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Practice Group:

Tax

Government Releases New Transfer Pricing Measures to Attack Multinationals

By ***Philip G. Diviny and Tamara Cardan***

On 13 February 2013, the Federal Government introduced legislation into Parliament that will significantly broaden the circumstances in which Australia's transfer pricing rules may be applied.

The legislation will come into force on 1 July 2013 or later on the date of Royal Assent.

Overview of Transfer Pricing

Australia's transfer pricing provisions aim to prevent multinational enterprises shifting profit from the Australian tax jurisdiction by non-arm's length dealings. Profit shifting may occur, for example, where a foreign resident supplies goods to its Australian resident affiliate and the Commissioner considers that the consideration paid was not an arm's length consideration. Where the transfer pricing provisions are applied, international transactions between related parties are deemed to occur on the same pricing terms as would apply if the entities were independent parties dealing at arm's length with each other.

Australian law does not prescribe a specific methodology for ascertaining what will constitute arm's length consideration. The Organisation for Economic Co-operation and Development (OECD) Guidelines indicate a hierarchy of methods that can be used to determine an appropriate transfer price, but they do not dictate the use of any one or more appropriate methods. The guidelines simply indicate the suitability of using a particular methodology in given circumstances. Broadly, there are two groups of methodologies - the "traditional" transaction methods, and the profit methods. The Australian judiciary has favoured transactional methods in ascertaining an arm's length consideration.

The New Provisions

Measures target overall profit levels

Rather than focusing on the pricing of individual transactions, the new provisions will adopt a broader, profit-based approach. This is achieved by the explicit incorporation into Australian law of the "arm's length principle" as contained in Article 9 of the OECD Guidelines.

This principle involves an examination of the conditions imposed between two enterprises in their commercial and financial relations. If these conditions differ from those which would have existed between independent enterprises with the result that Australian profit is lower than it otherwise would have been, then an adjustment can be made.

This involves a much wider exercise than a discrete examination of whether arm's length consideration was paid in respect of a specific transaction. The implementation of a profit based approach will, in many cases, deliver the Australian Taxation Office (ATO) guaranteed revenue through the application of the Transactional Net Margin Method. This is indeed the purpose of the measures, with the Government stating the measures will "protect" revenue of over AUD1 billion per year.

The provisions will apply the arm's length principle to dealings between both associated and non-associated entities. The rules are self-executing in their operation, and do not rely on the Commissioner to make a determination.

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Documentary requirements

The new measures do not mandate the preparation or keeping of documentation, however failing to do so will prevent a taxpayer from establishing a "reasonably arguable position". The consequence is that a lack of documentary evidence will prevent the taxpayer from seeking to mitigate administrative penalties imposed following a transfer pricing adjustment to its taxable income.

As a practical matter, taxpayers will need to hold contemporaneous documentation to support their transfer pricing position. This will need to include both contractual documentation and economic analysis of the pricing policies. All documentation must be prepared before the lodgment of the relevant tax return in order to support a reasonably arguable position.

Amendment period

The Commissioner will have a seven year amendment period under the new laws. Whilst this is clearly preferable to the previous unlimited amendment period, it is still significantly longer than other amendment time limits under the income tax laws.

Mutual agreement procedure

It remains to be seen how the new law will impact the current Mutual Agreement Procedures as set out in Australia's tax treaties. These procedures may be invoked where a transfer pricing adjustment in one country results in the same income being taxable in two jurisdictions. Where multinationals apply for relief from double taxation under these procedures, the ATO will negotiate with the overseas tax authorities to resolve the matter. Under transactional transfer pricing provisions, this would involve adjustments to the consideration for a discrete transaction.

However, the new rules do not contain specific guidance as to how the adjustments to profit levels will be linked to the numerous transactions between related parties, some of whom may not be located in treaty countries. This may prove problematic in the effective use of the Mutual Agreement Procedures.

Comment

The new rules will put substantial pressure on taxpayers to reconsider their transfer pricing policies and the documentation that supports them. The ATO will have much greater power to adjust a taxpayer's net profit levels and this power extends for up to seven income years.

The explicit incorporation of the OECD Guidelines into the new provisions will create practical difficulties, as these guidelines are often updated by the OECD. This new legislation gives the OECD Guidelines legal status.

In view of the changes, taxpayers will need strong transfer pricing policies and systems in place, together with contemporaneous documentation that establishes the entity determined its taxable income as if arm's length conditions had operated.

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