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The role of economic analysis in resolving uncertainties in the source concept and the arm's length principle

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Abstract
The 2015 OECD review of its transfer pricing guidance was in part focussed on the need to align transfer pricing outcomes with value creation, a process that was based on open market benchmarking and an examination of the economic functions performed, assets used and risks assumed by the parties. In broad terms this can be described as a further elaboration of "the arm's length principle", which the paper explores and contrasts with global formulary apportionment which some still advocate as the preferred approach to the taxation of multinational enterprises. The approach of Australian courts, evident in the High Court decisions in *Nathan's Case* and the *United Aircraft Corporation Case* has been to determine the source of income on the basis of a legal analysis of the facts and circumstances of each individual case, a process that gave significant weight to the legal arrangements put in place between the parties and gave little if any weight to economic and accounting analysis. This paper explores the impacts of these different approaches and the implications they have for the taxation aspects of trade and investment relations between Australia and its tax treaty partners. In particular the paper explores their implications in terms of providing workable certainty to support those relations and the taxation rules that apply to them. The paper also discusses the application of Australia's transfer pricing rules as articulated in Subdivision 815-B of the *Income Tax Assessment Act 1997* and Article 9 of Australia's double taxation agreements, the relationship between them, and whether they achieve the necessary workable certainty.

Keywords: Australia's transfer pricing rules, the arm's length principle, global formulary apportionment, Subdivision 815-B, Article 9 of Australia's double taxation agreements

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Introduction

Extensive work has been undertaken in recent years by the OECD/G20 in its Base Erosion and Profit Shifting Project (the BEPS Project), and in particular Actions 8-10 that dealt with the topic of *Aligning Transfer Pricing Outcomes with Value Creation*, the final response being published under that title in 2015[1]. While the OECD/G20 review was done in the context of cross-border dealings between associated entities, much of the analysis is equally applicable to independent entities that are not dealing wholly independently with each other, an important aspect since, as discussed later, Australia's domestic transfer pricing law does not require the entities to be associated.

Given the long running debate about alternatives to the arm's length principle which underpins the OECD approach and has unanimous acceptance within the OECD and G20 memberships, it is not unexpected that the OECD project would attract criticism. The criticism seems to be based on the fact that OECD confined itself to a remediation of the weaknesses detected in the practical application of the existing framework instead of undertaking a fundamental reconstruction of the international taxation system (Devereux and Vella, 2014)[2]. A key aspect of this criticism is a perceived reliance on existing principles, including the source and residency principles, which Devereux and Vella believed was misplaced given the organisational structures now used by multinational enterprises (MNEs) and the global nature of their value chains. Global formulary apportionment has been suggested as an alternative to the arm's length principle on the basis that the separate entity approach embodied in that principle is inherently flawed because it may not always account for the economies of scale and interrelation of various activities created by integrated businesses.[3] Those advancing the desirability of global formulary apportionment emphasise the reliability of the MNE's consolidated group profit as a basis for a jurisdictional allocation of that profit by use of a predetermined and mechanistic formula, most likely based on some combination of costs, assets, payroll and sales.[4]

While it is acknowledged that there are some cases where the application of the arm's length principle is uncertain, for the great majority of cases OECD member countries believe the principle provides a sound and workable solution where there has been an understatement of the amount of taxable profits in a particular jurisdiction. They have a number of overriding objections to the adoption of global formulary apportionment as a replacement. These include: the arbitrariness and vulnerability of formulaic approaches to manipulation; the movement away from market based comparability analysis; their lack of precision in determining arm's length rates of return relative to a country by country analysis of markets, economic conditions, functions, assets and risks; and the inability of global formulary apportionment to deal with exchange rate fluctuations. Differences in accounting standards may also be problematical.

There are some other important observations. While major global forces will have an impact on the economy of a particular country it needs to be recognised that each country has its own

[1] OECD (2015) *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 – 2015 Final Reports,* OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris.
[2] Devereux, M.P. and J. Vella, 2014. Are we heading towards a corporate tax system fit for the 21st century? *Fiscal Studies* 35(4): 449-476.
[3] See paragraph 1.10 of the *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* 2017 OECD Publishing, Paris (the OECD 2017 Transfer Pricing Guidelines).
[4] Paragraph 1.17 of the OECD 2017 Transfer Pricing Guidelines.

economic fingerprint. Unlike the arm's length principle, which is consistent with the real world relationship between the macro, micro and firm levels of economic activity and takes account of the market and economic conditions at each of these levels, global formulary apportionment creates a disconnect that impedes the determination of whether a country is obtaining its appropriate amount of revenue relative to local economic and business conditions and the economic contributions made by companies operating in that jurisdiction. There is also a real risk that it will impede the achievement of tax neutral treatment between domestically owned and foreign owned market participants, something that the use of tax incentives to attract foreign investment may also impair.[5] In terms of legal analysis it represents a significant move away from the concept of companies as separate legal entities and the concept of territorial connection that supports the validity of taxation laws.

It can be observed that integration and economies of scale are not unique to MNE structures. Independent single entities can and sometimes do form cooperative arrangements in the open market to achieve scale and synergies. For example, cooperative arrangements between independent researchers, designers, manufacturers and marketer/distributors may allow independent single entity members to obtain the benefits of synergies flowing from such integration. Moreover, synergies are possible within single entities, where different functions can be coordinated in a way to produce a cross-pollination of ideas that increases the creativity and productivity of the entity over and above what the separate functional areas could achieve on their own.[6]

While the strategies, structures, systems and processes adopted by a MNE may be designed to create and capture synergies, there is no guarantee that they will be successful in that regard. The integration of different activities and networking systems may produce negative effects across the integrated business or within parts of it since a lot depends on distributed leadership and an organisation's capability and culture. In other words, there are risks in adopting integrated global approaches as well as possible benefits. Global value chains and supply chains are subject to the risk of social, economic, political, technological and environmental disruptions which can adversely affect the financial performance of a MNE or parts of it.

There is also a question as to whether the conditions adopted by independent entities dealing wholly independently with each other would make any specific allowance for synergies, given that integration and collaboration can produce either negative or positive results as shown by the outcomes of merger and acquisition activity. Should synergies be obtained in tangible terms they will generally be reflected in increased sales, lower costs or enhanced creativity or productivity. They may also increase the intangible value of a MNE and be reflected in goodwill or the value of intangibles and knowhow. Accordingly, there is a argument that any synergies that may be able to be realised should generally be regarded as incidental to the integration or cooperation in which all parts are expected to make an individual economic contribution and obtain a commensurate economic benefit, accepting the

[5] See also the comparative evaluation of the arm's length principle and global formulary apportionment set out in paragraphs 1.6 to 1.32 of the OECD 2017 Transfer Pricing Guidelines.

[6] See Craig S. Fleisher, Barbette E. Bensoussan (2003) Strategic and Competitive Analysis: *Methods and Techniques for Analysing Business Competition*, Prentice Hall, especially Chapter 9 (Value Chain Analysis) at pp104-121, Chapter 10 (Blindspot Analysis) at pp131-132 and Chapter 14 (Functional Capability and Resource Analysis) at p 208; and Stephen A. Ross, Randolph W. Westerfield, Bradford D. Jordan, (2006) Fundamentals of Corporate Finance (Seventh Edition) (Alternate Edition), especially Chapter 25 (Mergers and Acquisitions) at p 801 (Alternatives to Merger).

possibility that those expectations may not be realised by the MNE group as a whole or by certain parts of the MNE. This is the broad mechanism underpinning the arm's length principle that is founded on open market comparability analysis and economic functional analysis at the single entity level, as discussed below.

In the international context the concept of a "single entity" is inextricably bound up with the concept of "taxpayer", which in turn is inextricably bound up with jurisdictional taxing rights and tax bases. Accordingly, a change from a "single entity" concept to a "multinational group" concept will have significant implications for revenue bases and tax administration. In this regard, it is noted that Australia's tax consolidation regime (Part 3-90 of the *Income Tax Assessment Act 1997* (*ITAA 1997*) excludes foreign entities from being a head company or a subsidiary member of a consolidated group.[7] The inability to specify such impacts on a country by country basis greatly reduces the attractiveness of global formulary apportionment.

The view expressed by Devereux and Vella nevertheless invites an examination of the relationship between Australia's "transfer pricing" rules and the operation of the traditional common law principles of source and residency. Given the context in which the criticism is made, this necessarily includes a consideration of the nature of "the arm's length principle" which underpins not only the longstanding OECD approach and the 2015 OECD/G20 review but also Australia's transfer pricing rules that are set out in Subdivision 815-B of the *ITAA 1997*. [8]

As will be clear from the discussion below, the concepts of source and residency operate in tandem insofar as the working out the Australian taxable income is concerned. However, there is significant flexibility for an MNE to determine its own residency and that of any of its constituent entities. Accordingly, this paper focusses on the common law concept of source and how it is impacted by Australia's double tax treaties (DTAs) and transfer pricing rules. These provisions were designed to address cases where profit has been understated, both in cases where a MNE has deliberately sought to shift profits to avoid Australian tax and other cases where, for whatever reason, the transfer pricing rules have been misapplied.

The paper will focus particularly on the general application of the principle to highly integrated global value chains involving cross-border dealings between subsidiaries of multinational groups, a highly common feature of cross-border trade and investment. As a broad approach, the analysis will focus on the current expression of the arm's length principle as reflected in the structure and wording of Subdivision 815-B of the *ITAA 1997*, especially given the close alignment of its drafting to the language used in Article 9 of Australia's DTAs, rather than analyse the evolution of Australia's domestic transfer pricing rules through their previous iterations in section 136 and Division 13 of the *Income Tax Assessment Act 1936* (the *ITAA 1936*) and Subdivision 815-A of the *ITAA 1997*. The paper does not discuss the Two Pillar Solution which has a conceptually different policy basis and methodology from the arm's length principle and is directed to ensuring a minimum level of taxation. Pillar One seeks to address the impacts of the digitalised economy by ensuring more of the profits of the largest and most profitable multinationals are taxed where the products or services are

[7] See section 703-15(2) of the *ITAA 1997*.

[8] It should be noted that Australia's domestic transfer pricing rules do not require the entities to be "associated" in the way required by the Associated enterprises Article in Australia's DTAs, merely that the conditions that operate between entities in their cross-border commercial or financial relations are non-arm's length (s815-115(1)). This aspect is discussed further in a later part of this paper.

consumed. Pillar One is primarily an attempt to address the problem of 'scale without mass'—being able to derive significant profits from a country without having the traditional physical presence (mass). Pillar Two seeks to establish a global minimum tax on large multinationals. While it is primarily seeking to address the 'race to the bottom' created by an increasing tendency among countries to provide low tax rates, tax incentives and tax exemptions to attract investment and create competitive advantages, it also helps to create a more level playing field between large multinationals and domestic businesses, which have little ability to access the same profit shifting strategies. (See Department of Prime Minister and Cabinet, Office of Impact Analysis, 9 May 2023, Budget Impact Statement.)

Nor does the paper address Article 7 (Business Profits) of Australia's DTAs which relates to the attribution (on a single rather than separate entity basis) of income and expenses of the enterprises to one or more permanent establishments that the enterprise may have in the treaty partner country. Nor does it address the domestic transfer pricing rules related to permanent establishments.[9] It is noted, though, that the concept of "permanent establishment" used in that Article creates a threshold for source country taxing rights on certain income, which to that extent has the effect of displacing the common law concept of "source".

The taxing rights over intra-group and intra-entity profits arising in respect of cross-border dealings with non-treaty countries are determined according to the general tax law framework embodied in the integrated operation of the *ITAA 1936*, the *ITAA 1997.* It is beyond the scope of this paper to cover the full breadth of the application of the Australia's tax law in non-treaty cases other than the application of the transfer pricing rules in Subdivision 815-B, which applies the arm's length principle to treaty and non-treaty cases alike.

The source principle

Over many years, in the context of arrangements by taxpayers to reduce their incidence of taxation, Australian courts have grappled with the question of whether individuals and companies can assign their right to receive income to associates in whose hands the income would not be taxed or would be more lowly taxed. The cases include *Norman v FC of T* (1963) 109 CLR 9; *Shepherd v FC of T* (1965) 113 CLR 385; *FC of T v Myer Emporium Ltd* (1987) 163 CLR 199; 87 ATC 4363; 18 ATR 693; and *Booth v FC of T* (1987) 19 ATR 514; 87 ATC 5100. While these cases are not directly relevant to the context of global profit shifting they have some interesting insights. In the *Myer Case* the High Court observed[10] that

> …the need to distinguish between capital and income for trust purposes and other purposes has focused attention on the difference between the right to receive future income and the receipt of that income, a difference which has given rise to the analogical difference between the fruit and the tree (see *Shepherd v FC of T* (1965) 113 CLR 385 at 396).

Extending the metaphor to the application of the arm's length principle, which determines the right to tax business profits on the basis of the conditions that operate in the commercial and financial relations between independent parties dealing at arm's length with each other, the analysis involves not only an examination of the productive capacity of "the tree" in question but also a determination of the country in which the metaphorical tree is planted. The added

[9] Subdivision 815-C of the *ITAA 1997.*
[10] 87 ATC 4370 per Mason ACJ, Wilson, Brennan, Deane and Dawson JJ.

complexity in the context of modern day global MNE value chains is that there generally will be more than one tree and more than one type of fruit; different functions and outputs at each stage of the global value chain.

Key conceptual building blocks in the Australia's company tax system, embodied in the *ITAA 1936*, the *ITAA* 1997 and the *International Tax Agreements Act 1953* (the *Agreements Act*), are the legal constructs generally referred to as "source" and "residency".[11] These constructs are relevant to the taxation of income and profits arising from cross-border dealings between companies. Subject to any express inclusions in or exclusions from assessable or taxable income, the broad framework of the Australian legislation is to tax non-resident companies on assessable income derived directly or indirectly from sources in Australia and to tax Australian resident companies on their assessable income derived directly or indirectly from all sources, foreign and domestic (ss 6-1 and 6-5 *ITAA 1997*), with due allowance for any loss or outgoing incurred in deriving the assessable income or necessarily incurred in carrying on a business for that purpose (ss 8-1 and 8-5 *ITAA 1997*).

Section 995-1 of the *ITAA 1997* contains the following relevant definitions:

> ***Australian source***: without limiting when ordinary income or statutory income has an ***Australian source***, it has an ***Australian source*** if it is derived from a source in Australia for the purposes of the *Income Tax Assessment Act 1936*;
>
> ***Australian resident*** means a person who is a resident of Australia for the purposes of the *Income Tax Assessment Act 1936*;
>
> ***foreign resident*** means a person who is not a resident of Australia for the purposes of the *Income Tax Assessment Act 1936*; and
>
> ***person*** includes a company.

Section 6 of the *ITAA 1936* relevantly provides:

> ***resident*** or ***resident of Australia*** means:
>
> > (b) a company which is incorporated in Australia, or which, not being incorporated in Australia, carries on business in Australia, and has either its central management and control in Australia, or its voting power controlled by shareholders who are residents of Australia; and
>
> ***non-resident*** means a person who is not a resident of Australia.

[11] The *Agreements Act* is the mechanism by which Australia's double tax treaties are given the force of law in Australia. Section 4 provides:

> (1) Subject to subsection (2), the Assessment Act is incorporated and shall be read as one with this Act.
> (2) The provisions of this Act have effect notwithstanding anything inconsistent with those provisions contained in the Assessment Act (other than Part IVA of the *Income Tax Assessment Act 1936*) or in any Act imposing Income Tax.

Section 3(1) of the *Agreements Act* provides that a reference to "Assessment Act" means the *ITAA 1936* or the *ITAA 1997*.

Australia's DTAs have standard Residence Articles which incorporate by reference the domestic rules of each of the Contracting States for determining tax residency.

By way of example, Article 4 of the UK DTA[12] contains the following provisions:

> 1 For the purposes of this Convention, a person is a resident of a Contracting State:
>
> > (a) in the case of the United Kingdom, if the person is a resident of the United Kingdom for the purposes of United Kingdom tax; and
> >
> > (b) in the case of Australia, if the person is a resident of Australia for the purposes of Australian tax.
>
> A Contracting State or a political subdivision or local authority of that State is also a resident of that State for the purposes of this Convention.
>
> 2 A person is not a resident of a Contracting State for the purposes of this Convention if that person is liable to tax in that State in respect only of income or gains from sources in that State.
>
> 4 Where by reason of the preceding provisions of this Article a person other than an individual is a resident of both Contracting States, then it shall be deemed to be a resident only of the State in which its place of effective management is situated.
>
> 5 Notwithstanding paragraph 4 of this Article, where by reason of paragraph 1 of this Article a company, which is a participant in a dual listed company arrangement, is a resident of both Contracting States then it shall be deemed to be a resident only of the Contracting State in which it is incorporated, provided it has its primary stock exchange listing in that State.

When considering the application of a treaty provision, including the Residence Articles of Australia's DTAs, regard needs to be had to the potential impact of the *Treasury Laws Amendment (OECD Multilateral Instrument) Act 2018*, which received Royal Assent on 24 August 2018. The OECD Multilateral Instrument (MLI) does not affect all of Australia's DTAs, notably Australia's treaties with the US and Germany fall outside its ambit. Nor does it cover cross border dealings and structures involving non-treaty countries. Its applicability depends on both treaty partners signing the MLI and agreeing to the treaty clauses to which the MLI will apply. The dates of effect in relation to withholding taxes and other taxes also need to be agreed between the treaty partners and each country needs to make the necessary changes to their domestic law to give the adopted provisions the force of law and ensure reciprocity. Where both countries agree, the MLI modifies but does not directly amend the treaty clauses nominated treaty clauses. If the necessary agreement is not reached the treaty is unaffected by the MLI.

[12] Convention between the Government of Australia and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and on Capital Gains (Canberra, 21 August 2003).

Insofar as currently relevant, Article 4 of the MLI (Dual resident entities) may affect the determination of the country in which a company[13] is resident. In resolving the issue Article 4 allows competent authorities to take account of the enterprise's place of effective management, the place where it is incorporated or otherwise constituted ***and any other relevant factors***. The Article does not specify what the other relevant factors are. In the absence of agreement between the competent authorities Article 4 provides that the company "shall not be entitled to any relief or exemption from tax provided by the Covered Tax Agreement except and to the extent and in such manner as may be agreed upon by the competent authorities of the Contracting Jurisdictions". It would be reasonable to conclude, consistent with the preamble to the MLI and Articles 6 (Purpose of a Covered Tax Agreement) and 7 (Prevention of Treaty Abuse) that the additional factors would include location specific attributes of the company's business and the extent to which substantive economic activities are carried out and create value; and, whether there are any facts and circumstances supporting a conclusion that the claimed dual residence status creates "opportunities for non-taxation or reduced taxation" that are contrary to the object and purpose of the provisions of the Covered Tax Agreement dealing with residency.

It seems a somewhat odd circumstance that the invocation of the Competent Authority process may result in the disallowance of treaty benefits where the competent authorities fail to reach an agreement, an outcome that seems justified only in cases where the objective facts and circumstances support a conclusion that there is treaty abuse.

The concern about dual residency stems from the fact that it can be used as a strategy to take advantage of tax system attributes that are intended to be limited to residents. However, quite apart from the problems associated with cases of dual residency, MNEs still have enormous flexibility in relation to determining the residency of the parent and its various subsidiaries, including through the use of entities in non-treaty countries. Accordingly, the focus of this paper is on the common law concept of "source" and how that is affected by the arm's length principle, that principle, as enshrined in Australian tax law, being relevant to both treaty and non-treaty cases[14].

The term "person" is not defined in Australia's DTAs, which provide that any such undefined term shall, unless the context otherwise requires, take the meaning it has under the law of the country applying the DTA that is relevant to the taxes covered by the DTA (See for example Clause 3.3 of the UK DTA and OECD (2017), *Model Tax Convention on Income and on Capital: Condensed Version* 2017, OECD Publishing at Clause 3.2), notwithstanding that the other Contracting State may use a different definition. The effect of subsections 3(1) and section 4 of the *Agreements Act* (which provide that the *ITAA 1936* and *ITAA 1997* are incorporated into and shall be read as one with the *Agreements Act*) and the definition of "person" in section 995-1 of the *ITAA 1997* is that, unless the context otherwise requires, the term "person" can include a company.

The concept of source is introduced by subsections 6-5(2) and (3) of the *ITAA 1997*. Those subsections provide:

[13] Article 4 of the MLI applies to "a person other than an individual".
[14] Article 9 (Associated enterprises) applies the arm's length principle in treaty cases and Subdivision 815-B applies the principle to both treaty and non-treaty cases.

(2) If you are an Australian resident, your assessable income includes the ordinary income you derived directly or indirectly from all sources, whether in or out of Australia, during the income year.

(3) If you are a foreign resident, your assessable income includes:

(a) the ordinary income you derived directly or indirectly from all Australian sources during the income year; and

(b) other ordinary income that a provision includes in your assessable income for the income year on some basis other than having an Australian source.

Section 6-10 broadly provides:

(1) Your assessable income also includes some amounts that are *not* ordinary income.

(2) Amounts that are *not* ordinary income, but are included in your assessable income by provisions about assessable income, are called *statutory income*.

(3) If an amount would be statutory income apart from the fact that you have not received it, it becomes statutory income as soon as it is applied or dealt with in any way on your behalf or as you direct.

(4) If you are an Australian resident [which would generally include an Australia subsidiary of a multinational group], your assessable income includes your statutory income from all sources, whether in or out of Australia.

(5) If you are a foreign resident, your assessable income includes:

(a) your statutory income from all Australian sources; and

(b) other statutory income that a provision includes in your assessable income on some basis other than having an Australian source.

As discussed below, the amount of any increase in Australian profits as a result of the operation of Australia's transfer pricing rules would be regarded as statutory income, and in some cases is deemed by specific statutory provisions to have a source in Australia. As a practical matter, in the case of an Australian resident company the question of jurisdictional source is not as important because ordinary and statutory income from all sources is taken into account, though other attributes like the ability to obtain a compensating adjustment in another jurisdiction are still important.

In comparing the operation of the arm's length principle and the source principle it is useful as a first step to consider the operation of subsections 6-5(2) and (3) and the relevant parts of section 6-10 of the *ITAA 1997* in isolation from other provisions of the *ITAA 1936,* the *ITAA 1997* and the *Agreements Act* (as incorporated into the Assessment Acts) that require specific amounts to be included in assessable income or taxable income on a basis other than having an Australian source. In the Australian tax system these amounts are generally referred to as statutory income. The concept of "source" is not defined in the domestic law in a way that would give practical certainty to its application. Accordingly, in the first instance, the determination of source is undertaken according to the common law. This approach is reflected in the High Court judgment in *Nathan v Federal Commissioner of Taxation* where

Isaacs J, as he was then, said that the determination of source was "a practical hard matter of fact"; that source is determined by what "a practical man would regard as a real source of income". [15]

In another High Court case, *Mount Morgan Gold Mining Co. Ltd v Commissioner of Income Tax (Q.)*, Higgins J observed that:

> the source from which income is derived or the place where it is earned, is not necessarily identical with the place where the business is carried on.[16]

These cases show that historically Australian courts did not accord primacy (or necessarily relevance) to the place where the business operations that create the means by and from which the income is paid were carried on; the general view of the courts was that this aspect was just one factor that, depending on the particular circumstances of the case, might have to be considered in determining geographical source of income or profits. The weight was placed on legal analysis with little if any room for economic analysis.

In *FC of T v United Aircraft Corporation* (1943) 68 CLR 525 (*United Aircraft*) Rich J elaborated on the judicial approach to determining geographical source:

> "Source" is not a technical term but, as the context shows, is used as a metaphorical expression. "Source" means not a legal concept, but something which a practical man would regard as the real source of income; "the ascertaining of the actual source is a practical hard matter of fact", *Overseas Trust* case (1926) SALR AD 44; *Liquidator Rhodesian Metals Ltd v Commissioner of Taxes* [1940] AC 774 at 789. At p. 788 of the latter case *Studebaker Corporation of Australasia Ltd v Commissioner of Taxation for NSW* 29 CLR 255 is cited by their Lordships without criticism…In *Tariff Reinsurance v Commissioner of Taxes* [1938] 59 CLR 194 at p 208 I explained how I understood the phrase[17] in the following passage:
>
>> This means, I suppose, that every case must be decided on its own circumstances, and that screens, pretexts, devices and other unrealities, however fair may be the legal appearance which on first sight they bear, are not to stand in the way of the court charged with the duty of deciding these questions. But it does not mean that the question is one for a jury or that it is one for economists set free to disregard every legal relation and penetrate into the recesses of the causation of financial results, nor does it mean that the court is to treat contracts agreements and other acts, matters and things existing in the law as having no significance.
>
> As the question to be determined in this case is a question of fact a decision on one set of facts is not binding and is often of little help on another set of facts…[18]

[15] (1918) 25 CLR 183 at pp 188-190
[16] (1922-23) 3 CLR 76 at pp 93-4
[17] The phrase Rich J is referring to relates to the calculation of the assessable income of non-residents that is expressed in the words "derived directly or indirectly from all sources in Australia" which appeared in section 25(1)(b) of the *ITAA 1936* and now appear in subsection 6-5(3) of the *ITAA 1997*.
[18] (1943) 68 CLR 525 at pp 537-8.

This lack of comfort with economic perspectives is understandable given longstanding approaches to legal analysis, but it presents an ongoing challenge in terms of the development of fiscal policy and its effective implementation, a challenge that is discussed further in the latter part of this paper. More recent judicial pronouncements make the point that tax law, as it applies to business, needs to be understood in the fiscal and commercial context in which it has to operate.[19]

It is worth considering the factual context of *United Aircraft* and the deliberations of the three High Court justices because they highlight the varying judicial approaches and the public policy issues that are at play. A number of these issues have since been clarified by legislation and the provisions in DTAs (particularly the fact that royalties "paid out of Australia" are now subject to withholding tax), but it is insightful to understand how the common law handled these issues, particularly the relative influence accorded to economic analysis and legal analysis in the application of the tax law.

The core facts in *United Aircraft* are as follows. A contract was entered into between the US corporation and an unrelated Australian company (the Commonwealth Aircraft Corporation Pty Ltd) in relation to the supply of industrial knowhow for the making of aircraft engines and spare and replacement parts for a period of five years with an option to renew for another five years. The contract purported to confer a "licence" on the Australian company but in fact no licence was granted under the agreement in relation to the current engine in production because the US corporation had no patents in Australia over that version and had no special exclusive right to manufacture that version of the engine in Australia. This was the majority view even though the agreement provided that the right or licence granted was to include the right at all times during the agreement to use within the licensed territory (Australia) any inventions and designs relating to the licensed engine (as well as reciprocal agreements to share free of charge any improvements in the design or construction of the licensed engine) which may from time to time be covered by letters patent, or registered designs or applications therefor owned and controlled by the US corporation. The information was communicated in the US by: the supply of drawings, specifications and all the necessary manufacturing equipment and tools to the agent of the Australian company in New York; the training of six Australian technicians in its US factory; and the provision of a skilled engineer from the US on loan to assist in oversighting the Australian operations, with the relevant remuneration to be paid by the Australian company. The US corporation also agreed to give the Australian company such information and advice as might reasonably be required to enable the manufacture of the engines and spare parts. The payment terms included a lump sum in two instalments and fees based on volumes of production ($500 for each engine produced and 7.5% on the price of all extra or spare parts, payable at the time of manufacture by the Australian company), and was subject to the further requirement that in each six months the licensee should pay $5,000 as a minimum payment, such payments being credited against the final obligation should the liability exceed $5,000 for the relevant six month period (or a minimum of $10,000 per annum) whether or not it manufactured any engines.

It appears that the taxpayer took every care to structure all elements it was required to perform under the contract so as to avoid any territorial connection with Australia that might create a taxing right over the "royalties". It executed the contract in the US and handed over the relevant technical documentation and equipment in the US. It ensured payment occurred in the US in US currency. The US corporation did not obtain any patent or registered design

[19] *Chevron Holdings Pty Ltd v Commissioner of Taxation* [2017] FCFCA 62 at [3] per Allsop CJ.

in Australia in relation to the documents and technical information pertaining to the version of the engine the subject of the agreement. Skilling of Australian engineers was done in the US. The Australian company paid the US engineers that were loaned to assist the production and testing of engines in Australia.

Latham CJ took the view that Australia's tax law at the time regarded income as being derived from property or from personal exertion (the work of persons or acts done by persons) and in his view these categories were comprehensive so far as Australian tax law was concerned; he had "not been able to think of any sources of income other than property and acts done". He concluded that the agreement between the parties was for the communication of information, and he was "unable to regard [this] as constituting a transfer of property". Prior to the agreement the US corporation had no property in Australia, and in his view the performance of the contract did not vest in the US corporation any property in Australia. He also concluded that the US corporation did not derive money from the manufacture of engines. In his view: "If such a person, being a company, has no servants or agents in Australia, it cannot…derive income from any acts done in Australia".[20]

The Chief Justice's analysis seems to turn on three key concepts. The first of these is his view that income from property and income from personal exertion exhaustively define the sources of income. Secondly, the legal definition of "property" in his view excludes certain contractually based income flows. The third (allied to the first and second) seems to be that it is the place where the right to receive a contractually based income stream is created that is the critical determinant of the geographical source of the income stream. This seems to also underpin the taxpayer's strategy of avoiding the creation of any territorial connection with Australia in respect of the creation of the right to receive income. The analysis places no weight on the fact that the contract was in relation to the transfer of commercial knowledge and knowhow with the express intention of enabling its use in the production of aircraft engines and spare parts by an unrelated Australian resident company in Australia. Nor does it place any weight on the fact that under the contract the Australian company licensee was liable to make payments based on that right to use the exclusive knowledge and knowhow to conduct manufacturing, or the volumes of its production of engines and spare parts, despite these facts being key elements in calculating the Australian entity's financial liabilities to the American corporation. The analysis excludes the practical business and economic reality that the use of the conferred rights occurs in Australia, was intended to occur in Australia, and the fact that the whole arrangement envisaged a financial liability arising on the Australian side as source of the funding outflow to America.

Rich J concluded that:

> Although property exists in the plans and drawings etc, supplied to the Australian company the moneys in question, part of the consideration paid to the respondent company, cannot be regarded as derived from property used by the latter company or on its behalf in Australia. Those moneys were derived not from the pieces of paper, but from the supply in America of the information recorded on the pieces of paper, information which was capable of being used in Australia or elsewhere…Their source may be regarded as substantially the contract…But in relation to the other payments which are called royalties the source as a question of fact should, I think, be regarded ***partly as the contract and partly things done in pursuance of the contract***. These

[20] (1943) 68 CLR 525 at pp 534-537.

> things included – the handing over in America by the American company to the Australian company ***of property*** belonging to the American company; ***the user in accordance with the contract by the Australian company of this property or its rights in the same in Australia***; the payment in America by the Australian company for the user in Australia of this property or the rights therein by that company. I am not prepared to draw from these facts the conclusion that the payment of the so-called royalties was a payment derived from a source in Australia. I think that the relevant facts, including the making of the contract, suggest that these payments had an American and not an Australian source. And the fact that the moneys were called royalties or were to be paid into what was called a royalty account does not alter the character of the moneys or affect the source from which they came…[21] [Emphasis added.]

While Rich J is of the view that the exclusive knowledge and knowhow is "property" and that the payments termed "royalties" arose due partly from the transfer of that knowledge and knowhow and in part from its use in Australia, he seems to imply that, in the final analysis, the use of property in Australia was not relevant to the determination of the geographical source of the royalties. He bases his judgment on the other evidence, in particular the locus of the making of the contract, the jurisdiction where the exclusive knowledge and knowhow was made available to the Australian company, and the fact that the relevant payments were "made" in America. Like Latham CJ, he seems to be placing the decisive impact on the locus of the creation of the right to receive the income stream, though he adds to that the fact that the payments were made in America, his emphasis seemingly being on the place of receipt (America) rather than the geographical and financial source of the payments (Australia).

Williams J came to a different conclusion. Having carefully analysed the agreement and the steps in performance of the agreement that had taken place in the US he made the following observations:

> …A decision as to the locus of the source upon one set of facts, although it may be authoritative for any principles of law which may be laid down, is no authority for determining the fact of source upon other or different facts. To adopt the words of the Chief Justice in *Tariff Reinsurances Ltd v Commissioner of Taxes* (Vic) [1938] 59 CLR 194 at p 205:
>
> > It is a question of fact whether income (or profits) is derived from a particular country. In *Federal Commissioner of Taxation v W. Angliss & Co Pty Ltd* my brother Starke sets out and examines a number of cases which have dealt with this subject. It is there shown that the question which arises is really a question of fact and that no absolute rule of law can be stated the application of which will make it possible to determine all cases.[22]
>
> The question is whether, in these circumstances, the source of the payment of the royalties to the American corporation ***in a practical business sense*** is the making of the agreement in America and the acts done by the American corporation in the performance of the agreement in America ***or*** the manufacture of the engines in Australia in the manner contemplated by the agreement ***or*** partly one source and partly the other. On each occasion that the Australian company manufactures an

[21] (1943) 68 CLR 525 at pp 539-540.
[22] (1943) 68 CLR 525 at p 545.

engine, it uses in Australia information supplied to it by the American corporation for use in Australia subject to the payment of a royalty for the use of the information on that occasion.[23] [Emphasis added.]

…The whole conventional basis of the agreement is that the American corporation has made the Australian company the usufructuary in Australia for a limited period of knowledge which is capable of being regarded, at least in a business sense, as the property of the American corporation. It is the valuable knowledge "which represents, so to speak, the capital fund which produces the income" *Nathan v Federal Commissioner of Taxation* [1918] 25 CLR 183 at p 189. To adopt the words of Rowlatt J (as he then was), in *British Dyestuffs Corporation* [129 L.T. 538] the American corporation "is using the property and taking an annual return from it". This profitable use is in Australia. If royalties have to be paid ***from Australia*** in respect of the exercise in Australia of a licence to use a process here, it is difficult to understand why, in a practical business sense, the royalties should be regarded as derived from a source in Australia if the process is patented, but as not so derived if it is not…[24]

In *British Dyestuffs Corporation* (supra) Rowlatt J (as he then was), treated the patents and the secret processes as being on the same footing. He said at p 542 "the real essence of it is this, that you have got here patented and secret processes; you can use them in this territory and in that territory…and all that has been done here is to use this American company practically as a licensee." In each case, as was pointed out by Phillimore J (as he was then), in *Delage v Nugget Polish Co. Ltd.* [92 L.T. 682] at p 685, the recipients are receiving a sum of money…"which they only gain because profitable work has been done in this country or because work has been done in this country."[25]

Williams J then noted the comments of Lord Halsbury in *Commissioners of Inland Revenue v Muller & Co's Margarine Ltd* [1901] AC 217 at p 236 to the effect that the goodwill of a business is not simply local unless the business is confined to a particular spot. The clear inference is that the goodwill of the United Aircraft Corporation should take account of its ability to exploit its exclusive knowledge and knowhow in other markets, like Australia.[26]

His Honour then goes on to say:

The present case is, in my opinion, distinguishable on its facts from any of the cases that were cited to us. The closest case on its facts is the *Tariff Re-insurance* case (supra). In that case it appeared that an Australian company carrying on the business of insurance in Australia took out a policy in England with an English company insuring itself against part of its risks. It was held the premiums paid to the English company were not derived by it from a source in Australia, and that the facts that the Australian company's business was an insurance business and that the premiums paid to the English company were measured by the premiums received by the Australian company did not alter that position. The fact that in that case the locus of the making of the contract of insurance with the English company was regarded as the source of the premiums does not, in my opinion, throw any light upon the source of the

[23] (1943) 68 CLR 525 at pp 549-550.
[24] (1943) 68 CLR 525 at p 550.
[25] (1943) 68 CLR 525 at p 550.
[26] (1943) 68 CLR 525 at p 551.

> royalties paid to the American corporation in the present case as consideration for allowing its manner of manufacture to be worked in Australia. Furthermore, especially since a separate consideration was paid to the American corporation for entering into the contract, I can see no reason why the whole of the royalties should not be attributed to an Australian source.
>
> The royalties payable on extra or spare parts are, of course, in a similar position to the royalties payable on the manufacture of the engines.[27]

Both Rich J and Williams J, unlike Latham CJ, were prepared to regard the rights that the United Aircraft Corporation held in its exclusive knowledge and knowhow as falling into the category of "property", and Williams J's judgment sets out the rationale to support that evolution of the common law. Rich J, however, despite acknowledging that *the user in accordance with the contract by the Australian company of this property or its rights in the same in Australia* was part of the causation for the payment of the royalty streams, did not see this feature as outweighing the circumstances that: the contract was concluded in America; the steps taken by United Aircraft Corporation to implement the transfer of the exclusive knowledge and knowhow all occurred in America; and payments were made in America.

Williams J saw the decision in relation to source as involving a choice between the making of the agreement in America and the acts done by the American corporation in the performance of the agreement in America ***or*** the manufacture of the engines in Australia in the manner contemplated by the agreement ***or*** partly one source and partly the other. He puts more weight on the locus where the exclusive knowledge and knowhow is actually used in production, and the fact that payments were flowing from Australia, rather than the preliminary stages of making the contract and making that knowledge and knowhow available to the Australian company. To his mind the royalty payments were inextricably bound up with the production occurring in Australia, namely the economic use of the knowledge and knowhow to create a business, that use in the context of that business, which in turn provides a metric and a funding source for the royalty payments that flowed from Australia. In his view these practical business considerations led to the conclusion that the source of income was Australia.

It is not suggested that *United Aircraft* raises issues of global profit shifting; the parties to the arrangements were independent of each other and were dealing at arm's length. However, it is relevant to how Australia's source rules may be vulnerable to tax planning in arm's length transactions.

The different lines of reasoning in *United Aircraft* demonstrate that the common law does not provide a predictable basis for the determination of the source of business profits, were the issue to be confined to the application of common law principles. The case emphasises the need for rules that can operate on the basis of objective criteria that have due regard to the nature and extent of any economic connection with Australia, the economic and commercial context in which the business profits are generated, and the functions performed, risks assumed and assets used in generating those profits. Because such rules have regard to economic and business practicalities of global businesses and markets, they are more robust

[27] (1943) 68 CLR 525 at pp 551-552.

against the possible manipulation, misapplication and uncertainty in the common law concept of source.

Reducing the uncertainty in the source principle

Legislative clarity regarding the calculation of assessable income and taxable income

The Australian approach to the uncertainties in the common law concept of source has been twofold. The general approach of Australian courts has been to determine the issue in accordance with the common law, an issue that remains relevant where the common law approach can still be applied. However, as mentioned above, there are some situations in which provisions of the domestic tax legislation (including DTAs that have been given the force of law in Australia through the *Agreements Act*) either deem certain income to have an Australian source[28], or require certain amounts to be included in either the assessable income or the taxable income of a taxpayer without reference to source. The Associated enterprises articles in Australia's DTAs have the force of law in Australia and specifically provide that any uplift in the profits of an Australian company as a result of the application of that Article "may be included in the profits of that enterprise and taxed accordingly"[29].

Section 815-115 provides a specific link between the uplift in the calculation of a company's profits according to the arm's length principle and the process of calculating its taxable income. The consequence is that any adjustments to assessable income or deductions that flow from the substitution of the actual conditions of the commercial or financial relations between the Australian taxpayer company and an offshore entity with the arm's length conditions become part of the (re)calculation of the Australian taxpayer's taxable income. This is confirmed by section 10-5 of the *ITAA* 1997 which contains a table of provisions that include in assessable income amounts that are not ordinary income, including by virtue of the application of the arm's length principle in Subdivision 815-B. However, these provisions make no reference to "source"; the determination of source is not a precondition to the application of Subdivision 815-B.

The statutory methodology for calculating the "taxable income" of a company is set out in section 4-15 of the *ITAA 1997*, namely adding up all the amounts of "assessable income" for the income year and deducting the total "deductions" for that year. The result is the taxable income. The assessable income is made up of "income according to ordinary concepts" (section 6-5 of that Act) and other amounts that are included in assessable income by specific provisions, which are called "statutory income" (sections 6-1 and 6-10). Amounts that are exempt from income tax under Commonwealth legislation or are expressly excluded from

[28] See for example ARTICLE 21 (Source of income) in the UK DTA provides that income or gains derived by a resident of the United Kingdom which, under any one or more of Articles 6 to 8 and 10 to 16 and 18, may be taxed in Australia shall for the purposes of the laws of Australia relating to its tax be deemed to arise from sources in Australia. Section 764-5 of the *ITAA 1997* now provides that where a treaty made on or after 28 March 2019 (when the DTA between Australia and Israel was signed) allows income, profits or gains of a person who is resident of a foreign country, or foreign territory to be taxed in Australia, that income and those profits or gains are deemed to have a source in Australia.
[29] See for example ARTICLE 9(1) (Associated enterprises) in the UK DTA. Section 5 of the *Agreements Act* provides inter alia that each provision of the UK DTA has the force of law according to its tenor. Australia's other DTAs have similar wording to clause 9(1) of the UK DTA and have all been given the force of law under various provisions of the *Agreements Act*.

assessable income under the *ITAA 1936 or the ITAA 1997* are not included in the calculation of assessable income (sections 6-1 and 6-20).

Subdivision 815-B was enacted into Australia's domestic tax law as part of the *Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Act 2013* and applies to income years starting on or after 29 June 2013, the date the Act received Royal Assent. For withholding tax purposes the provisions apply in relation to income derived, or taken to be derived, in income years starting on or after that date.[30]

It is useful to start with the description of the object of Subdivision 815-B that appears in section 815-105:

> (1) The object of this Subdivision is to ensure that the amount brought to tax in Australia from cross-border conditions between entities is not less than it would be if those conditions reflected:
>
> (a) the arm's length contribution made by Australian operations through functions performed, assets used and risks assumed; and
>
> (b) the conditions that might be expected to operate between entities dealing at arm's length.
>
> (2) The Subdivision does this by specifying that, where an entity would otherwise get a tax advantage from actual conditions that differ from arm's length conditions, the arm's length conditions are taken to operate for income tax and withholding tax purposes.

While the enactment of Subdivision 815-B in 2013 predates the 2015 OECD report *Aligning Transfer Pricing Outcomes with Value Creation*, the recommendations in that report are now incorporated into the July 2017 edition of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations[31]. As can be seen above, the object of the Subdivision is very closely aligned with the OECD's objective of better ensuring that for tax purposes the global profits are allocated between countries in accordance with the economic activities that generate them.

This is reinforced by the following definition in section 815-125 of "arm's length conditions", which are the benchmark for evaluating the actual conditions that operated between the entities in their cross-border dealings:

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[30] Section 815-15 of the *Income Tax (Transitional Provisions) Act 1997* Provides:

> (1) Subdivisions 815-B, 815-C and 815-D of the *Income Tax Assessment Act 1997* apply:
>
> (a) in respect of tax other than withholding tax—in relation to income years starting on or after the date mentioned in subsection (2); and
>
> (b) in respect of withholding tax—in relation to income derived, or taken to be derived, in income years starting on or after that date.
>
> (2) The date is the earlier of:
>
> (a) 1 July 2013; and
>
> (b) the day the *Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Act 2013* receives the Royal Assent.

[31] See the Foreword to *OECD (2017) Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* 2017, OECD Publishing, Paris.

(1) The ***arm's length conditions***, in relation to conditions that operate between an entity and another entity, are the conditions that might be expected to operate between independent entities dealing wholly independently with one another in comparable circumstances.

Most appropriate and reliable method to be used

(2) In identifying the arm's length conditions, use the method, or the combination of methods, that is the most appropriate and reliable, having regard to all relevant factors, including the following:
  (a) the respective strengths and weaknesses of the possible methods in their application to the actual conditions;
  (b) the circumstances, including the functions performed, assets used and risks borne by the entities;
  (c) the availability of reliable information required to apply a particular method;
  (d) the degree of comparability between the actual circumstances and the comparable circumstances, including the reliability of any adjustments to eliminate the effect of material differences between those circumstances.

Note: The possible methods include the methods set out in the documents mentioned in section 815-135 (about relevant guidance material).

Comparability of circumstances

(3) In identifying comparable circumstances for the purpose of this section, regard must be had to all relevant factors, including the following:
  (a) the functions performed, assets used and risks borne by the entities;
  (b) the characteristics of any property or services transferred;
  (c) the terms of any relevant contracts between the entities;
  (d) the economic circumstances;
  (e) the business strategies of the entities.

(4) For the purposes of this section, circumstances are comparable to actual circumstances if, to the extent (if any) that the circumstances differ from the actual circumstances:
  (a) the difference does not materially affect a condition that is relevant to the method; or
  (b) a reasonably accurate adjustment can be made to eliminate the effect of the difference on a condition that is relevant to the method.

There is no requirement in Subdivision 815-B that the entities engaging in cross-border commercial or financial relations based on non-arm's length conditions have to be under common ownership or control. The Subdivision sets out rules that apply generally to cross-border dealings between entities, not merely between entities in treaty partner countries. In this respect the Subdivision follows its predecessor Division 13 of the *ITAA 1936* which used the behaviour of "independent parties dealing wholly independently with each other" as the reference point for determining "the arm's length consideration". It is this formulation which more closely aligns with the objective of aligning the outcomes of commercial and financial relations with those that would be determined by market forces. This is in contradistinction to more limited scope of the Associated Enterprises Article in Australia's DTAs (generally Article 9), which can be explained by their bilateral nature and longstanding treaty practice. However, the establishment of common "control" or "ownership" can be problematical in some cases, especially where the offshore entity is located in a tax haven or a country with strict secrecy rules. The judicial approach to determining "control of a business" in *FC of T v*

Commonwealth Aluminium Corporation Limited[32], which was a prerequisite element for the application of Australia's original transfer pricing rules in section 136 of the *ITAA 1936*, led to the repeal of those provisions and their replacement in 1982 with Division 13, the precursor to Subdivisions 815-A and 815-B. In any event profit shifting does not necessarily rely on common control or ownership. Although, in all cases it relies on non-arm's length dealing, including cases where independent parties collude in a way that distorts the outcomes that would otherwise be produced by market forces and arm's length dealing to the detriment of the Australian revenue.

San Remo Macaroni Company Pty Ltd v FC of T [1999] FCA 1468 is an example of a global strategy to interpose a Swiss corporation, Bigalle SA, controlled by an accountant, between the Italian manufacturer of pasta products and the Australian buyer which charged a mark-up on the price charged by the Italian manufacturer, which had the effect of increasing the price paid by the Australian buyer. Under section 39B of the *Judiciary Act 1903 (Cwlth)* the taxpayer challenged the validity of determinations made by the Commissioner under Division 13 of the *ITAA 1936*[33] to reduce the prices paid to Bigalle SA to the arm's length consideration. In considering the question of whether Bigalle SA and San Remo Macaroni Company Pty Ltd were dealing with each other at arm's length Hill J stated at paragraph 62 of his judgment:

> It was clearly open to Mr Read (the taxation officer) on the material before him to form the view as he did that San Remo and Bigalle were not dealing with each other at arm's length, even if San Remo had no direct financial interest in Bigalle. The fact that Bigalle appeared to be owned and controlled by an accountant, the circumstances of its incorporation, the fact that no attempt was made to renegotiate prices as the Swiss franc appreciated and that what may have been some of the profit to Bigalle was repatriated to San Remo by way of loan all pointed to this conclusion. These facts pointed also to the conclusion that really all that was happening was a reinvoicing arrangement.

It is an accepted canon of statutory interpretation that, in the event of a conflict of laws a specific provision applying to the facts and circumstances of a case will override a general provision of wider application that also applies to those facts and circumstances.[34] It is therefore clear that in cases where non-arm's length dealing has resulted in the understatement of an MNE's taxable profit the specific provisions of Subdivision 815-B would have precedence in the event of any conflict with the general source principle. It is the nature of non-arm's length misallocations of profits that, prior to any adjustment authorised by Subdivision 815-B, the understated amount of profit has avoided the operation of Australia's taxing rules, including the source taxation rule that applies to Australian resident companies. The taxpayer's case is that the relevant amount of profit has its source in a country other than Australia and that the profit is properly regarded as being derived by a non-resident. The determination of the arm's length conditions in accordance with the statutory mechanism set out in Subdivision 815-B provides the statutory basis for the correction of the misallocation, which operates with the statutory framework for the calculation of the resident company's assessable income and taxable income. The ascertainment of that arm's length hypothetical and the determination of the amount of any

[32]*FC of T v Commonwealth Aluminium Corporation Limited* [1980] HCA 28; (1980) 143 CLR 646; 30 ALR 449; 11 ATR 42.
[33] Subsection 136AD(3).
[34]Purcell v Electricity Commission of NSW [1985] HCA 54; (1985) 60 ALR 652; (1985) 59 ALJR 689.

understatement of assessable income and taxable income relies on economic analysis and, where the Subdivision applies, is given legislative priority over the legal analysis relied on by the taxpayer to support the view that the relevant amount of profits has been derived by a non-resident and is not sourced in Australia under subsection 6-5(2) of the *ITAA 1997*. In other words, Subdivision 815-B displaces the common law concept of "source" and replaces it with a legislative framework that results in the determination of an amount of "statutory income" which is included in a resident company's assessable income by operation of section 6-10 of the *ITAA 1997*. More specifically: section 4-15 sets out the method for the calculation of a person's taxable income; section 6-10 provides for the inclusion of amounts of statutory income in a person's assessable income; section 10-5 confirms that amounts related to the application of the arm's length principle in Subdivision 815-B are amounts of statutory income that can be included in a person's assessable income; and section 815-115 provides that the arm's length conditions are to be used in working out an entity's taxable income in place of the non-arm's length conditions.

The question of whether Article 9 of Australia's DTAs is a head of power for making transfer pricing adjustments has long been debated and the enactment of Subdivision 815-A, which was subsequently replaced by Subdivision 815-B, was intended to remove this uncertainty, but did not resolve the treaty question. Interestingly, the description of Subdivision 815-A in section 815-1 states:

> The cross-border transfer pricing rules in this Subdivision are equivalent to, but independent of, the transfer pricing rules in Australia's double tax agreements.

Article 9 of Australia's DTAs have been given the force of law under the *Agreements Act*. The Associated enterprises Articles specifically provide that the understated amount "may be included in the profits of that enterprise and taxed accordingly" [35]. The formulation of that enabling power does not rely on the common law concept of source, nor legislative provisions that deem the source of those profits to be in Australia. Once given the force of law in Australia Article 9 in each of Australia's DTAs is incorporated into and to be read as one with the *ITAA 1997* and the *ITAA 1936* and the provisions of Article 9 are prioritised by section 4 of the *Agreements* Act to have effect notwithstanding anything inconsistent with them in the *Assessment Acts.* The only exceptions to this priority are Part IVA of the *ITAA 1936* and Subdivision 195-C of the *ITAA 1997.* Arguably, this enabling power to include the amount of understated profit in a resident company's assessable income and taxable income is given effect once the relevant calculations are made and the income tax assessment or amended assessment is raised.[36] Arguably, having regard to the overall legislative scheme for the calculation of assessable income and taxable income such amounts could be regarded as falling within the category of "statutory income".

It is noted that subsection 815-40 of the former Subdivision 815-A provides:

> The amount of a transfer pricing benefit that is negated under this Subdivision for an entity is not to be taken into account again under another provision of this Act to increase the entity's assessable income, reduce the entity's deductions or reduce a net capital loss of the entity.

[35] See for example ARTICLE 9 (Associated enterprises) in the UK DTA.

[36] Sections 166 and 167 of the *ITAA* 1936 and section 815-150 of the *ITAA 1997* refer. See also *Tech Mahindra Ltd v Commissioner of Taxation* [2016] FCAFC 130 and *Tech Mahindra Ltd v Commissioner of Taxation* [2017] HCATrans 58.

It is also noted that Subdivision 815-B, which replaces Subdivision 815-A and covers both treaty and non-treaty cases, does not contain a similar specific provision to prevent double taxation, though subsection 6-25(1) of the *ITAA 1997* provides that where the same amount is included in the assessable income by more than one provision the amount is included only once.

There is no specific provision that includes adjustments made under Article 9 of a DTA in the assessable income of a resident company. However, it could be argued on the basis of the reasoning set out above that the Article 9 adjustment is statutory income which is included in the company's assessable income by virtue of section 6-10 of the *ITAA 1997*.

That said, it may be unnecessary to rely on Article 9(1) as a separate head of legislative power for assessment purposes since Subdivision 815-B applies to treaty cases and is designed on the same principles as Article 9(1), albeit it also applies to non-treaty cases.

It is clear from the provisions of Australia's DTAs and domestic transfer pricing provisions that there is no authority to "re-write the accounts" of a company that is the subject of a transfer pricing adjustment. While the OECD Commentary on Article 9 uses the shorthand phrase of "[rewriting] the accounts of an enterprise" it expressly (and appropriately) confines that exercise to taxation authorities and the process of calculating the tax liabilities of associated enterprises.[37] However, there is a policy question as to whether appropriate adjustments should be made to the profit and loss statements and balance sheets to provide a sound starting point for the calculation of profits in subsequent years and to deal with the question of whether the amount of profit covered by the transfer pricing adjustment should be treated as accumulated profits or distributed as a deemed dividend. A full consideration of this question is beyond the scope of this paper, but its resolution obviously entails a recognition of the fact that the profits have already been moved out of Australia. That has consequences for the resident company's balance sheet, particularly if the profit shifting has resulted in the Australian company having to increase its borrowings or payables. It would also seem to require a consideration of whether any policy response would maintain a coherent international tax framework. Beginning with the introduction of Australia's imputation system[38], dividend withholding tax became less important than assuring that the correct amount of company tax was paid. This was reinforced in the negotiation of the Protocol to the Australia/US DTA[39].

[37] OECD (2014) Model Tax Convention on Income and on Capital: Condensed Version 2014, OECD Publishing, Commentary on Article 9 Concerning the Taxation of Associated Enterprises, at page 183.
[38] The Imputation System is contained in Part 3-6 of the *ITAA 1997*.
[40] Protocol Amending the Convention between the Government of Australia and the Government of the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income of 6 August 1982 ([1983] ATS 16), Article 6 paragraph 3.

Specific treaty rules to assist certainty in the sharing of taxing rights

Part of the clarification of taxing rights in relation to income, profits or gains derived by Australian companies and in relation to income streams they pay to non-residents was achieved through the provisions of Australia's DTAs*,* an extensive network that covers 46 treaty partners, including all of Australia's major trading and investment partners. As previously mentioned, Australia's DTAs have been included in the domestic tax law through the operation of the *Agreements Act.* In particular, following the High Court's decision in *FCT v Mitchum* (1965) 113 CLR 401, there was a concern that income of a non-resident in connection with a contract that required the performance of certain services in Australia may not be able to be taxed in accordance with section 25(1)(b) of the *Income Tax and Social Services Contribution Assessment Act 1936-1960* (which was the equivalent of section 6(3)(a) of the *ITAA 1997* cited above) if the income was not determined to have an Australian source under common law. In that case Barwick CJ (with whom Menzies and Owen JJ agreed) stated:

> I do not feel compelled or persuaded by the decision of the Court in *French's Case*[40] to hold that in every case where work forms the consideration for wages or salary paid, the source of the income constituted by the wages or salary is in the place where the work is done.[41]

Mitchum's Case is a resounding echo of cases like *Nathan* and *United Aircraft* (discussed above) that the common law cases on "source" do not create precedent or legal principle but turn on the legal analysis of the facts and circumstances of each individual case.

This inherent uncertainty in the application of the common law concept of "source" led to Australia's treaty practice of negotiating the inclusion a Source of income Article in its DTAs, in a unilateral or bilateral form depending on whether the treaty partner had a similar requirement in relation to the determination of source.[42] These legislative provisions displace the legal analysis typical of the application of the common law concept of "source" with a legislative presumption that the nature and scope of the taxing right conferred on Australia by a DTA carries with it the classification of the relevant income, profits or gains as having a source in Australia. The intention of these provisions was to ensure that the income tax assessment process needed to subject various types of income, profit or gains to tax in Australia was fully effective. This stipulation of a deemed Australian source seems designed to trigger the assessment power in section 6(3)(a) of the *ITAA 1997* (though, for the reason set out above, the statutory income provisions in section 6-10 may also apply on the basis that the relevant amount constitutes "statutory income"). The main point being that the deemed source rules seem directed to ensuring the effective taxation of non-residents, not residents.

The deemed source rules in Australia's DTAs operate where certain income profits or gains derived by a non-resident are taxable in Australia pursuant to the provisions of a DTA (sometimes in a protocol, as is the case with the Australia/Germany and Australia/Russia DTAs). Where the particular DTA does not contain such a deeming provision, because the

[40] (1957) 98 CLR 398; 11ATD 288.
[41] (1965) 113 CLR 401 at 408.
[42] See for example Article 21 (Source of income) in the UK DTA, which is in unilateral form, and Article 27 of the Convention between the Government of Australia and the Government of the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income, which is in bilateral form and is unaffected by the 2001 Amending Protocol.

Contracting States did not agree to its inclusion, the practice has been to include a deemed source rule in the *Agreements Act* as part of the process of giving the relevant DTA the force of law in Australia. This was the fall-back position adopted in relation to the Australia/China DTA (section 11S(2)) and, in relation to the Australia/Taiwan DTA (section 11ZF). Going forward, section 764-5 of the *ITAA 1997* includes a deemed source rule in relation to the Australia/Israel DTA, which was signed on 28 March 2019, and in relation to any DTAs made after that date.

Generally, the deemed source rule in DTAs and in the *Agreements Act* do not apply to Article 9[43]. However, the Australia/France and Australia/Israel DTAs are exceptions. The French DTA expressly includes a reference to Article 9 in Article 21 (Source of Income). In relation to the Australia/Israel DTA (and any subsequent DTA with another country), the deemed source rule in subsection 764-5(1) provides that:

> For the purposes of this Act, income, profits or gains have a source in Australia if:
>
> (a) for the purposes of an international tax agreement, the income, profits or gains are those of a person who is a resident of a foreign country or foreign territory; and
>
> (b) the effect of the agreement is that the income, profits or gains may be taxed in Australia.

Unlike the (legislated) deemed source rule in almost all of Australia's DTA and in sections 11S(2) and 11ZF of the *Agreements* Act, subsection 764-5(1) does not exclude Article 9 and on a plain reading of its terms it seems capable of including that Article within its scope. The corresponding adjustment provisions in Article 9(2) in most of Australia's DTAs seem to support the notion that prior to an adjustment to achieve an arm's length outcome on the Australian side the amount of the understatement is considered to be profits of the relevant counterparty associate in the treaty country.

Including Article 9 in the scope of subsection 764-5(1) is arguably consistent with the purpose of Article 9(1) in addressing any misallocation of profits resulting from non-arm's length conditions operating between the residents of the Contracting States in their financial or commercial relations. Both these aspects carry the implication that prior to any adjustment to address the non-arm's length conditions the profits were "those of a person who is resident of a foreign country", which is a prerequisite for the operation of the subsection. The extension of the scope of the deemed source rule in the French DTA and subsection 764-5(1) to seemingly include income profits or gains attributed to an Australian resident company under Article 9(1) represents a shift from the general treaty provision focussed on non-residents. However, it seems to make sense when one considers that non-residents are generally exempt from Australian tax on income, profits or gains that are not sourced in Australia.[44]

[43] The equivalent Article is Article 10 in the Irish DTA and Article 6 in the Singapore DTA.

[44] Special consideration is needed in cases where an Australian permanent establishment of a non-resident derives foreign income.

As an aside, the bilateral frame of reference implicit in Article 9 does not allow for the practical reality that global tax planning by MNEs can be multilateral and can include countries outside a country's treaty network.

The lack of consistency in treaty practice in relation to deemed source rules is unfortunate but could reasonably be viewed as the inevitable byproduct of bilateral negotiations between countries with different tax systems, differences in treaty practices and different systems of general law. Despite this inconsistency it seems highly unlikely, in the light of the above discussion, to be detrimental to Australia's ability to effectively tax transfer pricing adjustments made in the course of applying the arm's length principle as encapsulated in Article 9 of our DTAs and in Subdivision 815-B.

No doubt, over time the operation of Article 9 and the Source of income Articles in Australia's DTA and domestic law will be considered further in the light of the inclusion of statutory income in Australian assessable income by subsections 6-1 and 6-10 of the *ITAA 1997*, which do not rely on either a common law or deemed legislative "source" as a precondition for their operation, and the decision of the Full Federal Court in *Tech Mahindra Ltd v Commissioner of Taxation* [2016] FCAFC 130. The 2016 decision appears to have settled the issue that DTAs, once they are given the force of law in Australia under the *Agreements Act*, can operate as both a shield (in the sense of conferring benefits on a taxpayer) and a sword (imposing clearly defined tax liabilities over and above those imposed by the domestic law provisions of Australia's tax law)[45]. It is noted that special leave to appeal to the High Court was refused in that case[46], though it is likely that the full extent of its implications (and limits) will be the subject of further litigation. However, on balance the better view seems to be that an increase in a taxpayer's taxable income as a consequence of the operation of the Associated enterprises Article in a DTA would not be able to be effectively challenged in Australia on the basis that, as a general proposition, there was a lack of statutory authority to make that kind of adjustment, though the application of the transfer pricing rules according to their terms and the quantum of an adjustment would continue to be open to judicial review.

From the perspective of how source and residency are treated in DTAs, it is easy to see why at the negotiation stage capital importing countries would want to place significant emphasis on source-based taxation, while capital exporters would want to put the emphasis on residency. However, at the end of the day the ability to reach consensus and settle the final form of a DTA will depend on the overall importance each country attaches to the need for a DTA to facilitate trade and investment relations between the two countries. The reality is that even source taxing rights are shared, though there are some instances where according to general treaty practice exclusive taxing rights are conferred[47]. This allocation of taxing rights between treaty partners brings with it the need for treaty rules regarding the specification of income categories, the circumstances in which each type of income or profits may be taxed and the extent of that taxation; it does not leave the issue to be determined according to the concepts of source and residency as articulated by the common law.

[45] This issue was discussed by Joseph Tranzillo in his article entitled *Double Taxation Agreements: Shield or Sword?* in the Australian Tax Review, Volume 49 No 3, 2020 at 186.
[46] *Tech Mahindra Ltd v Commissioner of Taxation* [2017] HCATrans 58.
[47] Examples include shipping (Article 8 in the UK DTA) and business profits where the residence country enterprise does not maintain a permanent establishment in the treaty partner country (Article 7 in the UK DTA).

It is this greater specification of the bases of taxation that provides sufficient certainty for the countries negotiating the DTA to be able to conclude an agreement on the sharing of taxing rights and the avoidance of double taxation. However, this is not a complete panacea for uncertainty, evidenced by the need for the standard treaty provisions dealing with mutual agreement procedures to resolve conflicts in the application of treaties[48] and the more problematic future-focussed administrative practice of the Australian Taxation Office (ATO) in seeking to conclude Advance Pricing Arrangements[49]. Some of the risks in this latter process stem from the difficulties in stipulating with sufficient reliability the critical assumptions for profit forecasts in a way that makes sense in the context of the full scope of operations that an MNE conducts in Australia and how they fit into the MNE's integrated global value chain. (In fact, it was the manipulation of the contractual allocation of functions, assets and risks between the different parts of an MNE such that profit allocations did not correspond to the value created by underlying economic activity in a particular jurisdiction that necessitated the OECD/G20 review.) The scoping of an APA is an important issue and anomalies can arise if a particular feature of an MNE's operations or structures is analysed in isolation from the context of the MNE's global value chain and markets. Other risks stem from the inherent uncertainty in economic and business forecasts, the level of transparency an MNE is prepared to afford to the ATO and the other tax authority, and the robustness of governance processes on all sides to ensure the arrangement is implemented in good faith in accordance with its terms and the fact pattern on which it is based.

The arm's length principle

The arm's length principle, as articulated in Subdivision 815-B, operates to adjust any understatement of taxable income[50] by an Australian taxpayer, relative to what would have been derived if the parties had adopted conditions in their cross-border commercial and financial relations that would have been adopted in comparable circumstances by independent parties dealing wholly independently (or at arm's length) with each other. A similar articulation of the principle is set out in the Associated enterprises Article in Australia's DTAs and the OECD's Model Tax Convention and 2017 Transfer Pricing Guidelines.

In the application of the arm's length principle it is important to have regard to the core provisions of the Australian tax law that bear on the calculation of taxable income (and hence the "profit" referred to in Article 9(1)). For example, it could be argued that the mark ups of the kind discussed above that San Remo Macaroni Company paid to the interposed Swiss company Bigalle SA are not allowable deductions under section 8 of the *ITAA 1997* on the basis that they are incurred in the pursuit of an objective other than the gaining or producing of assessable income or necessarily incurred in the course of carrying on a business for that purpose. (See *Fletcher & Ors v FC of T* [1991] HCA 42; (1991) 173 CLR 97.) Where the reinvoicing charge is disallowed there is no understatement of profit or taxable income to which Subdivision 815-A or Article 9(2) would apply. The general anti-avoidance provisions in Part IVA of the *ITAA 1936* may also apply to some contrived and artificial arrangements.

The BEPS project and the Associated Enterprises and Business Profits Articles in Australia's DTAs[51] that have been progressively incorporated into Australia's domestic tax law over

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[48] See, for example, Article 26 of the UK DTA.
[49] PS LA 2015/4.
[50] The arm's length principle also allows the adjustment of overstated losses [See paragraph 815-120(1)(c)(ii)].
[51] See, for example, Article 7 (Business profits) and Article 9 (Associated enterprises) in the Convention between the Government of Australia and the Government of the United Kingdom of Great Britain and

many years through the *International Tax Agreements Act 1953* (the *Agreements Act*), have each recognised the longstanding uncertainties in the common law concepts of source and residency. The ongoing strategy in each case has been to provide greater certainty by proportionately allocating business profits, and the corresponding right to tax, in accordance with the extent that economic value has been created in the respective jurisdictions. This strategy is driven by the notion that profit allocation can be regarded as reliable when the outcomes of the commercial and financial dealings between parties reflect market forces.[52] It is implicit in this notion that competition in the marketplace, on the assumptions that it is fair[53] and that parties engage in a way that advances and protects their separate economic interests, is a reliable guide to what constitutes acceptable conditions in the commercial and financial relations between parties, provided the circumstances being compared are comparable. (On a wider perspective, it could be argued that fair competition is the foundation of a market capital system.) It is further assumed that an arm's length profit will be able to be calculated based on arm's length conditions determined in this way. The consequences seen to flow from this approach are that: the tax base of each country can be better protected; and competition is not distorted by some participants getting tax advantages from understating their profits.[54] In this vein the OECD guidance on "transfer pricing"[55] emphasises the importance of comparability analysis, including economic functional analysis, as an essential step in determining what an arm's length amount of profit should be in a particular jurisdiction. Another way of looking at this is to recognise that the arm's length principle carries the unstated assumption that the amount of company tax payable in a particular jurisdiction should be incidental to and consequential on the derivation of an arm's length profit for the functions performed, assets used and risks assumed in that jurisdiction.

A complicating factor in this whole analysis is that countries will sometimes use tax policy settings within their company tax base to achieve broader economic outcomes beyond the raising of revenue, by creating tax incentives with the hope that they will increase the country's competitiveness. One side effect, quite apart from the question of whether such incentives are effective in stimulating or changing business decisions regarding the location of investments, is that the tax base of the country granting such tax incentives is thereby reduced.

Another side effect is that the application of the arm's length principle becomes more nuanced where those incentives impact the calculation of a company's profits. An example of this in Australian tax law is the enactment of section 815-140 of the *ITAA 1997* to ensure that companies can continue to get the benefit of the concessional debt/equity ratios allowed by the thin capitalisation regime[56], but are prevented from using the concessionally high levels of gearing to justify an artificially higher rate of interest, in excess of an arm's length rate, that would entail a further loss of company tax revenue.

Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and on Capital Gains (Canberra, 21 August 2003) AUSTRALIAN TREATY SERIES [2003] ATS 22 (referred to as the UK DTA).

[52] See paragraphs 1.2 and 1.3 of the OECD 2017 Transfer Pricing Guidelines.

[53] The fairness of competition can sometimes be debateable where power is concentrated in one or a few market participants or where a dominant company is owned and supported by a government.

[54] See paragraph 1.8 of the OECD 2017 Transfer Pricing Guidelines.

[55] The OECD 2017 Transfer Pricing Guidelines. The term "transfer pricing" is something of a misnomer, being only one element in the examination of whether profits have been correctly allocated in respect of cross-border dealings.

[56] Division 820 of the ITAA 1997.

A third side effect is the implication tax exemptions and concessions may have in the legal classification of the rights conferred under DTAs. This led to the (ultimately unsuccessful) argument that DTAs merely allocate a right to tax which a treaty partner country may or may not exercise and that the allocation of such treaty rights does not support any further tax imposition on a taxpayer over and above what is available under domestic law[57].

In recent years the practical application of the principle and the public guidance on it have given rise to ongoing disputation between taxpayers and tax administrations to the point where the OECD and G20 countries recently undertook a joint review and agreed to the publication of further guidance[58]. That revision entailed a clarification and further elaboration of the OECD transfer pricing guidelines in relation to Article 9 (Associated Enterprises) of the OECD Model Tax Convention on Income and on Capital (the OECD Model) [59] consistent with the purpose of the arm's length principle that has always been the foundation of that Article. There was no change to the underlying policy. The review was directed to the provision of further explanations of the arm's length principle as the concept was always intended to operate. The review was a reaction to counter the attempted manipulation of the previous OECD guidance by some multinationals that sought to place an over-emphasis on the contractual allocation of functions, assets and risks between group subsidiaries in a way that led to outcomes that deviated from the outcomes one would expect under the arm's length principle. This was because the outcomes the MNEs contended for did not correspond to the value created through the underlying economic activity in a particular jurisdiction. The further elaboration was intended "[to ensure] that the transfer pricing rules secure outcomes that see operational profits allocated to the economic activities that generate them" [60], as was always intended by the arm's length principle. The revisions are now included in the OECD *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017* (the OECD Guidelines).[61]

Use of economic functional analysis to support the application of the arm's length principle

Returning to the exploration of economic functional analysis, this involves an evaluation of what functions were performed, what assets were used and what risks were assumed in each of the jurisdictions involved in the cross-border dealings, taking account of business, market and economic contexts in which those dealings occurred[62]. It is the economic and financial significance of the relative contributions each of these elements makes in each jurisdiction that is important. As the OECD 2017 Transfer Pricing Guidelines state, "Before making comparisons with uncontrolled transactions, it is …vital to identify the economically relevant characteristics of the commercial or financial relationships as expressed in the controlled transaction"[63]. The analysis focusses on what is happening in the real world of the MNE's business, and the real world of each of the component stages of the global value chain. Obviously, this involves identifying those activities or business structures whose impacts are

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[57] See *Tech Mahindra Ltd v Commissioner of Taxation* [2016] FCAFC 130 and [2017] HCATrans 58.

[58] OECD (2015), *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 – 2015 Final Reports*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris.

[59] Ibid at pages 13 to 181.

[60] *Aligning Transfer Pricing Outcomes with Value Creation,* at pages 9 - 10.

[61] The revisions related to transactions involving intangibles, the contractual allocation of risks, the level of returns provided to capital rich MNE group members and other high risk areas like profit allocations based on transactions that are not commercially rational, misapplication of transfer pricing methods and intra-group payments to erode the tax base.

[62] See D.1.2. *Functional analysis* in the OECD 2017 Transfer Pricing Guidelines at pp 51-73.

[63] Paragraph 1.35 of the OECD 2017 Transfer Pricing Guidelines.

purely internal to the group and wash out in the process of consolidating the MNE's financial results and ascertaining what if any economically relevant characteristics they have that would support internal charges in respect of the provision of goods and services between group members. Functions that do not create economic value, for example mere reinvoicing of the kind discussed above in relation to the *San Remo Macaroni* case, are in the final analysis disregarded in the process of determining the arm's length profit that is attributable to a geographical source.

Since the arm's length principle applies with the assistance of economic functional and comparability analysis and in relevant cases increases assessable income or taxable income above what would be determined under the source concept, its operation is inherently different from the way in which the court cases show that the source principle has traditionally been applied.

As can be seen from the *United Aircraft* case, in the application of the common law concept of "source" there was no guarantee that economic aspects would be given any weighting, though one might argue that the reasoning in the minority judgment of Williams J might gain wider acceptance today. However, Rich J in his reference to his earlier judgment in *Tariff Reinsurance v Commissioner of Taxes* [1938] 59 CLR 194 at 208 (cited above) outlines his objection to economists deciding questions of source, saying that they should not be "set free to disregard every legal relation and penetrate into the causation of financial results".

Debates about the different outcomes that can flow from legal, accounting and economic analyses have been long running. In his article *Tax Uncertainty*, Tony Pagone AM KC analysed how these different lenses have impacted on Australian court decisions relating to the classical taxation dichotomy between income and capital[64]. He points out the divergence that can occur between the tax outcomes produced by legal analysis relative to those suggested by economic and accounting analyses. Tax policy analysis, including for example the need to maintain the integrity of key concepts like the capital/income dichotomy, the concept of a taxpayer as a separate entity, assessable income and taxable income, might possibly be another ingredient. Then there is the complexity that there are likely to be competing economic and accounting analyses that, in the final analysis, need to be resolved in the process of determining the tax policy position. At the case level, the conduct of transfer pricing litigation invariably involves the resolution of conflicting positions, not only on the law but also in relation to conflicting economic and accounting evidence. This is not just a matter of ex post facto analysis of court decisions because it can be seen from the different judgments in the *United Aircraft* case (discussed above) that the tension between these different strands of analysis was being debated amongst High Court judges. Given the differing perspectives that have endured over a long period, the policy question is: what relevance should economic and accounting analyses have in deciding tax matters, and more specifically here, in relation to the application of Australia's transfer pricing rules?

The arm's length principle recognises that a group entity may be a separate profit or loss centre with individual characteristics and economically may be earning a profit even when the rest of the MNE group is incurring a loss.[65] Accordingly, in undertaking comparability analysis, including economic functional analysis, it needs to be recognised that some activities and features within an MNE can adversely impact the profits reported for tax

[64] Pagone GT – "Tax Uncertainty" [2009] MelbULawRw 30; (2009) Melbourne University Law Review 886, at section II A *Capital and Income Economic and Accounting Standards versus Legal Analysis*.
[65] Paragraph 1.29 of the OECD 2017 Transfer Pricing Guidelines.

purposes, either in overall terms or in relation to a particular part of the MNE. Examples could include: cases of mere reinvoicing to justify the charging or a margin; the imposition by the MNE of unsustainable financial risks on production entities to offset profits in one part of the MNE with finance costs that benefit another part of the MNE; product design limitations or technology that is less competitive and mean that distribution and after sales services have to work harder than their competitors; the booking of excessive inventories to parts of the MNE; or the supply of technology and knowhow that is overvalued or undervalued in intragroup dealings in order to shift profits between different parts of a MNE. As a corollary it should also be recognised that some parts of a global value chain may be more innovative and efficient than others or enjoy more beneficial local conditions.

In Australia, this objective of ensuring an arm's length return for economic functions, assets and risks is reflected in the objects clause in section 815-105 (cited above).

As discussed above, section 815-125, while non-prescriptive of the method to be used, stipulates that the arm's length conditions need to be ascertained using the most appropriate method or combination of methods. It also stipulates a list of specific factors that need to be taken into account in identifying "comparability of circumstances" for the purpose of undertaking the market benchmarking of independent parties dealing wholly independently (or at arm's length) with each other that is required by the arm's length principle. The list is non-exhaustive and the section requires "all relevant factors" to be taken into account. The list is substantively the same as the OECD list of "economically relevant characteristics or comparability factors" set out in paragraph 1.36 of the OECD 2017 Transfer Pricing Guidelines, though the OECD does not include the catch-all reference to "all relevant factors". In practice, it is very doubtful that the OECD would take exception to the inclusion of other factors if they can be shown to be relevant to the process of determining the comparability of circumstances.

Elements of uncertainty inherent in the arm's length principle

There are some elements of uncertainty that are inherent in the arm's length principle itself. The conceptual basis and practical application of the statutory mechanism in Subdivision 815-B (and in the Associated enterprises Article in Australia's DTAs) is dependent on the identification of a difference between the actual conditions that operate in connection with the commercial or financial relations between the entities, where that difference produces a lower amount of taxable income or a higher amount of tax loss than would be the case if the relevant arm's length conditions operated (subsections 815-115 and 815-120(1) and (2)). As far as the somewhat different treaty language is concerned, there is no substantive difference because an overstatement of a loss would arise because there is an amount of profit that has been understated. This competitive market benchmarking of the taxpayer's behaviour with what independent parties dealing wholly independently with one another might reasonably have been expected to have done is an essential component of the arm's length principle. The uncertainty arises where the dealings being examined are unique, highly integrated across two or more jurisdictions, or there are no comparable independent enterprises, or there is insufficient evidence of what conditions would have been established by independent enterprises in comparable circumstances. Whilst these difficulties are acknowledged by OECD member countries, the solution may lie in methodologies that involve less direct comparisons but are nevertheless consistent with the objective of finding a reasonable approximation of an arm's length outcome based on reliable information.[66]

The Macquarie Dictionary (Revised Third Edition) defines "comparable" as: capable of being compared; worthy of comparison. The Concise Oxford English dictionary (Eleventh Edition) defines it as: able to be likened to another; similar; of equivalent quality. These definitions carry the clear implication that a comparability analysis requires the specification of standards or criteria against which comparability is measured. As discussed above, both the OECD guidance and Subdivision 815-B are predicated on the need to identify by use of all the relevant factors, including the specifically nominated factors, the "comparable circumstances" that will provide a reliable basis for benchmarking.

The OECD guidance explains that "[e]conomically relevant characteristics or comparability factors are used in two separate but related phases in a transfer pricing analysis". [67] The first phase relates to the process of accurately delineating the controlled transaction and the second relates to the process of making comparisons between controlled and uncontrolled transactions in order to determine an arm's length price for the controlled transaction. After listing a number of characteristics or comparability factors, the OECD observes that:

> The extent to which any one of the [comparability] characteristics categorised above is economically relevant in a particular transaction depends on the extent to which it would be taken into account by independent enterprises when evaluating the terms of the same transaction were it to occur between them.[68]

Another part of that analysis of cases where the application of the arm's length principle is difficult would be a consideration of whether, by reference to objective criteria and cogent evidence of the behaviour of independent parties dealing wholly independently (or at arm's length) with each other, the taxpayer's position was commercially rational having regard to all the relevant facts and circumstances.

Section 815-135 requires that in applying the arm's length test as articulated in Subdivision 815-B the identification of the arm's length conditions is to be undertaken in such a way so as best to achieve consistency with the OECD 2017 Transfer Pricing Guidelines[69], a requirement that opens up a debate about the status the guidelines and the respects in which consistency is mandated. However, it seems clear that Australia's transfer pricing rules are aimed at ensuring for tax purposes that taxpayers are subject to taxation on an amount that can fairly be seen as an arm's length return for the economic value they are producing.

At the end of the day, even in cases where the comparability analysis required by subsections 815-115 and 815-120(1) and (2) - or by the terms of an Associated enterprises Article given the force of law in Australia - is faced with practical challenges, the process is directed to the determination of what independent parties dealing wholly independently (or at arm's length) with each other would have done. So how can the arm's length principle be applied in such cases? In that regard the OECD observes that:

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[66] Paragraph 1.9 of the OECD 2017 Transfer Pricing Guidelines.
[67] Paragraph 1.37 of the OECD 2017 Transfer Pricing Guidelines.
[68] Paragraph 1.37 of the OECD 2017 Transfer Pricing Guidelines.
[69] Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, as approved by the Council of the Organisation for Economic Cooperation and Development and last amended on 19 May 2017.

> Independent enterprises, when evaluating the terms of a potential transaction, will compare the other options realistically available to them, and they will only enter into the transaction if they see no alternative that offers a clearly more attractive opportunity to meet their commercial objectives. In other words, independent enterprises would only enter into a transaction if it is not expected to make them worse off than their next best option. (Paragraph 1.38 of the OECD 2017 Transfer Pricing Guidelines.)
>
> All methods that apply the arm's length principle can be tied to the concept that independent enterprises consider the options realistically available to them and in comparing one option to another they consider any differences between the options that would significantly affect their value. (Paragraph 1.40 of the OECD 2017 Transfer Pricing Guidelines.)

While the OECD guidance does not expressly state that it is permissible to ignore an option that independent parties dealing wholly independently (or at arm's length with one another) would not enter, it carries that clear implication. There is no necessary implication that arm's length parties would engage in the actual dealings that are under review. Such a situation is expressly covered by subsection 815-130(4) which provides that where independent parties dealing wholly independently with each other in comparable circumstances would not have entered into commercial or financial relations the identification of the arm's length conditions in such a case is to be based on that absence of commercial or financial relations.

In a similar vein, both the OECD guidance and Subdivision 815-B envisage that it may be necessary to include or exclude a particular condition in relation to an actual transaction in order to achieve comparability with what independent parties dealing wholly independently (or at arm's length) with each other would have done in comparable circumstances.

Paragraph 1.39 of the OECD 2017 Transfer Pricing Guidelines states, in part:

> …differences in economically relevant characteristics between controlled and uncontrolled arrangements need to be taken into account when establishing whether there is comparability between the situations being compared and what adjustments may be necessary to achieve comparability.

Subsection 815-130(3) provides:

> …if:
>
> (a) independent entities dealing wholly independently with one another in comparable circumstances would not have entered into the actual commercial or financial relations; and
>
> (b) independent entities dealing wholly independently with one another in comparable circumstances would have entered into other commercial or financial relations; and
>
> (c) those other commercial or financial relations differ in substance from the actual commercial or financial relations;

> the identification of the arm's length conditions must be based on those other commercial or financial relations.

Subsection 815-125(2) does not prescribe a particular methodology or place any limitations on the types of methodologies that might be available to determine the arm's length conditions, but requires the use of the method or combination of methods that are most appropriate and reliable. Nor does the Associated enterprises Article in Australia's DTAs. The possible methodologies include the traditional transaction methods[70] and the transactional profit methods[71] endorsed by the OECD. However, a special methodology may need to be developed to deal with the complexities of a particular case. The parameter set by subsection 815-125(1) is that the arm's length conditions to be established by the comparison with independent entities must be those that an independent entity dealing wholly independently with other entities would have adopted in comparable circumstances. In that process it seems appropriate to have regard to the statutory objective in section 815-105, which is the end goal to which the comparison is directed.[72]

Consistent with the statutory objective, which is aligned with the OECD objective of aligning transfer pricing outcomes with value creation in the context of applying treaty transfer pricing provisions, it seems appropriate to develop a less direct comparison with the behaviour of independent parties dealing wholly independently with each other, which is nevertheless based on a sound rationale and reliable data. Obviously, in cases where a direct comparison is not possible or practicable, regard would have to be had to characteristics, like size and the nature of the business activity, that would support the conclusion that the selected independent benchmark is the best available and reliable indicator for evaluating the profit performance of the tested entity.

However, given that there is a residual uncertainty in the application of the arm's length principle in such scenarios it is likely to result in litigation. Despite this, it seems unlikely that there would be enough support for a statutory response to reduce this uncertainty.[73] Nevertheless there seems to be sufficient foundation in Subdivision 815-B and the Associated enterprises Articles in Australia's DTAs for the courts and tax administrations to resolve those cases where there is difficulty in applying the arm's length principle.

One final area of residual uncertainty is the approach that Australian courts may adopt in relation to the use of the OECD 2017 Transfer Pricing Guidelines. In some respects their status is assisted by the enactment of section 815-135 which relevantly provides:

> For the purpose of determining the effect … Subdivision [815-B] has in relation to an entity, identify arm's length conditions so as best to achieve consistency with [inter alia] …the Transfer Pricing Guidelines for Multinational Enterprises and Tax

[70] See pages 101 to 116 of the OECD 2017 Transfer Pricing Guidelines.

[71] See pages 117 to 145 of the OECD 2017 Transfer Pricing Guidelines.

[72] See also sections 15AA and 15AB of the *Acts Interpretation Act 1901.*

[73] Compare subsection 136AD(4) of the previous Division 13 of the *Assessment Act 1936* which provided:

> For the purposes of this section, where, for any reason (including an insufficiency of information available to the Commissioner), it is not possible or not practicable for the Commissioner to ascertain the arm's length consideration in respect of the supply or acquisition of property, the arm's length consideration in respect of the supply or acquisition shall be deemed to be such amount as the Commissioner determines.

Administrations, as approved by the Council of the Organisation for Economic Cooperation and Development and last amended on 19 May 2017.

By their nature guidelines cannot cover the facts and circumstances of every case, nor can they be an exhaustive explanation of the entirety of the arm's length principle. In other respects the guidelines may use language that is open to interpretation. Nevertheless, the OECD guidance does contain core elements of general application in transfer pricing cases. Key among these are the factors involved in the determination of comparable circumstances.

Since they have been codified in section 815-105 and subsection 815-125(3) much of the potential uncertainty as to what are the key elements in the transfer pricing analysis has been removed.

That said, it is important that, particularly in cases where the application of the arm's length principle is difficult in relation to the ascertainment of "comparable circumstances", the commercially rational perspective encompassed in paragraphs 1.38 and 1.40 of the OECD 2017 Transfer Pricing Guidelines (quoted above) is endorsed by Australian courts. Were that to prove not to be the case, amending legislation would need to be introduced to stipulate that when determining the arm's length conditions and whether there is a difference between the actual conditions and the arm's length conditions the following factors should be considered:

the options realistically available to the entities at the time they entered into the actual commercial or financial relations;

the extent to which each of the options available at that time enabled each of the parties to meet their commercial objectives; and

the extent to which the actual conditions impacted on the ability of the taxpayer entity to meet its commercial objectives.

Ongoing international support for the arm's length principle

While there is ongoing debate about the ideal international tax system and criticisms of the arm's length principle, it still is the internationally accepted rule for ensuring the conditions that operate in the commercial or financial relations between related parties in different countries do not result in a misallocation of profits that reduces the tax properly payable in one or more countries. It continues to be endorsed by the OECD member and G20 countries.[74]

The wording of Article 9 (Associated Enterprises) of The United Nations Model Double Taxation Convention between Developed and Developing Countries (2017 Update) is identical to Article 9 (Associated enterprises) in the OECD Model Tax Convention[75].

[74] OECD (2017), OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017, OECD Publishing, Paris, page 18 at paragraph 15; OECD (2015), *Aligning Transfer Pricing Outcomes with Value Creation*, Actions 8 – 10 - 2015 Final Reports, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, Executive summary at page 9.
[75] OECD (2014), Model Tax Convention on Income and Capital: Condensed Version 2014, OECD Publishing.

Conclusions regarding the relationship between common law source and the arm's length principle

Both the common law concept of source and the arm's length principle are related to the concept of a separate entity, namely a taxpayer. Notwithstanding the fact that the taxpayer being contemplated in the current discussion is a resident of Australia, and despite the fact that, as discussed above, the assessable income of Australian residents includes ordinary and statutory income from all sources (subject to any specific statutory exclusions), the territorial aspect of common law source is still relevant when the Australian resident taxpayer is a subsidiary of a foreign owned MNE. It can be observed on the basis of the case law cited above that economic analysis was not a dominant feature in determining common law source.

By its very nature profit shifting involves changing or causing the change of the source of income from Australia to another country, whether to reduce Australian tax or to meet other corporate objectives such as cashflow management or hedging financial assets against adverse currency movements. It may also be the result of the misapplication of the transfer pricing rules, perhaps through reliance on incorrect or incomplete data, or a faulty economic analysis, or the need to achieve non-tax corporate objectives like cashflow management. Whatever the reason, the consequence of profit shifting is a reduction in the Australian tax base without reducing the profits of the MNE as a whole. In fact the MNE may obtain an overall benefit in that its tax payments are reduced.

The arm's length principle was developed as a response to the adverse impact that profit shifting has on the tax base of a country and the competitive dynamics between different participants in a market. It does this by allowing the understatement of taxable income or profit at an individual entity level to be adjusted on the basis of open market benchmarking of what individual entities dealing wholly independently (or at arm's length) with each other would have done in comparable circumstances. The impact of the arm's length principle is that it replaces the common law source concept with a statutory principle and negates the outcomes produced by non-arm's length dealings that have resulted in an understatement of Australian assessable income or taxable income or in an overstatement of losses. In some instances it is supported in the income tax assessment process by a deemed source rule that allows resident companies to be assessed on the amount of the understatement on the basis that it has an Australian source[76]; in other cases it is supported by the provisions that prescribe certain amounts to be "statutory income" that is included in assessable income[77].

The application of the arm's length principle as articulated in Subdivision 815-B and Australia's DTAs involves a combined application of legal analysis and economic analysis. It is not an application of economics in an unbounded way. It does not disregard every legal relation and penetrate into the recesses of the causation of financial results, or treat contracts agreements and other acts, matters and things existing in the law as having no significance, as feared by Rich J in the *United Aircraft case*[78] and *Reinsurance v Commissioner of Taxes*[79]. The role of economic analysis is confined by the object, prescription, mechanics and statutory

[76] Subsection 6-5(2) of the *ITAA 1997*, combined with Article 21 of the Australia/France DTA and with section 764-5 of the *ITAA 1997* in relation to the Australia/Israel DTA and later DTAs.
[77] Sections 6-10 and 10-5 of the *ITAA 1997.*
[78] (1943) 68 CLR 525.
[79] [1939] 59 CLR 194 at 208.

language of Subdivision 815-B and Australia's DTAs[80]. However, the arm's length principle elevates the role of economic analysis relative to its status under the common law source principle. It is necessary to take the economic analysis bearing on arm's length comparability into account in delineating the tested dealings and in testing them by reference to the conditions that independent parties dealing wholly independently with each other would have adopted in comparable circumstances.[81]

Given the highly integrated and generally complex structures of MNEs' global value chains and the ever shifting and evolving business strategies and market contexts, it is impossible to exhaustively and authoritatively state the full extent of the arm's length principle and its application. However, there is a reasonable level of confidence that Australia's DTAs and Subdivision 815-B, supplemented by case law and OECD guidance, now provide workable certainty for the great majority of cases. Despite this, international tax has traditionally been a highly contested space and the contested tax liabilities are often quite large`, bringing with it a high likelihood of further litigation. It seems likely that courts will give economic analysis a sharper focus as part of their wider legal analysis, and time will tell how they deal with the OECD's transfer pricing guidance. The biggest challenge will be the need to find answers where direct comparisons to comparable circumstance benchmarks are not possible or practicable.

[80] In other words, Australia's DTAs that have been given the force of law by the *Agreements Act*.
[81] Paragraph 1.36 to 1.39 of the OECD 2017 Transfer Pricing Guidelines and section 815-105 and subsection 815-125(3) of the *ITAA 1997*.