TR 95/D11 - Income tax: application of Division 13 of Part III (international profit shifting) - basic concepts underlying the operation of Division 13 for permanent establishments and circumstances in which subsection 136AE(4) will be applied

This document has been Replaced.

Draft Taxation Ruling

Income tax: application of Division 13 of Part III (international profit shifting) - basic concepts underlying the operation of Division 13 for permanent establishments and circumstances in which subsection 136AE(4) will be applied

other Rulings on this topic

IT 2446; TR 94/14

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What this Ruling is about

1. This Ruling provides guidelines on:

   (a) the basic concepts underlying the application of Division 13 of Part III ('Division 13') of the *Income Tax Assessment Act 1936* ('ITAA') to permanent establishments ('PEs'); and

   (b) the circumstances in which subsection 136AE(4) of Division 13 will be applied resulting in a deemed allocation of income and or expenses within a single legal entity (e.g. between a PE and its head office or between two PEs of the same entity).

2. This Ruling focuses on profit shifting issues arising from dealings between parts of a multinational enterprise ('MNE') that operates as a single legal entity carrying on business through PEs (e.g. as a head office and branch offices).

3. In broad terms, this Ruling provides guidance, based on the principles in Division 13, on allocating an appropriate amount of the actual income and expenses of a MNE between its Australian and foreign operations where international dealings between different parts of the MNE are concerned, so that the right amount of Australian tax is payable. In providing these guidelines, it is not being suggested that taxpayers must adopt the principles in Division 13 for any purpose unconnected with the calculation of their taxation liabilities.

4. In particular, this Ruling considers:

(a) the meaning and implications of the 'single entity approach' adopted by Australian law;

(b) the principles for determining the source of income;

(c) the interpretation and application of subsections 136AE(4) and (7) of Division 13;

(d) how regard is to be had to the internationally accepted arm's length principle in allocating income and expenses to PEs;

(e) timing issues associated with the derivation of income and the incurring of expenditure to be allocated under subsection 136AE(4); and

(f) the documentation needed in order to evaluate and review whether a taxpayer's allocation of income and expenses accords with subsection 136AE(4).

5. Subsections 136AE(4), (5) and (6) together effectively form a code within Division 13 for dealing with 'internal' profit shifting between a PE and its head office or another PE of the same entity, in circumstances other than where section 136AD has been applied to deal with profit shifting between that entity and another entity. The basic principle is contained in subsection 136AE(4), and the later subsections apply it to partnerships and trusts. Because the operative parts of the three subsections are all to the same general effect, this Ruling is expressed only in terms of subsection (4). Subject to any specific differences in the wording of the subsections, the views expressed on subsection (4) in this Ruling will in general apply also to subsections (5) and (6).

6. This Ruling does not deal with subsections 136AE(1) (2) and (3), which provide for the determination of the source of income and the allocation of related expenses where section 136AD has been applied to deem an arm's length consideration in respect of an international agreement between separate legal entities. Our views on the operation of subsections 136AE(1) (2) and (3) in conjunction with section 136AD are stated in Taxation Ruling TR 94/14, 'Application of Division 13 of Part III (international profit shifting) - some basic concepts underlying the operation of Division 13 and some circumstances in which section 136AD will be applied' ('TR 94/14') at paragraphs 123-125 and 412-419.

7. Any views expressed in this Ruling in respect of paragraphs 136AE(7)(a) and (c) will apply equally in making a determination under subsections 136AE(1)(2) or (3), to the extent that those views have relevance in separate entity situations.

8. Subsection 136AE(4) provides for determining the source of income or the extent to which expenditure is incurred in deriving income from a particular source, where that income or expenditure is in some part attributable to activities carried on through a PE. In a practical sense the result achieved may conveniently be expressed in terms of allocating income or expenditure to a PE. It is on this basis that this abbreviated way of expressing the function performed under subsection 136AE(4) is used throughout this Ruling.

9. Where a view is expressed in this Ruling in terms of a dealing between the head office and a PE of an entity, that view will apply equally to a dealing between two PEs of an entity.

10. This Ruling does not address in detail the threshold issue of what constitutes a PE and the circumstances in which an entity's presence in a country is regarded as a PE.

11. This Ruling does not specifically address the methodologies to be used in allocating expenses incurred by an entity between different parts of that entity. This will be the subject of a later Ruling.

12. In considering the guidelines provided in this Ruling on the application of Division 13, the terms of any relevant Double Taxation Agreement must also be considered. The interaction of Division 13 and Double Taxation Agreements will be the subject of later Rulings.

13. It is not the purpose of this Ruling to deal with matters already explained in Taxation Ruling TR 94/14.

Date of effect

14. This Ruling applies to years commencing both before and after its date of issue. However, the Ruling 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 the Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

Ruling

The role and structure of Division 13 as it applies to single legal entities

15. Subsections 136AE(4) (5) and (6) are intended to counter 'international profit shifting' by which Australia may be deprived of its fair share of tax, where a taxpayer carries on business, in Australia and overseas, by operating as a single entity through a PE or PEs. Such profit shifting is effected through the allocation of an inappropriate

amount of the taxpayer's income and or expenses between its Australian and overseas operations **(paragraphs 88-94)**.

16. In general, Australian law adopts a 'single entity approach' to dealings between a PE and another part of the same entity, such as its head office or another PE; it does not recognise such dealings because an entity cannot transact with itself or make a profit out of itself. The ITAA, including Division 13, generally adheres to this approach and does not recognise that, for income tax purposes, a dealing between parts of a single legal entity can result in a derivation of income or the incurring of expenditure **(paragraphs 95-97)**.

17. The single entity approach is not generally adopted for commercial and accounting purposes. For these purposes, internal dealings within the same legal entity, such as the transfer of trading stock or the provision of funds or services between profit or business centres of a MNE, are in practice recognised and recorded. Commercial practicalities ordinarily mean that these records are used as the basis for the allocation, for tax purposes, of the entity's income and expenditure between its Australian and overseas operations **(paragraph 98)**.

18. Subsections 136AE(4)-(6) and 136AE(7) complement this by providing that, in determining for tax purposes an appropriate allocation of a taxpayer's income and expenses to a PE, regard be had, inter alia, to the internationally accepted arm's length principle and to the circumstances that might be expected to have existed if the PE were a separate entity dealing at arm's length with other parts of the taxpayer entity **(paragraph 99)**.

19. The extent to which regard is to be had to the arm's length principle for the purposes of subsections 136AE(4)-(6) is restricted by the confines imposed by the single entity approach, and the limitation that, in this context, the arm's length principle is used only as a reference for the purposes of allocating, between parts of a taxpayer, income in fact derived, or expenditure in fact incurred, by the taxpayer **(paragraph 100)**.

The interaction between subsection 136AE(4) and Australia's Double Taxation Agreements

20. In considering the application of subsection 136AE(4), the terms of any relevant Double Taxation Agreement must also be considered. The Commissioner of Taxation may apply the provisions of Division 13 and/or the treaty provisions. In the event of any inconsistency, the treaty provisions will prevail unless the treaty itself provides for domestic law to apply **(paragraphs 101-107)**.

The interaction between subsection 136AE(4) and subsection 51(1)

21. It will not be necessary to consider applying subsection 136AE(4) for the purpose of denying or reducing a deduction claimed under subsection 51(1) if no deduction is in fact allowable under subsection 51(1). This may either be because the relevant expenditure, or part of it, was incurred other than for the gaining or production of a taxpayer's assessable income or in carrying on a business for that purpose, or because it was capital, private or domestic expenditure or incurred in producing exempt income **(paragraphs 108-112)**.

22. Subsection 136AE(4) may need to be invoked as an alternative basis upon which to support the disallowance of a deduction under subsection 51(1) if:

(a) there is some doubt about the operation of subsection 51(1) in the particular circumstances; and/or

(b) the facts indicate profit shifting from Australia has occurred through an allocation of a taxpayer's expenses to a PE that is inconsistent with the arm's length principle

(paragraphs 111-113).

23. Where expenditure is otherwise deductible under subsection 51(1), subsection 136AE(4) can apply to allow an adjustment to be made to the amount of that expenditure, where the conditions for its application have been satisfied **(paragraph 114)**.

Outline of the basic concepts

24. Subsection 136AE(4) applies, for a taxpayer other than a partnership or trustee, to deem, 'for all the purposes of [the ITAA]', income as derived from, or expenditure as incurred in deriving income from, a source or sources as determined by the Commissioner, if all of the following conditions are satisfied:

(a) the taxpayer is either:

(i) a resident carrying on a business outside Australia at or through a PE; or

(ii) a non-resident carrying on a business in Australia at or through a PE;

(b) a question arises as to whether either:

(i) income derived by the taxpayer has a source in or out of Australia; or

(ii) expenditure of the taxpayer is incurred in deriving income from sources in or out of Australia;

(c) none of subsections 136AE(1), (2) or (3) apply to determining that question;

(d) that question, if determined on the basis of the return furnished by the taxpayer, would have a tax result more favourable to the taxpayer than if the question were determined under subsection 136AE(4); and

(e) the Commissioner considers that the income or expenditure is attributable in some part to activities of the PE.
(paragraphs 115-117).

25. Subsection 136AE(7) provides that, in making a determination under section 136AE, the Commissioner must consider:

(a) the nature and extent of the business carried on by the taxpayer and where it is carried on;

(b) the circumstances that would have, or might reasonably be expected to have, existed if the PE were a separate entity dealing at arm's length with the taxpayer and other persons; and

(c) other matters considered relevant
(paragraph 118).

Paragraph 136AE(4)(a)

26. It is not a purpose of this Ruling to consider in detail the meaning of the terms and expressions 'taxpayer', 'resident', 'carries on a business' and 'permanent establishment' as used in paragraph 136AE(4)(a). By way of general guidance:

(a) subsection 136AE(4) applies to a 'taxpayer' (see paragraphs 25 and 211-213 of TR 94/14) who is an individual or a company **(paragraphs 119-120)**;

(b) whether a taxpayer is a 'resident' or 'non-resident' is determined by applying the definition of 'resident' in subsection 6(1) **(paragraphs 121-122)**;

(c) the expression 'carries on a business' has its ordinary meaning **(paragraph 123)**;

(d) the words 'at' and 'through' both connote that the business carried on is attributable to, or results from, the activities of the PE **(paragraph 128)**;

(e) the term 'permanent establishment' is defined in subsection 6(1), as being 'a place at or through which the person carries on any business'. Division 13 provides an extended definition of 'permanent establishment' in subsection 136AA(1) **(paragraphs 124-126)**;

(f) paragraph (b) of the definition of 'permanent establishment' in subsection 136AA(1) will include situations in which an entity has its property processed or manufactured on its behalf by another entity, irrespective of the nature of the actual business arrangement and dealings between the two **(paragraph 126)**;

(g) the definition of 'permanent establishment' in any applicable Double Taxation Agreement must also be considered **(paragraph 127)**.

Paragraph 136AE(4)(b)

The meaning of 'a question arises'

27. The test of whether either of the questions referred to in paragraph 136AE(4)(b) 'arises' is whether the particular factual situation of a taxpayer means that the question must be answered for the Commissioner to make a proper assessment of tax payable by the taxpayer. The answer to the question must therefore be relevant either to determining taxable income or matters such as entitlement to credits or rebates **(paragraphs 129-135)**.

The meaning of 'any income derived by the taxpayer'

28. Subsection 136AE(4) adheres to the single entity approach and authorises only the allocation of income in fact derived by a taxpayer. The application of subsection 136AE(4) cannot create a derivation of income from a dealing between parts of an entity, or determine the timing of derivation of the entity's income that is to be allocated **(paragraphs 138-140)**.

The meaning of 'derived from sources in Australia or sources out of Australia'

29. The geographical source of income, other than for those specific types of income for which the ITAA prescribes a source, is determined by taking a practical commercial view as to the real or actual origin of the income according to the facts and circumstances of a particular situation **(paragraphs 143-150)**.

30. Where income arises from the carrying on of a business, the source of that income is determined by where the activity or activities, from which the income in substance arises, take place **(paragraphs 146-147)**.

31. Where the essence of a business is a series of activities which together result in the derivation of income, then the source or sources of that income are determined by where the activities that are considered to be significant contributing factors to the derivation of the income take place. If activities that take place both in and out of Australia are significant contributing factors to the derivation of an item of income, then that income must be apportioned between sources in and sources out of Australia **(paragraphs 148-150)**.

The meaning of 'any expenditure incurred by the taxpayer'

32. Expenditure to which subsection 136AE(4) applies encompasses all losses and outgoings that may be an allowable deduction under a provision of the ITAA, including all losses and outgoings deductible under subsection 51(1) **(paragraphs 151-152)**.

33. The word 'incurred' refers to expenditure in fact incurred by the taxpayer. The single entity approach means that a dealing between a PE and its head office or another PE cannot create a liability, charge or payment which is 'expenditure incurred' or a deduction allowable under the ITAA. It follows that:

(a) a deductible amount cannot include a profit mark-up created by a charge between the PE and another part of the entity that is in excess of the expenditure actually incurred by the entity;

(b) nothing that occurs between the PE and another part of the entity with respect to discharging the liability for that expenditure can increase, reduce or in any way alter the amount deductible; and

(c) the timing of deductibility is determined by when the expenditure to be allocated to the PE is incurred by the entity, not by when any charge or payment in connection with that expenditure is made between the PE and another part of the entity;
(paragraphs 153-156).

The meaning of 'is incurred in deriving income from sources in Australia or sources out of Australia'

34. A PE is to be allocated that amount of the entity's expenditure, whether incurred through the PE itself or another part of the entity, that is incurred in deriving income allocable to the PE or is incidental and relevant to the business activities the entity carries on through the PE **(paragraphs 162-163)**.

35. Where it is not possible or practicable to precisely determine the extent to which an item of expenditure is incurred in deriving income from a particular source, a practical method of apportionment that results in a reasonable and appropriate dissection in the particular circumstances is normally acceptable **(paragraphs 164-166)**.

Paragraph 136AE(4)(c)

36. Paragraph 136AE(4)(c) ensures that there is no overlap between the operation of section 136AD and subsections 136AE(4)-(6), in the sense that the same item of income or expenditure cannot be subject to reallocation under both sets of provisions **(paragraphs 168-171)**.

Paragraph 136AE(4)(d)

37. The condition in paragraph (d) reflects an intention that a determination be made under subsection 136AE(4) where profit shifting, effected by an allocation by a taxpayer of income or expenses to a PE, results in the taxpayer's liability to Australian tax being less than it would be if the allocation were to be made in accordance with the subsection **(paragraphs 172-174)**.

38. This does not mean that a tax avoidance purpose must be identified before a determination can be made under subsection 136AE(4) **(paragraph 175)**.

39. The term 'tax result' refers to the amount of Australian tax payable by the taxpayer. The tax result is 'more favourable' to the taxpayer if less tax is payable on an assessment of the taxpayer, either for the year of income to which the relevant return relates, or for a different year. The 'return' which is relevant is that furnished for the year of income in which income to be allocated is derived, or in which expenditure to be allocated is incurred **(paragraph 176)**.

40. Where no return has been furnished for that year, paragraph 136AE(4)(d) means that no determination under subsection 136AE(4) can be made. If the taxpayer is in default in not furnishing the return, the Commissioner can make a default assessment under section 167 of the ITAA. The making of such an assessment does not require the

application of Division 13. However, in making any such assessment the Commissioner would in practice seek to apply principles which are as consistent as possible with those prescribed in subsections 136AE(4) and 136AE(7) **(paragraph 177)**.

Paragraph 136AE(4)(e)

41. Paragraph 136AE(4)(e) means that subsection 136AE(4) applies only if the facts support a conclusion that the whole or some part of the income or expenditure referred to in paragraph 136AE(4)(b) is 'attributable' to the activities of the PE referred to in paragraph 136AE(4)(a) **(paragraph 178)**.

42. For the purposes of paragraph 136AE(4)(e) the word 'attributable' means 'owing to', 'produced by' or 'resulting from', and connotes a contributory causal connection between the income or expenditure and the activities of the PE. The principles for determining whether income is in any part 'attributable' to the activities of a PE are essentially the same as those for determining whether those activities are in any part a 'source' of that income. Expenditure is attributable to activities of a PE if it is incurred in deriving income attributable to activities of the PE or is incidental and relevant to those activities **(paragraphs 179-181)**.

Result of the application of subsection 136AE(4)

Determination under subsection 136AE(4) as to source of income or apportionment of expenditure

43. A determination under subsection 136AE(4) as to the source of income or the apportionment of expenditure is made after having regard to certain prescribed matters, such as notional arm's length circumstances, that would not be taken into account in determining source or apportioning expenditure in the absence of subsection 136AE(4). It follows that the outcome of determining a matter under subsection 136AE(4) may differ from that if the same matter were determined under common law principles or other provisions of the ITAA **(paragraphs 184-192)**.

A determination under subsection 136AE(4) applies 'for all purposes of the ITAA'

44. For an Australian resident taxpayer, a determination made under subsection 136AE(4) as to the source of income applies for the purposes of provisions such as, for example, section 23AH ('foreign branch income' exemption) and subsection 160AF(1) (foreign tax

credits). A determination as to the extent to which expenditure is incurred in deriving income from a particular source may be relevant in particular under provisions such as subsection 51(1), and sections 79D and 160AFD (foreign losses) **(paragraphs 133-134; 193-195)**.

45. For a non-resident taxpayer, a determination as to the source of income is especially relevant under paragraph 25(1)(b) in determining assessable income, and for the deductibility of expenditure under provisions such as subsection 51(1), which require a connection between the expenditure and assessable income **(paragraphs 135, 194)**.

Requirements for a valid determination

46. In making a determination under subsection 136AE(4):

(a) the Commissioner must have satisfied himself that each of the preconditions in paragraphs (a) to (e) of subsection 136AE(4) is satisfied;

(b) the Commissioner must have had regard to the matters prescribed in paragraphs (a) to (c) of subsection 136AE(7); and

(c) the determination needs to be supported by sufficient relevant facts and information to demonstrate that an informed and reasonable decision has been reached in the circumstances of the case;
(paragraphs 196-199).

Subsection 136AE(7): relevant matters in determining source under subsection 136AE(4)

47. Where subsection 136AE(7) applies for the purposes of making a determination under subsections 136AE(4)-(6), it operates subject to the need to adhere to the single entity approach; regard is had to the matters in paragraphs 136AE(7)(a) (b) and (c) only to the extent to which they produce an allocation of income in fact derived or expenditure in fact incurred by a taxpayer **(paragraph 201)**.

48. The matters specified in paragraphs 136AE(7)(a) (b) and (c) must be considered together in arriving at a proper allocation under subsection 136AE(4). The relative weighting to be given to a particular matter will depend upon the circumstances of each case. None of the matters is, of itself, determinative of the proper amount to be allocated **(paragraph 202)**.

Paragraph 136AE(7)(a)

49. The object of paragraph 136AE(7)(a) in the context of subsection 136AE(4) is to ensure that the income and expenditure of a MNE is allocated between its parts in a manner taking account of the contributions that activities carried on through each part made to generating that income and expenditure. In considering the degree of connection between the relevant item of income or expenditure and the business activities carried on at a particular place, regard should be had, inter alia, to:

(a) the activities or functions performed in each country;

(b) the economic value of the contribution made by each of those activities or functions;

(c) the assets and skills employed in each country; and

(d) the degree and nature of any business or financial risks borne by the various parts of the taxpayer entity; **(paragraphs 204-205)**.

Paragraph 136AE(7)(b)

50. This paragraph prescribes the internationally accepted arm's length principle as one of the criteria to be considered in determining the amount of an entity's income and expenses that are to be allocated to a PE. The arm's length principle is predicated upon what independent entities dealing at arm's length might reasonably be expected to do in comparable circumstances **(paragraphs 206-207)**.

Interaction of arm's length principle and single entity approach

51. Adherence to the single entity approach means that the amounts of income and expenditure to be allocated to a PE under subsection 136AE(4) must be an allocation of some part of the actual income and expenditure of the entity as a whole. It is only within this framework that regard is to be had to the arm's length principle laid down in paragraph 136AE(7)(b). Subsection 136AE(4) and paragraph 136AE(7)(b) do not base the allocation of income and expenses between a head office and a PE on applying an absolute, unrestricted arm's length principle. Allocations of income and expenditure under subsection 136AE(4) can be made by having regard to the arm's length principle only to the extent that this is compatible with the fact that the taxpayer is one single legal and economic entity. Accordingly, a consideration of the arm's length principle under paragraph 136AE(7)(b) cannot result in the creation, for tax purposes, of income

or expenditure which has not in fact been derived or incurred by a taxpayer **(paragraphs 208-214)**.

Meaning of 'the circumstances that would have, or might reasonably be expected to have, existed'

52. The extent and nature of the 'circumstances' to which paragraph 136AE(7)(b) refers, and to which weight can be given in making an allocation under subsection 136AE(4), is effectively limited in a particular case by the need for those circumstances to produce an outcome which is consistent with the single entity approach. Accordingly, an allocation made under subsection 136AE(4) in a particular case will not necessarily reflect all of the 'circumstances' which might ordinarily pertain to an arm's length dealing between actual separate legal entities **(paragraphs 215-216)**.

53. Subject to this limitation, the 'circumstances' referred to will in general be those relevant to the pricing, terms and conditions of a comparable dealing between independent entities dealing at arm's length. These circumstances will be reflected in an outcome in relation to the pricing, terms and conditions of the dealing which:

(a) is comparable with that which would result from real bargaining between independent parties; and

(b) properly reflects commercial and market realities, and the relative economic value of the contribution made by the parties, in terms of the functions performed, assets and skills used, and risks assumed;
(paragraph 217).

54. Having regard to the 'circumstances' that would or might be expected to have existed in an arm's length situation calls for a broader consideration than just looking at what might have been an arm's length price for a dealing between a PE and its head office. Paragraph 136AE(7)(b) permits the reconstruction of an internal dealing so that the dealing in its entirety accords with what independent parties dealing at arm's length might be expected to have entered into in comparable circumstances. Regard may then be had to the pricing, terms and conditions which might be expected to have applied to the dealing as so reconstructed **(paragraphs 218-220)**.

55. What is a 'reasonable expectation' is a question of degree which requires a prediction of sufficient reliability for it to be regarded as reasonable **(paragraph 221)**.

Having regard to profit mark-ups in the pricing of internal dealings

56. Where income derived through one part of an entity is to any extent attributable to activities carried on through another part, then for the purpose of allocating that income, regard may be had to an arm's length charge between the relevant parts of the entity which includes a profit mark-up, in the sense that the charge can exceed the costs of performing the activities **(paragraphs 222-227)**.

57. Where activities are performed by one part of an entity for another, but no portion of any income derived by the entity is regarded as attributable to those activities, then only the actual amount of expenditure incurred in performing the activities is allocated to the other part of the entity. In making this allocation, regard may not be had to a charge between the relevant parts of the entity which includes a profit mark-up, even if such a mark-up might be expected to have been included in a charge for comparable activities in an arm's length dealing between independent parties **(paragraphs 228-230)**.

58. It may be an acceptable outcome of the application of arm's length pricing to an internal dealing in some circumstances for one part of an entity to be allocated an amount of income which exceeds expenditure allocated to it (i.e. a profit), whilst another part is allocated expenditure in excess of income (i.e. a loss) **(paragraph 282)**.

Recognition of charges such as 'interest' or ' royalties' between parts of an entity

59. Notional charges such as 'interest' or 'royalties' made between a head office and PE for funds transferred or intangibles used are only recognised for the purpose of allocating to the head office or PE amounts of actual expenditure incurred by the MNE in the form of payments of interest or royalties to third parties **(paragraphs 231-234)**.

60. For financial enterprises, the charging of an arm's length rate of interest on funds transferred in the ordinary course of business between a PE and another part of the entity may be accepted as ordinarily achieving an appropriate allocation of actual interest income and expenditure of the entity **(paragraph 235)**.

Practical application of subsection 136AE(4) and paragraph 136AE(7)(b) requires a commercially realistic approach

61. As paragraph 136AE(7)(b) gives notional recognition to an internal dealing involving a PE only for the purpose of allocating the actual income or expenditure of an entity, it is strictly necessary that

the internal dealing be traced to an identified dealing between the entity and a third party, because it is only through such a dealing that actual income or expenditure arises **(paragraphs 236-237)**.

62. The circumstances of a taxpayer's situation may mean that such tracing is not possible or practicable. It is then necessary, in allocating an entity's actual income or expenditure by reference to a notional arm's length amount imputed to an internal dealing, to have regard to what, as a matter of commercial reality, the relationship between the internal dealing and a related dealing with a third party might reasonably be expected to be **(paragraphs 238-242)**.

Methodologies for having regard to the arm's length principle in allocating income to a PE

63. In having regard to the arm's length principle in allocating income to a PE under subsection 136AE(4), it is appropriate to use one of the internationally accepted methodologies for applying that principle, i.e. a comparable uncontrolled price (CUP), cost plus or resale price method, or any other method that is reasonably capable of achieving a result which is consistent with the principle. The outcome of the use of these methodologies is one factor to be taken into account, along with the other matters in paragraphs 136AE(7)(a)-(c), in making a proper allocation of some part of the entity's actual income to the PE **(paragraphs 244-246)**.

64. The method or combination of methods that provides the highest degree of comparability with how independent entities dealing at arm's length would have allocated the relevant income, and that can be effectively applied to a particular situation, is the most appropriate, and hence preferred, method **(paragraph 250)**.

65. A functional analysis of an entity may form the basis for determining comparability with an arm's length outcome. Such an outcome is one that closely reflects commercial and economic reality and the relative economic value of the contributions made by activities carried on through different parts of the entity. A functional analysis would examine the overall relationship between parts of an entity, in terms of the functions performed, the assets and skills used and the degree and nature of any business or financial risks involved in the process of deriving the entity's income. The analysis would also ascertain in what capacity functions are performed (e.g. whether as principal or as agent) **(paragraphs 248-249)**.

66. As paragraph 136AE(7)(b) authorises a notional recognition of dealings between parts of an entity, a CUP, cost plus or resale price method may be used to determine what a notional arm's length consideration might be for such a dealing, for the purpose of having

regard to the arm's length principle in allocating income of the entity between those parts **(paragraph 251)**.

67. In appropriate circumstances, an arm's length profit split between parts of an entity, of profit it derives from a series of activities, may be made in proportions based on a functional analysis of the entity and the economic value contributed by those parts to deriving the profit. The outcome may be used in having regard, under paragraph 136AE(7)(b), to an arm's length allocation between the parts of the entity of the income and expenses that are attributable to the activities **(paragraphs 252-257)**.

68. In order to appropriately allocate income actually derived by an entity by reference to an arm's length pricing of a dealing between parts of the entity, it is strictly necessary to trace the internal dealing to a related dealing between the entity and a third party, and to take into account the pricing of that dealing and the factors or circumstances affecting that pricing **(paragraphs 258-259)**.

69. Where the circumstances of a taxpayer's situation mean that such tracing is not possible or practicable, it will be necessary, in allocating income by reference to the pricing of the internal dealing, to have regard to what the pricing of a related dealing with a third party might reasonably be expected to be, and to the factors that might reasonably be expected to be taken into account in determining that pricing **(paragraphs 260-261)**.

Allocating expenditure to a PE

70. Where subsection 136AE(4) is applied to allocate to a PE expenditure incurred by an entity in performing activities for the benefit or the purposes of the PE, then the amount to be allocated is the actual total costs of performing those activities **(paragraph 263)**.

71. As the allocation is limited to actual costs, to have regard under paragraph 136AE(7)(b) to a price for an internal dealing which results from the use of the CUP, cost plus, resale price, or any other method which incorporates a profit element into that price, will not produce an allocation of expenditure which is authorised by subsection 136AE(4) **(paragraphs 264-265)**.

72. Where subsection 136AE(4) is applied to allocate to a PE the whole or a part of expenditure incurred by an entity in a dealing with a third party, then the actual amount paid or payable to the third party forms the basis for the amount to be so allocated **(paragraph 266)**.

73. The circumstances of a taxpayer's situation may mean that it is not possible or practicable to relate an internal dealing to a particular third party dealing. It is then necessary to accept an approximation of

the actual expenditure for the purposes of its allocation under subsection 136AE(4), by having regard to what the pricing of the third party dealing might reasonably be expected to be **(paragraphs 267-268)**.

Paragraph 136AE(7)(c)

74. Paragraph 136AE(7)(c) permits regard to be had only to matters relevant either to determining the source of income or to determining the extent to which expenditure is incurred in deriving income from a particular source. These will in general be matters relevant to the operation of the principles for determining source or attribution, such as the common law principles or any rules in any applicable Double Taxation Agreement **(paragraphs 283-284)**.

75. When applying subsection 136AE(4), other relevant matters under paragraph 136AE(7)(c) will include any matter which needs to be taken into account to ensure that the allocation is of an entity's actual income and expenses **(paragraph 285)**.

Timing issues associated with the derivation of income and the incurring of expenditure to be allocated under subsection 136AE(4)

76. Income or expenditure does not become subject to allocation under subsection 136AE(4) until such time as it is derived or incurred in accordance with the principles that determine the timing of income derivation or the incurring of expenditure. Those principles are as applied independently of subsection 136AE(4), and nothing in subsections 136AE(4) or 136AE(7) alters such principles **(paragraph 286)**.

77. Income is only derived by an entity at the time when an amount is derived from a dealing with a third party, not at the time of a dealing between parts of the entity. Similarly, expenditure is incurred when an amount is incurred in a dealing with a third party, not when any charge or payment in connection with that expense is made between parts of the entity **(paragraphs 287-288)**.

78. If it can be established that an internal dealing and a related dealing between the entity and a third party take place in the same income year, then any period between the two dealings has no practical implications for the timing of derivation of income or incurrence of expenditure that is to be allocated under subsection 136AE(4) by reference to the internal dealing **(paragraph 290)**.

79. If it can be established that the internal and third party dealings take place in different income years, then whilst the amount to be

allocated is determined by having regard to the internal dealing, that amount is brought into the calculation of the entity's taxable income in the year of income in which the third party dealing takes place **(paragraph 291-293)**.

80. As trading stock transferred between parts of an entity remains on hand for the entity as a whole, any income of the entity from sale of the stock that is to be allocated between those parts is not derived, and hence not allocable, until the sale occurs and the stock ceases to be on hand for the entity **(paragraph 294)**.

81. The circumstances of a taxpayer's situation may mean that it is not possible or practicable to relate an internal dealing to a particular third party dealing. Where the relationship between the timing of the two dealings cannot be established as a matter of fact, it is necessary to rely upon the commercial realities of the taxpayer's business circumstances to determine what that relationship might reasonably be expected to be **(paragraphs 295-300)**.

Documentation

82. The record keeping obligations for taxpayers under the ITAA operate to require taxpayers who carry on business through a PE to keep records for ascertaining and evidencing the basis upon which, for tax purposes, income and expenses are allocated to the PE. Division 13 means that taxpayers need to keep sufficient documentation to evaluate whether their allocation of income and expenses to the PE gives an outcome consistent with that resulting from a consideration of the matters in subsection 136AE(7) **(paragraphs 302-303; 305)**.

83. The separate accounting records maintained by a taxpayer for a PE, together with any adjustments made for tax purposes, will be the starting point when we review whether the taxpayer's allocation of income and expenditure to a PE is appropriate for subsection 136AE(4) purposes **(paragraph 304)**.

84. Documenting an analysis of a taxpayer's significant business functions, the assets utilised in pursuit of that business, and the risks associated with the business activities, will have relevance in addressing matters under each of paragraphs (a) (b) and (c) of subsection 136AE(7) **(paragraph 306)**.

85. Taxpayers need to keep sufficient documentation to enable the arm's length principle to be addressed in determining a proper allocation of income and expenses to a PE when preparing and lodging tax returns. Our views at paragraphs 101-110 of Taxation Ruling TR 94/14 on the documentation needed for the analysis and processes involved in selecting and applying the internationally accepted arm's

length pricing methodologies, will apply where those methodologies are appropriate for pricing an entity's internal dealings**.** In addressing the arm's length principle in the context of an internal dealing, taxpayers will be expected to document the process of selecting an appropriate methodology and the way in which that methodology was used to arrive at an arm's length price for that dealing **(paragraphs 307-310)**.

86. Where the allocation of income or expenses by reference to an internal dealing requires a consideration of matters relevant to its relationship, in terms of pricing and timing, with a third party dealing or dealings, documentation will be needed which evidences the processes used by the taxpayer to establish and have regard to that relationship **(paragraphs 311-316)**.

Access to relevant information

87. Documentation and information which we request in accordance with paragraphs 82-86 will be sought under sections 263, 264, 264A or the exchange of information provisions of a relevant Double Taxation Agreement **(paragraphs 317-319)**.

Explanations

The role and structure of Division 13 as it applies to single legal entities

88. Division 13 is intended to counter 'non-arm's length transfer pricing' or 'international profit shifting' arrangements by which Australia may be deprived of its fair share of tax.

89. In general terms, the effect of Division 13 is that, for taxation purposes, non-arm's length dealings across international borders result in an allocation of related income and expenses measured by reference to the internationally accepted arm's length principle and the conditions which would have existed between independent parties under comparable circumstances.

90. Where profit shifting occurs through non-arm's length dealing under an international agreement between separate legal entities, section 136AD may authorise the Commissioner to deem an arm's length consideration to have been paid or received. Our views on the interpretation and application of section 136AD are discussed in detail in Taxation Ruling TR 94/14.

91. Where profit shifting occurs through international dealings between different parts of the same entity, subsections 136AE(4), (5)

and (6) may authorise the re-allocation of an appropriate part of the income and expenses between the Australian and foreign operations. These provisions are intended to deal with the situation of a taxpayer who carries on business in Australia and in another country or countries as a single legal entity, i.e. through a head office and a PE or PEs. Whilst transactions between the taxpayer and other entities may be at arm's length prices (and consequently, the Commissioner will not be applying section 136AD), tax payable in Australia may be reduced by the use, in effect, of internal transfer prices - e.g. between head office and PE or between PEs - that differ from arm's length prices.

92. Subsections 136AE(4), (5) and (6) together form a code within Division 13 which is entirely separate from section 136AD. Their operation, unlike subsections 136AE(1), (2) and (3), is not subject to the precondition that section 136AD has previously been applied. The basic principle is contained in subsection 136AE(4), and the later subsections apply it to partnerships and trusts.

93. Profit shifting within a single entity is of a different nature to that occurring between separate entities, because it occurs through transactions that are not recognised at law, but that are recognised purely for commercial purposes by entries in the accounts of the entity. Such profit shifting can be achieved in numerous ways which result in a distortion of the profits of a PE. For example, a MNE with an overseas head office and an Australian PE may shift profits from the PE by either:

(a) recording in its accounts an insufficient charge for trading stock manufactured by the PE and transferred to the head office for sale to third parties; or

(b) making an allocation in its accounts to the PE of an excessive proportion of expenses incurred through the head office in performing centralised administrative services; or

(c) making an allocation in its accounts to the PE of an excessive proportion of interest payable on borrowings made through the head office which are referable only in part to activities of the PE.

94. The problem can be illustrated by the case of a non-resident taxpayer, carrying on business in Australia through a branch, which allocates an excessive part of its expenses to the conduct of the income earning activities in Australia. For example, if $100 of expenses were incurred at arm's length in the conduct of the business both overseas and in Australia, and the whole $100 was charged as a cost to the Australian branch of the business, there would be a shifting of profits

from Australia, because part only of the $100 is appropriately related to the Australian activities.

95. The need for specific provisions dealing with PEs, separate from section 136AD, arises because Australian law adopts a 'single entity approach' (see paragraph 154). Although a PE and a head office may be considered for commercial or accounting purposes as separate business or profit centres of a MNE, they are both part of the same legal entity, generally a company. There is in law only one taxpayer. Unless specific statutory provisions exist (as in the case of offshore banking or foreign bank branch legislation), Australian law does not recognise dealings between PEs of the same enterprise or between a PE and its head office, because, at law, an entity cannot transact with itself or make a profit out of itself. As an entity cannot enter into contractual or other legal relationships with itself, 'transactions' between a head office and a PE are not transactions in the legal sense of the word. It follows that it is not possible for a head office and a PE to enter into legal relationships with each other or in their own right with respect to matters such as the sale of goods, the lending of money, or the licensing of technology or trademarks.

96. As dealings between parts of an entity have no legal existence or effect, they cannot produce a profit or a loss. A head office and PE may 'charge' one another in connection with dealings between them, but such internal charges are, at most, relevant only for internal accounting purposes in allocating the entity's profits among its separate business centres. An entity does not either derive assessable income or incur deductible expenditure if one part of the entity charges or makes a payment to another part.

97. At law there can be no agreement between parts of an entity such as a head office and a PE for the supply or acquisition of property or services. Dealings within a single entity are not covered by section 136AD, as they do not involve two parties and therefore cannot be the subject of an 'international agreement'. Whilst section 136AD is concerned with deeming an 'arm's length consideration' where 'property' is 'acquired' or 'supplied' under an 'international agreement', none of these terms as defined in Division 13 is relevant to subsections 136AE(4)-(6).

98. Notwithstanding the legal position, for commercial or accounting purposes a PE is normally regarded as a separate entity which enters into trading transactions with, and borrows from or lends to, its head office or other PEs of the same entity. In accordance with accepted accounting and commercial practice, and the exigencies of the efficient conduct of a MNE's business, it is ordinarily to be expected that separate trading accounts will be kept for a PE. Trading stock or other items supplied to the PE by other parts of the entity

would be entered into those accounts at the time of supply, as if they were purchases from a third party. This, as a practical reality, is how the MNE's accounts seek to allocate its actual income and expenses attributable to that stock between the PE and other parts of the entity. The entries in the accounts should reflect the real facts of the situation, and will accordingly be the starting point in ascertaining the amount of the entity's income and expenditure that is properly attributable to activities of the PE.

99. Where the conditions for the application of subsections 136AE(4)-(6) are satisfied, the Commissioner may determine the geographical source of income, or the extent to which expenses relate to income from a particular source, having regard, inter alia, to the circumstances that might have been expected to exist if the PE were a distinct and separate entity dealing at arm's length with the taxpayer (i.e. its head office or another PE) and other persons. In other words, the PE may be notionally treated as a separate entity for the purpose of having regard to the internationally accepted arm's length principle in allocating an appropriate part of the taxpayer's income or expenditure to the PE, in order to determine Australian tax payable by the taxpayer. This permits the appropriateness, for tax purposes, of a taxpayer's allocation of income and expenses to a PE to be judged, in part, by reference to the expected outcome if dealings between the PE and other parts of the entity were between separate entities dealing at arm's length. Normally, the income and expenses to be allocated to a PE by reference to the arm's length principle will be the same as one would expect to be allocated by the ordinary processes of good business accountancy.

100. A consideration of arm's length circumstances for subsection 136AE(4) purposes is not identical in all respects with an application of the arm's length principle between separate legal entities. Paragraph 136AE(7)(b) does not provide for the unrestricted treatment of a PE as a separate entity. It only prescribes a limited form of 'separate entity fiction', so that regard can be had to the arm's length principle, within the confines of the single entity approach, for the limited purpose of allocating income in fact derived, or expenditure in fact incurred under dealings by a taxpayer with a separate legal entity (also see paragraphs 208-214).

The interaction between subsection 136AE(4) and Australia's Double Taxation Agreements

101. In considering the application of subsection 136AE(4), the terms of any relevant Double Taxation Agreement must be considered. The Commissioner may apply the provisions of Division 13 and/or the treaty provisions. In the event of any inconsistency, the treaty

provisions will prevail unless the treaty itself provides for domestic law to apply.

102. An explanation of the interaction between Australia's Double Taxation Agreements and Division 13 in general is set out at paragraphs 184-186 of Taxation Ruling TR 94/14.

103. All of Australia's comprehensive Double Taxation Agreements contain a Business Profits article which, on a reciprocal basis, restricts taxing rights between tax treaty partner countries in relation to profits of an enterprise resident in one of those countries. This article generally provides that the profits of an enterprise resident in one country shall be taxable only in that country, unless the enterprise carries on business through a PE in the other country. Where business is carried on in such a manner, the other country may tax the profits of the enterprise, but only so much of them as is attributable to the PE in that country.

104. In addition, the Business Profits articles also provide a test for determining profits attributable to a PE. The articles generally provide that where an enterprise of one country carries on business in the other country through a PE, each country shall attribute to the PE the profits which it might reasonably be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a PE or with other enterprises with which it deals. This test is also the mechanism by which an adjustment may be made to counter profit shifting involving a PE and by which correlative relief may be granted to relieve double taxation arising as a result of a profit shifting adjustment made by a tax treaty partner country.

105. In determining profits attributable to a PE the Business Profits articles in all of Australia's Double Taxation Agreements expressly provide for recourse to domestic law in certain circumstances. These circumstances differ between agreements. For most Double Taxation Agreements the circumstances are where the information available is inadequate to determine the profits attributable to a PE. In other Double Taxation Agreements the circumstances include exceptional difficulties.

106. These provisions mean that the Double Taxation Agreements themselves provide for domestic law to be applied, so far as is practicable to do so, consistently with the principles of the Business Profits articles.

107. A detailed discussion of the interaction between the Business Profits articles of Double Taxation Agreements and Division 13 will be dealt with in a later Ruling.

The interaction between subsection 136AE(4) and subsection 51(1)

108. Our views on the interaction between subsection 51(1) and Division 13 in general are set out at paragraphs 19-22 and 187-203 of Taxation Ruling TR 94/14.

109. As one of its functions, subsection 136AE(4) authorises a determination as to the extent to which a taxpayer's expenditure is incurred in deriving income from sources in or out of Australia, where that expenditure is to some extent attributable to activities carried on by the taxpayer through a PE. It therefore facilitates the apportionment of expenditure incurred by a taxpayer between income derived from activities carried on by the taxpayer through a PE, and from other activities carried on by the taxpayer. One object of subsection 136AE(4) is to counter international profit shifting effected by way of an excessive allocation of a taxpayer's expenditure to the derivation of assessable income. Commonly this will require the application of subsection 136AE(4) for the purpose of denying or reducing a deduction under subsection 51(1).

110. However, it will be unnecessary to consider applying subsection 136AE(4) for this purpose if no deduction is allowable under subsection 51(1), either because the relevant expenditure, or part of it, does not meet the various tests for deductibility prescribed by the subsection.

111. Subsection 51(1) may be expected to apply to apportion a claim for a deduction if the proper conclusion to be drawn from all of the facts and circumstances is that a taxpayer had some other objective or purpose in addition to the pursuit of assessable income (*Fletcher & Ors v. FC of T* (1991) 173 CLR 1; 88 ATC 4834; (1988) 19 ATR 1765). A relevant example for present purposes might be a cost sharing arrangement implemented by a non-resident MNE, under which the costs allocated to its Australian PE for centralised activities performed by its head office are disproportionately high compared to the level of services actually provided or the benefits actually obtained.

112. Subsection 51(1) also provides that expenditure incurred in deriving exempt income is not an allowable deduction. Therefore, for instance, no deduction is allowable under subsection 51(1) for:

(a) expenditure incurred by an Australian company in connection with deriving foreign branch income that is exempt under section 23AH; or

(b) expenditure incurred by a non-resident in connection with deriving foreign source income that is exempt under section 23(r).

113. Subsection 136AE(4) may need to be invoked as an alternative basis upon which to support the disallowance of a deduction under subsection 51(1) if:

(a) there is some doubt about the operation of subsection 51(1) in the particular circumstances; and/or

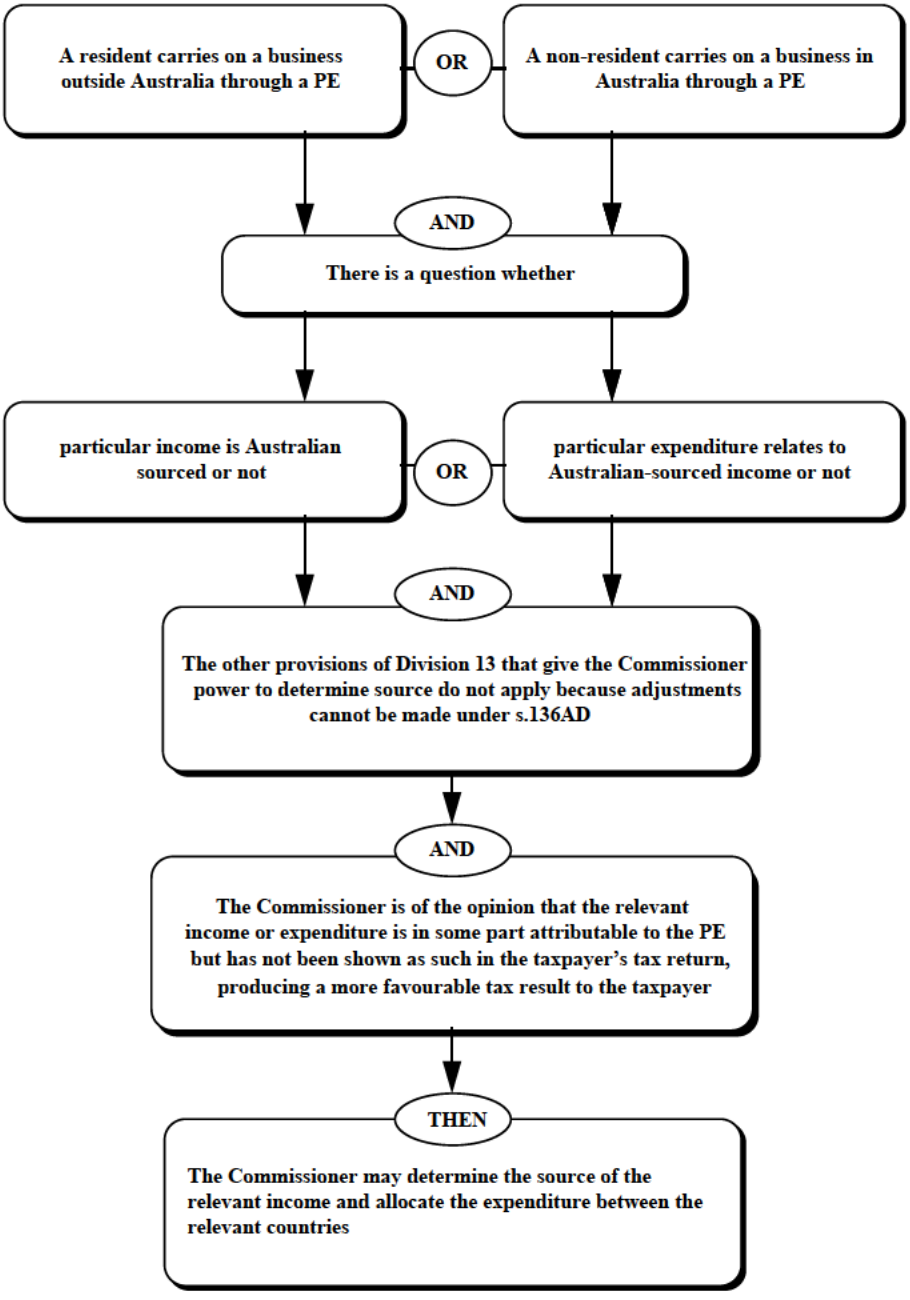
(b) the facts indicate profit shifting from Australia has occurred through an allocation of a taxpayer's expenses to a PE that is inconsistent with the arm's length principle.

114. An apportionment of expenditure made under subsection 136AE(4), after having regard to the matters prescribed in subsection 136AE(7), including arm's length circumstances, may differ from an apportionment of that expenditure which may be required to be made under subsection 51(1) (also see paragraphs 190-192). It follows that the difference in outcome of apportionments under subsections 136AE(4) and 51(1) may result in a determination under subsection 136AE(4) requiring the adjustment of an amount that is otherwise deductible under subsection 51(1).

Flowchart of subsection 136AE(4)

115. The basic structure of subsection 136AE(4) and the pre-conditions for its application are shown in the following flowchart:

WHERE:


A resident carries on a business outside Australia through a PE
OR
A non-resident carries on a business in Australia through a PE
AND
There is a question whether
particular income is Australian sourced or not
OR
particular expenditure relates to Australian-sourced income or not
AND
The other provisions of Division 13 that give the Commissioner power to determine source do not apply because adjustments cannot be made under s.136AD
AND
The Commissioner is of the opinion that the relevant income or expenditure is in some part attributable to the PE but has not been shown as such in the taxpayer's tax return, producing a more favourable tax result to the taxpayer
THEN
The Commissioner may determine the source of the relevant income and allocate the expenditure between the relevant countries

Outline of the basic concepts

116. As the above diagram indicates, the following conditions must all be satisfied before a determination can be made under subsection 136AE(4):

(a) 'a taxpayer other than a partnership or trustee' **(see paragraphs 119-120)** is either:

(i) a 'resident' **(see paragraphs 121-122)** and 'carries on a business' **(see paragraph 123)** in a country other than Australia 'at or through a PE' **(see paragraphs 124-128)** of the taxpayer in that other country; or

(ii) a non-resident and carries on a business in Australia at or through a PE of the taxpayer in Australia;

(b) 'a question arises as to whether, and if so, as to the extent to which' **(see paragraphs 129-137)** either:

(i) 'any income derived by the taxpayer' **(see paragraphs 138-140)** is 'derived from sources in Australia or sources out of Australia' **(see paragraphs 141-150)**; or

(ii) 'any expenditure incurred by the taxpayer' **(see paragraphs 151-156)** 'is incurred in deriving income from sources in Australia or sources out of Australia' **(see paragraphs 157-167)**;

(c) none of subsections 136AE(1), (2) or (3) apply to determining that question **(see paragraphs 168-171)**;

(d) that question, if determined on the basis of the return furnished by the taxpayer, would have a tax result more favourable to the taxpayer than if the question were determined under subsection 136AE(4) **(see paragraphs 172-177)**; and

(e) the Commissioner considers that the derivation of the income or the incurring of the expenditure is attributable, in whole or in part, to activities carried on by the taxpayer at or through the PE **(see paragraphs 178-187)**.

117. Where all of the above conditions are satisfied, the relevant income or expenditure is deemed for all the purposes of the ITAA to have been derived or to have been incurred in deriving income:

(a) from such source; or

(b) from such sources and in such proportions as the Commissioner determines;
(see paragraphs 182-199).

118. In making this determination, subsection 136AE(7) requires the Commissioner to have regard to:

(a) the nature and extent of the business carried on by the taxpayer and where it is carried on **(see paragraphs 204-205)**;

(b) the circumstances that would have, or might reasonably be expected to have, existed if the PE were a distinct and separate entity dealing at arm's length with the taxpayer and other persons **(see paragraphs 206-282)**; and

(c) such other matters as the Commissioner considers relevant **(see paragraphs 283-285)**.

Paragraph 136AE(4)(a)

The meaning of 'a taxpayer other than a partnership or trustee'

119. Subsection 136AE(4) applies only to taxpayers other than partnerships or trustees, who are covered by equivalent provisions in subsections 136AE(5) and 136AE(6) respectively.

120. Our views on the meaning of the term 'taxpayer' for the purposes of Division 13 are as stated at paragraphs 25 and 211-213 of Taxation Ruling TR 94/14. The term is defined in subsection 136AA(1) as including a partnership and a taxpayer in the capacity of a trustee, however the express wording to the contrary in paragraph 136AE(4)(a) overrides this for subsection 136AE(4) purposes. Accordingly, subsection 136AE(4) applies only to a 'taxpayer' as defined in subsection 6(1) of the ITAA, i.e. 'a person deriving income or deriving profits or gains of a capital nature'. In turn, subsection 6(1) defines the term 'person' to include a company, and the term 'income' is defined for Division 13 purposes in subsection 136AA(1) (also see paragraph 138).

The meaning of 'resident'

121. Paragraph 136AE(4)(a) is effectively divided into two limbs, in order to deal separately with taxpayers who are residents and taxpayers who are non-residents. This is necessitated by two factors. First, there are the differences in Australia's jurisdiction to tax residents and non-residents which are reflected in subsection 25(1) of the ITAA. Secondly, Division 13 is intended to deal with arrangements, dealings, etc. which have an international element, not those which are purely domestic. Subsection 136AE(4) is intended to effect an allocation of income derived and or expenses incurred by an entity between that part of the entity which resides or carries on business in Australia and

that part which resides or carries on business in another country. Because of these factors, the provision applies only where either an Australian resident carries on business through a PE in another country, or a non-resident carries on business through a PE in Australia.

122. The terms 'resident' and 'non-resident' are defined in subsection 6(1) of the ITAA. Australia's Double Taxation Agreements also contain provisions which define residency for the purposes of those agreements, including cases of dual residency, which must be considered where applicable.

The meaning of 'carries on a business'

123. The expression 'carries on a business' has its ordinary meaning for the purpose of Division 13. The body of law which has developed in respect of the similar expression in subsection 51(1) of the ITAA provides assistance in its interpretation.

The meaning of 'at or through a permanent establishment'

124. It is not a purpose of this Ruling to consider in detail the issue of what constitutes a PE or the circumstances in which an entity's presence in a country is regarded as a PE.

125. The term 'permanent establishment' is defined for the purposes of Division 13 in subsection 136AA(1) as being either a PE as defined in subsection 6(1), or 'a place at which any property of the taxpayer is manufactured or processed for the taxpayer, whether by the taxpayer or another person'.

126. The extended definition of PE in subsection 136AA(1) will include various commercial or industrial situations in which an entity has its property processed or manufactured on its behalf by another entity, irrespective of the nature of the actual business arrangement and dealings between the two. For example, a place where partly finished goods are subjected to further processing to bring them into a saleable condition will be a PE. So too will be a place of intermediate processing that leaves the relevant items in an incomplete state.

127. Each of Australia's Double Taxation Agreements contain a provision which defines the term 'permanent establishment' for the purposes of the agreement. Where applicable, the provisions of a Double Taxation Agreement will prevail over the ITAA in the event of inconsistency. A discussion of this definition in the agreements will be included in a later Ruling on the interaction between the Business Profits Articles of the agreements and Division 13.

128. The phrase 'at or through' a PE prescribes the connection between a business carried on by the taxpayer and a PE of the taxpayer. In this context the words 'at' and 'through' have a consistent and complementary meaning. The word 'at' refers to the PE as a geographical point at which the business is carried on. The word 'through' refers to the PE as the means or instrument of carrying on the business. Both words connote that the business carried on is attributable to, or results from, the activities of the PE.

Paragraph 136AE(4)(b)

The meaning of 'a question arises whether, and if so, as to the extent to which'

129. The condition prescribed by paragraph 136AE(4)(b) is that a question arise as to the extent to which any income derived by the taxpayer is derived from sources in or out of Australia, or any expenditure incurred by the taxpayer is incurred in deriving income from sources in or out of Australia. Clearly these are two separate questions, only one of which needs to arise.

130. The test to determine whether any such question 'arises' is whether the question must be answered before the Commissioner can make a proper assessment of the taxpayer. It is not relevant to whether the question has arisen to consider its degree of difficulty or contentiousness or whether the Commissioner and the taxpayer are in dispute as to the answer to be given to it.

131. The test of whether a question has 'arisen' is objective rather than subjective. It does not depend upon the Commissioner's opinion. It depends upon the factual situation of the taxpayer and whether the source of income is relevant to the proper assessment of the taxpayer in that situation.

132. Making a proper assessment of a taxpayer is not limited to determining the amount of assessable or taxable income; it extends to all other matters that are relevant to the assessment of tax payable, such as determining the taxpayer's entitlement to credits and rebates.

133. Where the taxpayer referred to in paragraph 136AE(4)(a) is an Australian resident carrying on business through an overseas PE, the taxpayer is assessable under paragraph 25(1)(a) on income derived from all sources. Accordingly, no question as to the source of income derived by such a taxpayer arises directly under subsection 25(1). However, that question may arise in determining whether an item of income is to be excluded from the assessable income under a provision such as section 23AH, which applies to certain 'foreign branch income' of Australian resident companies. The source of income may also be relevant for determining the taxpayer's entitlement

under subsection 160AF(1) to a credit for foreign tax paid on foreign income included in assessable income.

134. The proper assessment of an Australian resident taxpayer may also give rise to a question as to whether expenditure is incurred in deriving income from a particular source. This is the second question to which paragraph 136AE(4)(b) refers. This question may arise under subsection 51(1) in determining whether expenditure is deductible or incurred in deriving income that is exempt under a provision such as section 23AH. This question is also relevant to the operation of provisions such as section 79D and section 160AFD that deal with the treatment of foreign losses.

135. Where the taxpayer is a non-resident carrying on business in Australia through a PE, the taxpayer is assessable under paragraph 25(1)(b) only on income derived from sources in Australia, and is correspondingly exempt from Australian tax under section 23(r) on income derived from foreign sources. Therefore, the question of whether income is derived from sources in or out of Australia is necessarily relevant in making a proper assessment of such a taxpayer. Paragraph 25(1)(b) means that a question as to whether expenditure is incurred in deriving income from sources in or out of Australia necessarily arises in determining the deductibility of that expenditure under provisions such as subsection 51(1), which require a connection between the expenditure and assessable income.

136. The words 'as to the extent to which' contemplate a question of allocating a single item of income or expenditure between different sources. Under the Australian common law principles of source, a single item of income may, depending upon its nature, have in part an Australian source and in part a foreign source (also see paragraphs 141-150). Similarly, an item of expenditure may be incurred in part in deriving income from an Australian source, and in part in deriving income from a foreign source (also see paragraphs 157-167).

137. A question as to the extent to which profit is to be allocated to sources in or out of Australia could arise, and be dealt with, under Subdivision C of Division 2 of Part III of the ITAA, which covers businesses carried on partly in and partly out of Australia. The relationship between Division 13 and Subdivision C of Division 2 is dealt with in both subsection 136AE(9) and section 136AG. Subsection 136AE(9) means in effect that section 136AE is not to be used in any application of Subdivision C. Subsection 136AE(9) provides that Subdivision C is to be disregarded when deciding whether a question of the kind specified in paragraph 136AE(4)(b) arises. This does not, however, prevent the possible application of both Subdivision C and Division 13 to the same set of circumstances. Both provisions may be applied, although any amount or amounts

determined under section 136AE cannot be applied under Subdivision C. This is also reflected in section 136AG, which provides that where section 136AD or section 136AE has been applied in relation to any consideration, income or expenditure, that consideration, income or expenditure is not to be taken into account in the application of Subdivision C.

The meaning of 'any income derived by the taxpayer'

138. The term 'income' is defined for Division 13 purposes in subsection 136AA(1) to include any amount that is, or may be, included in assessable income or taken into account in calculating an amount that is, or may be, included in assessable income.

139. The word 'derived' refers to income in fact derived by a taxpayer. What is being allocated to source is actual income. Under the single entity approach such income can be derived only from a dealing between the taxpayer and a separate legal entity, not from a dealing between parts of the same taxpayer entity (also see paragraphs 95-96). Income is not subject to allocation under subsection 136AE(4) until such time as it is derived from a dealing with a separate entity; the timing of a dealing between parts of an entity does not, of itself, determine the timing of derivation of any income of the entity (also see paragraphs 286-287).

140. Subsection 136AE(4) authorises a determination, regarding income that a taxpayer has in fact derived, as to the amount of that income that is derived from a particular source. It does not authorise a determination which effectively deems the taxpayer to have derived a greater amount of income than was in fact derived.

The meaning of 'derived from sources in Australia or sources out of Australia'

141. Our views, in general terms, on the principles that, apart from subsection 136AE(4), apply in determining the source of income, are set out at paragraphs 143-150.

142. Our views on the extent to which subsection 136AE(4) extends or alters those principles are set out at paragraphs 184-188.

143. The ITAA prescribes a source for several specific types of income, e.g. royalties derived by a non-resident (section 6C), natural resource income (section 6CA), interest income under a loan secured by mortgage over property in Australia (subsection 25(2)), and certain profits from the sale of goods (sections 38 and 39).

144. Apart from this type of specific prescription, the ITAA does not provide guidelines for determining the source of income, and it is necessary to rely on the principles developed by the courts.

145. The word 'source' is not a legal concept; the real or actual source of an item of income must be determined as a practical matter of fact (see *Nathan v. FC of T* (1918) 25 CLR 183). No rule of general application can be prescribed; the question must be determined according to the facts and circumstances of each particular case. Commonly, it is a matter of judgment requiring the weighing up of the relative significance of a variety of contributing factors, often occurring in different places, which together give rise to the ultimate derivation of the income.

146. Where income arises from the carrying on of a business, the source of that income is determined primarily by considering the nature of the income, the nature of the business activities, and how and where those activities are performed. The questions to be answered are, first, 'what are the activities from which the income in substance arises?', and, secondly, 'where do those activities take place?'. Accordingly, income is derived from sources in Australia if it arises in substance from activities that take place in Australia.

147. If income arises wholly from business activities carried on by a MNE outside Australia that are separate from business activities it carries on in Australia, then the income is derived wholly from sources out of Australia.

148. At common law, a single item of income may, in appropriate circumstances, be regarded as derived from more than one source. Where a business essentially consists of a whole series of activities which together result in the derivation of income, then the source or sources of that income are determined by an examination of where each of the activities takes place and the importance of each activity to the earning of the income (see *C of T v. Kirk* [1900] AC 588; *FC of T v. W Angliss & Co Pty Ltd* (1927) 46 CLR 417; *C of T v. Hillsdon Watts Ltd* (1937) 57 CLR 36; 1 AITR 42; *C of T (NSW) v. Cam & Sons Ltd* (1936) 4 ATD 32). If an activity is judged to be a significant contributing factor to the derivation of the income, then the place where that activity takes place is in some part a source of the income.

149. Whether, and if so to what extent, an activity is a significant contributing factor to the derivation of income is a question of fact to be determined as a matter of business or commercial judgment. It involves making a qualitative judgment of the relative significance of the contribution made by the activities to generating the income.

150. If activities that take place in Australia and activities that take place out of Australia are both significant contributing factors to the

derivation of an item of income, then that income is derived from both sources in and sources out of Australia, and must be apportioned between those sources.

The meaning of 'any expenditure incurred by the taxpayer'

151. The term 'expenditure' is defined in subsection 136AA(1) to include losses and outgoings. Accordingly, section 136AE will impact on all the provisions of the ITAA, such as subsection 51(1), that are concerned with losses and outgoings.

152. The phrase 'expenditure incurred in deriving income' is defined in subsection 136AE(8) as including expenditure incurred in carrying on a business for the purpose of deriving income. Such expenditure may be an allowable deduction under the so-called second limb of subsection 51(1). Accordingly, section 136AE will apply to any expenditure that may be an allowable deduction under subsection 51(1).

153. The word 'incurred' refers to expenditure in fact incurred. Subsection 136AE(4) authorises a determination as to how much of expenditure that a taxpayer has in fact incurred is attributable to activities of a PE, and is accordingly to be allocated to deriving income from a particular source. It does not authorise a determination which deems the taxpayer to have incurred a greater or lesser amount of expenditure than was in fact incurred.

154. The treatment under the ITAA of payments made between a PE and its head office or another PE reflects an adherence to the single entity approach. As a head office and a PE are at law a single entity, any dealings between them such as a transfer of funds or trading stock, or the provision of services, cannot create a liability, charge or payment which is expenditure incurred or an allowable deduction under the ITAA (see *Max Factor and Co v. FC of T* 84 ATC 4060; (1984) 15 ATR 231). The single entity approach means that the amount deductible in calculating the taxable income of an entity attributable to the activities of its PE is determined by an allocation to the PE of actual expenditure incurred by the entity in dealings with separate legal entities; not by any payment or liability notionally created by a dealing between the PE and another part of the entity. A transfer of funds by the PE of an entity to its head office is not expenditure incurred by the entity.

155. Thus, where a non-resident MNE through its head office incurs expenditure on behalf of an Australian PE, and the PE transfers funds to the head office by way of reimbursement, the amount transferred is not expenditure incurred by the MNE and cannot be an allowable deduction under the ITAA. Rather, the amount of the actual

expenditure incurred by the entity through the head office is properly allocable to the PE and may be deductible in determining the amount of the taxable income of the entity that is attributable to the activities of the PE.

156. Although this may appear to effectively produce the same outcome as allowing a deduction for the payment between the PE and head office, the difference in approach has a number of significant implications:

(a) limiting deductibility to the entity's actual expenditure denies the possibility of a deductible amount including a profit mark-up created by a charge between the head office and PE that is in excess of the actual costs incurred by the entity;

(b) limiting the amount deductible to the amount of the entity's actual expenditure means that nothing that occurs between the head office and PE with respect to discharging the liability for that expenditure can increase, reduce or in any way alter the amount deductible. This is illustrated by the *Max Factor* case (supra). In that case it was held that no deduction was allowable under subsection 51(1) for exchange losses suffered by a taxpayer when transferring funds from a PE in Australia to its head office in the United States by way of reimbursement for the cost of raw materials supplied by the head office. The transfer of funds was a repatriation of capital rather than a payment in discharge of a liability incurred by the PE. As the head office and PE were a single entity, the supply of materials between them did not give rise to such a liability; and

(c) the timing of deductibility is determined by when the actual expense to be allocated to the PE is incurred by the entity, not by when any charge or payment in connection with that expense is made between the PE and another part of the entity.

The meaning of 'is incurred in deriving income from sources in Australia or sources out of Australia'

157. Our views on the principles that, apart from subsection 136AE(4), apply in determining the extent to which expenditure is incurred in deriving income from a particular source, are set out at paragraphs 159-167.

158. Our views on the extent to which subsection 136AE(4) extends or alters those principles are set out at paragraphs 190-192.

159. The need to determine the extent to which expenditure is incurred in deriving income from a particular source may arise in the context of determining whether the expenditure is an allowable deduction (e.g. under a provision such as subsection 51(1)), or whether, as an allowable deduction, it relates to foreign income for the purposes of applying various provisions relevant to the foreign tax credit system (e.g. section 79D, section 160AF and section 160AFD).

160. Where an item of expenditure is wholly and exclusively incurred in deriving income from one particular source (i.e. either a source in Australia or a source out of Australia), then the entire amount of the expenditure is allocated against income from that source. Determining whether expenditure relates exclusively to income from one particular source is a question of fact to be decided on the basis of the circumstances of each particular case. Where expenditure is incidental and relevant exclusively to business activities carried on either in Australia or out of Australia, then the whole amount of that expenditure is allocated to carrying on those activities. For example, interest payable on funds borrowed by a MNE and used exclusively for the purposes of business activities carried on through a PE.

161. Where an item of expenditure is incurred in deriving income from more than one source (i.e. both a source in Australia and a source out of Australia), then the extent to which the expenditure is incurred in deriving income from each source must be determined through an appropriate apportionment which allocates parts of the expenditure to each source. Where expenditure is incidental and relevant to business activities carried on both in and out of Australia, then parts of that expenditure are allocated to carrying on each of those activities. For example, expenditure which is a cost of performing centralised administrative services which benefit business activities carried on both in and out of Australia.

162. Expenditure of an entity is allocable to a PE to the extent to which the expenditure is incurred in deriving income allocable to the PE, or is incidental and relevant to the business activities the entity carries on through the PE. It does not matter where the expenditure is incurred; i.e. whether incurred through the PE itself or through its head office or another PE. Assuming the expense in other respects qualifies for deductibility, that expense is allocated to the PE and deductible in determining the amount of the entity's taxable income that is attributable to activities of the PE. Thus, for example, if the head office of a non-resident MNE performs administrative services for an Australian PE, then the expenditure incurred in performing the relevant activities should be allocated to the PE and may be deductible under the ITAA.

163. Conversely, if an entity incurs, through a PE, expenditure that relates to income allocable to, or activities carried on through, another part of the entity, then that expense cannot be deductible in determining the amount of the entity's taxable income that is attributable to activities of the PE.

164. Where an item of expenditure must be apportioned, difficult practical problems may arise in determining how much of the expenditure should appropriately be allocated to deriving income from each source. The leading case on apportionment of expenditure under subsection 51(1) is *Ronpibon Tin NL and Tongkah Compound NL v. FC of T* (1949) 78 CLR 47; 8 ATD 431. In that case the High Court noted that there were two kinds of items of expenditure that require apportionment:

(a) undivided items of expenditure in respect of things or services of which distinct and severable parts are devoted to producing assessable income and distinct and severable parts to some other cause; and

(b) those involving a single outlay or charge which serves both objects indifferently.

165. With the first category of outgoings, the Court considered that it might be possible to divide the expenditure in accordance with the applications which had been made of the things or services. With respect to the second category, the Court considered that there had to be some fair and reasonable assessment of the extent of the relation of the outlay to assessable income. No fixed rule of general application can be prescribed; the apportionment must be made on an objective basis according to a practical weighing of all of the facts and circumstances in a particular case (see also *Fletcher's* case (supra)).

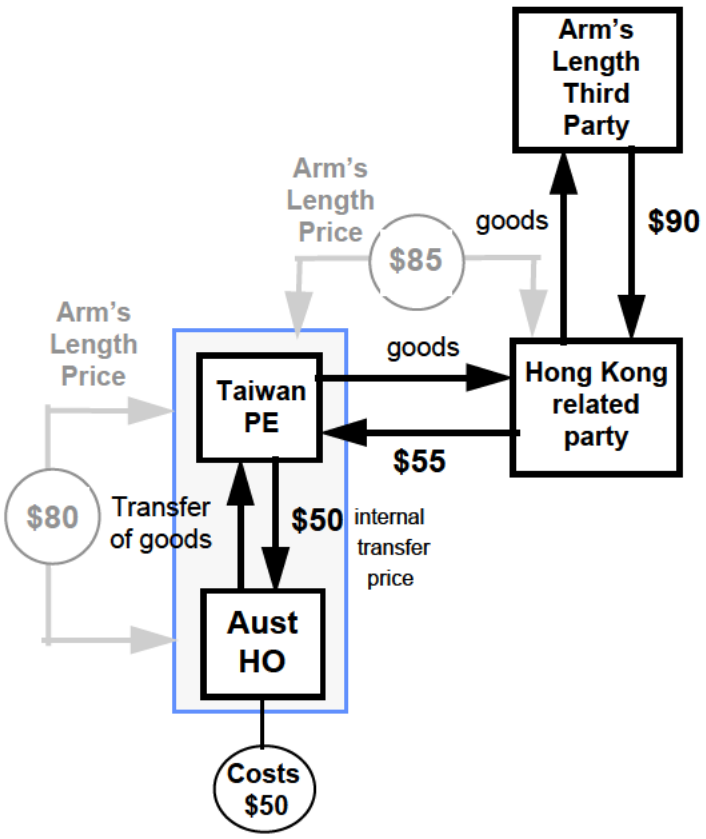
166. Our views on apportionment of allowable deductions for the purposes of applying the provisions relevant to the foreign tax credit system are set out in Taxation Ruling IT 2446. Again, the apportionment must be determined according to the circumstances of each case. With respect to the method of apportionment or allocation to be used, a broad, practical approach on a reasonable basis is required. Provided the method used can, on an objective basis, be regarded as resulting in a reasonable and appropriate dissection of the expenditure, it is normally acceptable.

167. Our views on the methods which may most appropriately be used to allocate particular categories of expenses will be the subject of a separate Ruling.

Paragraph 136AE(4)(c)

168. Paragraph (c) prescribes the condition that none of subsections 136AE(1), (2) or (3) applies in determining the question that arises under paragraph (b). This ensures that there is no overlap between the operation of section 136AD and subsections 136AE(4)-(6), in the sense that the same item of income or expenditure cannot be subject to reallocation under both sets of provisions. A precondition to the application of subsections 136AE(1), (2) and (3) is that section 136AD has previously been applied. Accordingly, paragraph (c) means that the question in paragraph (b) has not arisen in a case where section 136AD has been applied to adjust a non-arm's length price between the entity of which the PE is a part and another separate entity.

169. A situation in which subsection 136AE(4) and section 136AD might be applicable to the same item of income or expenditure is where a MNE carries on business in overseas countries through both branches and related companies. For example, the head office of an Australian resident company manufactures a product at a cost of $50, transports it to a branch in Taiwan and records the transfer at cost in its books of account (i.e. $50). The Taiwanese branch in turn sells it to a related Hong Kong resident company for $55. The Hong Kong company sells the product to independent purchasers for $90. Assume that an arm's length price for the dealing between the head office and branch is $80, and for the dealing between the Australian and Hong Kong companies is $85. Section 136AD could be applied to deem the Australian company to have derived $85 from the sale to the Hong Kong company, and subsection 136AE(1) then applied to allocate an appropriate portion (approximately $80) to sources in Australia. Alternatively, subsection 136AE(4) could be applied to allocate to sources in Australia the $55 of the income that the Australian company derived from sale of the product. This situation is illustrated below.



170. In the above circumstances, the Commissioner would seek to rely on section 136AD and subsection 136AE(1) rather than on subsection 136AE(4), as the application of subsection 136AE(4) would not tackle the real issue, which is the shifting of the non-arm's length profit away from the Australian company to the Hong Kong associate. However, to the extent that subsection 136AE(1) is applied to deem an Australian source for the relevant income, paragraph 136AE(4)(c) prevents subsection 136AE(4) from applying to that income.

171. Another example of a situation to which both section 136AD and subsections 136AE(4)-(6) may prima facie apply is where a separate entity constitutes a permanent establishment by acting as an agent.

Paragraph 136AE(4)(d)

172. The term 'that question' refers to either of the two questions in paragraph 136AE(4)(b).

173. The condition in paragraph 136AE(4)(d) requires the Commissioner to consider what, if a determination were to be made under subsection 136AE(4), that determination would be. If it is

found that the tax position that would result from such a determination is less favourable to the taxpayer than the result following from the treatment accorded the matter in the taxpayer's return, then the Commissioner may proceed to make and apply that determination (assuming that the conditions stated in the other paragraphs of subsection 136AE(4) are satisfied). If it is found that the tax position that would result from such a determination is identical with or more favourable to the taxpayer than the tax position that would follow from the facts as stated in the return, then the Commissioner abstains from making that determination and leaves matters as they are in the return.

174. The condition in paragraph 136AE(4)(d) is, broadly, that less Australian tax would be payable by the taxpayer if the question were determined on the basis of the return furnished by the taxpayer than would be payable if the question were determined under subsection 136AE(4). The rationale for this condition is that Division 13 is intended to counter profit shifting arrangements which deny Australia its fair share of tax. Accordingly, unless an arrangement has the effect of eliminating or reducing a taxpayer's liability to Australian tax, there is no justification to apply Division 13. In this respect, the condition in paragraph 136AE(4)(d) effectively performs the same role as the conditions in paragraphs (c) and (d) of each of subsections 136AD(1), (2) and (3) do for transactions between separate entities.

175. This is not to say that the existence of a purpose of tax avoidance has any relevance to paragraph 136AE(4)(d), or is in any sense a precondition to the application of subsection 136AE(4). Subsection 136AE(4) contains neither an express nor an implied requirement to this effect. In this regard, the view we express in Taxation Ruling TR 94/14 (refer at paragraphs 119-121; 401-409) to the effect that the Commissioner does not have to identify a tax avoidance purpose before making a determination under Division 13, includes a determination made under subsection 136AE(4).

176. The term 'tax result' refers to the amount of Australian tax payable by the taxpayer. The tax result is 'more favourable' to the taxpayer if, on the basis of the return, the assessable income is less than, or allowable deductions, rebates or credits are greater than, what would be the case were a determination made under subsection 136AE(4). The tax result is measured in terms of tax payable generally, and is not limited to tax payable on an assessment of the taxpayer for the year of income to which the relevant return relates. The tax result is more favourable to the taxpayer if the return furnished results in less tax being payable in respect of that year or a different year. If, on the basis of the return furnished, no tax is payable for the year of income to which the return relates, and a determination under subsection 136AE(4) would not result in any tax

becoming payable for that year, the condition in paragraph (d) may still be satisfied. This may be the case where, on the basis of both the return furnished and any determination made under subsection 136AE(4), there would be either no taxable income, or available rebates or credits would fully offset tax payable, for the year of income to which the return relates. In such circumstances, the condition in paragraph (d) is satisfied if, for instance, a determination under subsection 136AE(4) would reduce the amount of any loss which, on the basis of the return furnished, is available to be carried forward and offset against assessable income of future years.

177. The return which is relevant is that for the year of income in which the income to be allocated is derived or in which the expense to be allocated is incurred. A question remains as to what happens if no return has been furnished by the taxpayer for the relevant year of income. Because of paragraph 136AE(4)(d), the furnishing of a return is a precondition to the Commissioner being authorised to make a determination under subsection 136AE(4) for the year of income to which the return relates. If the taxpayer is in default in not furnishing the return, the Commissioner can make a default assessment under section 167 of the ITAA. In making such an assessment the Commissioner must make a genuine judgment or estimate as to the amount on which tax is to be payable, this amount then becoming the taxable income for section 166 purposes. Under section 167, the Commissioner is not required to ascertain assessable income and allowable deductions in order to go through the process of calculating taxable income which section 166 requires (see *Briggs v. DFC of T (WA) & Ors; Ex parte Briggs* 87 ATC 4278; (1987) 18 ATR 663). Accordingly, the making of an assessment under section 167 does not require the application of Division 13. However, in making any such assessment the Commissioner would in practice seek to apply principles which are as consistent as possible with those prescribed in subsections 136AE(4) and 136AE(7).

Paragraph 136AE(4)(e)

178. 'The income' and 'the expenditure' referred to is income and expenditure which has already satisfied the condition in paragraph 136AE(4)(b). Paragraph 136AE(4)(e) limits the scope of subsection 136AE(4), so that it applies only if some part of the income or expenditure referred to in paragraph (b) is also attributable to the activities of the PE referred to in paragraph (a). In other words, it is paragraph (e) that requires the connection between the income or expenditure and the PE.

179. The word 'attributable' has its ordinary meaning for the purposes of paragraph 136AE(4)(e). It means 'owing to', 'produced by' or

'resulting from' (see *Central Asbestos Co v. Dodd* [1972] 2 All ER 1135). It is synonymous with the phrase 'a material contributory cause of', and does not require a sole, dominant, direct or proximate causal connection (see *Walsh v. Rother District Council* [1978] All ER 510). In the context of paragraph 136AE(4)(e), the word connotes a contributory causal connection between the income or expenditure and the activities of the PE.

180. Accordingly, we consider that income is attributable to activities of a PE to the extent that those activities are a material contributing factor in generating the income. It is apparent from this that whether income is 'attributable to' activities of a PE is a question of fact and requires a consideration and weighting of factors similar to those relevant in determining whether the activities are a source of that income (see paragraphs 143-150). A similar qualitative judgment regarding the significance of the PE's contribution to deriving the income is involved.

181. Similarly, we consider that expenditure is attributable to activities of a PE to the extent that those activities are a material contributing factor in the incurring of the expenditure. Attributable expenditure is not limited to expenditure incurred through the PE itself as a cost of the activities carried on through it, but extends to expenditure incurred through another part of the entity for the benefit or purposes of the PE. Expenditure is attributable to activities of a PE if it is incurred in deriving income attributable to activities of the PE or is incidental and relevant to those activities (see paragraphs 162 - 163).

Result of the application of subsection 136AE(4)

182. Where all of the conditions prescribed in paragraphs 136AE(4)(a) - (e) are satisfied, the relevant income or expenditure is deemed for all the purposes of the ITAA to have been derived or to have been incurred in deriving income:

(a) from such source; or

(b) from such sources and in such proportions,

as the Commissioner determines.

183. A question that arises is the extent to which subsection 136AE(4) extends or alters the principles which in its absence are applied to determine the source of income (see paragraphs 143-150) or the apportionment of expenditure to deriving income from a particular source (see paragraphs 159-167).

Determination under subsection 136AE(4) as to source of income

184. Subsection 136AE(4) authorises a determination that an item of income has a source, either in whole or in part, which differs from that which it might have upon an application of common law principles.

185. A provision such as subsection 136AE(4), which confers a discretionary power to determine source, may authorise the apportionment of an item of income whether or not, apart from that provision, the item could be dissected (see *Hillsdon Watts* (supra) at CLR 51-52, AITR 51-52 per Dixon J and at CLR 48, AITR 49 per Rich J). Subsection 136AE(4) may authorise the allocation of an item of income to multiple sources in situations in which the common law might require an allocation to a single source. Under subsection 136AE(4), an item of income that is considered attributable to activities carried on both in and out of Australia may be allocated to each part of the entity which performs such activities, and the income deemed to have a source accordingly, notwithstanding that the source or sources so deemed might not accord with what the common law would regard as the source or sources of that income.

186. The matters to which regard must be had under subsection 136AE(7) in making a determination as to source under subsection 136AE(4) are not the same as those which determine source on an application of common law principles. Subsection 136AE(4) does not ignore or entirely displace the common law principles, but subsection 136AE(7) requires that regard be had also to certain additional matters which would not be taken into account in applying those principles. Paragraph 419 of Taxation Ruling TR 94/14 sets out a (non exhaustive) list of matters to which paragraphs (a) and (c) of subsection 136AE(7) permit regard to be had, which include but is not limited to 'the application of common law rules relating to source (though the application of Division 13 often presupposes that these rules have been effectively circumvented or that section 25 does not apply)'.

187. In particular, paragraph 136AE(7)(b) must be considered. Paragraph 136AE(7)(b) provides a basis to which regard is to be had in measuring the quantum of income to be allocated to a particular source, i.e. an arm's length amount. It requires that, where income derived by a taxpayer is in some part attributable to an activity performed by a PE, the amount to be allocated to the PE be determined by having regard to how much of that income the PE might be expected to have derived if it were a separate entity dealing at arm's length with the taxpayer. The common law does not prescribe that regard be had to any such specific basis in determining the quantum of income to be allocated to a particular source.

188. The notional arm's length circumstances to which regard must be had under paragraph 136AE(7)(b) would not, in the absence of that provision, be taken into account in determining the source of income. In prescribing that regard be had to the arm's length principle in determining source, paragraph 136AE(7)(b) authorises a determination based not on the actual circumstances, if they do not accord with an arm's length situation, but on a reasonable expectation of what the circumstances might be in an arm's length situation. Subsection 136AE(4) therefore seeks to impose tax not by reference to the actual circumstances, to the extent that they have resulted in profit shifting, but by reference, at least in part, to substituted notional circumstances.

189. Paragraph 136AE(4)(d) reflects this distinction between the tax result on the basis of the return furnished, and the tax result on the basis of a determination under subsection 136AE(4). To the extent that the tax result on the basis of the return reflects profit shifting that is an outcome of the application of the source principles existing independently of subsections 136AE(4) and (7) to the actual facts of a taxpayer's situation, then subsections 136AE(4) and (7) authorise a determination of source which produces a tax result by reference, at least in part, to substituted notional circumstances. Paragraph 136AE(4)(d) presupposes a different tax result between source determined under subsection 136AE(4) and source determined independently of subsection 136AE(4). If the view were taken that subsection 136AE(4) does not authorise a determination of source which differs from that which would be determined independently of subsection 136AE(4), then paragraph 136AE(4)(d) could not be satisfied and hence subsection 136AE(4) could never be applied.

Determination under subsection 136AE(4) as to apportionment of expenditure

190. We consider that subsection 136AE(4) also authorises, where appropriate, an apportionment of expenses to be made on a different basis from, or to produce a different result from, an apportionment made independently of that provision.

191. Similar reasoning to that at paragraphs 185-189 is applicable in considering the scope of subsection 136AE(4) relative to that of other provisions of the ITAA with respect to the allocation or apportionment of expenses. Under subsection 136AE(4) a determination is made as to the apportionment of expenditure after having regard to the matters prescribed in subsection 136AE(7), including notional arm's length circumstances. It must be possible that such an apportionment may differ from that which is required to be made under other provisions on an objective basis according to the actual facts and circumstances of a particular case.

192. We would add that, as the ITAA operates on the basis of an adherence to the single entity approach, then in this respect no fundamental inconsistency is to be expected between an apportionment of expenditure made under subsection 136AE(4) and another provision of the Act. The amount of expenditure to be apportioned is in all cases limited to the amount in fact incurred by the taxpayer.

A determination under subsection 136AE(4) applies 'for all purposes of the ITAA'

193. A determination made under subsection 136AE(4) as to the source of income derived, or as to the extent to which expenditure is incurred in deriving income from a particular source, applies 'for all purposes of' the ITAA.

194. The provisions of the ITAA for which a determination under subsection 136AE(4) will have implications are primarily those referred to at paragraphs 133-135 in connection with when a question of source may arise under the ITAA.

195. As indicated there, a determination under subsection 136AE(4) as to the source of income will apply for the purposes of determining whether the income is 'foreign branch income' under section 23AH, which exempts from Australian taxation certain foreign branch income derived by a resident company taxpayer. This means that the determination will apply for the purposes of paragraph (b) of the definition of 'foreign income' in subsection 23AH(12), which refers to 'an amount that is derived from sources in a foreign country'. Where a determination under subsection 136AE(4) has been made, 'foreign branch income' for section 23AH purposes will be only that part of the income which the Commissioner has deemed to have been derived from foreign sources, and which satisfies the other conditions for foreign branch income prescribed in section 23AH. A determination under subsection 136AE(4) as to whether expenditure is incurred in deriving income from a particular source will apply in determining whether expenditure is deductible or incurred in deriving income that is exempt under a provision such as section 23AH, or in considering the treatment of foreign losses under such provisions as section 79D and section 160AFD.

Requirements for a valid determination

196. Subsection 136AE(4) requires the Commissioner to make a formal determination as to either the source of any income derived or the extent to which any expenditure was incurred in deriving income from a particular source.

197. A determination made under subsection 136AE(4) needs to be supported by sufficient relevant information to demonstrate that an informed and reasonable decision has been reached in the circumstances of the case. The Commissioner must take into account all relevant facts and circumstances, and exclude all irrelevant circumstances from consideration.

198. In particular, the Commissioner must be satisfied that each of the preconditions in paragraphs (a) to (e) of subsection 136AE(4) is satisfied.

199. The circumstances or matters to which the Commissioner is to have regard in making a determination under subsections 136AE(1) - (6) are set out in subsection 136AE(7). It should be noted that subsection 136AE(7) provides that the Commissioner 'shall' have regard to the matters prescribed in paragraphs 136AE(7)(a) (b) and (c). Accordingly these matters are mandatory considerations to which the Commissioner is bound to have regard; there is no discretion as to whether or not to consider any of the prescribed matters. Conversely, subsection 136AE(7) must be accepted as exhaustively prescribing the matters which are relevant to be taken into account in making a determination under subsections 136AE(1) - (6).

Subsection 136AE(7): relevant matters in determining source under subsection 136AE(4)

200. In the application of subsection 136AE(4), subsection 136AE(7) requires that regard shall be given to:

(a) the nature and extent of any relevant business carried on by the taxpayer and the place or places at which the business is carried on (paragraph 136AE(7)(a));

(b) where the business is carried on at or through a PE - the circumstances that would have, or might reasonably be expected to have, existed if the PE were a distinct and separate entity dealing at arm's length with the taxpayer and other persons (paragraph 136AE(7)(b)); and

(c) such other matters as the Commissioner considers relevant (paragraph 136AE(7)(c)).

201. The preliminary wording of subsection 136AE(7), which introduces the matters specified in paragraphs (a) (b) and (c), expressly indicates that those matters are relevant only in applying subsections 136AE(1)-(6) to determine the source of income derived or the extent to which expenditure incurred is incurred in deriving income from a particular source. As previously discussed, subsection 136AE(4) applies only to allocating income in fact derived or

expenditure in fact incurred, and accordingly, regard is to be had to the matters specified in paragraphs (a)-(c) of subsection 136AE(7) only for this purpose. Most importantly, the matters to be considered under subsection 136AE(7) cannot authorise the allocation of amounts other than those actually derived or incurred by a taxpayer. The single entity approach means that such amounts can only be created by dealings between separate legal entities, and not by dealings between parts of the same legal entity. Subsection 136AE(7) operates subject to this limitation, and the matters specified in paragraphs (a) (b) and (c) are taken into account only to the extent to which they produce an outcome which adheres to the single entity approach, being an allocation of income actually derived or expenditure actually incurred by the taxpayer entity.

202. The matters specified in paragraphs 136AE(7)(a) (b) and (c) must be considered together in arriving at a proper allocation under subsection 136AE(4). The relative weighting to be given to a particular matter will depend upon the circumstances of each case. None of the matters should be taken in isolation as the basis for the allocation. For instance, regard might be had under paragraph 136AE(7)(b) to an arm's length price for a dealing between a PE and its head office, but that price is not the sole determinant of an appropriate allocation. Depending upon the circumstances, such an arm's length price may not produce an allocation that is consistent with an adherence to the single entity approach, or it may not sufficiently reflect an outcome which the matters referred to in paragraphs (a) and/or (c) of subsection 136AE(7) would favour.

203. By way of example, if an arm's length price for an internal dealing would produce an allocation of expenditure which exceeds the total of relevant costs actually incurred by a taxpayer, then no weight can be given to that price in making the allocation, even though paragraph 136AE(7)(b) might prima facie treat the arm's length price as a relevant matter to be taken into account (see paragraphs 215-216).

Paragraph 136AE(7)(a)

204. Our views on the types of matters to which regard may appropriately be had under paragraphs (a) and (c) of subsection 136AE(7) are set out at paragraph 419 of Taxation Ruling TR 94/14, i.e.:

(a) the nature and extent of any relevant business activities;

(b) the place or places at which the business is carried on;

(c) the functions performed in each country, the assets and skills employed in each country and the risks and responsibilities borne by the various entities;

(d) the economic value added to the relevant property in each location;

(e) the application of common law rules relating to source (though the application of Division 13 often presupposes that these rules have been effectively circumvented or that section 25 does not apply);

(f) the degree of connection between each amount of expenditure and the income derived in each jurisdiction;

(g) other circumstances relevant to a particular company and 'agreement'; and

(h) the operation of any source rules in any applicable Double Taxation Agreement.

Whilst the above list is expressed in terms of separate entity situations to which subsections 136AE(1) -(3) apply, similar matters will in general be relevant to single entity situations where regard is had to paragraphs 136AE(7)(a) and (c) in applying subsections 136AE(4)-(6).

205. Of the matters listed above, matters (a), (b), (c), (d) and (f) are relevant to paragraph 136AE(7)(a). This paragraph refers to the nature and extent of the taxpayer's business activities and the place or places at which those activities are carried on. It calls for a consideration of the degree of connection between the relevant item of income or expenditure and the business activities carried on at a particular place. For this purpose, a functional analysis of the taxpayer's business activities may appropriately be used to assess the relative significance of the contributions made by activities carried on at particular locations to generating the income and expenditure of the business (see paragraph 248). This would involve having regard to such matters as:

(a) the activities or functions performed in each country;

(b) the economic value of the contribution made by each of those activities or functions;

(c) the assets and skills employed in each country;

(d) the degree and nature of any business or financial risks borne by the various parts of the taxpayer entity.

Paragraph 136AE(7)(b)

206. Paragraph 136AE(7)(b) prescribes the internationally accepted arm's length principle as one of the criteria to be considered in determining the amount of income and expenses of an entity that are to be allocated to a PE.

207. In essence, the arm's length principle is the basic mechanism by which Division 13 seeks to counter 'non-arm's length transfer pricing' arrangements and to ensure that Australia receives its fair share of tax based on the economic value added by activities carried on in Australia or involving the use of Australian assets, infrastructure and skills. The basis of the arm's length principle is that pricing used in international dealings should reflect economic and commercial reality, as tested by reference to what independent parties dealing at arm's length either do, or might reasonably be expected to do, in comparable circumstances.

Interaction of arm's length principle and single entity approach

208. Application of the arm's length principle requires that members of a MNE be treated as operating as separate entities rather than as inseparable parts of a single unified business. Paragraph 136AE(7)(b) provides for the application of the arm's length principle within the context of the 'single entity approach' adopted by Australian law. The single entity approach reflects the legal reality that a PE is not a legal entity separate from the entity of which it is a part. Paragraph 136AE(7)(b) creates what is often referred to as a 'separate entity fiction' by treating a PE **as if** it were a separate entity dealing at arm's length with the entity of which it is a part and with other persons. In other words, the paragraph provides for the notional recognition of an entity and its PE as separate entities, in order to apply the arm's length principle to dealings of the PE.

209. However, this notional treatment of an entity and its PE as separate entities is only for the limited purpose of performing the function to which the introductory wording to paragraphs (a) (b) and (c) of subsection 136AE(7) refers; i.e. for determining under subsections 136AE(4)-(6) either the source of income derived by the taxpayer or the extent to which expenditure incurred by the taxpayer is incurred in deriving income from a particular source. For this limited purpose, paragraph (b) provides for regard to be had to notional prices and charges on notional dealings between parts of a single entity. It invites a comparison between the prices and charges the entity uses in its internal accounts with those one might expect if the entity and PE were separate and dealing at arm's length.

210. The application of the arm's length principle to dealings between parts of an entity cannot result in the creation of assessable income which has not actually been derived, or of deductions for expenditure which has not actually been incurred, by the entity. The purpose of applying the arm's length principle to ascribe notional amounts of income or expenditure to dealings between a PE and other parts of an entity is limited to determining what amounts of the entity's actual income and expenditure are properly attributable to the business activities it carries on through the PE. Paragraph 136AE(7)(b) operates to assist the Commissioner in exercising his allocation function under subsection 136AE(4) by authorising the allocation of actual income derived or actual expenditure incurred after considering how and to what extent one might reasonably expect it to have been derived or incurred in arm's length circumstances.

211. In considering the interpretation and application of subsection 136AE(4) and paragraph 136AE(7)(b), there is a distinction between:

(a) having regard to what an arm's length charge for a dealing between a head office and a PE might have been for the purpose of determining how much of the income derived and the expenditure incurred by a MNE is allocable to the head office and PE; and

(b) determining what an arm's length charge for a dealing between a head office and a PE might have been for the purpose of treating that charge as income derived or expenditure incurred by the head office or the PE respectively.

The provisions authorise the former, but not the latter.

212. In this sense, subsection 136AE(4) operates with respect to dealings within a single entity in a fundamentally different way to that in which section 136AD operates where a dealing between separate entities is involved. Under subsection 136AE(4), the notional arm's length consideration which paragraph 136AE(7)(b) ascribes to an intra-entity dealing is not in itself income derived or expenditure incurred. Rather it is used as a factor in determining the amount of actual income and expenditure of the entity which is to be allocated to sources in and out of Australia. On the other hand, section 136AD authorises the determination of an arm's length consideration, and this amount is itself deemed to be income derived or expenditure incurred for the purposes of the ITAA.

213. Where income derived by an entity through an overseas head office or PE is in some part attributable to activities performed by a head office or PE in Australia, paragraph 136AE(7)(b) requires that regard be had to what an arm's length consideration for those activities

might be in determining how much of that income may be deemed to have a source in Australia. Conversely, where income derived in Australia is in some part attributable to activities performed outside Australia, then what a notional arm's length charge for those activities might be must be considered in determining how much of that income may be deemed to have a source out of Australia.

214. This is entirely consistent with the single entity approach taken by Australian law. It does not involve recognising dealings or charges between a head office and PE for the purpose of including notional income or expenditure arising therefrom in taxable income. Rather, it notionally takes into account those charges and dealings (i.e. *as if* the head office and PE were independent entities) for the limited purpose of allocating actual income or expenditure of the entity which is attributable to activities carried on through both the head office and PE. This interpretation gives an appropriate notional recognition to head office - PE dealings and to the arm's length principle to be applied to such dealings under paragraph 136AE(7)(b), for the purposes of performing the function authorised under subsection 136AE(4).

Meaning of 'the circumstances that would have, or might reasonably be expected to have, existed'

215. The extent and nature of the 'circumstances' existing in an arm's length situation which can be taken into account under paragraph 136AE(7)(b) in making an allocation under subsection 136AE(4) is effectively limited in a particular case by the need for those circumstances to produce an outcome which is consistent with the single entity approach. As the only purpose of having regard to arm's length circumstances is to allocate amounts of an entity's actual income and expenditure to a PE, this necessarily limits the particular circumstances that may be given weight in performing the allocation. For this reason, the 'circumstances' to which weight can be given in a particular case will not necessarily be all of those which might ordinarily pertain to an arm's length dealing between separate entities.

216. For instance, as paragraph 136AE(7)(b) cannot authorise an allocation of amounts in excess of income actually derived or expenditure actually incurred, no weight can be given to a particular 'circumstance' referred to in that paragraph if to do so would have such an effect. For example, the inclusion of a profit mark-up in the price is invariably a 'circumstance' pertaining to an arm's length dealing between independent entities. Regard may be had to this circumstance, where appropriate, by including a profit mark-up in pricing a dealing between a PE and its head office for the purpose of allocating income (see paragraphs 225-227). However, no weight can

be given to this circumstance for the purpose of allocating expenditure (see paragraphs 228-230).

217. Subject to such necessary limitations, the 'circumstances' referred to will in general be those relevant to the pricing, terms and conditions of a comparable dealing between independent entities dealing at arm's length. These circumstances will be reflected in an outcome in relation to the pricing, terms and conditions of the dealing which:

(a) is comparable with that which would result from real bargaining between independent parties; and

(b) properly reflects commercial and market realities, and the relative economic value of the contribution made by the parties, in terms of the functions performed, assets and skills used, and risks assumed.

Our views on what this involves are discussed in Taxation Ruling TR 94/14 at paragraphs 64-78 and 310-327, in the context of determining an arm's length consideration under section 136AD. In general terms, a similar approach is relevant in considering comparability with arm's length circumstances for paragraph 136AE(7)(b) purposes.

218. Having regard to the 'circumstances' that would or might be expected to exist in an arm's length situation calls for a broader consideration than just looking at what might have been an arm's length price for a notional dealing between a PE and its head office. Paragraph 136AE(7)(b) permits a more general examination of how the conditions existing between the PE and head office in their commercial relations compare with those which would or might be expected to exist between independent entities dealing at arm's length. In some situations the way dealings between a PE and head office are structured, or the reasons for those dealings taking place at all, may cause income or expenses of the entity to be allocated between them in a way that would not have occurred between arm's length parties. The dealings between the PE and its head office viewed in their totality may differ from those which would take place between arm's length parties. Paragraph 136AE(7)(b) permits a reconstruction of the terms of an internal dealing in its entirety (rather than simply the pricing), so as to replicate the conditions which might be expected to have existed had the dealing been at arm's length. Paragraph 136AE(7)(b) enables reconstruction of dealings between a PE and head office to reflect an allocation of income and expenses that would have resulted had the dealings been structured in accordance with the economic and commercial reality of parties dealing at arm's length.

219. For instance, a PE may be required to maintain inventory levels in excess of what would reasonably be expected for an independent entity carrying on the particular type of business. It may be concluded that in an arm's length situation the head office would not have supplied stock on open-ended credit terms, or that the PE would not have acquired and warehoused stock excess to its requirements. In such circumstances, the dealings might be restructured for paragraph 136AE(7)(b) purposes to provide for credit and warehousing charges on an arm's length basis, so as to reflect a more appropriate allocation of the actual costs to the entity associated with the sale of the stock to third parties.

220. Under paragraph 136AE(7)(b), regard may be had not merely to what an arm's length price might be expected to have been for an internal dealing which actually took place. The provision also allows for a restructuring of the actual dealing, for instance, where its economic substance differs from its form, or where its form and substance are the same, but the dealing viewed in its totality differs from that which would have been adopted by arm's length parties. The price ascribed to an internal dealing may be an arm's length amount based on how the dealing is structured or on its other terms and conditions, however the structuring of the dealing or its other features may not accord with what arm's length parties would have agreed to in comparable circumstances. In such situations, regard may be had under paragraph 136AE(7)(b) to how arm's length parties might be expected to have structured the relevant dealing, and to the pricing, terms and conditions which might be expected to have then applied.

221. Paragraph 136AE(7)(b) refers not only to circumstances that would have existed, but also to those that 'might reasonably be expected' to have existed. The phrase 'might reasonably be expected' does not import absolute certainty, but is a matter of degree. The meaning of the phrase was considered recently in the context of section 177C of Part IVA of the ITAA by the Full Court of the High Court in *FC of T v. Peabody* 94 ATC 4663; (1994) 28 ATR 344. The Full Court, in a joint judgment, stated that a reasonable expectation requires more than a possibility; it requires a prediction, as to what would have taken place, which is sufficiently reliable for it to be regarded as reasonable.

Having regard to profit mark-ups in the pricing of internal dealings

222. The arm's length price for a dealing between independent entities will invariably include a profit mark-up, in the sense that the price charged by the party supplying an item or services will exceed the costs of that party in acquiring or producing that item or performing those services. The existence of such a profit mark-up as

is charged in an arm's length price is prima facie a 'circumstance' to which paragraph 136AE(7)(b) refers.

223. In having regard to paragraph 136AE(7)(b) to make an allocation under subsection 136AE(4), weight may be given, in appropriate circumstances, to an internal charge which includes a profit mark-up where the charge effects an allocation of income derived by an entity (see paragraphs 225-227), but not where it allocates expenditure (see paragraphs 228-230). Whether an internal charge allocates income or expenditure is determined by whether income actually derived by the entity is considered, to any extent, attributable to the performance of the activity for which the charge is made. If it is, then the internal charge is in the nature of an allocation of income. If it is not, then the charge effects an allocation of expenditure, and it is limited to the costs actually incurred by the entity in performing the activity (i.e. no profit mark-up). In this latter situation, a consideration of arm's length circumstances under paragraph 136AE(7)(b) cannot result in an allocation of more than the costs actually incurred.

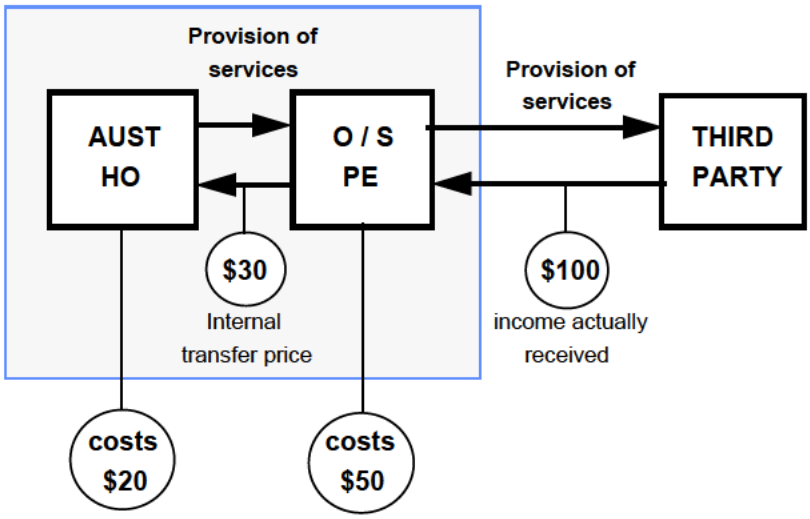
224. In circumstances where an internal charge appropriately includes a profit mark-up, the internal dealing does not, of itself, create this profit. Rather, the profit results from an allocation of the entity's income and expenses where the income exceeds the expenses incurred in generating that income. Paragraph 136AE(7)(b) does not say that an entity can make a profit out of dealing with itself (i.e. its PE), whether that profit equates with an arm's length amount or not.

225. Where income derived by a MNE is in some part attributable to activities performed by a PE, then any internal charge attached to those activities for tax purposes should reflect an allocation of an arm's length share of that income to the PE. The PE may be allocated income in excess of the actual costs incurred by the MNE in performing the activities, i.e. a profit mark-up, if those activities in arm's length circumstances would justify an allocation to the PE of that amount of the MNE's actual income. Of necessity, this is conditional on the MNE having derived that amount of actual income, and the allocation according with a due regard to the matters in paragraphs 136AE(7)(a) and (c). The only purpose of imputing an arm's length charge which exceeds actual expenditure incurred is to allocate actual income derived. In these circumstances, an amount in excess of the amount of costs incurred in performing the activities should be charged for tax purposes to the credit of the PE. If the income is derived by the MNE through some part of the entity other than the PE itself, i.e. its head office or another PE, then a corresponding debit should be charged against that part of the entity. In this way, the relevant credit and debit entries may appropriately

reflect, for tax purposes, the charging of a profit mark-up for activities performed by a PE.

226. For example, if a MNE derives, through an overseas PE, fees for performing work for a third party, and head office staff in Australia provide technical advice to the PE to enable its staff to perform the work, then in part the fee income may be regarded as attributable to activities performed by the head office. The charging between the head office and PE of an amount which equates with an arm's length price for the services provided by the head office may, for tax purposes, be considered an acceptable means of allocating to the head office its share of the actual fee income derived by the MNE. The notional charge between head office and PE may exceed the costs incurred by the MNE in performing the relevant head office activities, i.e. the charge may include a profit mark-up, provided the amount of the fee income derived by the MNE is sufficient to cover such a mark-up.

227. The example referred to in the previous paragraph can be illustrated in the following diagram:



In this example, the internal charge of $30 is a means of allocating to the head office a share of the $100 income derived by the MNE through the PE. As an allocation of income is involved, the charge can exceed the $20 costs incurred through the head office in performing the activities, assuming that the amount of $30 reflects an arm's length price.

228. Where a head office performs activities on behalf of, or for the purposes of, a PE, but no part of any income derived through the PE is regarded as attributable to those activities, the exercise under subsection 136AE(4) is to allocate to the PE only the actual costs

incurred in performing the activities. Common examples of such activities are:

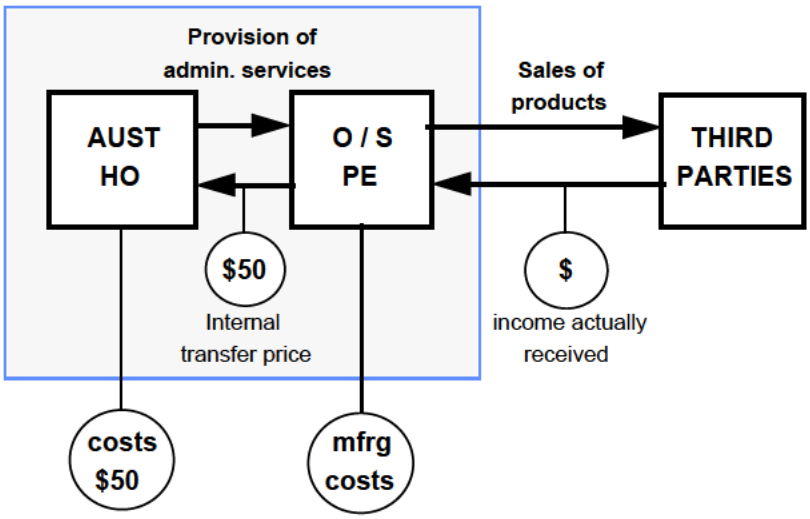
(a) administrative services;

(b) research and development activities;

(c) the borrowing of funds for use by the PE (where no business of banking is involved).

229. In making such an allocation, there is no question of allocating an amount greater than the amount of expenditure actually incurred by the entity; i.e. no profit element or mark-up can be added. If a MNE incurs, through its head office, expenditure on behalf of a PE, then the PE can be allocated only the amount of expenditure incurred; it cannot also be allocated whatever profit margin the entity would have added if it had been incurring the expenditure on behalf of an independent third party. To allocate such a profit element involves allocating to the head office a part of the income derived by the MNE through the PE, and where no part of that income is attributable to the activities, no such allocation is possible.

230. To take a simple example, suppose that a MNE carries on a business of manufacturing and selling products through an overseas PE. The MNE's Australian head office performs administrative services which benefit the PE. This can be illustrated in the following diagram:



In this example, the internal charge of $50 is a means of allocating to the PE the costs incurred by the MNE, through its head office, in performing the services. As an allocation of expenditure is involved, the charge cannot exceed the $50 costs actually incurred; no profit mark-up can be added, even if to do so might reflect an arm's length

price which the entity might have charged an independent third party for performing comparable services.

231. The methodology used to determine an arm's length price for an internal dealing, for the purpose of allocating income, may take costs such as for administrative services or research and development activities into account in calculating that price (see paragraph 244). If this is so, then no separate or further allocation of such costs should be made. To do so would involve a double counting of the expenses. For example, a cost plus method may take administrative expenses of a head office into account in determining the price charged by the head office to a PE for goods the head office transfers to the PE, for the purposes of allocating to the head office some part of the income derived through the PE from sale of the goods to third parties. If it does, then no further allocation to the PE in respect of such expenses should be made.

Recognition of charges such as 'interest' or ' royalties' between parts of an entity

232. Notional charges such as 'interest' or 'royalties' made between a head office and PE for funds transferred or intangibles used are only recognised for the purpose of allocating to the head office or PE amounts of actual expenditure incurred by the MNE in the form of payments of interest or royalties to third parties. Such notional charges are not, of themselves, recognised in determining taxable income attributable to activities of the PE.

233. With respect to royalties, the single entity approach taken by Australian law means that it is not possible to allocate legal ownership of intangible rights or property to any one part of an enterprise. Accordingly, no notional royalty charge can be made between a head office and a PE in connection with licensing the use of intangibles such as technology or trademarks owned by the MNE. However, it is appropriate that a MNE's actual costs of creating such intangible property be allocated to all parts of the entity that make use of it. For example, where research and development activities are centralised in one part of an entity, it is appropriate for the costs of performing those activities to be charged to all parts of the entity that make use of any intangibles resulting from the activities.

234. If a MNE which is not a financial enterprise borrows funds through its head office and transfers those funds to a PE for its use, the amount of the interest actually payable by the MNE to the third party lender is an expense allocable to the PE. A notional interest charge made by the head office to the PE may be recognised for the purpose of allocating to the PE the amount of interest expense actually

incurred. If there is no actual interest cost to the MNE attaching to the funds transferred (i.e. if the funds are internally generated rather than borrowed from a third party), then there is no interest expense to be allocated to the PE, and hence no notional interest charge can be made between head office and PE. Where a charge is appropriate, there is no question of considering what an arm's length interest rate might be for the purpose of allocating a profit element to the head office for transfer of the funds. No part of the income derived from the business activities performed by the PE is attributable to the borrowing activity performed by the head office.

235. Different considerations apply to a financial enterprise, because of the nature of the business of borrowing and lending which it carries on. The interest income it derives is a business profit which may be considered attributable to both the borrowing and lending activities performed. If the Australian head office or PE of a financial enterprise transfers funds to an overseas PE or head office respectively, and those funds are used to derive income, then some part of that income may be attributable to the enterprise's Australian business activities. The charging of an arm's length rate of interest, such as an appropriate inter-bank lending rate, on the funds transferred, may be an acceptable means of determining, for subsection 136AE(4) purposes, the part of the income deemed to have been derived from sources in Australia. Such charging may reflect commercial reality by effecting an appropriate arm's length allocation between parts of the enterprise of interest income it derives, and interest expense it incurs, in dealings with third parties. Accordingly, in normal circumstances, entries in the accounts of a financial enterprise which reflect arm's length interest charges on funds transferred between parts of the enterprise (i.e. its head office and PEs) may, for tax purposes, be an acceptable means of allocating to those parts appropriate amounts of the enterprise's actual third party interest income and expenses. Clearly this applies only to transfers in the ordinary course of business of funds used for trading purposes, and not to transfers related to the provision of capital.

Practical application of subsection 136AE(4) and paragraph 136AE(7)(b) requires a commercially realistic approach

236. As previously discussed, subsection 136AE(4) adheres to the single entity approach and only authorises the allocation between parts of an entity of actual income derived and actual expenditure incurred by that entity. In order to give effect both to this and to paragraph 136AE(7)(b), it is strictly necessary that an internal dealing between the PE and another part of the entity be connected with or traced to an identified dealing between the entity and a third party, because it is

only through such third party dealings that the entity's actual income or expenditure arises. Whilst regard is to be had under paragraph 136AE(7)(b) to whether the circumstances of an internal dealing accord with the arm's length principle, in performing an allocation under subsection 136AE(4) the internal dealing cannot be considered in isolation, because it does not of itself create actual income or expenditure. Any income or expenditure notionally ascribed to such a dealing is given recognition by paragraph 136AE(7)(b) only for the limited purpose of allocating between parts of the entity the actual income or expenditure of the entity arising from a third party dealing.

237. The tracing of an entity's internal dealings to particular dealings between the entity and third parties may be possible where, for example, the business activities involve the sale of a discrete product, and its sale price and all relevant costs can be separately identified or established.

238. However, the circumstances of a particular type of business may make such tracing a practical impossibility. For example, a head office may transfer components or semi-finished goods to a PE, which sells the fully assembled or finished product. Or the PE may complete the assembly or finishing process and in turn transfer the goods to another PE to sell. Determining whether a component transferred actually generated income for the MNE, for the purpose of allocating that income to the head office, may be a practical impossibility. Even if the income generated from particular sales of the finished product of which the component is a part can be identified, which commonly may be impossible, this does not in any event of itself establish the amount of income referrable to the component. If unable to perform such tracing, it is not possible to know exactly what the amount of the actual income is, and hence to ascertain with precision its relativity to the notional arm's length amount ascribed to the internal dealing (i.e. whether or not the amount ascribed to the internal dealing exceeds the actual income derived).

239. In these circumstances, we recognise that in making an allocation of actual income and expenditure, it will be necessary to have regard to the notional arm's length amount imputed to the internal dealing, without being able to identify exactly what the amount of that actual income and expenditure is. The circumstances of a taxpayer's situation may require that commercial realities be relied upon to ensure an appropriate relativity between the notional and actual amounts, where practicalities mean that the relationship cannot be established as a matter of fact.

240. This does not mean that in such circumstances no actual evaluation of the relationship between an entity's internal and third party dealings is required. What is required is that the commercial

realities of a taxpayer's business be relied upon to assess what that relationship might reasonably be expected to be (see paragraphs 261, 268 and 298).

241. In the absence of evidence to the contrary, commercial realities should ordinarily mean that it may reasonably be expected that a taxpayer's dealings with third parties give rise to arm's length amounts of income or expenditure. Provided this is so, then having regard to arm's length charges between parts of the entity should effect an allocation of the actual income or expenditure which accords with commercial reality and with subsection 136AE(4). This is the fundamental philosophy underlying paragraph 136AE(7)(b) and its use in conjunction with subsection 136AE(4) to counter intra-entity transfer pricing. An appropriate relationship between an entity's internal and external dealings is ensured by commercial realities, provided both dealings accord with arm's length principles.

242. For example, in the case of financial enterprises we recognise that it is not ordinarily practicable or possible to trace either the source or end use of funds transferred between branches in order to identify and allocate the actual interest income and expenditure of the enterprise associated with those funds. Accordingly, we accept that having regard to interest charges at appropriate arm's length inter-bank rates on inter-branch transfers of funds, may ordinarily be expected to give a result consistent with an allocation of actual third party interest income and expenses which accords with subsection 136AE(4).

Methodologies for having regard to the arm's length principle in allocating income to a PE

243. As previously discussed, where income derived by an entity is in some part regarded as attributable to an activity performed by or for a PE, the exercise under subsection 136AE(4) involves an allocation of income. Otherwise, the exercise is to allocate the expenses incurred in performing the activity. Different considerations apply to allocating income from those which apply to allocating expenses (see in particular paragraphs 222-230), and these are reflected in the differing methodologies to which it is appropriate to have regard in effecting such allocations. Our views on the considerations relevant to allocating expenditure are discussed at paragraphs 262-268.

244. There are several internationally accepted methodologies that are used to apply the arm's length principle under section 136AD in determining an arm's length consideration for dealings between separate entities. Our views on the use of the CUP, resale price, cost plus and profit methods are stated in general terms in Taxation Ruling

TR 94/14 at paragraphs 86-100 and 343-367, and will be the subject of a later Ruling.

245. We consider that these methodologies are relevant in having regard to the arm's length principle in allocating income to a PE under subsection 136AE(4). The 'separate entity fiction' created by paragraph 136AE(7)(b) prima facie enables the use of such methodologies in having regard to the notional outcome had the PE been a separate entity dealing at arm's length with the entity of which it is a part and with other persons.

246. However, the use of the accepted methodologies for paragraph 136AE(7)(b) purposes is subject to the need for an allocation made after reference to the matters in subsection 136AE(7) to adhere to the single entity approach. This means that in using these methodologies to determine an arm's length pricing for an internal dealing, the pricing and circumstances of relevant third party dealings must also be taken into account (see paragraphs 258-261). Regard may be had to what a notional arm's length outcome might have been if a head office and PE were dealing as separate entities, but only for the purpose of allocating to the head office and PE parts of an actual amount arising from a dealing between the MNE and a separate entity.

247. In other words, paragraph 136AE(7)(b) calls for a consideration of whether an allocation of an entity's income and expenses between its head office and PEs is comparable with how separate entities dealing at arm's length would have shared that income and expenditure. The provision requires an examination as to whether the allocation of income and expenditure to the PE reflected in the entity's accounts is the income and expenditure that the PE might reasonably be expected to have derived and incurred if it were a separate entity dealing at arm's length with other parts of the entity.

248. By having regard to how arm's length parties would have gone about the process of allocating income, the object is to produce a result that closely reflects commercial and economic reality and the relative economic contributions made. A functional analysis may form the basis for determining an arm's length outcome by examining the overall relationship between the members of a MNE to understand the contributions each makes to the economic value created. Such an analysis will examine the functions performed, the assets and skills used and the degree and nature of any business or financial risks involved in the process of deriving income of the MNE. In this way, a reasonable reflex can be obtained of the economic value of the contribution made by the activities carried on in Australia. A more detailed discussion of what is involved in conducting a functional analysis will be the subject of a later Ruling on arm's length methodologies.

249. A functional analysis of a MNE is intended to ascertain not only which functions are performed by the head office and each PE, but also in what capacity they perform those functions. The analysis may show that a PE or head office, viewed as a separate entity, performs activities either as a principal (accepting all the risks and entitled to a commensurate share of the profits of the activity), or as an agent for or on behalf of another part of the MNE (with limited risks and for a limited return). If a PE or head office, viewed as a separate entity, would properly be regarded as acting as an agent, then an arm's length remuneration for the activities it performs may take the form of a commission or fee which is a fraction of the profit derived from those activities. Regard may be had to the amount of such a fee in determining the amount of income to be attributed to the PE or head office from performance of the activities. For an illustration of this point, see paragraph 281.

250. The concept of comparability is central to the operation of the arm's length principle, and hence to all of the internationally accepted methodologies used to apply the principle. The method or combination of methods that provides the highest degree of comparability and that can be effectively applied to a particular situation is the most appropriate method and the one that should be preferred. The functional analysis effectively forms the basis for determining comparability and ultimately leads to selecting the most appropriate methodology to achieve an arm's length result.

251. The CUP, cost plus and resale price methods are primarily transaction based; they are typically applied to a particular transaction or series of transactions and used to determine what a notional arm's length consideration might be for that transaction or transactions. Such transaction based methods can be used under paragraph 136AE(7)(b), as it gives notional recognition to transactions between a head office and a PE. Such methods may therefore appropriately be used in determining a notional consideration in respect of such notional transactions for the purpose of having regard to the arm's length principle in allocating actual income and expenses under subsection 136AE(4).

252. Where the particular facts and circumstances mean that it is not possible or practicable to apply these methods, other methods, including profit splits and profit comparisons may need to be considered and the most appropriate method, or mixture of methods, selected.

253. In applying subsection 136AE(4), the amount of the income and expenditure to be allocated is fixed; it is the actual income derived and the actual expenditure incurred by the entity. Paragraph 136AE(7)(b) calls for a consideration of how that fixed amount is to be shared

between parts of the entity in proportions based on the arm's length principle. A methodology which appropriately has regard to the arm's length principle in allocating fixed amounts of income and expenditure is the so-called profit split method. This method determines an arm's length split or allocation of profits. It addresses the question, 'what split or allocation of profits would independent enterprises have expected from engaging in the relevant business activity?'.

254. Broadly, this method, as applied to separate entities, seeks to approximate an arm's length outcome by splitting the combined profit from non-arm's length dealings between the parties involved, based on an analysis of their relative contributions to deriving that profit. The first step in applying this method is to ascertain the combined profit derived by the parties from the relevant dealings. Then, having carried out an analysis of the functions performed by each of the parties, taking account of the assets and skills contributed by each party and the risks each assumes, that combined profit is split between the parties on the basis of the economic value each has contributed. Regard is had to what sort of returns arm's length parties would seek for the use of the relevant assets and skills and the assumption of risks, where this information is available.

255. The profit split method thus involves an evaluation of the nature, extent and importance of each party's contribution to the earning of the overall profit, and also a consideration of how arm's length parties would have accordingly allocated that profit.

256. This method may appropriately be adapted and applied to split an overall profit, made by an entity as a result of a particular series of activities, between a head office and PE which have each contributed to the derivation of that profit. A typical series of activities might be that illustrated by the example at paragraph 269. A functional analysis of the MNE will provide the basis for determining the economic value that the head office and PE have contributed to deriving the overall profit. This will in turn provide the basis to determine the proportions in which that profit is split between the head office and PE, thus effecting an appropriate arm's length allocation of income and expenditure for paragraph 136AE(7)(b) purposes.

257. Where the actual amount of the entity's overall profit can be identified, then that amount is used for the profit split. Where, in the circumstances, it is not possible or practicable to identify the actual overall profit, then an anticipated or estimated overall profit figure, based on what that profit might reasonably be expected to be, may be used (also see paragraphs 260-261 and 267-268).

258. The notional arm's length figure resulting from the application of the accepted methodologies cannot be used independently of the

MNE's actual income, but only for the limited purpose of allocating that income. Therefore, in order to appropriately allocate income of a MNE by reference to the pricing of an internal dealing, it is strictly necessary to quantify the actual income of the MNE from a third party dealing to which the internal dealing can be identified as related. In other words, the pricing of the third party dealing determines the amount of income which is subject to allocation by reference to the pricing of the internal dealing. Determining an arm's length price for an internal dealing does not, of itself, determine the amount of income allocable to a PE. In particular, the need to adhere to the single entity approach means that if an arm's length price for an internal dealing exceeds the amount of income in fact derived by the entity as a whole from a related dealing with a third party, then the arm's length price cannot be used as a basis to allocate more than the actual amount derived. This point is illustrated at paragraph 280.

259. The single entity approach requires a consideration of the relativity between the pricing of an internal dealing and the pricing of the entity's relevant third party dealings. As well as having regard to an arm's length pricing for the internal dealing, the circumstances that affect the pricing of the third party dealing must also be taken into account. Otherwise, the amounts allocated to a PE and head office by way of an arm's length pricing of their dealing with each other will not have the requisite connection to the entity's actual income to represent the allocation of that income that subsection 136AE(4) authorises. By taking into account the factors or circumstances which result in the pricing of the third party dealing that produces the actual income, the requisite relativity between the pricing of that dealing and of the internal dealing is obtained.

260. In practice, the exact amount of the actual income will commonly not be known. It may not be known at the time that the internal dealing takes place and is recorded in a taxpayer's accounts, if this precedes the third party dealing from which the income is derived. Or the circumstances of the taxpayer's business may make it a practical impossibility to connect the internal dealing with a particular third party dealing (also see paragraph 238).

261. In these circumstances, it will be necessary, in allocating income by reference to the pricing of the internal dealing, to have regard to what the pricing of the third party dealing might reasonably be expected to be, and to the factors that would determine that pricing. This is to be judged according to the commercial realities of the particular circumstances of the taxpayer's business. Evidence of pricing used generally by the taxpayer in arm's length dealings with third parties with respect to the particular product or item that is the subject of the internal dealing may be used for this purpose. Or, presuming the third party dealing to be at arm's length, then an

appropriate accepted methodology for calculating an arm's length consideration for that dealing may be used to approximate the amount of actual income.

Allocating expenditure to a PE

262. Our views on the methodologies to be used in allocating expenses incurred by an entity between parts of the entity will be the subject of a more detailed discussion in a later Ruling.

263. Where subsection 136AE(4) is applied to allocate to a PE expenditure incurred by an entity in performing activities for the benefit or the purposes of the PE, then the amount to be allocated is the actual total costs of performing those activities (also see paragraphs 228-230).

264. As the allocation is of actual costs and does not involve any profit element (i.e. an allocation of income in excess of costs), methodologies which incorporate a profit element into the price of a dealing, such as the CUP, cost plus and resale price methods to which regard may be had under paragraph 136AE(7)(b) in allocating income to a PE, are not relevant in allocating expenditure. An allocation of expenditure made after having regard to the pricing of an internal dealing that results from the use of such methodologies will not be authorised by subsection 136AE(4). That allocation will not adhere to the single entity approach, as it will effectively represent an allocation of an amount of expenditure which exceeds the amount actually incurred by the entity.

265. This may be illustrated by considering the situation of a MNE that, through its head office, incurs costs in performing administrative services solely on behalf of a PE. All costs incurred in performing the relevant activities are to be allocated to the PE. This includes both direct costs such as the salaries of staff used to perform the activities plus an appropriate proportion of indirect costs or overheads without which the activities would not be performed at all. If the total of those costs is $100, then the Commissioner cannot, after having regard to paragraph 136AE(7)(b), apply subsection 136AE(4) to deem the amount to be allocated to be $120 on the basis that an independent party dealing at arm's length would seek a $20 profit or commission for performing the activities.

266. Where subsection 136AE(4) is applied to allocate to a PE expenditure incurred by an entity in a dealing with a third party, then the actual amount paid or payable to the third party is the amount to be allocated. For the purposes of applying subsection 136AE(4), the charge for the internal dealing will equate with the pricing of the third party dealing. An example is the allocation of interest costs incurred

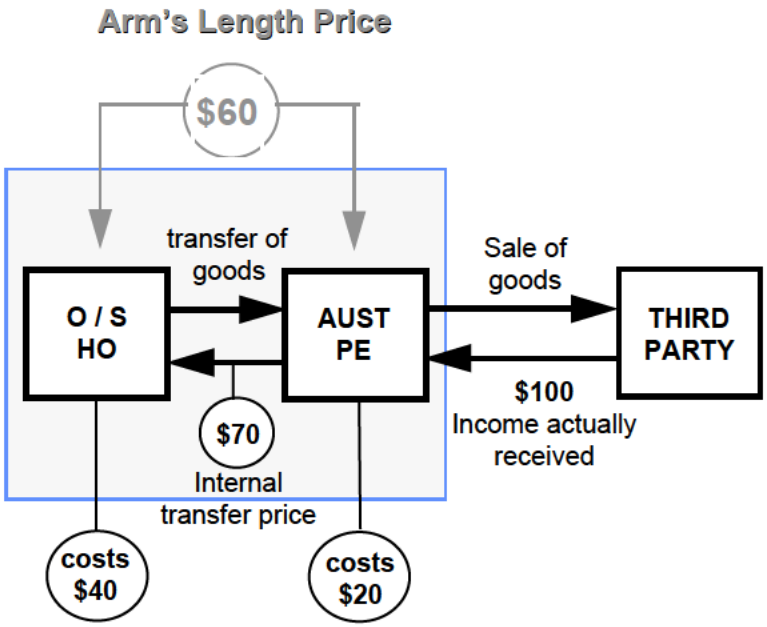
by a non-financial enterprise through its head office on funds borrowed and transferred to a PE for its use. The interest rate chargeable on the internal dealing in the accounts of the MNE will equate with the interest rate payable by the MNE to the third party lender.

267. In practice, it may not always be possible or practicable to precisely ascertain the exact amount of the actual expenditure for the purposes of the allocation process prescribed by subsection 136AE(4). The circumstances of the taxpayer's business may make it a practical impossibility to connect the internal dealing with a particular third party dealing by which the actual expenditure is incurred (also see paragraph 238). It may not be possible or practicable to identify particular property that is transferred internally as being acquired through a particular third party dealing. For example, it may not be practicable in some circumstances to trace the source of funds transferred between the head office and a PE of a non-financial enterprise to a particular borrowing by the MNE.

268. In such circumstances it will be necessary to accept an approximation of the actual expenditure for the purposes of its allocation under subsection 136AE(4), by having regard to what the pricing of the third party dealing might reasonably be expected to be. This is to be judged according to the commercial realities of the particular circumstances of the taxpayer's business. Thus, in the above example, the interest rate chargeable on the funds transferred to the PE might be based on average rates payable by the MNE on its third party borrowings, or on prevailing market rates ordinarily payable by a borrower in the MNE's circumstances.

Example of the operation of paragraph 136AE(7)(b)

269. To take a simple example, suppose that a MNE derives $100 from selling goods to customers. Goods are manufactured to a partly finished state by an overseas head office at a cost of $40, imported into Australia and, after some additional manufacturing, sold by an Australian PE to arm's length parties for $100. The transfer price recorded in the MNE's accounts (at the time of transfer) is $70. The Australian PE sells the goods to customers after additional manufacturing and selling costs of $20 are incurred. The MNE has derived an overall net profit of $40, of which $10 has been allocated in its accounts to the Australian PE and $30 to the overseas head office. This example can be illustrated in the following diagram (see next page):



Recording of "transaction" in the MNE's accounts:

Consolidated Accounts for external reporting:		**Internal Accounts for "cost accounting" purposes:**			
Of entity:		**Of Aus PE:**		**Of O/S HO:**	
Actual Inc.	$100	Actual Inc.	$100	"Notional" Inc.	$70
less:		less:		less:	
Actual Exp.	$60	"Notional" Exp.	$90	Actual Exp.	$40
Actual profit	$40	"Notional" profit	$10	"Notional" profit	$30

Application of ss136AE(4) by the ATO to the "transaction":
(In this example, the ATO would probably seek to make a Div 13 adjustment)

	Aus PE:	**O/S HO:**
Allocation of Actual Inc. ($100)	approx $40	approx $60
Allocation of Actual Exp. ($60)	$20	$40
Net profit (or loss) on "transaction"	**approx $20**	**approx $20**

270. In this situation, the income derived from sale of the goods may be considered attributable to activities carried on through both the head office and the PE, and accordingly an allocation of parts of that income must be made to each.

271. In making this allocation, regard may be had under paragraph 136AE(7)(b) to the accepted methodologies for applying the arm's length principle. A CUP, cost plus, resale price or other appropriate method may be used to test the $70 price at which the foreign head

office transferred the goods to the Australian PE against an arm's length amount. Whichever of the methods is most appropriate in the circumstances should be used to determine an arm's length price of the manufactured goods in comparable circumstances. If, for example, this price is found to be $60, then this will be taken into account under paragraph 136AE(7)(b), and may provide a basis for a $10 increase in the Australian PE's share of the MNE's income derived from the sale of the goods in Australia.

272. Alternatively, if comparables on price or profit margin cannot be identified, a profit split method would appear suited to this situation. Under this method the overall profit of $40 is split between the head office and branch based upon the relative value of their respective contributions to deriving it, as ascertained through a functional analysis of the MNE. This might ascertain the arm's length return to the Australian PE for its manufacturing, marketing and distribution functions, compared with the manufacturing functions of the foreign head office. If, as a result, the arm's length return for the branch's functions is ascertained to be a net profit of $20, this will necessitate an increase in the Australian PE's share of the MNE's actual profit to $20. In other words, the $70 transfer price shown in the MNE's accounts will be adjusted downwards by $10 to effect an allocation of $60 income to the foreign head office and $40 to the Australian PE.

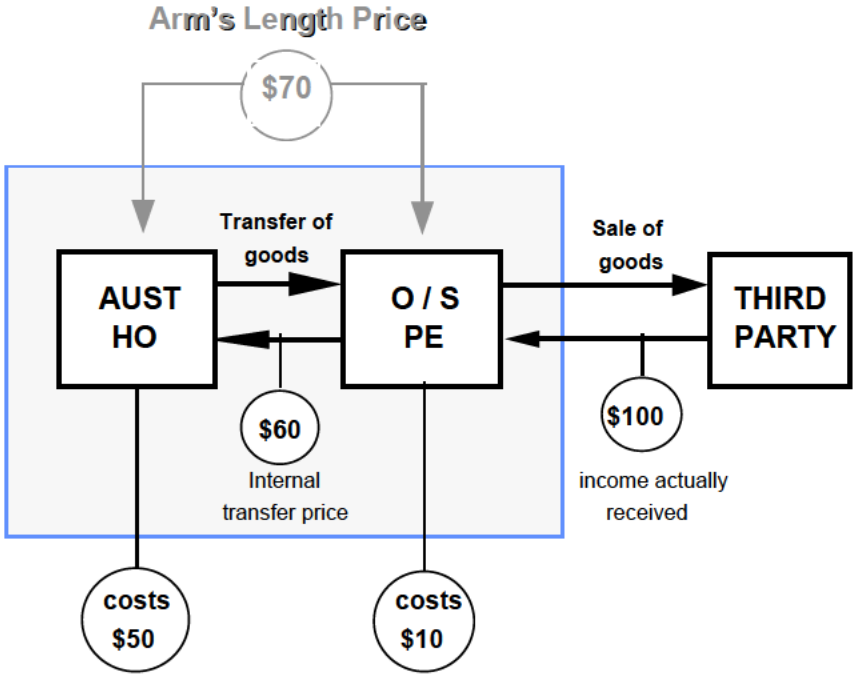
273. In this situation, a determination under subsection 136AE(4) cannot be made to include the notional arm's length amount of $60 as an expense in determining the profits of the Australian PE. Rather, a determination can properly be made as to the source of the $100 which the MNE, through the Australian PE, in fact derived. In making this determination consideration can be given as to what proportion of that $100 income would have been derived by the branch if it were a separate entity dealing at arm's length. Regard may be had to the $60 arm's length price or value of the goods transferred in determining that $40 is income derived by the MNE from sources in Australia and that $60 is income derived from sources out of Australia.

274. In this example, the foreign head office has incurred expenses of $40 in performing activities that are in part a source of the $100 income derived through the Australian PE. In the accounts of the MNE it may be appropriate for an amount of $60 to be credited to the foreign head office and debited to the Australian PE, as being an arm's length consideration for the activities performed by the head office. Such entries in the accounts are not representing that the MNE, through the head office, incurred $60 in manufacturing costs when only $40 was actually incurred. They are not creating a notional $20 expense from a dealing between the head office and branch. Rather, they are effecting an allocation to the foreign head office of $60 of the income which the MNE derived through the Australian PE from third

parties. In other words, the additional $20 is an allocation to the foreign head office of income derived through the branch, not an allocation to the Australian PE of expenses incurred by the foreign head office.

275. The allocation of $60 of income to the head office means that the $40 of manufacturing costs remain with the foreign head office. The $60 figure is allocated as an arm's length amount of income attributable to performing activities costing $40. The amount of an arm's length consideration is calculated on the basis of the recipient bearing its own costs of earning that consideration. Therefore, allocating income by reference to an arm's length consideration necessarily takes care of the allocation of costs. As the costs of deriving the consideration are factored into calculation of the amount, it is unnecessary and inappropriate to perform a separate exercise to allocate those costs. If it were otherwise, then a tracing exercise would be required to ascertain the quantum and the deductibility of the manufacturing costs incurred by the foreign head office which are appropriately allocable to the Australian PE. The notional arm's length figure of $60 can only be used as a factor in determining the proportion of the $100 actual income that is to be allocated to the Australian PE. It cannot be used independently of the amount of actual income derived.

276. To take another example, suppose that goods are manufactured by the Australian head office of a MNE at a cost of $50 and exported to an overseas branch. The transfer price recorded in the MNE's accounts is $60. The branch sells the goods to customers for $100 after incurring selling costs of $10. The MNE has derived an overall net profit of $40, of which $10 has been allocated in its accounts to the head office and $30 to the branch. This example can be illustrated in the following diagram (see next page):



Recording of "transaction" in the MNE's accounts:

Consolidated Accounts for external reporting:		**Internal Accounts for "cost accounting" purposes:**			
Of entity:		**Of Aus HO:**		**Of O/S PE:**	
Actual Inc.	$100	"Notional" Inc.	$60	"Notional Inc.	$40
less:		less:		less:	
Actual Exp.	$60	Actual Exp.	$50	Actual Exp.	$10
Actual profit	$40	"Notional" profit	$10	"Notional" profit	$30

Application of ss136AE(4) by the ATO to the "transaction":
(In this example, the ATO would probably seek to make a Div 13 adjustment)

	Aus HO:	**O/S PE:**
Allocation of Actual Inc. ($100)	approx $70	approx $30
Allocation of Actual Exp. ($60)	$50	$10
Net profit (or loss) on "transaction"	**approx $20**	**approx $20**

277. Again, the income derived from sale of the goods may be considered attributable to activities carried on through both the head office and the PE, and accordingly an allocation of parts of that income must be made to each. In making this allocation, the Commissioner will use appropriate arm's length methods to test the $60 price at which the head office transferred the goods to the branch. If, for example, the arm's length price is found to be $70, then this will be taken into account under paragraph 136AE(7)(b), and may provide

a basis for a $10 increase in the head office's share of the MNE's income derived from the sale of the goods.

278. Again, if comparables on price or profit margin cannot be identified, a profit split method may be suited to this situation based upon the relative value of the contributions made by the Australian head office and the foreign PE to deriving the entity's income. If, as a result, the arm's length return for the branch's functions is ascertained to be a net profit of $20, this will necessitate an increase in the head office's share of the MNE's actual profit to $20. In other words, the $60 transfer price shown in the MNE's accounts will be adjusted upwards by $10 to effect an allocation of $70 income to the head office and $30 to the branch.

279. As with the previous example, a determination under subsection 136AE(4) cannot be made to include the notional arm's length amount (of $70) either as income in determining the profits of the head office, or as an expense in determining the profits of the branch. It cannot be determined that the head office derives $70 income from the branch, and that such income has an Australian source. That would not be making a determination as to the source of income actually derived. Rather, a determination can properly be made as to the source of the $100 which the MNE, through the branch, in fact derived. In making this determination consideration would be given to what proportion of that $100 income would have been derived by the branch if it were a separate entity dealing at arm's length with its head office. Regard would be had to the $70 arm's length price or value of the goods transferred which may result in the Commissioner determining that $70 is income derived by the MNE from sources in Australia and that $30 is income derived from sources out of Australia. As with the previous example, each recipient would bear its own costs, as reference to the arm's length consideration factors into the calculation the allocation of costs.

280. The above example assumes that the tracing exercise required to determine the actual income derived by the MNE is both practicable in the circumstances and accurate. If the actual income derived by the MNE were found to be less than $70, then that figure cannot be used as a basis for allocating $70 of income to the head office, as this would involve allocating notional, not actual, income. If, for example, it were established that the MNE actually derives not $100, but only $60, when the goods are sold to arm's length customers, then this would determine the amount of income which is subject to allocation by reference to, among other things, an arm's length price for the internal dealing. As the only purpose of having regard to that arm's length price is in allocating the actual income of $60 between the head office and PE, then if the arm's length price for the internal dealing exceeds $60, this factor cannot authorise an allocation of more income

than $60. This exemplifies how matters other than the arm's length pricing of an internal dealing must be taken into account in arriving at a proper allocation. The circumstances that result in the $60 sale price to arm's length customers must also be considered in making the allocation. If, for instance, the MNE is pursuing a market penetration strategy and the customer price is for this reason set below normal levels, then this must be taken into account in allocating the entity's income under subsection 136AE(4).

281. The example in paragraph 276 assumes that the functional analysis of the MNE establishes that the branch acts on its own behalf in performing the relevant selling activities. If the analysis were to establish that the branch, viewed as a separate entity, in substance acts merely as a selling agent for the head office, and there is evidence that an arm's length agent's fee in such circumstances is a reimbursement of costs plus a margin of 5% of gross income, then regard would be had to an arm's length amount of only $15 in allocating part of the $100 income to the branch.

282. It may be an acceptable outcome of the application of arm's length pricing to an internal dealing for one part of an entity to be allocated an amount of income which produces a profit to that part from the dealing, whilst another part is left with a loss. In the example in paragraph 276, an arm's length price for the internal dealing may be determined, in all of the circumstances, to be $55. Using this to allocate $60 actual income will produce a profit of $5 to the head office, whilst the PE is allocated $5 income against expenses of $10. Such an outcome may, depending on the circumstances, appropriately reflect commercial reality and an arm's length allocation of income and expenses. The fact that the MNE has not made a profit may be solely attributable to the activities of the PE. The activities of the head office may be profitable, whilst those of the PE, for various commercial reasons, may not be.

Paragraph 136AE(7)(c)

283. Paragraph 136AE(7)(c) directs that regard be had to 'such other matters as the Commissioner considers relevant'. This must be read in the context of subsections 136AE(1) - (7). It refers not to matters at large, but to matters relevant to the making of a determination under subsections 136AE(1) - (6); i.e. a determination as to the source of income or the extent to which expenditure is incurred in deriving income from a particular source.

284. These will in general be matters relevant to the operation of the principles for determining source or attribution, such as the common law principles or any rules in any applicable Double Taxation

Agreement (see matters (e) and (h) as listed at paragraph 204). Considerations of some other type altogether will not in general be relevant, although relevant matters could include factual matters such as the manner in which the taxpayer carries on business and its relationships with other entities.

285. When applying subsection 136AE(4), other relevant matters under paragraph 136AE(7)(c) will include any matter which needs to be taken into account to ensure that the allocation is in accordance with the single entity approach, being an allocation of actual income and expenses as authorised by subsection 136AE(4). Such matters might include the relationship between an internal dealing involving a PE and a related dealing between the taxpayer entity and a third party (also see paragraphs 261, 268 and 298).

Timing issues associated with the derivation of income and the incurring of expenditure to be allocated under subsection 136AE(4)

286. Subsection 136AE(4) authorises the deemed allocation of income that has been derived, and expenditure that has been incurred; it does not deem the income to have been derived or the expenditure to have been incurred. The principles that determine the timing of derivation of income are those developed by the courts, primarily in interpreting subsection 25(1), whilst those relating to incurrence of expenditure have been developed primarily in respect of subsection 51(1). Nothing in subsections 136AE(4) or 136AE(7) alters these principles.

287. As mentioned earlier, the single entity approach means that a dealing between the head office and PE of an entity cannot give rise to a derivation of assessable income or the incurring of deductible expenditure. Only an actual dealing between the entity and a third party can do this. No assessable income is derived until such time as income is actually realised by the entity by way of an amount received or receivable from a separate legal entity. This may be illustrated by reference to the example at paragraph 276. If $70 income is to be allocated to the head office (after having regard to an arm's length pricing of its dealing with the PE and the other matters in paragraphs (a) (b) and (c) of subsection 136AE(7)), then the $70 is only derived as assessable income when the $100 of which it is a part is actually derived (i.e. at the time of the eventual sale by the PE to the third party). Until then, the $70 exists as a purely notional unrealised amount; it only becomes assessable income when the actual income of which it is a part is derived upon the sale of the goods to the third party customer.

288. Similarly, expenditure is incurred when an entity, through either its head office or a PE, transacts with a third party, not when such parts of the entity transact with each other (see *Max Factor* case (supra)). A deductible expense is incurred only when paid or payable by the entity to a separate legal entity. The timing of deductibility for subsection 51(1) purposes is determined by when the actual expense to be allocated to the PE is incurred by the entity, not by when any charge or payment in connection with that expense is made between the PE and another part of the entity (also see paragraph 156).

289. Thus, whilst subsection 136AE(7) contemplates that regard be had to an internal dealing for the purpose of allocating income or expenditure arising from a third party dealing, subsection 136AE(4) only authorises the allocation of income derived and expenditure incurred, and the timing of derivation and incurrence is determined by the third party dealing, not the internal dealing.

290. Where the internal dealing takes place in the same income year that the income is derived from, or the expenditure is incurred in relation to, the third party dealing, then any period between the two dealings has no practical implications for the timing of derivation of income or incurrence of expenditure to be allocated under subsection 136AE(4).

291. If trading stock is transferred internally and it can be established that the stock was purchased from third parties in a previous income year, then any purchase costs that are to be allocated are incurred in the earlier year.

292. If trading stock is transferred internally within an entity and it can be established that the stock was sold to third parties in a later income year, then any sale proceeds that are to be allocated are derived in the later year. The ITAA does not authorise the taxing of notional income referrable to an internal transfer of trading stock simply because as a result of the transfer the stock is leaving Australia's taxing jurisdiction. Australia can only subject to tax an appropriate part of the actual income as and when it is derived on the sale of the stock to third parties. Whilst regard may be had to the pricing of the internal dealing in order to determine the amount of that income to be allocated to parts of the entity, the amounts so allocated are not assessable as income until the year of derivation.

293. In these circumstances the entity's accounts might, for tax purposes, appropriately include a provision which records accrued unrealised income as at the end of the income year in which the internal transfer occurs, as measured by reference to an arm's length pricing of the transfer. This provision is then debited as and when income is actually derived from a related third party dealing.

294. Where trading stock is sold by an entity to a third party, this effects both a derivation of income in the form of the sale proceeds, and a reduction in the value of trading stock on hand. If the stock was transferred internally (e.g. between a head office and PE) prior to its sale, this does not effect either a derivation of income or a reduction in the entity's trading stock on hand. In the accounts of the entity the stock transferred will be shown as on hand with the PE rather than with the head office. Whilst the stock remains on hand with the entity as a whole, no sale of the stock is recognised, and no income from its sale is derived. Accordingly, as long as the stock remains on hand in the accounts of the PE, any notional income attributed to the head office at the time of the transfer cannot be treated as derived. If the stock remains on hand with the PE (and hence with the entity) at the end of the income year in which the internal transfer takes place, the income to be allocated between head office and PE by reference to the arm's length pricing of the transfer is not derived in that income year.

295. In certain circumstances it may be a practical impossibility to conduct the requisite tracing exercise needed to connect the internal dealing with a third party dealing and the actual income or expenditure it creates. If it is not possible or practicable to trace an internal dealing to a related third party dealing, then the relationship between the timing of the two dealings cannot be established as a matter of fact.

296. For instance, if a head office exports component parts for inclusion in a product manufactured and sold by an overseas PE, it may be a practical impossibility to ascertain when particular components, as part of identifiable finished products, are eventually sold. The finished products may be sold in the same income year that the components were transferred between head office and PE, but commonly they will not be. Large quantities of components may be exported in batches and stockpiled overseas for some time before their use in the manufacturing process, which in turn may occur some time before the eventual sale of the product.

297. Similar practical difficulties exist for financial enterprises in determining the timing of derivation of income arising from third party dealings that is to be allocated between parts of the enterprise by reference to arm's length interest charges on funds transferred internally (also see paragraph 242).

298. In these circumstances, it is necessary that the commercial realities of the particular circumstances of a taxpayer's business be relied upon to determine what the timing relationship between related internal and third party dealings might reasonably be expected to be. In terms of practical significance, what must be determined is whether the internal and third party dealings might reasonably be expected to occur in the same, or a different, income year.

299. It may accord with a commercially realistic appraisal of the particular circumstances of a taxpayer's business activities that there is ordinarily no significant period between an internal dealing and a related third party dealing. For example, where trading stock is manufactured and transferred internally for sale to customers, the frequency of turnover of the items transferred may justify a conclusion that as a matter of commercial reality the timing of the internal dealing and the third party dealing are ordinarily sufficiently coincidental to treat derivation of the income arising from the third party dealing as taking place in the same income year as the internal dealing. It then accords with commercial reality to accept that the accounting entries recording the internal dealing will appropriately reflect the timing of the derivation of income. The income to be allocated will be brought to account for tax purposes at the same time as recognising the notional arm's length pricing of the internal dealing, on the basis that the internal and third party dealings are judged according to commercial realities to have occurred in the same income year.

300. A commercially realistic appraisal of a taxpayer's business activities may lead to the conclusion that the internal and third party dealings may reasonably be expected not to have occurred in the same income year. An example might be the situation referred to in paragraph 296. In such circumstances any income to be allocated by reference to the pricing of the internal dealing is to be treated as unrealised as at the end of the income year in which the internal dealing occurs. The income will be subject to allocation only in the income year in which it may reasonably be expected, as a matter of commercial reality, to have been derived.

Documentation

301. The following discussion outlines our views on the types and extent of documentation taxpayers who carry on business through a PE need to keep for tax purposes in respect of the processes they use to allocate income and expenses to the PE. A detailed discussion of the documentation needed for addressing matters relevant to Division 13 in general will be the subject of a later Ruling.

302. Where a question arises as to the source of income, or the allocation of expenditure to deriving income from a particular source, in applying a provision of the ITAA which is relevant to determining a taxpayer's liability to income tax, the taxpayer needs to keep records for the purposes of addressing that question in preparing and lodging a tax return. Section 262A of the ITAA imposes obligations on taxpayers carrying on business to keep records that explain transactions and other acts relevant for any purpose of the Act. In particular, the section requires taxpayers to keep any documents that

are relevant for the purpose of ascertaining their income and expenditure, and documents which evidence and explain the basis for, and method used in, making any estimate, determination or calculation under the Act. Accordingly, taxpayers who carry on business through a PE are required to keep records which evidence the basis upon which, for tax purposes, income and expenses are allocated to the PE.

303. Under Australia's self-assessment regime, taxpayers have a responsibility to lodge a correct tax return. In terms of Division 13, this means that, in fulfilling this responsibility and calculating their liability to income tax, taxpayers who carry on business through a PE should make an allocation of income and expenses to the PE which gives an outcome consistent with that resulting from a consideration of the matters in subsection 136AE(7). We consider that in order to do this effectively, taxpayers need to maintain sufficient documentation to evaluate whether the processes they use to make an allocation give such an outcome, so that their tax returns may be prepared on this basis.

304. Notwithstanding that, under Australian law, a PE and head office are a single legal entity, for accounting and commercial purposes a PE is commonly treated as a separate entity which can transact with its head office, and separate accounts are usually constructed and maintained to record the profitability of the PE. Where separate accounts are maintained, it is expected that these will reflect the underlying reality behind the transactions. Accordingly, the amounts recorded in the accounts will be the starting point when we evaluate whether a taxpayer's allocation of income and expenditure to a PE is appropriate for the purposes of subsection 136AE(4).

305. In reviewing the appropriateness, in terms of subsection 136AE(4), of a taxpayer's allocation of income or expenditure, we will seek to rely as much as possible on documentation that should be created by the taxpayer in the ordinary course of conducting its business. However, we will expect taxpayers to keep documentation to show that they have addressed whether the processes used for allocating income and expenses to a PE produce an outcome that is, for tax purposes, consistent with having due regard to the matters specified in paragraphs 136AE(7)(a) (b) and (c), and that their tax returns have been prepared on this basis.

306. This documentation should include an economic functional analysis of the taxpayer entity's significant business functions, the assets utilised in pursuit of that business, and the risks associated with the business activities. This information is relevant to evaluating the contribution of the PE to carrying on the business, in assessing the extent to which the activities of the PE generate the income and expenses of the business, and in having regard to the arm's length

principle in allocating income and expenses to the PE. Accordingly, documentation in respect of the functional analysis will have relevance in addressing matters under each of paragraphs (a) (b) and (c) of subsection 136AE(7).

307. Paragraph 136AE(7)(b) means that taxpayers need to specifically address the arm's length principle in determining a proper allocation of income and expenses to a PE when preparing and lodging tax returns. The need to have regard to the arm's length principle in allocating income and expenses to a PE does not require a head office and a PE to actually conduct their dealings so as to deal with each other as though they were independent entities dealing at arm's length. What it does require is that a taxpayer's tax returns reflect an allocation of income and expenditure to the PE made after having regard to what amounts the PE would have derived or incurred if the head office and PE were independent entities dealing at arm's length.

308. Where taxpayers have not used arm's length amounts in the ordinary course of conducting dealings between a PE and other parts of the taxpayer entity, or in recording those dealings for accounting or commercial purposes, adjustments needed in order to have regard to arm's length amounts should be made for tax purposes at the time of preparation of their tax returns.

309. Our views on the documentation requirements for demonstrating compliance with the arm's length principle in dealings between separate entities are broadly addressed in Taxation Ruling TR 94/14 (paragraphs 101-110; 368-377). To the extent that the analysis and processes involved in the selection and application of internationally accepted methodologies used to apply the arm's length principle as discussed in that Ruling also apply, having regard to paragraph 136AE(7)(b), to dealings within a single entity, the documentation requirements discussed in that Ruling are equally relevant for such dealings.

310. In addressing the arm's length principle in the context of an internal dealing, we expect that taxpayers will document the process of selecting an appropriate methodology and the way in which that methodology was used to arrive at an arm's length price for that dealing. Taxpayers can reduce the likelihood of disputation with the Commissioner over the pricing, for tax purposes, of their internal international dealings, if they create documentation, based on the use of contemporaneous information, to support:

(a) the process for selecting the methodology used to set such pricing, including the necessary functional analysis, and the reasons for choosing a particular methodology; and

(b) the application of the chosen methodology to specific or generalised dealings as they occur, and a reasonable sample checking of results to determine whether the methodology has achieved an arm's length result.

311. The process involved in having regard to the arm's length principle in allocating income and expenditure to a PE may create documentation requirements, as outlined below, that are additional to those previously discussed. These requirements are essentially an outcome of the need for a consideration of the matters in subsection 136AE(7) to produce an allocation which adheres to the single entity approach.

312. Having regard to the pricing of an internal dealing under paragraph 136AE(7)(b) for the purposes of making an allocation under subsection 136AE(4), involves a consideration of matters relevant to the entity's third party dealings; either a particular third party dealing where it can be identified as related to the internal dealing, or, where not, those third party dealings to which the internal dealing might reasonably be expected to relate (also see paragraphs 261 and 268).

313. Where it is possible and practicable to trace an internal dealing to a particular related dealing with a third party, then in order to test and demonstrate the appropriateness, for subsection 136AE(4) purposes, of an allocation made by reference to the pricing of the internal dealing, we will request documentation which evidences:

(a) the process used to perform such tracing; and

(b) that the pricing of the internal dealing reflects an appropriate relativity, in terms of adherence to the single entity approach, with the pricing of the third party dealing.

314. Where a taxpayer is of the opinion that it is not possible or practicable to relate an internal dealing to a particular third party dealing, documentation will be needed which evidences:

(a) the taxpayer's evaluation of the particular business or commercial circumstances that support its opinion;

(b) the taxpayer's evaluation of which third party dealings might reasonably be expected to relate to particular internal dealings; and

(c) that the pricing of the internal dealing reflects an appropriate relativity, in terms of adherence to the single entity approach, with the pricing of those third party dealings referred to in paragraph (b).

315. Allocating income and expenditure under subsection 136AE(4) by reference to internal dealings requires a consideration of the

relationship, from a timing viewpoint, between those dealings and the entity's third party dealings (also see paragraphs 287-300).

316. Where a taxpayer is of the opinion that it is not possible or practicable to relate an internal dealing to a particular third party dealing, so as to establish the relationship between the timing of the two dealings as a matter of fact, this will create particular documentation requirements. Referring to those categories of documentation listed at paragraph 314 above, documentation in the first category will again be needed, and documentation in the second category may be used to support the taxpayer's assessment of what the timing relationship between relevant internal and third party dealings might reasonably be expected to be.

Access to relevant information

317. Where documentation and information that we request in accordance with paragraphs 301-316 is held in Australia, it will be sought under sections 263 or 264 of the ITAA.

318. Where the documentation or information is held offshore, and access to it cannot be obtained in a reasonable time frame through other means, a formal request may be needed under sections 264 or 264A (offshore information notices). A request for information may also be made to a foreign tax administration under the exchange of information provisions of a relevant Double Taxation Agreement. A request under section 264 or 264A may be served on a PE in Australia of a non-resident taxpayer with respect to relevant information held at the taxpayer's offshore head office, as the PE and head office are parts of the same legal entity.

319. Additional guidelines on the use of the access provisions in the context of Division 13 will be provided in a later Ruling.

320. **Table of Contents**

Your comments

321. If you wish to comment on this Draft Ruling, please send your comments by: 22 June 1995
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Commissioner of Taxation

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