Australia issues draft tax guidelines regarding transfer pricing documentation, penalties and reconstruction

Executive summary

Businesses need to follow Australia’s new transfer pricing laws, introduced in 2013, to self-assess whether there is a transfer pricing benefit for the purpose of their tax returns. Two new draft tax Rulings and two new draft Practice Statements describe the Australian Tax Office's approach and standards that are expected. These raise the bar and businesses need to urgently consider these in order to manage down tax risks, including businesses with upcoming June 30 balance dates.

On 16 April 2014, the Australian Taxation Office (ATO) released two new draft transfer pricing Taxation Rulings and new two draft Practice Statements, which represent the ATO's first documented view on how the new transfer pricing laws (Subdivisions 815-B and 815-C) will apply and what taxpayers need to do.

The documents set out high ATO expectations of taxpayers. They are important because the ATO has become increasingly aggressive on transfer pricing issues. Consistent with the global trends and Base Erosion Profiting Shifting (BEPS) debate, a surge in ATO compliance activities is likely to occur in the next few months.

The release of the draft Rulings and Practice Statements is an important development for multinational companies, impacting how transfer pricing should be managed.

In order to manage the additional risks and uncertainties that arise from Subdivisions 815-B and 815-C, taxpayers need to have a clear framework and process for managing tax transfer pricing issues:

- A key part of the framework will be the use of contemporaneous transfer pricing documentation to explain the approach followed and its consistency with the law.
- The documentation will also be relied upon to mitigate the extent of penalty tax in the event the approach does not satisfy the arm’s length principle.
Taxpayers should review their readiness for the new transfer pricing rules (Subdivisions 815-B and 815-C) and the new documentation rules. This review should factor in the ATO expectations expressed in the draft Rulings and Practice Statements.

**Detailed discussion**

**Overview of the new law**

Australia’s new transfer pricing laws (Subdivisions 815-B to 815-D of ITAA 1997 and 284-E of the Tax Administration Act 1953):

- Introduce a self-assessment obligation on taxpayers that receive transfer pricing benefits
- Link potential penalties to the preparation of transfer pricing documentation, and
- Formalize the ability for transactions to be reconstructed, so as to substitute hypothetical transactions for actual transactions in determining arm’s length outcomes.

The new draft Rulings and Practice Statements provide welcome insight into the ATO’s view of the practical application of the new rules. Although they are still only draft, it is expected that the final Rulings and Practice Statements will predominantly reflect these versions.

This Alert summarizes the impacts of the draft Rulings and Practice Statements and what taxpayers need to do to manage transfer pricing matters.

**Documentation requirements - TR 2014/D4 and draft PSLA 3673**

TR 2014/D4 and draft PSLA 3673 set out the ATO’s view on the transfer pricing documentation requirements that must be satisfied in order for a taxpayer to potentially have a Reasonably Arguable Position (RAP) for penalty reduction purposes.

TR 2014/D4 articulates the ATO’s views on the interpretation and practical application of key concepts in the new law relating to transfer pricing documentation:

- Whether documentation will be taken to have been “prepared before the time by which the entity lodges its income tax return”
- What is required to “explain the particular way in which the law applies”
- What is required to “explain why the application of the Subdivision in that way best achieves the consistency” with the relevant Organisation for Economic Cooperation and Development (OECD) guidance material
- What is required to “explain the particular way in which the Subdivision applies” in the context of the reconstruction provision (discussed below)
- What is required to “explain the particular way in which the Subdivision applies” in the context of the provision dealing with the interaction with the thin capitalization regime
- What it means for the required records to be able to be “readily ascertained”

The documentation requirements in relation to the application of the law largely seek to codify fundamental elements of the OECD Guidelines that are generally common practice. However, there is now an increased rigor that taxpayers must satisfy in considering and documenting these fundamental elements specified under the law. For example, taxpayers will need to have a particularly robust analysis of comparability and the basis for the selection and rejection of each of the transfer pricing methods.

TR 2014/D4 notes the statutory requirement for a person carrying on a business to keep records that explain transactions and acts, including those concerning transfer pricing, and that there is an administrative penalty for failing to do so. The Ruling states that having documentation that satisfies the RAP requirements will also satisfy the requirement to keep records. However, documentation that meets the statutory requirements to keep records will not necessarily satisfy the requirements to have a RAP.
Strict enforcement of contemporaneous documentation
A key point made in TR 2014/D4 is that transfer pricing documentation prepared after the income tax return has been lodged cannot be taken into account in meeting the requirements in order to potentially have a RAP. As such, a taxpayer will not have a RAP in the event of a transfer pricing audit, even where documentation has been prepared unless it is prepared prior to lodgment of the company's tax return. This represents a strict view by the ATO and means that taxpayers should ensure that documentation is prepared prior to lodging a tax return. For those companies with a 30 June 2014 year end, this will mean that documentation will need to be prepared by 15 January 2015.

Taxpayers need to consider potential reconstruction
One area of uncertainty that arises from Subdivisions 815-B and 815-C is whether taxpayers need to consider the possible application of the transfer pricing reconstruction provision in every case. This is explained in detail in TR 2014/D3 discussed below.

TR 2014/D4 indicates that taxpayers have to consider the potential for reconstruction in every case. Taxpayers may then be required to substitute alternative transactions (including hypothetical transactions) for their actual transactions.

The documentation the ATO will look for: Draft PSLA 3673
Draft PSLA 3673 sets out what ATO officers will consider when reviewing transfer pricing documentation. It has less detail on documentation requirements than the previous Taxation Ruling TR 98/11. However it is very clear in relation to the records that should be reviewed by the ATO and, by implication, the ATO's expectation of records to be prepared by the taxpayer.

It appears that draft PSLA 3673 sets a higher standard for documentation than was previously expected. For example, it sets out expectations on documents in relation to a taxpayer's internal procedures and controls, management performance systems, divisional business plans, reports recommending strategies, and the balance and sources of debt and equity.

Draft PSLA 3673 sets out the ATO's new “5 step” process for taxpayers to follow when preparing transfer pricing documentation. The five steps are:

- Step 1: Identify the actual conditions in connection with the commercial or financial relations
- Step 2: Select the most appropriate and reliable method to be used to identify the arm's length conditions
- Step 3: Identify the comparable circumstances relevant to identifying the arm's length conditions
- Step 4: Application of the transfer pricing rules so as best to achieve consistency with the relevant guidance material
- Step 5: Monitor, review and update transfer prices, as necessary

ATO approach to transfer pricing penalties: Draft PSLA 3672
Draft PSLA 3672 sets out a process for ATO officers to follow when determining whether a tax penalty should apply in the event of a transfer pricing adjustment. It provides a good overview of the legislation and insights into the key factors the ATO will consider when determining transfer pricing penalties. This includes what factors ATO officers should take into account when considering a remission of penalties.

If a taxpayer’s dominant purpose for entering into a scheme is to obtain a transfer pricing benefit, penalties of up to 50% apply. Where it is determined that this was not the case, penalties of up to 25% apply. Lower rates apply where the taxpayer can establish a RAP, potentially reducing penalties to 10%. The Commissioner also retains the discretion to wholly or partially remit penalties, based on the facts and circumstances of a case.

Draft PSLA 3672 does not deal with penalties relating to statements, i.e., reasonable care considerations. Accordingly, these provisions must also be considered in determining a
taxpayer’s potential liability, with the potential for additional penalties to be imposed.

**ATO views of reconstruction power: TR 2014/D3**

TR 2014/D3 provides the ATO’s view on the application of Section 815-130 of ITAA 1997 which sets out the relevance of the actual commercial or financial relations in determining the arm’s length conditions. As a basic rule, the arm’s length conditions should be based on the form and substance of the actual commercial or financial relations. However, the Section provides exceptions where arm’s length conditions must be based on alternative commercial or financial relations. This is referred to as the reconstruction provision.

The reconstruction provision is not a power reserved for only the ATO to apply. TR 2014/D3 states it must be considered in every case by taxpayers self-assessing whether they have received a transfer pricing benefit. For many taxpayers this will be a difficult and time consuming process, particularly if they have numerous, unique or complex related party dealings.

**ATO views on considering substance over form**

To the extent the economic substance of the commercial or financial relations is inconsistent with the form, the economic substance prevails and the form is disregarded. While this concept is not controversial and aligns with the OECD Guidelines, the impact for taxpayers is potentially significant.

The ATO, in TR 2014/D3, expects taxpayers to survey the commercial or financial relations and the conditions adopted by independent entities. Where the actual relations are unique, taxpayers will need to demonstrate that all elements of the relations are commercially rational and best serve the separate economic interests of the taxpayer.

**The reconstruction provision: ATO views**

One of the ongoing sources of difficulty with the new transfer pricing law is the broad wording of the reconstruction provision. This is made more challenging by the expansive analysis the ATO appears to expect in order for taxpayers to determine their relations are those which independent entities would enter.

The OECD Guidelines include an additional test that should be satisfied prior to reconstructing a transaction; being that the actual structure practically impedes the tax administration from determining an appropriate transfer price. The OECD Guidelines indicate that these circumstances will be exceptional, and that it is generally inappropriate to restructure an actual transaction. Unfortunately, the draft Ruling does not provide any comfort that the ATO will only apply, and only expect taxpayers to apply, the reconstruction provisions in the exceptional circumstances in line with the OECD Guidelines.

TR 2014/D3 also expects taxpayers (and allows the ATO) to test the individual elements of the actual relations, so as to determine which
should be retained or rejected, and whether any additional elements should be included. This selective approach, under which the ATO can seek to “cherry pick” individual elements to accept or disregard, potentially ignores the overall commerciality of the relations between entities.

Next steps for businesses

To manage the additional risks and uncertainty that arise from Subdivisions 815-B and 815-C, taxpayers need to have a clear framework and process for managing tax transfer pricing issues. That will include strong emphasis on documentation.

A key part of the framework for most taxpayers will be the use of contemporaneous transfer pricing documentation to explain the approach the taxpayer has followed and its consistency with the law. The documentation will also be relied upon to mitigate the extent of penalty tax in the event the approach does not satisfy the arm's length principle.

Companies with a 30 June 2014 year ends will soon have to close off their financial years, and need to follow Subdivisions 815-B and 815-C to self-assess whether there is a transfer pricing benefit for the purpose of their tax return. The draft Rulings and Practice Statements, in combination with the 2010 OECD Guidelines, describe the approach and standards that are expected in order to manage down tax risk.

Taxpayers should review their readiness for Subdivisions 815-B and 815-C and the new documentation rules. In particular:

- Assess the extent of penalty protection required for the company in relation to tax risks
- Review legacy documentation for its adequacy to explain the company’s position using the concepts and tests of Subdivisions 815-B and 815-C
- Review any gaps in relation to transactions not adequately covered by legacy documentation
- Consider whether there are any exceptions that may require self-assessment of a transfer pricing benefit and whether this can be fixed prior to year end
- Pay special attention to potential high risk transactions, e.g., business restructures, marketing hubs and aggressive financing
- Assess whether there is sufficient information and resources to satisfy the self-assessment and documentation requirements
- Consider whether the transfer pricing risk profile needs to be communicated to internal stakeholders

Taxpayers need to have a procedure in place that allows monitoring of transfer pricing on an annual basis. Taxpayers must be able to annually attest to the fact that their transfer pricing outcomes continue to reflect the Australian business operations. Where there are any material changes to the business, extra care should be taken to ensure that these have been adequately documented, including a consideration of the applicability of the reconstruction provisions.
For additional information with respect to this Alert, please contact the following:

**Ernst & Young (Australia), Brisbane**
- Kevin Griffiths  +61 7 3243 3754  kevin.griffiths@au.ey.com

**Ernst & Young (Australia), Melbourne**
- Keir Cornish  +61 3 9288 8051  keir.cornish@au.ey.com

**Ernst & Young (Australia), Perth**
- Joe Lawson  +61 8 9429 2489  joe.lawson@au.ey.com

**Ernst & Young (Australia), Sydney**
- Paul Balkus  +61 2 9248 4952  paul.balkus@au.ey.com
- Danielle Donovan  +61 2 8295 6333  danielle.donovan@au.ey.com
- Jesper Solgaard  +61 2 8295 6440  jesper.solgaard@au.ey.com
- David Tracey  +61 2 9248 5085  david.traceye@au.ey.com

**Ernst & Young LLP, Australian Tax Desk, New York**
- Michael Anderson  +1 212 773 5280  michael.anderson@ey.com

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**EY Transfer Pricing**

- **Global Transfer Pricing**, Germany
  Thomas Borstell, +49 211 9352 10601

- **Americas**, United States
  Purvez Captain, +1 713 750 8341

- **EMEIA**, Germany
  Oliver Wehnert, +49 211 9352 10627

- **Asia Pacific**, Singapore
  Luis Coronado, +65 6309 8826

- **Japan**, Tokyo
  Kai Hielscher, +81 3 3506 1356

- **Global Markets**, United Kingdom
  John Hobster, +44 207 951 6438

- **OME**, Amsterdam
  Victor Bartels, +31 88 4071378
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