

Transfer Pricing: Two ATO court losses lead to tax law changes

Assistant Treasurer Bill Shorten has released a Treasury consultation paper and unveiled a brief one month consultation period leading to a rewrite of Australia's domestic transfer pricing rules. At the heart of the rewrite will be a reconsideration of the application of the internationally accepted arm's length principle, consistency of interpretation with Australia's double tax agreements, and the relevance of the OECD's Transfer Pricing Guidelines in the context of Australian domestic tax law.



In the midst of Victoria's Melbourne Cup public holiday, Assistant Treasurer Bill Shorten released a Treasury consultation paper and unveiled a brief one month consultation period ahead of a re-write of Australia's domestic transfer pricing rules.

At the heart of the rewrite will be a reconsideration of the application of the arm's length principle, consistency of interpretation with Australia's double tax agreements, and the relevance of the OECD's Transfer Pricing Guidelines in the context of Australian domestic tax law.

Separately, the law will be amended to make clear that transfer pricing adjustments can be based on the appropriate articles in Australia's double tax agreements (DTAs) as well as on the domestic rules. This change will be retrospective to 1 July 2004.

The proposed rewrite of the domestic transfer pricing rules (Division 13) is the direct result of two high profile ATO Court losses (Roche Products; SNF Australia). The real issue however, is about competing transfer pricing methodologies - the ATO wants to expand the ability to use profit methodologies, but is severely constrained by the current legislation, and judicial decisions.

The Government claims Division 13 is "out of kilter with international norms", and the rewrite will bring the domestic rules "into

line with international best practice". It is also said the new rules will better integrate the OECD Transfer Pricing Guidelines, but as discussed below, the Guidelines struggle to deal with the real and philosophical conflict between transactional methodologies and profit based methodologies. In short, the OECD Guidelines do not currently provide the level of certainty the Government claims; with the consequence any rewritten Division 13 will not be able to achieve a better result.

Summary

The Press Release and consultation paper are inconsistent in some respects, and in others do not accurately reflect the state of the competing international positions. This makes the consultation process critical. The following highlights our initial observations.

We know

- Division 13 will be re-written;
- Comparability testing at the transaction level will give way to comparability testing at the profit level, at least to some extent and in some manner;
- There will be greater alignment between the domestic rules and the OECD Guidelines; and
- Transfer pricing adjustments will be authorised under the relevant Articles of Australia's double tax agreements as well as domestic law.

We do not know:

- How alignment with the OECD Guidelines will be achieved;
- Whether the OECD hierarchy of methodologies will remain good law in Australia; or
- Whether Australia moves towards a legislated “most appropriate methodology” regime.

Other potential changes

The consultation paper also raises for discussion the following legislative design changes.

- **Self-executing rules:** currently Division 13 operates only when the Commissioner makes a “determination”. This is no longer considered consistent with Australia’s self-assessment regime.
- **Record keeping requirements:** more prescriptive rules should be introduced to mandate the requirement to produce and maintain “contemporaneous documentation”.
- **Documentation penalties:** new penalties would be introduced to counter a failure to meet the record keeping requirements.
- **Time limits for amendments:** the current unlimited period for making transfer pricing amendments may be replaced with a time limit.

This process is all about giving the ATO access to profit based methodologies.

It would appear the rewritten Division 13 will have a prospective application.

But this will be undermined if the ability to use a double tax agreement, as a separate taxing head, is retrospectively “clarified”.

If the OECD hierarchy of methodologies remains effective (at more than a lip service level) then there may be limited consequences, particularly for commodity transactions. (The litmus test will be whether the new rules would produce a different result if the SNF case was decided under the new law.)

It is likely the negotiation of Advance Pricing Agreements (APA’s) will now proceed

solely on a profits basis (except perhaps in the most vanilla of commodity cases). The game changer, particularly for SMEs, is the proposed requirement for them to produce and maintain contemporaneous documentation.

For those with APA’s under consideration or negotiation, expect some delays. For taxpayer’s with ATO audit activity, expect a greater zeal from the auditors, and a stronger preference for profit methods.

For taxpayer’s without adequate documentation, start planning to have it in place.

The arm’s length standard: Australia’s current domestic rules v OECD approach

The arm’s length principle is the global standard for determining whether the transfer prices of international related party transactions are acceptable. However, nations differ in the way the principle is applied.

Australia’s current domestic transfer pricing rules (Division 13) focus on determining the arm’s length **consideration** at the relevant **transaction** level. The OECD looks to the determination of an arm’s length **profit** as the benchmark for international related party transactions.

The different approaches have implications for the choice of methodology to be adopted when seeking to establish that the tested related party transactions meet the arm’s length standard.

The focus of Division 13 on ‘transactions’, drives towards the use of traditional transactional methodologies (comparable uncontrolled pricing (CUP), resale minus, cost plus). Collectively these look to whether the price or margin of the tested transactions are comparable to arm’s length transactions.

Conversely, the focus on profit permits the use of comparable profit methodologies (CPM), where comparability is tested at the profit level, and the underlying individual tested transactions are disregarded.

In the SNF case, the trial judge rejected the use of the Transactional Net Margin Method (TNMM - a form of profit methodology) when seeking to establish the arm’s length consideration for specific transactions in accordance with Division 13.

In that case, the ATO had argued there were no acceptable comparables; therefore none of the traditional transactional methodologies could be applied; and thus the use of a comparable profit methodology was both justified and necessary.

The trial judge did not agree, finding there was a global market for the tested chemical products, and comparable arm’s length prices could be identified. SNF succeeded, being able to demonstrate it did not pay more for the purchased chemicals than an arm’s length price, established by reference to the CUP methodology.

Hierarchy of methodologies

All transfer pricing methodologies seek to establish a comparable against which the tested transactions can be assessed for meeting the arm’s length standard. But different countries hold varying views on the legitimacy and relevance of different methodologies. As a general proposition, European countries favour traditional transactional methods, whilst the USA (and apparently the ATO) favours profit based methodologies.

The OECD Guidelines say “... the selection of a transfer pricing method always aims at finding the most appropriate method for a particular case”. The framework for selecting between methodologies is referred to as the ‘hierarchy of methodologies’. The 1995 Guidelines describe the hierarchy in this way:

“Traditional transaction methods are the most direct means of establishing whether conditions in the commercial and financial relations between associated enterprises are arm’s length. As a result, traditional transaction methods are preferable to other methods.”

[The Guidelines then acknowledged complex circumstances may require use of profit methodologies.]

This clear preference for transactional methods has been watered down a little in the 2010 Guidelines, but still:

"...where, taking account of the [relevant criteria], a traditional transaction method and a transactional profit method can be applied in an equally reliable manner, the traditional transaction method is preferable to the transactional profit method. Moreover, where, taking account of the [relevant criteria] the comparable uncontrolled transfer pricing method can be applied in an equally reliable manner, the CUP method is to be preferred."

The reticence of the majority of OECD member nations to profit methods is quite clearly articulated later in the Guidelines.

"In no case should transactional profit methods be used so as to result in over-taxing enterprises mainly because they make profits lower than the average, or in under-taxing enterprises that make higher than average profits. There is no justification under the arm's length principle for imposing additional tax on enterprises that are less successful than average or, conversely, for under-taxing enterprises that are more successful than average, when the reason for their success or lack thereof is attributable to commercial factors."

And further:

"...it is not appropriate to apply a transactional profit method merely because data concerning uncontrolled transactions are difficult to obtain or incomplete in one or more respects."

Proposed changes

The key thrust of the proposed changes to Division 13 is found in this comment from the consultation paper.

"The revised rules will be broadened from pricing transactions, as is the case currently, to determining an arm's length outcome for the full range of material dealings or arrangements in place between parties that do not deal at arm's length."

How is this to be read? In particular, how is it to be understood where the OECD Guidelines are either going to be specifically incorporated into domestic tax law, or at the very least given some authoritative status.

On one hand, the minimalist view would simply see a relatively minor change, so that focus on 'profit' would be permissible. This change would permit the use of profit methods, but only where traditional methodologies are found inappropriate (i.e. the existing OECD hierarchy of methodologies, as described above, remains applicable). This minimalist approach,

however, seems inconsistent with the 'big bang' nature of the press release and consultation process.

Alternatively, Australia's new domestic law could mandate a sole focus on profits, and effectively circumvent the use of traditional methods. This would move Australia decisively towards the US position, and thus away from the consensus positions in the OECD Guidelines. Such an outcome would make a mockery of better aligning Australia's rules with current international norms. This extreme approach also seems unlikely.

The result is likely to be somewhere in between, with a recommendation from the Ralph Review being resuscitated - "that Australia should introduce a legislative requirement to use the most appropriate methodology, along with guidance on how to determine the most appropriate methodology."

The OECD Guidelines already provide a framework for choosing the most 'appropriate' methodology, so again, perhaps the consultation will be at the lower threshold, considering whether to write this framework into the domestic law, or whether to incorporate it by reference.

Submissions to the consultation process: RSM Bird Cameron is in the process of compiling a submission to the consultation process. This must be lodged by 30 November 2011. Should any clients wish to make points in this regard, please contact your engagement tax partner to have your views reflected.

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