PCG 2018/5 - Diverted profits tax

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This practice statement is being updated and moderated for consistency with the APA Review recommendations. During the interim period where current ATO public guidance materials are being updated, any inconsistencies will be disregarded and the APA Review recommendations will be applied (available at Findings report APA program review). Further guidance can be obtained by emailing internationalsgatekeeper@ato.gov.au, if required.

There is a Compendium for this document: **PCG 2018/5EC** .

Australian Government
Australian Taxation Office

Practical Compliance Guideline
PCG 2018/5

Diverted profits tax

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Relying on this Guideline

This Practical Compliance Guideline sets out a practical administration approach to assist taxpayers in complying with relevant tax laws. Provided you follow this Guideline in good faith, the Commissioner will administer the law in accordance with this approach.

Table of Contents **Paragraph**

What this Guideline is about

1. This Guideline sets out our risk assessment and client engagement frameworks for the diverted profits tax (DPT). It also outlines our compliance approach when the DPT is identified as an area of concern.

2. You can use this Guideline to:

- understand our approach to assessing risk
- determine the engagement you can expect from us based on the risk of your arrangement, where that risk is identified in the course of our ordinary compliance activity, and
- determine the level of engagement we would generally expect from you based on your assessment of the risk of your arrangement, and the types of products that may be appropriate to provide you with greater certainty.

Structure of this Guideline

3. This Guideline is structured as follows:

- background to the DPT
- our compliance approach
- our risk assessment framework
- our client engagement framework, and
- relevant documentation.

Background to the DPT

4. The DPT is designed to ensure that significant global entities (SGEs) pay tax in Australia that properly reflects the economic substance of their activities in Australia and that they do not reduce the amount of tax they pay by diverting profits offshore through contrived arrangements with related parties. The measure is also intended to encourage taxpayers to provide information to the Commissioner to allow for the more timely resolution of tax disputes.

5. The DPT applies to DPT tax benefits obtained in income years commencing on or after 1 July 2017, even if the scheme was entered into or commenced before that time. Where the DPT applies, the Commissioner may make a DPT assessment imposing tax at a rate of 40% on the diverted profit.

6. For the DPT to apply, the following criteria must be satisfied:

- the relevant taxpayer has obtained, or would but for section 177F of the *Income Tax Assessment Act 1936* (ITAA 1936)[1] obtain, a tax benefit (the DPT tax benefit) in connection with a scheme in a year of income (paragraph 177J(1)(a))
- it would be concluded, having regard to the matters in subsection 177J(2), that a person who entered into or carried out the scheme or any part of the

[1] All legislative references are to the *Income Tax Assessment Act 1936* unless otherwise indicated.

scheme did so for a principal purpose of, or for more than one principal purpose that includes a purpose of:

- enabling the relevant taxpayer to obtain a tax benefit, or both to obtain a tax benefit and to reduce one or more of the relevant taxpayer's foreign tax liabilities, in connection with the scheme, or
- enabling the relevant taxpayer and another taxpayer (or other taxpayers) each to obtain a tax benefit, or both to obtain a tax benefit and to reduce one or more of their foreign tax liabilities, in connection with the scheme (paragraph 177J(1)(b))

- the relevant taxpayer is an SGE for the relevant year of income (paragraph 177J(1)(c))
- a foreign entity is an associate of the relevant taxpayer at any time in the relevant year of income (paragraph 177J(1)(d))
- the foreign entity entered into or carried out the scheme or any part of the scheme, or is otherwise connected with the scheme or any part of the scheme (paragraph 177J(1)(e))
- the relevant taxpayer is not an entity listed in paragraph 177J(1)(f) (paragraph 177J(1)(f)), and
- it is reasonable to conclude that none of sections 177K ($25 million income test), 177L (sufficient foreign tax test) and 177M (sufficient economic substance test) apply in relation to the relevant taxpayer, in relation to the DPT tax benefit (paragraph 177J(1)(g)).

7. An outline of our views on the law is set out in Law Companion Ruling LCR 2018/6 *Diverted profits tax*. This Guideline should be read in conjunction with LCR 2018/6.

8. Due to the seriousness of making a DPT assessment, Law Administration Practice Statement PS LA 2017/2 *Diverted profits tax assessments* provides direction to our staff on the steps that must be followed in order to make a DPT assessment, and after a DPT assessment is made. The process outlined in PS LA 2017/2 is rigorous and includes several layers of endorsement and oversight.

Date of effect

9. This Guideline has effect from 1 July 2017 and applies to existing and new arrangements.

Our compliance approach

General compliance activity

10. We expect that a DPT risk will usually be identified in the course of our ordinary compliance activity.

11. Once a DPT risk is identified, our compliance approach may include ongoing monitoring of the risk or active consideration. Our decision-making process in relation to compliance activity is guided by the circumstances of the particular case. We will generally prioritise our resources to address arrangements that we consider pose the highest risk.

12. We will generally tell you if we intend to commence an examination of a DPT risk. As part of our examination, we will consider information available to us and may request further information from you as outlined in the documentation section of this Guideline.

13. We will seek to communicate our findings to you once we have concluded our examination and will outline our proposed compliance approach going forward. This may include further compliance activity or no further action. If we consider your arrangement to

be low risk, we may continue to monitor your arrangement having regard to any additional information that becomes available.

14. In some cases we may identify other treatment strategies where there is an identified DPT risk. This may include a recommendation to seek greater certainty through an advance pricing arrangement (APA) or a private ruling.

15. It is important to note that in the course of our compliance activity we may consider the application of the DPT concurrently with other provisions of the income tax law, including the transfer pricing rules in Division 815 of the *Income Tax Assessment Act 1997* (ITAA 1997). In order for the DPT to apply, the criteria set out in paragraph 6 of this Guideline must be satisfied. These criteria include the principal purpose test in paragraph 177J(1)(b) which is the central provision around which the DPT operates.[2] Consequently, while the DPT provisions are not provisions of last resort, consistent with the operation of Part IVA generally, it is expected that the DPT will be applied in limited circumstances.

APAs

16. The extent to which an APA provides assurance in relation to the potential application of the DPT will depend upon the date that the APA application or renewal is or was entered into, and whether the APA contains a DPT clause. The DPT clause is explained at paragraphs 53 to 55 of this Guideline.

APA applications and renewals entered into prior to 4 April 2017[3]

17. In these circumstances, assurance relating to the DPT will generally not be provided to a taxpayer.

APA applications and renewals entered into on or after 4 April 2017

18. In these circumstances, the covered transactions will generally be considered low risk for the purposes of the DPT for the period of the APA. The relevance of a low risk rating is explained at paragraph 19 of this Guideline.

Monitoring compliance stage

19. In reviewing a lodged Annual Compliance Report, where the covered transactions are considered to be low risk for the purposes of the DPT, we will generally not apply compliance resources to review the potential application of the DPT. This however, does not afford the same protection as an APA that includes a DPT clause.

20. If the APA includes a DPT clause, we will only consider the application of the DPT in relation to the covered transactions where the taxpayer has not complied with the terms of the APA or where there has been a breach of an APA critical assumption.

21. Where there has been a breach of an APA critical assumption, we will consider our treatment of the breach in accordance with Law Administration Practice Statement PS LA 2015/4 *Advance Pricing Arrangements*. For instance, if there is a material change in the facts about the taxpayer or its affiliates that constitutes a breach, we may consider

[2] In considering the application of the principal purpose test, we will have regard to Law Companion Ruling LCR 2015/2 *Section 177DA of the Income Tax Assessment Act 1936: schemes that limit a taxable presence in Australia* at paragraphs 11 to 16.

[3] The *Treasury Laws Amendment (Combating Multinational Tax Avoidance) Act 2017* and the *Diverted Profits Tax Act 2017* received Royal Assent on 4 April 2017.

whether the change in circumstances results in a potential risk of the DPT applying to the covered transactions.

Settlements

22. If there is a risk that the DPT may apply to an arrangement covered by a proposed settlement, we will generally seek to resolve the matter before proceeding with the settlement.

23. Taxpayers may request the insertion of a DPT clause in their settlement deeds. We will consider the insertion of such a clause on a case by case basis. Taxpayers engaged in settlement negotiations with us who would like such a clause are encouraged to make a request during the early stages of the settlement negotiations.

Our risk assessment framework

24. This section is designed to assist you in assessing the risk of your arrangement. This section contains:

- Our framing questions for assessing risk. Our framing questions are intended to serve as a general guide and should not be treated as an exhaustive list of the kinds of matters we may take into account. We may consider additional matters depending on the circumstances of a particular case.
- An outline of matters that we consider relevant to the application of the sufficient economic substance test (SES test), in addition to the applicable framing questions. This includes guidance at Appendix 2 of this Guideline on what we consider to be high and low risk scenarios in relation to the SES test.
- An outline of other guidance products that we consider relevant to the level of engagement we expect from you.

25. You should consider this section in conjunction with the DPT risk assessment process at Appendix 1 of this Guideline.

Our framing questions for assessing risk

26. You can assess the risk of your arrangement having regard to the framing questions outlined in paragraphs 27 to 31 of this Guideline. The framing questions are indicative of the matters we are likely to consider when assessing the risk that the DPT applies to an arrangement. The framing questions are separated into a number of categories although there may in a particular case be significant overlap in relation to these categories.

Preliminary framing questions

27. In conducting a preliminary assessment of risk we will generally consider the following questions:

(a) Is the taxpayer an SGE?

(b) Is the $25 million income threshold satisfied?

(c) Does the taxpayer have any international related party dealings?

28. If any of these questions are answered in the negative then we are unlikely to consider the potential application of the DPT further (other than to test or confirm the conclusion reached and monitor any future arrangements).

Transaction-specific framing questions

29. In assessing the risk of a particular arrangement we may consider a number of transaction-specific framing questions if the taxpayer is otherwise within the scope of the DPT. These questions are likely to focus on whether the arrangement involves:

(a) the transfer or effective transfer of valuable intangible assets offshore

(b) the transfer or effective transfer and/or centralisation of functions and/or risks offshore

(c) a significant transfer of value relative to overall profitability

(d) the mischaracterisation of payments (for example, service fees rather than royalties)

(e) the use of hybrid entities and/or instruments

(f) back-to-back or flow-through arrangements

(g) the booking of profit offshore in a manner disproportionate to staff headcount and/or capability

(h) the profit made by an entity relative to their contribution within the context of the overall value chain appearing uncommercial, or

(i) any other features that are unusual having regard to the nature of the relevant business operations, including but not limited to

(i) the arrangement seems more complex than is necessary to achieve the relevant commercial objective, or includes a step or series of steps that appear to serve no real purpose other than to gain a tax advantage, for example:

- transactions which interpose an entity to access a tax benefit
- intra-group or related party dealings that merely produce a tax result
- arrangements involving a circularity of funds

(ii) the tax result of the arrangement appears at odds with its commercial or economic result, for example, a tax loss is claimed for what was a profitable commercial venture or transaction

(iii) the arrangement results in little or no risk in circumstances where significant risk would normally be expected, for example, arrangements where the taxpayer's risk is significantly limited because of the existence, for instance, of a 'put' option

(iv) the parties to the arrangement are operating on non-commercial terms or in a non-arm's length manner, for example, transactions which do not occur at market rates/value

(v) there is a gap between the substance of what is being achieved under the arrangement (or any part of it) and the legal form it takes, for example, arrangements where a series of transactions taken together produce no economic gain or loss, such as where the whole scheme is self-cancelling.

Framing questions relevant to the principal purpose test

30. The following questions may be relevant to the application of the principal purpose test. The questions outlined in paragraph 31 of this Guideline may also be relevant when considering this test:

(a) Is there a more straightforward way that the commercial objectives of the arrangement could be achieved?

(b) Are there other ways (for example, more convenient, commercial or cost-effective ways) to achieve the same commercial end?

(c) Were any alternatives to the arrangement considered and, if so, why were they rejected?

(d) Are the entities' roles explicable by commercial reasons or is the role of any entity in the arrangement explicable solely or principally by tax reasons?

(e) What are the commercial benefits and drivers for setting up in each jurisdiction involved?

(f) Is the arrangement more complex or contain more steps than is necessary to achieve the commercial objectives?

(g) What are the quantifiable non-tax financial benefits of the arrangement?

Framing questions relevant to the SES test

31. In assessing whether an arrangement satisfies the SES test, we are likely to consider the following kinds of questions. Affirmative answers to the following questions indicate a greater likelihood of satisfying the SES test:

(a) Is there a genuine commercial rationale for the arrangement under consideration and does the arrangement achieve that end?

(b) Have the changes that could be expected to result from the arrangement in the relevant business operations occurred?

(c) Is the legal form and documentation consistent with the economic substance of the arrangement?

(d) Is there evidence of market conduct that resembles the arrangement?

(e) Would the arrangement be expected to be seen between parties dealing at arm's length?

(f) Where the transaction involves the centralisation of business assets, functions and/or risks, is centralisation common in the relevant industry?

(g) Where the arrangement involves the transfer of valuable intangible assets offshore, is there a corresponding change in the functional profile of the relevant entities and does the recipient entity possess the competencies necessary to manage the assets?

(h) Where the arrangement involves the transfer of functions offshore, is there a corresponding change in the functional profile of the relevant entities and does the recipient entity possess the competencies necessary to perform the functions?

(i) Where the arrangement involves the transfer of economically significant risks offshore, is there a corresponding change in the functional profile of the entities and does the recipient entity possess the competencies necessary to manage the contractually assumed risks?

(j) In relation to the economically significant risks identified in (i), do the relevant entities exercise actual control over these risks and perform control functions and risk mitigation functions?

(k) Do the relevant entities have the financial capacity to assume the risks and are they exposed to the upside or downside of risk outcomes?

(l) Do the contractually assumed risks align with the actual significant risks controlled and managed by each entity in the arrangement?

(m) Have the entities contractually assumed risks under the arrangement before the outcome of such risks are known or reasonably knowable (that is, have the entities contractually assumed the risks before events or circumstances have resulted in the amelioration of some or all of those risks)?

Matters relevant to the application of the SES test

32. The SES test is an exception to the application of the DPT. The SES test will apply (that is, the exception will be satisfied) where it is reasonable to conclude that the profit made as a result of a scheme by each relevant entity reasonably reflects the economic substance of the entity's activities in connection with the scheme.

33. The scenarios at Appendix 2 of this Guideline are provided to illustrate some of the matters we will consider in assessing risk in relation to the SES test.

34. The scenarios at Appendix 2 include both high and low risk scenarios. The high risk scenarios highlight the circumstances in which we consider it unlikely that the SES test will apply. The low risk scenarios highlight the circumstances in which we consider it likely that the SES test will apply.

35. Under the SES test, to the extent relevant, regard is to be had to the 2010 OECD Transfer Pricing Guidelines (the OECD Guidelines) and other documents covered by section 815-135 of the ITAA 1997[4] in determining whether the profit made by an entity reasonably reflects the economic substance of the entity's activities in connection with the scheme.

36. When we are determining whether the profit made by an entity reasonably reflects the economic substance of the entity's activities in connection with the scheme, to the extent relevant, we will have regard to the OECD Guidelines[5] in relation to the use of transfer pricing methods including both the traditional transaction methods and the transactional profit methods. The appropriate method will depend on the circumstances of the particular case.

37. Generally, we will accept, based on an assessment of sufficient information and documentation, a profit that falls within a range of acceptable results, provided that the profit made by each entity reasonably reflects the relative significance of the functions performed by the entity and the entity's relative contribution within the context of the overall value chain.

38. In addition, in considering the 'profit' made by each entity as a result of the scheme, we will generally determine 'profit' in a general commercial sense, having regard to accounting measures as a guide.

[4] These documents include the Aligning Transfer Pricing Outcomes with Value Creation, Action 8-10 – 2015 Final Reports, of the Organisation for Economic Cooperation and Development, published on 5 October 2015 (2015 OECD Report).

[5] Read together with the 2015 OECD Report.

Other relevant guidance products

39. We consider the following guidance products relevant to determining the level of engagement we expect from you:

(a) Practical Compliance Guideline PCG 2017/1 *ATO compliance approach to transfer pricing issues related to centralised operating models involving procurement, marketing, sales and distribution functions*

(b) Practical Compliance Guideline PCG 2017/4 *ATO compliance approach to taxation issues associated with cross-border related party financing arrangements and related transactions*, and

(c) Practical Compliance Guideline PCG 2017/2 *Simplified Transfer Pricing Record Keeping Options.*

40. If your arrangement is in the green zone under PCG 2017/1 or PCG 2017/4[6], there is no expectation that you will separately engage with us in relation to the DPT. Practically, this means we will generally only dedicate compliance resources to review your arrangement in accordance with the relevant Guideline.

41. Similarly, if your arrangement is in the white zone under PCG 2017/1 or PCG 2017/4, we will generally only undertake compliance activity to the extent stipulated in the relevant Guideline.

42. If you are eligible to apply any of the following simplified transfer pricing record keeping options under PCG 2017/2, there is no expectation that you will separately engage with us in relation to the DPT for covered transactions:

(a) distributors

(b) low-level inbound loans, and

(c) low-level outbound loans.

43. Practically, this means we will generally only undertake compliance activity to the extent stipulated in the Guideline.

44. Our approach to assessing risk in such cases is limited to the types of arrangements outlined in the specified Guidelines.

Guidance products – insurance arrangements

45. When considering the application of the DPT in the context of insurance arrangements, we will have regard, among other relevant matters, to existing ATO advice and guidance on these arrangements. Specifically, we will have regard to the guidance contained in Taxation Ruling TR 96/2 *Income tax: taxation implications of arrangements known as financial insurance and financial reinsurance* and Law Administration Practice Statement PS LA 2007/8 *Treatment of non-resident captive insurance arrangements.*

46. Refer to SES Scenario 12 in Appendix 2 of this Guideline for an example of an insurance arrangement that would be considered low risk for the SES test.

Our client engagement framework

47. We expect you to engage with us if, having considered the risk of your arrangement taking into account our risk assessment framework, you conclude that there is a potential DPT risk associated with your arrangement.

[6] Where you have multiple financing arrangements, PCG 2017/4 provides that your risk zone for an income year will reflect that of your highest risk financing arrangement.

48. If your arrangement requires further engagement with the ATO to obtain greater certainty, the main avenues of engagement are:

- seeking entry to the APA program
- applying for a private ruling, and
- contacting the DPT specialist team.

49. As early as possible during the APA or private ruling process, we will advise you if an alternative product is better suited to your circumstances.

APA program

50. The APA program can provide certainty with respect to the application of the DPT to covered transactions for an agreed period. For certain DPT tax benefits[7], the APA program is our preferred product when we need to consider the substance of a group's overall value chain.

51. In most cases, we do not expect the DPT to be a risk that will potentially affect the outcome of an APA. However, where it does represent such a risk, where practicable, we will seek to deal with the DPT as a collateral issue in parallel with the development of the APA.

52. Where it is not practicable to resolve a DPT risk during the APA process, it is unlikely that we will proceed with the APA and the matter may be referred internally for further consideration.

DPT clause

53. If you wish to obtain further assurance in relation to the DPT, you can request that a DPT clause be inserted into an APA. The standard DPT clause provides written assurance to you that, in relation to the covered transactions under an APA, we will not seek to issue a DPT assessment for the income years covered by the APA. However, this is subject to:

(a) critical assumptions not being breached

(b) the absence of certain omissions and false or misleading statements, and

(c) the relevant DPT tax benefit being a 'covered DPT tax benefit'.[8]

54. At your request, we will consider extending the standard DPT clause to include a DPT tax benefit that arises from a tax benefit referred to in paragraphs 177C(1)(bb), (bbaa), (bba) and/or (bc). Taxpayers may be required to provide further information to enable us to make a decision in relation to any such request.

55. If you would like a DPT clause included in an APA, we ask that you make note of it in your APA submission or as early as possible in the APA process.

Private rulings

56. You may lodge a request for a private ruling on the application of the DPT in relation to a particular arrangement. A private ruling may be appropriate where you require a greater level of certainty in relation to the application of the law.

[7] Tax benefits referred to in paragraphs 177C(1)(a), (b) and (ba).
[8] A covered DPT tax benefit is a tax benefit referred to in paragraphs 177C(1)(a), (b) and (ba).

57. However, it should be noted that you will only obtain a greater level of certainty if the arrangement ruled upon reflects the arrangement actually carried out, and all relevant matters are disclosed.

Contacting the DPT specialist team

58. The ATO has a dedicated team responsible for the DPT. If you have a general enquiry regarding our engagement strategy, you may contact us at divertedprofitstax@ato.gov.au.

Relevant documentation

59. There are no specific record-keeping requirements for the DPT. Taxpayers will need to keep appropriate records of their arrangements and transactions in the normal way.

60. We have, however, sought to outline in paragraphs 62 to 72 of this Guideline the kinds of documentation we may consider relevant should your arrangement require engagement (for example, during the APA process). The documentation may also be relevant when we are assessing risk during compliance activity.

61. The documentation outlined in this Guideline is intended as a general guide and should not be treated as an exhaustive or mandatory list of the kinds of documentation we may take into account. The relevance of particular documentation will turn on the circumstances of the arrangement in question.

General

62. In considering the application of the DPT, we will have regard to information in our possession, including but not limited to:

(a) lodged Australian income tax returns

(b) international dealings schedules (IDS)

(c) Australian notices of assessment

(d) Country-by-Country reporting data exchanged automatically or by exchange of information request

(e) information obtained from foreign jurisdictions through exchange of information processes

(f) other information provided previously under another compliance product, and

(g) other relevant information from third party sources.

63. To further assist us in considering the application of the DPT, you may provide the following information:

(a) a general submission outlining your views about the application of the DPT, for example, the basis for satisfying any exemptions

(b) IDS working papers

(c) annual reports or general purpose financial statements

(d) contemporaneous transfer pricing documentation, and

(e) intercompany agreements and relevant company policies regarding such dealings.

64. Where you have chosen to use a simplified transfer pricing record keeping option, we will have regard to the record-keeping obligations outlined in PCG 2017/2.

Principal purpose test

65. In considering the application of the principal purpose test, we may have regard to the following kinds of source documents, where they are relevant to the matters listed in subsection 177J(2):

(a) presentations and other papers prepared in relation to the arrangement and circulated to the taxpayer's management team and board of directors

(b) minutes of board and other meetings at which the arrangement was considered, and

(c) internal cost-benefit analyses – this could include quantifiable productivity gains, cost savings, synergistic benefits, location specific benefits, reduction of non-income tax costs, provision of government incentives and any other relevant costs and benefits associated with the arrangement.

Sufficient foreign tax test

66. In considering the application of the sufficient foreign tax test, we may have regard to the following kinds of documents:

(a) foreign income tax returns

(b) foreign notices of assessment (or equivalent)

(c) foreign tax receipts and notices of refund (or equivalent)

(d) foreign tax instalment notices and running balance accounts (or equivalent)

(e) general ledger entries and other accounting documentation

(f) any advice or valuations obtained in relation to the potential tax consequences of proposed structures or transactions

(g) any approvals of tax holidays or other reductions in tax, and

(h) correspondence from foreign revenue agencies.

SES test

67. In considering the application of the SES test, we may have regard to the following kinds of documents:

(a) global value chain information including details of each entity and the activities each entity performs

(b) source documents which form part of, evidence or relate to the arrangement including agreements between relevant entities

(c) commercial, regulatory and tax advice obtained in connection with the arrangement

(d) transfer pricing documentation including functional analyses for entities connected to the arrangement and analysis on the appropriateness of the transfer pricing method adopted having regard to the outcomes under multiple transfer pricing methods

(e) source documents demonstrating that the relevant entities are undertaking functions, using assets and assuming risks in accordance with the functional analyses supplied (for example, approvals, correspondence, meeting

minutes, reports, specifications and written directions demonstrating that entrepreneurial entities are overseeing and/or performing key functions and making key decisions in accordance with the functional analyses supplied)

(f) details about staff numbers, key personnel, including their job titles, descriptions, and responsibilities

(g) valuation reports, working papers and related documentation where assets, functions and/or risks are transferred offshore in connection with the arrangement

(h) details of any changes to the transfer pricing policy in the relevant period, including the rationale for any such changes (for example, reports documenting functional analyses for relevant entities, correspondence exchanged between key decision makers regarding the benefits of certain structures, and actuarial reports of cost modelling)

(i) details of any changes to intercompany agreements and company policies in the relevant period, and

(j) evidence of actual cash flows in accordance with the arrangement.

68. The documents that will be relevant in a particular case will depend on the circumstances of the case including the nature of the arrangement and the relevant industry sector. We provide some further guidance in relation to specific kinds of arrangements in paragraphs 69 to 72 of this Guideline.

Related party financing arrangements

69. In the context of related party financing arrangements and related transactions, paragraph 65 of PCG 2017/4 provides examples of the kind of documentation that may be relevant in relation to the relevant risk indicators.

Procurement, marketing, sales and distribution hubs

70. The framing questions listed at paragraphs 111 to 113 of PCG 2017/1 may assist taxpayers in identifying and preparing relevant documents in relation to procurement, marketing, sales and distribution hubs.

Intellectual property arrangements

71. For intellectual property (IP) arrangements, we will pay close attention to intercompany agreements and company policies relating to the development, enhancement, maintenance, protection and exploitation of the relevant intangible assets. Source documents evidencing that the relevant entities are operating in accordance with intercompany agreements, company policies, transfer pricing documentation and other information supplied for the relevant period are likely to assist us in considering the application of the SES test.

72. We may also have regard to the following kinds of documents:

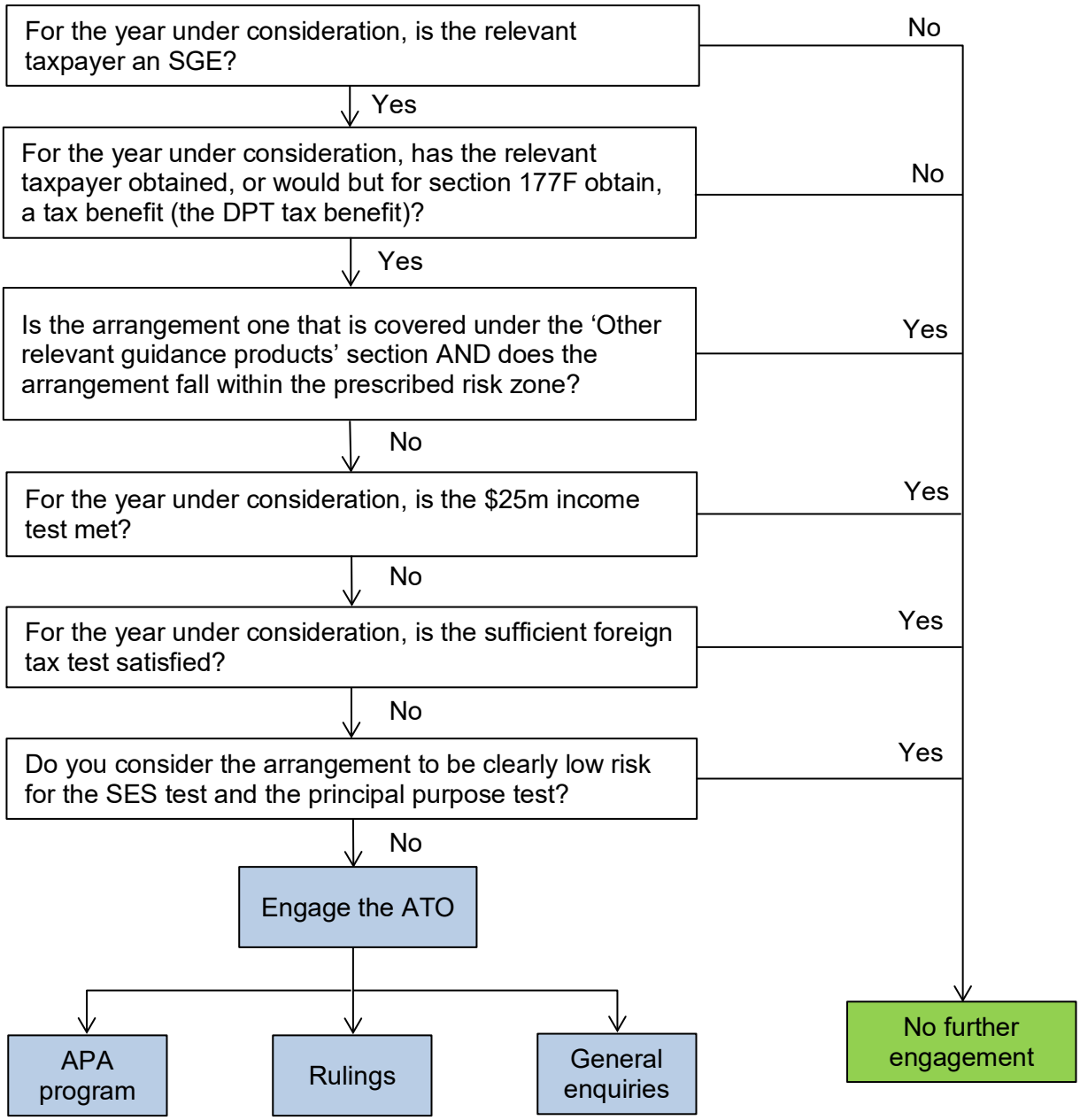
(a) source documents demonstrating that the relevant entities are undertaking functions, using assets and assuming risks in accordance with representations made by the taxpayer (for example, approvals, correspondence, meeting minutes, reports, specifications and written directions demonstrating that entrepreneurial entities are overseeing and/or performing key functions and making key decisions in accordance with transfer pricing documentation and any functional analyses supplied)

(b) full details of the intangible assets associated with the scheme including the name and nature of the asset (for example, a patent), a detailed description of the asset, registration details of the asset as relevant to the entities' domestic and offshore business, full details of all intercompany agreements and policies associated with the asset, full details regarding the contribution of relevant entities to the development, enhancement, maintenance, protection and exploitation of the asset

(c) full details of how the legal ownership of the intangible assets in (b) has changed from creation or acquisition to the end of the review period, and full details (including any advice) as to the effect of the change in ownership for any commercial or regulatory (including taxation) matters, and

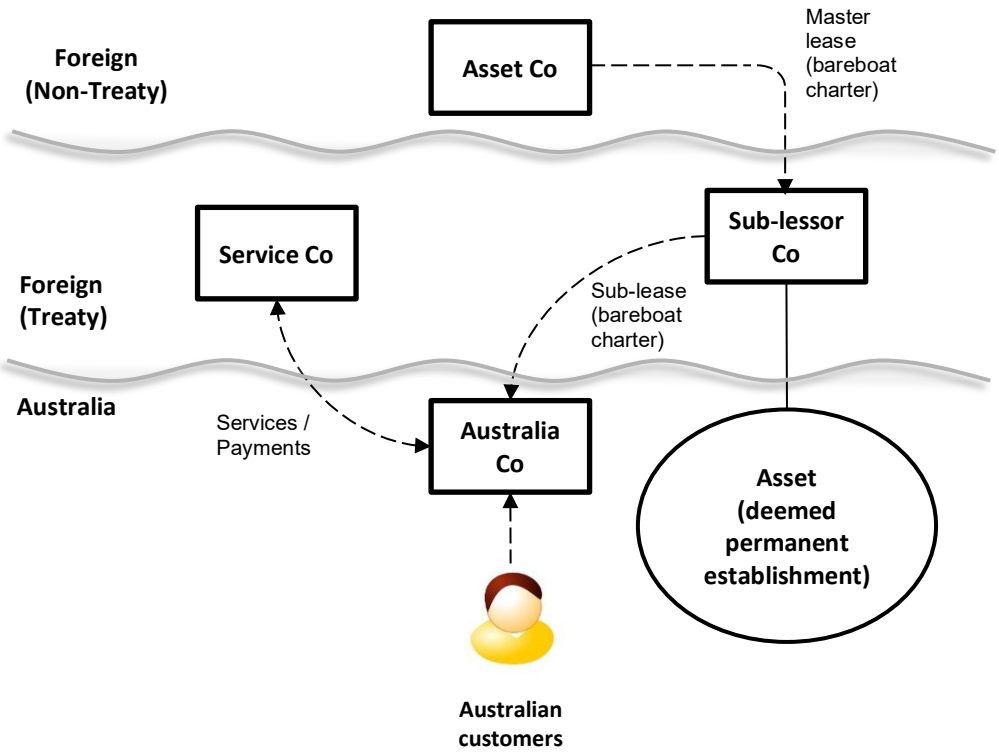
(d) contemporaneous valuation reports, working papers and associated documentation where intangible assets and relevant functions have been transferred offshore.

Appendix 1 – DPT risk assessment process



Appendix 2 – Low and high risk scenarios for the SES test

SES Scenario 1: lease in lease out arrangement – high risk



Background

73. *Australia Co is a wholly owned subsidiary of a global parent entity engaged in the operation of oil drilling rigs. Asset Co and Sub-lessor Co are also members of the global group.*

74. *Asset Co is the legal owner of a drilling rig and provides the requisite finance and insurance for the asset. Asset Co is a resident of a country that does not have a tax treaty with Australia. Sub-lessor Co is resident of a country that has a tax treaty with Australia.*

75. *Asset Co leases the rig to Sub-lessor Co under the Master Lease for $300 million per annum.*

76. *Sub-lessor Co sub-leases the rig to Australia Co on substantially the same terms for the same period for $350 million per annum under a sub-lease arrangement.*

77. *Australia Co utilises the rig in the conduct of its business. As part of the conduct of its business, Australia Co is responsible for identifying and liaising with third party customers, the marketing and scheduling of the rig, managing its outsourced contractors, and managing operational, environmental and utilisation risks associated with the rig.*

78. *The sub-lease contract between Sub-lessor Co and Australia Co mirrors the terms of the Master Lease agreement and there are no inherent risks borne by Sub-lessor Co. Accordingly, risks are shared between Asset Co and Australia Co.*

79. *After taking into account the costs associated with the running of its business, Australia Co makes a return commensurate with its functional profile.*

80. *Service Co is a foreign related party of Australia Co and undertakes various technical, crewing and other services related to the operation of the rig on behalf of Australia Co. Service Co employs staff with the requisite skills to perform the obligations under the contracts.*

81. *The interposition of Sub-lessor Co results in a reduction or exclusion from Asset Co's liability to pay royalty withholding tax on the lease payment. This is a consequence of the Double Tax Agreement in force between Australia and the foreign country in which Sub-lessor Co is a tax resident.*

82. *There is a substantial equipment permanent establishment (PE) of Sub-lessor Co in Australia. However, Sub-lessor Co does not perform any additional functions that would result in Sub-lessor Co being considered to be carrying on a business through a PE in Australia (pursuant to subsection 6(1)) and the relevant treaty does not deem the PE to be carrying on a business. As such, no Australian royalty withholding tax could apply between the lease payments made by Sub-lessor Co to Asset Co.*

SES analysis

83. *Based on the information available to us, the profit made as a result of the scheme by Australia Co and Service Co appears to reasonably reflect the economic substance of the entity's activities in connection with the scheme.*

84. *Notwithstanding Sub-lessor Co being party to the sub-lease agreement with Australia Co, it does not undertake any active functions in respect of the sub-lease. No independent consideration or negotiation is undertaken by Sub-lessor Co to determine the relevant terms and conditions of the sub-lease nor does Sub-lessor Co actively engage in managing any inherent risks from the underlying agreement (for example, defaulting payments).*

85. *Based on the information available to us, the profit made as a result of the scheme by Sub-lessor Co ($50 million) does not appear to reasonably reflect the economic substance of Sub-lessor Co's activities in connection with the scheme.*

86. *Asset Co, as the Master Lease holder, is responsible for the acquisition and financing of the rig, and the ongoing insurance of the rig with external providers. A functional analysis determines that Asset Co should have received $350 million for its economic activities in connection with the scheme.*

87. *Based on the information available to us, the profit made by Asset Co as a result of the scheme does not appear to reasonably reflect the economic substance of Asset Co's activities in connection with the scheme. We would consider this to be high risk in the context of the SES test.*

SES Scenario 2: lease in lease out arrangement – low risk

88. *Assume the following modifications to the facts of Scenario 1 in paragraphs 73 to 87 of this Guideline.*

89. *Sub-lessor Co is the central leasing entity for the global group and is responsible for the sub-lease of rigs to related party operating entities in various regions of the world (including the Mediterranean, Africa and South America). Sub-lessor Co is responsible for global marketing and scheduling of the rigs, managing outsourced contractors, and adhering to local government reporting and compliance obligations in the country of Sub-lessor Co. Sub-lessor Co also bears utilisation risk in relation to the vessel and its financial performance is a function of its ability to optimise utilisation of the asset during the period of the head lease.*

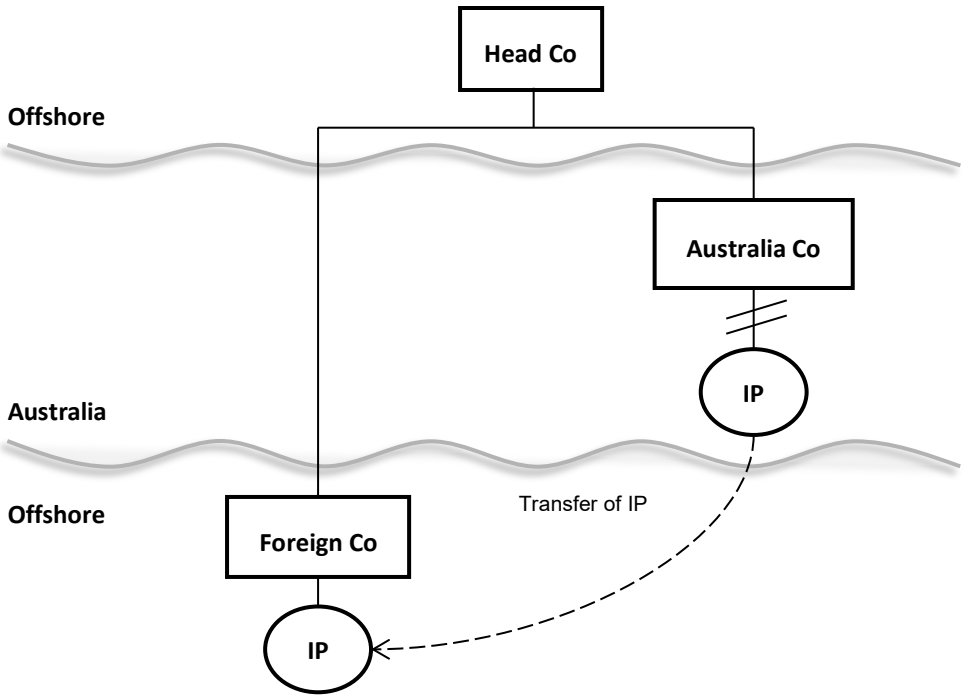
90. *Sub-lessor Co enters into a Master Lease agreement with Asset Co under arm's length terms. Sub-lessor Co then sub-leases the rig to Australia Co after negotiating the terms and conditions of the lease for $350 million per annum under a sub-lease arrangement. Australia Co utilises the asset in the conduct of its oil drilling business.*

91. *In this modified scenario, Sub-lessor Co is able to demonstrate that it carries out significant functions and bears actual risk in its role as sub-lessor. After taking into account*

the costs associated with the running of its business, Australia Co makes a return commensurate with its functional profile and Asset Co is remunerated in accordance with the financial and economic risks borne by it in respect of the rig.

92. *Based on the information available to us, the profits made by Australia Co, Asset Co and Sub-lessor Co as a result of the scheme appear to reasonably reflect the economic substance of their activities in connection with the scheme. We would consider this to be low risk in the context of the SES test.*

SES Scenario 3: intangibles migration (pharmaceutical) – high risk



Background

93. *Australia Co is part of a global pharmaceutical group. The group's core business is the development and commercialisation of pharmaceutical products. The group derives the bulk of its income from the sale of medicinal drugs. The development and manufacture of the drugs requires the group to exploit a range of IP assets.*

94. *On 1 July 2017, the group restructured. Prior to the restructure, Australia Co was the legal and beneficial owner of the IP associated with medicinal drug #16 (MD16) including registered trademarks, patents, know-how and processes. Australia Co performed all functions associated with developing, enhancing, maintaining, protecting and exploiting MD16. This involved funding and managing the development of the drug over a 10 year period, including:*

- *employing highly skilled staff in Australia*
- *designing, controlling and funding research*
- *undertaking testing and quality control for early phase pre-human testing and clinical trials*
- *centrally managing and funding clinical trials*
- *conducting research and development (R&D) projects associated with improvement of the drug and enhancements to the delivery and administration of the drug*

- *developing a manufacturing process for the active ingredient, and*
- *managing compliance with relevant regulatory requirements.*

95. *On 1 July 2017, at the final stage of clinical trials and prior to commercialisation, Australia Co and Foreign Co entered into an agreement which legally transferred the ownership of all the existing registered IP relating to MD16 to Foreign Co. This included exclusive rights to utilise the registered IP for the manufacturing, distribution, marketing and commercialisation process. The trademarks for the product were also permanently assigned to Foreign Co. Foreign Co is the legal owner of the IP for MD16 post 1 July 2017.*

96. *At the time the registered IP was transferred, Foreign Co employed a small number of staff with limited experience in the development and commercialisation of pharmaceutical products.*

97. *Following the disposal, a manufacturing contract was entered into between Foreign Co and a third party manufacturer to produce MD16 for the purpose of global sales. Evidence available to us indicates that Australia Co undertakes functions related to the manufacture and commercialisation of MD16 for the global market, including:*

- *set-up and maintenance of the third party manufacturing processes, and*
- *oversight of testing and quality assurance of the drug.*

98. *Australia Co also continues to perform functions associated with developing, enhancing, maintaining, protecting and exploiting MD16, including:*

- *design of drug packaging including content*
- *coordination of the marketing program for the drug, and*
- *managing legal protection.*

99. *Australia Co is remunerated on a cost plus basis for the services provided to Foreign Co. Foreign Co is responsible for payment to the third party manufacturer for the production of the drug and receives all income from global sales of the drug.*

100. *The effect of the arrangement is to move ownership of the IP offshore and the subsequent profits arising from the global sales of the drug.*

SES analysis

101. *We take the view that an independent entity in circumstances comparable to Australia Co would not have entered into the arrangement as it involves Australia Co disposing of valuable IP while continuing to undertake the main functions in connection with the commercialisation of the IP. If the transfer of the IP had not taken place, Australia Co would have derived the income from global sales of the drug.*

102. *At the time of the disposal of the IP, the drug was fully developed and ready for commercialisation. Following its disposal, Foreign Co enjoys legal and beneficial ownership of the IP and derives a majority of the profits from its exploitation.*

103. *The form of the transaction allocates all risks that come with owning the IP to Foreign Co, as the purchaser. However, as set out above, Australia Co continues to bear economically significant risks associated with the exploitation of the IP. The functions required to exploit the drug, including the legal protection of the IP, management of the third party manufacturing contract and distribution of the drug, continue to be performed by Australia Co.*

104. *Based on the information available to us, the profits made by Foreign Co and Australia Co as a result of the scheme do not appear to reasonably reflect the economic substance of their activities in connection with the scheme. We would consider this to be high risk in the context of the SES test.*

SES Scenario 4: intangibles migration (pharmaceutical) – low risk

105. *Assume the following modifications to the facts of Scenario 3 in paragraphs 93 to 104 of this Guideline.*

106. *Australia Co determines that it does not have the requisite skills and resources to successfully commercialise MD16. In addition to the transfer of the registered IP rights in respect of MD16 to Foreign Co, the following are also transferred to Foreign Co from Australia Co:*

- *the manufacturing know-how and process manuals for MD16*
- *marketing and trade intangibles associated with MD16 such as key contracts with suppliers*
- *customer contracts and customer lists, and*
- *regulatory compliance plans, draft approval applications and other supporting materials.*

107. *Further, a number of key employees of Australia Co involved in the decision making and management of the MD16 project were also relocated to Foreign Co. Foreign Co also employed additional personnel locally who are qualified and skilled in the development and commercialisation of pharmaceutical products.*

108. *Foreign Co provided market value[9] compensation to Australia Co in relation to the transfer of the registered IP, as well as associated business assets and other intangibles.*

109. *Australia Co made a gain on the disposal on the registered IP which it included in its assessable income. The R&D integrity rules applied to the relevant parts of this gain.*

110. *After the transfer of the MD16 business, Australia Co continued to perform various functions to develop, enhance and protect the MD16 IP under an agreement with Foreign Co to provide contract R&D and other support services. These functions were only performed for a short transitional period following the transfer of the business to Foreign Co and were performed under the direction of Foreign Co staff. Australia Co was remunerated by Foreign Co for these services in accordance with arm's length principles.*

111. *After the transition period, Australia Co provided limited contract R&D services in relation to the MD16 at the direction of Foreign Co and was remunerated accordingly.*

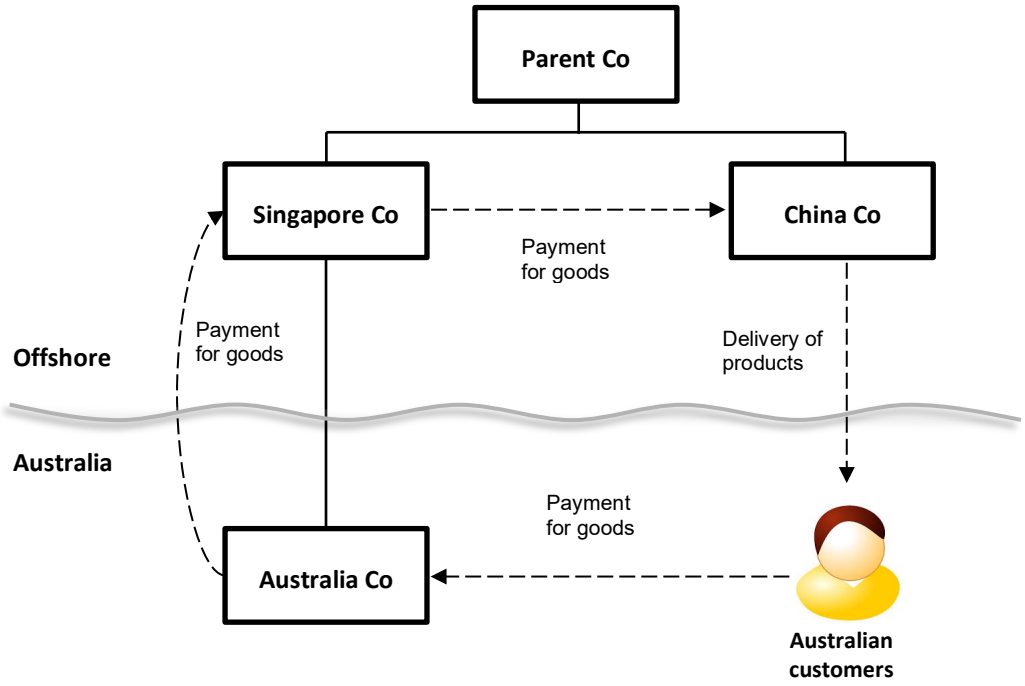
112. *Foreign Co employees are responsible for the planning and design of the manufacturing process for MD16. Foreign Co also bears the relevant risks associated with the exploitation of the IP, including risks associated with the manufacture and distribution of the MD16 product. Furthermore, Foreign Co has the financial capacity to bear the costs of managing and mitigating these risks as well as assuming any potential losses.*

113. *Foreign Co is entitled to the profits from the global sales of the MD16 products as a result of the functions and risks assumed by Foreign Co.*

114. *Based on the information available to us, the profits made by Foreign Co and Australia Co as a result of the scheme appear to reasonably reflect the economic substance of their activities in connection with the scheme. We would consider this to be low risk in the context of the SES test.*

[9] Refer generally to the ATO website 'ATO advice and guidance on market value'.

SES Scenario 5: distributor – high risk



Background

115. *Parent Co, Australia Co, Singapore Co and China Co are members of a global group which designs, manufactures and markets electrical appliances.*

116. *China Co owns the group's manufacturing facilities and is responsible for:*

- *manufacturing the products*
- *undertaking testing and quality control*
- *assembling and packaging the products*
- *organising delivery of finished goods to Australian customers*
- *undertaking all stages of production scheduling, including planning supply and capacity, and*
- *managing selection of suppliers and raw materials.*

117. *Singapore Co is the initial purchaser of the finished goods and distributes the goods in the Asia-Pacific region. Singapore Co buys the goods from China Co at a percentage mark up on cost. Singapore Co further subcontracts to Australia Co for distribution to Australian customers. Singapore Co does not take physical possession of or make any changes to the products.*

118. *There are 2,000 employees in Singapore Co who perform centralised ordering and invoicing, human resources, logistics and sales and distribution functions for various countries in the Asia-Pacific region. Information available to us suggests that Singapore Co performs ordering functions for Australian sales based on instructions from Australia Co. We do not have any evidence that Singapore Co employees undertake any relevant functions in relation to the generation of Australian sales.*

119. *The terms of the contractual agreement between Australia Co and Singapore Co provide that Australia Co is a limited risk distributor and that Australia Co's purchase price is set in order to achieve a particular targeted adjusted operating margin of 2%. As set out in the distribution agreement between Australia Co and Singapore Co, Australia Co's main*

responsibilities as a distributor are the provision of routine sales and marketing support functions, and the delivery of administrative services. Pursuant to this agreement, Australia Co is the contracting party in all agreements entered into with Australian customers and these customers only have recourse to Australia Co.

120. *Available evidence suggests that Australia Co assumes the relevant risks including inventory risk, market risk, customer credit risk, and warranty and product liability risk.*

121. *Australia Co employs over 500 personnel who perform a variety of functions, including:*

- *researching, developing and implementing local sales and marketing strategies, including promotional and marketing activities*
- *sales forecasting and demand planning*
- *order management, for example, determining purchasing volumes and then sending the orders to Singapore Co for processing*
- *maintaining and strengthening existing client relationships and seeking new opportunities, and*
- *negotiating discounts with resellers.*

122. *In examining the arrangement between Singapore Co and Australia Co, we review information provided by the taxpayer as well as publicly available information, Country-by-Country reports and information obtained under exchange of information processes.*

123. *To further understand the arrangement, we seek to conduct functional analyses of Australia Co and Singapore Co and issue a number of requests for information to obtain additional information about their roles and functions. Australia Co is not forthcoming in engaging with us, consistently requests lengthy extensions of time to respond and provides incomplete responses to our requests for information.*

124. *As a result, we rely on available information to complete our review. This information suggests that over the years, Australia Co has undertaken market development activities which enhanced the value of the global group's brand name, with the strategy of building the group's market share in Australia.*

SES analysis

125. *Based on the information available to us, we take the view that the profits made by Australia Co and Singapore Co do not appear to reasonably reflect the economic substance of their activities in connection with the scheme. Australia Co is the contracting party in all agreements entered into in the Australian market and it has an obligation to provide the products to customers. Australia Co's staff perform, significant functions including developing and implementing local marketing and promotional strategies, which are a crucial driver for the group's success in the Australian market. Australia Co's activities capture market share and generate value creation in Australia, and contribute to the strengthening of the global brand.*

126. *Furthermore, Australia Co bears market, inventory, warranty and customer credit risk. Australia Co undertakes functions and assumes risks that are consistent with the functional characterisation of a fully-fledged distributor. Australia Co's characterisation as a limited risk distributor does not align with its actual roles and responsibilities. On this basis, the profit made by Australia Co as a result of the scheme does not appear to reasonably reflect the economic substance of its activities in connection with the scheme.*

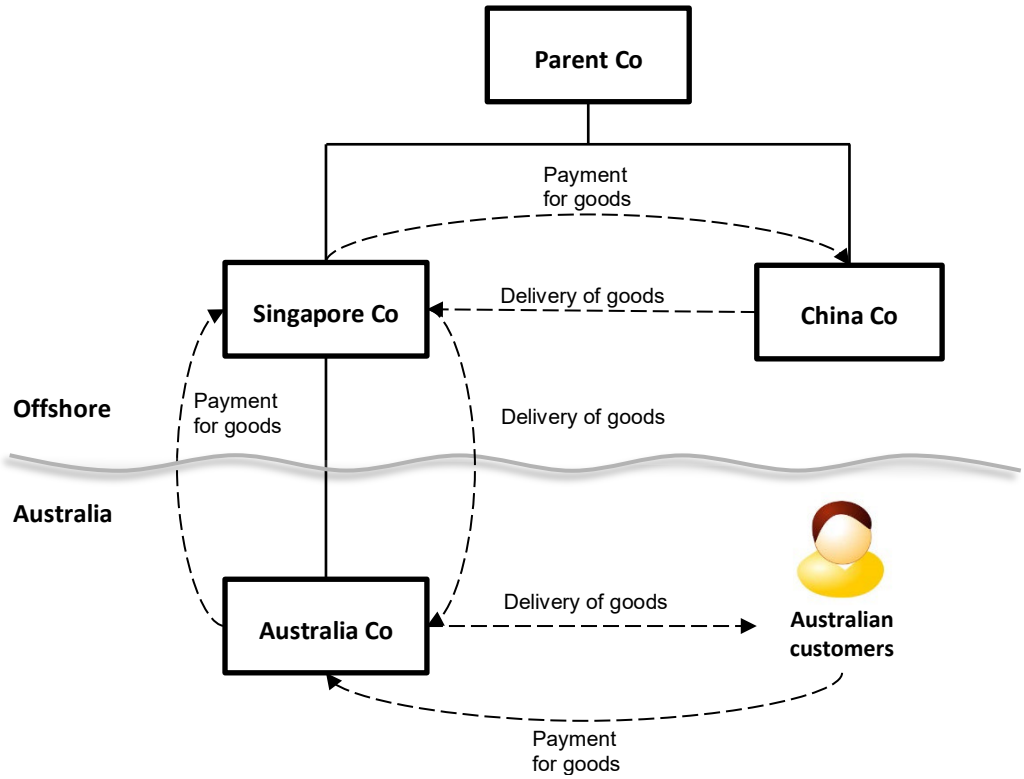
127. *Although there are a large number of employees in Singapore Co who are performing sales, marketing and distribution functions, these activities relate to sales made in the Asia-Pacific region excluding Australia. It is the activities performed by Singapore Co*

that relate directly to Australian sales that are relevant when considering the appropriate level of profit derived by Singapore Co for the purposes of the SES test. Available evidence demonstrates that Singapore Co has a limited, non-value adding role in relation to the sales made to Australian customers.

128. *Singapore Co purchases products from China Co but does not take physical possession of the products. The purchases and delivery are based on Australia Co's instructions. Singapore Co relies heavily on Australia Co to perform key functions and Singapore Co's functions add value only to sales made in regions other than Australia.*

129. *Based on the information available to us, the profit made by Singapore Co as a result of the scheme does not appear to reasonably reflect the economic substance of its activities in connection with the scheme. We would consider this to be high risk in the context of the SES test.*

SES Scenario 6: distributor – low risk



Background

130. *Assume the following modifications to the facts of Scenario 5 in paragraphs 115 to 129of this Guideline.*

131. *Singapore Co takes physical possession of the products from China Co in order to perform quality checks on the products to ensure they adhere to the relevant industry safety standards and regulations. As the group's distributor for the Asia-Pacific region, Singapore Co is also responsible for all significant decision-making activities referable to the sales of the product to Australian customers.*

132. *Australia Co has a separate agreement with Singapore Co which provides that Singapore Co is responsible for and assumes the economically significant risks that relate to the sale of goods to Australian customers. These risks include inventory risk, customer credit risk, and warranty and product liability risk. Singapore Co has exercised control over*

these risks through the performance of functions such as quality control and inventory management. Singapore Co also has the financial capacity to assume these risks. In the past it has been required to pay for warranty and product liability claims and to bear the cost of customer bad debts.

133. *Of the 2,000 plus employees in Singapore Co, over 500 employees undertake significant functions in relation to the generation of Australian sales, including:*

- *researching, developing, directing and managing local sales and marketing strategies, including promotional and marketing activities*
- *sales forecasting, demand planning and order management*
- *coordinating manufacturing, logistics, sales and distribution functions*
- *product development, ongoing product monitoring and commercialisation*
- *maintaining and strengthening existing client relationships and seeking new opportunities, and*
- *negotiating discounts with resellers.*

134. *The taxpayer is able to demonstrate that the distribution agreement between Australia Co and Singapore Co is an accurate representation of Australia Co's main responsibilities, that is, the provision of routine sales and limited marketing support functions, as well as the delivery of routine administrative services. Australia Co employs 50 personnel in carrying out these functions. Australia Co's purchase price is set in order to achieve a targeted adjusted operating margin that appropriately reflects its significant economic contribution to the transaction. Based on the functional and comparability analysis the margin is higher than the return in Scenario 5.*

135. *Further to the functional analyses of Australia Co and Singapore Co, evidence available to us confirms that Singapore Co's role in directing and managing sales and market development activities in Australia has enhanced the value of the global group's brand name and increased the group's market share.*

SES analysis

136. *While Australia Co maintains its role in providing routine sales, limited marketing support functions and routine administrative services, Singapore Co's staff perform significant functions in generating Australian sales. This includes developing and implementing local marketing and promotional strategies which are a crucial driver for the global group's success in all relevant markets. Singapore Co's activities capture market share, generate value creation in Australia and contribute to the building of the global brand. Singapore Co also assumes the relevant risks associated with the distribution of the products in Australia.*

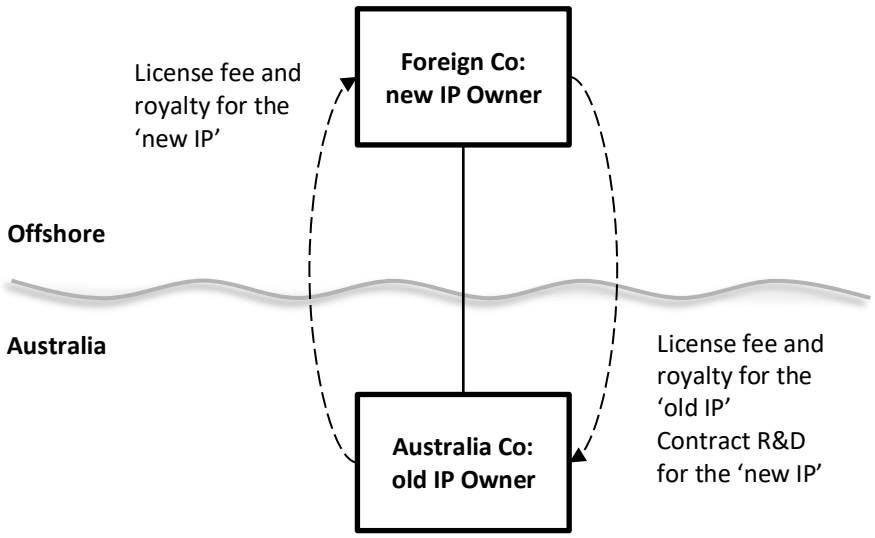
137. *Importantly, in considering the activities performed by Singapore Co in relation to the generation of Australian sales, it is clear that Singapore Co possesses actual decision-making responsibilities in directing sales and marketing strategies as well as managing and controlling the implementation of market development activities. With its product development and client management functions also reflected by the capability of its staff, it is evident that Singapore Co performs key functions in adding value specifically to the generation of sales in Australia. Based on the information available to us, the profit made by Singapore Co as a result of the scheme appears to reasonably reflect the economic substance of its activities in connection with the scheme.*

138. *China Co owns the group's manufacturing facilities and is appropriately rewarded for the goods supplied to Singapore with a mark-up on cost.*

139. *Based on the information available to us, it also appears that the profits made by Australia Co and China Co as a result of the scheme reasonably reflect the economic*

substance of their activities in connection with the scheme. We would consider this to be low risk in the context of the SES test.

SES Scenario 7: intangibles migration – high risk



Background

140. *Foreign Co is the parent company of a global group. Australia Co is a wholly owned subsidiary of Foreign Co and the holding company for the group's Australian operations. The group derives income from the sale of goods and associated services. The distribution of goods and the provision of associated services require the group to exploit IP assets including copyrights, patents and trademarks.*

141. *On 1 July 2017, the group restructures. Prior to the restructure, Australia Co was the legal and beneficial owner of group IP (the old IP) and performed all functions associated with developing, enhancing, maintaining, protecting and exploiting the old IP. Australia Co received income from global customer sales on behalf of the group. From 1 July 2017, Australia Co licences the old IP to Foreign Co to allow Foreign Co to produce future versions of goods using the old IP. After entering into this agreement, Australia Co becomes a sales agent of Foreign Co in relation to the sale of the goods to Australian customers. Under the licensing agreement, Foreign Co also becomes the legal owner of group IP developed post 1 July 2017 (the new IP).*

142. *The evidence available to us suggests that the development of the new IP is wholly reliant on the enhancement and exploitation of the old IP so that the old IP forms the platform upon which the new IP is developed. Australia Co has a central role in the development of the new IP during the period following entry into the licensing arrangement, but is only engaged by Foreign Co on a contract R&D basis in respect of this work. Foreign Co pays licence fees to Australia Co on arm's length terms for the use of the old IP and remunerates Australia Co on a cost plus basis for providing contract R&D services associated with new IP. The amount of licence fees paid by Foreign Co to Australia Co declines over a short timeframe as the new IP is developed. Licence fees are no longer payable after the goods associated with the new IP are released to market.*

143. *Following this, key personnel are relocated offshore and Australia Co starts to provide limited R&D support to Foreign Co. Australia Co distributes goods to Australian customers only and is remunerated by Foreign Co on a cost plus basis. Foreign Co employs the key personnel and starts to perform the majority of functions associated with developing, enhancing, maintaining, protecting and exploiting the new IP. For example:*

- *Foreign Co performs functions integral to the ongoing development of the new IP such as designing and controlling research programs*
- *Foreign Co undertakes strategic decision-making in respect of the commercialisation of the new IP and takes protective action where IP rights are infringed*
- *Foreign Co coordinates offshore sales and marketing strategies on behalf of the group, and*
- *Foreign Co provides technical support to customers.*

144. *These functions are a key aspect of the group's business model and vital to the success of the business globally. Foreign Co also sells and distributes the goods to offshore customers and receives income from global group sales. Foreign Co enters into new global agreements with third parties as the existing agreements with Australia Co expire.*

145. *The effect of these arrangements is to move ownership and development of group IP offshore.*

SES analysis

146. *On the available evidence, we take the view that the profits made by Foreign Co and Australia Co do not appear to reasonably reflect the economic substance of their activities in connection with the scheme.*

147. *Foreign Co enjoys legal and beneficial ownership of the new IP and derives a majority of group profits from the exploitation of the new IP, either through royalties from the use of the new IP by other group companies or directly through the manufacture and sale of products incorporating the new IP. This is mainly achieved via the modification and exploitation of the old IP, despite the absence of a legal form disposal of the old IP by Australia Co to Foreign Co.*

148. *Based on the evidence available, it is also considered that in the period following entry into the licensing agreement, Foreign Co did not have the capacity to undertake these further R&D activities as it did not have the expertise, know-how or qualified staff to do so and only paid Australia Co for the provision of 'limited R&D' services. While key personnel are eventually transferred to Foreign Co, it is considered that the activities undertaken by these employees after the transfer did not significantly contribute to the development of the new IP.*

149. *Additionally, the level of profit made by Australia Co is indicative of a sales agent with no responsibility for long term product or market development and this does not reflect Australia Co's contribution towards the development, enhancement, maintenance and protection of the new IP during the period following entry into the licensing arrangement. As the key R&D specialists and know-how in relation to the old IP remained in Australia during this period, Australia Co's role was not merely of a contract R&D provider but rather Australia Co played a key role in the development of the new IP, including the making of key decisions during the R&D process.*

150. *Based on the information available to us, the profits made by Foreign Co and Australia Co as a result of the scheme do not appear to reasonably reflect the economic substance of their activities in connection with the scheme. We would consider this to be high risk in the context of the SES test.*

SES Scenario 8: intangible migration – low risk

151. *Assume the following modifications to the facts of Scenario 7 in paragraphs 140 to 150 of this Guideline.*

152. *Foreign Co is the primary R&D entity of the global group and accordingly has staff with the necessary skills, experience and capability to provide the relevant R&D services to further develop and enhance group IP.*

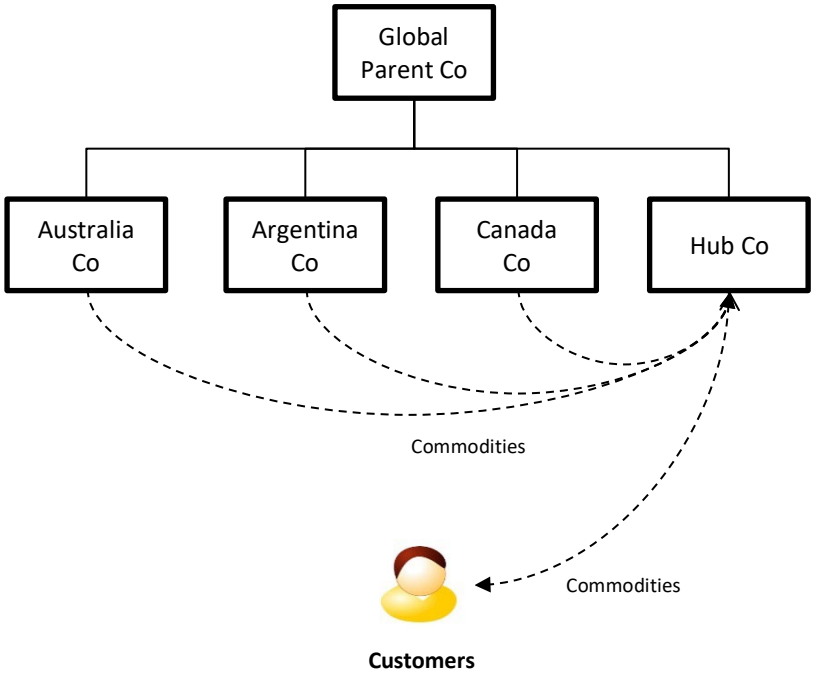
153. *The strategic decision was made for Australia Co to sell the IP to Foreign Co.*

154. *Under this alternative arrangement, Australia Co received market value[10] consideration for the disposal of the IP from Foreign Co in accordance with arm's length principles. Australia Co made a gain on the disposal of the registered IP which is included in its assessable income. The R&D integrity rules applied to the relevant parts of this gain.*

155. *Going forward, Foreign Co is entitled to the profits from the global sales of goods associated with the old and new IP as a result of the functions and risks assumed by Foreign Co.*

156. *Based on the information available to us, the profits made by Foreign Co and Australia Co as a result of the scheme appear to reasonably reflect the economic substance of their activities in connection with the scheme. We would consider this to be low risk in the context of the SES test.*

SES Scenario 9: marketing hub – high risk



Background

157. *Australia Co, Hub Co, Argentina Co and Canada Co are all members of a global group. The global group generates income primarily through selling commodities both in the Asia Pacific and Atlantic markets.*

158. *Australia Co, Argentina Co and Canada Co carry out mining, processing, inland transport and port activities for commodities in their respective jurisdictions. Australia Co,*

[10] Refer generally to the ATO website 'ATO advice and guidance on market value'.

Argentina Co and Canada Co also undertake exploration activity to provide long term reliable supply and to maintain the product brand.

159. *Australia Co provides commodities for the Asia-Pacific market whereas the Atlantic market commodities are sourced from Canada Co and Argentina Co.*

160. *Under the group's arrangements, Australia Co, Argentina Co and Canada Co exclusively sell all their production (on Free on Board terms) to Hub Co, which then on-sells the commodities immediately to third party customers (on Free on Board terms) in the two regional markets.*

161. *Due to Hub Co's participation in the sales market, it collects 'sales-side' market intelligence for the two distinct markets to assist in the identification of, and marketing to, potential customers (technical specification to price sensitivity, volume to price sensitivity, the customer's stockpile levels, demand cycles, sales by competitors, etc).*

162. *Under the arrangement, Australia Co, Argentina Co and Canada Co use the 'sales-side' market intelligence to assist them in their production planning. In addition, in order to secure sales, Hub Co is also dependent on the technical and production information gathered by Australia Co, Argentina Co and Canada Co in relation to their commodities as customers utilise this information to inform their purchase decisions. Accordingly, Hub Co is highly dependent on Australia Co, Argentina Co and Canada Co to provide technical marketing assistance to allow it to secure the sale of the commodities to third parties.*

163. *Australia Co, Argentina Co and Canada Co provide Hub Co with ongoing 'production-side' market intelligence (forecast production schedules, port loading delays, changes in product quality, production/quality of competitors, etc) and a feedback channel to their operating assets to allow Hub Co to most effectively sell its commodities.*

164. *Hub Co also receives information from group personnel located in the jurisdictions of the customers, who provide real time information of market conditions and customer contact in those regions.*

165. *Physically, Australia Co, Argentina Co and Canada Co hold the commodities in port stockpiles until sold. Hub Co does not alter the commodities, or take physical possession.*

166. *Australia Co, Canada Co and Argentina Co sell commodities to Hub Co at a discount relative to their respective regional index price which allows Hub Co to generate profits on the sale of the commodities to third party customers.*

167. *Australia Co employs staff who perform the following activities:*

- *exploration, development, and maintenance of mining rights*
- *design and implementation of production plans, including development of new production techniques*
- *mining activities (including support activities such as managing contractors)*
- *mine maintenance to deliver volumes as agreed with customers*
- *operation of mine to port infrastructure*
- *technical activity in relation to the commodities, including specification testing, efficient stockpiling at the port and efficient ship loading*
- *collating market conditions and intelligence from the producer side, and*
- *developing business strategies for the production and sales of the commodities to third party customers.*

168. *Canada Co and Argentina Co undertake similar functions in relation to their local markets.*

169. *The taxpayer has provided documentation that stipulates that Hub Co assumes the following risks:*

- *accounts receivable late payment risk, and*
- *market risk.*

170. *Hub Co employs staff who undertake the following activities:*

- *market analysis and contract negotiation*
- *provision of technical and other information from Australia Co, Argentina Co and Canada Co to customers*
- *managing accounts receivable and accounts payable, and*
- *invoicing and other administrative tasks.*

SES analysis

171. *On the available evidence, we take the view that the profits made by Australia Co and Hub Co do not appear to reasonably reflect the economic substance of their activities in connection with the scheme.*

172. *While Hub Co performs marketing activities and other administrative functions, we do not consider that these activities reasonably reflect the level of profits that it is receiving given that Australia Co, Canada Co and Argentina Co (as well as the personnel located in the local jurisdictions of the customers) provide key functions to Hub Co to allow it to secure its third party contracts.*

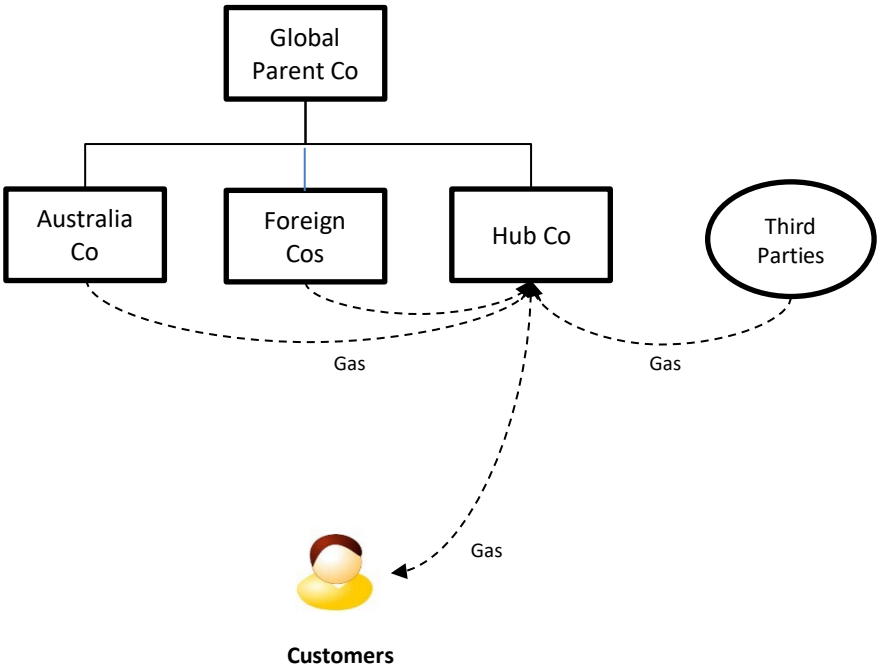
173. *Based on the functional analyses undertaken by us, Australia Co staff are responsible for ensuring planning, production and technical marketing of the commodities as well as collating local market intelligence. Australia Co undertakes significant activities in relation to the production, scheduling and specifications of the commodities which are important to the group's third party customers. Key value chain decisions and management functions are undertaken by Australia Co in relation to the Asia-Pacific sales and Hub Co does not undertake the activities required to obtain its third party contracts or to satisfy its contractual obligations, and relies on the functions and decision-making activities of its related parties in order to fulfil its obligations.*

174. *Further, as inventory is mined and transported to stockpiles at port and held until requested by customers, most of the market risk is still held by Australia Co. Hub Co bears limited market risk as the commodities are not sold to Hub Co unless the commodities are needed to fulfil a sales agreement with a customer. Hub Co does not have full control over the sales in relation to the supply, delivery or scheduling of the commodities as these are all dependent on Australia Co's functions. As such, Hub Co does not have a real exposure to losses based on the price or volume of the transaction.*

175. *Although Hub Co legally assumes accounts receivable late payment risk, based on the information available to us, Hub Co does not have the ability to manage and control any of its exposure to this risk and does not have the financial capacity to bear the risks apart from the ability to call on the financial resources of its parent.*

176. *Based on the information available to us, the profits made by Australia Co and Hub Co as a result of the scheme do not appear to reasonably reflect the economic substance of their activities in connection with the scheme. We would consider this to be high risk in the context of the SES test.*

SES Scenario 10: marketing hub – low risk



Background

177. *Australia Co, Hub Co and a number of foreign companies (Foreign Cos) are all members of a global group. The global group generates income primarily through the sale of oil and gas in various regional markets around the globe.*

178. *The global group acquires a percentage interest in the rights to develop a prospective natural gas field in Australia. This field holds proven reserves of natural gas that are able to be commercialised into liquefied natural gas (LNG). Australia Co is incorporated to carry out the front end engineering design, the subsequent extraction of the natural gas and its conversion to LNG. The Foreign Cos undertake similar activities in their local jurisdictions.*

179. *Hub Co is a global hub for the group and carries out marketing, storage (as required), shipping and other related services in the LNG markets. The role of Hub Co as a global hub pre-dates the LNG sales agreement with Australia Co.*

180. *Australia Co and the Foreign Cos enter into long-term sales agreements with Hub Co to sell 100% of their production to Hub Co, including any excess production volumes. Hub Co also purchases a diverse portfolio of LNG from third party producers, using a mixture of medium to long term supply contracts and spot purchases. Hub Co also owns and leases seaborne freight capacity.*

181. *Hub Co has a number of long term third party sales contracts that are fulfilled using both related party and third party supplies.*

182. *Hub Co identified the small number of foundation buyers (that were the basis for the group's Final Investment Decision (FID) in the Australian LNG project). LNG produced by Australia Co is on-sold by Hub Co to the foundation buyers, as well as other third party customers.*

183. *Hub Co is responsible for ensuring that the orders are most optimally scheduled and fulfilled. For example, this could address situations where there are urgent customer orders to be met or where there is port congestion requiring diversion of the affected ship to another port.*

184. *Hub Co takes legal title of the LNG from Australia Co and the Foreign Cos upon loading of the LNG onto the vessel. While Australia Co and the Foreign Cos are responsible for ensuring liquefaction of the natural gas and piping of the LNG at the load ports, Hub Co is responsible for the shipping of the LNG to the customers from the load port until delivered.*

185. *Hub Co develops business strategies for the sale of LNG to third party customers. Australia Co and the Foreign Cos provide Hub Co with on-going production information (forecast production schedules, transportation delays, changes in LNG specifications, etc); Hub Co is not solely reliant on this information to inform its marketing and trading strategies. Hub Co has third party providers and in-house employees responsible for obtaining third party market information to assist in its decision-making and price negotiations.*

186. *Australia Co, as the operator of the Australian LNG project for the global group, employs staff or contractors to perform the following activities:*

- *maintenance of exploration and extraction rights and licensing, and compliance with all associated environmental and safety regulations*
- *cargo loading*
- *implementation of production plans, with input from Hub Co in relation to cargo loading scheduling*
- *extraction activities including maintenance of equipment and infrastructure*
- *liquefaction of the natural gas and piping of the LNG at the load ports*
- *technical activity in relation to the LNG, including specification testing*
- *collating production information*
- *joint venture governance and management, and*
- *invoicing and other administrative tasks.*

187. *The Foreign Cos undertake similar functions in their local markets.*

188. *Hub Co employs staff who are located in the same jurisdiction as Hub Co to undertake the following activities:*

- *identification of customers and maintenance of relationships*
- *market analysis and contract negotiation with customers*
- *sales portfolio optimisation across the large range of potential customers and contracts, for example customer diversification, the mixture of the longer and medium term contracts and spot sales at differing prices*
- *key contribution to the commercial assumptions and modelling that underpin the FID decision for the project, including market risk assessment and cost-benefit analysis of recovering reserves to meet customer demand*
- *organising shipping logistics for the delivery of LNG to third party customers*
- *passing on technical specification and other information from Australia Co and the Foreign Cos to customers*
- *shipping activities*
- *short term storage activities*
- *managing accounts receivable and accounts payable, and*
- *invoicing and other administrative tasks.*

189. *There are no staff in Australia that have the ability or capacity to undertake the activities performed by Hub Co.*

190. *The taxpayer has provided documentation which demonstrates that Australia Co and Hub Co assume various entrepreneurial risks. Australia Co takes on entrepreneurial risks related to the construction, financing and operation of the LNG project and management of the joint venture parties. Australia Co assumes production volume and production cost risk and, to an extent, also bears price risk in relation to the sales to Hub Co.*

191. *Hub Co assumes further entrepreneurial risks related to the marketing, sourcing, sales and delivery of the LNG, such as:*

- *market risks, including in relation to sales volume and price*
- *shipping risk, including demurrage risk at the discharge port, and*
- *customer non-performance risk, including late payment, non-payment and refusal to accept a compliant cargo.*

SES analysis

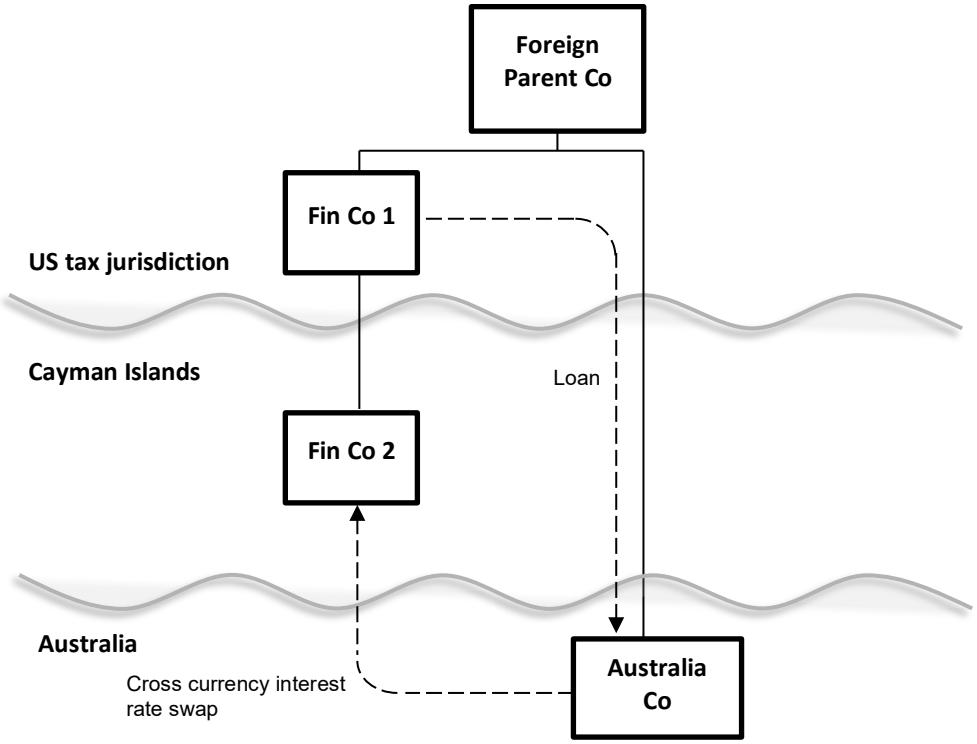
192. *Based on functional analyses and the evidence provided, Australia Co's staff are responsible for exploration, construction, operations, project financing, extraction of the natural gas, and loading of the LNG. Further, as a result of the long term sales and purchase agreement with Hub Co, Australia Co receives the market index price (with market based adjustments for specification, etc) and has a relatively certain income stream for its production volumes to allow it to focus its resources on production rather than marketing and portfolio management.*

193. *Hub Co undertakes key sales, marketing decisions and management functions. In this regard, Hub Co is responsible for securing sales, arranging shipping and delivery to third party customers. It is also responsible for portfolio optimisation and, in some instances, a degree of storage. Hub Co therefore also takes on entrepreneurial risks, including some degree of market price risk, being the difference between the price it pays to Australia Co and receives from third party customers.*

194. *In addition, the documents provided by the taxpayer support a conclusion that Hub Co has assumed customer non-performance risk, which primarily arises from spot contracts with new customers negotiated by Hub Co. The evidence supports the conclusion that Hub Co possesses the ability to manage and control its exposure to these risks (such as having the authority within the group to blacklist these customers) and possesses the financial capacity to bear the risks.*

195. *Based on the information available to us, the profits made by Australia Co, Hub Co and Foreign Co as a result of the scheme appear to reasonably reflect the economic substance of their activities in connection with the scheme. We would consider this to be low risk in the context of the SES test.*

SES Scenario 11: financing arrangement – high risk



Background

196. *Australia Co is a wholly owned subsidiary of Foreign Parent Co. Australia Co is engaged in the production, marketing and distribution of packaged food and beverages. Australia Co has an Australian dollar functional currency for Australian accounting and tax purposes.*

197. *Fin Co 1 is the treasury company for the global group. It is responsible for entering into financial transactions with external parties for the purposes of group debt funding, hedging and other cash management activities. Fin Co 1 has 40 full time employees and performs various treasury functions, including:*

- *negotiating with external banks for funding*
- *managing all incoming and outgoing cash flows and deposits*
- *making decisions in respect of the investment of surplus funds*
- *managing interest and currency risks at a global level*
- *preparing and maintaining relevant treasury policy and governance documents, and*
- *making decisions as to which group entities are advanced loans and determining the terms, conditions and pricing of such loans.*

198. *Fin Co 1 is funded by equity from Foreign Parent Co and sources debt funding for the global group from third party borrowings. The traceable debt cost of US dollar funds for Foreign Parent Co is 3%.*

199. *On 1 July 2017, Australia Co refinances its Australian Dollar (AUD) $500m loan from Fin Co 1 into an equivalent US dollar (USD) loan. The repayment terms are interest only. The refinancing of the loan from AUD to USD results in an actual reduction in interest rate. The interest rate on the AUD loan was fixed at 5% and the interest rate on the USD loan is fixed at 3%. Fin Co 1 is subject to Australian interest withholding tax on the payment of interest.*

200. *The multinational group's decision to refinance the related party loan creates an exposure for Australia Co to exchange rate movements (that is, USD to AUD). This is said to result in commercially significant volatility in Australia Co's standalone cash flow, financial accounts and tax performance which results in the group deciding to have a member of the Australian tax consolidated group enter into a foreign currency derivative with another overseas member of the group to reverse the foreign currency exposure created under the related party borrowing. This newly created risk (that is now having to be managed), results in Fin Co 1 incorporating a subsidiary in the Cayman Islands, Fin Co 2.*

201. *Fin Co 2 enters into a cross currency interest rate swap with Australia Co. At this time the AUD and USD currencies are at parity. Under the terms of the swap agreement Australia Co notionally exchanges USD$500m for AUD$500m (there is no physical exchange of principal). At maturity, Australia Co will notionally pay AUD$500m and notionally receive USD$500m. In addition, Australia Co incurs annual periodic payments being the net of a payment of AUD interest (at 5% calculated by reference to the AUD$500m) and a receipt of USD interest (at 3% calculated by reference to the USD$500m). The periodic payments under the swap are net settled in USD (this does not eliminate the cash flow risk for Australia Co on the USD borrowings). Fin Co 2 does not enter into an arrangement to hedge the exposure it has assumed. The group does not enter into an arrangement with a third party to hedge the exposure at a group level.*

SES analysis

202. *The effect of the swap arrangement is that the cost of the loan to Australia Co is the same as before the refinancing however, after the refinancing, the interest cost is less and the balance is for the periodic swap payments. For Australian tax purposes, the periodic swap payments are deductible under the Taxation of Financial Arrangements provisions and are not subject to Australian interest withholding tax.*

203. *Fin Co 2 has one part time employee, is capitalised with nominal equity, and does not undertake any other treasury functions. The sole purpose of incorporating Fin Co 2 was for it to act as a counterparty under the swap arrangement. All but one of the directors of Fin Co 2 are on the board of Fin Co 1 and the directors usually reside in the United States. The role of the Fin Co 2 directors was essentially limited to entering into the swap arrangement. Fin Co 2 pays an annual dividend to Fin Co 1. This payment corresponds to its net periodic receipts from Australia Co.*

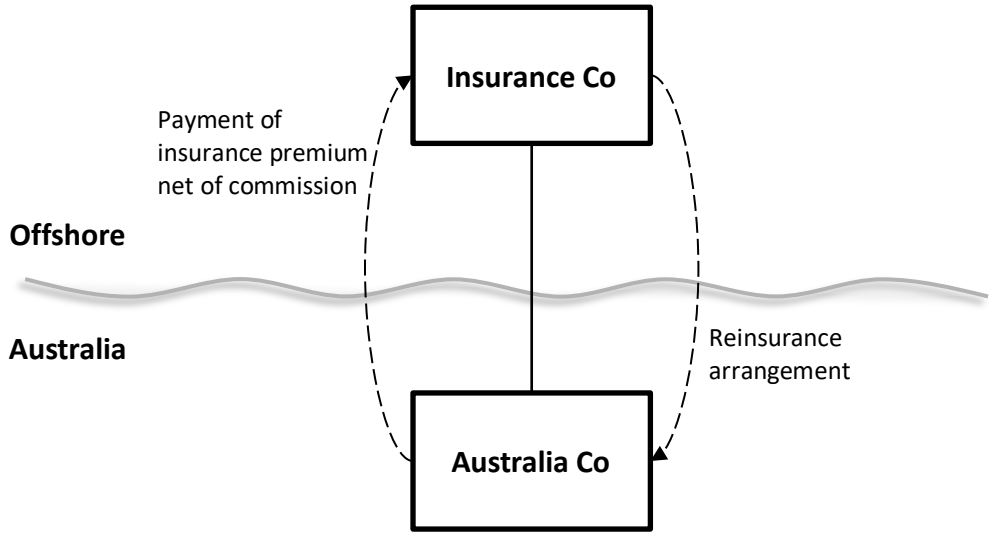
204. *The terms of the swap agreement, and the economic environment prevailing at the time the swap was entered into, meant that Fin Co 2 was a net receiver of periodic payments over the life of the swap arrangement. At maturity, Fin Co 2 made a net loss in relation to its notional right to receive AUD$500m and its notional obligation to pay USD $500m. It received a contribution of equity from Fin Co 1 to finance this net loss. Australia Co uses the proceeds of the net gain at maturity to, in part, meet its obligation to repay the USD loan to Fin Co 1. As the terms of the swap arrangement do not provide for an exchange of physical cash flows with respect to the notional principal and periodic interest payments, the swap does not manage the cash flow risk for Australia Co (that is, Australia Co does not receive USD to meet its periodic loan and principal repayments).*

205. *The information provided indicates that Fin Co 1's employees are actively engaged in performing the relevant functions and managing the relevant risks in respect of the refinanced loan. The Commissioner considers the profit made by Fin Co 1 appears to reasonably reflect the economic substance of its activities in connection with the scheme.*

206. *The information provided indicates that Fin Co 2 does not actively manage the foreign currency exposure arising from the swap arrangement. In addition, Fin Co 2 is not capable of meeting its obligations under the arrangement without contributions of equity from its parent, Fin Co 1. As a result the Commissioner considers that Fin Co 2's profit does not appear to reasonably reflect the economic substance of its activities in*

connection with the scheme. We would consider this to be high risk in the context of the SES test.

SES Scenario 12: insurance arrangement – low risk[11]



207. *Insurance Co is the reinsurer of a global group and is a resident in Bermuda. Insurance Co is authorised and registered to conduct an insurance business in Bermuda.*

208. *Insurance Co enters into reinsurance arrangements with Australia Co who provides insurance services to third parties in Australia. There is a genuine transfer of significant insurance risk to Insurance Co from Australia Co, with Insurance Co assuming the insurance risks under the reinsurance cover provided. Insurance Co is an associate of Australia Co.*

209. *Insurance Co employs staff located in Bermuda, who carry out underwriting, manage and control Insurance Co's arrangements with Australia Co, and manage Insurance Co's assets and investments. These employees have the requisite skills to undertake these activities.*

210. *Australia Co undertakes any reinsurance of its insurance risk exposure on arm's length terms and in a way which reflects its commercial risk appetite.*

211. *An insurance premium (net of commission) that is struck on arm's length terms is paid by Australia Co to Insurance Co.*

212. *Insurance Co has the capacity to pay and indeed does pay out any insurance claims made by Australia Co.*

213. *Costs incurred by Insurance Co are priced on arm's length terms, and there is no evidence of biased allocation of costs between the relevant insured risks and its other business.*

214. *Insurance Co undertakes any retrocession*[12] *of the reinsured risk to other reinsurers on arm's length terms and in a way which reflects its commercial risk appetite.*

[11] This scenario draws upon the guidance contained in PS LA 2007/8

[12] Retrocession involves reinsurance of a reinsured risk by one reinsurance company with another. In this scenario, Insurance Co (the reinsurance company) may wish to manage its risk exposure under the risks it has reinsured with Australia Co by 'ceding' (reinsuring) part of that risk under a retrocession (reinsurance) arrangement with another reinsurance company.

215. *Insurance Co holds a level of capital in its investment portfolio which corresponds to the liability that it manages. Capital reserve levels and measurement of accounting liabilities in Insurance Co reflect the commercial nature of the relevant risks.*[13]

216. *Based on the information available to us, the profits made by Australia Co and Insurance Co as a result of the scheme appear to reasonably reflect the economic substance of their activities in connection with the scheme. We would consider this to be low risk in the context of the SES test.*

Commissioner of Taxation
26 September 2018

[13] Regard may be had to the capital requirements and standards of the Australian Prudential Regulation Authority in assessing commerciality.

References

ATOlaw topic(s)	Tax integrity measures ~~ Part IVA ~~ Other
Legislative references	ITAA 1936 ITAA 1936 Pt IVA ITAA 1936 6(1) ITAA 1936 177C(1)(a) ITAA 1936 177C(1)(b) ITAA 1936 177C(1)(ba) ITAA 1936 177C(1)(bb) ITAA 1936 177C(1)(bba) ITAA 1936 177C(1)(bbaa) ITAA 1936 177C(1)(bc) ITAA 1936 177DA ITAA 1936 177F ITAA 1936 177J(1)(a) ITAA 1936 177J(1)(b) ITAA 1936 177J(1)(c) ITAA 1936 177J(1)(d) ITAA 1936 177J(1)(e) ITAA 1936 177J(1)(f) ITAA 1936 177J(1)(g) ITAA 1936 177J(2) ITAA 1936 177K ITAA 1936 177L ITAA 1936 177M ITAA 1997 ITAA 1997 Div 815 ITAA 1997 815–135 Diverted Profits Tax Act 2017 Treasury Laws Amendment (Combating Multinational Tax Avoidance) Act 2017
Related Rulings/Determinations	LCR 2015/2 LCR 2018/6 TR 96/2
Other references	PCG 2017/1 PCG 2017/2 PCG 2017/4 PS LA 2007/8 PS LA 2015/4 PS LA 2017/2 2010 OECD Transfer Pricing Guidelines 2015 OECD Report
ATO reference	1-AN371U0
ISSN	2209-1297
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