


***TR 97/D5 - Income tax: international transfer pricing:
the effects of determinations made under Division 13
of Part III, including consequential adjustments
under section 136AF***

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Draft Taxation Ruling

Income tax: international transfer pricing: the effects of determinations made under Division 13 of Part III, including consequential adjustments under section 136AF

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What this Ruling is about

Class of person/arrangement

1. This Ruling explains the effects of a determination made under the provisions of Division 13 of Part III (Division 13) of the *Income Tax Assessment Act 1936* (the Act). In particular, the Ruling explains:

- (1) the effect of the term 'for all purposes of the application of this Act' or 'for all purposes of this Act' used in sections 136AD and 136AE respectively (paragraphs 3 to 6);
- (2) the operation of section 136AF where a determination has been made under section 136AD (paragraphs 7 to 32); and
- (3) the application of section 170 of the Act to a determination made under Division 13 (paragraphs 35 to 37).

Date of effect

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

Ruling and Explanation

The term 'for all purposes of the application of this Act' or 'for all purposes of this Act'

3. A determination made under sections 136AD and/or 136AE applies, in relation to the particular taxpayer, for all purposes of the application of the Act, but does not alter the actual terms, conditions, or prices agreed to between the parties.

Adjustments under sections 136AD and 136AE

4. A determination made under section 136AD in relation to the consideration in respect of the supply or acquisition of property can result in adjustments to increase assessable income or disallow or reduce otherwise allowable deductions. Other adjustments that can result from a determination include adjustments to:

- (1) exempt income (including deductions in deriving such income);
- (2) the cost of acquisitions and value of disposals for depreciation and capital gains purposes;
- (3) income covered under section 128B (dividends, interest and royalties) that is subject to withholding tax; and
- (4) other matters for which the Act makes special provision including:
 - (a) capital costs for special provisions which allow for a full, or partial, capital deduction (e.g., allowance for industrial property under Division 10B of Part III and building allowance under Division 10D of that Part);
 - (b) costs for specific deduction provisions (e.g., research and development costs under section 73B);
 - (c) the amount of expenditure subject to recoupment provisions (e.g., sections 82KJ, 82KK, 82KL); and
 - (d) income that is subjected to special provisions that can affect the calculation of taxable income (e.g., taxation of overseas ships under Division 12 of Part III).

5. An adjustment made under section 136AD can also have flow-on consequences for the taxpayer into subsequent years, where that consideration is also relevant to the operation of other provisions of the Act. The terms 'for all purposes of the application of this Act' or

'for all purposes of this Act' would, therefore, include such flow-on effects in matters such as:

- (1) changing the values of closing and opening trading stock under section 28 (see paragraphs 136 and 439 to 440 of Taxation Ruling TR 94/14);
- (2) the amount of bad debts that may be available for write-off under subsection 51(1) or section 63 (but see the comment in paragraphs 182 and 183 of TR 94/14 on the possible restriction on the availability of a deduction for bad debts); and
- (3) reducing carried forward losses under sections 79D and 160AFD, 79E or 80, including a reduction as a result of increasing exempt income or Australian source or foreign source income in the current year (also see paragraphs 197 to 199 of TR 94/14).

6. Determinations made under subsections 136AE(4) to (6) with respect to the same legal entity can also be made for purposes such as:

- (1) for a resident Australian taxpayer:
 - (a) determining the source or sources, and the allocation of income to each source (e.g., under subsection 25(1));
 - (b) determining the extent to which expenditure was incurred in deriving income from a particular source, or sources, and the allocation of expenditure to each source (e.g., under subsection 51(1));
 - (c) the application of section 23AH (exempt foreign branch income);
 - (d) the application of subsection 160AF(1) (foreign tax credits); and
 - (e) the application of sections 79D and 160AFD (treatment of foreign losses);
- (2) for a non-resident taxpayer:
 - (a) determining assessable income under paragraph 25(1)(b); and
 - (b) determining the deductibility of expenditure under various provisions, including subsection 51(1).

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Consequential adjustments under section 136AF

7. The function of section 136AF, as explained in the explanatory memorandum to the Income Tax Assessment Amendment Bill 1982, is:

'... to complete the process, begun by section 136AD, of reconstruction of a taxpayer's affairs to what they would have been if the relevant profit shifting arrangement had not been effected.'

8. Section 136AF authorises the Commissioner to make the following three types of consequential adjustments:

- (1) excluding an amount of income from the assessable income of the relevant taxpayer - paragraph 136AF(1)(a);
- (2) allowing a deduction to the relevant taxpayer - paragraph 136AF(1)(b); and
- (3) deciding that an amount of interest withholding tax (or part thereof) should not have become payable by the relevant taxpayer - subsection 136AF(3).

9. The relevant taxpayer may be the taxpayer or another party to the international agreement that is the subject of the initial adjustment under section 136AD.

10. It is a pre-requisite to the operation of section 136AF that section 136AD must have been applied by the Commissioner to increase assessable income or disallow or reduce a deduction. Section 136AF cannot apply if the provisions of subsections 136AE(4) to (6) have been applied, as these provisions deal with an allocation (within the same legal entity) of the taxpayer's income or expenditure and only apply in cases where section 136AD does not apply to the particular dealing.

11. Where a consequential adjustment is made under paragraph 136AF(1)(b) to allow a deduction, in whole or in part, subsection 136AF(2) authorises the Commissioner to allow the deduction under such provision of the Act as the Commissioner determines. This provision ensures the deduction will be allowable notwithstanding that the relevant taxpayer may not have actually incurred the relevant expenditure or that a deduction may not otherwise be allowable under any other provision of the Act.

12. The basic operation of section 136AF is shown in the flow-chart illustrated on the next page.

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graph TD
    Q1{Has section 136AD been applied to increase assessable income or disallow or reduce a deduction?}
    Q1 -- YES --> Q2{If the parties to the relevant dealing had been dealing at arm's length then, for a relevant taxpayer:}
    Q1 -- NO --> R1[section 136AF does not apply]
    
    Q2 --> Q3a{Has income been included in assessable income that would not have been included? [s136AF(1)(a)(i)]}
    Q2 --> Q3b{Would an amount have been allowed as a deduction? [s136AF(1)(b)(i)]}
    Q2 --> Q3c{Has interest withholding tax become payable, and been paid, that would not have become payable? [s136AF(3)(b)]}
    
    Q3a -- YES --> Q4a{Is it fair and reasonable that:}
    Q3a -- NO --> Q4a
    Q3b -- YES --> Q4a
    Q3b -- NO --> Q4a
    Q3c -- YES --> Q4a
    Q3c -- NO --> Q4a
    
    Q4a --> Q5a{The amount should not be included in the relevant taxpayer's assessable income? [s136AF(1)(a)(ii)]}
    Q4a --> Q5b{The amount should be an allowable deduction to the relevant taxpayer? [s136AF(1)(b)(ii)]}
    Q4a --> Q5c{The amount of interest withholding tax should not be payable by the relevant taxpayer? [s136AF(3)(c)]}
    
    Q5a -- YES --> R2[A consequential adjustment would follow under section 136AF]
    Q5a -- NO --> R2
    Q5b -- YES --> R2
    Q5b -- NO --> R2
    Q5c -- YES --> R2
    Q5c -- NO --> R2
    
    R2 --> R3[The deduction would be granted under such provision of the ITAA as the ATO determines [s136AF(2)]]
    R1 --> R3
  
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The flowchart determines if section 136AD has been applied to increase assessable income or disallow or reduce a deduction. It starts with a decision box: "Has section 136AD been applied to increase assessable income or disallow or reduce a deduction?". If "YES", it proceeds to a box: "If the parties to the relevant dealing had been dealing at arm's length then, for a relevant taxpayer:". This leads to three parallel questions: "Has income been included in assessable income that would not have been included? [s136AF(1)(a)(i)]", "Would an amount have been allowed as a deduction? [s136AF(1)(b)(i)]", and "Has interest withholding tax become payable, and been paid, that would not have become payable? [s136AF(3)(b)]". Each of these has a "YES" or "NO" outcome. All "YES" outcomes and "NO" outcomes from these three questions lead to a box: "Is it fair and reasonable that:". This leads to three parallel questions: "The amount should not be included in the relevant taxpayer's assessable income? [s136AF(1)(a)(ii)]", "The amount should be an allowable deduction to the relevant taxpayer? [s136AF(1)(b)(ii)]", and "The amount of interest withholding tax should not be payable by the relevant taxpayer? [s136AF(3)(c)]". Each of these has a "YES" or "NO" outcome. All "YES" outcomes and "NO" outcomes from these three questions lead to a box: "A consequential adjustment would follow under section 136AF". This leads to a box: "The deduction would be granted under such provision of the ITAA as the ATO determines [s136AF(2)]". If the initial question is "NO", it leads directly to a box: "section 136AF does not apply".

Circumstances where section 136AF would be appropriate

13. Where a determination has been made under section 136AD, it could normally be expected that the consequential adjustment under section 136AF would follow.

14. For example, where an Australian resident company has paid interest to a non-resident company that is excessive under arm's length principles and the non-resident company paid interest withholding tax (at a rate below the normal company tax rate), a determination and adjustment would be expected to be made under subsection 136AD(3) against the Australian company to reduce the allowable deduction for the interest payment to an arm's length amount.

15. In that case, a determination and consequential adjustment would also be expected to follow under subsection 136AF(3) in respect of the excessive part of the payment to the non-resident company that was subjected to interest withholding tax.

16. In these circumstances, subsection 136AF(3) effectively allows for the remission of the relevant part of the withholding tax on the basis that it should not have been paid.

Circumstances where section 136AF does not apply

17. Section 136AF does not provide for consequential adjustments to be made in certain circumstances.

18. For example, in an interest-free loan situation where interest should have been charged by a non-resident company to an Australian resident company, if the Commissioner were to make a determination and adjustment under subsection 136AD(2) against the non-resident company so as to deem an interest withholding tax liability, no consequential adjustment could be made by way of a deemed deduction to the resident company under section 136AF.

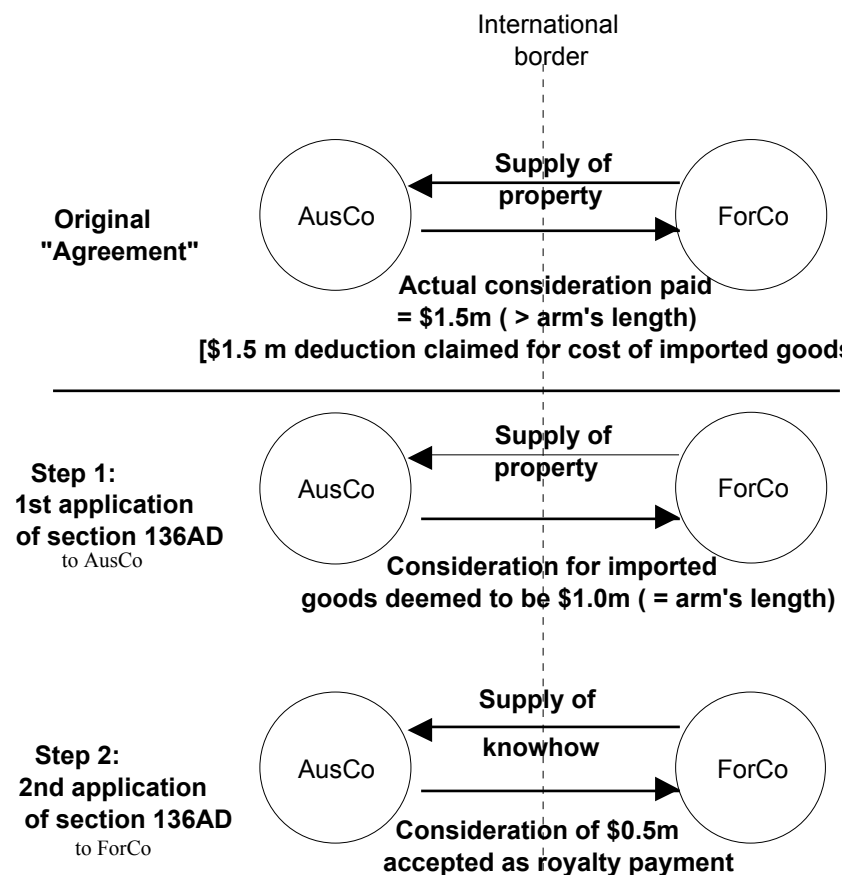
19. The reason for this is that the opening words of subsection 136AF(1) do not provide for a compensating adjustment where a section 136AD determination is made to impose or increase a taxpayer's withholding tax liability.

20. In these situations, however, it would normally not be appropriate for the Commissioner to make a subsection 136AD(2) determination and adjustment against the non-resident company to raise the withholding tax liability in the first instance, because such an interest-free loan arrangement has not by itself disadvantaged the

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Australian revenue. An exception would be where the resident company is a tax-exempt entity.

21. Another situation where a section 136AF consequential adjustment would not be available (or appropriate) would be where an Australian company acknowledged that its imports had been overpriced under arm's length principles, but then satisfactorily demonstrates that, although the company had not been separately charged, the price included an equivalent amount for royalties due to the related party overseas supplier which satisfied arm's length principles. This situation can be illustrated as follows:



22. In the above example, it is assumed that two determinations would be required under section 136AD in order to restore the revenue situation that would have applied if AusCo had, in the first instance, correctly dissected the payments to ForCo into their respective components.

23. The first of those determinations would be made under subsection 136AD(3) against the Australian company (AusCo) for the \$0.5 million excessive allowable deduction for its imported goods

(step 1). This determination would enable its trading stock account to be properly adjusted for tax purposes (see paragraph 5 above) and to clearly establish the extent to which it may be entitled to a subsection 51(1) deduction for the royalty payment.

24. The second determination would be made under subsection 136AD(2) against the non-resident company (ForCo) for the withholding tax liability on the \$0.5 million royalty **(step 2)** - because of the positive revenue effect in this case.

25. For the same reasons as outlined in paragraph 19 in relation to the previous example in paragraph 18, no adjustment would be available to AusCo in terms of allowance of a deduction for the royalty payment under subsection 136AF(1).

26. Nor would a deduction be allowable to AusCo for the royalty payment as a result of the subsection 136AD(3) determination made against AusCo applying for all purposes of the Act in relation to it; any such 'flow-on' adjustment would be limited to matters pertaining to the adjusted cost of the property in respect of which the excessive consideration was paid, i.e., the imported goods as distinct from the property in respect of which royalties were properly chargeable.

27. Nevertheless, whilst AusCo would remain *prima facie* entitled to a subsection 51(1) deduction for the royalty payment, if the withholding tax liability determination made under subsection 136AD(2) against ForCo is not met, subsection 221YRA(1A) would operate to preclude a deduction being allowed to AusCo for the royalty payment. If the withholding tax liability is met, subsection 221YRA(2) would operate to allow a subsection 51(1) deduction for the royalty to AusCo.

28. The end result in the case of AusCo is that the reduction in its allowable deduction for stock purchases is made pursuant to a determination and adjustment made under subsection 136AD(3), whilst its entitlement to a deduction for the royalty component of the payment actually made by it to ForCo will be governed by other provisions of the Act, namely subsection 51(1) and subsections 221YRA(1A) and 221YRA(2).

The operation of subsections 136AF(4) to (6)

29. The purpose of subsections 136AF(4) to (6) is to extend the ordinary dispute resolution procedures available in Part IVC of the *Taxation Administration Act 1953* to a taxpayer who is dissatisfied with the Commissioner's decision not to make a determination under section 136AF.

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30. It could normally be expected that a subsection 136AF(1) or subsection 136AF(3) determination and consequential adjustment would be made by the Commissioner for a relevant income year (or years) following the making of a section 136AD determination if all the material facts and circumstances are clear and the amended assessment made as a consequence of the section 136AD determination is not in dispute. However, the Commissioner would not consider making a determination under section 136AF before an objection or appeal lodged in relation to the relevant section 136AD determination and adjustment is finally resolved.

31. It is relevant here that there is no time limit on the making of an amendment to give effect to a subsection 136AF(1) or subsection 136AF(3) determination and that any refund of tax paid resulting from such an amendment may qualify for payment of interest by the Commissioner under subsection 9(1) of the *Taxation (Interest on Overpayment and Early Payments) Act 1983*, subject to subsection 9(1A) which relates to that part of the overpayment attributable to the provision of correlative relief.

32. It is relevant also that any potential section 136AF consequential adjustments would need to be taken into account for purposes of settlement negotiations in relation to a disputed section 136AD determination adjustment.

Penalties arising from a Division 13 adjustment

33. Where a determination has been made by the Commissioner under sections 136AD or 136AE to increase assessable income or disallow or reduce a deduction, section 225 of the Act applies.

34. The operation of section 225 and other relevant provisions of Part VII of the Act, where Division 13 has been applied in a taxpayer's assessment, will be covered in a separate Ruling.

Amendments to give effect to Division 13 adjustments

35. Where a determination has been made under section 136AD and/or 136AE, any relevant amendment to an assessment would normally be made under subsection 170(9B) of the Act, which ensures there is no time limit for making an amendment to give effect to transfer pricing adjustments made under section 136AD or section 136AE ('prescribed provisions'), or under either the Business Profits or Associated Enterprises Articles of a Double Tax Agreement ('relevant provisions'). These terms are defined in subsection 170(14).

36. Paragraph 170(9C)(a) limits the operation of subsection 170(9B) in that it does not authorise an amendment where a prescribed

provision has previously been applied in relation to the particular supply or acquisition, or a prescribed or relevant provision has previously been applied in relation to the same subject matter. In these cases, any further amendment in respect of the specific supply or acquisition, or subject matter, as the case may be, can only be made in accordance with the other provisions of section 170.

37. Subsection 170(10) also provides for amendments to be made 'at any time' to give effect to the consequential adjustment provisions contained in section 136AF.

Detailed contents list

38. Below is a detailed list of the contents of this draft Ruling:

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Your comments

39. If you wish to comment on this draft Ruling please send your comments by: 18 July 1997

to:

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40. Wherever possible, comments should include a reference to the specific paragraph to which the comments relate. Comments intended to express an alternative view to that expressed in the draft Ruling should also include the reasoning upon which such view was formed to enable the matter to be considered in detail.

Commissioner of Taxation

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- ITAA 221YRA(2)
- ITAA Pt VII
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case references