THE TAX INSTITUTE

THE MARK OF EXPERTISE

30 September 2016

Mr Alex Chee
Director
Energy & Resources, Public Groups
Australian Taxation Office
GPO Box 9845
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By email: offshorehubs@ato.gov.au

Dear Mr Chee,

ATO Compliance Approach to transfer pricing issues related to centralised operating models involving procurement, marketing sales and distribution functions

The Tax Institute welcomes the opportunity to make a submission to the Australian Taxation Office in relation to the *ATO Compliance Approach to transfer pricing issues related to centralised operating models involving procurement, marketing sales and distribution functions* Consultation Paper (**Consultation Paper**).

Summary

Our submission below addresses our main concerns in relation to the Consultation Paper. In particular, the Consultation Paper should distinguish between what guidance an ATO officer requires to determine which zone an affected taxpayer falls into, what will happen if an audit occurs and what steps a taxpayer can take to move between risk zones.

Discussion

1. Overview

The Consultation Paper is a draft Practical Compliance Guideline (**PCG**). The purpose of a PCG is to 'represent guidance material on how the ATO will allocate its compliance resources according to assessments of risk, and may outline administrative approaches that mitigate practical difficulties relating to the operation of tax laws[1]'.

[1] See paragraph 23 PCG 2016/1

The PCG is directed at transfer pricing issues related to the location and relocation of certain business activities (including marketing, sales and distribution functions) and operating risks into a centralised operating model[2] – these are colloquially known as 'marketing hubs'.

Based on the above, our expectation is that the PCG sets out the circumstances where the ATO will apply compliance resources to marketing hubs. However, the draft PCG blurs the lines between a 'compliance roadmap' for ATO officers and a document to help a taxpayer (hub) determine which risk zone it may fall in. For example:

(i) Paragraph 35 gives the impression that the various risk factors referred to in that paragraph are the only factors that ATO officers are to have regard to. By contrast, paragraph 36 states that it is the net tax impact of a taxpayer's arrangement and whether the taxpayer has transfer pricing documents that will determine its 'base rating';

(ii) Paragraph 54 states that if taxpayers are in the yellow or amber zones and do not satisfy the behavioural indicators then their risk rating may be increased. This statement clearly envisages the ATO possibly increasing a taxpayer's risk rating at some point in time. It is therefore evident that taxpayers are not able on their own to confidently determine their final risk rating; and

(iii) Paragraph 56 states that taxpayers may be required to disclose whether they have assessed the risk rating of their hub. This paragraph should make it clear that the relevant risk rating to be disclosed is the 'base rating' and not the 'final risk rating'. Paragraph 36 draws the relevant distinction between the two ratings. While taxpayers should be able to determine their base risk rating, they will not be able to determine their final risk rating as this includes taking into account behavioural indicators which encompasses engagement with the ATO and provision of documentation to the ATO over an indefinite period.

Paragraph 15 states that the Guide is premised on the basis that the hub has 'commercial and economic substance', and that if the arrangement is not one that independent entities would have entered into, or is one that would have been entered into on different commercial or financial terms, the Guide does not apply. This undermines a large part of the comfort that a taxpayer might otherwise draw from the risk framework, as it seems a green zone rating could be overridden at any time by the ATO taking a negative view on whether the hub has 'commercial and economic substance'. If this is the case, it substantially narrows the application of the draft PCG.

It is accepted that the draft PCG will not be binding (as it is a not a Ruling). However, some taxpayers will be encouraged to achieve a green-zone rating by changing their record-keeping behaviour. To achieve a satisfactory level of comfort, the draft PCG needs to be more precise as to the actions a taxpayer will need to take to move to a lower risk zone.

[2] See paragraphs 1 and 2 of the draft PCG

We recommend that the draft PCG more clearly demarcate between guidance relating to assisting taxpayers (hubs) to determine which risk zone they may fall in and providing a 'compliance roadmap' to ATO officers for purposes of allocating compliance resources. This will become particularly important if the ATO decides to include a question in the Reportable Tax Position Schedule asking taxpayers to advise which zone they fall in[3] as it will be critical the draft PCG provides sufficient clarity in demarcating the zones for taxpayers.

Further, we also recommend that the draft PCG set out when and in what form the ATO will indicate to taxpayers that their base risk rating has been adjusted upwards.

The draft PCG also blurs the line between the ATO's compliance approach for marketing hubs set out in the draft PCG and the ATO's usual risk assessment processes. For example, there would appear to be little practical difference between the matters referred to in paragraph 81 that the ATO will examine as part of a normal risk review and the matters the ATO will examine as part of the process described in the draft PCG when regard is given to the ATO's transfer pricing documentation requirements in paragraph 105 and the behavioural indicators set out in paragraph 52.

We suggest there should be a clearer and more tangible difference between the ATO's compliance approach for marketing hubs set out in the draft PCG and the ATO's usual risk assessment processes.

2. Two-pronged test

The crux of the guidance is contained in the table at the back of the draft PCG. Five zones have been set out. The relevant factors to take into account to provide a preliminary indication of which zone a taxpayer may sit in are:

(i) Whether the hub's profit is more or less than a 100% mark-up of the costs of the hub; and
(ii) The amount of the 'net tax impact' of the hub.

Addressing (i) above, a taxpayer may glean from the draft PCG that the ATO may consider the 'cost plus' 100% mark-up method is the only transfer pricing method that an entity can use. While paragraph 31 indicates this is not the case, the paragraph alone does not provide enough comfort to taxpayers on this matter. It would be useful for the ATO to indicate some acceptable alternatives (see below).

[3] Which we understand is currently under consideration

Addressing (ii) above, the 'net tax impact' test along with whether the taxpayer has transfer pricing documentation is then used to determine a taxpayer's 'base rating'[4] and which of the blue to red zones they fall in. We are concerned that there is a significant difference between compliance activity that will apply to an entity that is in the amber zone and an entity that is in the red zone, which for example will trigger the application of the Commissioner's formal information gathering powers.

Where a hub is in the red zone, the Commissioner should be in a position to advise the hub that it falls in the red zone and what the hub needs to do to move to another zone and regain the opportunity to negotiate an advance pricing agreement (**APA**). It seems harsh not to permit a hub to be able to negotiate an APA without having this opportunity.

We make some suggestions below for the Commissioner to consider:

(i) The Commissioner could consider applying a similar methodology (ie processes and principles) to determine the level of risk associated with the hubs that are used to determine which quadrant a taxpayer is in when applying the Risk Differentiation Framework;
(ii) It may be more simple to have three zones rather than five zones;
(iii) The PCG should also include information regarding how a hub can move to a lower risk zone. While it is fairly clear what factors may push a hub up towards the red zone, it is not clear what a hub can do to move back down towards the green zone. This information may well help to positively influence the behaviours of taxpayers using hubs and move them towards engaging in behaviours that make the hub a lesser compliance risk.

3. Transfer pricing documentation

Paragraph 36 states that the net tax impact of a taxpayer's arrangement and whether the taxpayer has transfer pricing documents will determine its 'base rating'. This statement is expressed in black and white terms: either a taxpayer has transfer pricing documents or it does not. Paragraph 45, however, goes further and states that the Commissioner regards not only the existence but also the quality of transfer pricing documents as being critical to the assessment of risk related to hubs that are outside the green zone.

Paragraphs 103 to 106 of the draft PCG go further again and set out the ATO's expectations around required transfer pricing documentation. The ATO's view in these paragraphs would seem to be an 'absolute' view of transfer pricing documentation requirements. No guidance is provided in the draft PCG with respect to how the Commissioner (let alone taxpayers if they are to perform this exercise) should determine the quality of a taxpayer's transfer pricing documents.

[4] See paragraph 36 of the draft PCG

It seems to be implied that so long as the hub can satisfy all the ATO's documentation requirements set out in paragraphs 103 to 106, the hub will stay in its zone. Where the hub may fall short of the ATO's expectations of the required documentation, then it is likely to be moved to a higher risk zone. This is particularly significant for hubs which are otherwise in the amber zone, which would automatically be moved to the red zone, and denied access to an APA.

We refer to Taxation Ruling TR 98/11 which considers, among other things, the 'quality' of transfer pricing documentation. We suggest a similar approach could be implemented here in relation to hubs. This would have the effect of encouraging hubs to prepare better quality documentation.

It would also be useful that where, in the Commissioner's view, a hub's documentation fell short, the hub could be given the opportunity to make improvements to their documentation to satisfy the Commissioner rather than be moved to a higher risk zone as a consequence of not having satisfactory documentation in the first place. In our view, it would be better if taxpayers are assisted to get their documentation right rather than just 'punished' for getting it wrong. After the hub has had the opportunity to amend its documentation, if the Commissioner is still not satisfied, the Commissioner could consider escalating the issue for audit. There needs to be clear guidelines so that both the taxpayer and the relevant ATO officers know when a matter should be escalated to an audit.

Therefore, it would be desirable if there was some flexibility around the nature and quality of the transfer pricing documentation a hub needs to prepare. This would also help ensure that the Commissioner was not moving to apply certain compliance activities to taxpayers unnecessarily without first giving them a chance to properly comply.

4. Other matters

(i) We note the statement in paragraph 22 (and also footnote 2) that the ATO's compliance approach does not (because it cannot) differentiate between scenarios involving inbound or outbound arrangements and transactions. Nevertheless, we are concerned, particularly in the absence of being able to consider a draft schedule for procurement hubs at the same time, that materially different risk assessment approaches could be adopted by the Commissioner with respect to inbound and outbound hubs.

(ii) The 'commercial realism' factor (paragraphs 126(b) and 134 of the draft PCG) – we query whether a secondary test is actually needed. Further, and in response to question (a) in paragraph 134, it is not evident what additional information an indicator based on the ratio of operating expenses to sales would provide to the Commissioner that is not already available under the 'cost plus' indicator, as both have regard to costs borne by the hub.

(iii) Reference to the controlled foreign company (**CFC**) rules (paragraph 148 of the draft PCG) – it would be useful if this point could be fleshed out so that

taxpayers understand the impact of the CFC rules and how they impact the calculation.

(iv) Step 2 of the table at the back of the draft PCG (base risk zone) is not consistent with paragraph 36[5]. The table shows the existence (or otherwise) of transfer pricing documentation as forming part of Step 3.

(v) It would be useful if the ATO could use more direct language in the draft PCG. This will help to ensure the guidance provided in the draft PCG is clear and more certain.

If you would like to discuss any of the above, please contact either me or Tax Counsel, Stephanie Caredes, on 02 8223 0059.

Yours sincerely

Arthur Athanasiou
President

[5] Which states that it is the net tax impact of a taxpayer's arrangement and whether the taxpayer has transfer pricing documents that will determine its 'base rating'