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Australian Government
Australian Taxation Office

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Transfer pricing and business restructuring

Distinguishing between business driven and tax driven restructuring

In an article in the December 2006 edition of *European Taxation*, Jeffrey Owens, the Director of the OECD's Centre for Tax Policy and Administration, says in relation to the tax implications of business restructuring,

> 'The dialogue between business and government on this issue tends to be a dialogue of the deaf. Business states that the restructuring is driven by sound commercial consideration and tax administrations think that it is all tax-driven. Both are in some respects right and wrong.'

How then do we break down the stereotypes and undertake an objective evaluation of corporate restructures to determine what is business driven and what is tax driven?

As a preface I would say that unless there is a material change in the ongoing structural tax position in Australia, for example because profitable elements of a business are being shifted to another jurisdiction, or the restructure itself has material tax impacts in its very implementation, the Tax Office is unlikely to be excited about it.

It can, I think, be reasonably accepted that the structures of multinational enterprises will evolve over time. Natural life events of corporations present business opportunities to grow the range of products and services, enter new markets, make strategic acquisitions, and divest assets that do not make a good fit with core business or strategic intent.

We have seen this taking place over time and impacting the structure of multinationals. Competitive pressures, market conditions and changes to operating or regulatory environments will elicit responses which often have a structural element.

In my experience **it is around the essential elements of a multinational, set out below, that restructuring occurs**.[1] In some cases those elements are the drivers; in other cases they are cited as a justification.

I find it useful in thinking about corporate structures and restructures to keep the essential elements of multinational organisations in mind so that a comparison between the real world of the taxpayer, as an enterprise, and its internal machinations can be used as a guide to differentiate business driven restructures from tax driven restructures.

In a real world sense, 'structure' is the organisational configuration, the deployed functionality of a multinational, by which any strategy developed by the owners and managers is implemented, operations are conducted, and funding and cash flow are managed[2]. The Tax Office will focus on which functions are performed where, and why, which people and assets are involved, how all the key elements of the business fit together - and the extent to which the different activities contribute to the profit and profitability of the multinational. From there we can begin to understand how the group's activities as a global set come to form a value chain with the external suppliers and the customers. Where the offshore position is not known, at least we can understand the part of the value chain on the Australian side of the business. Once the value chain and its current level of financial performance are understood, the Tax Office is in a position to evaluate any restructuring by identifying what will be different and what difference, if any, the changes are likely to make to operations and financial outcomes. Obviously, our focus will be on how the changes will impact the Australian side of the business and why. With Australian based multinationals the analysis will encompass the global operations.

We are not being naive or unrealistic about business performance. We see a range of performance. Some businesses are really well run, others less so; some are failing. However, a reasonable starting assumption with multinationals that are going concerns, I find, is to work on the basis that the multinational's business has been intentionally established, positioned and operated by its owners and managers who have put planning, budgeting, reporting and governance mechanisms in place, and appointed people to key roles, to achieve the financial results and strategic outcomes they are seeking. A necessary part of any tax analysis, therefore, is to understand these goals from the perspective of the business itself - and to ascertain how the multinational is trying to achieve them. Important elements of this are establishing what the multinational does (or does not do) to optimise the investment in the business and the productivity of its operations. There may well be unexploited potential that is depressing the value of the investment - and which might excite the interest of corporate raiders.

It stands to reason that it is the way in which the operations collectively are conducted which drives the capacity of the business to create value, subject to market and wider economic constraints. This is what creates the financial rewards that are shared between the owners, the managers and staff, the suppliers and the customers, according to their relative

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contributions and bargaining positions, and subject to market conditions and the needs of the business. Owners and managers will have expectations as to the level of returns they expect from their investment and the manner in which they expect to be rewarded. Through their experience and evaluation of it they will also have an understanding of the likely returns and the potential of the business to improve or take advantage of business opportunities that present. These insights would be expected to be drivers of business restructures. The linkages back to the evaluation of the present business and its markets and the projected causal link to the improvements sought through the restructure should be evident. Where this is not the case a question arises as to what were the objectives and what was driving them.

The Tax Office expects that there will be a correlation between the profitability of an enterprise and its tax payments, subject to tax concessions. We would also expect that real movements in productivity, whether up or down, will flow through to profitability and tax performance. Hence the Tax Office will examine the nature of all key activities conducted by a multinational that are relevant to the profitability of its Australian operations to determine whether in fact their contribution to profit is appropriately reflected.

At one level 'structure' can be understood as lines and boxes on a chart showing the ownership of the parent company and its subsidiaries; and it is important to understand how the formal legal ownership and reporting structure relates to the organisational configuration. In this way we can understand where the formal legal structure mirrors the operations and, in those areas of divergence, develop an understanding of why the differences exist and any non-operational roles of various parts of the legal structure. It is common in my experience to see the number of subsidiaries far exceeding the number of business divisions and functional units in a multinational group and the Tax Office will be interested in the roles of subsidiaries not naturally connected with the conduct or the funding of the business.

Reporting arrangements can also vary depending on whether one is considering the management of the real world operations or the statutory reporting requirements. The Tax Office will want to understand any differences in the two sets of reports and how each of the respective sets of reporting is used by the business. In my experience multinationals tend to make decisions and run the business on the basis of the business management reporting since this is more likely to give a true picture of the economic contribution to profit. The financial statements are prepared to meet local regulatory requirements and reflect the positions multinationals take on matters like transfer pricing, capitalisation, group financing and cashflow management. Accordingly, many of the tax risks may arise in the statutory accounts themselves, despite the fact that these statements are usually prepared with the benefit of external expert advice and are often subject to independent audit.

In the same way **it is important to understand the translation of the accounting information into the set of numbers required for the tax return and the calculation of tax.** This has become an increasing focus of Tax Office operations in the large business sector. Following a pilot of 40 groups in the 2008 financial year we are expanding coverage to a further 80 groups in the current financial year. The pilot identified instances of tax risks associated with corporate restructures. In one case there was the structured sale of a business to generate capital losses to shield capital gains on the sale of other assets. In other cases we have seen financial restructures that have channelled debt into Australia. The interest expense offsets taxable income in Australia, but the income stream obtained by the use of the debt funding flows into Australia as exempt dividends and the interest expense and dividend income flow out of Australia with little or no tax being paid in Australia or anywhere else.

At another level one could regard a multinational enterprise as an economic molecule that can be represented as a financial model. It includes the sourcing of equity and debt funding, through a series of investor and capital market relationships, and at costs that reflect the business's tolerance to debt and the owners' returns on their equity. The model would reflect that the funding is applied in acquiring investments, assets or conducting operations that are projected to require certain levels of working capital and generally produce cash flows from transactions with customers sufficient to create a surplus. It has a capital structure, budgets for revenue and expenditures based on experience and expectations for improvements; and measures their achievement. It acquires uses, amortises, and sometimes creates, devalues or loses assets. It somehow rewards its owners. Its performance can be understood in terms of its revenue efficiency and its cost efficiency and its potential future cash flows. It has a cost of capital reflecting the cost of debt and returns paid to its owners. It has a market capitalisation or value based on its actual and expected cash flows. Some activities are balance sheet driven, others rely on the talent of staff. Multinationals generally understand the levels of equity they need to be viable and competitive. They understand their tolerance to debt and where, and at what prices, they may be able to secure funding and liquidity - because the debt markets tell them all these things. They understand and actively manage their access to capital markets, building relationships with key bankers and major shareholders. There will be a specific focus on the share price of listed companies. In other cases lenders, trade creditors and potential investors will have an interest in the value of the assets and operations and the liquidity of the business. There is a wide range of tax issues relevant to corporate financing, asset and cash flow management and the separate and joint administration of those provisions can sometimes present difficulties.

Another critical aspect of understanding multinationals is understanding how they go to market; how they build the customer base and distribute the goods and services they produce into those markets; how they position themselves in their markets and develop and implement strategies[3]. This also requires an understanding of the structural dynamics and economic drivers in each of those markets; for example whether participants compete on price or niche, and the long term relationships that may exist between the multinational and its customers. The broader economics of the market will

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show whether the market is in balance or has a surplus or shortfall in supply. It is important to understand where the economic power rests, whether major customers call the shots, or whether the suppliers are price setters. This will depend on the degree of competition, the extent to which buyers can obtain supply from other sources and the relative levels of supply and demand in the market more generally. Barriers to entry and exit also impact. Market and product cycles have a bearing on the role of marketing and distribution and pricing. Competition and the risk of substitutes also play a part. When considering improvements in profitability over a period it is useful to understand whether the profitability is price driven or volume driven, or both.

It is important to understand how multinationals innovate; whether for example they do their research and development in the home jurisdiction; the other operational circumstances in which know how and breakthroughs are created; how they organise the ownership and protection of valuable intangibles; who gets to use them and how value and income is reflected. Innovation is a real profit driver in multinationals, often reflected in the intangibles the multinational has created or acquired. These cluster around design, manufacturing, marketing, distribution and strategic positioning. All the other functions can generally be regarded as yielding a basic rate of return. There is a lot of tax planning directed to the placement of high value intangibles in low tax jurisdictions and the attendant issue of the taxation (or shielding) of royalty and other payment streams.

It is important to distinguish between the group as a whole and its geographical divisions. Some of the functions of a multinational may be centralised, others decentralised. Certain functions may be performed internally on a cost recovery basis. Others may be priced by reference to market indicators. Often the structure adopted will be designed to optimise the after tax return to the group as a whole and to direct cash flow in the most effective way to meet group requirements, minimise the cost of funds and best manage interest and exchange rate exposure. All of this is understandable, but it may sometimes raise jurisdictional issues in relation to transfer pricing when the economic contribution by each jurisdiction to the multinational's profit is not properly reflected.

Where the need for restructuring is business driven, a multinational will have a strategy in mind which it believes will enhance the profitability of the group. There will be specific drivers in focus, which can again be compared to the analysis of revenue and cost efficiency that established the base state from which improvement is sought. Multinationals will have internal hurdle rates as benchmarks, along with a range of other measures and performance criteria seen by them as critical to their business. In large diverse organisations like multinationals, in one form or another, there will be corresponding mandates, authorities and risk management requirements tailored for the various senior managers and regions and their contribution to the overall profitability of the group. The respective contributions to profit will need to be measured and understood in order for the business to be managed. A corollary to this is that the contributions to profit before and after a restructure need to be examined to determine the effectiveness of the changes.

The optimisation of a multinational's value chain through a restructuring can raise similar tax issues from a jurisdictional perspective as can arise with the optimisation of existing structures. Moreover there are examples where some multinationals have sought to restructure purely to obtain significant tax advantages.

I have found the following questions particularly important in differentiating between business driven and tax driven restructuring:

(i) What are the commercial objectives being sought from the restructuring? If these are clear and defensible then the Tax Office will have less concern about the overall restructuring. In this regard restructures that are based on reliable data and a sound basis for the projection of benefits, where there is no selectivity used that might distort the outcomes, are more likely to be able to be demonstrated to be business driven, assuming the bulk of the benefit is reflected in improved profitability on a before tax basis. There may however be components of the arrangement that may require more scrutiny, especially where a particular element of the arrangement does not appear to be necessary in order to obtain the non-tax benefits. In one case we examined the restructuring of the marketing and distribution functions of an Australian business. It was difficult to understand in that case why, even given the improvements being sought, the marketing entity needed to be held under different ownership in a low tax jurisdiction.

(ii) What has changed? Amongst other things the Tax Office is likely to consider changes in the following:

- ownership or line of ownership
- funding arrangements and cash flow impacts
- the deployment of functions
- the deployment and ownership of assets, and
- the incidence and control of risks.

(iii) What differences do the changes make? Where there is a demonstrable causal link between the source of the business problem, the means adopted to provide a solution and the effect of those steps, it is easier to demonstrate that

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the restructure is business driven. Where this is not the case the Tax Office is likely to ask other questions. At another level it is important to distinguish between nominal changes and substantive changes. If nothing has changed in practice the Tax Office will be guided by that reality.

It is not sufficient that a restructure can be justified on the basis that it improves the financial position of the group as a whole, or is at least done with that in mind. Jurisdictional issues can be overlooked in this process. From a tax perspective the economic contribution made by Australia to the profit channel needs to be recognised in the allocation of global profit, which is required to be done on the basis that the Australian side of the business is independent of the parent and dealing wholly independently with the related entities.

(iv) Do the steps involved in the restructure line up with the parts of the business in which improvements are sought, or are they broader (or narrower) than what would be needed to improve that part of the business? The extension or narrowing of the restructure may indicate other purposes which would need to be understood. We have been examining one case where a major takeover occurred that significantly increased the global business of the group. The group was pursuing a growth through acquisition strategy and wanted to acquire a wider range of products and skills and strengthen its market presence. Prior to the acquisition the Australian side of the acquiring multinational had a gross profit percentage of 40%, as did the target entity. After the takeover the combined entity on the Australian side had a gross profit percentage of 20%. In the course of the acquisition the supply chain was restructured and the cost of the inputs for the manufacturing and distribution businesses in Australia, which it was purchasing from group entities in low tax jurisdictions, was markedly increased, leaving the Australian operations unprofitable. The case is now the subject of a transfer pricing review.

(v) If the restructuring is complex, is that because the business issues and context are complex, or is the complexity driven by non-business factors? In one case we saw the use of circular funding and the interposition of a number of tax haven entities. These did not seem to us to be necessary for the more straightforward task of funding a new investment.

(vi) Does each of the key steps in the restructuring, and do they all in combination, have the effect that would be expected of that type of transaction or is the substantive effect different from what one would expect from the form? The Tax Office will have regard to form and substance. It would generally be difficult not to accept the form of a transaction at face value unless there is something anomalous or the transaction is one step in a wider set of arrangements that colours the nature and effect of the particular step.

(vii) Are the transactions of the particular form used in the restructuring typical to the form usually adopted by businesses in the particular context under examination? If the form of the restructuring is out of place in the context of the operations being restructured or in that market it will be necessary to understand why that form was adopted. For example, if debt funding is provided to a business that could not borrow on the open market a question will arise as to the purpose and object of the transaction.

(viii) Do any tax advantages emerge from the restructuring? What is the nature and extent of any tax advantage? How do any tax advantages compare with the value of any benefits flowing from improvements to business operations or structures? I have seen cases where the taxpayer has done a cost/benefit analysis in relation to a restructuring but did not include the likely tax reduction in the analysis of the projected delta cash flows. When the tax impacts were analysed they were much more significant than the projected business benefits. Interestingly the benefits arose in a low tax jurisdiction which had a higher cost of living than Australia. There were also questions about what really changed in the business since key parts of the functions still had to be performed in Australia and the offshore entity had limited scope to enhance the profitability of the value chain - but was going to take a significant amount of the profit that would otherwise arise in Australia. There was another case some years ago where the restructuring involved a fairly straightforward re-invoicing of purchases by the Australian business from Europe through an entity in a low tax jurisdiction. The entity in the low tax jurisdiction added a significant mark-up to the goods, resulting in tax deductions in Australia and an accumulation of profit in the low tax jurisdiction. In that case the re-invoicing arrangement was adding no benefit to the business - in fact it was increasing the costs - and the only advantage from the restructuring was the tax benefit. It was not hard to see that this restructuring was tax driven.

Once an understanding of the business has been developed there is an antecedent position against which to benchmark a restructure. This is not to say that all restructures have to be commercially successful; but the business cause and business effect have to be objectively seen as the drivers. Properly analysed, it becomes clearer which restructures are business driven and which ones are tax driven. It also becomes clearer what steps are essential to securing the business benefits and which, if any, steps might be seen as opportunistic tax driven elements that are unnecessary to the core objective and might be open to challenge.

Advance Pricing Agreements: what role do they play in tax administration? Can they apply to corporate restructures?

By their nature Advance Pricing Agreements are predictions based in large part on the kinds of business and financial analysis already discussed above. The above analysis may at times tend to assume the integrity of financial statements as accurately reflexing the legal entity's economic contribution to group profit. In many cases there may be checks and

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balances in the wider system that might suggest, at least for some purposes, that such reliance is justified. Market disclosures and reporting by Australian based multinationals listed on Australian stock exchange will often carry a high degree of reliability derived from the exacting nature of the scrutiny and the consequences of inaccuracy. At that level internal dealings wash out to form the consolidated picture and we can see the single count of economic value creation across the whole group.

However, consistent with accounting concepts and standards which focus on economic substance - and require it to be preferred where the picture it creates of financial performance and condition differs from that created on the basis of the legal form - the analysis of dealings within multinational groups can make no such assumption about integrity. This is because there may be a lack of economic tension between the parties in their dealings that produces outcomes at a subsidiary level or country level that, while furthering the economic interests of the group as a whole, are inconsistent with the outcomes that would be achieved if the subsidiary entities or geographical divisions were independent parties trying to optimise their separate economic interests in the way they dealt with each other in the open market.

Hence an objective diagnostic is needed to evaluate the relative economic contributions of the related parties to the overall profit and profitability. The respective contributions need to be understood, not just at the level of historical patterns and trends but at the deeper level of structural dynamics and economic drivers that give confidence that the patterns and trends are reliable and we can understand and accept why those patterns and trends are presenting. I think that this is the value added by economic functional analysis. It identifies the functions performed by each of the relevant parties, not simply in terms of the different parts of the business that are doing things, but in terms of the economic significance of the various functions performed to the creation of value, which economists and accountants then calibrate as wealth or profit. For example, re-invoicing transactions so that they flow through an interposed entity in a tax haven is a function; but it does not create economic value and hence the interposed entity should not be regarded as entitled to a share of the profit. Economic functional analysis has regard to the economic assets made available or created by the respective parties in the business process of creating the profits and profitability and to the economic risks assumed by each of the parties.

While legal assets and risks are taken into account, it is the economic assets and risks that are determinative when there are differences. There are many instances where a party has made an economic contribution that is not recognised by the vesting of legal rights. A distributor may expend significant amounts in developing a market for products but not be the owner of the marketing intangibles. In some cases the distribution function may require significant expertise, as in the case of the detailing of pharmaceuticals to doctors in order to promote support for prescription medicines. In such a case the related party transactions may be the purchase of the active ingredients from an associated company in a low tax jurisdiction and a transactional focus based on a legal analysis of purchase agreements may miss the essential question of whether the distributor is being rewarded sufficiently for the economic contribution the marketing function makes to the profit and profitability of the value chain.

It seems clear that the transfer pricing provisions in the Associated Enterprises Articles of Australia's treaties and the provisions of Division 13 of the *Income Tax Assessment Act 1936* allow a re-setting of positions beyond what legal rights would require. Were this not the case the provisions would be inoperative.

Having done the economic functional analysis we are able to see the drivers of revenue and costs and the other contextual parameters that we can say have produced a level of profits that, if those drivers and parameters remained constant, would be expected to be produced in the future. It is the understanding of the underlying fundamentals and a judgment about their sustainability that gives the confidence to agree an Advance Pricing Agreement. The sustainability of the patterns and trends in the business is critical. To get to that understanding requires the depth of analysis described above.

Ideally the economic functional analysis is done on a global basis to increase its reliability and ensure the results make sense across the full value chain and separate markets and countries. Where only part of a business is subject to an application for an Advance Pricing Agreement the analysis will still be able to be done, for example where a taxpayer submits the Australian operations to scrutiny but does not want a bilateral or multilateral Agreement that also covers the offshore activities.

Even within the Australian operations it may sometimes be feasible to do a transfer pricing analysis in respect of one feature of the business. However that becomes fraught with difficulty when the feature being examined is closely linked to other functions, assets or risks such that an independent assessment of it becomes unreliable in terms of the extent to which that feature on its own contributes to profit and profitability.

Of course all businesses will change over time and part of the Advance Pricing Agreement process is to set a sensible review date having regard to how long it is likely that the fundamentals of the business will remain materially the same.

Advance Pricing Agreements may be a way of managing transfer pricing risks that arise in the context of a corporate restructure. It will be important in those instances to establish the antecedent position in relation to the profit and profitability of the business, and the respective economic contributions of the relevant entities and jurisdictions. Only then can changes to those structures and operations be sensibly understood.

It needs to be borne in mind that an Advance Pricing Agreement is a compliance product, designed to assist taxpayers

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self manage their transfer pricing risk from a tax perspective. It therefore needs to be soundly based so that the extrapolation of results is reliable in terms of being as accurate a forecast as is reasonably practicable, having regard to the importance of the issues being covered. It has to be based on sound principles and data that has integrity. The assumptions framing the analysis of future performance have to be clearly demonstrated as being collectively the probable future context in which the business will operate. They cannot present risks of anomalies or distortions. The Tax Office needs to be assured that the assumptions are robust and that the necessary sensitivity analysis has been done. The arrangement as a whole has to make business sense. Without this level of rigour the risk is that the parties adopt a more arbitrary and, to my mind, unjustifiable process of taxation by negotiation.

In all transfer pricing examinations, including the consideration of applications by taxpayers for Advance Pricing Agreements, three fundamental questions arise:

1. Is the arrangement one that would be contemplated by arm's length parties such that on a two-sided analysis, having regard to all the relevant facts and circumstances, they would be likely to agree mutually acceptable terms and conditions?
2. If the answer is 'no', how do the transfer pricing provisions of Australia's treaties and Division 13 apply?
3. If arm's length parties would enter the arrangement, are the terms and conditions consistent with the outcomes that would have been achieved by independent parties dealing wholly independently with each other? These cases are somewhat less controversial though the recent Administrative Appeals Tribunal case of *Roche Products Pty Ltd v Commissioner of Taxation*[4] shows that problems arise even at that level and that a more exacting approach is needed to the question of comparability.

There are many examples of leveraged funding strategies where parent companies provide debt funding to very thinly capitalised subsidiaries. One could fairly confidently say in some of these cases that on the basis of industry practice the funding arrangements are not of a kind that arm's length parties would enter.

In other cases taxpayers propose to transfer some of their functions or assets to an entity in low tax jurisdictions and attribute a significant share of its profit to that entity. In some cases this occurs when the Australian side of the business is performing quite well and expects to continue to improve its profit and profitability.

So called 'risk stripping' as a tax strategy is one example of this. It appears to be based on the proposition that the higher the risk an enterprise assumes the higher the reward it is entitled to. At one level the proposition seems unobjectionable. However in some cases one has to ask why a profitable business would preclude itself from taking full advantage of the profitability of its operations by disposing of part of its business. The question is particularly more acute if the functions or assets being disposed of are essential to the profitable operation of the Australian operations and do not in themselves constitute a separate business. Moreover their transfer may open up a series of new risks. In the absence of compelling business reasons one has to consider the tax aspects to determine objectively whether they are driving the arrangements. Depending on the facts and circumstances this may require a consideration of Part IVA as well as the transfer pricing provisions.

If arm's length parties would not enter these transactions, assuming for the moment that the facts and circumstances support such a conclusion, how do the transfer pricing provisions apply? This takes us to the transfer pricing provisions themselves and an examination of their scope and effects.

Are the Associated Enterprises Articles in Australia's Treaties a separate head of power from Division 13?

One issue emerging as a debate in this context is whether the Associated Enterprises Articles in Australia's tax treaties provide a separate head of power to Division 13 in addressing transfer pricing problems. This matter has not been the subject of a court decision and admittedly while the issue is not free from doubt the Tax Office has taken the view that the Articles do provide a separate head of power.[5]

Inevitably this takes one to a consideration of the terms of the Associated Enterprises Articles which are framed in terms that an adjustment amount of profits **may** be included in the profits of an enterprise and taxed accordingly. The word 'may' has been interpreted by some as giving permission through the treaty for a Contracting State to enact enabling legislation to achieve the result envisaged by the terms of the Article. Of course many countries will already have transfer pricing legislation and be thinking how the treaty might affect it.

Arguably another perspective is that the Article envisages that the tax authorities of the Contracting States are empowered to make appropriate adjustments. To the extent that treaties follow norms, countries may approach the treaty as establishing 'the international rules of the game' as to when and how transfer pricing adjustments should be made, and how relief by way of compensating adjustments should also be given.

In other words the reference to 'may' in the Article is taken as referring to the administration not the legislature. This seems to be the view taken by the OECD[6].

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The answer to this question may well turn on the means by which particular countries give legal effect to their treaties. An international learned perspective on this issue is provided by Philip Baker, QC of Gray's Inn, in *Double Taxation Agreements and International Law*[7] where he points out said:

> "Different states have adopted different views on this point …
>
> If the treaty has become part of the domestic law, then why should revenue authorities not exercise that jurisdiction up to this defined limit?
>
> Ultimately, the answer will depend upon the constitutional situation in each state. … In the United States … the Constitution provides that revenue bills must originate in the House of Representatives and receive the approval of both parts of Congress. Treaties, on the other hand, are negotiated by the Executive … and are then submitted to the Senate for their advice and consent. … it seems that the constitutional structure should argue against the ability of the executive to increase the level of taxation on any person by the provisions of a treaty."

Enactment of treaties in Australia

Australian treaties are given the force of law in Australia by the *Income Tax* (*International Agreements) Act 1953*. Section 4 of that Act says that:

1. Subject to the next succeeding sub-section, the Assessment Act is incorporated and shall be read as one with this Act.
2. The provisions of this Act have effect notwithstanding anything inconsistent with those provisions contained in the Assessment Act or in an Act imposing Australian tax.

Each treaty is then given the force of law by a specific section of the Agreements Act. For example, for the UK convention, section 5 says:

> "Subject to this Act … the provisions of the convention, so far as those provisions affect Australian tax, have the force of law according to their tenor."

A clear implication of the incorporation of the Assessment Act and its needing to be read as one with the Agreements Act is that the Commissioner of Taxation has the general administration of the Agreements Act.

The term 'profit' is not defined in Australia's treaties. In such circumstances it falls to the meaning that the term has under the laws from time to time in force in the State seeking to apply the treaty. Subsection 3(2) of the Agreements Act states,

> 'For the purposes of this Act and the Assessment Act, a reference in an agreement to profits of an activity or business shall, in relation to Australian tax be read, where the context permits, as a reference to taxable income derived from that activity or business.'

The issue of whether treaties conferred a separate head of power to the then section 136, the forerunner to Division 13, and the associated issue of the Commissioner's power to amend an assessment were discussed to some extent in *Case N69*[8]. It was agreed between the parties (both of whom were represented by eminent counsel) that the Commissioner could amend the assessments. Transfer pricing adjustments were still maintained, but were at a reduced level consistent with the independent enterprise test in the Associated Enterprises Article since the Board of Review decided that Article IV of the UK treaty prevailed over section 136 because of the inconsistency between them and that therefore effect has to be given to Article IV.[9]

Any doubt about the Commissioner's power to amend was removed in 1982 with the enactment of subsection 170(9B) which was introduced as part of the Bill enacting Division 13 and provides,

> 'Subject to subsection (9C), nothing in this section prevents the amendment, at any time, of an assessment for the purpose of giving effect to a prescribed provision **or** a relevant provision'

The disjunctive drafting tends to support an argument that a relevant provision is a separate head of authority. So, what might be those separate heads of authority?

'Prescribed provision' is defined in subsection 170(14) as meaning section 136AD or 136AE. These are the operative provisions of Division 13 that apply to taxpayers (which could be companies) and branches.

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'Relevant provision' in its current form is defined in the same subsection as meaning,

> a) 'a provision of a double taxation agreement that attributes to a permanent establishment or to an enterprise the profits it might be expected to derive if it were independent and dealing at arm's length; or
>
> b) [There is a specific provision relating to the Timor Sea Treaty that is not presently relevant.]'

In its original form as part of the 1982 Bill introducing Division 13, 'relevant provision' was defined as,

> 'paragraph (3) of Article 5 or paragraph (1) of Article 7 of the United Kingdom agreement or a provision of any other double taxation agreement that corresponds with either of those paragraphs'

At that time the references to the Business Profits Article (Article 5) and the Associated Enterprises Article (Article 7) were to the powers to adjust profits that were misallocated due to non-arm's length conditions operating. There was no equivalent of the Corresponding Adjustment provisions that we now see in many of Australia's treaties. The only remedy in those days was that Competent Authorities were given the power to consult in order to endeavour to resolve disputes regarding transfer pricing adjustments under Articles 5 and 7. However, this power was conferred by Article 20 of the then UK Agreement.

In summary, the special power to amend assessments in relation to transfer pricing adjustments under treaties was initially confined to the power to make **debit** amendments. This tends to support the argument that the transfer pricing provisions were intended by Parliament to be a separate head of power.

In this regard the Explanatory Memorandum accompanying the Bill introducing subsections 170(9B) and (9C) included the following explanations:

> Notes on Clause 21: Amendment of assessments
>
> "New sub-section 170(9B) … contains a corresponding power of amendment where a matching provision of a double taxation agreement is applied instead of Division 13[10].
>
> In their practical effect, proposed sub-sections 170(9B) and (9C) will clarify the powers of the Commissioner to amend an assessment where a provision of a double taxation agreement that deals with profit shifting may be applicable. Sub-section 4(2) of the *Income Tax (International Agreements) Act 1953* provides that the provisions of that Act are to have effect notwithstanding anything inconsistent with those provisions contained in the Principal Act. Technically, therefore, the provisions of a double taxation agreement that deal with profit shifting, either under a "business profits" article (e.g., Article 5 of the Australia/U.K. agreement), or an "associated enterprises" article (e.g., Article 7 of that agreement), may have to be applied instead of Division 13. Where the profit shifting provisions of a double taxation agreement are to apply in these circumstances, sub-sections 170(9B) and (9C) confer the same specific powers of amendment of an assessment as are to be provided in relation to revised Division 13."

An analysis of penalty provisions like section 226(2C) which imposes the lesser amount of penalty where a treaty provision and Division 13 each apply to produce different amounts of additional liability, could arguably also be seen as supporting a view that there is a separate head of power under Australia's treaties to adjust transfer prices to correct misallocations of profits.

The Explanatory Memorandum (EM) for the Income Tax Assessment Amendment Act 1982 introducing Division 13

The EM accompanying the Bill that inserted Division 13 also expressly indicated that double tax agreements themselves would operate to make adjustments.

> Notes on 136AB: "It is not proposed that Division 13 will override the Income Tax (International Agreements) Act 1953. The double taxation agreements which appear as Schedules to that Act ***contain their own provisions to deal with profit shifting arrangements which occur in an agreement context***, and these provisions are based on application of the arm's length principle."
>
> Notes on 136AE: "The section's second basic function is to deal with the situation of a taxpayer carrying on business in one country and, which as the same legal entity, has one or more branch offices (or "permanent establishments") in another country or countries through which the business is also carried on. … Technically,

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section 136AD cannot apply because any profit shifting in this case is internal, between a head office and its branch or branches, or between branches.

Each of the basic functions is within the scope of existing section 136 … Moreover, each of these functions is, in the situations with which those agreements deal, carried out by provisions in each of Australia's comprehensive double taxation agreements with other countries - see, for example, paragraph (3) of Article 5 and Article 7 of the Australia/U.K. agreement.:

Main features comments on Clauses 19 and 21-23

"*There can be situations, **for which both existing section 136 and each of the double taxation agreements make provision**, where it is not feasible to ascertain the arm's length consideration that is to be taken as a benchmark. This can happen where the nature of the industry is such that relevant arm's length dealings do not exist, or where information about arm's length dealings is not available to the taxation authorities. The new provisions will, in relation to such situations, enable appropriate re-construction of Australian taxable income arising in international transactions.*

…

*Reflecting the position that exists in relation to existing section 136, an assessment may be amended to give effect to the revised Division at any time … **Where a double taxation agreement provision operates to reallocate profits**, amendment of assessments will be authorised on the same basis.*"

The nature and purpose of the Associated Enterprises Articles and their connection to the treaty purposes

Australia's double tax treaties have the dual purposes of avoiding double taxation and the prevention of fiscal evasion. The second purpose, while its terminology might be read as emotive in Australia, was a broader concept than what we understand to be the illegal avoidance of tax. It is I believe apt to embrace the misallocation of profit through conditions that operate in a way that produce non-arm's length outcomes.

It seems clear that *GE Capital Finance Pty Ltd (Highland Finance Trust)* v. *F C of T* [2007] FCA 558 was concerned with the first purpose of avoiding double taxation by sharing taxing rights and in respect of which in Middleton J's view Australia had not sufficiently dealt with the liability of deemed permanent establishments of trusts to tax on interest income arising in Australia on the same basis as business profits. In the course of his judgment Middleton J expressed the view that section 3(11) of the Agreements Act facilitated the operation of the Business Profits Article which his Honour saw as enabling and not imposing tax itself. However his Honour was addressing the question of whether the legislature had gone far enough to ensure that in the circumstances outlined the interest income would be taxed as business profits rather than under the withholding tax regime; he was not considering the misallocation of profits. Nevertheless it is clear that some people are reading his Honour as interpreting the Business Profits Article as confined to the sharing of taxing rights. It also seems clear that they are extrapolating that view to the determination of the nature and scope of the Associated Enterprises Articles in Australia's treaties.

The international debate, or should I say one side of it, seems to envisage that the Business Profits Article may have been serving more than one purpose. The first seems to be that it is directed to the sharing of taxing rights by providing that non residents should not be taxed on their business profits unless they have established a sufficient territorial connection, described in the treaties as the threshold of having a 'permanent establishment' through which they carry on business, and then providing that it is only the profits attributable to the permanent establishment that may be taxed. The second seems to be that, in order to ensure the integrity of the attribution of profits, a second rule based on a hypothetical distinct and separate enterprise dealing wholly independently with the enterprise of which it is a permanent establishment is included.[11] In speaking of this aspect of the Business Profits Article the Board of Review says,

"… the method prescribed by Art III(3) for ascertaining the profit attributable to the country of source ensures that only one principle shall be followed, with the result that each country will not quantify two different amounts attributable to the same source, thereby leaving some part of the profits unrelieved from double taxation. At the same time the method prescribed prevents the enterprise of one territory with a permanent establishment in the other from evading its full fiscal obligation to that other territory ... Art III is concerned both with the avoidance of double taxation and with the prevention of fiscal evasion."[12]

Much of the debate about whether treaties confer powers on tax authorities seems to derive from the function of treaties in sharing taxing rights. On one view this is not the purpose of the Associated Enterprises Articles which on this basis would be seen to be directed at ensuring the integrity of the treaty against attempts to produce profit allocations that do not reflect the economic contributions of the parties. The other leg of the debate seems to revolve around the legislative standing of treaties, which has been discussed above.

In the Explanatory Memorandum to the *Income Tax (International Agreements) Amendment Act 1995* the following purposes are attributed to Australia's treaties:

> "Australia's DTAs are designed to:
>
> a) Prevent double taxation and provide a level of security about the tax rules that will apply to particular international transactions by:-
>
> - allocating taxing rights between the contracting countries over different categories of income;
> - specifying rules to resolve dual claims in relation to the residential status of a taxpayer and the source of income; and
> - providing, where a taxpayer considers that taxation treatment has not been in accordance with the terms of a DTA, an avenue for the taxpayer to present a case for determination to the relevant taxation authorities.
>
> b) Prevent avoidance and evasion of taxes on various forms of income flows between the treaty partners by:-
>
> - providing for the allocation of profits between related parties on an 'arm's length' basis;
> - generally preserving the application of domestic law rules that are designed to address transfer pricing and other international avoidance practices."

Commentators and overseas decisions

In the context of different constitutional requirements for revenue legislation, different methods of enactment and different statements of the purpose of tax treaties, it is not surprising that some commentators state that treaties merely restrict the tax that can be imposed. For example, in *Klaus Vogel on Double Taxation Conventions,* Vogel says:

> "DTCs merely restrict, rather than generate, domestic law. The first conclusion to be drawn from this is that Art. 9 by itself cannot be an independent legal basis for upward income adjustments."[13]

On the other hand, J. Oliver expressed a different view in 'Double Tax Treaties in United Kingdom Law', *British Tax Review,* 1970, p. 388 at page 398:

> "It appears to the writer that these "Associated Enterprises" treaty articles do take effect in United Kingdom law even though they go further than the provisions of section 485 and may lead to an increase in a liability to United Kingdom tax which could not otherwise arise. This is because the wording of section 497 (1)(c)(ii) is so wide, referring to residents who have "special relationships" with non-residents, and therefore enables the treaty provisions to take effect."

Baker also referred to several decisions in the Netherlands where it was held that there was no legal provision which prevented a treaty from imposing a heavier tax burden. He also referred to contrasting decisions in the German and French courts.

Vogel also referred to an earlier German position which based profit adjustments solely on the treaty adjustment rule.[14]

The Tax Office position

The Tax Office view, previously stated in Public Rulings, though not fully elaborated, is that the treaties do enable us to make transfer pricing adjustments as an alternative to Division 13. As discussed above, while there may be debate, there is a basis for the Tax Office view. I have refrained from using the metaphor of 'the sword and the shield' because I believe it is confusing.

Australian treaties also include paragraph (3), which is not in the OECD model.

> "**(3)** Nothing in this Article shall affect the application of any law of a Contracting State relating to the determination of the tax liability of a person, including determinations in cases where the information available to the competent authority of that State is inadequate to determine the income to be attributed to an enterprise, provided that, on the basis of the available information, the determination of that tax liability is consistent with the principles stated in this Article."

This paragraph can be interpreted, having regard to the legislative framework discussed above, as implying that paragraph (1) is conferring a substantive power that would override Division 13 but for this express saving. The specific

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reference to cases where there is insufficient information arguably extends what the Commissioner could do if he were confined to the treaty alone. Moreover, Australia needed to reserve its statutory power to apply its transfer pricing rules in cases involving cross-border dealings between treaty country residents who did not fall within the description of associated enterprises.

Roche Products Pty Ltd v. F C of T [15]

The question of whether the transfer pricing provisions in treaties are a separate head of power was raised before Downes J in the *Roche Case.* The Commissioner relied upon two alternative bases to support the assessments - section 136AD and the Associated Enterprises Articles in Australia's treaties with Switzerland and Singapore.

However his Honour did not decide the point since the parties agreed that Division 13 applied and would produce the same outcome in the facts and circumstances under consideration. His Honour did however say that, while the Commissioner did not present a fully developed argument, much could be said for the view that treaties shared taxing rights and did not confer any power to assess.

One can understand the general expectation that countries will legislate their own rules for the governance of revenue matters and that generally that will not be seen to be the purpose of treaties. That said treaties are given the force of law in Australia thereby removing the limitation that they can only be pleaded on a country to country level. Once given the force of law they can be pleaded by citizens. The debate is whether they can be pleaded by tax administrations in some circumstances as authority for taking assessment action. Arguably treaties do confer some powers on tax administrations, for example the power to exchange information, to make corresponding adjustments in transfer pricing cases. Arguably in some cases the legislation enacting treaties may affect the application of the tax law in Australia, for example by deeming certain income to have an Australian source.

It seems clear that the Associated Enterprises Articles of Australia's treaties do have a bearing on the operation of Division 13 through the requirement of consistency; and can therefore affect the way those provisions apply. Some would say that this effect is limited to adjusting the operation of Division 13 where it would otherwise overreach the treaty.

For example the application of Division 13 to a particular supply or acquisition of property may produce an anomaly in cases where according to the treaty there is no misallocation of profit in overall terms. In a practical sense the limitation would appear to be to methodologies available under the treaty and to the amount of adjustment available under the treaty. However, one has to question whether this line of argument assumes that both sets of provisions can apply in all cases. If in a particular case Division 13 cannot apply but the treaty envisages the situation as being one where an increase in profit is appropriate, does the treaty allow the Commissioner to make the adjustment?

The constitutional and legislative standing of the Associated Enterprises Articles in Australia's treaties is not free from doubt and it seems clear that the debate around this issue could possibly continue until finally determined by the Courts. For its part the Tax Office will continue to reflect on the issue. In cases where Division 13 and the relevant Associated Enterprises Article apply it is unlikely that a Court will seek to resolve to point. It may be that the debate may have to be had in a case where the consideration for an acquisition or supply of property is not the source of the transfer pricing problem.

Footnotes

[1] The elements of a multinational were the subject of an interesting article by Pauly, LW and Reich, S 'National structures and multinational corporate behaviour: enduring differences in the age of globalization', *International Organization*, 1997, Cambridge, vol. 51, issue no 1, pp. 1-30.

[2] Organisational configuration is discussed in more detail in Hames, RD 2007, *The five literacies of global leadership: what authentic leaders know and you need to find out*, Jossey-Bass, Chichester, England.

[3] See Porter, ME 'How competitive forces shape strategy', *Harvard Business Review*, 1979, Boston, vol. 57, issue no. 2, p. 137.

[4] [2008] AATA 639.

[5] See paragraphs s 63-79 of Taxation Ruling TR 92/11, paragraphs 18 and 184-186 of Taxation Ruling TR 94/14, paragraphs 2.1 to 2.9 of Taxation Ruling TR 2001/11 and paragraphs 29-33 of Taxation Ruling TR 2001/13.

[6] See OECD Committee on Fiscal Affairs, *Model Tax Convention on Income and on Capital*, 2000, OECD, Paris, vol. 1, Commentary on Article 9 Concerning the Taxation of Associated Enterprises, at paragraph 2.

[7] Baker, P 1991 Double Taxation Agreements and International Tax Law, Sweet & Maxwell, London, pp. 6-8. This position is maintained in Baker, P 2006, *Double Taxation Conventions: A Manual on the OECD Model Convention on Income and on Capital*, Sweet & Maxwell, London, pp. B-1 to B-4.

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[8] (1963) 13 TBRD 270.

[9] See (1963) 13 TBRD 270 at 284. I note the Board of Review also said that their application of section 136 would not have produced an amount of taxable income different from that produced by an application of Article IV.

[10] Prior to the enactment of Division 13 in 1982 necessary adjustments to taxable income were made by way of an original 'special' assessment under section 168. Subsection 168(1) of the 1936 Assessment Act provides,

'The Commissioner may at any time during any year, or after its expiration, make an assessment of the taxable income derived (or that there is no taxable income) in that year or any part of it by any taxpayer and of the tax payable thereon (or that no tax is payable).'

[11] The Business Profits Articles in Australia's treaties reflect the view that in Australian law there is only one entity; that one cannot make a profit out of oneself; and that it is therefore a question of attributing income and expenses.

[12] (1963) 13 TBRD 270 at 281.

[13] 1997 edition at page 571.

[14] Page 521.

[15] [2008] AATA 639.

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