

Transfer Pricing Update



13 November 2014

ATO's views on transfer pricing reconstruction provisions released

The Australian Taxation Office (ATO) has released TR2014/6, outlining the Commissioner of Taxation's views on the application of the reconstruction provisions contained in Australia's new transfer pricing rules.

After a 6 month consultation process, the release of TR 2014/6 confirms the Commissioner's views on when and how the reconstruction provisions in Section 815-130, of Subdivision 815-B of the *Income Tax Assessment Act 1997 (ITAA)* apply.

The significance of these reconstruction provisions is that they authorise the Commissioner to re-price, reconstruct or disregard a cross border transaction, should it not be considered arm's length (either by reference to comparable third party evidence or hypothesising as to what independent third parties would do in comparable circumstances).

TR 2014/6 offers little comfort to taxpayers that such powers will only need to be considered and addressed in 'exceptional circumstances' as suggested in both

the Explanatory Memorandum to the new Subdivisions 815-B-D and the OECD's *2010 Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (the OECD Guidelines). The construct of TR2014/6 suggests a potentially broader application to transfer pricing compliance requirements.

A recap of the new laws

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This particular update deals with TR 2014/6. Separate KPMG Updates will be made available at a later date in respect of other ATO works currently in progress, including:

- The finalised Ruling and Practice Statements currently in draft on Transfer Pricing (TP) Documentation and penalties (TR 2014/D4, PS LA 3672 and PS LA 3673) and
- Simplification Measures (safe harbours) regarding simplified TP record keeping requirements for particular transactions or taxpayer groups.

A recap of the new laws

Subdivisions 815-B–D require that taxable income be determined based on conditions that would have operated between independent entities dealing at arm's length. These provisions have application to income years beginning on or after 29 June 2013.

These new transfer pricing provisions do this by requiring taxpayers to conduct an analysis to self-assess the extent to which the actual conditions of their international related party transactions differ from the arm's length conditions for those transactions. Where they differ and the difference results in a tax advantage (i.e., a 'transfer pricing benefit'), the arm's length conditions will be taken to operate instead for income tax and withholding tax purposes.

Section 815-130 provides a significant power to the Commissioner as it allows him to effectively disregard the form of the conditions relating to the actual transactions conducted by taxpayers and replace them with 'arm's length' conditions, where:

- the form of the actual commercial or financial relations is inconsistent with the substance of those relations;
- independent entities dealing wholly independently with one another in comparable circumstances would have entered into alternate commercial or financial relations (i.e. being different in substance from the actual commercial or financial relations); or
- independent entities dealing wholly independently with one another in comparable circumstances would

not have entered into commercial and financial relations at all.

Where alternate dealings are used to replace the actual dealings, the analysis will require the ATO to hypothesise an outcome that may have occurred between unrelated parties based on the substance of the actual conditions of the taxpayer. Importantly it is not necessary for the ATO to identify dealings that exactly replicate those of the taxpayer, but merely those alternate dealings that most closely reflect the substance of the modified relations.

Finally, it is worth noting that the powers provided under Section 815-130 only operate to negate a transfer pricing benefit and cannot operate to create a benefit.

TR 2014/6 outlines the Commissioner's views on the application of these reconstruction provisions.

Major concerns previously raised

Submissions identifying concerns and questions regarding the draft ruling were requested and provided to the ATO prior to 30 May 2014. The ATO has subsequently met with representatives of various bodies to work through these identified concerns to finalise the ruling.

KPMG made submissions both in its own right and as a party with other professional bodies. Chief among the concerns in these submissions were:

- the seemingly expansive manner in which the 'substance v form' tests were being evaluated in the original draft ruling.
- the apparent inconsistency between the draft ruling and the OECD Guidelines (which now underpin Australian TP law), which prescribe that reconstruction should only be applied in exceptional circumstances. Specifically the concern was the potentially broader application of the reconstruction powers outlined in the draft ruling (compared to those outlined in the OECD Guidelines).
- the ATO's language in aligning TP dealings with deliberate tax avoidance more likely to attract the attention of the General Anti-Avoidance Rule (GAAR), relating to Part IVA.

A [KPMG Transfer Pricing Update](#) was published in May 2014 outlining KPMG's views on the draft ruling.

Key developments and observations

Whilst TR 2014/6 differs somewhat in content from the draft TR 2014/D3 which it replaces, it differs little in effect. It appears that the ATO has largely resisted making changes to address concerns previously raised. As a result, the ruling will require careful consideration for taxpayers when developing TP policies and documentation in Australia.

Some important observations of TR2014/6 are noted below.

1. 'Exceptional circumstances'?

The ruling states that where arm's length conditions differ to actual conditions, the reconstruction provisions will be applied automatically without the need for the Commissioner's discretion. Furthermore, TR2014/6 suggests that no qualifying analysis is required to assess whether the actual structure impedes the ATO from determining the appropriate transfer price (which is a requirement under the OECD approach) as this is assumed to be the case under the ruling.

This and a number of factors noted below would seem to be at odds with the OECD Guidelines which contemplate that powers of reconstruction should only be used in 'exceptional circumstances'. Additional text has been added by the ATO into the final ruling, to justify the Commissioner's position on this point. Arguably much of this commentary seems only to add to the sense that the Australian rules go beyond the approach contemplated in the OECD Guidelines.

2. Lifting the comparability standard

Through the ruling, the comparability standard has been set very high for taxpayers as TR2014/6 states that the actual conditions must be 'identical' to arm's length conditions for comparability purposes when considering the application of Section 815-130.

This has raised the standard of comparability from the draft ruling and has the potential to substantially increase the number of situations where the reconstruction provisions will apply. This approach would seem to be inconsistent with the Full Federal Court's comments on

comparability in *The Commissioner of Taxation v SNF Australia Pty Ltd [2011] FCAFC 74*. In particular at paragraphs 102-103 the Full Federal Court noted in response to the Commissioner's arguments for a high degree of exactness of comparability, that a "...strict norm of operation..." was not only "inflexible" but also "deeply impractical" and that it was highly unlikely that OECD Guidelines were meant to be applied in such a manner.

3. A broad definition of substance

The ruling seeks to define the concept of 'substance' very broadly and devotes a number of pages to this, suggesting that substance is driven by that which may be considered to make commercial sense. This subjective approach appears to differ to a plain reading of the provisions which appears only to require a factual comparison of the form and substance of the arrangements.

Again, this very broad interpretation adopted in the ruling has the potential to substantially increase the number of situations where the reconstruction provisions will apply.

4. Section 815-130 applies to acts and omissions

In the ATO's view, taxpayers are subject to the reconstruction provisions for both situations where the actual conditions differ from the arm's length conditions and where omissions to act represent departures from arm's length behaviour. Consequently a failure to act in certain situations to bring the actual commercial or financial conditions into line with comparable arm's length conditions will likely be challenged by the ATO.

This may for example, apply to taxpayers not renegotiating existing sales contracts at expiration in cases where offshore marketing entities enter new agreements with those customers. In this example, the Commissioner may argue that an arm's length party would try to renegotiate a local contract rather than 'do nothing' at the expiration of the contract.

5. Section 815-130 applies to existing transactions

The ruling confirms the Commissioner's view that Subdivision 815-B will apply to ongoing dealings that were entered into before 29 June 2013, to the extent that they impact an entity's Australian tax position for income years for which Subdivision 815-B applies. As an

example, this means that the Commissioner may try to use Section 815-130 to deny royalty payments made in respect of a pre-existing sale and license back arrangement entered into prior to Subdivision 815-B coming into effect, should the Commissioner consider that the taxpayer acting at arm's length, would have never have sold the intangibles in the first place.

6. The treatment of debt

Whilst the example provided in the draft ruling to reconstruct the debt as equity under the first exception to the basic rule, has been removed, it has retained its position that the arm's length testing of cross border financial arrangements should be carried out prior to the application of the Thin Capitalisation provisions.

However, TR 2014/6 leaves it open for the Commissioner to challenge debt that has been priced in an arm's length manner but where the taxpayer is not considered sufficiently profitable.

7. Refocusing the examples provided

A number of the examples in the ruling have been modified and/or supplemented to focus on marketing hubs (using the mining industry as the backdrop to the example), transfers of intangibles and loss making companies. Whilst some of these examples are outlined in the Appendix (and therefore not formally part of the ruling nor binding on the Commissioner), these focus areas largely appear in line with current ATO areas of concern and compliance activity.

8. Consequential adjustments

There is no guidance provided in respect of how the consequential adjustment provisions will work, where the reconstruction provisions have been applied. The ATO acknowledges this point in its Compendium of Comments, and also acknowledges that different outcomes could result from different parts of the Act, but indicates this falls outside the scope of TR 2014/6.

9. No guidance on documentation

There is no clear guidance provided to taxpayers as to how they might document defensible positions and meet the contemporaneous documentation requirements. Whilst the ATO has signalled that additional documentation guidance will be provided along with further guidance on the application of penalties in future

rulings and practice statements (highlighted above as other ATO works currently in progress), taxpayers with June year ends have fast approaching tax return lodgement dates. More guidance to assist these taxpayers prepare formal documentation to seek penalty protection would have been helpful and welcome.

What action should you take?

As these new laws are part of the Australian income tax self-assessment regime, the onus lies with the taxpayer to ensure compliance with the laws. Further Public Officers will be required to sign-off on this self-assessment when he or she lodges the annual Income Tax Return. To ensure that transfer pricing policies and associated self-assessment compliance can be supported, taxpayers should:

- Ensure that transfer pricing policies are up to date and well aligned to the commercial and operational objectives. To the extent transfer pricing policies are driven by overseas headquarter operations, active dialogue may be required to explore how the policies may be updated to ensure compliance with Australia's new requirements but also, in other jurisdictions.
- Ensure that agreements are in place that reflect the appropriate conditions and cross-border dealings between entities and contain the appropriate terms that would be expected at arm's length. Many taxpayers may have agreements that were entered into several years ago and whilst seemingly appropriate at the time, may need to be reviewed and updated in light of current law and current commercial operations.
- Ensure that these agreements are consistent with the actual operational and financial dealings. This is crucial to the operation of the reconstruction powers, as differences between the form and substance of inter-company arrangements will bring the taxpayer into the scope of the provisions. From experience this can be a key risk area.
- Ensure that formal transfer pricing documentation is prepared and updated prior to the lodgement of the income tax return to reflect the current operations and dealings, and include the analysis now required under Subdivision 815-B-D (such as considering if or

how Section 815-130 applies or does not apply).

Taxpayers may also consider preparing a compliance plan as to how they might revisit the analysis and documentation to deal with changes or evolutions in the business and intercompany arrangements, as required annually by Subdivisions 815-B-D.

- Ensure that material ongoing dealings that were entered into before 29 June 2013 are reviewed in light of the potential application of the reconstruction provisions in Sections 815-130. Additional work may be required to document positions based on the new rules.
- When implementing new structures or arrangements, taxpayers should consider how best to work with their operations teams in real time to undertake the relevant analysis and prepare the supporting documentation.

If you have any questions or concerns please contact your local KPMG Transfer Pricing representative or the KPMG professionals listed below.

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