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GLOBAL TRANSFER PRICING SERVICES

Global Transfer Pricing Review

Australia

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TAX



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The transfer pricing landscape in Australia continues to evolve as tax authorities are seeking to approach transfer pricing (TP) through new and more far reaching laws (subdivision 815) based on self assessing 'transfer pricing benefits' by reference to 'arm's length conditions'. These new laws are retrospective for treaty countries back to 1 July 2004 under subdivision 815-A. Subdivisions 815-B – 815-D incorporate the Organisation for Economic Co-operation and Development (OECD) Transfer Pricing Guidelines and introduce new TP documentation requirements going forward for application to both treaty and non treaty countries (with an amendment period for adjustments reduced to 7 years).

The new TP laws were introduced in 2013 in response to the Commissioner's loss in 2011 in the Full Federal Court case of *Commissioner of Taxation vs. SNF (Australia) Pty Ltd*. In this case, the court found that the existence of ongoing losses in an Australian subsidiary does not necessarily mean that the price paid from international related parties is not arm's-length. The new legislation differentiates itself from its predecessor, laws under Division 13 incorporates a focus on profit as one of the arm's length conditions to be considered in determining whether transactions between foreign related parties are on an arm's-length basis.

The Australian Taxation Office (ATO) plans to update and revise its TP rulings and practice statements. A number of these are due for release in draft form in the second quarter of 2014.

Given its more holistic view on arm's length conditions surrounding cross border transactions, the Australian Government views the new TP rules as the cornerstone to its strategy on OECD'S Base Erosion and Profit Shifting (BEPS). The Australian government has been overt in its statements regarding its intention to use its G20 presidential term to demonstrate strong leadership in this area. The ATO has, unsurprisingly, been tasked with driving the BEPS agenda in Australia and has established a taskforce with its focus being:

- To work with international partners to establish the purpose of Australian businesses in low-tax jurisdictions.
- Address BEPS through compliance activities, including bilateral and multilateral audits, supported by newly implemented laws.
- To understand digitalization of the Australian economy and the implications for the tax system.
- To support Australian and OECD policy development.

To support these activities, the ATO has recently launched a compliance initiative, the International Structuring and Profit Shifting (ISAPS) program. This is in addition to its annual compliance activities which includes its existing TP review work and its Advance Pricing Arrangement (APA) program. The ISAPS project is a compliance program for which the initial phase commenced in the last quarter of 2013 and will continue throughout 2014. The ATO anticipates that the work performed in this phase will form the basis for an audit program likely beginning in late 2014. The areas covered by this program are broader than just TP and include other corporate income tax areas such as permanent establishments, thin capitalization, controlled foreign companies (CFC), particularly focusing on offshore trading hubs and business restructuring.

Basic information

Tax authority name

Australian Taxation Office (ATO).

Citation for transfer pricing rules

Income Tax Assessment Act 1936; Income Tax Assessment Act 1997; International Tax Agreements Act 1953; TR 92/11, Income tax: application of the Division 13 transfer pricing provisions to loan arrangements and credit balances; TR 1994/14, Income tax: application of Division 13 of Part III (international profit shifting); TR 97/20, Income tax: arm's length transfer pricing methodologies for international dealings; TR 98/11, Income tax: documentation and practical issues associated with setting and reviewing transfer pricing in international dealings; TR 98/16, Income tax: international transfer pricing, penalty tax guidelines; 1999/1, Income tax: international transfer pricing for intra-group services; TR 2000/16, Income tax: international transfer pricing – transfer pricing and profit reallocations adjustments, relief from double taxation and the MAP; TR 2001/11, Income tax: international transfer pricing, operation of Australia's permanent establishment rules; TR 2002/2, Income tax: meaning of 'Arm's Length' for the purpose of subsection 47A(7) of the Income Tax Assessment Act 1936 (ITAA 1936) dividend deeming provisions; TR 2003/1, Income tax: thin capitalization – applying the arm's length debt test; TR 2004/1, Income tax: international transfer pricing, cost contribution arrangements; TR 2005/11, Income tax: branch funding for multinational banks; TR 2007/1, Income tax: international transfer pricing: the effects of determinations made under Division 13 of Part III of the Income Tax Assessment Act 1936, including consequential adjustments under section 136 AF of that Act; TR 2010/7, Income tax: the interaction of Division 820 of the Income Tax Assessment Act 1997 and the transfer pricing provisions; TR 2011/1, Income tax: application of the transfer pricing provisions to business restructuring by multinational enterprises.

The ATO plans to update and revise its TP rulings and practice statements listed above, in light of the new TP legislation (a number of which are due for release in draft form in the second quarter of 2014).

Effective date of transfer pricing rules

1 July 2004 for subdivision 815-A and 1 July 2013 for subdivision 815-B, C & D of the Income Tax Assessment Act 1997.

What is the relationship threshold for transfer pricing rules to apply between parties?

Parties not dealing with each other at arm's length, having regard to any connection between them, or any other relevant circumstances (not limited to control or shareholding).

What is the statute of limitations on assessment of transfer pricing adjustments?

A 7 year amendment period.

Transfer pricing disclosure overview

Are disclosures related to transfer pricing required to be prepared or submitted to the revenue authority on an annual basis (e.g. with the tax return)?

Yes.

What types of transfer pricing information must be disclosed?

The ATO has introduced a new International Dealings Schedule (IDS) to be lodged with the income tax returns for 2012 and subsequent years where taxpayers have international related party dealings of more than 2 million Australian dollars (AUD) per year. The IDS requires far more detailed disclosures about international related party dealings than the Schedule 25A which it replaces, including: description and amounts of related party transactions, disclosures related to transactions of special interest to the tax authority, disclosures relating to arm's length transfer pricing methods used and whether documentation has been prepared. The IDS is used as a risk assessment tool by the ATO to target its compliance activities in transfer pricing and its international tax program.

Under the ATO's APA program, the taxpayer is required to prepare and submit an Annual Compliance Report to the ATO disclosing the covered transactions, according to the requirements of Practice Statement Law Administration PS LA 2011/1.

There is no formal requirement to provide the transfer pricing documentation to the ATO as part of the tax return disclosures.

What are the consequences of failure to prepare or submit disclosures?

An administrative penalty may apply for failure to prepare or submit the IDS.

Transfer pricing study overview

Is preparation of a transfer pricing study required – i.e. can the taxpayer be penalized for mere failure to prepare a study?

No.

Other than complying with a requirement per the previous question, describe the benefits, if any, of preparing and maintaining a transfer pricing study?

Penalty mitigation by establishing a Reasonably Argued Position (RAP). The existence of a well focussed and relevant transfer pricing study can help reduce the risk of a transfer pricing audit and may mitigate penalties if there is an adjustment following a transfer pricing audit.

To satisfy the requirement and/or obtain the benefits, are there any requirements on when the transfer pricing study must be prepared and submitted?

Documentation should be prepared contemporaneously as transactions are entered into contractually or physically but must be completed by the time the tax return is filed in order for the taxpayer to rely on it for penalty protection.

When a transfer pricing study is prepared, should its content follow Chapter V of the OECD Guidelines?

Yes, in applying Subdivision 815-B, the new law now requires the taxpayer to refer to the *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, as published by the OECD and last amended on 22 July 2010. The ATO Tax Rulings aim to follow the OECD Guidelines closely and the ATO's Tax Ruling TR 98/11 details contemporaneous documentation required to evidence compliance with

the arm's length principle to reduce the risk of audit and mitigate penalties in the event of an audit adjustment. The ATO's 'four step process' involves functional analysis, industry analysis which focuses on the Australian taxpayer, company overview, selection and application of method, description of comparables, conclusions and the establishment of an annual review process.

Does the tax authority require an advisor/tax practitioner to have specific designation in order to prepare or submit a transfer pricing study?

No.

Transfer pricing methods

Are transfer pricing methods outlined in Chapter II of the OECD Guidelines acceptable?

Yes.

Is there a priority among the acceptable methods?

No, although the ATO recognizes that the Comparable Uncontrolled Price (CUP) method provides the most direct comparison where sufficiently reliable information is available. The SNF case emphasized a practical application of the CUP method over the TNMM.

If there is no priority of methods, is there a "best method" rule?

The ATO seeks to adopt the method that is most appropriate to the circumstances of the specific case.

Transfer pricing audit and penalties

When the tax authority requests a taxpayer's transfer pricing documentation, how long does the taxpayer have to submit its documentation?

Normal ATO practice is to expect documentation to be supplied within 28 days of request.

If an adjustment is proposed by the tax authority, are dispute resolution options available to the taxpayer outside of competent authority?

For tax treaty countries, the taxpayers may seek correlative relief or adjustments under Associated Enterprises, Method of Elimination, and MAP provided in Australia's comprehensive Double Taxation Agreements (DTAs). All Australian taxpayers, however, unilaterally have recourse to domestic tax provisions such that, where agreement cannot be reached with the ATO, the taxpayer can take the matter to court or to the Administrative Appeals Tribunal or consider Alternate Dispute Resolution options that may be available. As the focus of these actions is only to consider the merits of the adjustment under domestic tax law, foreign related parties will need to seek relief options that may be available under the domestic laws in their own jurisdiction (if applicable).

If an adjustment is sustained, can penalties be assessed? If so, what rates are applied and under what conditions?

Yes. A standard Shortfall Penalty rate is 25 percent of the tax avoided for transfer pricing adjustments where the taxpayer does not have a reasonably arguable position; 50 percent of the tax avoided, where the sole or dominant purpose was to avoid tax and the taxpayer does not meet the 'Reasonably Argued Position' (RAP) standard.

In addition a Shortfall Interest Charge (SIC) and General Interest Charge (GIC) may also be applied to tax and penalties. For a more detailed description of these charges and the circumstances under which they are levied visit <http://www.ato.gov.au>.

To what extent are transfer pricing penalties enforced?

Often.

What defences are available with respect to penalties?

Maintaining documentation of a sufficiently high quality; commercial realism analysis; cooperation with the ATO in providing the information requested; voluntary disclosure, preferably before the audit notification.

What trends are being observed currently?

In recent years, the ATO has been very active in scrutinizing taxpayers' transfer pricing practices with a view to protecting Australia's revenue base. The ATO has increased its transfer pricing capability through external recruitment and maintains an annual TP program of risk reviews and audits. In addition to this, the ATO commenced its ISAPS initiative late in 2013. Transactions with respect to related party loans and guarantee arrangements, royalty arrangements, business restructuring, the transfer of intellectual property and the mining, pharmaceutical and motor vehicle industries continue to receive scrutiny by the ATO. Furthermore, periods of prolonged losses or low profitability continue to be a focus of the ATO (regardless of whether there are material related party transactions or not).

Special considerations

Are secret comparables used by tax authorities?

No.

Is there a preference, or requirement, by the tax authorities for local comparables in a benchmarking set?

Yes. Although there is no formal requirement to use local comparables in an Australian benchmark study, the ATO would generally prefer Australian comparable companies during review or audit. Where a regional set is used for Australian purposes, the ATO will focus on the Australian comparables and

their relative position in the set. Where necessary, the ATO will conduct its own analysis to identify Australian comparable companies for benchmarking purposes.

Do tax authorities have requirements or preferences regarding databases for comparables?

No.

What level of interaction do tax authorities have with customs authorities?

High.

Are management fees deductible?

Yes, provided that management fees comply with the arm's length principle and meet general income tax deductibility requirements.

Are management fees subject to withholding?

No.

Are year-end transfer pricing adjustments permitted?

Yes. However, year-end adjustments have the potential to increase risk especially where there is an unclear transfer pricing policy, the adjustments are applied inconsistently or the characterization of the adjustment is unclear.

Other unique attributes?

None currently, although in determining the new guidance it will issue under the new law, the ATO is considering various options to simplify transfer pricing documentation and compliance (such as exemptions from TP rules or adjustments, simplified TP methods and safe harbors, exemptions or simplified documentation requirements, exemptions from penalties, simplified APA procedures). A discussion paper was released in March 2014 and any developments are expected to feed into the ATO's update and review of its TP rulings and practice statements.

Other recent developments

The new TP laws under subdivision 815 aim to modernize Australia's TP rules and to ensure consistency in their application between both tax treaty and non-tax treaty cases. As with Australia's previous TP rules, the new provisions are sufficiently broad to capture non-arm's-length dealings between both related and unrelated parties.

In addition the new TP legislation is aligned with the more general policy intent of self-assessment. Consequently the new rules are self-executing which places a higher degree of emphasis on taxpayers, and particularly public officers, who must form a view at the time of submission of the income tax return that foreign related party transactions have been structured and priced on an arm's-length basis for tax purposes, for which they may be held accountable.

The new legislation does grant the ATO the power to reconstruct dealings (Section 815-130) in situations where there is inconsistency in the form and substance of a particular arrangement and situations where the arrangement is not one that would have been entered into by independent parties acting at arm's-length. While the Act does not specifically include an 'exceptional circumstances' requirement, the reconstruction provisions in section 815-130 are intended to be consistent with those described in paragraph 1.65 of the OECD's TP Guidelines. The ATO intends to use its new powers under Subdivision 815 to pursue its BEPS agenda and implement the ISAPS program.

As well as specific legislation to include both trusts and partnerships (subdivision 815-D), the new legislation also has application to entities with permanent establishments (Subdivision 815-C). The application of the permanent establishment rules in Australia provides for the allocation of income and expenses between an entity and

its related parties to be reflective of that between separate entities dealing wholly independently with each other. In October 2012, the Board of Taxation released a Discussion Paper in relation to a review of tax arrangements applying to permanent establishments. This review considered whether Australia should adopt the OECD's functionally separate entity treatment for permanent establishments. While not yet publically available, the Board of Taxation has delivered its report to the Government in April 2013.

As a key consequence of enacting new TP laws, the ATO plans to update and revise its existing TP rulings and practice statements issued under Division 13. A number of these are due for release in draft form in the second quarter of 2014, including new draft rulings covering TP documentation and the Commissioner's reconstruction power under subdivision 815, and a new practice statement in respect of transfer pricing penalties. In addition to this program, the ATO also released a revised draft Taxation Determination (TD 2014/D7) in January 2014, outlining its position in which it considers that capital support payments are capital in nature and non-deductible.

The ATO has also entered into a pilot program with the US Internal Revenue Service to conduct joint transfer pricing audits. There are three cases currently running under this program, although additional joint audit cases are expected to be identified from the current ISAPS program.

Tax treaty/double tax resolution

What is the extent of the double tax treaty network?

Extensive.

If extensive, is the competent authority effective in obtaining double tax relief?

Almost always.

When may a taxpayer submit an adjustment to competent authority?

After an adjustment is proposed to the taxpayer. This will usually be in the form of a position paper.

May a taxpayer go to competent authority before paying tax?

Yes.

Advance pricing agreements

What APA options are available, if any?

Unilateral, bilateral, and multilateral.

Is there a filing fee for APAs?

Not currently.

Does the tax authority publish APA data either in the form of an annual report or through the disclosure of data in public forums?

Yes. The ATO publishes an annual report on recent developments of its APA program through its official website.

Please provide some information on how successful the APA program is and whether there are any known difficulties?

Following a review of its APA program, the ATO issued PSLA 2011/1 in March 2011, which sets out available APA products and the ATO's policies

and procedures in relation to APA applications. A key feature of the new APA program is the introduction of three APA products to deal with simple, standard and complex international related party dealings, as well as a streamlined APA renewal process.

While the Commissioner supports both unilateral and bilateral APAs, a bilateral approach is generally favored for its ability to resolve double taxation. To date, the ATO has concluded bilateral APAs with the revenue authorities of the US, UK, Canada, Japan, Korea, Switzerland, New Zealand, Denmark and Singapore. In 2011–12, 37 APAs were completed with large businesses (turnover more than AUD250 million) and 29 APAs were completed with small/medium enterprises.

The ATO has recently undertaken some internal restructuring, and it is unclear how the APA program will be resourced and managed going forward. Further guidance is expected from the ATO. However, it is expected that the ATO will seek to understand the global supply chain and consider BEPS type issues in all APA applications and renewals going forward.

Language

In which language or languages can documentation be filed?

English.

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