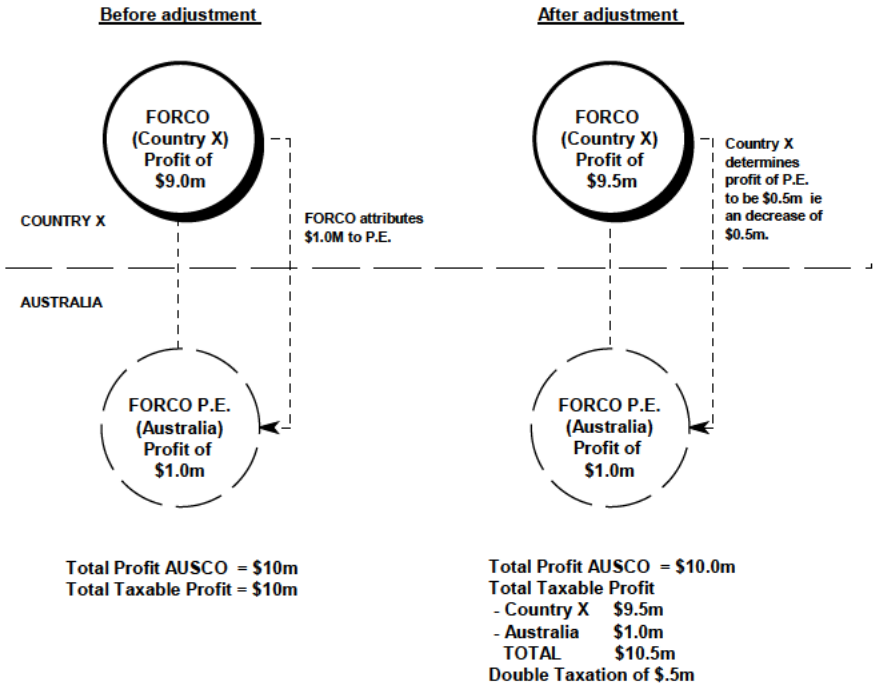
(c) the foreign income is subject to tax in the listed country.

156. Income tax imposed by a tax treaty partner country in contravention of a Business Profits Article of a DTA would not qualify as exempt foreign branch income under section 23AH of the ITAA for similar reasons to those explained in relation to the foreign tax credit system (see paragraphs 149 to 154 above).

### Juridical double taxation - non-resident taxpayer

157. Juridical double taxation may occur where a non-resident taxpayer with a permanent establishment in Australia is subject to an adjustment by a foreign tax authority. An example would be where a foreign company (Forco) is resident in country X, lodges tax returns in both countries and declares a profit 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 dealings between the foreign head office and the Australian permanent establishment resulted in an overstatement of the profit attributable to the permanent establishment. 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).

***JURIDICAL DOUBLE TAXATION - NONRESIDENT TAXPAYER***




158. Juridical double taxation will result until such time as:

(a) the ATO agrees that the profit of the permanent establishment should have been $0.5 million and reduces

the Australian sourced profit of the taxpayer from $1 million to $0.5 million;

(b) the tax administration of country X is convinced that its adjustment is incorrect and withdraws its adjustment; or

(c) the two tax administrations reach some agreement between (a) and (b).

***No double tax agreement***

159. The income of a non-resident taxpayer derived from sources in Australia for Australian tax purposes is not affected by a foreign tax administration merely reducing the amount of income it regards as attributable to a permanent establishment in Australia or sourced in Australia. A correlative adjustment to relieve juridical double taxation arising for a foreign profit reallocation adjustment is therefore not available. Australian law will be applied in determining the amount of the taxable income for the purposes of the ITAA of a non-resident company derived from sources in Australia, ie. when calculating assessable income derived from sources in Australia and allowable deductions.

***Double tax agreement applies***

160. For a general discussion of mechanisms provided in DTAs which are designed to avoid juridical double taxation arising out of a profit reallocation adjustment made by a tax administration of a tax treaty partner country in accordance with the Business Profits Article of a relevant DTA (e.g., Article 7 of the Vietnamese agreement) see paragraphs 105 and 109 above.

161. The question of whether a correlative adjustment will be made by the ATO to relieve juridical double taxation arising from a profit reallocation adjustment by a tax treaty partner country, being the country of residence of the taxpayer, will depend upon the ATO agreeing with the adjustment. Where the ATO agrees with a profit reallocation adjustment which decreases the profits attributable to a permanent establishment in Australia of the non-resident taxpayer, the Business Profits Article of a relevant DTA will operate to reduce the taxpayer's taxable income.

162. This reduction in taxable income is achieved , for example in relation to Articles 7 and 22 of the Vietnamese agreement (the Business Profits and Source of Income articles), by a decrease in the profits attributable to a permanent establishment in Australia and derived from sources in Australia. Depending upon the circumstances of the 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. Subsection 3(2) of the Agreement Act provides for references in agreements to profits of an activity or business to be read, where the context so permits, as a reference to taxable income derived from that activity or business for the purposes of the Agreements Act and the ITAA. This provision recognises that, in Australia, tax is levied on taxable income not profits. The reduction in taxable income of the non-resident taxpayer correlates to the increase in profits considered to have been derived from non-Australian sources by the tax treaty partner country.

***Mutual agreement procedure***

163. Non-resident taxpayers generally become aware of the potential for juridical double taxation or taxation not in accordance with a relevant DTA when a tax treaty partner country proposes to:

(a) reduce the amount of profits considered attributable to the permanent establishment in Australia and accordingly reduce credits or deductions for Australian taxes paid on those profits or, if an exemption country, reduce the amount of exempt profits; or

(b) determine that no permanent establishment exists in Australia and accordingly reduces credits or deductions for Australian taxes paid on profits or, if an exemption country, reduces the amount of exempt profits, previously considered to be attributable to a permanent establishment in Australia.

164. A request for competent authority assistance under the Mutual Agreement Procedure article should, in the first instance, be made to the country of residence of the taxpayer (except for the United Kingdom agreement which provides for the request to be made to the competent authority of either country). If the competent authority of the adjusting country confirms that the adjustment is in accordance with the DTA and considers that the taxpayer's case has merit, that competent authority will make representations to the Australian competent authority for a correlative adjustment.

*Presentation of case*

165. For all DTAs, a company taxpayer will be required to present its case to the competent authority of the country of which they are a resident (except for the United Kingdom agreement which permits the taxpayer to present its case to either competent authority). The Australian competent authority will be advised in due course by the competent authority of the tax treaty partner country should the case require endeavours for mutual resolution. To assist the resolution of cases in the quickest possible time frame, taxpayers are requested to

provide to the Australian competent authority with details of cases presented to foreign competent authorities which are likely to require a correlative adjustment by Australia. The provision of these details will also ensure that the Australian competent authority is satisfied that the case has been presented within the time periods permitted in the Mutual Agreement Procedure Article of the relevant DTA.

*When domestic time limits apply*

166. Refer paragraphs 120 and 121 above for an explanation of when DTAs override domestic time limits and when they do not. A correlative adjustment for a non-resident taxpayer will be effected by an amended assessment to reflect a reduction in the taxable income of the taxpayer. In turn, this reduction in taxable income may arise from a reduction in assessable income derived from Australian sources or an increase in allowable deductions. Where the relevant DTA overrides domestic time limits, this amended assessment may be made at any time. Where the relevant DTA does not override domestic time limits (see paragraph 122 above), section 170 will apply to limit the time within which an assessment may be amended (except where the DTA itself provides a time limit - see paragraphs 120 and 123 to 127 above). An amendment may be made at any time for cases falling for consideration under subsection 170(9B).

*Year of adjustment*

167. Where Australia is to make a correlative adjustment, the adjustment will be made by amending the taxpayer's assessment for the year of income corresponding to that adjusted by the tax treaty partner country (similar to situation for resident taxpayers - see paragraph 139 above).

*Foreign domestic appeal rights*

168. The situation in relation to the provision of a correlative adjustment and domestic appeal rights in the tax treaty partner country for non-resident taxpayers is the same as that applying for resident taxpayers - see paragraphs 140 to 142 above).

*Competent authority communications*

169. After the Australian competent authority receives advice from the competent authority of the country of which the taxpayer is a resident communications between competent authorities will generally be by exchange of position papers as outlined in paragraphs 143 to 144 above.

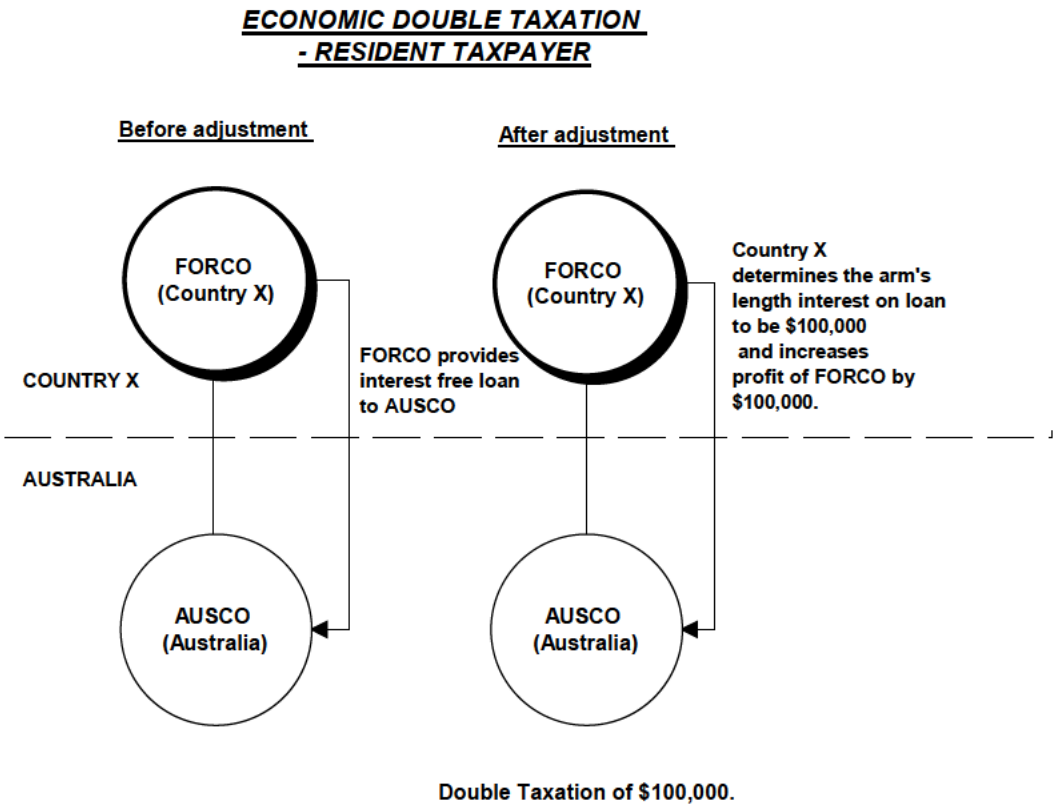
170. The principles outlined in paragraphs 145 and 146 above in relation to competent authority communications for resolution of cases presented by resident taxpayers will apply equally for cases presented by non-resident taxpayers to a tax treaty partner country competent authority (or in the case of the United Kingdom agreement, to the Australian competent authority).

**Economic double taxation**

171. Most OECD member countries (including Australia) and other countries base the income tax liability of their resident taxpayers on their worldwide income. Profits may be shifted out of a company resident in one country to an entity in another country through transfer pricing or other non-arm's length dealings.

172. These non-arm's length dealings are generally undertaken within a MNE group. Most countries have a mechanism in their domestic law by which to ensure that profits may be adjusted for tax purposes to those that would have been derived on an arm's length basis, e.g., Division 13 of Part III of the ITAA. Economic double taxation may arise within a MNE group where a foreign tax administration, for tax purposes, upwardly adjusts the profits of an enterprise resident in that country as a result of transfer pricing or non-arm's length dealings with an associated company resident in Australia.

173. By way of example, Forco is a company resident in country X and provides an interest free loan for business purposes 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 Austco were dealing on an arm's length basis, Ausco would have paid Forco $100,000 interest on the loan.




174. Economic double taxation would arise until such time as either:

(a) the ATO agrees that $100,000 reflects an arm's length rate of interest and allows a deduction for this 'notional' expense to Ausco;

(b) the tax administration of country X is convinced that its adjustment is incorrect and withdraws its adjustment; or

(c) some agreement between (a) and (b) is reached between the two tax administrations.

### *No double tax agreement*

175. Relief for economic double tax arising from a foreign tax administration transfer pricing adjustment will not generally be available under domestic law. There are no provisions under our domestic tax law which permits either:

(a) a deduction to be allowed where no expenditure has been incurred; or

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

merely because the profits of a related entity have been increased by a foreign tax administration which results in economic double taxation.

176. The question of whether income has been derived and its source are questions of fact and law.

177. The foreign tax credit system does not provide for relief from economic double taxation because the tests in paragraphs 160AF(1)(a) and (b) are not satisfied. That is, the Australian entity has not paid foreign tax, for which it is personally liable, in respect of foreign income which has been included in its assessable income.

### *Deemed dividend*

178. Where a foreign tax administration considers that profits have been transferred to an company resident in Australia, for example by paying an excessive amount to an Australian resident, and accordingly reduces the deduction claimed in that country for the excess (resulting in economic double tax), and also deems the excess to be a 'dividend' paid by the foreign company to the Australian resident company for its tax purposes, relief by way of a section 23AJ of the ITAA exemption for the 'deemed dividend' is not available.

179. The section 23AJ exemption only applies to dividends for the purposes of the domestic law, i.e., section 6. This means that a section 23AJ exemption cannot be claimed for income received by a resident which was a 'deemed dividend' by a comparable tax country.

### *Double tax agreement applies*

180. All of Australia's DTAs have an Associated Enterprises Article which operates where non-arm's length dealings between associated enterprises have resulted in profits being shifted out of a tax treaty partner country. The Associated Enterprises Article determines on an arm's length basis the profits of an enterprise which may then be taxed in accordance with the Business Profits Article.

181. Most of Australia's DTAs have a provision which provides for a correlative adjustment to relieve any economic double taxation arising from an adjustment to profits of an enterprise under the Associated Enterprises Article.

182. There are basically two types of provisions in Australia's DTAs specifically designed to provide relief from economic double taxation:

(a) credit provision - contained in the Methods for Elimination of Double Taxation Articles of DTAs and generally provides for relief from economic double taxation to be provided by way of a credit to the Australian resident company for additional tax paid by the associated

foreign company as a result of a transfer pricing adjustment by the tax treaty partner country; or

(b) appropriate adjustment provision - contained in the Associated Enterprises Articles of DTAs and generally provides for an 'appropriate adjustment to the amount of tax charged' to be made by Australia where a tax treaty partner country makes a transfer pricing adjustment to an associated foreign enterprise.

183. Both types of economic double tax relief provisions are limited in application to adjustments which are made in accordance with the relevant DTA, i.e., the arm's length principle as set out in the Associated Enterprises Article. Ultimately, the question of whether a correlative adjustment will be made by the ATO to relieve economic double taxation arising from a transfer pricing adjustment will depend upon Australia agreeing with the adjustment made by the tax treaty partner country. The principles to be applied by the ATO for this purpose will be the same as those which the ATO applies when making a transfer pricing adjustment. These principles are outlined in Draft Taxation Ruling TR 95/D22 entitled 'Income tax: using arm's length transfer pricing methodologies in international dealings between associated enterprises'.

184. The Mutual Agreement Procedure Article in those DTAs which include an economic double tax relief provision exists to facilitate agreement between tax treaty partner countries on the application of the Associated Enterprises Article in transfer pricing adjustment cases. The operation of the Mutual Agreement Procedure Article in this context is discussed at paragraphs 216 to 243 below.

185. Relief under an economic double tax relief provision of a DTA will be available for a transfer pricing adjustment where the adjustment is in accordance with the DTA. However, where an adjustment under the domestic law of a tax treaty partner country is not in accordance with the relevant DTA, e.g., the adjustment goes beyond the scope of the Associated Enterprises Article, then the economic double tax relief provision in the DTA has no application. Double tax relief would not generally be available for such adjustments.

186. Some of the economic double tax relief provisions in Associated Enterprises Articles specifically refer to adjustments made 'according to the provisions of paragraph (1)' (Article 9(3) of the Finnish agreement) and 'by virtue of paragraph (1)' (Article 9(2) of the United States agreement). It is arguable that this limitation would mean that economic double tax relief may not be available for a transfer pricing adjustment made under other paragraphs of the Associated Enterprises Articles which permit in certain circumstances recourse to domestic

law, i.e., Article 9(2) of the Finnish agreement and Article 9(3) of the United States agreement. It is our view that a transfer pricing adjustment made after recourse to domestic law as permitted by the relevant DTA would, nevertheless, be an adjustment in accordance with paragraph 1, providing it does not go beyond the scope of paragraph 1. This means that paragraph 2 will still be applicable to enable relief to be granted where arm's length principles have been applied by the tax treaty partner country when making a transfer pricing adjustment.

### *No economic double tax provision in DTA*

187. In the absence of a provision in a DTA specifically directed at the problem of economic double taxation (e.g., Article 9(3) of the Vietnamese agreement, and Article 9(2) of the OECD Model Double Tax Convention), the view is taken that the tax treaty partner countries are not under an obligation to avoid economic double taxation and, in those circumstances, the Mutual Agreement Procedure Article does not apply to assist in the resolution of economic double taxation cases.

188. Australia's DTAs which do not have a provision specifically directed at economic double taxation are those with Germany, Switzerland and Italy.

### *Credit provisions*

189. Some of Australia's DTAs provide for a credit to relieve economic double taxation arising from a tax treaty partner country transfer pricing adjustment. These provisions may be found in Article 19(4) of the United Kingdom agreement; Article 18(4) of the 1972 New Zealand agreement; Article 17(4) of the Japanese agreement; and Article 23(4) of the Malaysian agreement.

190. Where one of the above four countries makes a transfer pricing adjustment in accordance with the Associated Enterprises Article of the relevant DTA, these provisions provide that Australia is to give credit relief in accordance with the article to the related Australian entity for the extra tax chargeable on the adjusted amount of profits. For the purpose of giving this credit relief, the adjusted amount is deemed to have a foreign source and is also deemed to be income of the Australian entity.

191. The credit articles (the Methods for Elimination of Double Taxation Articles) in which these provisions are located apply generally subject to the domestic laws of the tax treaty partner countries in relation to credits for foreign taxes (e.g., Article 19(2)(a) of the United Kingdom agreement). The deeming of the adjusted

amount to be foreign source income of the Australian entity is therefore important to ensure the conditions necessary for the allowance of a foreign tax credit under the domestic foreign tax credit provisions in Division 18 are satisfied.

192. In particular, the entitlement to a credit for foreign taxes under subsection 160AF(1) depends upon the resident taxpayer's assessable income including foreign income for the year of income (paragraph 160AF(1)(a)) and the payment of foreign tax in respect of the foreign income (paragraph 160AF(1)(b)). However, neither the DTA economic double tax relief provision nor subsection 6AB(3) of the ITAA 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 - both being further requirements to satisfy paragraph 160AF(1)(b). Nevertheless, it is our view that the DTA should be interpreted in a manner which deems the threshold tests for an entitlement to a foreign tax credit under subsection 160AF(1) to be satisfied.

193. Such an interpretation would be consistent with McHugh's J comments in *Thiel v. Federal Commissioner of Taxation* 90 ATC 4717 at 4727 where it was stated that DTAs are treaties and are to be 'interpreted in accordance with the rules of interpretation recognised by international lawyers: *Shipping Corporation of India Ltd v. Gamlen Chemical Co (A/Asia) Pty Ltd* (1980) 147 CLR 142 at 159'. McHugh J goes on to explain that those rules are codified in the Vienna Convention on the Law of Treaties to which Australia is a party. Article 31 of the Vienna Convention requires that a treaty be interpreted 'in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose'. Article 31(2) of the Vienna Convention permits recourse to be had to supplementary means of interpretation where an interpretation according to Article 31 leaves its meaning obscure or ambiguous or leads to a result which is manifestly absurd or unreasonable. It is obvious that the object and purpose of provisions such as Article 19(4) of the United Kingdom agreement is to effectively provide a credit to relieve economic double taxation.

194. This interpretation would also be consistent with the discussion in 1968 in CITCM 864 (Canberra Income Tax Circular Memorandum No 864) on Article 19(2) of the United Kingdom agreement. In CITCM 864 at paragraph 339, it is explained that Article 19(2) 'provides for the allowance against Australian tax of credit for United Kingdom tax on income from sources in the United Kingdom'. Paragraph 340 indicates that the amount of credit is to be calculated in accordance with the Agreements Act and the ITAA. It goes on to state that '[t]hese provisions do not affect the general principle of allowance of credit for United Kingdom tax', i.e., that the domestic laws must

operate in a way which gives effect to the general principle, which is the provision of relief from economic double tax. Article 19(4) links in with other paragraphs of Article 19 by providing that 'relief shall be given in accordance with this Article'.

195. In summary, this means that relief in accordance with Article 19(4) of the United Kingdom agreement will generally be achieved through the domestic foreign tax credit system, but not in such a way which would defeat the spirit and objective of Article 19(4), i.e., to relieve economic double taxation.

196. Prior to the introduction of the foreign tax credit system in the 1987/88 income year, Australia would give effect to Article 19(4) of the United Kingdom agreement by providing an exemption under paragraph 23(q) of the ITAA instead of a credit. Refer to paragraph 354 of CITCM 864.

197. The above interpretations and principles applicable to Article 19 of the United Kingdom agreement are also applicable to the equivalent provisions of the 1972 New Zealand agreement, the Japanese agreement and the Malaysian agreement.

198. Where a resident is entitled to a credit under subsection 160AF(1), a credit for the foreign tax paid is authorised to the extent of the amount of Australian tax payable on the foreign income. This amount is calculated - in accordance with the formula set out in subsection 160AF(3) - by applying the 'average rate of Australian tax' to the 'adjusted net foreign income' (both terms being defined in subsection 160AF(8)), and deducting from the resultant amount any rebates relating exclusively to the foreign income to which the taxpayer is entitled, other than a rebate allowable under a rating act for the year of tax.

199. For the purpose of calculating the foreign tax credit, the adjusted amount will need to be allocated to a class or classes of income (subsection 160AF(7)), e.g., in relation to 1987/88 years the adjusted amount must be classed as either interest or other income (other classes will apply to other years).

200. Transfer pricing adjustments often take many years to finalise and usually involve the imposition of penalties or interest. Taxation Ruling IT 2527, in explaining the definition of 'foreign tax' in subsection 6AB(2), states that foreign 'taxes' which represent amounts paid to a foreign government to satisfy a liability for interest, fines, penalties or any other similar obligations are not income taxes and do not qualify for credit relief. That principle is recognised internationally and is reflected in Australia's DTAs. Each of Australia's DTAs specifically deny 'tax' status to any amounts which represent a penalty or interest imposed under the law in force in

Australia or in the tax treaty partner country relating to the taxes to which the DTA applies, thereby preventing such amounts from being eligible for credit relief under the respective DTAs.

*Losses*

201. Where the foreign associated company is still in a loss situation after a transfer pricing adjustment by a tax treaty partner country, no correlative adjustment can be made, e.g., where the associated company's foreign losses are reduced, say, from $2 million to $100,000. There is no additional foreign tax or foreign income to give rise to a credit.

202. Where the Australian resident company is in a loss situation but the foreign associated company is in a profit situation and pays additional foreign tax as a result of a foreign transfer pricing adjustment, the correlative adjustment position will be governed by the following domestic rules applicable to the carry forward and transfer of credits within a company group of credits for foreign taxes:

(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 permitting carrying forward credits for foreign taxes apply.

*Adjustment for withholding taxes*

203. Where source country taxation would have been imposed by Australia in accordance with the relevant DTA on the adjusted profits, the amount of correlative adjustment credit will be reduced by the amount of withholding tax that would have applied if the dealings had been undertaken on an arm's length basis. For example, assume:

(a) that Forco is a company resident in the United Kingdom and Austco is a company resident in Australia, being a wholly owned subsidiary of Forco;

(b) Forco provides an interest free loan to Austco for business purposes;

(c) the United Kingdom tax administration makes an adjustment under the Associated Enterprises Article, Article 7 of the United Kingdom agreement, to increase the profits of Forco by $100,000 representing interest that would have been payable on the loan to Austco if the dealings had been on an arm's length basis;

(d) Forco is required to pay an additional $30,000 tax to the United Kingdom;

(e) the ATO agrees that the United Kingdom tax administration's adjustment is in accordance with Article 7 (the Associated Enterprises Article) of the United Kingdom agreement;

(f) in the absence of Australia having a source country taxing right, Austco's entitlement to a foreign tax credit would be $30,000.

204. In the above circumstances, Austco's entitlement to a foreign tax credit will be reduced to $20,000, reflecting a reduction of $10,000 representing the interest withholding tax that Forco would have borne on the interest payments and which Austco would have been required to withhold, if the dealings had been undertaken on a arm's length basis. The extra tax chargeable by the tax treaty partner country would have been only $20,000 in the above scenario if the dealings had been undertaken on an arm's length basis - the tax treaty partner country would have been required to give a credit for Australian interest withholding tax of $10,000 - thereby reducing its extra tax from $30,000 to $20,000 (or, alternatively, if the country operated an exemption system, no additional tax would have been charged).

### *Appropriate adjustment provisions*

205. Australia's DTAs (other than those identified in paragraph 187 above which have no economic double tax relief provision and those in paragraph 189 above which have a 'credit provision') have what is known as an 'appropriate adjustment' provision to relieve economic double taxation resulting from a transfer pricing adjustment by a tax treaty partner country, e.g., Article 9(3) of the Vietnamese agreement.

206. Appropriate adjustment provisions impose an obligation upon Australia to 'make an appropriate adjustment to the amount of tax charged' on profits of a resident taxpayer, where those profits have also been taxed by a tax treaty partner country in accordance with arm's length principles of the Associated Enterprises Article. A correlative adjustment will only be made where Australia agrees that the tax treaty partner adjustment is in accordance with the DTA, i.e., where the ATO agrees with the transfer pricing adjustment by the tax treaty partner country both in principle and as regards the amount. This approach is consistent with that outlined in paragraph 6 of the Commentary to the OECD Model Tax Convention.

*'Appropriate adjustment' mechanisms*

207. The 'appropriate adjustment' will generally be effected by an amendment of the resident taxpayer's income tax assessment. The 'appropriateness' of the amendment will be determined by domestic law and will depend upon the nature of the profits adjusted (i.e., the income or expenditure).

208. Assuming Forco is a company resident in a tax treaty partner country where the relevant DTA has an 'appropriate adjustment' provision and Ausco is an associated company resident in Australia, the following scenarios illustrate what would be an 'appropriate' adjustment:

(a) **Fully deductible:** Assume Forco supplies goods to Ausco for $100,000 where the arm's length price for the goods is $200,000. Country X includes an additional $100,000 income in Forco's taxable profits, resulting in additional tax payable of $50,000 where country X's tax rate is 50%. An appropriate correlative adjustment will be effected in Australia by amending Ausco's income tax assessment to reduce its taxable income by $100,000 (on the basis that Ausco would have been entitled to a deduction for $100,000 if the dealings had been undertaken on an arm's length basis) which results in a refund to Ausco of $36,000 where the Australian tax rate is 36%.

(b) **Wholly assessable:** Assume Ausco supplies goods to Forco for $400,000 where the arm's length price for the goods is $200,000. Country X increases Forco's taxable profits by reducing Forco's allowable deductions by $200,000 resulting in additional tax payable of $100,000 where country X's tax rate is 50%. An appropriate correlative adjustment will be effected in Australia by amending Ausco's income tax assessment to reduce its taxation income by $200,000 (on the basis that Ausco would have only derived $200,000 in assessable income had the dealings been undertaken on an arm's length basis) which results in a refund to Ausco of $72,000 where the Australian tax rate is 36%.

*Secondary adjustment - withholding taxes*

209. Australia argues strongly to maintain source country taxing rights both at international forums such as the OECD and in bilateral treaty negotiations. Determination of what is an 'appropriate adjustment to the amount of tax charged' on profits adjusted in accordance with a transfer pricing adjustment under Article 9, will be

undertaken consistently with Australia's position in relation to source country taxing rights. The Australian revenue will suffer in favour of the revenue of the tax treaty partner country only to the extent it would have done so if the relevant dealings had been undertaken on an arm's length basis.

210. Therefore, in certain circumstances, it is appropriate that any source country taxing rights (e.g., interest or royalty withholding taxes) that would have been exercised by Australia if the dealings had been on arm's length basis, be taken into account in determining what is an 'appropriate adjustment to the amount of tax charged' on the adjusted profits.

211. For example, assume Forco (a company resident in a tax treaty partner country) provides an interest free loan to its wholly owned subsidiary resident in Australia, Ausco, for business purposes where the arm's length amount of interest would be $100,000. Country X includes an additional $100,000 income in Forco's taxable profits, resulting in additional tax payable of $50,000 where country X's tax rate is 50%. The amount of an appropriate adjustment to the amount of tax charged on the adjusted profits by Australia will be determined by calculating, in relation to both Ausco's and Forco's income tax liabilities, the Australian tax revenue effect that would have resulted if the relevant dealings had been undertaken on an arm's length basis. This amount will be determined by calculating the:

(a) reduction in Ausco's Australian tax liability on the basis that they would have been entitled to a deduction for $100,000 if the dealings had been undertaken on an arm's length basis (i.e., $36,000 assuming an Australian tax rate of 36%);

(b) **less** Forco's liability to interest withholding tax that would have arisen under section 128B of the ITAA and which Ausco would have been required to deduct and forward to the ATO under sections 221YL and 221YN of the ITAA (10% of $100,000 = $10,000) if the dealings had been undertaken on an arm's length basis.

212. In the above scenario this will result in $26,000 (i.e., $36,000 - $10,000) being the amount of appropriate adjustment to the amount of tax charged on the adjusted profits which is to be provided by Australia.

213. However, in many cases there will be no need to reduce the appropriate adjustment to take into account source country taxing rights as withholding taxes may have actually been paid. If, in the above scenario, Ausco subsequently recognised a debt of interest and paid the interest to Forco in a manner which results in a liability to

interest withholding tax and that amount of withholding tax has been paid, the 'appropriate adjustment to the amount of tax charged' on the adjusted profits will $36,000. Reference should also be made to paragraph 238 below concerning the year in which a correlative adjustment is to be provided; and paragraphs 244 to 249 below concerning the ATO view that generally no deduction under subsection 51(1) will be allowable for the subsequent payment.

*Losses*

214. 'Appropriate adjustment' provisions require the profits subject to the transfer pricing adjustment to have been 'charged to tax' in both Australia and the tax treaty partner country. Where no additional tax has been charged by the tax treaty partner country as a result of a transfer pricing adjustment, the 'appropriate adjustment' provisions (e.g., Article 9(3) of the Vietnamese agreement) has no application. No additional tax may charged because, for example, the foreign associated company is still in a loss situation after the transfer pricing adjustment (where inflated losses have been reduced) or where the tax treaty partner country has a tax threshold amount for companies and the profits of the foreign company are less than this threshold even after the transfer pricing adjustment.

215. Nor will Article 9(2) apply where additional tax has been charged to the foreign associated company, but the Australian resident company is in a loss position. There will not be an amount of tax charged on the adjusted profits in Australia and therefore no adjustment can be made. In cases where the Australian resident company is in a profit situation and the correlative relief sought, if granted, would take the taxpayer into a loss situation, relief will be limited to the extent of the profit.

***Mutual agreement procedure***

216. Where a correlative adjustment is sought under either a 'credit provision' or an 'appropriate adjustment' provision of a DTA to relieve economic double tax resulting from a transfer pricing adjustment by a tax treaty partner country, the companies concerned should present their cases to the appropriate competent authorities under the Mutual Agreement Procedure Article of the relevant DTA.

217. The address of the Australian competent authority is provided in paragraph 115 above.

*Taxation not in accordance with DTA*

218. The Mutual Agreement Procedure Article provides that a company may present a case to the competent authority of the country of which they are a resident where the action of that country or the tax treaty partner country or both countries result or will result for the company in taxation not in accordance with the DTA. There are, therefore, two companies and two scenarios which could lead to the presentation of a case under this Article:

(a) the foreign associated company could present a case to the competent authority of that country, if it regards the transfer pricing adjustment made by the tax treaty partner country not to be in accordance with the Associated Enterprises Article (e.g., where it disagrees with method used to calculate arm's length profits); or

(b) the Australian resident company could present a case to the Australian competent authority where:

(i) it is aware that an adjustment has been made or is proposed to be made by the tax treaty partner country under the Associated Enterprises Article of the DTA to the profits of the foreign associated company in relation to dealings between that company and the Australian resident company; and

(ii) taxation not in accordance with the DTA results or will result unless a correlative adjustment is made in accordance with a provision of the DTA (e.g., Article 9(3) of the Vietnamese agreement).

219. Where a correlative adjustment is sought from Australia to relieve economic double taxation which has arisen as a result of a transfer pricing adjustment by a tax treaty partner country, the Australian resident company should present its case to the Australian competent authority.

220. There have been instances where the associated foreign company has presented a case to the competent authority of the tax treaty partner country (but no case has been presented to the Australian competent authority) seeking a correlative adjustment to be provided to the Australian resident company. In some cases, the Australian resident company has been aware of neither the request for a correlative adjustment nor the transfer pricing adjustment in relation to its dealings with the associated foreign company. The Australian competent authority may have become aware of such cases through correspondence with the competent authority of the other country.

221. The Australian competent authority will, in the above circumstances, contact the Australian resident company where a

request for a correlative adjustment has not been received from that company. The company will be asked whether it wishes to present a case under the Mutual Agreement Procedure Article in relation to its dealings with a related party resident in the tax treaty partner country.

222. In general, however, both the Australian resident company and the foreign associated company should present their cases to the respective competent authorities.

*Time limit for presentation of case*

223. Similar to the situation in relation to juridical double taxation (see paragraphs 34 and 35 above), the first notification of the action giving rise to taxation not in accordance with the DTA in for the purposes of the time limit in the Mutual Agreement Procedure Article of DTAs (e.g., last sentence of Article 24(1) of the Vietnamese agreement) will be the assessment notice or similar notification of a tax liability provided by the tax treaty partner country to the foreign associated entity in relation to the transfer pricing adjustment.

*When domestic time limits apply*

224. As explained in relation to juridical double taxation, domestic time limits are overridden by the terms of the Mutual Agreement Procedure Articles in many of Australia's DTAs. For example, the last sentence in Article 24(2) of the Vietnamese agreement states that '[t]he solution so reached shall be implemented notwithstanding any time limits in the national laws of the Contracting States'. Special provisions in the Malaysian and Irish agreements are outlined in paragraph 120 above.

225. However, there are a number of DTAs which do not have a provision specifically overriding domestic time limits in the Mutual Agreement Procedure Article (see paragraph 122 above). Some of these DTAs have a 'appropriate adjustment' provision to relieve economic double taxation. Subject to a reciprocal interpretation by the appropriate tax treaty partner country, it is considered that the words of 'appropriate adjustment' provisions could be sufficient to require Australia to make a correlative adjustment irrespective of domestic time limits, i.e., '**shall** make an appropriate adjustment' [emphasis added]. This interpretation will in effect override domestic time limits which would otherwise apply in relation to DTAs with Singapore, France, Belgium, Philippines, Thailand and Fiji.

226. The 'credit provisions' of Australia's DTAs are generally subject to domestic law and cannot be interpreted in a manner which would in effect override domestic time limits for these DTAs. The DTAs where

time limits have not been overridden in either the Mutual Agreement Procedure Article or the credit provision are those with the United Kingdom, New Zealand (1972) and Japan. The Malaysian agreement overrides domestic time limits where a case is presented to the competent authority within 6 years of the tax year in question.

227. Article 9(4) of the Canadian agreement differs from other DTAs in that it limits the period within which Australia would be required to make a correlative 'appropriate adjustment' in accordance with Article 9(3), to six years from the end of the year of income or tax year in respect of which the profits adjusted by the Canadian tax administration relate. It is our view that the combined effect of Article 9(3) and (4) of the Canadian agreement means that domestic time limits are replaced with a six year period. This means that if domestic time limits permit only a shorter period of time then the DTA will operate to extend that period to six years. Alternatively, if domestic time limits permit a longer time, then this provision would reduce that period to six years. In conclusion, a correlative adjustment may be made by Australia where the Australian taxpayer presents a case for such relief to the Australian competent authority within 6 years from the end of the year of income of the foreign associated company adjusted by Canada.

*Requirements for presentation of case*

228. The Commentary to the Mutual Agreement Procedure Article (Article 25) of the OECD Model Tax Convention outlines two stages of the procedure. The first stage relates to the presentation of a case by a taxpayer to the competent authority of the country of which they are resident where the conditions outlined in paragraph (1) of Article 25 are satisfied. These conditions are where a resident considers that the action of one or both of the tax treaty partner countries results or will result for that person (i.e. a company in the context of this Ruling) in taxation not in accordance with the DTA. The first stage continues with the competent authority considering under paragraph (2) of Article 25:

(a) whether the claim appears to be justified; and

(b) whether the competent authority itself is not able to arrive at an appropriate solution.

229. For a claim to be considered justified for the purposes of paragraphs (1) and (2) of Article 25, the action complained of needs to be directed specifically at the taxpayer.

230. Actions directed specifically at a resident company taxpayer which are considered to result or likely to result in taxation not in accordance with a DTA will include:

(a) advice in writing to the associated foreign enterprise from a tax treaty partner country proposing to tax that enterprise on profits which have been taxed to the Australian resident company by Australia. This advice should include details about the basis upon which the profits of the associated foreign enterprise are to be adjusted, including identification of the non-arm's length dealings to which they relate and the amount of profits to be adjusted and how this amount is calculated;

(b) an assessment or similar notification of an additional tax liability to the foreign associated enterprise, indicating that the additional tax relates to an adjustment to profits in relation to non-arm's length dealings with the Australian resident company.

231. Actions which are not considered to justify competent authority resolution include;

(a) an audit or examination of the associated foreign enterprise's activities in a tax treaty partner country;

(b) requests from a tax treaty partner country for information about the dealings between the Australian resident company and the associated foreign enterprise.

232. However, such actions may in time develop to a stage which would justify competent authority consideration. Action of the tax treaty partner country which results or will result for the person in taxation not in accordance with the DTA must be more than a mere possibility - it needs to be more probable than not - to warrant competent authority consideration.

233. When presenting a case to the Australian competent authority, taxpayers should provide the following information:

(a) the basis upon which they have formed the opinion that the action of one or both tax treaty partner countries results or will result for that taxpayer in taxation not in accordance with the relevant DTA (refer subparagraph 131(b) above);

(b) full details of the action relied upon, including identification of the tax treaty partner country involved, how the action affects the liability to tax of both the associated foreign enterprise and the Australian resident company and identification of the taxation considered not to be in accordance with the relevant DTA; and

(c) how the taxpayer wants the problem resolved, including provisions of the domestic tax law and the DTA which would effect resolution.

234. In deciding whether or not to make a correlative adjustment or to communicate with the competent authority of the tax treaty partner country to try and resolve the case, the Australian competent authority will form its own opinion as to whether taxation contrary to the particular DTA results or will result. A correlative adjustment to relieve double taxation arising out of a transfer pricing adjustment made by a tax treaty partner country will be made if the Australian competent authority is satisfied that the adjustment is in accordance with the principles embodied in the relevant DTA and where mechanisms providing for relief are available, either under the relevant DTA or domestic law.

235. Where a tax treaty partner country makes a transfer pricing adjustment contrary to the principles in the relevant DTA, the Australian competent authority will correspond and exchange information with the tax treaty partner country to try and resolve the case by reaching a mutual understanding:

(a) as to the principles embodied in the DTA;

(b) the facts involved with the case; and

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

236. A tax treaty partner country ruling or policy of a general nature which the taxpayer believes could be applied to them and, if so, may result in taxation not in accordance with the DTA would not be sufficient to warrant competent authority consideration under paragraphs (1) and (2)of the Mutual Agreement Procedure Article.

237. However, such items of a general nature may be brought to the attention of the competent authority who may decide to endeavour to resolve any difficulties or doubts about the application of the DTA with the competent authority of the tax treaty partner country under paragraph (3) of the Mutual Agreement Procedure Article. Such a resolution will usually be of general application and not related to any particular taxpayer.

*Year of adjustment*

238. Where a correlative adjustment is to be made by Australia, the adjustment will be made in relation to the year of income corresponding to that adjusted 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 enterprise in relation to non-arm's length dealings with the Australian resident company during the year ended 31 December 1992. Appropriate relief (under either a

'credit provision' or an 'appropriate adjustment' provision) will be provided to the Australian resident company in relation to income tax assessed for the years ended 30 June 1992 and 1993 (assuming the taxpayer does not have a substituted accounting period).

*Foreign domestic appeal rights*

239. The Mutual Agreement Procedure Articles provide a problem resolution process which is **in addition** to objection, review or appeal rights which may be available:

(a) to the associated foreign company under the domestic law of its country of residence, e.g., objection, review and appeal rights, or under Australian domestic law (e.g., in relation to withholding taxes); and

(b) to the Australian resident company under Australian domestic law.

Depending upon the circumstances of each case, the making of a correlative adjustment by Australia will be conditional upon either:

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

(b) the associated foreign company and the tax treaty partner country agreeing to advise the Australian competent authority should domestic objection, review or appeal rights be exercised in that country.

However, in the latter scenario, the issue of an amended assessment or a credit for foreign taxes will be deferred until such time as the foreign appeal rights have lapsed, or are subsequently rescinded or exhausted.

240. The successful exercise of domestic review processes in the tax treaty partner country may result in there no longer being taxation which is contrary to the DTA. It would be inappropriate for the Australian resident company to obtain correlative relief in Australia where the associated foreign enterprise is proceeding to litigate against the tax treaty partner country adjustment for which correlative relief has been granted.

*Competent authority communications*

241. Competent authority communications for economic double taxation cases will be the same as communications for juridical double taxation cases - see paragraphs 143 to 146 above.

*No resolution of case*

242. Where the Australian resident company:

(a) has not sought relief from economic double tax under a provision of the relevant DTA (i.e., either a 'credit' or 'appropriate adjustment' provision) and presented its case to the competent authority under the Mutual Agreement Procedure article of a relevant DTA; or

(b) where the competent authorities have failed to resolve the case with a view to avoiding the taxation contrary to the DTA;

the taxing by the other country of the profits of the associated foreign company in relation to its dealings with the Australian resident company will, in our view, be in contravention of the DTA. In this case, Australia is not obliged by the DTA to make a correlative adjustment and relief for economic double taxation will generally not be available under domestic law (see paragraphs 175 to 177 above).

243. Taxpayer's may wish to consider seeking an Advance Pricing Arrangement in accordance with Taxation Ruling TR 95/23 to resolve these situations for future years.

**Retrospective adjustment or repatriation**

244. The ATO is aware of a number of cases where Australian resident companies have sought to relieve economic double taxation by claiming deductions under subsection 51(1) for subsequent voluntary payments purporting to represent a retrospective adjustment to dealings previously undertaken with an associated foreign company. For example, assume:

(a) Ausco is a company resident in Australia and Forco is a company resident in a tax treaty partner country, country X - both companies are wholly owned subsidiaries of another foreign company (i.e., sister companies);

(b) during the year ended 30 June 1992, Ausco buys goods from Forco for a consideration of $1 million;

(c) during the year ended 30 June 1995, country X subjects Forco to audit and determines that the arm's length consideration for the goods sold to Ausco is $2 million, and accordingly adjusts and taxes Forco on an extra $1 million profit under the Associated Enterprises Article of the relevant DTA. Economic double taxation to the extent of $1 million results; and

(d) in an attempt to relieve the resultant economic double taxation, Ausco voluntarily pays an additional $1 million to Forco during the year ended 30 June 1995 and claims a deduction under subsection 51(1) of the ITAA in its income tax return for that year.

245. It is our view that voluntary payments made in the circumstances outlined above are not deductible under subsection 51(1) of the ITAA.

246. In the circumstances outlined above there would be no legal obligation upon Ausco to make the subsequent (retrospective) variation to the purchase price of the goods. The payment in these circumstances was made for the purpose of relieving economic double taxation and not incurred in gaining or producing assessable income or necessarily incurred in carrying on a business for the purpose of gaining or producing assessable income as required by subsection 51(1).

247. A subsequent payment representing a retrospective variation to the purchase price of goods previously provided, which is made merely for the purposes of relieving economic double taxation, would, in our view, have a connection so tenuous with the derivation of assessable income so as to take it outside the range of relationships between expenditure and assessable income that would attract deductibility (*FC of T v. Manchester Unity IOOF* 94 ATC 4235, per French J at 4255). In the same case Lockhart J, at 4240, stated '...[a] deduction is allowable under s.51(1) if it is incidental to the gaining or producing of assessable income: *Ronpibon* at ATD 434; CLR 55; and it is incidental if there is a sufficient proximate relationship between the income and the occasion for the loss or outgoing: *Kidston Goldmines Limited v. FC of T* 91 ATC 4538 at 4544-4546; (1991) 30 FCR 77 at 84-85; *FC of T v. J D Roberts*; *FC of T v. Smith* 92 ATC 4380 at 4387-4389; (1992) 37 FCR 246 at 256-7'.

248. In addition to such a payment not being considered an allowable deduction under subsection 51(1), such a payment may also be considered not in accordance with the arm's length principles embodied in Division 13 and the Associated Enterprises Article of the DTAs.

249. However, it is recognised that there may be other circumstances where a variation to the price of goods previously provided may result in expenditure which is an allowable deduction, e.g., where a payment is 'reasonably capable of being seen as desirable or appropriate from the point of view of the pursuit of business ends of the business being carried on for the purpose of earning assessable income' (*Magna Alloys and Research Pty Ltd v. FC of T* (1980) 33 ALR 213 per Deane and Fisher JJ at 235).

**Payment of interest on correlative adjustments**

250. 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).

251. Amendments were made to the Overpayments Act in 1994 which generally widened the circumstances in which interest is paid to taxpayers who overpay their income tax and to provide for interest to be paid to taxpayers who pay their income tax early. However, certain overpayments arising from the provision of correlative relief by the ATO may not qualify for interest or may qualify for a limited amount of interest.

252. The amendments to the Overpayments Act which widen the circumstances where interest is payable apply in relation to assessments (including amended assessments) and credits made on or after 1 July 1994 in relation to the 1993-94 income year or subsequent years. The limitations and denial of interest in certain circumstances where correlative relief is provided (see paragraphs 257 to 260 below) apply in relation to any year where correlative relief is provided on or after 1 July 1994.

***Payment of interest***

253. Generally, interest will be payable on overpayments of tax arising from the provision of correlative relief, whether by way of a 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 income year.

254. For years of income prior to the 1993/94 year credits for foreign taxes do not give rise to an overpayment of tax upon which interest is payable.

255. For the 1985-86 to 1993-94 years of income, interest may be payable in certain circumstances where correlative relief is provided by way of a credit amended assessment. However, for years prior to the 1985-86 year, the payment of interest is limited to cases arising as a result of a successful objection, review or appeal and is payable only from 14 February 1983.

256. All payments of interest on overpayments arising from the provision of correlative relief will be subject to the limitations

outlined in paragraph 257 below and certain overpayments outlined in paragraph 258 below may not qualify for any interest.

### *Limitations on amount of interest paid*

257. Where interest is payable on an overpayment of tax which have 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 lesser of:

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

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

(b) the amount of correlative relief being provided.

### *No interest payable*

258. Subsection 9(1A) and paragraph (b) of the definition of '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.

259. 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 [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'.

260. Section 3A of the Overpayments Acts 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'.

# Your comments

261. If you wish to comment on this Draft Taxation Ruling, please send your comments by: 9 February 1996

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