In Search of Elusive Profits or Adventures in Australian Transfer Pricing

After presenting a brief introduction to Australian transfer pricing rules, this article considers recent case law concerning the ability of the Commissioner to administer the transfer pricing provisions under Australian law and income tax treaties.

1. Introduction

In March 2012, Australia’s Treasury released for comment Exposure Draft legislation which, when enacted, will make extensive changes to Australia’s transfer pricing rules. If the reader has not been following recent transfer pricing developments in Australia, some of the proposed changes, such as giving the force of domestic law to the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (hereinafter OECD Guidelines), may seem to be somewhat unorthodox; others, such as allowing the Commissioner to use treaties as a separate assessment power – doing away with an almost universal principle that income tax treaties should act as a “shield” and not a “sword” – plainly odd.

Something really important must have happened Down Under that made the Australian Taxation Office to cry wolf and the Australian Treasury to issue the call of barbarians at the gate.

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2. Transfer Pricing Rules before 1981; Section 136

Australia’s transfer pricing rules go all the way back to 1936, when the Income Tax Assessment Act 1936 (ITAA36) was enacted with section 136, which was, in substance, an early implementation of a profit-based transfer pricing method. This provision allowed the Commissioner to reconstruct the taxable income of a taxpayer based solely on the taxpayer’s revenues. The operating provision in section 136 was as follows:

[If it appears to the Commissioner that the business [carried on in Australia] produces either no taxable income or less than the amount of taxable income which might be expected to arise from that business, the person carrying on the business... shall be liable to pay income tax on a taxable income of such amount of the total receipts... of the business as the Commissioner determines.

Without a doubt, tax administrations worldwide would kill to have a provision like the former section 136, and indeed the legislature in 1936 seems to have understood this. The Commissioner’s power to reconstruct taxable income is limited by a requirement that, in order for section 136 to apply, the Australian business must be controlled principally by non-residents (section 136 had other conditions which are not relevant to this discussion).

In essence, section 136, instead of struggling with determining whether dealings that resulted in a loss were arm’s length, simply required that an Australian business controlled by non-residents be earning an after-tax profit comparable to other similar businesses. If such profits were not earned and the business had not yet gone bankrupt, the business would be required to pay tax on the comparable profits, as determined by the Commissioner.

There were other limits to this section: for example, it did not apply to outbound transfer pricing, did not apply to income not linked to business or passive activities and did not allow the Commissioner to adjust the actual receipts of the Australian business. However, the key limitation of section 136 was the requirement of “control” by non-residents, which caused its ultimate demise at the hands of the High Court in 1980, when it handed down a judgement in FCT v. Commonwealth Aluminium Corporation Limited. It is useful to recap the main facts of the case.

The taxpayer was an Australian company most of the shares of which were held by non-residents. The Commissioner argued that the non-resident shareholders had a capacity to control the Australian business and that the inference had to be drawn that this capacity was exercised. It therefore followed that the main condition of section 136 was satisfied. On the other hand, the taxpayer argued that there was no evidence of such control and in any case owning shares does not equate to controlling the company. The High Court noted that a business is generally controlled by its directors, officers and employees, and while shareholders do have capacity to control, in this case there was no evidence that the shareholders did exercise their capacity to control.

Looking back from the year 2012, it seems that the Commissioner was trying to argue that the taxpayer and its shareholders were not dealing at arm’s length, as otherwise the Australian business would have returned higher profits. It follows that the inference has to be drawn that the shareholders controlled the taxpayer. The Court, however, refused to infer control from lower profits and preferred...
to decide on the factual evidence of actual control. Later in the article, the author will return to somewhat similar arguments which were advanced by the Commissioner some 20 years later and which gave rise to consequences of similar proportions.

As a consequence of the High Court’s decision, the Treasury became concerned about a significant reduction of the scope of the transfer pricing provisions with the corresponding increased risks for the revenue. This necessitated the introduction in 1981 of Division 13 of the ITAA36, which has been Australia’s transfer pricing provision since then.

3. Current Transfer Pricing Rules: Division 13

In order to overcome the High Court’s decision in Commonwealth Aluminium Corporation, the government introduced, in 1981, a new Division 13 of the ITAA36. In the Second Reading Speech for the bill introducing the new provisions, the Treasurer stated that the new provisions are required to “deal comprehensively with the shifting of profits out of Australia, whether by transfer pricing or other means”. The Second Reading Speech also included the following comments:

- the contribution of the OECD was acknowledged;
- the operation of Division 13 does not depend on a dominant tax anti-avoidance purpose; and
- Division 13 applies where parties deal at other than arm’s length under an international agreement. Where parties are not dealing at arm’s length, the Commissioner is entitled to use arm’s length prices instead of the actual agreed consideration.

A detailed explanation of Division 13 could be found in the Explanatory Memorandum to the bill. There are many excellent publications on all aspects of Australia’s transfer pricing rules, and this article does not aim to provide a comprehensive or detailed review of those rules. Rather, it will focus on the aspects of the transfer pricing rules that are relevant in the context of recent developments. These aspects can be summarized as follows:

- in order to apply the new transfer pricing provisions, the Commissioner must be satisfied that (1) any two or more of the parties to the agreement were not dealing at arm’s length with each other in respect of the agreement and (2) if independent persons were dealing at arm’s length under the agreement, the arm’s length consideration would be different from the actual consideration under the agreement;
- if these requirements are met, the Commissioner may redetermine the taxpayer’s assessable income or allowable deductions by using “the internationally accepted arm’s length principle”. The Explanatory Memorandum noted that this is the same principle as that used in Australia’s income tax treaties to enable the determination of profits attributable to business activities; and
- where the determination of the arm’s length consideration is not feasible, the Commissioner may reconstruct Australian taxable income from the international transactions (i.e. the transactional profit-based methods may be used only as a last resort).

The Explanatory Memorandum noted that there were a number of methods by which an arm’s length consideration might be calculated, and that the more commonly accepted methods are the comparable uncontrolled price (CUP), cost-plus and resale methods. While not mentioned in the Explanatory Memorandum, these are the methods listed in the 1979 Report of the OECD Committee on Fiscal Affairs on Transfer Pricing and Multinational Enterprises (hereinafter 1979 OECD Transfer Pricing Report).

Also, the Explanatory Memorandum went to great lengths to state that the proposed transfer pricing rules do not overstep the taxing authority allocated to Australia under its existing income tax treaties. For example The Explanatory Memorandum mentioned that the arm’s length principle, introduced by the legislation, is an internationally accepted principle that is not different from the requirements under Australian treaties. It went on to state that:

- it is not proposed that the [new legislation] will override the Income Tax (International Agreements) Act 1953. The double taxation agreements which appear as Schedules to that Act contain their own provisions to deal with profit shifting arrangements... and these provisions are based on application of the arm’s length principle.

Lastly, it is notable that the Explanatory Memorandum did not mention the 1979 OECD Transfer Pricing Report at all, notwithstanding that the Second Reading Speech seems to imply that the new rules were developed based on the OECD documents.

The new transfer pricing provisions were enacted as Division 13 of the ITAA36 to apply from 27 May 1981. The old section 136 was repealed.

4. Administration by the Australian Tax Office

Since the introduction of Division 13 in 1981, Australia, as an OECD member, has been an active member of the OECD Working Group 6 on Transfer Pricing, and it is not surprising that the Australian Taxation Office has been administering Australia’s transfer pricing provisions based on the OECD Guidelines. In administering Division 13, the Australian Taxation Office issued a number of other rulings that refer to the OECD documents as the basis of the administration of Division 13.

For example, the Australian Taxation Office’s Taxation Ruling TR 94/14 “Application of Division 13”, released in 1994, discusses the administration of Division 13 in the framework of the 1979 OECD Transfer Pricing Report – in particular, around the arm’s length principle. The Ruling also makes a comment that while Division 13 and treaty provisions are based on the same arm’s length principle, due regard should be given to the precise wording of the provisions, and that the Commissioner may apply Division 13 and/or the treaty provisions. The author will come back to this comment later.

Also, Taxation Ruling TR 97/20 “Arm’s length transfer pricing methodologies”, issued in 1997, states that the Ruling follows the 1995 OECD Guidelines.
It is interesting that Ruling TR 97/20 requires the use of the “most appropriate method” and discusses a range of situations where the use of the transactional profit methods is more appropriate. In contrast, it is only the 2010 OECD Guidelines that introduced a requirement to use the “most appropriate method”, while retaining the superiority of the traditional transactional methods in certain circumstances. It appears that while referring to the OECD documents, the Australian Taxation Office had in mind the US transfer pricing regulations, which attribute equal importance to both traditional and profit-based methods.

The statistics on advance pricing agreements released by the Australian Taxation Office show that the transactional net margin method (TNMM) (similar to the US cost-plus method) has been by far the most commonly used method in Australian advance pricing agreements. While this is not unusual in an APA context, it may suggest the Australian Tax Office’s familiarity with, if not preference for, the profit-based methods.

5. Transfer Pricing Case Law

As shown above, it is not difficult to conclude that, at least on a literal reading of Division 13 and its Explanatory Memorandum, the practical aspects of the administration of the transfer pricing provisions by the Australian Taxation Office have not been fully in line with the legislation and extrinsic material. Anecdotal evidence suggests that between 1981 and 2008, the Australian Taxation Office has been making transfer pricing adjustments, but where a taxpayer contested the adjustment, the Australian Taxation Office preferred to settle out of court. Because of this practice, prior to 2008, the substantive provisions of Division 13 were not tested before the courts.

6. The Roche Case

The year 2008 was a pivotal one for Australian transfer pricing provisions, with the Administrative Appeals Tribunal handing down its decision in Roche and putting the administrative practices of the Commissioner to test.

Before considering this decision, one should bear in mind that the Administrative Appeals Tribunal is the lowest level of appeal in Australia. Generally, it is used when an appeal directly to the Federal Court is not warranted, for example, where the matter on appeal is a question of fact or the amount of tax in dispute is small. A decision of the Administrative Appeals Tribunal does not create a precedent and may be appealed to the Federal Court on a question of law. It is also possible to appeal to the Federal Court directly, bypassing the Tribunal. A single-judge decision of the Federal Court may then be appealed to the Full Federal Court and, lastly, the High Court may be asked to grant a special leave to appeal a decision of the Full Federal Court. However, there is no right to appeal to the High Court.

Roche Products Pty Limited (Roche Australia) was a subsidiary of a Swiss company and part of an international group. The group carried on the business of selling pharmaceuticals, reagents and other diagnostic products, selling the products to subsidiaries, such as Roche Australia, which then sold the products to customers in their relevant market. As many sales were internal, there was rarely a free market for a specific pharmaceutical product or even potentially comparable products. Even when comparable prices could be found, they could vary, as marketing and retail circumstances were often different.

Prior to the appeal to the Tribunal, Roche Australia and the Commissioner agreed that Roche Australia, in purchasing pharmaceuticals from other group companies, was not dealing with them at arm’s length, and this matter was not before the Tribunal.

The Commissioner argued that prices that would have been paid by Roche Australia to unrelated parties dealing with Roche Australia at arm’s length were lower than the amounts actually paid by Roche Australia. On this basis, the Commissioner used the arm’s length prices and assessed Roche Australia on the difference, which was in excess of AUD 100 million. Roche Australia, on the other hand, argued that while it was not dealing at arm’s length, the arm’s length prices would not be lower than the prices it actually paid.

Reading the decision, it is obvious that the Judge struggled with the relevance of the highly detailed economic analysis presented to him by both parties:

Transfer pricing issues related to taxation are apparently highly sophisticated and highly complex in the United States. Each of the experts is an economist specialising in the field. Their approach to the issues before me must be coloured by their United States experience. At times I wondered why Australian experts could not have approached this matter with just as much skill as the experts from the United States but without some of the presumptions which their work must have led to. Unfortunately, none of the experts were either asked to, or did, directly address the provisions of either double tax treaties or the Assessment Act. Had they done so my task might have been easier.

The Judge then proceeded to comment on the evidence presented by the Commissioner’s expert, noting that the expert used “calculations of the mark up from the internet”; examined activities that Roche Australia was not involved in; used very small samples to draw conclusions; justified profitability “using the profitability of international advertising agencies, as comparable to internal marketing deliberations of a pharmaceutical company”; and justified transfer pricing outcomes based on “because I believe that to be the appropriate mark-up”.

His Honour’s comments on the taxpayer’s experts were less colourful, but also showed a certain disconnect between the economic evidence provided from both sides and the conventional legal practice of interpretation of law.

It is not surprising that the Judge found the evidence based on the profit-based methods largely irrelevant, and preferred to use the comparable transactions, however remote they might be to the dealings under consider-

ation. In doing so, the Judge accepted the OECD Guidelines without questioning their relevance, but noted that:

The obvious starting point is to look for actual arm’s length transactions, preferably for the same goods in the same market. Where there are no arm’s length sales of the same goods in the same market it may be possible to find very similar goods or a very similar market. Then, the question is whether the goods or markets are sufficiently comparable and whether any, and if so, what, adjustments can be accurately made to compensate for any differences.

This approach is a common one for valuers...

It is also not surprising that, in determining the arm’s length consideration, the Judge preferred to use a more familiar valuation approach based on actual sales, rather than venturing into the world of markups made by other enterprises under different circumstances. After all, there was nothing in Division 13 that would cast any doubt on the approach taken by the Court.

After a detailed analysis of comparable prices, the Court reduced the transfer pricing adjustment to AUD 45 million (from AUD 110 million). The case was not appealed by either party. The outcome of the case was perhaps not unexpected and merely demonstrated that Australian courts had little appetite for profit-based methods based on complex economic analysis, as long as some form of comparable transactions were available. This outcome was not different from the outcome contemplated by the Explanatory Memorandum in 1981 when the transfer pricing rules were enacted.

Notably, the Judge also questioned the ability of the Commissioner to make transfer pricing assessments based directly on the applicable income tax treaty and not on Division 13. Specifically, the Judge noted that “there is a question in this case... as to whether the double tax treaties confer power on the Commissioner to assess income tax at all”. In any case, treaties deal with “profits” and refer to “independent enterprises dealing wholly independently”, whereas Division 13 refers to “acquisitions” and parties “dealing at arm’s length”.

Based on the parties’ submissions, the Judge was not required to rule on this matter. Nevertheless, he noted that “[treaties] allocate taxing power between the treaty parties rather than conferring any power to assess on the assessing body. On this basis, Division 13 should be seen as the relevant legislative enactment pursuant to the power allocated”.

From reading the decision, it becomes clear that the Judge had fired a shot across the Commissioner’s bow, warning him that his administering of the transfer pricing provisions was now open to challenge.

7. **Roche: Australian Taxation Office’s Decision Impact Statement**

In response to the decision of the Tribunal, the Australian Taxation Office released a Decision Impact Statement with two main observations. The first observation is a mere comment that where the traditional transfer pricing methods are not available, the Tribunal has the power to apply the profit-based methods. This, however, was not in dispute.

The second observation effectively represents the Commissioner firing a shot back, saying that he was not bound by the observations made by His Honour on the treaty power to assess and would continue to adhere to the view that the business profits or associated enterprises article of an applicable treaty may provide a separate basis for assessing transfer pricing adjustments, independently of Division 13. In doing this, the Commissioner reiterated his comment originally made in Taxation Ruling TR 94/14 that there are two separate powers of assessment under the transfer pricing provisions: the power under the domestic rules in Division 13 and a separate power under income tax treaties. This means that the Commissioner is able to make a transfer pricing adjustment under a treaty, as long as that treaty allocates to Australia a right to tax, even where the domestic transfer pricing provisions do not allow a transfer pricing adjustment.

In other words, treaties may be used not only as a “shield”, protecting taxpayers from double taxation and denying domestic taxation where the treaty does not allocate a right to tax, but also as a “sword”, taxing taxpayers where the treaty allocates a right to tax, even though there is no taxation under the domestic rules. Only a few countries apply their income tax treaties in this manner.

This comment in the Decision Impact Statement regarding the double assessment power left taxpayers concerned and, in the course of the National Tax Liaison Group meetings with the Australian Taxation Office, a question was asked on the legal basis for the separate assessment power. In March 2009, a representative of the Australian Taxation Office replied that the Explanatory Memorandum to the bill introducing Division 13 makes it “quite clear” that the transfer pricing amendments may be made directly by operation of the associated enterprises article of an applicable treaty. However, as shown earlier, the Explanatory Memorandum is far from clear on this point.

It is not unreasonable to assume that, while claiming that Roche did not have any impact on the administration of the transfer pricing provisions, the transfer pricing experts of the Australian Taxation Office understood very well that the tide had turned. However, they needed a test case to gauge how strong the tide was. The opportunity presented itself with the audit of SNF (Australia) Pty Limited (SNF Australia).

8. **The SNF case**

SNF Australia was an Australian resident company and a member of a global group headquartered in France. During the years under review, SNF Australia bought chemical products from group manufacturers overseas and sold the chemicals to unrelated end-users in Australia. Also during the years under review, SNF Australia was in a tax loss position.

The Commissioner made transfer pricing adjustments based on the TNMM on the grounds that comparable
prices were not available. The taxpayer disagreed and appealed to the Federal Court in 2010 on the grounds that SNF Australia was paying less to its suppliers than the suppliers were charging independent third parties for the same or similar products; this pricing information was available; and therefore the CUP method should be applied to demonstrate that the consideration was arm’s length.

The single-judge court agreed with the taxpayer, and the Commissioner appealed to the Full Federal Court, which handed down its decision on 1 July 2011.³ Reading the judgement in SNF and considering its implications, one may easily be forgiven for thinking that the Commissioner was determined to lose the case by making arguments some of which were found by the Court to be “rhetorical, perhaps flamboyantly so” or of “little, indeed no, legal consequence”.

The taxpayer presented evidence that included relevant product groups, actual invoices and other documentation which showed that (1) there were comparable transactions with unrelated parties of the same supplies as those that supplied to SNF Australia and (2) the prices charged in those comparable transactions were higher than those that the suppliers charged to SNF. As such, the taxpayer argued that this was the required evidence that the actual prices were not higher than prices charged to independent parties dealing at arm’s length, and that therefore there was no basis for a transfer pricing adjustment under Division 13.

The Commissioner advanced the following arguments.

The taxpayer’s evidence was in the nature of hearsay and therefore inadmissible on the grounds that the taxpayer’s witness, who was the Worldwide Customer Service Manager at SNF France, was not directly involved in the sales by the overseas suppliers to third parties. While this was indeed a novel argument, it was rejected by the Court on the grounds that additional information provided by the taxpayer was sufficient to address the Commissioner’s concerns. It is, however, a troubling development, as it is the taxpayer that is required to bear the burden of proof and demonstrate arm’s length pricing in unrelated dealings. Had the Court accepted this argument, the scope of the CUP method in Australia would be severely limited.

The Commissioner also argued that the comparable transactions came from sales overseas, whereas the taxpayer was in Australia and therefore the comparables should also be from Australian sales. The Court disagreed on the facts and found that SNF Australia was part of a global market for the relevant products, and therefore any transaction within the global market could be comparable.

Another argument advanced by the Commissioner was that the comparables were not valid, as in order to be a comparable, the purchaser (as the sellers were the same in both the comparable and actual sales) must be in exactly the same position as SNF Australia, including persistent tax losses. As no transactions with such a hypothetical purchaser were included, there are no comparables and therefore the TNMM should be used. Curiously, the Commissioner, in making this argument, tried to refer to the statement in the OECD Guidelines that comparables require comparable circumstances, which should be read as identical. The Court found that the Commissioner’s argument is of a “deeply impractical nature” and not only lacks merit on its own terms but is also legally unsound. The Court stated that it was not necessary to find a transaction with a party in exactly the same circumstances and that any differences should, where possible, result in adjustments and not the exclusion of the comparable. In addition, the Court noted that the OECD Guidelines did not require finding a party in exactly the same circumstances.

While on the point of the OECD Guidelines, the Court found that the OECD Guidelines were not a legitimate aid to the construction of the income tax treaties, as there was no evidence that either Australia or the relevant treaty counterparties (China, France, and the United States) either agreed to apply the OECD Guidelines in the application of the equivalent of article 9 of the OECD Model, or that it was their practice to do so. Further, the Court found that Division 13 is the domestic implementation of Australia’s obligations under article 9 of its income tax treaties, and is intended to give effect to the equivalents of article 9. Notably, the Court stated that:

the double taxation treaties are designed to ensure that the taxing regimes of two jurisdictions do not result in double taxation. If they were to be interpreted in a manner which would permit or foster conflicting outcomes between the two States in question their whole point would be frustrated.

The Commissioner sought to rely on two Canadian transfer pricing cases, but the Court rejected this approach on the grounds that the text of the Canadian transfer pricing provision was materially different from the Australian provision.

Desperately perhaps, the Commissioner further argued that in order to prove that the actual prices were below arm’s length consideration, the taxpayer is required to specify a single, particular figure which was the arm’s length price. As the taxpayer provided a range of figures, the taxpayer failed to meet this burden of proof. This approach was contradicted even by the Commissioner’s expert witness and, again unsurprisingly, the Court found that the taxpayer had proved that the prices paid were less than the prices paid by independent comparable purchasers, and therefore the taxpayer’s prices did not exceed arm’s length consideration.

The Commissioner placed significant emphasis on the recurring losses of the taxpayer. The taxpayer presented evidence that the overseas suppliers were also suffering losses and were selling to Australia at a loss. The Commissioner argued that the evidence was “an outburst” and should be excluded. The Court rejected this approach and accepted the taxpayer’s evidence of losses.

Amusingly, the Commissioner did have a document that could potentially show that at least some suppliers were not suffering losses on a full absorption basis at least in respect of some products. However, the Commissioner evidently was not interested in any of the details, and the Court responded to this by commenting that the document shows that:

one of the suppliers was selling to the taxpayer something called ‘powders’ at a profit… Was it a single transaction? When was it? How much was involved? Which supplier? For how long? Without the answers to these questions one does not really know what this evidence means.

The Commissioner argued that the taxpayer was suffering losses that would have forced an independent operator from the market, and therefore the taxpayer’s motive was to suffer losses in Australia and to shift profits to France by transfer pricing. The Court noted that the motive and purpose of the taxpayer were irrelevant in transfer pricing considerations, and in any case, the taxpayer presented evidence of overly low sales, high costs, high competition, excessive stock levels and poor management that contributed to the losses, even though the losses were consistently suffered for over 14 years.

The Commissioner also argued that the taxpayer was only able to continue to trade because of an injection over the period of AUD 31.2 million in share capital from its parent, and that an independent distributor would not have continued to trade at a loss for 13 years. While the Court found that it was unclear, legally, where this argument fits in the appeal, the Decision Impact Statement released by the Australian Taxation Office in November 2011 and discussed later, sheds more light on the Commissioner’s thinking.

Based on the above reasoning, the Commissioner’s appeal was dismissed. Again, there was nothing unusual in the Court’s decision – the taxpayer was able to demonstrate comparable arm’s length dealings with unrelated parties, and the actual prices paid by the taxpayer were lower than the prices paid by unrelated parties. There was nothing extraordinary in this outcome.

It appears that the Commissioner did not dislike the comparable pricing, but the fact that a business carried on in Australia was not making profits. As such, in the Commissioner’s mind, a profit should be assessed either under the TNMM, or by somehow reconstructing a hypothetical transaction that would be profitable to the taxpayer. These arguments are eerily reminiscent of the Commonwealth Aluminium Corporation Limited case discussed above.

It is intriguing that the additional tax that would have been collected by the Australian Taxation Office if it had won the SNF case was a measly AUD 1 million (or just above AUD 2 million, taking into account penalties and interest). As Australian transfer pricing professionals were celebrating yet another case lost by the Australian Taxation Office, little did they realize that while the Australian Taxation Office lost the AUD 1 million battle, it was about to win the thermonuclear transfer pricing war.

9. The Empire Strikes Back

The Australian Taxation Office did seek a Special Leave to High Court in the SNF case. In addition, on 1 November 2011, the Assistant Treasurer announced that the government will reform the transfer pricing rules to bring them in line with international best practices, improving the integrity and efficiency of the tax system. The announcement stated that a recent court case demonstrated certain “difficulties” with the transfer pricing provisions, and therefore the government is taking action to ensure that multinationals pay the correct amount of tax in Australia. Further, the announcement stated that the changes will apply from 1 July 2004.

On the same day, the government released a detailed Discussion Paper on the proposed changes.

The Discussion Paper proposed that the arm’s length principle be redesigned to move away from pricing transactions, as is the case currently, to determining an arm’s length outcome for the full range of material dealings or arrangements between parties that do not deal at arm’s length. The policy objective stated in the Discussion Paper is to apply the transfer pricing provisions to reflect Australia’s economic contribution, based on the totality of functions, assets and risks that relate to the relevant Australian operations. In other words, merely showing that existing prices of a specific transaction are arm’s length will no longer be sufficient to demonstrate arm’s length dealings. Specifically, the Discussion Paper recommends:

– the introduction of a specific rule to ensure interpretative consistency between tax treaty provisions generally and the explanations provided in OECD materials, where treaty provisions reflect those in the OECD Model;
– improving comparability by requiring the use of the most appropriate method and effectively attributing the same importance to the profit-based methods as the traditional transactional methods. In doing this, the Discussion Paper refers to the 2010 OECD Guidelines;
– ensuring that a separate assessment power exist under Australian income tax treaties; and
– moving transfer pricing to self-assessment and retaining the discretionary power of the Australian Taxation Office in cases where information kept by the taxpayer is insufficient or for reconstruction of transactions by the Australian Taxation Office. The latter would be appropriate where the arrangements of independent parties dealing at arm’s length would differ from the actual arrangements or where independent parties would not have entered into any arrangements at all. Presumably, the Australian Taxation Office would seek to reconstruct dealings between SNF Australia and SNF France to ensure that an amount of profit is allocated to Australia. Taking it a step further, this could be interpreted to mean that companies with international related-party dealings are not expected to suffer losses in Australia.
The Discussion Paper also proposed a number of other changes. While these changes are not covered in this article, they are included for the sake of completeness:

- legislating the attribution of profits to a permanent establishment as a “functionally separate entity”. The approach of the Australian Taxation Office has been to disallow an allocation of intra-branch profits or losses (for example, only actual expenses incurred by an entity may be allocated to its branch, and a markup by the head office may not be allocated to the branch together with the actual costs);
- introducing a legislative requirement to maintain transfer pricing documentation. At present, Division 13 merely requires taxpayers to deal at arm’s length but does not require that taxpayers maintain specific transfer pricing documentation;
- limiting the time period for transfer pricing amendments. At present, there are no time limits on transfer pricing amendments by the Australian Taxation Office; and
- introducing certain measures to better align article 9 in future Australian income tax treaties with article 9 of the OECD Model.

In respect to the Discussion Paper, the Treasury received 25 submissions from taxpayers, industry associations and consultancies. Generally, the submissions welcomed a review of transfer pricing rules, but were overwhelmingly critical of a short discussion period, the retrospective aspect of the new legislation, the broad reconstruction power that will be given to the Commissioner and the introduction of a new taxing power under Australian treaties.

While some submissions supported a reference to the OECD Guidelines, others questioned the scope and the version of the Guidelines, whereas still others opposed the mandatory reliance on the Guidelines altogether.


On 7 November 2011, the Australian Taxation Office released a Decision Impact Statement on the Full Federal Court judgement in SNF. One should bear in mind that in Australia, decisions of the Full Federal Court create a precedent, and one would expect the tax authorities to set a good example in following Court judgements, even those that the Commissioner did not win.

The Decision Impact Statement mentioned the government’s announcement that the transfer pricing rules will be rewritten, but stated that until the new rules are enacted, the Commissioner, and the Decision Impact Statement, would deal with the tax administration under the current law:

- the Australian Taxation Office accepted that the TNMM was not a valid method for establishing an arm’s length consideration where other methods can be used. This is different from the Commissioner’s position expressed in the Decision Impact Statement on Roche;
- in respect of the Commissioner’s requirement for “identical circumstances”, the Statement noted that the Commissioner was misunderstood, that it was never the Australian Taxation Office view, but that nevertheless the arm’s length consideration must make commercial sense for the actual taxpayer. As such, the Statement reiterated that the Commissioner would continue considering all factors and circumstances particular to the taxpayer, rather than merely the transaction under review. This appears to reflect the Commissioner’s arguments advanced in SNF, but also appears to contradict the Court’s judgement;
- in respect of the losses suffered by the taxpayer, the Statement noted that, firstly, in applying the CUP method, an allowance should be made for market penetration pricing. It is unclear whether the Australian Taxation Office meant that the market penetration strategy should be imputed to both independent parties to reduce the prices. Secondly, the Statement explains what the Commissioner meant in his submission that an independent distributor would not have agreed to suffer losses. The view of the Australian Taxation Office is that, if dealing at arm’s length, a taxpayer would have sought separate compensation, which would have resulted in a profit amount allocated to Australia. As such, the Commissioner would be entitled to make an additional transfer pricing adjustment based on this hypothetical transaction. It is interesting to compare this thinking with the taxpayer’s evidence submitted to the Court in which it was established that the suppliers would not be selling products to SNF Australia at the same lower prices if SNF Australia were not a related party pursuing a market penetration strategy. Essentially, the Australian Taxation Office appears to say that at the actual prices there would have been no business in Australia, but as a business has been actually established, it is not allowed to consistently suffer losses;
- the Australian Taxation Office essentially rejected the Court’s view of the OECD Guidelines, stating that it would “continue to apply the principles of transfer pricing... consistently with the Guidelines”; and
- the Statement noted that the litigation did not resolve the question of whether treaties give the Commissioner a separate assessment power, and the Australian Taxation Office will maintain its long-held view that they indeed do. This appears to be in direct contradiction of the decision of the Full Federal Court.

11. **Draft Exposure Legislation**

Notwithstanding the criticism of the Discussion Paper, on 16 March 2012 the Treasury released an Exposure Draft of the proposed amendments to implement the first stage of the transfer pricing reforms. The first stage is designed to ensure that Australian income tax treaties are able to be applied independently of domestic rules. The main features of the Exposure Legislation include:

- new Division 815 of the Income Tax Assessment Act 1997 which will operate concurrently with the domestic transfer pricing rules in Division 13 of the...
While the Exposure Draft is redolent of the repealed section 136, the new legislation will give the Commissioner an almost unchecked power to allocate profits to Australia using profit-based methods; reconstruct imaginary transactions where the Commissioner believes that the Australian business does not earn enough profit; and disregard the domestic transfer pricing rules in Division 13 as irrelevant under the statute. There will be no need to look back at the judgements in *Roche* or *SNF* and should the Commissioner make a new transfer pricing rule, it could simply ask the Treasury to legislate it through making a regulation.

The last point is worth considering further, as this may easily become the focal point for future transfer pricing litigation in Australia.

The new legislation requires working out the transfer pricing benefit consistently with the documents referred to in the legislation, which are the 2010 OECD Model and Commentaries, and the 2010 OECD Guidelines. However, the legislation also states that these documents apply only “...to the extent the documents are relevant”. The Explanatory Memorandum to the new legislation says that since no current Australian treaties are based on the 2010 OECD Model, previous OECD Models and Commentaries will continue to apply for the purposes of interpreting Business Profits articles of the existing treaties, but only to the extent that they are “relevant”.

This semi-ambulatory approach may create fascinating tensions between the relevance of a version of the OECD Model and the 2010 OECD Guidelines. It will be interesting to see which approach the Australian courts will take in interpreting the relevance of these documents in each particular case.

To complicate matters further, the new legislation gives the Treasury the ability, through issuing Regulations, to declare which parts of the OECD documents are relevant, or not relevant, in specific circumstances. In addition, the Treasury may declare any other document, or part of a document, to become a document relevant to working out the transfer pricing benefit for all or for specific circumstances.

For example, the Treasury may issue a Regulation that this article will become a document relevant to interpreting the transfer pricing benefits. Alternatively, the Treasury may declare that an ATO’s Public Ruling will become a document based on which the transfer pricing provisions should apply.

One would hope that the Treasury will not use its new powers to overturn court decisions that the ATO finds unhelpful and will limit the scope of Regulations to the OECD developments.

At the time of writing this article, the new legislation was in the final stages of being enacted by the Parliament.

**12. The Way Forward**

Late Professor Martin Ginsburg once stated that “every stick crafted to beat on the head of a taxpayer will, sooner or later, metamorphose into a large green snake and bite the Commissioner on the hind part”. While the proposed changes may today be seen as unassailable, it is inevitable that the taxpayers will find a way to not only challenge them, but also to turn the tables on the Commissioner.

In a broader sense, the OECD announced in March 2012 that it is to simplify its transfer pricing guidelines. The current Guidelines are seen as too complex, and their application is riddled with uncertainties. For these reasons, an increasing number of countries shy away from applying the Guidelines, choosing instead to issue domestic transfer pricing circulars that provide more certainty. It is not necessary to go far from Australia to see some examples of this approach. It would be curious if Australia, in the name of the modernization of its transfer pricing provisions, wrote the 2010 Guidelines into its tax law, while the OECD, together with Australia’s main trading partners,
were moving to a different, more modern, set of transfer pricing guidelines.

The purpose of this article is not to criticize the approach taken by the Commissioner or the Treasury following the outcome of Roche and SNF. However, it may well be the case that working together with relevant taxpayers, encouraging forward compliance, conducting better risk analysis and being committed to the cooperative dispute resolution, could produce a better outcome for the Commissioner than changing transfer pricing and other anti-avoidance rules to align the law with the administrative practices that suit the Australian Taxation Office.