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Tax Insight

Australia

Deloitte Tohmatsu Tax Co.

March 2019

ATO guidance on inbound distributors : How green are your profits?

1. Snapshot

On 13 March 2019, the ATO released Practical Compliance Guideline PCG 2019/1, which sets out ‘profit markers’ that the ATO will use under its compliance approach to assess the transfer pricing (TP) risk of inbound distribution arrangements. This is the finalised version of the PCG which had been released in draft in November 2018 as PCG 2018/D8.

Inbound distributors should self-assess their results against the ATO’s profit markers to determine the ATO view of the relevant risk zone and hence the resultant level of ATO scrutiny they may face. If affected taxpayers need to prepare a Reportable Tax Position (RTP) schedule, the result of this self-assessment should be disclosed therein.

Should taxpayers find themselves outside the low risk zone and decide to shift into that zone, there is a transition period for 12 months from 13 March 2019 for taxpayers to amend their results to “an appropriate transfer pricing outcome” which is implied to be the low risk zone. Alternatively, taxpayers can apply for an APA. If an APA is sought, it may be preferable to enter into bilateral APA discussions, rather than a unilateral discussion with the ATO, so that the involvement of the overseas competent authority helps to bring a balanced and principled approach.

Taxpayers may also choose to ‘document-and-defend’ their arrangements by preparing TP documentation and defending their position should it be challenged by the ATO. The profit markers are necessarily general, and do not take account of the particular circumstances and profitability of particular groups. In some cases, the ATO identified profit markers may indicate a medium or high risk outcome, but on comprehensive review of the facts and the TP analysis, the taxpayer’s position may nonetheless be supportable.

Whilst there is now increased clarity regarding the ATO ‘game plan’ around its approach to TP for inbound distributors, we note that there continues to be asymmetry between (1) inbound distribution arrangement being assessed against this PCG and (2) outbound centralised marketing and distribution arrangements (PCG 2017/1). Moreover, whilst PCGs are simply an ATO risk assessment framework and are not an interpretive view of the law, the profit markers are not safe harbour administrative concessions nor should they be profit expectations. Taxpayers will need to be able to robustly defend their positions should they not fall within the ATO’s ‘green’ zone, given that the ATO is likely to challenge those arrangements.

We have set out below in more detail the implications of the PCG and what considerations taxpayers should have going forward.

For details on the draft PCG and our original comments thereon, please refer to our previous Tax Insights article.

2. What does PCG 2019/1 say?

To assess the TP risk of inbound distribution arrangements, the ATO will use ‘profit markers’ for three industry sectors ((1) Life Sciences, (2) Information and communication technology (ICT) and (3) 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. Also, being in the red zone precludes taxpayers from requesting a ‘pre-qualified’ unilateral APA and if they expect to stay in the red zone, there are likely to be factors that would make reaching an agreement on a normal APA difficult.

The ATO’s profit markers are based on an EBIT margin, being earnings before interest and tax (EBIT) / sales. The margins 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.

(1) Life sciences

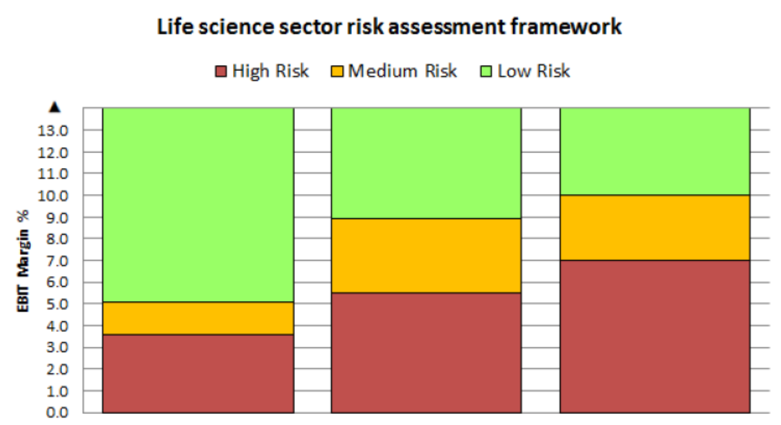
The life sciences industry consists of entities involved in the discovery, development, production and sales, and marketing of medicine including patented drugs, generic drugs, medical equipment, over-the-counter and animal health. The ATO has identified three sub-categories within the life sciences 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.



	Category 1	Category 2	Category 3
High risk	Below 3.6	Below 5.5%	Below 7%
Medium risk	Between 3.6% - 5.1%	Between 5.5% - 8.9%	Between 7% - 10%
Low risk	Above 5.1%	Above 8.9%	Above 10%

(2) Information and communication technology

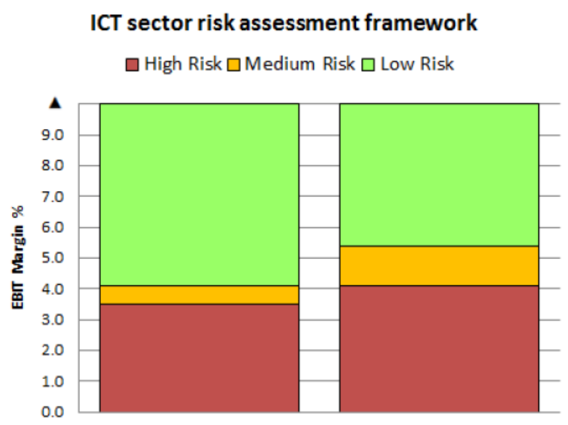
The ICT industry sector includes all types of consumer and enterprise computer hardware and software products, digital communication devices, applications, IT solutions and ancillary services that enable interaction through technology.

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.

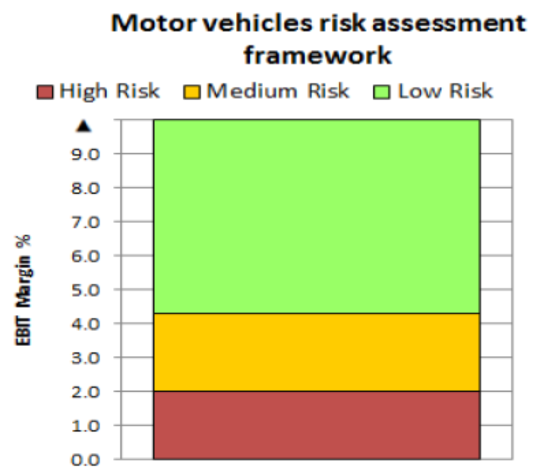
The ATO's identified profit markers and risk zones per category are detailed below.



	Category 1	Category 2
High risk	Below 3.5%	Below 4.1%
Medium risk	Between 3.5% - 4.1%	Between 4.1% - 5.4%
Low risk	Above 4.1%	Above 5.4%

(3) 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.

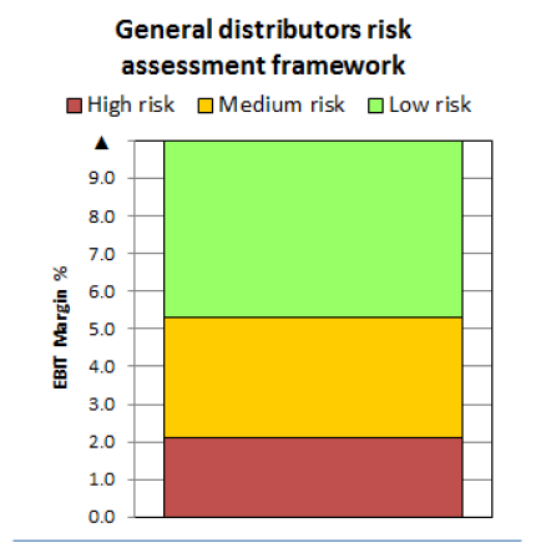


High risk	Below 2%
Medium risk	Between 2% - 4.3%
Low risk	Above 4.3%

(4) 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.



High risk	Below 2.1%
Medium risk	Between 2.1% - 5.3%
Low risk	Above 5.3%

3. What does this mean for taxpayers with distribution arrangements in Australia?

(1) Self-assessment of position under the PCG

The first step is for taxpayers to review their arrangements against the formulaic ATO risk assessment framework to assess into what risk zone they fall, and to document that assessment. We note that the associated profit markers have not changed from the draft PCG. In some cases, the nature of the categories outlined by the ATO may make it difficult for taxpayers to self-assess which category they fall into, and may give rise to taxpayers inappropriately self-assessing themselves into the wrong risk category (whether too high or too low).

(2) Reportable tax position

For those taxpayers that need to lodge a Reportable Tax Position (RTP) schedule, they are effectively forced into disclosure to, and potentially engagement with, the ATO.

Category C of the RTP schedule currently refers to PCG 2018/D8 (based on the ATO RTP website updated as at 11 February 2019). We assume that this reference will in due course be updated to refer to PCG 2019/1. The question requires taxpayers to self-assess their risk zone, and states that a taxpayer must self-report as high risk if they have not applied the PCG.

The RTP process therefore becomes an additional tool for the ATO to target its compliance focus in respect of inbound distributors.

(3) Risk Management Options

Based on the preliminary assessment, it may be appropriate to take action. Options available to taxpayers include:

① transition to the low risk zone (the transition period is for 12 months from the publication of the PCG), including potential engagement with the ATO

② apply for an APA, or

③ document-and-defend their position.

Whilst taxpayers in any risk zone can seek to enter APA discussions with the ATO, if taxpayers are in the high risk zone (and they expect to stay there), there are likely to be factors that would make reaching an agreement on an APA difficult. In terms of the "pre-qualified APA", the ATO states that these APA applications need to be "*aligned to the profit markers in* [the PCG]", however, it is not clear whether this means taxpayers should fall within the low risk zone or simply fall outside the high risk zone. Based on our recent experience with the ATO, it is unlikely that a position in the 'high risk' zone would be accepted for an APA, and an explanation will need to be provided to support an APA process for a position that does not fall in the 'low risk' zone. It may be appropriate to enter into bilateral APA discussions, rather than a unilateral discussion with the ATO, so that the involvement of the overseas competent authority helps to bring a balanced and principled approach to TP and to mitigate potential double taxation or subsequent mutual agreement procedure (MAP) processes.

In terms of documenting and defending positions, the ATO has made it clear that the profit markers should not be relied upon to determine arm's length conditions and the PCG does not replace an appropriate comparability analysis and proper application of the TP obligations under the law. Therefore, it is important for groups to appropriately analyse and document their existing arrangements to demonstrate compliance with the Australian TP rules. This will include undertaking appropriate comparability analysis(es), and robustly documenting the arm's length nature of the arrangements.

Before deciding on a particular course of action, we recommend that taxpayers consider all relevant factors including:

- the likely action of the revenue authority on the other side of the transactions;
- global policies;
- existence of robust benchmarking and TP documentation supporting pre-existing arrangements;
- the possible flow-on consequences in other markets if the Australian distribution margin is altered; and
- the overall profitability of the global supply chain.

4. Concerns with the ATO approach

We have a number of concerns with the ATO's approach set out in the PCG:

① The ATO appears to be moving away from the arm's length principle by applying overly simplistic approaches to TP that does not recognise the economic circumstances of distributor operations or variations in function and asset profile

② Lack of transparency in the ATO not making available the benchmarking approach, results and its rationale for selecting the 'profit markers'

③ Potential for ATO case teams to apply the 'profit markers' as 'quasi-benchmarks' in TP audits and APAs, in a manner that is not aligned with the arm's length principle

④ Access to the APA program may become more challenging, given the relatively high 'profit markers' that taxpayers may need to meet, and may result in increased instances of double taxation and/or increased MAP processes.

⑤ Lack of symmetry between ATO approach for inbound distribution arrangements (as covered in this PCG) and outbound distribution arrangements (as covered in the ATO's PCG 2017/1 on offshore marketing hubs).

5. Potential silver lining?

Whilst there are concerns with the PCG and the ATO's approach, there are a number of positives:

① Increased clarity regarding the ATO 'game plan' around its approach to TP for inbound distributors.

② Where the other side of the transaction involves a jurisdiction which has a double tax treaty with Australia, and may have a supportive competent authority with a different view, taxpayers can look to engage with the overseas revenue authority to argue the position with the ATO, either as part of a MAP process or a bilateral APA.

Finally, it should be remembered that PCGs are not an interpretive view of the law, the profit markers are not safe harbour administrative concessions nor should they be profit expectations. Rather they are simply an ATO risk assessment framework. Moreover, taxpayers may take positions contrary to the PCG, provided they are supported by appropriate TP analysis and documentation.

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Contacts

Deloitte Touche Tohmatsu

Soulla McFall, Partner smcfall@deloitte.com.au
Cam Smith, Partner camsmith@deloitte.com.au
Geoff Gill, Partner gegill@deloitte.com.au
Paul Riley, Partner pbriley@deloitte.com.au
Mark Wilkie, Partner mawilkie@deloitte.com.au

Japanese Services Group(JSG)
Australia & Oceania Practice

Shinichi Takenaka, Partner stakenaka@deloitte.com.au
Daisuke Nagata, Senior Manager danagata@deloitte.com.au

Issued by

Deloitte Tohmatsu Tax Co.
Tokyo Office
Marunouchi Nijubashi Building, 3-2-3 Marunouchi, Chiyoda-ku, Tokyo 100-8362, Japan
Tel : +81 3 6213 3800
email : tax.cs@tohmatsu.co.jp
Corporate Info. : www.deloitte.com/jp/en/tax
Tax Services : www.deloitte.com/jp/tax/s/en