DECEMBER 2018

AUSTRALIAN TRANSFER PRICING ALERT

The ATO is focusing on Australian taxpayers who distribute goods or digital products/services acquired from related foreign entities. The release of draft guidance PCG 2018/D8 provides the latest ATO framework for inbound distributors to assess their transfer pricing risk.

PCG 2018/D8

On 23 November 2018 the ATO released Draft Practical Compliance Guideline PCG 2018/D8 (the PCG) which outlines the ATO's intended compliance approach to the transfer pricing outcomes associated with activities of local entities distributing goods purchased from related foreign entities for resale, and distributing digital products or services where the intellectual property in those products or services is owned by related foreign entities.

The PCG provides guidance to taxpayers classified as inbound distributors as to how the ATO will assess their level of transfer pricing risk and allocate its compliance resources. The PCG outlines how inbound distributors will be assessed as either high, medium or low risk depending on the profits the distributor earned for that year and the industry segment of the distributor (i.e. life science, information and communication technology (ICT), motor vehicles and general distributors).

TRAFFIC LIGHT RISK RATING APPROACH

The PCG follows a similar 'traffic light' risk rating approach that the ATO has used in its previous PCGs on marketing hubs (PCG 2017/1) and cross border financing arrangements (PCG 2017/4) and takes into account a combination of quantitative and qualitative factors in order to classify the taxpayer into high, medium or low risk zones. Refer to BDO's previous Transfer Pricing Alert on PCG 2017/4 for detail.

Where the taxpayer finds themselves in a high risk zone they can expect that the ATO will contact them for further review and monitoring, including potential audit proceedings (especially where the taxpayer has been in losses at any time in the last three years). Conversely, should the taxpayer be in the low risk zone, the ATO have stated that they will "generally" not allocate compliance resources to assess the taxpayers transfer pricing arrangements with respect to the inbound distribution arrangements, except to confirm the taxpayer's self-assessment against the PCG. Taxpayers within the medium risk zone will have their arrangements monitored by the ATO and may be contacted by the ATO before further compliance resources are allocated.

SPECIALISATION

Transfer pricing

ZARA RITCHIE
Global Leader, Transfer pricing, Melbourne
+61 3 9605 8019
zara.ritchie@bdo.com.au

MICHAEL SMITH
Partner, Transfer pricing, Melbourne
+61 3 9603 1885
michael.smith@bdo.com.au

NATALYA MARENINA
Partner, Transfer pricing, Brisbane
+61 7 3237 5853
natalya.marenina@bdo.com.au

NICK DRIZEN
Associate Director, Transfer pricing, Perth
+61 8 6382 4661
nick.drizen@bdo.com.au

JOEL PHILLIPS
Partner, Transfer pricing, Sydney
+61 2 8264 6572
joel.phillips@bdo.com.au

MORE INFORMATION

1300 138 991
www.bdo.com.au

NEW SOUTH WALES
NORTHERN TERRITORY
QUEENSLAND
SOUTH AUSTRALIA
TASMANIA
VICTORIA
WESTERN AUSTRALIA

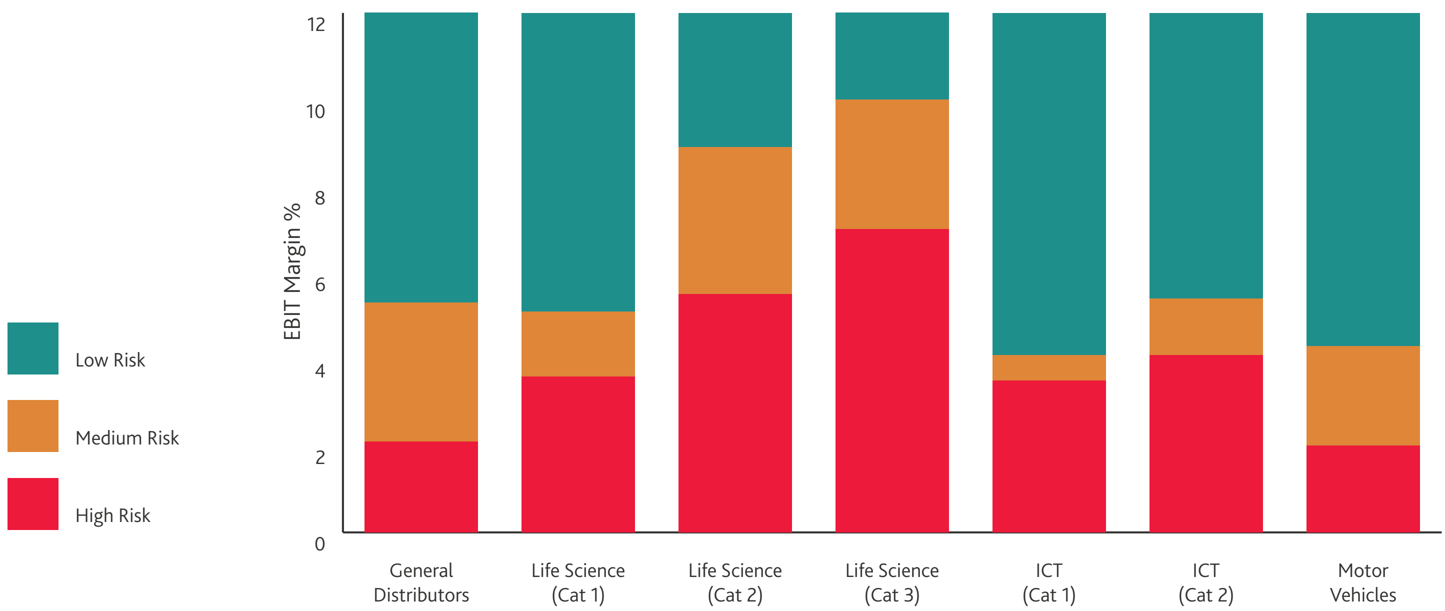
As a further incentive for multinational enterprises (MNEs) with inbound distribution arrangements taxpayers in the low or medium risk zones will be invited to participate in a streamlined "pre-qualified" unilateral APA regarding their inbound distribution arrangements, however, to be eligible to participate the taxpayer will likely need to broadly accept the underlying comparables utilised by the ATO to arrive at the profit markers within the PCG. There will also be a 12-month window of opportunity where the ATO will allow a taxpayer to arrange their transactions (both historically and prospectively) to be in the low risk zone. By doing so, the taxpayer will be able to avoid penalties and reduce interest on a subsequent transfer pricing adjustment.

PROFIT MARKERS

Consistent with prior ATO PCGs, the risk zones are low (green), medium (yellow) and high (red). The higher the risk rating, the more ATO scrutiny taxpayers can expect. Being in the red zone also precludes taxpayers from requesting a pre-qualified unilateral APA process. The ATO's profit markers are based on earnings before interest and tax (EBIT) / sales (EBIT margin).

RISK ZONE	TAXPAYERS RELATIVE TO THE PROFIT MARKERS	ATO APPROACH
LOW	At or above profit marker A	The ATO will generally not allocate compliance resources to assess transfer pricing outcomes in relation to taxpayer's inbound distribution arrangements other than to confirm their characterisation as an inbound distributor, and to the extent of the activities undertaken.
MEDIUM	Below profit marker A, but at or above profit marker B	The ATO will monitor arrangements using available data and may contact taxpayers to seek a better understanding of their circumstances before deciding to allocate further compliance resources.
HIGH	Below profit marker B	The ATO will consider appropriate treatment options and recommend that taxpayers review their transfer pricing policy.

RISK ASSESSMENT FRAMEWORKS (FOR ALL INDUSTRIES COMBINED)



HIGH RISK	<2.1%	<3.6%	<5.5%	<7.0%	<3.5%	<4.1%	<2.0%
MEDIUM RISK	2.1% to 5.3%	3.6% to 5.1%	5.5% to 8.9%	7.0% to 10.0%	3.5% to 4.1%	4.1% to 5.4%	2.0% to 4.3%
LOW RISK	>5.3%	>5.1%	>8.9%	>10.0%	>4.1%	>5.4%	>4.3%

Source: ATO website

While the PCG provides insights regarding the ATO's expectations for inbound distributors, many taxpayers may find that the profits required to reach the low risk zone within the PCG are higher than the returns they have achieved. With distribution arrangements now a clear focus area of the ATO, taxpayers in this position will need to assess their transfer pricing arrangements and associated documentation in preparation for increased ATO scrutiny. Further, even if they fall within the green zone, taxpayers are expected to continue to self-assess themselves for compliance with transfer pricing legislation and prepare applicable supporting documentation.

APPLICABILITY

Once finalised, the PCG will have effect from the date of publication and will apply to existing and new inbound distribution arrangements. The PCG will be applicable to "inbound distributors" which is defined in the PCG to be an entity that predominantly distributes either goods into Australia purchased from related entities or digital products or services where the intellectual property in those products or services is owned by related foreign entities. This said, the PCG continues to identify a range of indicators that will determine if an entity is in fact considered an inbound distributor and it is anticipated that this definition will be a matter of conjecture, especially for those entities that would otherwise be in the medium or high risk zones.

Small distributors that are eligible for application of the Simplified Transfer Pricing Record Keeping Rules (contained in PCG 2017/2) will be exempt from the PCG as will those entities that have agreed their transfer pricing arrangements with the ATO through Advanced Pricing Agreements (APAs), an ATO settlement, a court or Administrative Appeals Tribunal decision, or where the ATO has previously reviewed and considered the arrangement low risk.

BDO COMMENT

- Due to the relatively high profit expectations identified within the PCG, many inbound distributors who believe themselves to be compliant with transfer pricing legislation may well find themselves in a medium or high risk zone
- The ATO acknowledges that this outcome does not mean that arrangements are not arm's length, however the PCG risk assessment does provide guidance as to how compliance resources will be allocated
- Taxpayers can transition to the low risk zone, apply for an APA, or document-and-defend their position
- MNE's may find it difficult however to restructure their arrangements in order to fall within the low risk zone and at the same time manage the risk of transfer pricing adjustments in foreign vendor countries
- The ATO has at its disposal various sources of information allowing it to identify inbound distributors that are likely to fall within the medium and high risk zones of the PCG. Taxpayers in this position will likely be called upon by the ATO to disclose their rating against the PCG and should be ready explain how they have self-assessed their transfer pricing arrangements to be arm's length
- BDO anticipate that the ATO will proceed with taxpayer identification and risk assessment activities in the first half of 2019. BDO would therefore urge all MNE's with inbound distribution entities in Australia to review their transfer pricing arrangements and to ensure that they have sufficient transfer pricing documentation in place in accordance with Australian requirements and ATO expectations as defined in TR 2014/8
- Those MNE's wishing to further reduce the risk of a transfer pricing adjustment (and associated penalties and interest) may wish to enter into an early engagement process with the ATO through the APA program
- Comments on the PCG are due by 21 December 2018 so please contact BDO with any comments or if you would like to lodge a submission.