Could an Australian APA be enforced in a court?

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Abstract: An advance pricing arrangement (APA) is generally an arrangement between a taxpayer, the Australian Taxation Office (ATO) and sometimes also a foreign tax authority regarding the income tax treatment of international transactions, agreements or arrangements between related parties or associates. Advance pricing arrangements often represent a compromise between the taxpayer and the ATO where a dispute is resolved by execution of an APA in relation to future years (sometimes bilaterally). Since an APA is a compromise and deals with future years, the outcome may differ from that which would result under arm's length conditions. Taxpayers who wish to enforce such agreements against the ATO will find it difficult to do so through court processes. Disputes over APAs are currently resolved by administrative means, importantly including mutual agreement procedure. This article considers whether taxpayers or the Commissioner of Taxation might also be able to bring such disputes before a court.

Introduction

Advance pricing arrangements (APAs) often represent a compromise between the taxpayer and ATO where a dispute is resolved by execution of an APA in relation to future years (sometimes bilaterally or multilaterally). They are OECD endorsed and have a long history of satisfactory use in Australia. Since they are a compromise and deal with future years, the outcome may differ from that which would result under "arms length conditions". Taxpayers who have a dispute with the ATO over the operation of such APAs, such as whether key assumptions have changed, will find it difficult to resolve such matters through court processes under the law as it currently stands.

This position may be changed if the APA were executed as a deed or issued as a ruling. Neither is current ATO practice, but it is open to taxpayers to make such a request if they wished.

APA defined

The letters APA stand for "advance pricing arrangement" and the expression is not found in the Income Tax Assessment Acts (ITAAs). Such arrangements are, however, the subject of PS LA 2011/1 issued by the Commissioner in March 2011.[1] They are defined there in paras 8 and 9 as:

> "8. An APA is an arrangement that determines, in advance of controlled transactions, an appropriate set of criteria (for example, method, comparables and appropriate adjustments thereto, critical assumptions as to future events) for the determination of the transfer pricing of those transactions over a fixed period of time.
>
> 9. An APA will generally apply for three to five years but may be longer, for example, where the covered international related party dealings continue for a period in excess of five years. An APA can be concluded either unilaterally, bilaterally or multilaterally."

They are also referred to in the OECD literature on transfer pricing. In particular, the OECD publication *Transfer pricing guidelines for multinational enterprises and tax administrations*[2] (OECD Guidelines) mentions them and the procedures to establishing them are discussed in the annexure[3] to the guidelines. They are defined in the glossary to the OECD Guidelines as:

> "An arrangement that determines, in advance of controlled transactions, an appropriate set of criteria (e.g. method, comparables and appropriate adjustments thereto, critical assumptions as to future events) for the determination of the transfer pricing for those transactions over a fixed period of time. An advance pricing arrangement may be unilateral involving one tax administration and a taxpayer or multilateral involving the agreement of two or more tax administrations."

Although the language is slightly different, I do not believe the two definitions are significantly different in effect.

One of the more interesting parts of the OECD Guidelines is the paragraphs dealing with "Possible approaches for legal and administrative rules governing advance pricing arrangements".[4] The OECD there considers a number of approaches a state may adopt to justify a practice of entering into APAs. They are:

(1) para 3 of art 25 of the Model Tax Convention (mutual agreement); an APA is simply a specific mutual agreement between two competent authorities and it may be a case not otherwise provided for under the convention (ie not meeting the arms length pricing requirement otherwise required in other articles);[5] and

(2) local statutes may give a power to administer the tax system, or a power to issue rulings, that may be in general enough terms to extend to APAs.[6]

Both the OECD Guidelines and its annexure make it clear that in the OECD's opinion the mutual agreement procedure is not relevant to a unilateral APA.

Typical terms

PS LA 2011/1 states that the expected terms of an APA would include (the author has made some comments, where appropriate, about what occurs in typical APAs in practice):[7]

(1) the names and addresses of the parties to the APA (the APA is executed by an authorised representative of the taxpayer and the Commissioner);

(2) the international related party dealings covered by the APA (there is generally a statement that the taxpayer "has agreed to calculate the consideration for its related party international dealings in accordance with the arms length principle");

(3) the period and tax years covered by the APA (typically, three to five years);

(4) the agreed transfer pricing methodology and how it is to be applied to the covered international related party dealings, for example, the calculation of gross profit or net operating profit margins (most use the transactional net margin method giving a target net operating profit margin as a percentage of sales for the whole enterprise);

(5) if applicable, the arm's length range agreed under the APA;

(6) a definition of relevant terms which have formed the basis of calculating the transfer pricing methodology (for example, sales, cost of sales, operating profit etc);

(7) the accounting standards on which the financial statements are based (often stated to be AIFRS);

(8) critical assumptions upon which the transfer pricing methodology is based (generally no major business or legislative change);

(9) procedures to be followed if it is necessary to make compensating adjustments (the adjustment fee); and

(10) the taxpayer's consequential obligations as a result of the agreement to the APA (for example, the need to lodge annual reports and the taxpayer's record keeping requirements).

It is fair to say that APAs generally conform to these requirements. They do occasionally also deal with permanent establishment and withholding tax issues. The author is not aware of an APA that has ever been described as an "agreement", or which was executed as a deed, or which was described as a contract.

The APA is generally provided to taxpayers for execution under a covering letter, which will say (in the case of a unilateral arrangement, for instance):

> "Once the APA comes into effect and *(the taxpayer)* has agreed to and complies with its terms, the ATO is administratively bound by the terms of the APA. The APA requires *(the taxpayer)* to comply with particular requirements and depends on critical assumptions being met. If those requirements are complied with and those assumptions met, the Commissioner of Taxation is prevented from imposing any additional income tax on the covered international related party transaction(s) than is payable on the price worked out under the APA."

It is interesting that the letter refers to the Commissioner of Taxation being "administratively bound". Such letters issued under the predecessor TR 95/23 often referred to the ATO considering itself "legally and administratively bound":

> "This letter is issued pursuant to paragraph 13[8] of Taxation Ruling TR 95/23, Income Tax: Transfer Pricing – Procedures for Bilateral & Unilateral Advanced Pricing Arrangements. The ATO considers itself to be legally and administratively bound by the terms of this APA as a consequence of the issue of this letter and your acceptance of the terms as outlined therein."

Status considered

Ruling?

An APA is not a public ruling as contemplated by s 385-5 of Sch 1 to the Taxation Administration Act 1953 (Cth) (TAA),[9] in particular because it does not meet the requirement of s 385-5(3)(b) and state that it is a public ruling. This is so even though it is created consistently with PS LA 2011/1. It is unlikely that any taxpayer would seek to have a public ruling address such commercially sensitive information.

It is also not a private ruling, under s 359-5 TAA, in particular because it does not meet the requirement of s 359-20(1) TAA and state that it is a private ruling.

It is interesting to speculate on whether an APA could constitute a valid private ruling, and indeed whether the Commissioner could be forced to issue a private ruling which dealt with the subject matter contained in a typical APA. A practical issue, however, is that the Commissioner may feel many APAs represent an agreed compromise rather than a verifiably strict application of the law to the relevant facts.

A taxpayer may apply under s 359-5 TAA for a ruling as to whether a provision would apply. The ruling can address any matter involved in the application of the provision.[10] So there would seem no obvious reason why a private ruling could not be issued in relation to the application of Div 815 of the Income Tax Assessment Act 1997 (Cth) (ITAA97) to a taxpayer's future years returns.

Section 359-35 TAA provides that the Commissioner must issue the ruling sought, subject to certain exceptions which are not obviously relevant in the context of an APA:

> "(1) The Commissioner must comply with an application for a *private ruling and make the ruling. However, this obligation is subject to subsections (2) and (3).
>
> (2) The Commissioner may decline to make a *private ruling if:
>
> (a) the Commissioner considers that making the ruling would prejudice or unduly restrict the administration of a *taxation law; or
>
> (b) the matter sought to be ruled on is already being, or has been, considered by the Commissioner for you.
>
> (3) The Commissioner may also decline to make a *private ruling if the matter sought to be ruled on is how the Commissioner would exercise a power under a relevant provision and the Commissioner has decided or decides whether or not to exercise the power."

Of greater possible impact is s 357-110 TAA, which says:

> "(1) If the Commissioner considers that the correctness of a *private ruling or an *oral ruling would depend on which assumptions were made about a future event or other matter, the Commissioner may:
>
> (a) decline to make the ruling; …"

Since APAs invariably provide a way to determine future profits levels, but are heavily dependent on the assumed nature of the business at a future date, it would seem likely that the Commissioner would be able to rely on s 357-110 to avoid being forced to give a private ruling.

Section 357-110 says, of course, that the Commissioner *may* decline to make the ruling. So we still need to determine his likely attitude to such a request.

PS LA 2011/1 does not discuss whether an APA could be issued as a ruling. Interestingly TR 95/23 had a comment on the point. At para 114 of that ruling, the Commissioner said:

> "Where a unilateral APA is completed, the ATO will provide written confirmation of the concluded arrangement between the ATO and the taxpayer. The ATO will not provide a Private Binding Ruling for bilateral or unilateral APAs because such arrangements are not considered to fall within the scope of the Private Binding Ruling System. The ATO would consider itself administratively bound in any event by the terms of an APA providing the taxpayer complies with all the terms and conditions and providing that there are no substantive changes in the critical assumptions."

This was, of course, issued in 1995 when the relevant ruling provisions were less flexible. It may be that the Commissioner's

reluctance at that time was driven by a concern that such rulings would be unable to deal with questions of fact.[11] In *Furse*,[12] Hill J said:

> "First, the decision whether or not the parties to the relevant agreement were dealing with each other in relation to the agreement at arm's length is a question of fact for the tribunal to find. That question was, as I have indicated, vitiated by error. It is not for the Court in determining an appeal on a question of law to find the facts upon which that question of law may depend. More importantly, however, the determination of the arm's length amount is a matter entrusted to the opinion of the Commissioner or, in proceedings before the tribunal, to the tribunal. It is not a matter entrusted to this Court. The Court cannot itself form an opinion in a case where the tribunal has not either formed the opinion at all or where the tribunal's opinion is vitiated by error. The Court's function in relation to opinions is one of Judicial review only, that is to say the Court will review the exercise of discretion to determine whether or not that exercise of discretion has been vitiated by error: *Avon Downs Pty Limited v Federal Commissioner of Taxation* [1949] HCA 26; (1949) 78 CLR 353 at 360."

If the content of an APA was issued as a ruling and a taxpayer acted in accordance with it, the taxpayer would benefit from the Commissioner being bound by it. Subject to facts being incorrect, or inaccurate or misleading information being given to the Commissioner, he is obliged to accept a return lodged by a taxpayer which relies on and reflects the position given in the ruling. It is more puzzling that PS LA 2011/1 does not address the issue specifically. This absence may indicate that the Commissioner would now consider a ruling. He is certainly not prevented from doing so.

A taxpayer who does not act in accordance with the ruling suffers certain consequences (chiefly the risk of a 25% additional tax in the event of adjustment), but these do not include the creation of a right of action by the Commissioner for "breach" of the ruling.

We then have a situation where it is likely an APA is not a ruling, and the Commissioner cannot be compelled to issue it as a ruling.

Contract?

The essential terms of an APA are briefly described above. It is clear that there are two (or more) parties to the document. It is in writing. It is signed by the parties. It is not in the form of a deed (the chief elements of which are the actual description of the instrument, the date, names of the parties, recitals, testatum (for example, "this deed witnesses", or similar statement) and testimonium (execution clause).

The major area of enquiry, then, when trying to determine whether the document created binding contractual obligations between the taxpayer and the Commissioner, is whether there is consideration passing.[13]

From para 18 of PS LA 2011/1, the Commissioner lists the benefits of an APA to a taxpayer:

> "(a) provides a taxpayer with certainty on an appropriate transfer pricing methodology, enhancing the predictability of the tax treatment of the taxpayer's international related party dealings
>
> (b) eliminates or substantially reduces the risk of double taxation arising from international related party dealings (particularly where the APA is bilateral)
>
> (c) is prospective, but methodologies under an APA may be used subject to agreement, to resolve issues in years prior to the APA. For example, a taxpayer may seek an APA following a risk review but prior to an audit commencing, and the APA methodology may be agreed to be applied to years that would otherwise be subject to audit
>
> (d) provides a possible solution to situations where there is no realistic alternative way of both avoiding double taxation and ensuring that all profits are correctly determined and taxed at the appropriate time
>
> (e) provides taxpayers with a more flexible approach to obtaining approval for a novel methodology that is particularly appropriate to their circumstances
>
> (f) reduces compliance cost to the taxpayer by eliminating the risk of transfer pricing risk review or audit and the imposition of penalties by taking a different practical approach to the application of the arm's length principle
>
> (g) reduces the record keeping burden as taxpayers know in advance which records are required to be kept to substantiate the application of the APA approach to ascertaining pricing or profits relating to the covered international related party dealings
>
> (h) allows a taxpayer to predict costs and expenses, including tax liabilities more accurately."

What was the promise made, and the act done in return for it? Has the Commissioner promised not to audit, provided the taxpayer prepares returns on the agreed basis? Query whether this promise is adequate consideration at law.

In addition, it should be noted that the terms of the APA itself are never explicit as to the Commissioner's promise. We must look to other sources for these promises.

They are at most implied from PS LA 2011/1, although query whether the Commissioner is bound in relation to administrative practice by PS LA 2011/1 for taxpayers who enter into APAs, especially by para 148:

> "Where the ATO is satisfied [after reviewing the taxpayer's annual compliance report] that the taxpayer has complied with the terms of the APA, the ATO will make no further contact with the taxpayer other than an acknowledgment letter …"

The relevant undertaking was expressed in slightly different language in TR 95/23 where para 30 stated:

> "The ATO will not make any adjustments, under Division 13 of the Act and/or the relevant provisions of the DTAs, to the TPM used by the taxpayer provided there has been compliance with the terms and conditions of the APA (see paragraphs 147 to 151)."

Arguably, if the Commissioner's undertaking arises under a practice statement or even a public ruling, it is not part of the consideration given for the agreement itself.

The other possible source is the covering letter. It, however, merely recites the Commissioner's belief that he is bound by the arrangement.

In addition, the APA specifically states that the taxpayer agrees to calculate its transfer prices in accordance with the arms length principle. Arguably the taxpayer is doing precisely what it would be required to do absent the APA.

In the face of a probable failure of consideration, taxpayers must consider executing a deed if they wish to have an agreement which can be enforced in court.

Ultra vires?

Even if it the Commissioner entered into a deed (say promising not to amend provided terms are adhered to), there is a question as to whether this is a promise the Commissioner can validly make. The main concern is where the agreement (including the key assumptions on which it usually said to be dependent) is adhered to, but in future years the outcome is not "arms

length" and therefore returns based on it do not meet the requirements of the ITAA.

Any authorisation would likely be found in the so-called general administration power granted in s 8 of the *Income Tax Assessment Act 1936* (Cth):

> "The Commissioner shall have the general administration of this Act."

Although simply expressed, the section has been held to give the Commissioner power "to do whatever may be fairly regarded as incidental to, or consequential upon, the things that the Commissioner is authorised to do by the taxation laws".[14] It would seem arguable that if the Commissioner wished to enter into a deed embodying the terms of an APA he would be able to do so under the general administration power.

Priestly QC has suggested,[15] however, that the principles he draws from the *Fayed* case in the UK[16] indicate care is required to avoid the any agreement being found ultra vires. In particular, he argues that Fayed shows the courts will accept compromises of past debts as within power, but will be reluctant to accept agreements which fix future tax liabilities on an agreed basis, regardless of the actual recorded transactions.[17] He sees a distinction where the ATO are merely giving guidance "as to the tax treatment of a proposed transaction where all relevant circumstances attending the transaction are fully disclosed, even if that guidance involves the (ATO) foregoing tax that might arguably be payable on proper construction of the legislation".[18]

He also expresses the view that agreements with multilateral effect are more likely to be intra vires because they fall under the provisions of the relevant convention.[19] This is consistent with the argument put by the OECD in relation to the source of power for signatory states to enter into bilateral or multilateral APAs (noted above).

The reference to bilateral or multilateral agreements being authorised by the relevant convention requires a consideration of what the conventions and commentaries say, and the status of this material. The discussion that follows considers the position prior to Div 815 ITAA97, and the post-Div 815 position is briefly considered at the end of this part.

The argument put by the OECD is found in paras 4.140 and 1.142 of the OECD Guidelines:[20]

> "4.140 APAs involving the competent authority of a treaty partner should be considered within the scope of the mutual agreement procedure under Article 25 of the OECD Model Tax Convention, even though such arrangements are not expressly mentioned there. Paragraph 3 of that Article provides that the competent authorities shall endeavour to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention. Although paragraph 32 of the Commentary indicates that the matters covered by this paragraph are difficulties of a general nature concerning a category of taxpayers, it specifically acknowledges that the issues may arise in connection with an individual case. In a number of cases, APAs arise from cases where the application of transfer pricing to a particular category of taxpayer gives rise to doubts and difficulties. Paragraph 3 of Article 25 also indicates that the competent authorities may consult together for the elimination of double taxation in cases not provided for in the Convention. Bilateral APAs should fall within this provision because they have as one of their objectives the avoidance of double taxation. Even though the Convention provides for transfer pricing adjustments, it specifies no particular methodologies or procedures other than the arm's length principle as set out in Article 9. Thus, it could be considered that APAs are authorised by paragraph 3 of Article 25 because the specific transfer pricing cases subject to an APA are not otherwise provided for in the Convention. The exchange of information provision in Article 26 also could facilitate APAs, as it provides for cooperation between competent authorities in the form of exchanges of information.
>
> …
>
> 4.142 Some countries lack the basis in their domestic law to enter into APAs. However, when a tax convention contains a clause regarding the mutual agreement procedure similar to Article 25 of the OECD Model Tax convention, the competent authorities generally should be allowed to conclude an APA, if transfer pricing issues were otherwise likely to result in double taxation, or would raise difficulties or doubts as to the interpretation or application of the Convention. Such an arrangement would be legally binding for both States and would create rights for the taxpayers involved. Inasmuch as double tax treaties take precedence over domestic law, the lack of a basis in domestic law to enter into APAs would not prevent application of APAs on the basis of a mutual agreement procedure."

Article 25 to the Model Tax Convention provides:[21]

> "**ARTICLE 25**
> **MUTUAL AGREEMENT PROCEDURE**
>
> (1) Where a person considers that the actions of one or both of the Contracting States result or will result for him in taxation not in accordance with the provisions of this Convention, he may, irrespective of the remedies provided by the domestic law of those States, present his case to the competent authority of the Contracting State of which he is a resident or, if his case comes under paragraph 1 of Article 24, to that of the Contracting State of which he is a national. The case must be presented within three years from the first notification of the action resulting in taxation not in accordance with the provisions of the Convention.
>
> (2) *The competent authority shall endeavour, if the objection appears to it to be justified and if it is not itself able to arrive at a satisfactory solution, to resolve the case by mutual agreement with the competent authority of the other Contracting State, with a view to the avoidance of taxation which is not in accordance with the Convention.* Any agreement reached shall be implemented notwithstanding any time limits in the domestic law of the Contracting States.
>
> (3) *The competent authorities of the Contracting States shall endeavour to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention. They may also consult together for the elimination of double taxation in cases not provided for in the Convention.*
>
> (4) The competent authorities of the Contracting States may communicate with each other directly, including through a joint commission consisting of themselves or their representatives, for the purpose of reaching an agreement in the sense of the preceding paragraphs." (emphasis added)

It remains the case that art 25, and its various counterparts in Australia's treaties do not contain a reference to the concept of an APA. As noted above, the concept is first found in the OECD Guidelines. The commentary to art 25 does refer to the OECD Guidelines and essentially refers readers to that document: "That report represents internationally agreed principles and provides guidelines for the application of the arm's length principle of which the Article is the authoritative statement".[22]

The question of whether art 25 authorises the creation of an APA then requires a conclusion that the OECD Guidelines form part of the commentary to the Model Tax Convention.

The report referred to was approved by the OECD Council on 27 June 1995 and replaced an earlier report adopted by the OECD Council on 16 May 1979.

The double tax agreement (DTA) is a Schedule to the *International Tax Agreements Act 1953* (Cth) and s 4(1) of that Act provides that "the Income Tax Assessment Act shall be incorporated into, and read as one with this Act." The DTA then becomes part of Australia's domestic law.

Domestic courts are required to apply customary international law in the interpretation of tax treaties. There are a number of Australian authorities for the proposition that interpretation by Australian courts of international treaties should be in accordance with the Vienna Convention.[23]

Pursuant to art 31 of the Vienna Convention, a treaty is to be interpreted "in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in light of its objects and purpose."

In *Thiel's* case, Dawson J (minority) said in relation to art 31:

> "The context includes, in addition to the text, any instrument which was made by one or more parties in connection with the conclusion of the treaty and accepted by the other parties as an instrument related to the treaty. For my part, I do not see why the OECD model convention and commentaries should not be regarded as having been made in connection with and accepted by the parties to a bilateral treaty *subsequently concluded* in accordance with the framework of the model." (emphasis added)

Noting some doubts raised by certain international commentators on whether art 31 applies to commentaries, Dawson J said:

> "I turn, therefore, to Article 32 of the Vienna Convention which allows recourse to be had to supplementary means of interpretation, including the preparatory work of the treaty and the circumstances of its conclusion, in order to confirm the meaning resulting from the application of Art. 31, or to determine the meaning when the interpretation according to Art. 31 leaves the meaning ambiguous or obscure or leads to a result which is manifestly absurd or unreasonable. Whilst the model convention and commentaries may not strictly amount to work preparatory to the double tax agreement between Australia and Switzerland, they are documents which form the basis for the conclusion of bilateral double taxation agreements of the kind in question and, as with treaties in pari materia, provide a guide to the current usage of terms by the parties. They are, therefore, a supplementary means of interpretation to which recourse may be had under Art. 32 of the Vienna Convention."

Edwardes-Ker notes an argument that the scope of art 32 is even wider (at ch 21.01):[24]

> "Under this Vienna Convention Approach, the more supplementary means of interpretation suggest a meaning for a term which conflicts with an apparently clear meaning for a term which conflicts with an apparently clear meaning, the less such means should be ignored – because they suggest that genuine or 'informed' clarity should prevail over apparent clarity.
>
> In practice, even when the application of Article 31 results in a meaning which is apparently clear (i.e. neither ambiguous nor obscure) one can only be certain that such apparent clarity accords with genuine or 'informed' clarity by recourse to supplementary means of interpretation … Typically, therefore, counsel (on both sides) will invoke supplementary means of interpretation to confirm their opposing views on the meaning of a treaty term."

Arguably, the OECD Guidelines represent extrinsic materials permitted to be considered as an aid to interpretation of an international agreement.[25]

We are then left with the perennial question of whether the OECD Guidelines from 1995 are to be incorporated into treaties that predate them.

Edmonds J in *Virgin* suggested that the preferred approach was ambulatory:[26]

> "I have to say that I am of the same disposition in the present case. Lest I be misunderstood, I want to make it quite clear that insofar as Art 3(2) of the Model Convention and its analogue in the Swiss Agreement mandates recourse to domestic law meanings, assuming they exist, cf., *Thiel* 171 CLR at 343 in [29] above, I am firmly of the view that the better and preferred approach should be ambulatory and not static. That was the conclusion reached by the OECD Committee on Fiscal Affairs (1992 OECD Model, Official Commentary on Art 3, para 11), which led to the 1995 amendment to Art 3(2) of the Model Convention to adopt, specifically, the ambulatory approach.
>
> On the other hand, I do not think I have to answer the static/ambulatory question because I am firmly of the view that the term 'the Australian income tax' in Art 2(1)(a) accommodated and encompassed, at the time of the conclusion of the Swiss Agreement, the taxation of capital gains …"

So although not finally settled, it is likely that the extrinsic materials suggesting bilateral and multilateral APAs are authorised by art 23 of the Model Tax Convention will be relevant in interpreting all treaties to which Australia is a party and where the question arises.

The overall conclusion to this point, then, is that there are a number of lines of argument to support a view that an APA expressed as a deed, particularly a multilateral one, would not be ultra vires, even where in future years a review found that the outcome was not "arms length".

Does Div 815 improve the position re "ultra vires"?

It is interesting to consider whether the introduction of Div 815 affects these conclusions.

Subdivision 815-A operates from years beginning 1 July 2004 (retrospectively), but only if you are looking at a treaty country. If there is no treaty, then Div 13 still operates.

Division 13 was repealed by the Bill introducing Subdiv 815-B and both it and Subdiv 815-A cease to operate in respect of years where Subdivs 815-B, 815-C and 815-D operate. Subdivisions 815-B, 815-C and 815-D operate from 1 July 2013 on both treaty and non-treaty partner transactions.

If tax treaties themselves have an independent taxing power in the manner suggested in the Commissioner's SNF appeal statement, then they still operate that way even after Subdiv 815-B. Presumably, such an approach is now less attractive to the Commissioner than one under Subdiv 815-B.

In this note, the operation of Subdiv 815-B will only be considered. Subdivision 815-C deals with permanent establishments, while Subdiv 815-D deals with partnerships and trusts.

The key focus is on s 815-35 ITAA97, which brings OECD commentary into play in the operation of the ITAA in certain circumstances.

It is important at the outset to note the relationship between Subdiv 815-B and the rest of the Act. Unlike Div 13, the Subdivision is self-executing. Section 815-115 ITAA97 provides that:

> "(1) For the purposes covered by subsection (2), if an entity gets a *transfer pricing benefit from conditions that operate between the entity and another entity in connection with their commercial or financial relations:
>
> (a) those conditions are taken not to operate; and
>
> (b) instead, the *arm's length conditions are taken to operate ..."

In general terms, s 815-115 may be described as the "assessing provision" in

Subdiv 815-B on the basis that, where the requirements in s 815-115(1) are satisfied in respect of conditions that operate between the entity and another entity in connection with their commercial or financial relations, s 815-115(2) requires (ie mandates) the arm's length conditions to be used (instead of the actual conditions) in working out (as relevant depending on which subpara of s 815-120(1)(c) ITAA97 applies):

(1) the amount (if any) of the entity's taxable income for the income year;

(2) the amount (if any) of the entity's loss of a particular sort for the income year;

(3) the amount (if any) of the entity's tax offsets for the income year; and

(4) the amount (if any) withholding tax payable in respect of interest or royalties.

In this respect, it is relevant to observe that there is no requirement for the Commissioner to make a determination that s 815-115 applies. Instead, s 815-115(2) will simply apply in working out the above amounts (as relevant) where s 815-115(1) is satisfied. This will be the case (ie s 815-115(1) will be satisfied) where:

- the entity gets *a transfer pricing benefit* (as defined in s 815-120); and
- the *transfer pricing benefit* is obtained from conditions that operate between the entity and another entity in connection with their commercial or financial relations

The explanatory memorandum (EM) goes on to state that "commercial or financial relations" could include (but are not limited to) one or more of the following:

- a single transaction or a series of transactions;
- a practice, understanding, arrangement, thing to be done or not be done, whether express or implied and whether or not legally enforceable;
- the options realistically available to each entity;
- unilateral actions or mutual dealings;
  - a strategy; or
  - overall profit outcomes achieved by the entities.

The EM explains that taxpayers and the Commissioner are expected to identify the particular adjustment item even when using a profit method, unlike Subdiv 815-A, where a formal determination could be made.[27]

Arm's length conditions

The concept of "arm's length conditions" is then critical in understanding the operation of the Subdivisions.

"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."

Where the actual conditions differ from the arm's length conditions, s 815-120(1)(a) will be satisfied. The note to s 815-115 states in relation to the conditions applying in respect of commercial or financial relations, that these "include, but are not limited to, such things as price, gross margin, net profit, and the division of profit between the entities".

Prescribed documents to be used in determining the effect of Subdiv 815-B

Section 815-135 ITAA97 provides that for the purpose of determining the effect that Subdiv 815-B has in relation to an entity, the arm's length conditions (see s 815-125) must be identified so as best to achieve consistency with the documents specified in s 815-135, being:

- unless otherwise prescribed in the regulations to the ITAA97, the OECD Guidelines) (see s 815-135(2)(a) and (4)); and
- a document or part of a document prescribed by the regulations to the ITAA97 for the purposes of s 815-135(2)(b) (see s 815-135(2)(b)).

Additionally, s 815-135(4) provides that the regulations to the ITAA97 made for the purposes of s 815-135(2)(b) may prescribe different documents or parts of documents for different circumstances.[28]

We can see that the OECD material is not imported into the body of the Act. The legislative requirement that the Commissioner give effect to the ITAA provisions "so as best to achieve consistency" with the OECD material certainly reduces the risk that agreeing to outcomes consistent with such material will be found to be ultra vires. Subdivision 815-B does not, however, expressly authorise the creation of APAs and the OECD material relating to APAs is then unlikely to be relevant to the operation of Subdiv 815-B. It seems likely then that s 815-35 would not materially affect a conclusion as to whether a particular unilateral or bilateral APA was ultra vires where the APA terms do not reflect "arm's length conditions".

Administratively binding?

The ATO covering letter referred to earlier in this article contains a statement that the ATO considers itself "administratively bound" by the APA. The expression is not found in tax legislation. It is possible it may refer to *Public Service Act 1999* (Cth) obligations on officers to follow published guidance or personally face penalties. It appears the expression dates from the period before 1992, when there was no formal binding ruling system. The Commissioner issued practice statements and IT rulings to the effect that he would not deviate from administratively binding opinions unless the law changed or a tribunal decision was inconsistent with them. The author is not aware of instances where the Commissioner has failed to honour an APA which is expressed to be administratively binding. The author is, however, unable to identify a principle under which such a failure would be reviewable by a court.

Estoppel?

Is there an argument that the presence of an APA would act as an estoppel against the Commissioner acting inconsistently with that APA? Potentially, the principle of estoppel may provide equitable relief and act to prevent the Commissioner from acting inconsistently to a promise made by him, even in the absence of consideration or a legally binding contract.

Broadly, estoppel can arise in three circumstances: where the courts have ruled on a particular issue (issue estoppel); where there is an agreement between the parties; or where a representation is made by one to another.

In the context of an APA, even if it could not be considered a legally binding agreement, the Commissioner may be bound in equity by the representations made to the taxpayers in the APA.

There are three elements which must be satisfied to give rise to estoppel for a representation made:

- the representation must be made in the context of affecting existing legal rights between the parties;[29]
  that the representation creates or encourages an assumption that a

particular legal relationship or interest would arise or be granted;[30] and

- that it would be unconscionable for the person making the representation to depart from the representation made.

It would be relatively straightforward to identify representations made by the Commissioner in an APA which would give rise to an assumption about the Commissioner's future conduct. It may also be straightforward to demonstrate a detriment to the taxpayer if the Commissioner departs from an APA which would point to the departure being unconscionable. However, in the absence of a legally binding contract, what is more problematic is identifying a legal relationship between the Commissioner and the taxpayer which is affected by the representation made.

In addition, there is considerable difficulty in applying the principle of estoppel to matters of taxation, which has been highlighted by the Full Federal Court decisions of *Day*[31] and *Spassked*[32] in 2007. The courts in each matter followed a long line of authority, identifying an obstacle in applying issue estoppel in the taxation context.

The House of Lords decision in *Hope*[33] succinctly summarised that line of authority stating that "there is a high and frequent authority for the proposition that it is not in the nature of a decision given on one rate or tax that it should settle anything more than the bare issues of that one liability and that consequently, it cannot constitute an estoppel when a new issue of liability to a succeeding year's rate or tax comes up for adjudication".

Accordingly, the Commissioner is obliged by the Act to issue an assessment to a taxpayer relating to a particular year of income. A court determination, relating to a particular issue or event in one taxation year does not act as an estoppel to prevent the Commissioner from his obligation to apply the Act and issue an assessment in a subsequent year of income, based on the information before him.

Although dealing with issue estoppel, the court's reasoning may be applied more broadly to the context of an APA. Where the Commissioner has entered into an APA with a taxpayer in a particular year of income, based on materials and information in his possession at that time, it is unlikely that such an agreement could be said to act as an estoppel against the Commissioner fulfilling his statutory obligation and applying the Act to issue an assessment (even if contrary to the APA) based upon the information available to him at the time of making an assessment.

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1 Previously dealt with under TR 95/23.

2 OECD, Committee on Fiscal Affairs, *Transfer pricing guidelines for multinational enterprises and tax administrations* (OECD Guidelines) Paris, 1995 (as updated in 1997); see para 4.124 et seq for a more detailed discussion of their use.

3 OECD, *Annex: Guidelines for conducting advance pricing arrangements under the mutual agreement procedure ("MAP APAs")* (OECD Annex) 1999. Website at www.oecd.org/dataoecd/10/10/38008392.pdf.

4 OECD Guidelines 1995, paras 4.140 to 4.142.

5 OECD Guidelines 1995, para 4.140.

6 OECD Guidelines 1995, para 4.141.

7 Para 127; broadly consistent with the OECD Annex, 1999.

8 "13. In respect of unilateral APAs the ATO will provide written confirmation of the agreement reached between the taxpayer and the ATO (see paragraph 144)."

9 See also definition of "public ruling" in s 995-1 ITAA97.

10 S 395-5(2) TAA.

11 S 14ZAF TAA; see also TD 96/16.

12 *Re Trustee of the Estate of the Late AW Furse; A/C Jessica N Delaney and A/C Skye Nea Delaney) v FCT* [1990] FCA 470.

13 *Beaton v McDivitt* (1987) 13 NSWLR 162 (CA), McHugh JA at 181; following *Australian Woollen Mills Pty Ltd v The Commonwealth* (1954) 92 CLR 424 at 456-457.

14 B Quigley, "The Commissioner's powers of general administration: how far can he go?", paper delivered to the 24th TIA National Convention — Bright Lights Big City, 12 March 2009, Sydney, at p 1; see also *Grofam Pty Ltd v FCT* (1997) 36 ATR 493.

15 LJ Priestly QC, (2002) 12 *Revenue Law Journal* 40.

16 *Fayed v Clark* [2002] Simon's Tax Cases 910.

17 LJ Priestly QC, (2002) 12 *Revenue Law Journal* 40 at 51; see also M Bersten, "Independence and accountability of the Commissioner of Taxation", paper delivered to the Law Council of Australia Taxation Law Workshop, 9 November 2002, Coolum, at p 13.

18 LJ Priestly QC, (2002) 12 *Revenue Law Journal* 40 at 51.

19 Ibid at 58.

20 See also OECD Annex, 1999, para 7.

21 OECD, *Model tax convention on income and on capital* (condensed version), 2008. Approved by the OECD Council on 17 July 2008 (the relevant concepts in the 2005 version were substantially similar).

22 OECD, *Model tax convention on income and on capital*, 1995, commentary on art 9 at para 1.

23 *See Thiel v FCT* (1990) 171 CLR 338; *Koowarta v Bjelke-Petersen* (1981-1982) 153 CLR 168; *The Commonwealth v Tasmania* (1983) 158 CLR 1.

24 M Edwardes-Ker, *Tax treaty interpretation*, Alfa Print, 1995.

25 *In Roche*, this appears to be accepted by the tribunal; *Roche Products Pty Ltd and FCT* [2008] AATA 639 (22 July 2008) at para 34.

26 *Virgin Holdings SA v FCT* [2008] FCA 1503. Edmonds J again confirmed the relevant principles of treaty interpretation in *Resource Capital Fund III LP v FCT* [2013] FCA 363 at [46] et seq (although note comments by Einfeld J in the Federal Court decision of the first instance in *Lamesa Holdings BV v FCT* 97 ATC 4229 at 4237 where the opposite view was expressed).

27 At 3.16 et seq.

28 No such regulations have been made at the time of writing.

29 *Combe v Combe* [1951] 2 KB 215.

30 *Mobil Oil Australia Ltd v Lyndel Nominees Pty Ltd* [1998] 153 ALR 198.

31 *FCT v Day* [2007] FCAFC 193.

32 *Spassked Pty Ltd v FCT* [2007] FCAFC 205.

33 *Society of Medical Officers of Health v Hope* [1960] AC 551.