



## Tax Insights

# Inbound distribution arrangements

How do your profits stack up against the ATO's profit markers?

### Snapshot

On 23 November 2018, the ATO released [draft Practical Compliance Guideline \(PCG\) 2018/D8](#) on inbound distribution arrangements.

The draft PCG sets out 'profit markers' that the ATO will use under its compliance approach to assess the transfer pricing (TP) risk of inbound distribution arrangements. The ATO provides profit markers for three industry sectors:

- i. Life Sciences
- ii. Information and communication technology (ICT) and
- iii. Motor vehicles,

and a catch-all segment called 'General distributors'.

The term 'inbound distribution arrangement' is intentionally broad and is designed to cover entities that distribute goods purchased from related foreign entities for resale or distribute digital products or services where the intellectual property in those products or services is owned by related foreign entities.

As with other PCGs, the risk zones are low (green), medium (yellow) and high (red) – the higher the risk rating, the more ATO scrutiny taxpayers can expect. Being in the red zone also precludes taxpayers from requesting a pre-qualified unilateral APA process.

The ATO's profit markers are based on earnings before interest and tax (EBIT) / sales (EBIT margin) and they are generally quite high compared to the results of our recent benchmarking experience – taxpayers may well find themselves in the 'red zone', notwithstanding, their arrangements may be commercial and supported by appropriate TP documentation.

The ATO has not published, and does not intend to publish, the supporting benchmarks that have been used to determine the profit markers. The OECD TP Guidelines state that information used by tax authorities should be publicly available so that taxpayers have an adequate opportunity to defend their own positions and to safeguard effective judicial control by the courts. We will be recommending that the ATO makes its benchmarks and rationale for the profit markers publicly available.

The PCG does not apply if the taxpayer has an APA, a settlement agreement with the ATO, a court or Administrative Appeals Tribunal decision or the ATO has conducted a review of the inbound distribution arrangements and provided a low risk or high assurance rating for those arrangements.

Should taxpayers fall outside the low risk zone, the ATO has provided a transition period of 12 months from the date of publication of the PCG. If during this transition period a taxpayer makes a voluntary disclosure in relation to all income years where the arrangement was in place and adjusts the historic and prospective pricing to reflect an **appropriate transfer pricing outcome**, the Commissioner will consider remitting shortfall penalties to nil and shortfall interest charge to the base rate.

There is no definition for what "an appropriate transfer pricing outcome" is, but given the heading of the section (*Transitioning existing arrangements to the low risk zone*), it is implied that taxpayers would need to adjust their returns to fall within the low risk zone.

An alternative course of action for taxpayers to obtain certainty is to seek an APA.

Alternatively, taxpayers can choose to 'document-and-defend' their arrangements by preparing TP documentation and defending their position, should it be challenged by the ATO.

It should also be remembered that PCGs are not ATO interpretive views of the law. Whilst we believe that taxpayers should review their TP arrangements to determine where they sit within the ATO's risk assessment framework, and consider mitigation strategies for any potential risks

identified, moving towards the 'green' zone may not always be necessary or appropriate.

In taking a position, taxpayers should take into consideration many factors including global policies, the existence of robust benchmarking and TP documentation supporting pre-existing arrangements and the overall profitability of the global supply chain. Additionally, taxpayers in jurisdictions with a double tax treaty may have a supportive revenue authority on the other side of the transaction with a different view and negotiating authority in a mutual agreement procedure (MAP) context.

Disappointingly, there is a lack of symmetry between inbound distribution (as covered in this PCG) and outbound distribution arrangements (as covered in the ATO's PCG on offshore marketing hubs PCG 2017/1). We will be raising this issue again as part of the formal consultation.

The ATO has also included comments regarding possible disclosure of the risk zone via the Reportable Tax Position (RTP) schedule – it is likely that self-assessed risk ratings will likely be required on the RTP schedule in due course.

### In detail

This PCG, like many of other PCGs, seems to be a formulaic approach directed at influencing behavioural change by taxpayers.

Although the PCG makes it clear that the identified profit markers are not 'safe harbours', it is possible that the ATO will start to target these returns as 'quasi-benchmarks' in APAs and reviews/audits, as evidenced by the ATO's comments that arrangements in the 'red' zone are unlikely to be able to be settled via an APA. Comments on interactions between the PCG and the APA program are provided below.

It should also be remembered that PCGs do not provide technical advice or interpretation of the law, nor do they limit the operation of the law. The ATO acknowledges that, having a low risk rating does not necessarily mean that the TP outcomes are correct or that taxpayers have a reasonably arguable position. Equally, having a high risk rating under this Guideline does not necessarily mean that the arrangements fail to comply with Australia's TP rules. Therefore, TP documentation supporting annual filing positions remains important, particularly for penalty protection purposes.

Moreover, looking at arrangements holistically, being in the low risk zone from an Australian perspective, could have adverse consequences on the level of risk on the other side of the transaction (for example, in a MAP situation with another revenue authority, which believes in lower distribution returns) and may not be in line with the overall group policy, thereby putting pressure on the overall supply chain.

Once finalised, the PCG will have effect from the date of publication and will apply to existing and new inbound distribution arrangements.

**Risk zones**

The ATO’s risk zones are outlined below.

Risk zone	Relative to profit markers	ATO approach
<b>Low</b>	At or above profit marker A	<p>ATO will focus on characterisation, not TP outcomes</p> <p>ATO open to early engagement APA discussions and more likely to invite taxpayers to make a formal APA application.</p> <p>Taxpayers are eligible to request a pre-qualified unilateral APA process</p>
<b>Medium</b>	Below profit marker A, but at or above profit marker B	<p>ATO will monitor arrangements and may discuss with taxpayer before deciding to allocate further compliance resources.</p> <p>ATO open to early engagement APA discussions and may invite taxpayers to make a formal APA application.</p> <p>Taxpayers are eligible to request a pre-qualified unilateral APA process (but prior year outcomes may be reviewed)</p>
<b>High</b>	Below profit marker B	<p>ATO will consider appropriate treatment options and recommend that taxpayers review their TP policy.</p> <p>ATO may:</p> <ul style="list-style-type: none"> <li>• write to taxpayers to express its concern</li> <li>• actively monitor the arrangement, or</li> <li>• commence a review or audit.</li> </ul> <p>ATO will take into account additional factors, include global supply chain, tax profile of related parties and the amount of tax at risk.</p> <p>ATO considers that consistent loss makers pose a very high TP risk and will prioritise cases where taxpayers are in an overall loss position for the aggregate of the current and previous two income years.</p> <p>Taxpayers may seek early engagement APA discussions, but they will not be eligible to request a pre-qualified unilateral APA process.</p>

**Profit markers**

The ATO has undertaken various benchmarking exercises to understand the relevant profit margins earned by independent distributors pertinent to the Australian economy. We understand that the ATO has used both Australian and foreign companies in its analysis, however, in common with the approach in earlier PCGs, it does not intend to publish its benchmarking

analyses. We will be advocating for the underlying information that has informed these profit markers to be made publicly available.

The financial ratio that the ATO uses for its profit markers is Earnings Before Interest and Tax (EBIT) relative to sales (i.e. EBIT margin), commonly referred to as an Operating Margin. The ATO considers that the EBIT margin provides a reasonable basis for it to identify TP risks for *inbound* distribution arrangements. It should be noted that this ratio differs from the ratio used by the ATO to risk rate *outbound* distributors, where a net cost plus (NCP) method, or Berry Ratio, is the gauge. In most cases an EBIT / Sales ratio will lead to a higher rate of profits for a distributor, meaning that the ATO's expectation is that inbound distributors with ostensibly the same characteristics as outbound distributors are expected to achieve higher returns. The apparent anomalies in this position are not dealt with in the draft PCG and this asymmetry is disappointing.

For example, the ATO acknowledges in PCG 2018/D8 that where inbound distributors undertake more economically significant functions relative to the generation of overall value, they would be expected to earn a relatively higher profit (i.e. higher EBIT / Operating Margin). The ATO also makes mention of taking into account whether the inbound distributors are significantly developing, enhancing, maintaining, protecting or exploiting intangibles when assessing risk. Unfortunately such acknowledgment (about value-add functions and contributions to intangibles driving higher returns) was not present in PCG 2017/1 in the context of outbound arrangements.

The EBIT margins used by taxpayers should be the margins related to the inbound distribution arrangement only, with revenues and costs of any other business activities being carried on to be excluded from the calculation. The ATO acknowledges that determining the significance of unrelated revenues and costs to the risk assessment process is a matter of judgment. Whilst providing different profit markers for different industries is useful, it may be challenging and burdensome for taxpayers to self-assess which particular category they fall in to.

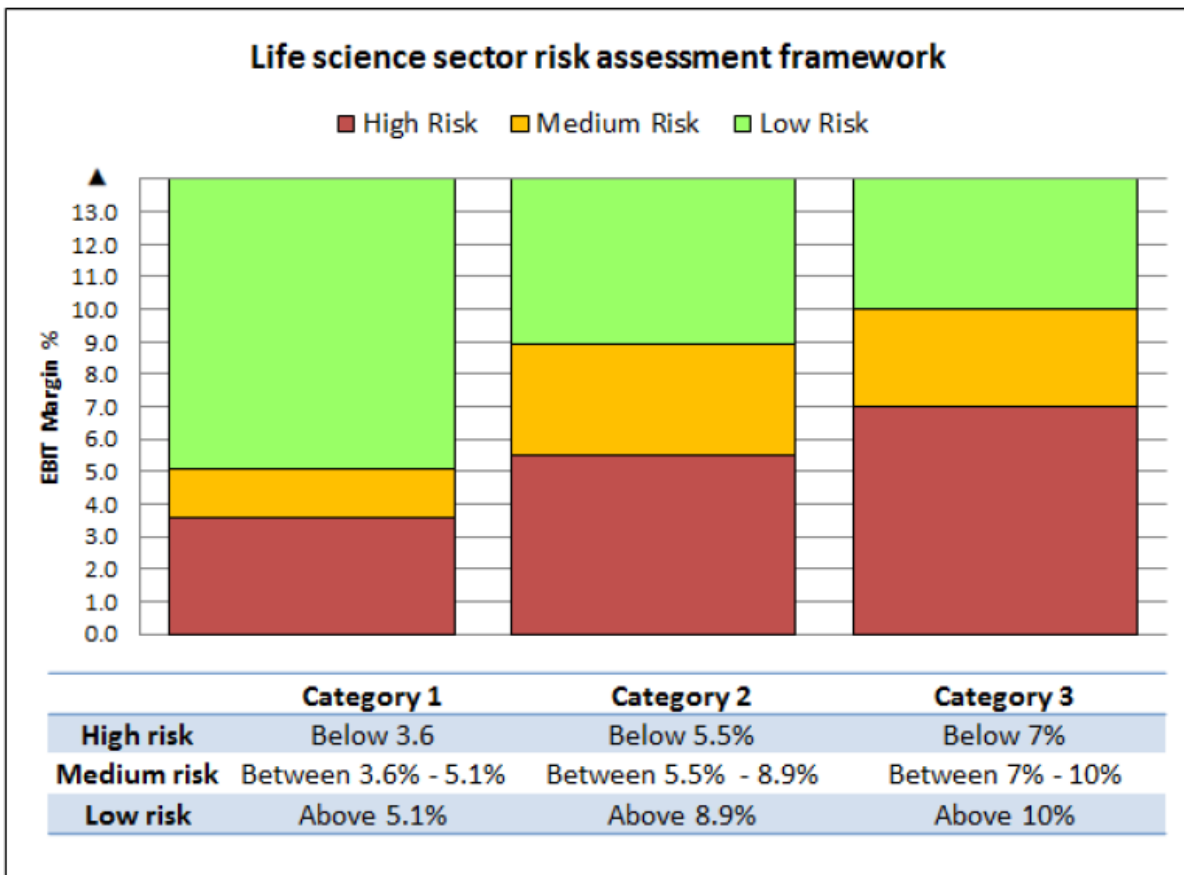
The profit markers per industry sector are outlined below.

### **Life sciences**

The life sciences industry consists of entities involved in the discovery, development, production and sales, and marketing of medicine. The ATO has identified three sub-categories within the life sciences industry, reflecting increasing levels of activities that incrementally generate value:

1. Distribution of life science products, including detailing and marketing and logistics and warehousing;
2. Activities in item 1 above, plus regulatory approval, market access or government reimbursement activities;
3. Activities in items 1 and 2, plus specialised technical services.

The ATO's identified profit markers and risk zones per category are detailed below.



Per the ATO’s definitions, a taxpayer is either a ‘distributor’ or a ‘distributor-plus’. However, some distributors do not perform certain key functions – a classic example is outsourced warehousing/logistics. For example, a company may provide technical services (e.g. training on how to use products), but it may not be responsible for obtaining regulatory approvals nor undertake warehousing. The PCG methodology would see this company in ‘Category 3’, but looking at the company in a balanced way, there could arguably be some modification for functions not performed. As such, a company might self-assess itself into a higher risk category than it should be in when the company’s functional profile is considered in a balanced and holistic way. This may lead to inappropriate risk rating outcomes.

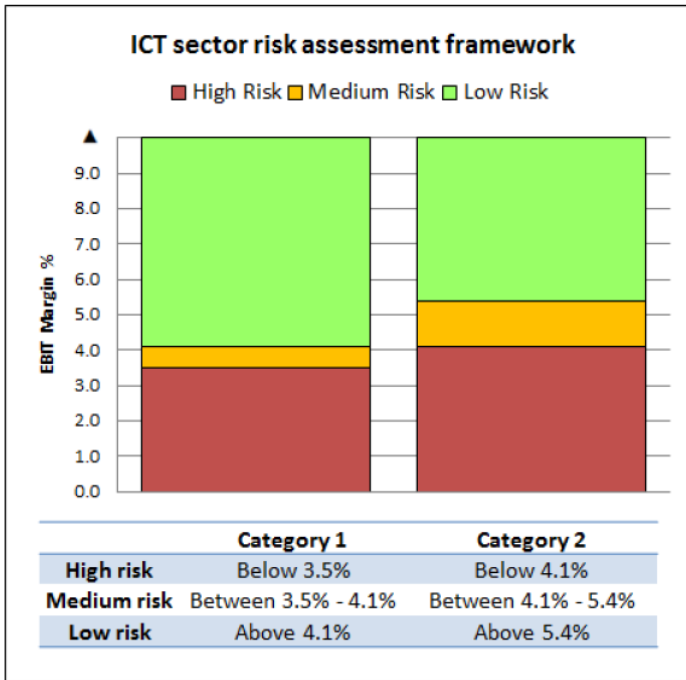
**Information and communication technology**

The ICT industry sector includes all types of consumer and enterprise computer hardware and software products, digital communication devices, applications, IT solutions and ancillary services that enable interaction through technology.

Similar to the life sciences sector, the ATO has identified two sub-categories, reflecting increasing levels of activities that incrementally generate value:

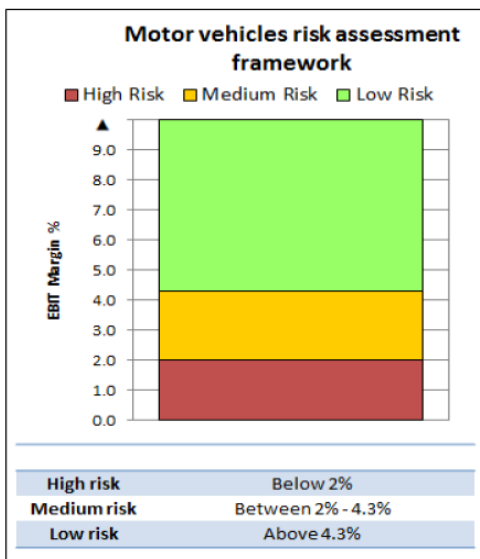
1. Distribution of ICT products, including sales and marketing, pre and/or post-sales services and logistics and warehousing;
2. Activities in item 1 above, plus complex sales processes, direct selling activities and/or large customer relationship management.

The ATO’s identified profit markers and risk zones per category are detailed below.



**Motor vehicles**

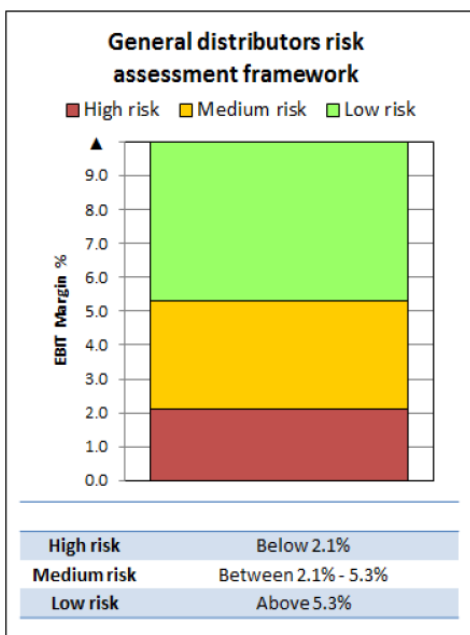
The ATO considers entities to be in the motor vehicles industry sector if their business trades in passenger vehicles, trucks, buses, motorcycles or other recreational motorised vehicles or their associated parts. The ATO provides commentary on the motor vehicle industry and states that the role of a motor vehicle distributor includes a range of functions that support the activity of distribution including marketing and sales, after sales support, procurement and administration, insurance activities, as well as functions involving transportation, warehousing and inventory management. Motor vehicle distributors are assessed as a single category based on one set of profit markers, which is outlined below.



**General distributors**

The general distributors category is a broad category that covers a wide range of industries and circumstances. As such, the ATO has not specifically identified categories of activities but rather TP risk for general distributors is assessed as a single category based on one set of profit markers. The ATO does comment, however, that it expects entities performing more activities to have a higher profit. It should be noted though that, based on the OECD Transfer Pricing Guidelines, whilst more functions/risks can lead to higher profits, they may also lead to an entity incurring losses.

The ATO’s identified profit markers and risk zones for general distributors are detailed below.



**Interaction with APAs**

As mentioned above, the PCG will not apply to taxpayers with an APA, a settlement agreement with the ATO, a court or Administrative Appeals Tribunal decision, or those with inbound distribution arrangements previously reviewed by the ATO and attributed low risk or high assurance ratings.

PCG 2018/D8 provides lengthy commentary on how taxpayers can obtain certainty via an APA. However, the ATO states that where taxpayers are in the high risk zone (and are expected to stay there), there are likely to be factors that would make it difficult to reach an agreement under the APA program.

The ATO also comments that significant divergence between EBIT and Profit Before Tax (PBT) will require particular attention, given the ATO’s assertion that inbound distributors are not expected to enter into significant debt arrangements.

The draft PCG includes commentary on a pre-qualified APA process. The APA application needs to align with the profit markers in the draft PCG



(although it is not clear whether this means taxpayers should fall within the low risk zone or simply fall outside the high risk zone). The pre-qualified APA process means there is reduced information gathering, focusing on confirming (i) the appropriate characterisation as an inbound distribution arrangement and (ii) the applicability of the transactional net margin method (once confirmed, this eliminates the need to prepare benchmarking). Pre-qualified APAs will still go through the ATO's triage process (outlined in PSLA 2015/4).

Transactions covered by an APA (including pre-qualified APAs) entered into after 4 April 2017 will be considered low risk for the purposes of Diverted Profits Tax (DPT), however, taxpayers should make note of the desire to have DPT sign-off in the APA submission or as early as possible to enable the ATO to gather sufficient information to make a decision on the request.

### Next steps

We recommend that taxpayers review their arrangements against the formulaic ATO risk assessment framework.

Based on the preliminary assessment, it may be appropriate to approach the ATO to obtain certainty. As outlined above, taxpayers can either

- i. Transition to the low risk zone,
- ii. Apply for an APA, or
- iii. Document-and-defend their position.

Before deciding on a particular course of action, we recommend that taxpayers consider all relevant factors including global policies, existence of robust benchmarking and TP documentation supporting pre-existing arrangements, the overall profitability of the global supply chain and the likely action of the revenue authority on the other side of the transaction.

The ATO has requested that comments be provided by 21 December 2018. Deloitte will be making a submission and we welcome comments for inclusion.

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