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Global Tax Alert

News from Transfer Pricing

Australian Taxation Office releases final guidance on compliance approach to distributor profit margins: Action required

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Executive summary

The Australian Taxation Office (ATO) recently released new guidance - [Practical Compliance Guideline PCG 2019/1](#) (the PCG) - which will be relevant for all multinational enterprises (MNEs) with distribution operations in Australia (whether the Australian activities are limited to distribution or these form part of broader business operations).

The guidance will be relevant to MNEs involved in the following:

- ▶ MNEs required to file a **Reportable Tax Position (RTP) schedule** with the ATO, which for years ending on or after 30 June 2018 includes all entities with Australian turnover in excess of AU\$250 million.
 - MNEs with years ending on or after 31 December 2018 are required to disclose their self-assessed risk-rating per the guidance in their RTP Schedule.
 - Where reliable segmented data is available, the risk rating needs to be determined and reported for distribution segments of broader businesses.
 - The self-reported risk rating is likely to form a key component of the ATO's risk assessment of the entity.
- ▶ MNEs involved in or planning for formal field-based risk reviews, including Streamlined Assurance Reviews (which will be conducted for all taxpayers with revenue in excess of AU\$250m), should consider conducting detailed transfer

pricing analysis and documentation that is likely beyond the level required to establish minimum compliance where they are assessed as having a risk rating beyond the low risk level under the guidance. In particular:

- Field-based risk reviews do not directly result in transfer pricing adjustments. However adjustments can arise once a case is escalated from risk review to audit.
 - As such, in order to minimize transfer pricing risk, a key objective is to deal with ATO risk concerns at the field-based risk review level.
 - Although the risk rating under the guidance is intended for initial risk assessment purposes only (and should not form the basis of detailed ATO field-based risk review analysis), a risk rating beyond the low risk level per the guidance indicates a level of ATO risk concern that should be comprehensively addressed to minimize the risk that the ATO will seek to escalate the case to a full audit.
- MNEs with **existing Advance Pricing Agreements (APAs) or involved in/considering applying for an APA.**
- MNEs whose outcomes fall outside of the low-risk zone are likely to face increased scrutiny and as such will find it more difficult to secure ATO support for an APA unless analysis is conducted to directly address the risk concerns expressed under the guidance.
 - Again, in order to address these risk concerns, it will be important to conduct detailed transfer pricing analysis and documentation that is likely to be beyond the level required to establish minimum transfer pricing compliance.
 - The guidance is likely to affect the ATO's starting position for unilateral APA, Mutual Agreement Procedure and bilateral APA discussions.

In light of the above, MNEs should take immediate action to assess their risk rating under the guidance, determine what reporting is required, and what action should be taken. The guidance does not replace the proper operation of the law and as such, it is possible and even likely in some circumstances, that a risk guidance result outside the low-risk zone can be defended as being appropriate with the support of properly constructed transfer pricing analysis and documentation.

Detailed discussion

The PCG outlines how the ATO assesses the level of transfer pricing risk for inbound distributors based largely on quantitative factors. The final PCG largely follows the earlier draft PCG 2018/D8 which was released on 23 November 2018.

Consistent with the approach adopted in other recently released PCGs (such as PCG 2017/1 on centralized operating models and PCG 2017/4 on intra-group financing arrangements), the framework in the PCG categorizes inbound distributors into color-graded risk zones (high, medium and low risk zones) having regard to profit markers set by the ATO based on the Earnings Before Interest and Tax (EBIT) margin, calculated on a five-year weighted average basis. The higher the risk zone rating, the greater the potential impact for taxpayers and the greater the ATO attention.

The ATO intent is to allow inbound distributors to identify scenarios when they might have reduced ATO compliance activities. However, the profit margins and ATO approach will categorize many inbound distributors as being of medium and high risk, with significantly increased ATO oversight and compliance activities.

Inbound distributors need to carefully consider the implications and their response.

PCG applies to all distributors

The PCG applies to inbound distribution arrangements of any scale, which covers businesses primarily involved in (together with the provision of any ancillary services):

- The distribution of goods purchased from related parties for resale, or
- The distribution of digital products or services where the intellectual property in those products or services is held by international related parties.

The ATO considers the focus of inbound distributors to be on selling business to business, rather than to household consumers. However, the PCG notes that inbound distributors may have some retail operations (which is not their primary sales channel).

The PCG does not apply to an inbound distributor that adopts the Distributor option under the Simplified Transfer Pricing Record Keeping Options set out in PCG 2017/2.

Further, the risk framework does not apply to taxpayers where any of the following applies to their inbound distribution arrangements for the current income year:

- An APA
- A settlement agreement with the ATO
- A court or Administrative Appeals Tribunal decision involving the taxpayer

- ▶ A review of the inbound distribution arrangements has been conducted by the ATO, for which the ATO provided a low-risk or high-assurance rating

The PCG is applicable to prior and future periods.

The risk assessment framework

The framework set out in the PCG involves assessing transfer pricing risk by comparing the profit outcome of inbound distribution arrangements against the ATO's profit markers.

The ATO has set profit markers for three specific industry segments

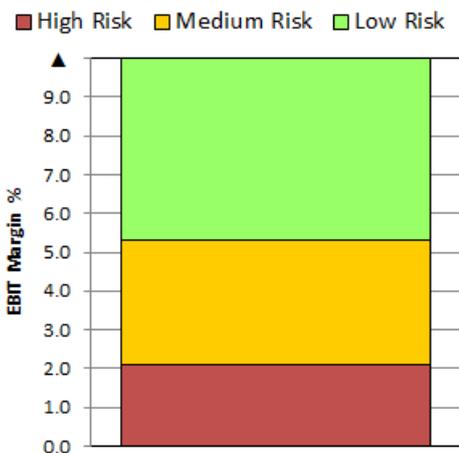
- ▶ Life Sciences
- ▶ Information and Communication Technology (ICT)
- ▶ Motor Vehicles
- ▶ And a fourth for general distributors (applying to all other inbound distributor arrangements)

The ATO has emphasized that the profit markers should not be relied on as "safe harbors."

Profit markers

General distributors

The profit markers for general distributors apply to any distribution arrangements not otherwise covered by the specific industry sectors outlined in the PCG (see below). The relevant risk zones are summarized in the diagram below:



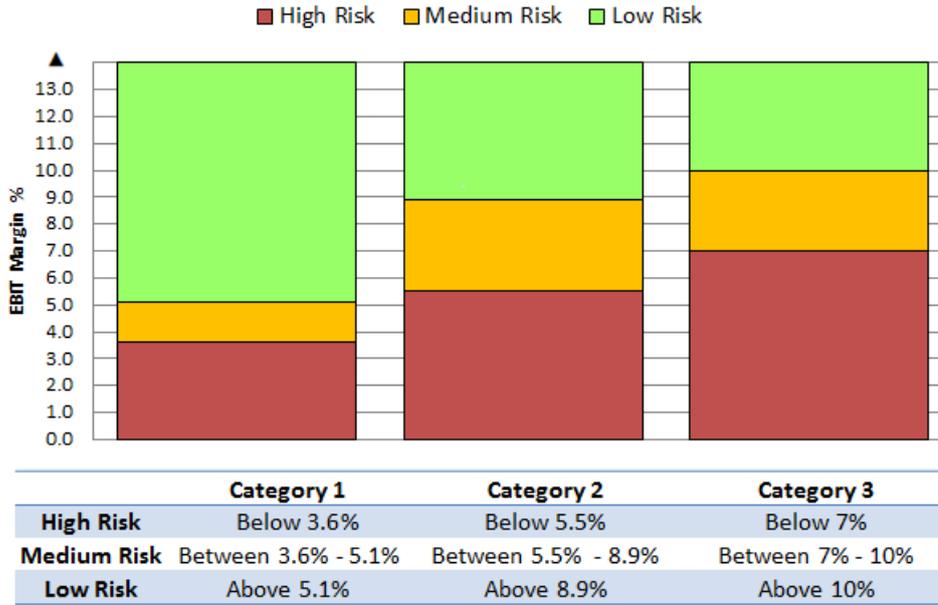
High Risk	Below 2.1%
Medium Risk	Between 2.1% - 5.3%
Low Risk	Above 5.3%

Life Sciences Sector

This sector includes distributors of pharmaceutical products, medical devices and animal health products, and is sub-categorized based on activities that incrementally generate value as follows:

- ▶ Category 1: Distribution activities, including detailing and marketing, logistics and warehousing activities
- ▶ Category 2: Activities in Category 1, plus regulatory approval, market access or government reimbursement activities
- ▶ Category 3: Activities in Category 1 and 2, plus specialized technical services such as training and assistance in conducting surgical procedures involving medical devices

The profit markers for the life sciences sector are summarized in the diagram below:

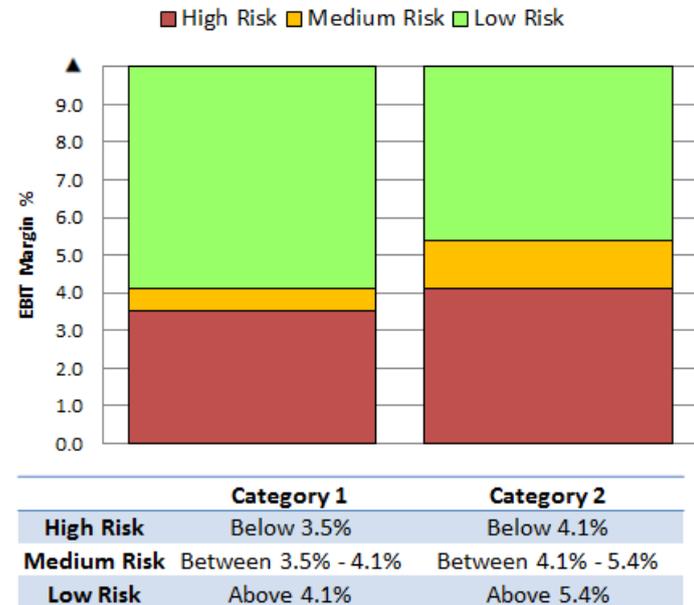


ICT Sector

This sector covers 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. It is sub-categorized based on activities that incrementally generate value as follows:

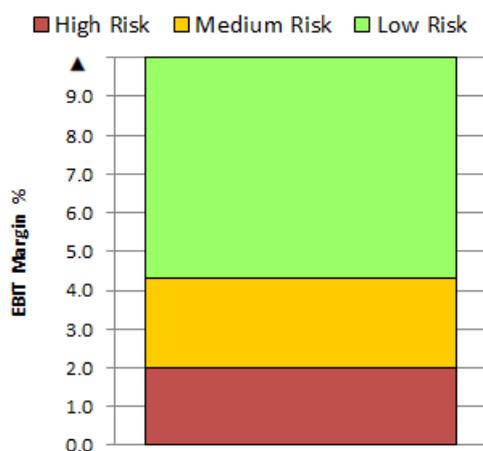
- ▶ Category 1: Distribution activities, including sales and marketing, pre- and post-sales services, and logistics and warehousing activities
- ▶ Category 2: Activities in Category 1, plus complex sales processes, direct selling activities and/or large customer relationship management activities

The profit markers for the ICT sector are summarized in the diagram below:



Motor Vehicles Sector

The profit markers for motor vehicle distributors are summarized in the diagram below:



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

ATO compliance approach varies with its risk classification

The ATO's compliance approach for each risk zone is as follows:

- ▶ Low risk zone - The ATO will generally not allocate compliance resources to assess transfer pricing outcomes of inbound distributors in this zone other than to confirm characterization and the extent of the activities undertaken. The ATO will be open to APA discussions with these low risk inbound distributors, who are also eligible to request a pre-qualified APA process.
- ▶ Medium risk zone - The ATO will monitor the inbound distribution arrangements using available data and may seek a better understanding of relevant circumstances before deciding to allocate further compliance resources. The ATO may be open to APA discussions with medium risk inbound distributors, who are also eligible to request a pre-qualified APA process.
- ▶ High risk zone - The ATO will consider appropriate options and may recommend the taxpayer review its transfer pricing policies. This may involve the ATO writing to the taxpayer expressing their concern, actively monitoring the taxpayer's distribution arrangements, or commencing a review or audit. These high-risk inbound distributors may

be able to request an APA, although the ATO has expressed that there are likely factors which will make an APA difficult to conclude. They are also not eligible to request a pre-qualified APA process.

The PCG does not provide formal safe harbors, nor does a high-risk classification imply that the taxpayer's position is unsustainable. Rather the PCG, like other PCGs, reflects the ATO desire to encourage taxpayers to revisit transfer pricing matters where they fall outside the low risk zone, to allow better deployment of ATO compliance resources and to explain ATO actions in the event of higher perceived risks.

Self-assessment and disclosing the risk classification to the ATO

Taxpayers who are inbound distributors and are required to file an RTP schedule with the ATO will be required to self-assess and report their risk zone rating having regard to the PCG. The RTP obligation applies:

- ▶ By written request from the ATO, or
- ▶ Automatically if the taxpayer's Australian revenue exceeds AU\$250m for years ending on or after 30 June 2018.

The first year for which reporting is required is the year ended 31 December 2018.

Additionally, the ATO is also requesting that taxpayers report their self-assessed risk zone rating per the PCG as part of ATO reviews of businesses' tax arrangements (including Streamlined Assurance Reviews).

Next steps

Reporting risk assessments to the ATO

The PCG is unclear regarding risk assessments for taxpayers having sizeable functions such as manufacturing, services or other functions in addition to their inbound distribution activities. These taxpayers may experience difficulty in making appropriate disclosures under the RTP schedule.

The ATO's approach to categorization outlined in the PCG also does not have regard to the intensity of particular functions and can therefore give rise to substantial differences in categorization despite minor differences in functions.

For instance, a life sciences company performing regulatory activities for a small portion of its product range would fall under Category 2 rather than Category 1. The current approach is therefore likely to result in a number of "false

positives” where functional intensity is not taken into account. Given that the lower end of the “green zone” for taxpayers in Category 1 lies within the “red zone” for Category 2 taxpayers, differences in accounting for functional intensity might cause taxpayers to be falsely categorized, resulting in potentially inaccurate risk assessments and compliance implications for taxpayers.

Taxpayers should work with their local tax professional if they are uncertain whether the above scenarios apply, or if they are unsure how best to report their risk assessments.

Choosing an appropriate course of action

The ATO specifically notes that the guidance in the PCG does not limit the application of the law or relieve taxpayers of their legal obligations to comply with relevant tax laws, and that the profit markers should not be relied on as “safe harbors.” In this regard, having a low-risk rating does not necessarily mean that one’s transfer pricing outcomes are correct or that there is a reasonably arguable position.

By the same token, having a high-risk rating does not necessarily mean that a taxpayer’s inbound distribution arrangements fail to comply with Australia’s transfer pricing rules: it means instead that the ATO will more likely implement more extensive compliance activities and seek greater assurance around such transfer pricing arrangements.

Given the profit markers outlined in the PCG, it is anticipated that a large number of taxpayers will fall into the medium- or high-risk zone, notwithstanding where they have performed robust benchmarking analysis and associated transfer pricing documentation support.

It is highly recommended that taxpayers outside of the low risk zone should:

- ▶ Review their transfer pricing arrangements to determine how the PCG risk assessment framework applies to them
- ▶ Consider what analysis to conduct and approaches to adopt in order to manage and document their existing positions prior to an ATO review

Some options taxpayers may wish to consider include:

1. **Document and further support current positions** -

Where neither of the above options are appealing, taxpayers will need to consider what additional work is required to ensure their existing transfer pricing positions are appropriately supported to reflect an appropriate transfer pricing outcome.

2. **Apply for an APA** - Taxpayers may wish to obtain certainty by approaching the ATO for an APA. The concept of a pre-qualified APA has been introduced by the PCG which aims to streamline the APA process for eligible taxpayers (although the benefits are not entirely clear at this stage). The ATO has however specified that the pre-qualified approach entails application of the transactional net margin method (TNMM) which applies the ATO profit markers, and will also require a broader review of other tax matters.
3. **Transitioning to the low-risk zone** - The ATO has offered to remit penalties and interest on prior year amendments for taxpayers who choose to adjust their transfer pricing arrangements to “reflect an appropriate transfer pricing outcome” (e.g., aligning with the low-risk zone), and align with a low-risk zone going forward. It is anticipated that given the level of profit markers required to fall within a low-risk zone, some inbound distributor taxpayers could find this to be an inappropriate option in the context of their business circumstances.

Selecting the most appropriate risk mitigation strategy will require analysis of whether any risk is real and appropriate in the context of relevant facts. This may require consideration of many factors, not just by the Australian distributor taxpayer but also by the overseas supplier entities and the parent group. Some potential factors include:

- ▶ Evaluation of the analysis and information required to document and strengthen the position taken
- ▶ Impact on the global supply chain and overall profits
- ▶ Whether any recalibration of transfer pricing arrangements is consistent with the global policies of the group
- ▶ Whether any recalibration of transfer pricing arrangements would result in potential challenges from the revenue authority on the other side of the transaction
- ▶ In the case of APAs, the costs vs benefits having regard to the likelihood of concluding an APA with the tax authorities based on terms outside the low-risk zone

Again, the guidance does not replace the proper operation of the law. It remains important to ensure that transfer pricing outcomes continue to be appropriately assessed with respect to the arm’s-length principle, which is the only legislative basis for the assessment of transfer pricing outcomes. MNEs with outcomes that fall outside the low-risk zone should ensure their position is appropriately supported given the increased reporting and scrutiny of these arrangements that is likely to arise from this new guidance.

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