

# Transfer Pricing Update

16 February 2015

## ATO's views on record keeping provisions released

On 17 December 2014, the Australian Taxation Office (ATO) released Transfer Pricing (TP) Ruling TR 2014/8, outlining the Commissioner of Taxation's (Commissioner) views on the application of the record keeping provisions in subdivision 284-E of Schedule 1 to the Taxation Administration Act 1953 (284-E) in relation to documenting a taxpayer's compliance with the TP legislation set out in subdivisions 815-B, C and D of the Income Tax Assessment Act 1997 (815B-D).

Australia's TP provisions do not mandate the preparation or keeping of TP documentation, however failing to do so prevents an entity from establishing a reasonably arguable position (RAP). Establishing a RAP is important to help to support the TP position of an entity and significantly lowers administrative penalties in the event of a TP adjustment.

The ATO also released a Practice Statement on TP penalties (PS LA 2014/2) as well as simplified TP record keeping options for taxpayers (PS LA 2014/3).

### Summary of record keeping provisions

#### Questions to be addressed

When addressing the requirements, the Ruling suggests that a documentation framework is established on the basis of five questions for an entity to consider, which exceeds the documentation requirements under the pre-existing four-step process and also goes beyond the Organisation for Economic Co-operation and Development (OECD) standard for TP documentation.

In particular, taxpayers are now required to consider the commerciality of their arrangements and whether the actual conditions that operate in their related-party dealings are comparable with arm's length conditions to ascertain whether there is a difference, which results in a TP benefit. In practice, the required comparison between actual and arm's length conditions will require taxpayers to consider whether the structure of their cross border dealings is in line with commonly observed behaviour between independent parties in the same industry.

Pleasingly for taxpayers, the ATO has provided some level of recognition that the degree of detail and comprehensiveness required depends on the complexity and risk inherent in the TP arrangements. This is in line with the ATO's general strategy to focus its review activity on transactions that are perceived as high risk.

### Reconstruction powers

The Ruling provides additional guidance on how the reconstruction provisions in 815B-130 should be addressed and states that ordinarily the 'basic rule' should apply (i.e. substance and form are consistent).

In general, we would expect the basic rule to apply when transactions/arrangements are widely observed in the relevant industry. Taxpayers with 'high risk' transactions/arrangements (such as lower profitability or unique dealings) would be expected to address the reconstruction provisions and support, inter alia, the commerciality of these.

### Reliance on overseas documentation

Where TP documentation is prepared overseas, the Public Officer of the Australian subsidiary will need to ensure the documentation addresses all the requirements of the new TP law to be eligible for a RAP, including that the entity has full and free access to TP documentation. As such, global documentation prepared in line with the OECD Guidelines will likely need to be supplemented to address the more onerous documentation requirements under 284-E.

### Timing requirements

A key requirement is that the documentation (including all supporting information) must be in place by the time of lodgement of the tax return.

### Penalties

In the event of a TP adjustment, penalties which are assessed as a percentage of the tax shortfall can be levied pursuant to PS LA 2014/2. The penalty percentage would range between 10 percent and 50 percent depending on whether the TP arrangements were entered into with the sole or dominant purpose of avoiding tax in Australia and whether the taxpayer has a RAP. Having a RAP requires both compliance with the

record keeping provisions under 284-E and the general 'as likely as not' RAP test.

There are also certain situations where, with a RAP, the penalty may be reduced below 10 percent, which include in the event of voluntary disclosure and where the Commissioner exercises his discretion.

## Summary of simplification guidance

In recognition of the compliance burden that preparing TP documentation can place on businesses, the ATO has also released new administrative guidance which reduces the TP documentation requirements for certain taxpayers and/or international related party dealings (IRPDs). It can be accessed online from the ATO's homepage: [www.ato.gov.au/Business/International-tax-for-businesses/In-detail/Transfer-pricing/Simplifying-transfer-pricing-record-keeping/](http://www.ato.gov.au/Business/International-tax-for-businesses/In-detail/Transfer-pricing/Simplifying-transfer-pricing-record-keeping/)

### General eligibility criteria

To be eligible for TP documentation relief under the ATO simplification guidance, taxpayers must satisfy general eligibility criteria. Taxpayers will be considered to have failed the general eligibility criteria if one or more of the following circumstances considered to be high risk by the ATO apply:

- 1. Sustained losses** – Applies where a taxpayer has incurred losses for three or more consecutive years including the year for which they are considering applying the simplification guidance.
- 2. IRPDs with specified countries** – Applies where a taxpayer has any IRPDs with specified countries (as defined in the International Dealings Schedule (IDS) such as Cyprus, Jersey, Cayman Islands and Liechtenstein.
- 3. Restructure** – Applies where a taxpayer has undergone a restructuring event during the year.

## Categories of taxpayers/IRPDs eligible

Subject to the satisfaction of the general eligibility criteria above, the ATO has outlined four key categories under which taxpayers and/or IRPDs may be subject to TP documentation relief. However, these categories are also subject to further specific eligibility criteria.

### **Taxpayer categories**

There are two categories under which certain taxpayers can obtain TP documentation relief for all of their IRPDs (excluding loans or capital transactions). These categories are:

- 1. Small taxpayers** – applies where the turnover of the 'Australian economic group' is less than A\$25 million and specified services that make a significant contribution to the group account for less than 15 percent of turnover (either expenses or income).
- 2. Distributors** – applies to wholesale trade businesses where the turnover of the 'Australian economic group' is less than A\$50 million and Profit Before Tax (PBT) is greater than 3 percent of sales revenue.

Taxpayers remain ineligible if any of their IRPDs are broadly associated with royalties, licence fees or R&D arrangements.

### **IRPD categories**

There are two categories under which taxpayers can obtain TP documentation relief for specific IRPDs. These specific IRPDs are:

- 1. Intra group services** – applies to 'routine' service IRPDs of A\$1 million or less; or less than 15 percent of total revenue or expenses of the 'Australian economic group'. Eligible services IRPDs must be priced as cost plus 7.5 percent (or greater) for outbound services (revenue) and cost plus 7.5 percent (or less) for inbound services (expenses).

The ATO has indicated 'specified services' remain ineligible. These services are defined vaguely and include activities that contribute significantly to the creation, enhancement or maintenance of value in the Australian economic group, including financial trading, asset management software development and marketing services.

- 2. Intercompany loans** – Taxpayers can apply the ATO simplification guidance to Australian dollar denominated inbound loans provided the combined balance of these loans (both inward and outward) is A\$50million or less at all times throughout the relevant financial year, and the interest rate is no more than the indicator lending rate for 'small business; variable; residential secured; term, as published monthly by the Reserve Bank of Australia.

This rate is currently 7.1 percent, which can be seen to be generous when compared to current market conditions for some entities. However, in terms of setting the interest rate, taxpayers would still need to reasonably justify the level of interest charged.

### **Obligations remain**

To apply the simplification measures, an entity must assess its compliance with the TP rules. While this may not require formal TP documentation, some level of analysis may be required.

The ATO has stated in PS LA 2014/3 that tax officers will not review the records of entities or IRPDs that have elected to apply the simplification measures, beyond conducting a check to confirm the eligibility of the election. As such, it is recommended that taxpayers document their eligibility of the relevant criteria.

Additionally, the ATO simplification guidance does not obviate the need for a taxpayer to complete and lodge an IDS if their IRPDs are greater than A\$2million for the relevant year. Taxpayers making the voluntary election to rely on the ATO's simplification guidance would inform the ATO of their election through a new disclosure to be included on the IDS.

### **Three year introduction period**

The ATO has indicated that the ATO simplification guidance will be introduced for an initial period of three years (income years commencing from 1 July 2013 and ending 30 June 2016). During this time, the use of the simplification guidance will be carefully monitored by the ATO.

## Overall conclusions

- Overall, the new ATO documentation rules provide useful guidance for taxpayers and generally align with the increased TP expectations that multinational companies are facing globally. Accordingly, it is important that taxpayers take positive and proactive steps to ensure that their TP affairs are documented and supported contemporaneously.
- Taxpayers that rely on global documents that are prepared in accordance to the OECD standard should consider whether the Australian documentation requirements are fully addressed.
- The ATO Simplification Rules are generally very positive and will provide welcome relief for many taxpayers. However, it is important that eligible taxpayers continue to monitor their TP arrangements and their ongoing eligibility for the documentation concession each year.

## Contact us

### **Anthony Seve** **Partner**

+61 3 9335 8728  
aseve@kpmg.com.au

### **David Bond** **Partner**

+61 8 9263 7177  
dbond@kpmg.com.au

### **Frank Putrino** **Partner**

+61 3 9838 4269  
fputrino@kpmg.com.au

### **Tony Gorgas** **Partner**

+61 2 9335 8851  
tgorgas@kpmg.com.au

### **Jane Rolfe** **Partner**

+61 3 9288 6341  
janerolfe@kpmg.com.au

### **Jeremy Capes** **Partner**

+61 2 9335 7873  
jeremycapes@kpmg.com.au

**kpmg.com.au**

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