

## The *SNF* case: A fundamental rejection of the ATO's approach to transfer pricing matters

In the first substantive transfer pricing case to be heard by the Full Federal Court, *FCT v SNF (Australia) Pty Ltd* [2011] FCAFC 74 (see 2011 WTB 23 [875]), the ATO's present approach towards transfer pricing matters has been fundamentally rejected.

### The case in a nutshell

By way of background, this case concerns a not untypical Australian taxpayer SNF (Australia) Pty Ltd, a wholly French owned distributor of certain chemical products.

SNF Australia, which sustained trading losses over a protracted period, was subject to a transfer pricing audit by the ATO. During this audit, the ATO determined, using the Transactional Net Margin Method (TNMM), that SNF Australia was insufficiently profitable as

compared to companies with a similar function and risk profile.

On this basis, the ATO attributed SNF Australia's tax losses to the overcharging of SNF Australia by international related parties for the products it distributed in Australia. Accordingly, based on their analysis and approach the ATO raised transfer pricing assessments for approximately \$13m.

The ATO decision was challenged and ultimately appealed by SNF Australia to the Federal Court. Subsequently, the case was appealed to the Full Federal Court by the ATO after the taxpayer was successful at first instance (see *SNF (Australia) Pty Ltd v FCT* [2010] FCA 635, reported at 2010 WTB 29 [1153]).

Before the Full Federal Court, SNF Australia successfully argued that its related party transactions were on an arm's length basis. Therefore, the Court ruled transfer pricing adjustments could not be raised by the ATO.

SNF Australia's principal argument was that the Comparable Uncontrolled Price (CUP) method could be used to demonstrate the arm's length nature of the transactions. That is, the prices paid

for products it acquired from its international related parties were less than those paid by independent third parties that acquired similar products from the SNF group.

In addition, SNF Australia was able to convince the Full Federal Court that its losses were not the result of the SNF group's transfer pricing policies, but rather the result of commercial factors such as a market penetration strategy, management issues and excess sales staff.

### Implications

While the Full Federal Court's decision focused largely on the specific facts and circumstances of the taxpayer, a number of key principles with general application for taxpayers with international related party transactions can be identified. These are discussed briefly below. The case provided an opportunity to clarify a number of further issues. However, during litigation, these have not been pursued by the ATO.

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### **ATO audit approach**

Historically, particularly in the context of small to medium taxpayers, the ATO has frequently relied upon the profitability based TNMM to:

- Decide if taxpayers were to be the subject of transfer pricing compliance action; and
- Determine the arm's length nature of transactions during transfer pricing risk reviews, audits and other transfer pricing related matters.

Therefore, the TNMM has been the cornerstone in guiding the ATO's approach to transfer pricing matters. For example, it has been used to determine when to make transfer pricing adjustments or encourage taxpayers to enter into negotiations for Advance Pricing Agreements.

However, while not ruling on the validity of the TNMM under Australian domestic law, the Full Federal Court dismissed this approach in preference to the CUP method where available. The CUP method, like other transactional based methods, essentially looks at the pricing

of specific transactions of a taxpayer rather than overall levels of profitability. This decision should, if followed, have a significant impact on the ATO's approach to transfer pricing matters going forward. In particular, it will:

- Provide support for loss-making and low profitability taxpayers seeking to defend their transfer prices against the ATO; and
- Require the ATO to move away from merely looking at a taxpayers's overall profitability, to focusing on the actual nature of their international related party transactions. In particular, the specific commercial facts and circumstances applicable to each individual international related party transaction will be far more relevant.

### **Transfer pricing documentation and taxpayers' burden of proof**

The Court's decision has reiterated that in transfer pricing matters, the burden of proof in defending the arm's length nature of international related party transactions rests with the taxpayer.

SNF Australia's success in this case was based on its ability to ultimately provide appropriate transfer pricing documentation, including expert opinion and reasoned support based on the actual commercial realities of the transac-

tions under dispute. Therefore, for taxpayers wishing to defend the arm's length nature of their transfer prices against ATO attack, it is absolutely imperative that they prepare and maintain high quality and commercially relevant transfer pricing documentation.

Further, the Court's decision has emphasised the need to ensure *transfer pricing documentation is not merely prepared on a global basis, but tailored to the specific requirements of each relevant jurisdiction.*

For example, in jurisdictions such as the USA, profit methods such as the TNMM (or Comparable Profits Method as it is called there) are preferred. Accordingly, *transfer pricing documentation based solely on such foreign rules may no longer be able to be applied in Australia without modification.*

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### **Application of the CUP method**

In this case, the ATO argued for an extremely strict interpretation of when valid comparables are available to apply



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the CUP method. For example, the ATO sought to reject the use of any external comparables (i.e. those between 2 parties unrelated to parties to the transaction under review).

This contention was however firmly rejected by the Full Federal Court. The Court preferred a broader approach to comparability looking at the individual characteristics of the transactions including the nature of the property concerned, the functions performed by the relevant entities and the market where the transactions occurred.

**'In this case, the ATO argued for an extremely strict interpretation of when valid comparables are available to apply the CUP method.'**

The Full Federal Court did not however consider that the economic circumstances of the parties or their business strategies would generally play a major role in identifying appropriate comparables. Further, the Court made it clear that potential comparables need not be identical in every possible manner to be valid.

### Double Tax Agreements

There has been some speculation amongst some commentators that recent court decisions in an immigration law context had changed the generally accepted view that Australia's Double Tax Agreements are required to

be interpreted as international treaties in accordance with international law.

The Court's decision in SNF has however confirmed the generally accepted view. Accordingly, primary international interpretative materials such as the OECD Model Treaty Commentary is relevant to their effect in Australian domestic law. However, the Court has not accorded similar status to secondary material such as the OECD Transfer Pricing Guidelines.

However, the Court was not specifically requested to opine on the ATO's long-held view that the Associated Enterprises Article in Australia's Double Tax Agreements constitutes an independent power to make transfer pricing adjustments.

This argument received favourable comment from Middleton J in his decision at first instance. However, it had been abandoned during the case on the basis the ATO and the taxpayer agreed the operation of any such independent power would be no more extensive than available under Div 13 in the circumstances.

This untested matter may provide the ATO with a basis to maintain its present views on persistent loss making companies as well as its approach to this matter more generally despite their rejection by the Full Federal Court.

Uncertainty in the transfer pricing environment will therefore remain until the ATO's position is clarified.

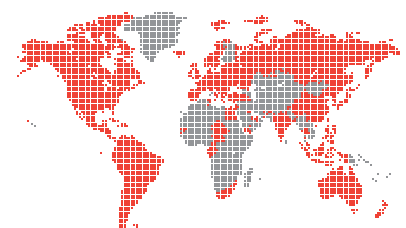
### Uncertainty remains

While this decision has provided further guidance to taxpayers, significant uncertainty remains. It is still open for the Commissioner to seek special leave to appeal the decision to the High Court, maintain a contrary view based on matters not argued before the Federal Court or request Treasury to amend the law.

**'The answer for taxpayers is as always to continue to prepare and maintain high quality, jurisdiction-specific, commercial relevant contemporaneous transfer pricing documentation.'**

Accordingly, at this juncture, taxpayers should review their existing transfer pricing policies and ongoing discussions with the ATO to ascertain their conformity with the SNF decision and its implications.

However, given the current uncertain environment, the clear, pragmatic and fundamental message for taxpayers is to continue to prepare and maintain high quality, jurisdictionally specific, and commercially relevant contemporaneous transfer pricing documentation. This will enable taxpayers to best select and defend their current transfer pricing policies from an increasingly hostile ATO.



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