The new transfer pricing landscape in Australia

What does it mean for you?

Australia's transfer pricing landscape has changed dramatically. The enactment of new transfer pricing laws (the new laws) – part of the biggest overhaul of Australia's transfer pricing rules for 30 years – has been accompanied by the ATO's establishment of a new anti-profit-shifting taskforce and notification of a significant increase in ATO investigations of multinational corporations (MNCs) operating in Australia.

Uncertainty around the ATO's enforcement of the new laws, coupled with increased ATO scrutiny of MNCs' tax structures and transfer pricing practices, means that MNCs need to understand how the new laws apply to them and consider what steps to take to prepare for the possibility of future ATO transfer pricing review.

This article comments on key features of the new laws, the new ATO taskforce, the substantial increase in profit-shifting risk reviews and audits flagged by the ATO, and identifies some important practical considerations arising from the new laws' operation. Our comments are focused on what is different under the new laws, including what practical measures taxpayers should take to respond to the changing transfer pricing environment in this country.

Key takeaways – the new transfer pricing laws	
Commencement	Australia's new transfer pricing laws apply to tax years commencing on or after 1 July 2013
Profit focus	The new laws focus on arm's length profit and profit allocation as opposed to the arm's length pricing of transactions
	This may give the ATO wider powers to attack loss-makers, given the ability to enquire into whether profit outcomes are commercially realistic
Reconstruction	The new laws give the ATO broader reconstruction powers and there is considerable uncertainty as to how those powers will be applied
	Conditions between international related parties must be consistent with those that would have been in place between independent entities in comparable circumstances, otherwise the reconstruction rules may apply
Self-assessment	Public officers must determine their businesses' compliance with the new laws before signing and lodging their tax returns
	Where non-arm's length pricing has led to insufficient Australian taxable income, "upward" transfer pricing adjustments have to be self-assessed – either through the accounts before year end, or in the tax return
	Where non-arm's length pricing has led to excessive Australian taxable income, "downward" transfer pricing adjustments cannot be self-assessed post year end in the tax return
Documentation	Failure to prepare transfer pricing documentation by the time the tax return is lodged means a reasonably arguable position (RAP) cannot exist for penalty purposes
	There is significant uncertainty on what transfer pricing documentation must contain for taxpayers to have a RAP
Finance	Arm's length interest rates on inbound related-party debt have to be based on rates that would have applied to notional arm's length amounts of debt
Time limit	The new laws include a seven-year time limit on the Commissioner's ability to amend assessments to give effect to transfer pricing adjustments
OECD guidance	The new laws must be applied so as best to achieve consistency with the OECD's transfer pricing guidelines.

Key takeaways – the new ATO task force and increased audit activity
The ATO has established a new, anti-profit-shifting taskforce which has two key functions:
• Working with offshore tax authorities to investigate the substance of the operations of Australian MNCs' offshore affiliates
• Investigating whether highly profitable global MNCs doing business in Australia are deliberately avoiding tax.
The ATO will undertake 60 new audits of MNCs in the next few years. Key targets are restructures that route profits away from Australia and to low-tax countries or tax havens. The ATO has flagged 125 risk reviews and 26 audits focused on profit-shifting in 2013-14.

1. The new transfer pricing laws

The enactment of *Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Act 2013* on 29 June 2013 heralds a new era in transfer pricing in Australia.

The new laws have arrived against a backdrop of international focus on base erosion and profit-shifting (BEPS), with the G8, G20 and OECD all agreeing on the need for action to curtail this problem, through avenues including transfer pricing. The new transfer pricing laws form part of a package of legislation, together with new general anti-avoidance provisions, highlighting the Government's treatment of transfer pricing as a major tax avoidance issue.

The new laws (Subdivisions 815-B, 815-C and 815-D of the *Income Tax Assessment Act 1997*) apply to income years commencing on or after 1 July 2013, prospectively replacing the former laws in Division 13 *ITAA 1936* and Subdivision 815-A *ITAA 1997*. Subdivision 815-B applies to entities, 815-C to permanent establishments, and 815-D to partnerships and trusts. The new legislation is essentially the same as the bill introduced in February this year (refer to the previous Deloitte transfer pricing alert).

The stated aim of the new laws is to modernise Australia's transfer pricing rules and bring them into line with international standards and best practices. While this is a positive move, the downside is that there is considerable uncertainty as to the scope of the new laws and how the ATO might seek to apply them in practice. To alleviate some of this uncertainty, the ATO is drafting guidance on two key aspects of the new laws: reconstruction and documentation.

New Subdivision 815-B applies where an entity gets a transfer pricing benefit, which is essentially defined as a lesser tax outcome due to the cross-border conditions of its commercial or financial relations with another entity differing from arm's length conditions. Where this is the case, the new provision substitutes the arm's length conditions for the actual conditions. "Arm's length conditions" are the conditions, including the price, gross margin, net profit, and the division of profit that might be expected between independent entities dealing wholly independently with one another in comparable circumstances.

This focus on arm's length profit and profit allocation is a key difference with the former laws in Division 13 *ITAA 1936*, which focused on the arm's length consideration of transactions. This potentially opens the door for a broader enquiry as to whether a taxpayer's profit outcomes are "commercially realistic", notwithstanding that particular cross-border related-party transactions reflect market prices.

Some important practical implications of the new laws are explored in section 4 below.

2. The new ATO taskforce

The ATO has announced the establishment of a new taskforce to investigate corporate tax evasion, including evasion through profit-shifting.

Details on the form of the taskforce have not yet been finalised. However, *The Age* newspaper reports[1] from an interview with the new Commissioner of Taxation, Chris Jordan, that part of the new unit's role will be to work closely with offshore tax authorities to establish the purpose and review the operations of Australian businesses in low-tax territories.

This is consistent with other statements from the Commissioner and other senior ATO officers, including:

- The Commissioner recently pledged that the ATO would be intensely scrutinising complex structures used by multinationals to shift profits to tax havens, including testing that the legal structures match their substance and what is actually happening on the ground and

- Mark Konza, Deputy Commissioner, LBI, recently said that the ATO will continue to focus on profit-shifting cases, with a particular emphasis on "those restructures that erode Australia's tax base, including service hubs, alienation of intellectual property, and digital duplication."

The new unit's investigations offshore are likely to involve multi-country audits (which we are already involved with in practice) that will test the substance behind companies' assertions of what is happening in offshore countries.

The Age further suggests[2] that the new taskforce will also investigate whether highly profitable MNCs doing business in Australia are deliberately avoiding Australian tax. This is in line with recent comments from the Commissioner, when he suggested that Australian taxpayers reporting less than one to two per cent of their multinational group's global income will be subject to ATO transfer pricing scrutiny.

Establishment of the new ATO taskforce does not mean that Australian taxpayers cannot restructure their operations to move functions, assets and risks offshore. What it does mean is that taxpayers engaging in these types of commercial reorganisations must be prepared for ATO review, which generally involves preparing transfer pricing documentation in relation to the restructure itself and the post-restructure transactions. This will include, for example, ensuring:

- There are robust commercial reasons behind the restructure

- That the transfer pricing model for intra-group pricing is consistent with the actual operations in the offshore territory(ies) post restructure and

- Detailed documentation is prepared supporting the commercial rationale for the new structure and the arm's length nature of intra-group pricing and financial outcomes post reorganisation. This will form an important first line of defence if/when the ATO initiates a transfer pricing review.

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[1] *The Age*, 2 July 2013, *Tax Office Casts for Biggest Fish*
[2] Ibid.

An example of the type of Australian entity likely to be reviewed is a marketing services provider, where Australian customers buy goods or services from the marketing entity's offshore affiliate, and where that affiliate is located in a low-tax country. It is clear that the ATO intends to review these kinds of structures and that it will challenge relevant financial outcomes where the Australian entity is, in practice, undertaking activities or bearing risks over and above those stated in its inter-company agreements.

3. Increase in ATO profit-shifting risk reviews and audits

The ATO recently flagged[3] that it will open 60 new cases of suspected tax avoidance by Australian and international companies through profit-shifting, adding to the 26 investigations of Australian MNCs' offshore restructures already under review. Of the 60 new cases, the ATO has said that 20 are likely to involve entities in the energy and resources sector.

Targets for investigation will be companies that deliberately restructure their operations to route profits through low-tax countries or tax havens to avoid paying higher taxes in Australia, particularly where this involves marketing hubs that have little substance.

Disclosures now required in taxpayers' International Dealings Schedules (IDS) will mean that it is easy for the ATO to identify which Australian taxpayers have undertaken restructures, so these must be designed, implemented and supported appropriately (refer to comments in the above section).

Furthermore, the ATO's *Compliance in focus 2013-14* report[4], released on 16 July 2013, reveals the ATO's view that "profit shifting is becoming increasingly common…" and confirms that profit-shifting will be very high on the ATO's review and audit activity agenda for the next 12 months. This report indicates that, in the coming year, the ATO will undertake profit-shifting risk reviews and audits in relation to more than 150 MNCs. A further 680 reviews and 115 audits will be performed by the ATO in relation to Australian entities' tax-haven related activities.

As a result of this impending ATO review activity, MNCs are likely to place an increased premium on being prepared for reviews, obtaining certainty and effectively managing any disputes that do occur, particularly having regard to potential disruption to their business. Advance Pricing Arrangements (APAs) can be a good option for taxpayers seeking to avoid time-consuming transfer pricing disputes and wishing to obtain certainty on transfer pricing filing positions before relevant tax returns are lodged – particularly where restructures are involved. However, the ATO appears to be becoming more discerning about which APA applications should be accepted into the program and has recently questioned some applications involving restructures, so APAs (particularly unilateral) may not always be a readily available option.

4. Key practical implications of the new transfer pricing laws

Although the new laws maintain adherence to the arm's length principle, several significant changes have been introduced. Australian taxpayers with international related-party dealings should have regard to these changes and how they affect their existing transfer pricing policies and filing positions. Outlined below are our views on how historical transfer pricing practices will be most affected by the new laws and what taxpayers should do to best protect themselves from ATO transfer pricing review and challenge.

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[3] The Age, 6 July 2013, *Scrutiny on the bounty: tax probe on global giants*
[4] http://www.ato.gov.au/uploadedFiles/Content/CS_C/downloads/CSC35735NAT74689.pdf

4.1 New ATO powers of reconstruction

The aspect of the new laws causing most concern is the provisions in Subdivision 815-B dealing with non-recognition and reconstruction of actual related-party transactions and arrangements. Subdivision 815-B requires that arm's length conditions be determined having regard to both the legal form and the substance of the arrangements and also whether independent parties in comparable circumstances would have entered into those arrangements. This is not just a reconstruction power for the ATO; Subdivision 815-B requires an entity to self-assess its tax outcomes on the basis of arm's length conditions, so that taxpayers must address these matters in preparing their tax returns.

Subdivision 815-B legislates the relevance of economic substance in applying the arm's length principle. The provision includes a specific reconstruction rule which essentially requires that arm's length conditions be determined based on what independent parties might be expected to have done in comparable circumstances. The principal concern is that the reconstruction rule in Subdivision 815-B goes beyond what is contemplated in the OECD transfer pricing guidelines.

What's happening in Australia with economic substance, commerciality and reconstruction under transfer pricing rules can be seen as part of a global trend. Governments and tax administrations are increasingly viewing transfer pricing rules as anti-abuse measures. The line between transfer pricing rules and general anti-avoidance rules is becoming increasingly blurred. There seems to be considerable overlap in these rules for tax auditors when imposing their views on commerciality and what makes commercial sense. "What's the commercial rationale for that?" is the first question ATO auditors may now ask when faced with the transfer pricing of a multinational's business restructure, financing arrangements or loss-making operations.

Too much emphasis on the ability of a tax administration to reconstruct transactions (outside of exceptional circumstances as emphasised by the OECD Guidelines) encourages second guessing of business decisions by tax auditors. It invites them to ask the question: "why did you do it like that?", and to answer it with "you could have made more profits if you'd done it like this, so that's what an independent party would have done and that's what we'll be taxing you on". The concern here is the tension that will arise if/when the ATO tries to tell taxpayers how to run their businesses.

In a reconstruction context, the ATO enquiry will become whether the controlled transaction has economic substance, whether it makes commercial sense, and whether it would be entered into by independent parties acting in a commercially rational manner. In evaluating this, emphasis will be placed on the availability of comparables, and the need to consider such matters as the options realistically available to the parties, their relative bargaining power, and which party "controls" relevant risks.

The world of transfer pricing is increasingly being populated with laws and guidelines that liberally use concepts such as economic substance, reconstruction, commercial sense, commercially realistic outcomes, options realistically available, and bargaining power. It seems that as thinking on the arm's length principle evolves, its inherent uncertainty increases, bringing with it the inevitable potential for differing views, greater disputes, and unrelieved double taxation for multinationals.

One sure thing under the new rules is that Australian taxpayers' pricing policies with international affiliates must reflect the underlying substance of the parties' commercial relationships – and that such relationships are consistent with those that would have been entered into by independent entities in comparable circumstances. Also, regular reviews of whether operating models remain consistent in practice with the models originally implemented will become increasingly important.

What should taxpayers do?

- Review whether transfer pricing arrangements are in line with the economic substance of the arrangement
- Consider whether transactions or financial relations would have been entered into by independent parties in comparable circumstances. The new rules do not require related parties to choose options that have the highest tax outcomes, but the commercial thinking behind why such options were considered and rejected should be documented
- Document and maintain analysis of the above in transfer pricing records
- Monitor forthcoming ATO guidance on the practical operation of the new reconstruction provisions.

4.2 Transfer pricing in a self-assessment environment

The new laws apply on a self-assessment basis. This means that taxpayers will now have to do the work to determine whether their international related-party arrangements are arm's length before lodging their income tax returns.

Where non-arm's length pricing results in lower taxable income in Australia, taxpayers will be expected to self-assess transfer pricing adjustments to increase taxable income. This will place additional pressure on public officers who are signing tax returns to ensure their entities' compliance with the new laws.

Unfortunately, and unfairly, the new laws do not allow taxpayers to self-assess transfer pricing adjustments that result in lower Australian taxable income. This means that taxpayers' transfer pricing analyses should be performed before year end, so that any pricing adjustments required to lower profits to reflect arm's length outcomes can be put through the statutory accounts – as such adjustments cannot be made through tax returns.

Historically, many Australian taxpayers have commenced preparation of their transfer pricing documentation after year end and hoped that intra-group pricing and financial outcomes were arm's length. Under the new laws, taxpayers should be looking at their budgeted profit and analysing whether, based on relevant financial and economic circumstances, it will represent an arm's length return. If not, the taxpayer has the whole year to modify its actual prices, or develop arguments as to why their profit result will be different.

What should taxpayers do?

- Self-assess the arm's length nature of transactions/arrangements prior to year end
- Make pricing or other adjustments prior to year end
- Focus on the arm's length nature of transactions as they are entered into as well as the commercial basis for the profit outcomes
- Prepare documentation evidencing and supporting the above prior to lodgement of the relevant income tax return.

4.3 New transfer pricing documentation rules

Under the new laws, failure to prepare the required transfer pricing documentation by the time the relevant tax return is lodged will mean that an entity cannot have a RAP for penalty purposes. In practice, this means that failure to support a transfer pricing position with contemporaneous transfer pricing documentation will result in a minimum penalty of 25 per cent being applied to any subsequent adjustment to taxable income imposed by the ATO.

On this basis, the timing of taxpayers' transfer pricing documentation preparation becomes more important than under the previous rules. As discussed above, this means that transfer pricing analyses should be performed and documented before tax returns are lodged (and preferably before year end – given transfer pricing adjustments to reduce taxable income cannot be made through tax returns) in order that inter-company pricing arrangements and their financial outcomes are supportable as consistent with the arm's length standard. Where disclosures are made on taxpayers' IDS that no supporting transfer pricing documentation exists, this effectively means no RAP exists in respect of the transactions concerned.

A lack of transfer pricing analyses and documentation may also have tax governance/risk management implications for companies, including the possibility of having to highlight contestable and material transfer pricing positions to the ATO through a Reportable Tax Position schedule.

In addition to greater emphasis on the timing of preparation of supporting transfer pricing documentation, the content and focus of such documentation will be required to change under the new rules, particularly in respect of substantiating arm's length conditions and aligning the actual conditions to arm's length conditions.

Furthermore, transfer pricing reports prepared offshore for Australian taxpayers will have to be reviewed to ensure that they comply with the new laws. For example, appropriate material regarding the Australian business' operations, transactions, financial results and market conditions will have to be included. This may present a challenge to MNCs that have centralised approaches to the preparation of global transfer pricing documentation. Many MNCs have argued that the headquarter country's transfer pricing documentation requirements have 'essentially the same requirements, or more, than just about everywhere else in the world and has about 95 per cent of the information needed, save for a handful of exception jurisdictions.' Under Australia's new rules, these practices may not be good enough to enable the local Australian operations to have a RAP for penalty purposes.

What should taxpayers do?

- Undertake transfer pricing analyses and prepare supporting documentation prior to lodgement of the relevant income tax return
- Ensure transfer pricing documentation is of a standard that will provide a RAP
- Monitor forthcoming ATO guidance on transfer pricing documentation and RAP requirements.

4.4 New transfer pricing rules regarding intra-group finance

Under the new laws, intra-group financing is one of the more complicated and uncertain areas of Australian transfer pricing.

The financing aspects of the new laws are intended to give legislative support to the ATO's views on this in *Taxation Ruling* TR 2010/7. This effectively means that identification of an arm's length interest rate requires determining an arm's length creditworthiness for the borrower, which in practice can often require establishing whether the taxpayer's capital structure is arm's length. The resulting pricing may be based not on the actual debt amount, but on an arm's length debt amount.

Recent ATO and Treasury statements clearly suggest that the ATO will maintain its current review focus on intra-group debt, particularly where it involves hybrid instruments. In this environment, it is critical that taxpayers with material amounts of international related-party debt review the debt's pricing, to ensure it complies with the new transfer pricing rules. In particular, where thin capitalisation rules apply, arm's length interest rates on inbound debt have to be determined based on the rate that would have been applied to a notional arm's length amount of debt.

The commercial realism of the debt amount/capital structure also needs to be considered in light of the ATO's comments in TR 2010/7 in relation to whether the capital structure results in a commercially realistic arm's length profit outcome.

In addition, having regard to proposed reduction to Australia's thin capitalisation safe harbours in the recent federal budget, it is possible that the use of the arm's length debt test may increase, as taxpayers look for ways to support their interest deductions in light of the planned reduction in the safe harbour debt to equity ratio.

What should taxpayers do?

- Look beyond just the price of the loan
- Consider the arm's length nature of the debt/capital structure
- Price international related-party loans according to notional arm's length amounts of debt
- Consider whether post interest profitability is "commercially realistic"
- Document the above analyses prior to lodgement of the relevant income tax return.

4.5 The ATO's approach to loss makers

Subdivision 815-B seems intentionally drafted so as to be capable of authorising an ATO approach, e.g. in the *SNF Australia* type of scenario, of treating the incurrence of losses which could not be sustained by independent parties as of itself evidencing non-arm's length conditions, whether or not those losses arise from third-party or even domestic transactions.

We are increasingly seeing the ATO take questionable positions on loss-making subsidiaries, including the view that the economic rationale for the existence of a subsidiary is to add to the profitability of the multinational enterprise, so that if the subsidiary is in a situation of systemic loss (for whatever reason) and requiring parental financial support, it is to benefit the multinational in some unidentified manner and not arm's length by definition. It is sufficient for Subdivision 815-B purposes under this approach to have commercial or financial relations between the Australian subsidiary and its foreign parent to which to connect the conditions. In some cases it has been suggested that the subsidiary is performing a service for the parent in this regard and should be compensated by way of a service fee (see for example the SNF Australia Decision Impact Statement issued by the ATO).

At the extreme, it could be argued that this ATO thinking equates the arm's length principle with a requirement to make profits. In the ATO's view of the world, there's something inherently non-arm's length about making a loss. Such thinking is facilitated by Subdivision 815-B's explicit description of profits and the allocation of profits as "conditions" for the purposes of applying the provision.

What should taxpayers do?

- Consider the commercial (i.e. non-transfer pricing) drivers of losses/low profits
- Include an analysis of commercial reasons for losses/low profits, as well as pricing, in the transfer pricing documentation.

4.6 Time limit for transfer pricing amendments

Previously there has been no limitation on the period in which the Commissioner could amend an assessment to give effect to a transfer pricing adjustment. A seven-year amendment period is included in the new laws.

There is no time limit on the Commissioner's ability to ascertain additional amounts of withholding tax payable under Subdivision 815-B, or the Commissioner's ability to make consequential adjustments.

5. Conclusions

Recent developments ensure that transfer pricing will remain a key priority for the ATO. This is particularly so now that the new laws and the new anti-profit-shifting taskforce are in place and that the ATO has flagged a significant number of profit-shifting risk reviews and audits in 2013-14. This focus on transfer pricing is likely to be reinforced by the current interest in MNCs' transfer pricing arrangements from community groups, the media, government and global tax authorities.

The changing global tax environment for MNCs gives rise to significant challenges for dealing with transfer pricing issues, and the introduction of new Australian transfer pricing laws means that it is now more important than ever for taxpayers to ensure they are satisfied that their prices and financial outcomes reflect arm's length conditions and that their cross-border arrangements are commercial. The new Australian transfer pricing landscape has arrived and Australian taxpayers need to ready themselves for it.

As a final comment, we note the possibility that global and Australian transfer pricing guidance could change further, as a result of the OECD's and Australian Treasury's BEPS projects. Further commentary on BEPS is expected from these bodies shortly. We await this commentary with interest.

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