Global Transfer Pricing Landscape

Australia

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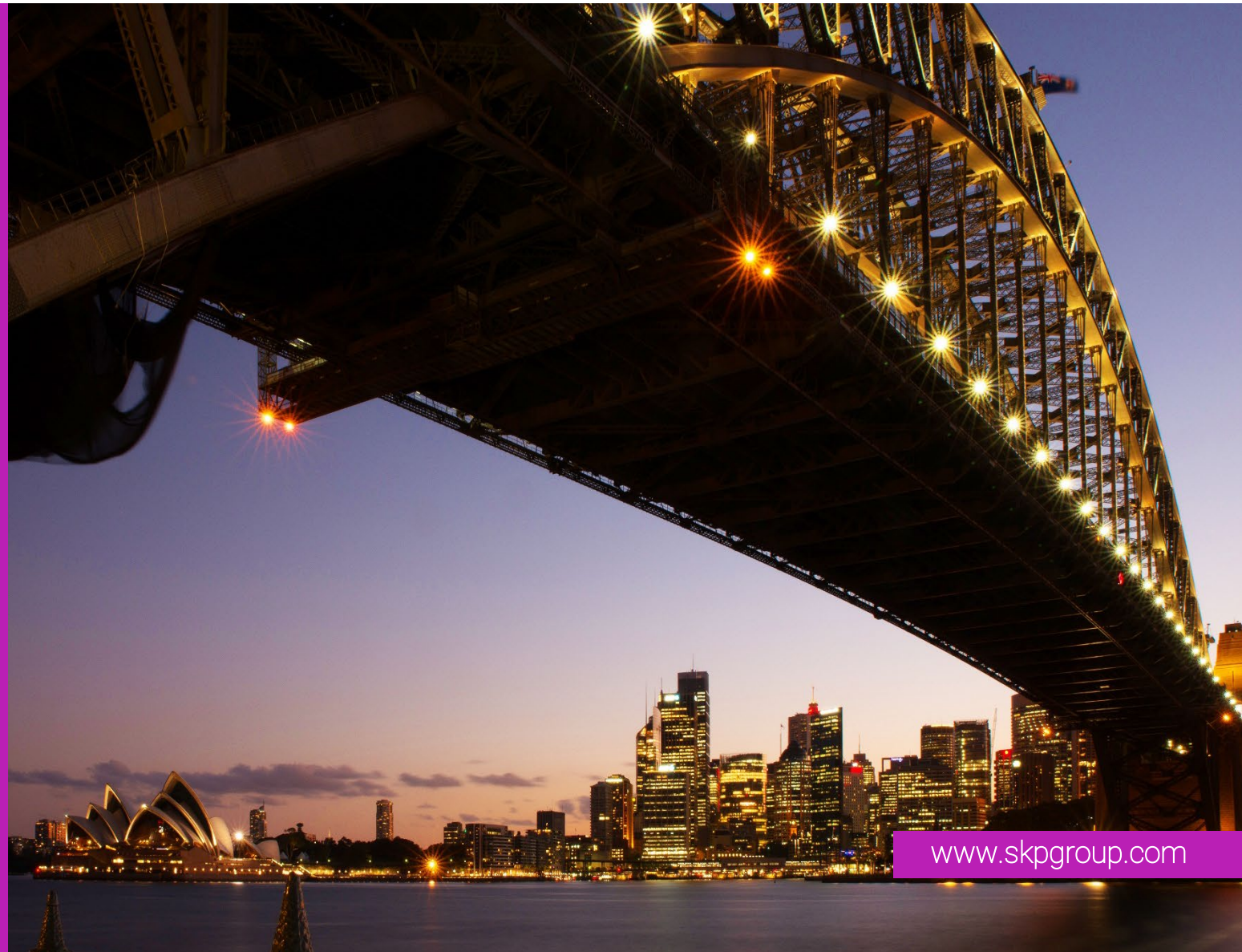

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Highlights

1982

Division 13 of Part III of the Income Tax Assessment Act (ITAA), 1936 applies to income years commenced prior to 1 July 2013.

2012

Subdivision 815-A of the ITAA, 1997 was introduced with retrospective effect from 1 July 2004 to 30 June 2013.

2013

Subdivision 815-B, 815-C and 815-D of the ITAA, 1997 and subdivision 284-E of Schedule 1 of the Tax Administration Act (TAA), 1953 were made applicable to income years starting on or after 1 July 2013. This year also witnessed the start of the new self-assessment-based regime.

2016

Australian government announces the implementation of the Organization for Economic Co-operation and Development's (OECD's) new transfer pricing documentation standards (Country by Country Report, Master File and Local File).

2017

Establishment of Tax Avoidance Taskforce, Introduction of a diverted profits tax (DPT), increase in penalties for failure to lodge on time and penalties relating to statements and documents to the ATO

2020

Guidance for transfer pricing on account of COVID-19 issued

Introduction

In Australia, transfer pricing legislations was enacted in 1982, through Division 13 of Part III of Income Tax Assessment Act (ITAA) applicable to income years commenced prior to 1 July 2013.

In 2012, Subdivision 815-A was enacted with retrospective effect for income years commencing between 1 July 2004 to 30 June 2013. It operates concurrently with Division 13 for transactions with related parties in countries that have a double taxation agreement with Australia.

With respect to the transfer pricing for the income years starting on or after 1 July 2013; New Laws were introduced in 2013:

- Subdivision 815-B - Arm's length principle for cross-border arrangements between entities;
- Subdivision 815-C - Arm's length principle for Permanent Establishments (PEs); and
- Subdivision 815-D - Special rules for trusts and partnerships

Furthermore, subdivision 284-E of the TAA, 1953 outlines transfer pricing documentation requirements for having a Reasonable Arguable Position (RAP).

Apart from the above regulations, the Australian Tax Office (ATO) has in place relevant provisions of double tax treaties and has issued various rulings that assist in the interpretation/application of the existing regulations and issues not covered in the existing statutes.

Arm's Length Conditions

Arm's length conditions are the conditions that might be expected to operate between independent entities dealing wholly independently with one another in comparable circumstances.

Arm's Length Methodologies

The legislation requires taxpayers to adopt the "most appropriate" TP method and refers to the OECD Guidelines in this regard. Methods include traditional transaction methods (e.g., CUP, resale price, and cost plus) and traditional profit-based methods (e.g., profit split and TNMM). Any other method that results in an arm's-length outcome is also acceptable. However, other methods should only be used where one of the other traditional transaction or profits-based methods cannot be reliably applied.

Transfer Pricing Documentation

Contemporaneous documentation

Although the preparation of transfer pricing documentation is not a legal requirement, the failure to prepare transfer pricing documentation by the time the relevant tax return is filed would mean that a RAP does not exist in the event of a TP adjustment. The penalty risk will be reduced by preparing and maintaining contemporaneous transfer pricing documentation that meets the RAP standard.

In order to have a RAP, it is required that the documentation should:

- be prepared before the time the taxpayer lodges its income tax return;
- be prepared in English or readily accessible and convertible into English;
- explain the particular way in which Subdivision 815-B or 815-C of the ITAA 1997 applies (or does not apply);
- explain why the application of Subdivision 815-B or 815-C of the ITAA 1997 to the matter (or matters) in that particular way best achieves the consistency with the prescribed guidance material.

The ATO recommends that 'five key questions' be considered by taxpayers while preparing transfer pricing documentation. The five key questions are as follows:

1. What are the actual conditions that are relevant to the matter(s)?
2. What are the comparable circumstances relevant to identifying the arm's length conditions?
3. What are the particulars of the methods used to identify the arm's length conditions?
4. What are the arm's length conditions and is/was the transfer pricing treatment appropriate?
5. Have any material changes or updates been identified and documented?

It needs to be noted that Australia does not subscribe to the separate legal entity approach. As a result of these differences and the interactions with domestic legislation in relation to source rules, TP for PEs can be a complex matter.

Apart from the above, for large companies that operate in Australia (entities with an annual global income of AUD 1 billion or more), the ATO shall receive the Country by Country Report (CbCR), a Master File and a Local File. These reporting requirements apply for income tax years beginning on or after 1 January 2016, and the filling date is within 12 months after the end of the financial year.

There is no documentation obligation for domestic transactions.

Reportable Tax Position (RTP)

Taxpayers are required to lodge RTP schedules in the following cases:

- The ATO sends a notification to the taxpayer, notifying them of the requirement to lodge the RTP schedule,.
- For the years ending on or after 30 June 2019, the taxpayer meets certain criteria (specifically, if it is a public company or a foreign-owned company and meets the AUD250 million total business income threshold).

Where taxpayers have to prepare an RTP schedule as part of the income tax return, any related-party dealing will typically need to be disclosed as an RTP Subject to certain conditions.

Preparation and submission of documentation

The preparation of documentation is not specified compulsory; however in order to comply with documentation requirements set out in Subdivision 284-E for having a RAP and to justify the transactions disclosed, documentation needs to be prepared. Further, a comprehensive report need not be prepared each year, if there are no material changes in nature, quantum of transactions or the operations of the taxpayer. In such cases, an addendum would be sufficient.

Further, for an MNE with multiple entities in Australia, there is no specific guidance or requirement in relation to combining TP reports, and whether a combination of reports is appropriate will depend on the facts and circumstances.

In the case of an inquiry from the ATO, documentation needs to be submitted within 28 days of the request.

Simplified Documentation

The ATO developed simplified transfer pricing record- keeping options that eligible businesses can apply to minimize their record-keeping costs. The application of these options shall exempt certain categories of taxpayers:

- Distributors with a turnover of less than AUD 50 million and profit before tax that exceeds 3% of sales;
- Low value-adding intra-group services with a markup of no less than 5% for services provided and no more than 5% for services received;
- Technical services with a markup of no less than 10% for services provided and no more than 10% for services received;
- Outbound loans with related parties where the loan is denominated in AUD, the amount lent does not exceed AUD 50 million, and the interest rate is at least as specified (2.33% for the 2020 tax year);
- Inbound loans with related parties where the loan is denominated in AUD, the amount lent does not exceed AUD50 million, and interest does not exceed as specified (2.33% for the 2020 tax year);

Further, each such category has a number of very specific access conditions, and in order to apply the options, the taxpayer must satisfy all the prescribed conditions and are required to notify the ATO by making a disclosure in the annual International Dealings Schedule (IDS).

Selection of comparables

Comparables may be selected from internal as well as external sources. In the absence of internal transactions being undertaken in similar circumstances, external comparables would be preferred.

Although there is no legal or formal requirement for local jurisdiction comparables, the ATO has a strong preference for local comparables. The ATO will generally accept foreign comparables only if it can be demonstrated that reliable local comparables are not available.

Multiple year data

A valid conclusion as to what constitutes an arm's length outcome for a dealing usually requires examination of several years of dealings for both the controlled and uncontrolled parties.

The number of years that need to be examined depends on the facts and circumstances of the case, but as a starting point, the ATO usually considers the year under audit and the preceding four years. Taxpayers may wish to consider the current year and previous four years when setting their prices, subject to their case's particular facts.

Interquartile range

There are no formal guidelines on the determination of the appropriate point in the range. However, interquartile ranges are generally acceptable.

Fresh benchmarking vs. roll forwards and update of the financials

There is no specific requirement to update the comparable benchmarking search annually. Generally, such benchmarking may be rolled forward with a refresh of the financial information of the comparables for an additional one or two years where there have not been significant changes in the industry, or the functional profile of the tested party and the financial results of the tested party are not at the low end of the comparable benchmark range.

Simple vs weighted average

Generally, weighted rather than simple averages are used in determining averages over a period.

Certain Specific Provisions

Reconstruction provision

Reconstruction provisions are unique to the Australian law and are wide enough to empower the ATO to redefine the actual transactions based on how independent entities in comparable circumstances would have dealt with these transactions.

Commerciality test

Under this test, taxpayers must replace the actual commercial or financial relations if independent parties would not have entered into the actual arrangement or would not have entered into an arrangement altogether. Accordingly, Australian taxpayers should support the commerciality of their overall outcomes in addition to justify the arm's length nature of the individual transaction.

Reporting and Compliance

Related party disclosures along with the filing of annual corporate tax return

The ATO requires an International Dealings Schedule (IDS) to be filed with the

income tax return. It requires taxpayers to disclose (which must be completed regardless of the quantum of the transactions):

- Details of restructuring events involving related international parties
- Dealings with branch operations

In addition, if the aggregate amount of taxpayers' international dealings are more than AUD 2 million, they are required to disclose certain additional information.

The taxpayer is obliged to disclose information about related-party international dealings, including:

- the nature and amount of certain categories of transactions;
- details of dealings of a financial nature;
- receipts or payments of non-monetary consideration;
- details of restructuring events;
- details of arm's length methodologies used;
- the level of documentation held to support the selection and application
- of the most appropriate arm's length methodologies;
- details of disposals or acquisitions of any interest in a capital asset;

The date for filing the income tax return is due on six months and 15 days after the end of the income tax year. If international related-party dealings exceed AUD2 million (including average loan balances), an IDS must be lodged as part of the corporate tax return.

Statute of limitations for transfer pricing audits

Under the new laws, the statute of limitations on assessment of transfer pricing is seven years. However, the tax legislation applicable for income years starting before 1 July 2013 does not provide any time limitations and therefore can be challenged indefinitely.

The risk areas that can trigger transfer pricing queries during general tax audits are:

- Payment of royalties/management fees;
- Financial arrangements;
- Persistent losses, inconsistent profit/loss patterns;
- Business restructurings; and
- Dealings with tax heaven jurisdictions, etc.

APA and MAP Procedures

Taxpayers may opt for unilateral, bilateral, and multilateral Advance Pricing Agreements (APAs) for a period of three to five years.

Historically, rollbacks were available subject to the ATO's agreement and the taxpayer's facts. While rollbacks are still included, more recently, the ATO is moving away from retrospective application of APAs, instead favoring other mechanisms such as a 'letter of comfort' or a 'settlement deed.' The taxpayer may also apply for Mutual Agreement Procedures (MAPs).

BEPS/CbCR Applicability

Reporting requirements

Australian based groups, as well as Australian subsidiaries of foreign groups, termed as Significant Global Entities (SGEs) with an annual global income of more than AUD 1 billion or more, are required to comply with CbCR rules with respect to the income years commencing on or after 1 January 2016.

SGEs will be required to lodge with the ATO:

- A CbCR that includes the following information for each country that the Multinational operates: revenue, profit (loss) before income tax, income tax paid, income tax accrued, stated capital, accumulated earnings, tangible assets, number of employees, and main business activity. Where the CbCR is lodged in a jurisdiction that automatically exchanges it with the ATO, this lodgement can be replaced with a notification.;
- A Master File that provides an overview of the Multinational's global business, its organizational structure and its transfer pricing policies; and
- A Local File that contains detailed information about the local taxpayer's operations and intercompany transactions. The Australian interpretation of the Local File is not a transfer pricing documentation report but a collection of transactional data and other information;
- With regards to the Local File, the ATO has set out a 'Two-Tier' reporting requirement viz: Short form Local File - Australian Reporting Entity can provide the short form Local File to the ATO if it meets at least one of the following criteria:
  - The aggregate value of its international related party dealing is less than $2 million, and it has no international related party dealings on the short form exceptions list, or
  - the Simplified Transfer Pricing Record Keeping criteria for 'small taxpayers' and materiality, and it has no IRPDs on the short form exceptions list;
  - Where the reporting entity doesn't meet the criteria for the short form Local File, it will be required to complete the detailed Local File.

All CbC statements must be lodged within 12 months after the end of the reporting period to which they relate.

Generally, the Australian reporting entity will be responsible for providing the Master File and the Local File. The CbCR will need to be lodged separately, usually by the head entity in its jurisdiction.

The preparation and lodgement of CbCR, Master and Local File documentation are separate and distinct from the preparation of Subdivision 815–B documentation for Subdivision 284–E purposes. Thus, the new rules simply add an extra layer of reporting, and an additional reporting date (i.e., 12 months after the end of the reporting period).

Automatic exchange of CbCRs

Australia is currently one of the 67 jurisdictions that have signed the CbC Multilateral Competent Authority Agreement (the MCAA) to facilitate the exchange of CbCRs between tax authorities in different jurisdictions. However, the CbCR can only be exchanged between Australia and another signatory when each jurisdiction has activated exchange with the other.

Penalties and Other Consequences of Non-compliance

The penalty rates if no RAP can be established are generally 25% to 75% of the tax shortfall amount. These penalties may be reduced if the taxpayer can demonstrate that it has a RAP through the transfer pricing documentation finalized at the time of lodgement of the tax return.

In the case of delayed payments of the aforesaid penalties, the ATO may levy a shortfall interest charge and general interest charge.

In addition to the above penalties, effective from 1 July 2017, 'failure to lodge on time (FTL)' penalties and penalties relating to statements and failing to give documents to the ATO have now been significantly increased and its ranges from AUD 105,000 to AUD 525,000. Further, penalties relating to statements and failing to give documents to the ATO, the base penalty amounts for SGEs in respect of penalties relating to making false or misleading statements or failing to give documents to the ATO ('culpable behaviour' penalties) have been doubled, i.e., now it ranges from 50% to 150% of the tax shortfall amount where no RAP can be established.

Tax Avoidance Task Force

Established in 2016, the task force investigates and challenges the most aggressive tax avoidance arrangements, including profit shifting focusing majorly on MNEs. Its role is to ensure that these entities pay the right amount of tax, according to law.

The principal objectives of the Task Force are to:

- Detect tax avoidance to protect revenue and maintain the integrity of the tax system;
- Increase transparency and develop a better understanding of commercial drivers and the industries in which taxpayers operate;
- Improve our data, analytics, risk, and intelligence capabilities to identify and manage tax avoidance risk;
- Provide the community with confidence that large public and private groups and wealthy individuals are paying the right amount of tax, according to law, in Australia.

Diverted Tax Profits (DPT)

In addition to the specific TP legislation, Australia also has a diverted profit tax that looks at transactions that are taxed overseas at a low rate (generally less than 24% effective tax) and where obtaining a tax benefit is a principal purpose of the arrangement. Diverted profits tax is levied at 40%, i.e., higher than the normal

tax rate, and is not subject to relief from double taxation under Australian tax treaties. The diverted profit tax applies to significant global entities (SGEs). Broadly speaking, SGEs are Australian taxpayers that form part of an MNE that has a global turnover exceeding AUD 1 billion.

Multinational Anti-Avoidance Law (MAAL)

The MAAL was introduced to broadly ensure that MNEs do not use complex, contrived and artificial schemes to avoid a taxable presence in Australia and that multinationals pay their fair share of tax on the profits earned in Australia. MAAL applies to SGE's (namely entities with either the annual global income of AUD 1 billion or more or that is are part of a group of entities that have an annual global income of AUD 1 billion or more) and applies to income years commencing on or after 1 January 2016.

Broadly, the MAAL will apply to certain schemes or in connection with the scheme:

- A foreign entity supplies goods or services to an Australian customer;
- An Australian entity that is an associate of or is commercially dependent on the foreign entity undertakes activities directly in connection with the supply;
- Some or all of the income derived by the foreign entity is not attributable to an Australian PE, and
- The principal purpose, or one of the principal purposes of the scheme, is to obtain an Australian tax benefit or to obtain both an Australian and foreign tax benefit;
- SGEs are also subject to increased penalties for tax shortfalls arising from the application of the MAAL.

ATO - Guidance on Transfer Pricing Arrangements in Response to COVID-19

The ATO has published guidance to help navigate businesses through the economic impacts of COVID-19 and changing related-party arrangements.

Assessing the economic impacts of COVID-19 on transfer pricing arrangements.

ATO has emphasized gathering evidence to support any changes to, or impacts on, the business as a result of COVID-19 and advised the taxpayers to document the same. Certain parameters to assess the economic impact of COVID-19 on TP arrangements listed by the ATO are:

- Function, Asset and Risk profile of the Australian entity before and after COVID-19;
- Economic circumstances, where the actual economic impacts of COVID-19 on the Australian operations including a broader analysis of how the relevant industry has been affected;

- Changes in contractual obligations between the Australian entity and its related parties;
- Evidence of the impact (if any) of COVID-19 on the specific product and service offerings of the Australian entity and how this has affected the financial results; and
- Evidence of changes in business strategies as a result of COVID-19.

Supporting the arm's length nature of transfer pricing outcomes

The ATO has acknowledged that using comparable analysis may not reliably support arm's length outcomes of continuing transfer pricing arrangements impacted by COVID-19, particularly in the short term. In such scenarios, the ATO has sought to understand the financial outcomes that would have been achieved by the taxpayer, sans the impact of COVID-19, which would include:

- A detailed profit and loss analysis showing changes in revenue and expenses, with an explanation for variances resulting from COVID-19 or analysis of budgeted (pre-COVID-19) versus actual results;
- Details of profitability adjusted to where your outcome would have been if COVID-19 had not occurred – this should consider all factors that have a positive or negative impact on your profits and should be supported by evidence. An example of such evidence would be canceled order requests to demonstrate reduced sales revenue;
- Rationale and evidence for any increased allocation of costs or a reduction of sales (and subsequent changes in operating margins) to the Australian entity, taking into consideration its function, asset and risk profile;
- Evidence of any government assistance provided or affecting the Australian operations.

PCG 2019/1 and COVID-19 impacts.

The Practical Compliance Guideline (PCG) 2019/1 addresses the transfer pricing issues related to Australian inbound distribution arrangements. The guideline provides a detailed risk rating of inbound distributors based on their profit level and functional factors. It also outlines the framework followed by ATO to allocate its resources for scrutinizing the TP arrangements of such inbound distributors. The profit markers developed by ATO for assessing transfer pricing risk are based on the benchmarking exercise conducted using a five year weighted average EBIT margin. Considering the limitation of publicly available data regarding the pandemic's impact, the ATO has explicitly mentioned that it does not seek to review PCG 2019/1 due to COVID-19 currently.

Impact on Advance Pricing Agreements due to COVID-19

ATO has proactively encouraged taxpayers to engage with them in case critical assumptions in the APA have been breached or are likely to be breached due to the negative impact of COVID-19 on businesses. Under such a circumstance, the ATO has sought to understand the impact on the APA of the breach and consider appropriate outcomes such as business as usual, renegotiating the APA over the time period of the demonstrable impact, or suspending/modifying the APA for

a set period. For ongoing APA negotiations, the ATO has stated that standard APA processes and analysis will continue to apply only where COVID-19 does not significantly impact the taxpayer's economic performance. If the business is significantly affected by COVID-19, the taxpayer should consider placing the APA application on hold or mutually end the APA process.

Changing related party arrangements

Consequent to the above guidance, the ATO has also published a notification intending to monitor tax advantages by changing related party arrangements in the COVID-19 environment. In this regard, the ATO has stated that it will review such changes by examining documentation to assess whether –

- Independent parties dealing wholly, independently in comparable circumstances would have mutually agreed to change the existing related party agreements or arrangements;
- A mismatch between the substance of the actual dealings or relations and changes made to related party agreements or arrangements;
- Purpose of the changes to the agreements or arrangements was to obtain an Australian tax benefit;
- Changes to the related party agreements or arrangements and the commercial justification developed in anticipation of a potential review by ATO originated with a tax adviser;
- In addition, the ATO has also recommended taxpayers to inform them about any changes to related party agreements or arrangements due to COVID-19 and encouraged transparency in this regard to avoid future tax scrutiny.

Condonation of delay in preparing transfer pricing documentation

The Australian transfer pricing rules require you to prepare compliant transfer pricing documentation by the time your income tax return is lodged. Failure to prepare the documentation in time means you will not have a reasonably arguable position, which may result in the imposition of penalties.

The ATO will work with taxpayers that are affected by COVID-19 and who are unable to get their transfer pricing documentation in order before the lodgment of their current income tax return. In such cases, the ATO will take an administrative approach for penalties whereby ATO may remit the portion of penalties if the following criteria are met:

- Lodgment due date for income tax return was between 1 March and 15 July;
- Transfer pricing documentation compliant with Subdivision 284-E was in place for the previous income year;
- There has been no material change to related-party arrangements since the last income year;
- Completion of transfer pricing documentation on or before lodgment due date is otherwise reasonably arguable.

Summary of Transfer Pricing Requirements

Effective from

1982

Compliance Requirements

- IDS is to be filed for disclosing transfer pricing transactions along with the income tax return.
- Contemporaneous documentation establishing a RAP must be in existence at the date of lodgement of the tax return to gain penalty protection. Filling of CbCR, Master File and Local File within 12 months from the end of the relevant income year (applicable to SGE)

Penalties

Penalties - 25% to 75% of the shortfall tax amount if no RAP can be established

Interest may be levied if payment of penalties is delayed ‘Failure to lodge on time (FTL)’ penalties- AUD 105,000 to AUD 525,000

Penalties relating to statements and failing to give documents to the ATO – 50% to 150% of the tax shortfall amount

Method and Preference for Comparable

Five methods as defined by the OECD.

Preference for local comparables.

Peculiar Features

Reconstruction provisions and commerciality test.

APA

Available

BEPS/CbCR Applicability

Applicable

About Nexdigm (SKP)

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