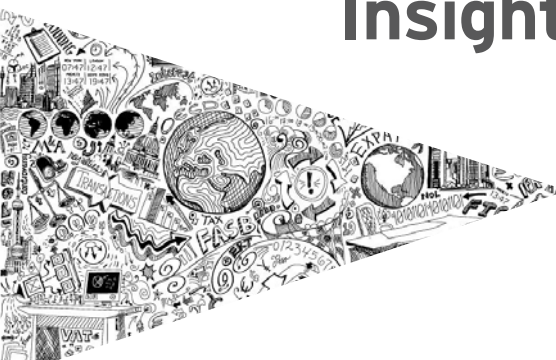


Transfer Pricing Insight



Full Federal Court rejects ATO transfer pricing approach

Who is affected?

- ▶ Taxpayers currently applying profit based approaches for transfer pricing purposes
- ▶ Taxpayers with international related party transactions and generating losses in Australia
- ▶ Taxpayers with transfer pricing tax controversies with the ATO
- ▶ Taxpayers affected by recent ATO rulings on intra-group finance and business restructures

On 1 June 2011, the Full Federal Court, in a significant transfer pricing decision, accepted the primacy of the comparables method for the taxpayer, SNF (Australia) Pty Ltd, to test whether purchases from its related entities were priced consistently with the arm's length principle of Australia's transfer pricing laws.

The Court rejected the Australian Taxation Office (ATO) contention that Australia's law requires an assessment of 'what a purchaser in identical circumstances to those of the taxpayer would have paid, but for its membership of the group'. The Court held that Australia's law purely aims to assess whether the price paid for the goods was no more than arm's length consideration. The ATO failed on all three grounds of appeal, as it had failed in the earlier single judge decision.

This decision is highly significant for groups with international transfer pricing issues. It creates a major conundrum for the ATO's reliance on the profit based Transaction Net Margin Method (TNMM) and the ATO's transfer pricing compliance risk assessment which looks to the entity's overall financial performance. The ATO's approach of substituting a hypothetical transaction in its recent rulings on business restructures and intra-group financing must also logically be re-examined as a result of this decision.

This Tax Insight outlines the decision and:

- ▶ Its far-reaching impacts
- ▶ How it may affect the ATO's future approach to transfer pricing
- ▶ Actions for taxpayers

We also provide a technical overview of the case and other relevant issues raised by the decision.

Highlights of the decision

- ▶ **Comparable transactions can be used even if the taxpayer has a loss:** The ATO failed to establish that a taxpayer's losses automatically mean that a taxpayer's transfer pricing is not arm's length. Where a taxpayer has comparable transactions available, the fact that the taxpayer has made losses is irrelevant. The decision contains a detailed analysis of the application of the OECD's five comparability factors and the comparable uncontrolled price (CUP) method.
- ▶ **Application of TNMM is still uncertain, but not rejected:** The Court did not specifically address the application of the TNMM, as it concluded that the CUP method was available. The decision implies an ordering of the transfer pricing methods, with a strong preference first for CUPs, second for the other traditional methods of cost plus and resale minus and then for the profit based methods of TNMM and profit split.
- ▶ **ATO's approach in business restructure and intra-group finance rulings under question:** In both of these rulings, the ATO has proposed that it can substitute a hypothetical transaction for the actual international related party transaction undertaken by the taxpayer. The SNF decision clearly brings this approach into question. In particular, in respect of the intra-group financing ruling, where global prices readily exist for all levels of debt, it will be difficult for the ATO to propose that a hypothetical level of debt should be substituted for the actual transaction, purely on the grounds that the actual level of debt does not result in a commercially realistic result for the taxpayer.
- ▶ **Arm's length price has a range of answers:** The Court confirmed that there is not always just one arm's length price in respect of a transaction and that a range of results may exist. The taxpayer will be entitled to succeed if it shows prices paid were less than or equal to an arm's length price.

Far-reaching impacts for business

This decision has a pervasive effect on the selection and application of transfer pricing methods for all Australian taxpayers with international related party transactions. The greatest impact will be for taxpayers:

- ▶ That currently apply the TNMM or other profit based approach
- ▶ With international related party transactions and having an Australian loss
- ▶ Under ATO review or audit

Practical implications for taxpayers include:

- ▶ **Careful analysis of potentially comparable transactions required:** Given the Court upheld the taxpayer's CUP analysis despite the ATO's objections, taxpayers currently applying the TNMM or other profit based method will need to consider whether any potentially comparable transactions exist. The Court made it clear that the comparability bar cannot be set too high, otherwise taxpayers would never be able to source comparable transactions. Particular care is needed where a potential comparable transaction may result in a more favourable price or profit outcome to the Australian taxpayer than under the application of the TNMM, as it is likely the ATO will carefully scrutinise potentially comparable transactions in the future.
- ▶ **Overseas transactions may be comparable:** The Court accepted evidence there was a global market for the product purchased by SNF. Even though the foreign affiliates made over 99% of comparable sales to purchasers outside Australia, this did not impact their comparability. Therefore, when analysing any potential comparable transactions, taxpayers will need to consider whether comparable

transactions have taken place with third parties in any part of the global organisation. Analysis will then be required as to whether the geographic location of the transactions impacts the comparability of the transaction.

- ▶ **Documentation of commercial reasons for losses:** A taxpayer with international related party dealings that has incurred losses should ensure documentation is prepared to explain that the losses are as a result of non-transfer pricing reasons. The Full Federal Court noted that SNF did not need to prove that its motive was not to make losses in Australia and to move profits to France by transfer pricing. However, the fact that SNF showed the losses were due to reasons other than transfer pricing allowed the judges to focus on the CUP analysis without distracting questioning of the reasons for the losses.
- ▶ **Review of controversy strategy:** Taxpayers in risk review, audit or controversy with the ATO need to carefully consider the impact of the decision on their controversy strategy. Taxpayers in losses and/or relying on the TNMM should revisit whether there are any comparable transactions available, casting the net wider than before. They should also consider whether either of the other traditional methods, being cost plus or resale minus, are available. Finally, where losses have been incurred, the preparation of a detailed commercial justification is critical.
- ▶ **Senior personnel may be called upon to provide transfer pricing evidence:** In both the single judge and Full Federal Court decisions, the testimony provided by senior executives was very influential. The Full Federal Court noted that the information provided by the Australian managing director and the US supplier's financial controller should be inferred as being reliable and cogent on the basis of their seniority and situation in the 'institutional framework' of the group.

What does the decision mean for the ATO?

This decision raises many questions for the ATO including:

- ▶ **The acceptability of the TNMM:** Especially when the taxpayer is in losses and has comparable transactions to justify the prices paid.
- ▶ **Impact on intra-group financing ruling:** The ATO contends that, when assessing an arm's length interest rate on intra-group financing, it can substitute an arm's length amount of debt to determine an appropriate interest rate. The SNF decision clearly brings into question this approach where an arm's length consideration can be determined for the actual amount of debt that has been entered into by the taxpayer.
- ▶ **Impact on business restructure ruling:** In this ruling, the ATO proposes that when assessing if the consideration under the business restructuring arrangement is arm's length, the ATO can substitute a hypothetical transaction - an agreement that might reasonably be expected between independent parties dealing at arm's length in comparable circumstances. The reasoning in the SNF case appears to be inconsistent with this interpretation.
- ▶ **Application of double tax agreements (DTAs):** The role of DTAs as a separate head of taxing power has still not been resolved, despite the DTAs more easily allowing the substitution of a hypothetical transaction.

We expect the ATO to consider possible action including:

- ▶ **Appeal to the High Court:** The ATO will have to determine the possible grounds of appeal, the strategic implications and whether any further decision could be even more detrimental.

- ▶ **Issue a Decision Impact Statement:** To confine application of the decision to the facts and circumstances of the SNF case. However, we consider that the wider implications cannot be easily dismissed by limiting the case's impact to only the facts and circumstances of the particular case.
- ▶ **Seek a rewrite of Division 13:** Given the uncertainty after this and other recent transfer pricing cases, the ATO may pursue a rewrite of Division 13.

Action required

Businesses should review their existing transfer pricing policy and:

- ▶ Identify any **internal** third party comparable transactions, i.e., comparable transactions between a member of the taxpayer group and an independent party, either in Australia or overseas
- ▶ Identify any **external** comparable transactions, i.e., transactions between two independent parties (outside the taxpayer group) that are comparable to the related party transaction undertaken
- ▶ Determine whether alternative transaction based methods, such as the cost plus or resale price method are available to set or test transfer prices
- ▶ Ensure senior management are fully aware and cognisant of the selection process and application of the group's transfer pricing policy on the Australian operations
- ▶ Fully document the non-transfer pricing reasons for any Australian losses or less than commercially realistic results
- ▶ Review controversy strategy where transfer pricing is under ATO review or in dispute
- ▶ Consider pursuing an advance pricing arrangement (APA) with the ATO in order to obtain certainty around international related party transactions

A technical overview of the case

SNF, a distributor of chemicals in the Australian market, purchased from its related parties in various countries including France, the United States and China. These related parties also made sales to unrelated parties. SNF applied the CUP method in illustrating that its purchases from related parties took place for no more than arm's length consideration. SNF had incurred losses in Australia over an extended period of time.

The ATO sought to adjust SNF's taxable income under the Division 13 transfer pricing rules, citing SNF's ongoing losses as the main reason for the adjustment. The ATO applied a profit based TNMM showing the financial performance of companies with comparable functions, assets and risks was greater than SNF's financial performance over the entire period. The ATO concluded the prices paid by SNF to international related parties should be reduced and its taxable income should increase.

SNF pointed to comparable transactions between its related suppliers and non-Australian purchasers. SNF argued the geographic location of these suppliers did not impact the price paid, as there was a global marketplace for the products. SNF argued that its sustained losses were commercially justified and unrelated to its transfer pricing arrangements.

The single Federal Court judgement of the Hon Justice Middleton upheld SNF's comparability analysis and rejected the ATO's application of the TNMM.

The ATO appealed to the Full Federal Court on three grounds:

- ▶ The evidence did not show the third party transactions were comparable
- ▶ The supplier's losses were irrelevant and should not have been accepted under the evidentiary rules
- ▶ Division 13 requires transactions 'where the purchasers shared each and every quality of the taxpayer' except for being a related party, in order to be comparable

The ATO failed on all three counts.

Comparability analysis

The Court had regard to evidence analysing the transactions against the OECD's five comparability factors, being: product similarity; functional comparability of the purchasers to SNF; contractual terms and conditions of the transactions; economic circumstances of the markets in which the transactions occurred; and the business strategies of the respective parties.

Overall, the most contentious of the five comparability factors was the economic circumstances of the market and, in effect, the acceptance of foreign transactions. The taxpayer argued, and the Court accepted, that there was a single, global market for the products. Part of the evidence that supported this conclusion was that the French supplier of the product generally charged each subsidiary of a single multinational customer the same price for a product, regardless of the location of the subsidiary. The finding that there was a global market was instrumental in the Court's acceptance that the price should not be adjusted to take into account that SNF's Australian market was highly competitive.

Requirements of Division 13

The Court accepted Justice Middleton's analysis of Division 13's requirements and quoted from the single Court judgement: "The essential task is to determine the arm's length consideration in respect of the acquisition. One way to do this is to find truly comparable transactions involving the acquisition of the same or sufficiently similar products in the same or similar circumstances, where those transactions are undertaken at arm's length."

Continual losses

SNF global management outlined that the group's aim was to hold 50% market share of their chemical product category globally. At the time under review, the global share was 38%. It was accepted that SNF was continuing to trade in the Australian market in order to support the global market penetration strategy, which was considered critical to the long term strategic plans of the SNF group globally. The trial Court accepted, and the Full Federal Court did not contradict this finding, that the continual losses 'would have forced an independent operator from the market'. The Commissioner contended that an independent distributor would not have continued to trade at continual losses over a 13 year period to support a market penetration strategy for the benefit of an unrelated supplier. However, it appears the Commissioner did not put any arguments to support this proposition: nor did he put forward the argument that the taxpayer should have been remunerated separately for its role in supported the market penetration strategy.

Other issues

Relevance of OECD guidelines

The Court considered the OECD guidelines and concluded that they were guidelines only. There was no evidence that any of the States in question applied the guidelines in employing the transfer pricing article of

the relevant DTA. However, the Court's comments 'should not foreclose any future attempt to demonstrate that the guidelines do, in fact, evidence State practice'.

Impact of DTAs and applicability of the TNMM

In the single Court decision both the taxpayer and the ATO were prepared to rely solely on Division 13, so the associated enterprises article of the relevant DTAs was not considered.

Generally the wording of the associated enterprises article in Australia's DTAs refers to accruing profits to the enterprises as if they were independent enterprises, unlike the focus of Division 13 on Commissioner substituting arm's length consideration for each transaction. The DTAs thus more readily allow for the use of the TNMM.

While the Full Federal Court did not specifically address the application of the TNMM, the decision does not reject its application. The decision implies an ordering of the transfer pricing methods, with a strong preference for CUPs, then other traditional methods of cost plus and resale minus and then the profit based methods of TNMM and profit split. Further, if there are some areas of weakness in the comparability factors of the potentially comparable transactions, then other profit based methods may be used to cross-check the analysis.

How Ernst & Young can help

Ernst & Young's multi-disciplinary team of professionals can help you manage both the transfer pricing issues associated with this decision. To discuss the impacts of this ruling on your business, please contact your local Transfer Pricing advisor listed below.

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