PS LA 2016/2 - Administration of scheme penalties arising from the application of Subdivision 815-A for income years which started on or after 1 July 2004 and before 1 July 2012 (transition period)

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PS LA 2016/2

Administration of scheme penalties arising from the application of Subdivision 815-A for income years which started on or after 1 July 2004 and before 1 July 2012 (transition period)

For income years which commenced within the transition period, this practice statement explains when liability for a transfer pricing scheme penalty arises, how to apply a scheme penalty, how to assess an entity's scheme penalty and matters the Commissioner considers in remitting such penalty.

This practice statement is an internal ATO document, and is an instruction to ATO staff.

Taxpayers can rely on this practice statement to provide them with protection from interest and penalties in the following way. If a statement turns out to be incorrect and taxpayers underpay their tax as a result, they will not have to pay a penalty. Nor will they have to pay interest on the underpayment provided they reasonably relied on this practice statement in good faith. However, even if they don't have to pay a penalty or interest, taxpayers will have to pay the correct amount of tax provided the time limits under the law allow it.

1. Scope

1A. This practice statement explains how the ATO will administer scheme penalties arising from the application of Subdivision 815-A of the *Income Tax Assessment Act 1997* (ITAA 1997) and section 815-10 of the *Income Tax (Transitional Provisions) Act 1997* (IT(TP)A 1997) for income years commenced within the transition period. This practice statement deals with:

- when liability for a transfer pricing scheme penalty arises
- applying a scheme penalty
- assessing an entity's scheme penalty, and
- remission considerations – to ensure a consistent exercise of the Commissioner's discretion to remit all or part of a scheme penalty.

1B. All legislative references in this practice statement are to Schedule 1 to the *Taxation Administration Act 1953,* unless otherwise stated.

1C. This practice statement does not deal with scheme penalties that arise from the application of:

- Subdivisions 815-B and 815-C of the ITAA 1997[1], and
- Part IVA of the *Income Tax Assessment Act 1936* (ITAA 1936).

[1] Guidance on scheme penalties arising from these rules is found in Law Administration Practice Statement PS LA 2014/2 *Administration of transfer pricing penalties for income years commencing on or after 29 June 2013.*

2. Background

2A. For income years which commenced on or after 1 July 2004 and before 29 June 2013, Subdivision 815-A of the ITAA 1997 (Subdivision 815-A) applies to bring to tax a 'transfer pricing benefit'[2] by empowering the Commissioner to make a determination under section 815-30 of the ITAA 1997, by increasing taxable income, decreasing tax losses, or decreasing net capital losses, as appropriate (Subdivision 815-A Determination).

2B. Subdivision 815-A is only relevant to entities to which one of Australia's tax treaties containing the transfer pricing articles applies; that is, where the entity is a resident of one or both of the contracting states to the tax treaty.

2C. The references in Subdivision 815-A to 'international tax agreements', or to parts of them, ensures that if an entity gets a 'transfer pricing benefit', the benefit and the amount of that benefit is consistent with Australia's tax treaties.[3]

2D. Division 13 of the ITAA 1936 (Division 13)[4] can also apply during the transition period to allow the Commissioner to deem arm's length consideration to be given for tax purposes for certain international dealings.

[2] Section 815-15 of the ITAA1997 defines the term 'transfer pricing benefit' as essentially an amount of profit which but for non-arm's length conditions operating between an Australian resident entity and an associated entity might have been expected to accrue to the Australian entity.

[3] Paragraph 1.18 of the Explanatory Memorandum to the Tax Laws Amendment (Cross-Border Transfer Pricing) Bill (No. 1) 2012.

[4] Division 13 of the ITAA 1936 was repealed by the *Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Act 2013.*

2E. Importantly, section 815-40 of the ITAA 1997 ensures that an entity's transfer pricing benefit that is negated under Subdivision 815-A is not to be taken into account again under another provision. This includes Division 13.

2F. If the Commissioner makes a Subdivision 815-A Determination to negate a transfer pricing benefit of an entity, then subsection 284-145(2A)[5] applies a scheme penalty to an entity's scheme benefit for an income year which commenced on or after 1 July 2012 but before 29 June 2013.

2G. Similarly, if the Commissioner applies Division 13, then subsection 284-145(2)[6] applies a scheme penalty in relation to that entity's scheme benefit.

2H. Significantly, for income years which commenced within the transition period, section 815-10 of the IT(TP)A 1997 ensures that an entity will only be liable to a scheme penalty in relation to the scheme benefit which could have been denied by another provision of the tax law had Subdivision 815-A not been enacted.[7]

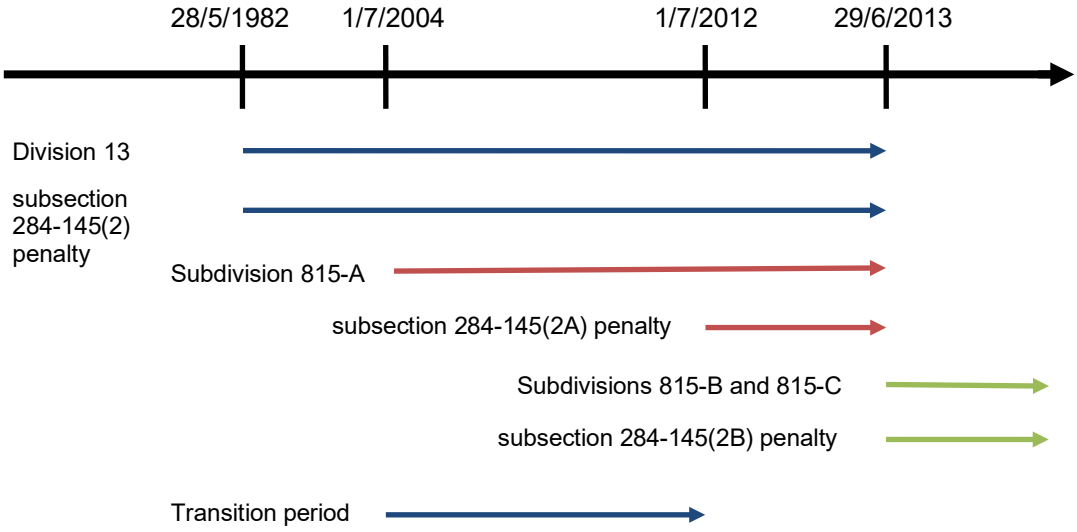
2I. In summary, the transfer pricing rules, including relevant scheme penalty provisions, apply as follows:

2J. Moreover, this diagram highlights the transition period applicable to this practice statement.

3. Statement

3A. If the Commissioner makes a Subdivision 815-A Determination in respect of an income year commencing within the transition period, ATO personnel are to exercise sound judgement in each instance in deciding whether the Commissioner should allocate resources to assess a scheme penalty. In so deciding, ATO personnel need to take into account, whether:

- extra complexity and/or costs arise in applying Division 13, and
- the scheme penalty, if assessed, would be remitted in full in accordance with the guidelines set out below.



[5] Provided that the entity would have got a scheme benefit from a scheme but for the Commissioner making a Subdivision 815-A Determination (paragraph 284-145(2A)(a)) and provided that subparagraph 284-145(1)(b)(i) does not apply in respect of the scheme.

[6] Provided that the entity would have got a scheme benefit from a scheme but for the Commissioner applying Division 13 (paragraph 284-145(2)(a)) and provided that subparagraph 284-145(1)(b)(i) does not apply in respect of the scheme. Subsection 284-145(2) was repealed by the *Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Act 2013*.

[7] Paragraphs 1.142 & 1.143 of the Explanatory Memorandum to the Tax Laws Amendment (Cross-Border Transfer Pricing) Bill (No. 1) 2012.

3B. No further resources should be allocated to applying Division 13 in order to impose a scheme penalty if ATO personnel decide that:

- applying Division 13 will be overly complex and/or gives rise to unnecessary costs, and/or
- it is appropriate to fully remit the scheme penalty that otherwise applies.

3C. If ATO personnel decide in appropriate circumstances that a scheme penalty should apply, then ATO personnel should:

- apply Division 13, including making Division 13 Determinations, where the conditions for the application of Division 13 have been satisfied, in assessing the scheme benefit (scheme shortfall amount), and
- calculate the scheme penalty in accordance with Subdivision 284-C using the scheme shortfall amount. The scheme shortfall amount is the additional amount of income tax the entity is liable to pay as a result of the application of Division 13.[8]

3D. The effect of doing this in appropriate circumstances is that the entity will:

- be liable to primary tax arising from the Commissioner negating a transfer pricing benefit by making a Subdivision 815-A Determination. The entity's primary tax will be equal to the amount in the Subdivision 815-A Determination multiplied by the applicable tax rate
- not be liable to primary tax arising from the application of Division 13 unless in extremely rare instances the amount determined under Division 13 is greater than the amount determined under Subdivision 815-A, and
- only be liable to a scheme penalty under subsection 284-145(2) arising because of the application of Division 13.

3E. In the vast majority of instances, the amount of the transfer pricing benefit negated under Subdivision 815-A will be the same as the difference between the arm's length and actual consideration under Division 13 for the same cross border dealings. In such instances, the scheme shortfall and scheme penalty amounts applicable will also be the same. However, Example 1 below deals with a scenario where these amounts are different and, for illustration purposes, does not take into account the extra complexity and/or costs that may arise and the penalty remission guidelines.

[8] See subsection 284-145(2) and section 284-150.

3F. Importantly, section 815-10 of the IT(TP)A 1997 does not apply to income years commencing after 30 June 2012. Attachment A summaries in a flowchart the process for determining the type of scheme penalty ATO personnel can impose.

Example 1: Transfer pricing scheme penalties for income years commenced within the transition period

3G. *For the income year ended 30 June 2011, the Commissioner makes a Subdivision 815-A Determination in respect of Lachlan Ltd, an Australian resident's cross border dealings with its parent company Jessica Ltd, a resident of a tax treaty partner country. The Commissioner determines that Lachlan Ltd gets a transfer pricing benefit equivalent to the difference between what would have been its taxable income had arm's length conditions applied and its actual taxable income. The transfer pricing benefit in respect of the Subdivision 815-A Determination is $40 million. The primary tax payable in respect of this transfer pricing benefit is $12 million ($40m x 30%).*

3H. *The Commissioner also determines that the actual consideration for the cross border dealings differs from the arm's length consideration and applies Division 13. The difference between the actual consideration received and the arm's length consideration under Division 13 is $30 million.*

3I. *Lachlan Ltd does not have a sole or dominant purpose of getting a scheme benefit from a scheme but does not have a reasonably arguable position.*[9]

3J. *Lachlan Ltd's scheme shortfall amount is $12 million in relation to the Subdivision 815-A Determination and $9 million ($30m x 30%) in relation to the Division 13 Determination.*

3K. *Lachlan Ltd is liable to tax of $12 million on the transfer pricing benefit. Lachlan Ltd is also liable under paragraph 284-160(b)(i)*[10] *to a scheme penalty of $2.25 million ($9m x 25%).*

[9] Nor does subsection 284-160(3), subsection 284-220(1) or section 284-225 apply.
[10] As of 28 June 2013.

4. Remission of transfer pricing scheme penalties

4A. When making remission decisions concerning transfer pricing penalties for income years commencing within the transition period, ATO personnel must ensure that the Commissioner's discretion under subsection 298-20(1) is exercised in accordance with the principles set out below[11].

4B. ATO personnel should exercise the Commissioner's discretion regarding transfer pricing penalties to reduce the base penalty amount otherwise applying from 10% to nil, where the taxpayer:

(1) has genuinely made a reasonable attempt in good faith to comply with the arm's length principle in preparing the tax return, having regard to what a reasonable business person in the taxpayer's circumstances would do;

(2) has used its best endeavours to document the process of selecting and applying an arm's length method at the time the transaction was negotiated, or at the time the relevant income tax return was prepared, on the basis of the information in the taxpayer's possession and any other information that was reasonably available to the taxpayer at the time;

(3) can satisfy the ATO that there was no tax avoidance intention or purpose in adopting the pricing outcomes arrived at from performing the process mentioned in subparagraph (2) above; and

(4) where the transfer pricing adjustment is made as a result of audit action, the taxpayer has fully co-operated with the ATO, including providing all relevant information in the taxpayer's possession or reasonably available to the taxpayer so as to achieve an expeditious conclusion of the audit.

4C. Full remission will not be granted in instances where a transfer pricing adjustment has been made because of the failure by the taxpayer to furnish the income tax return in accordance with the terms of any relevant advance pricing arrangement that the taxpayer has with the ATO.

4D. The matters set out below are relevant to the Commissioner's discretion to remit:

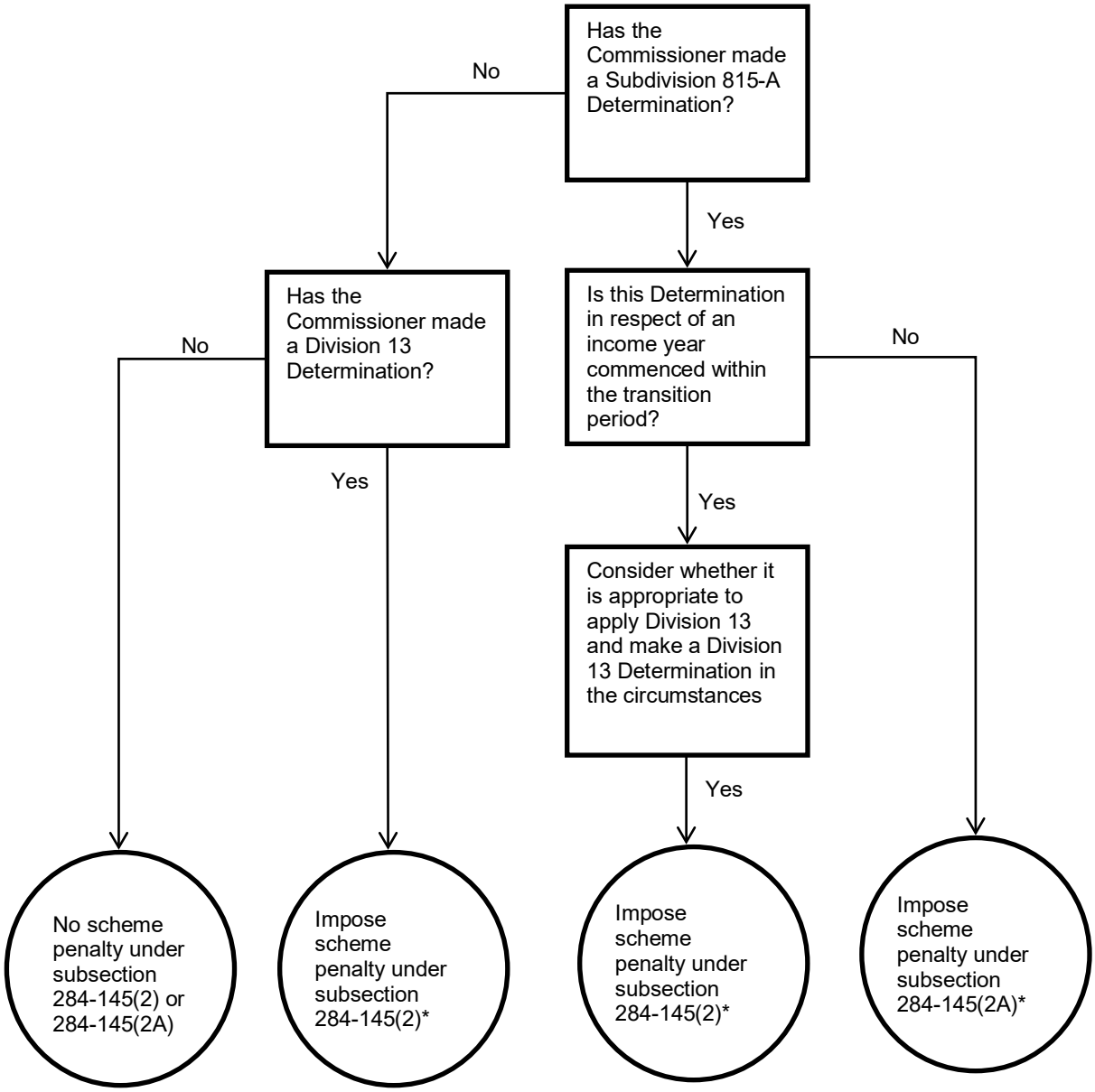
- the quality of a taxpayer's process and the adequacy and relevancy of documentation created and maintained in applying the arm's length principle, and
- the reasonable availability of guidance to taxpayers on transfer pricing at the relevant time.

4E. In relation to the first point in paragraph 4D, taxpayers assessed as falling in the medium-high quality and high quality categories under Chapter 4 of Taxation Ruling 98/11 *Income tax: documentation and practical issues associated with setting and reviewing transfer pricing in international dealings* will be regarded as having satisfied the requirements of subparagraphs 4B(1) and (2).

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Date of effect	Income years that commenced between 1 July 2004 and 28 June 2013 inclusive

[11] For consistency, these principles have been drawn from paragraphs 36 to 40 of former Taxation Ruling 98/16 *Income tax: international transfer pricing – penalty tax guidelines (Withdrawn)*. These principles also apply to remission decisions concerning transfer pricing scheme penalties imposed under subsections 284-145(2) and 284-145(2A) for income years starting on or after 1 July 2012 and before 29 June 2013.

Which scheme penalty applies?



* Assuming that an entity has received a scheme benefit from a scheme

Amendment history

Date of amendment	Part	Comment
5 May 2016	All	First published.

References

Legislative references	ITAA 1936 ITAA 1936 Pt IVA ITAA 1936 Div 13 ITAA 1997 ITAA 1997 Subdiv 815-A ITAA 1997 Subdiv 815-B ITAA 1997 815-15 ITAA 1997 815-30 ITAA 1997 815-40 ITAA 1997 Subdiv 815-C ITAA 1997 Div 820 IT(TP)A 1997 IT(TP)A 1997 815-10 TAA 1953 TAA 1953 Sch 1 Subdiv 284-C TAA 1953 Sch 1 284-145(1)(b)(i) TAA 1953 Sch 1 284-145(2) TAA 1953 Sch 1 284-145(2)(a) TAA 1953 Sch 1 284-145(2A) TAA 1953 Sch 1 284-145(2A)(a) TAA 1953 Sch 1 284-150 TAA 1953 Sch 1 284-160(b)(i) TAA 1953 Sch 1 284-160(3) TAA 1953 Sch 1 284-220(1) TAA 1953 Sch 1 284-225 TAA 1953 Sch 1 298-20(1) Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Act 2013
File references	1-5ICHRTK
Other references	Explanatory Memorandum to the Tax Laws Amendment (Cross-Border Transfer Pricing) Bill (No. 1) 2012
Related public rulings	TR 98/16 (Withdrawn) TR 98/11
Related practice statements	PS LA 2014/2
ATOlaw topic	International issues ~~ Transfer pricing
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