KPMG

KPMG Tax Now

2 October 2019

The price is right – Glencore wins in the Federal Court

The Federal Court has delivered Glencore Investment Pty Ltd ("Glencore") a significant win against the Commissioner of Taxation (the "Commissioner") in relation to the transfer prices it used on certain cross-border related party transactions associated with its Cobar copper mining operations.

Summary

The decision in *Glencore Investment Pty Ltd v Commissioner of Taxation* [2019] FCA 1432, delivered on 3 September 2019, has implications for taxpayers, notably being the first transfer pricing case in Australia following the Full Federal Court's decision in *Chevron Australia Holdings Pty Ltd v Commissioner of Taxation* [2017] FCAFC 62 ("Chevron").

We understand that the Commissioner filed an appeal against the decision on 1 October.

In summary, Justice Jennifer Davies held that:

a) Glencore had discharged the onus of proof that the amended assessments raised by the Commissioner under Division 13 and Subdivision 815-A were excessive;
b) The Commissioner's primary case was rejected on the basis that the Commissioner had misapplied Division 13 and Subdivision 815-A; and
c) On the evidence, the consideration that Glencore was paid for its copper concentrate in the relevant years was within an arm's length range.

Key messages

The Federal Court in Glencore applied the principles established by the Full Federal Court in Chevron and SNF[1]:

- Division 13 and Subdivision 815-A do not permit or require the construction of an abstract hypothetical agreement between abstract independent parties (Chevron); and
- The evidentiary standard taxpayers need to meet in relation to comparability for purposes of Division 13 (and now also in relation to Subdivision 815-A) in order to satisfy the statutory onus of proof is not set at an unattainable height (SNF). The Commissioner's submissions in relation to comparability in SNF and now again in Glencore have been described as being "deeply impractical".

The Glencore case provides important insights into the approach the courts are likely to take when examining transfer pricing matters under Division 13 and/or Subdivision 815-A, for example:

[1] *Commissioner of Taxation v SNF (Australia) Pty Ltd* [2011] FCAFC 74.

- It is evident that identifying the hypothetical transaction continues to be problematic for the Commissioner. The decision may provide a catalyst for the Commissioner to revisit
- the approach being taken in a number of current audit cases having regard to how the courts are applying Division 13 and Subdivision 815-A;
- The Glencore case reinforces the position of taxpayers that have good comparables, however, may provide little comfort to taxpayers that are unable to provide evidence of comparable dealings between independent entities.

Glencore reinforces that evidence is key and taxpayers should direct their attention to gathering a combination of evidence:

- Providing evidence to all the facts and circumstances surrounding the tested transaction;
- Analysis of comparable transactions; and
- Evidence that the comparable transactions identified are characteristic of typical arm's length arrangements and via independent expert opinion where issues are more complex.

We explore these matters in more detail below.

Background

Glencore appealed against objection decisions made by the Commissioner disallowing the taxpayer's objections to amended assessments issued to it for the 2007, 2008 and 2009 income years (the "relevant years"). In the relevant years, Cobar Management Pty Ltd ("Cobar Management"), an Australian member of the multiple entry consolidated group headed by Glencore, managed and operated a mine in Cobar, New South Wales, and sold 100 percent of the copper concentrate produced at that mine to its Swiss parent, Glencore International AG.

The amended assessments had been raised by the Commissioner on the following alternative bases:

- Under Division 13 of Part III of the *Income Tax Assessment Act 1936* ("Division 13") on the basis that the consideration paid by Glencore International AG to Cobar Management for the copper concentrate in the relevant years was less than the consideration that might reasonably be expected to have been paid in an arm's length dealing between independent parties; and
- Under Subdivision 815-A of the *Income Tax Assessment Act 1997* ("Subdivision 815-A") on the basis that conditions operated between Glencore International AG and Cobar Management which differed from those which might be expected to have operated between "independent enterprises" with the result that Cobar Management obtained a transfer pricing benefit.

The transaction under examination was an agreement made in February 2007 between Cobar Management and Glencore International AG ("February 2007 Agreement"), known in the copper concentrate industry as a "price sharing agreement". Under the February 2007 Agreement, the copper concentrate was sold at a price based on a formula which broadly encompassed a reference point price pegged to the London Metal Exchange cash settlement price for copper grade "A" as averaged over a period (the quotational period). Glencore International AG could elect to link the quotational period to either the month of shipment of the copper concentrate from the loading port of embarkation or the month of

arrival of the copper concentrate at the port of disembarkation. Further, within each alternative, Glencore International AG had the option to elect one of three quotational periods to be declared prior to each shipment from the loading port, at which time it would be aware of the average copper prices in (at least) one of the periods from which it was to make its selection (known in the copper concentrate industry as "quotational period optionality with back pricing"). A deduction was then made from the copper reference price for treatment and copper refining charges ("TCRCs"), which for the relevant years were fixed at 23 percent of the copper reference price (as calculated) for the payable copper content of the copper concentrate.

Central to the case was the replacement by the February 2007 Agreement of a series of life of mine offtake agreements which had first been entered into between Cobar Management and Glencore International AG in mid-1999, with each having been structured as "market-related" agreements. The February 2007 Agreement, being a "price-sharing" agreement, was a fundamentally different type of agreement to a "market-related" agreement.

The amended assessments issued to Glencore incorporated adjustments to remove the effect of both the 23 percent price sharing mechanism (and replace it with a 50 percent benchmark / 50 percent spot TCRCs which the Commissioner identified as the rate previously used by Cobar Management) and to reflect the impact of a consistently applied quotational period.

The parties' respective cases

The Commissioner's primary case

The Commissioner's primary case was that the February 2007 Agreement was a non-arm's length dealing which favoured Glencore International AG to the detriment of Cobar Management, and that an independent mine producer with Cobar Management's characteristics would not have agreed to price sharing at all or to quotational periods with back pricing optionality. Instead, in the Commissioner's view, it might reasonably have been expected to have sold its production in the relevant years under a life of mine agreement on market-related terms and limited quotational period optionality with no back pricing.[2]

On the Commissioner's case, the hypothetical transaction to be adopted for the purposes of both Division 13 and Subdivision 815-A was: [3]

- A long-term contract originally entered into in July 1999 and amended and continued from time to time;
- Between independent parties with the characteristics of Cobar Management and Glencore International AG;
- For the sale of 100 percent of the copper concentrate for the life of the mine; and
- With terms as to price to be negotiated and amended as between the parties on an annual basis to reflect the market conditions, including changing benchmark terms and the commercial needs of the parties.

[2] At [5].
[3] At [33].

Glencore's primary case

Glencore's primary case was that the terms governing pricing under the contractual agreements which applied in the relevant years were terms that existed in contracts for the sale of copper concentrate between independent market participants and thus were terms that might be expected to be found in an agreement between the relevant hypothetical parties.[4]

Glencore submitted that unlike the position in Chevron – where the controlled loan agreement, which was structured without security and covenants, would not have been seen in the market between independent enterprises – the provisions in the February 2007 Agreement were observable in contracts between Glencore International AG itself and enterprises independent of it, and there was nothing to suggest that those counterparties were acting other than in a commercially rational manner. [5]

The evidence relied upon by the respective parties

The decision considered evidence, both lay and expert, presented by the Commissioner and Glencore, as well as joint expert reports. One joint expert report was prepared by the mining industry experts (Mr Wilson, Mr Ingelbinck and Mr Kowal) and another was prepared by the financial experts (Mr van Homrigh and Mr Samuel). Transfer pricing disputes turn on the evidence adduced by taxpayers and the Commissioner. It is critical to appreciate how Glencore approached its evidentiary burden. A summary of the evidence filed by both parties is set out at the end of this document.

The court's decision

Justice Davies identified the task facing the court as follows:

> "…it is necessary to hypothesise a reliably comparable agreement not affected by the lack of independence and the lack of arm's length dealing for the purpose of determining whether the consideration actually given for the copper concentrate that [Cobar Management] sold to [Glencore International AG] in the relevant years was less than the consideration which might reasonably be expected to have been paid if the parties had been independent and acting at arm's length in relation to the supply (Div 13) and, in the case of Subdiv 815-A, whether an amount of profits might have been expected to accrue to [Cobar Management] if the transaction it entered into with [Glencore International AG] had been entered into, had [Cobar Management] and [Glencore International AG] not been related and been dealing with each other at arm's length."[6]

Identifying the hypothetical transaction

Her Honour followed the Full Federal Court's decision in Chevron, and indicated that the task of ascertaining the consideration that might reasonably be expected would have been paid to Cobar Management for the copper concentrate that it sold to Glencore International AG is not to be undertaken upon the hypothesis that Cobar Management was not a

[4] At [29].
[5] At [311].
[6] At [310].

member of the Glencore Group. As such, on the evidence in the present case, her Honour found that the consideration that might reasonably be expected to be received by an independent seller of copper concentrate in the position of Cobar Management must therefore be determined on the hypothesis of:

- An independent buyer of copper concentrate in the position of Glencore International AG acquiring the whole of Cobar Management's copper concentrate for the life of the mine and providing logistical and marketing support to the seller of the copper concentrate; and
- An independent seller of copper concentrate in the position of Cobar Management selling the whole of its production of copper concentrate to an independent buyer for the life of the mine, and with no need for a marketing department or logistics expertise.[7]

Glencore provided evidence of 12 agreements for the sale of copper concentrate between independent parties which contained quotational period optionality (including back pricing) and/or price sharing mechanisms. Glencore submitted that those agreements demonstrate that these features:

a) Were actually agreed in the copper concentrate market in the period leading up to and during the relevant years; and
b) Are therefore conditions which form part of a pricing structure that might be expected to have operated between a producer/seller of copper concentrate in the position of Cobar Management and a purchaser wholly independent of it during the relevant years.[8]

Glencore did not contend that any of the agreements were directly analogous to the agreement between Cobar Management and Glencore International AG but submitted that the agreements provided illustrations of price sharing agreements between arm's length parties under copper concentrate agreements between 2002 and 2011[9] and that the contracts illustrated the broad variety of quotational period clauses, including quotational periods with back pricing optionality, that might be expected to be agreed between independent parties.[10]

By contrast, the Commissioner submitted that these contracts did not support the proposition that price sharing provisions were adopted in situations comparable to that faced by Cobar Management in late 2006 and throughout the relevant years.[11]

After considering the evidence before the court, Justice Davies found that there was no warrant to restructure the February 2007 Agreement from a price sharing contract to a market-related contract and rejected the Commissioner's contention that the appropriate hypothetical was a market-related contract rather than a price sharing contract.[12] In reaching this conclusion, Justice Davies said that the evidence showed that:[13]

- The February 2007 Agreement was a form of agreement seen in the market between independent enterprises in the relevant years; and

[7] At [172] and [181].
[8] At [172] and [181].
[9] At [253].
[10] At [277].
[11] At [253].
[12] At [322].
[13] At [320].

- The price sharing methodology adopted by the parties under the February 2007 Agreement was a recognised, legitimate and accepted way for copper concentrate to be priced and one which other market participants, independent of each other and dealing at arm's length, also adopted at the time in respect of the supply of concentrate by a mine producer to a trader. This was supported by the experts, including the Commissioner's experts.

The Commissioner's approach, in her Honour's opinion, impermissibly restructured the actual contract entered into by the parties (a price-sharing transaction) into a contract of a different character (a market-related contract) contrary to the decisions in Chevron, both at first instance and on appeal.[14] As such, for purposes of identifying the hypothetical transaction upon which the comparative analysis is to be subsequently conducted, no adjustment was required to the form of the February 2007 Agreement to reflect that transaction as one entered into between independent parties dealing at arm's length.[15]

Comparability analysis

Having accepted, on the evidence, Glencore's submission that the hypothetical transaction was to be based on the actual transaction entered into between Cobar Management and Glencore International AG, Justice Davies then considered whether the pricing arrangements for the sale of copper concentrate under the February 2007 Agreement reflected an arm's length price.

Glencore presented, through its lay witness, evidence of the business and conditions of the industry in which it operated. It also presented 12 comparable agreements, none of which could be said to be truly comparable to the tested transaction (a fact freely admitted by Glencore). In considering the significance to be attributed to the comparable transactions, her Honour was assisted by the independent expert evidence presented by both parties of industry practice[16]. In particular that these contracts would have been reference points for price sharing terms in the industry.

Her Honour was satisfied on the evidence that the 23 percent price sharing rate agreed between Cobar Management and Glencore International AG was within an arm's length range (the evidence showed a range of 21-26 percent in the 2006 Brook Hunt Report;[17] the "comparable contracts" had price sharing percentages ranging from 20 percent to 27.5 percent[18]). However, her Honour was not satisfied, as submitted by the Commissioner, that a discount might be expected to have been allowed between independent parties for the benefit of the quotational period optionality provided for in the February 2007 Agreement.

In reaching these conclusions, her Honour rejected the Commissioner's arguments that none of the contracts put into evidence by Glencore were directly comparable (to the transaction between Cobar Management and Glencore International AG), and that there was no evidence of any price sharing agreements being entered into in the copper concentrate market in any of the relevant years, or of any mine in production agreeing to a 100 percent

[14] At [314] and [322].
[15] At [320].
[16] i.e. the Brook Hunt Report, an annual publication examining the global markets for copper concentrate: *Glencore* at [93], [347].
[17] At [347].
[18] At [348].

offtake agreement on price sharing terms, or that any other mine had ever entered into a three year price sharing agreement. [19]

In her Honour's view, the Commissioner's approach with respect to comparability had been rejected by the Full Federal Court in SNF on the basis that, if correct, it would have the consequence that "a taxpayer who bears the onus in tax appeals, could never succeed in such a [transfer pricing] case for the bar will be set at an unattainable height"[20]. The Full Federal Court in SNF had described a submission by the Commissioner that sought "to discern the presence of a strict norm of operation inflexibly requiring one kind of comparable and forbidding all others" and which "refuse[d] to admit the possibility of making adjustments for differences" as being "deeply impractical". In Justice Davies' view, the contracts adduced by the taxpayer evidence the degree of variability in contracts adopting such terms and are probative evidence that such terms might be expected to operate between hypothetical mine producers and traders independent of each other and acting at arm's length.[21]

Conclusion

In light of the above findings, Justice Davies held that the prices received by Cobar Management for the copper concentrate it supplied to Glencore International AG under the February 2007 Agreement were within an arm's length range and accordingly Glencore had discharged its statutory onus of proof. More particularly, her Honour held that:

- As the consideration paid by Glencore International AG to Cobar Management for the concentrate fell within the range of consideration that might reasonably be expected to be paid, the amended assessments based on Divisions 13 were excessive; and
- Glencore did not get a transfer pricing benefit within the meaning of ss815-15(1) ITAA 1997 because, for the purposes of paragraph 815-15(1)(c), there was no amount of profits which, but for the conditions mentioned in Article 9 of the tax treaty between Australia and Switzerland might have been expected to accrue to Glencore but which, by reason of those conditions, did not so accrue. As such, the amended assessments based on Subdivision 815-A were excessive.

KPMG observations

1. Identifying the hypothetical transaction

It is evident from the Glencore case that identifying the hypothetical transaction for purposes of Division 13 and Subdivision 815-A continues to be problematic for the Commissioner. In general, the task is not to restructure the actual contract entered into by the parties into a contract of a different character and taxpayers should have regard to this in preparing transfer pricing documentation and defending positions.

2. Establishing comparability

While the Glencore case reinforces the position of taxpayers that have good comparables, it is likely to provide little comfort to taxpayers that are unable to provide evidence of

[19] At [344].
[20] At [102] of Full Court decision in *SNF*
[21] At [344].

comparable dealings between independent entities. Strong comparability is the key in planning and developing transfer pricing policies and represents safer ground for companies' tax governance, being consistent with the OECD Guidelines.

3. Evidence is key

It is for the taxpayer to establish what a seller and purchaser would have regard to in deciding on pricing terms. In order to discharge the burden of proof, companies should consider the evidentiary angles open to them which may include a combination of:

- Direct lay evidence to all the facts and circumstances surrounding the tested transaction,
- Evidence of comparable transactions, and
- Evidence (via independent expert opinion) that the comparable transactions identified are characteristic of typical arm's length arrangements.[22]

4. Use of experts

Experts can be very helpful in supporting cases both in the courts and also in audits. In seeking to bolster positions with experts, it is recommended that regard is had to, inter alia, the following key points:

- Any expert opinions should be constrained to their specialist field of knowledge in strict compliance with the Code of Conduct – it is not their role to act as an advocate. [23]
- Parties should be cognisant that the extent to which expert opinion will be probative is highly contingent on the quality of questions asked. Experts must be driven toward the correct statutory question and not "totally irrelevant" questions.[24]
- It is not for experts to use the benefit of hindsight to derive a favoured pricing choice, nor will opinions on pricing – but on a fundamentally different type of contract to that agreed – have any relevance.

5. Potential implications for Subdivision 815-B

Glencore does not consider the current transfer pricing provisions in Subdivision 815-B. However, there are nevertheless some useful insights from Glencore. Whilst Subdivision 815-B also involves identifying a hypothetical transaction between independent entities (ss815-125(1)), it does so in a far more structured way (ss815-130). In essence, it would be necessary for the Commissioner to show that independent entities dealing wholly independently with one another in comparable circumstances "would not" have entered into the actual commercial or financial relations and "would" have done something different or nothing at all. Consequently, a taxpayer that has evidence, similar to that relied upon by Glencore, showing that independent entities do enter into similar transactions should have strong prospects of being able to be resist such an argument and overcome application of ss815-130(3).

---

[22] At [12].

[23] At [403]-[404].

[24] At [248].[25] Her Honour observed that much of this evidence was irrelevant because it ignored the corporate relationship completely and, thus, did not engage with the statutory questions for determination under Division 13 and Subdivision 815-A. At [172].

Summary of evidence

Glencore's evidence

Glencore's witnesses	Overview of evidence filed in the proceedings
Mr David Kelly A chartered accountant who provided the court with lay evidence	Four affidavits sworn in the proceedings relating to: • The copper market and pricing in terms of copper concentrate • The Glencore group and business • Glencore International AG's acquisition and ownership structure • His involvement in the Cobar mine, the operations of the mine, and the challenges faced by the mine in the period 2006-2009 • The logistics and risks for Cobar Management in selling its copper concentrate, if it had been independent of its parent and sought to sell its copper concentrate directly to smelters[25] • Exhibits to his affidavits included examples of other offtake agreements for the sale of copper concentrate containing price sharing and quotations period back pricing terms
Mr Richard Wilson An expert in market analysis of the global copper concentrate industry.	Three reports prepared for the proceedings. • The first report was directed to answering the following question: Whether the conditions that operated under the agreement as it applied for the relevant years differ from that which might be expected to operate between a producer/seller of copper concentrate in the position of Cobar Management and a purchaser independent of Cobar Management having regard to the circumstances of Cobar Management in the period 1999 to 2007 • The second and third reports were in response to the mining industry expert reports filed by the Commissioner, Mr Leonard Kowal and Mr Marc Ingelbinck
Mr Tony Samuel A Forensic Accounting Expert	One report prepared which responded to the Commissioner's financial analysis expert, Mr David van Homrigh

[25] Her Honour observed that much of this evidence was irrelevant because it ignored the corporate relationship completely and, thus, did not engage with the statutory questions for determination under Division 13 and Subdivision 815-A. At [172].

The Commissioner's evidence

The Commissioner's witnesses	Overview of evidence filed in the proceedings
Mr Marc Ingelbinck A mining industry expert	Prepared two reports directed to answering the following questions:[26] 1. whether the conditions that were operating between Cobar Management and Glencore International AG differed from the conditions; and 2. whether the consideration received or receivable by Cobar Management for the sale of copper concentrate to Glencore International AG was different from that which might reasonably be expected to operate between an independent Producer/Seller and an Independent Buyer dealing independently with each other. The questions were asked first without the benefit of the affidavits of Mr Kelly and the report of Mr Wilson, and secondly to expressly consider them.
Mr Leonard Kowal A mining industry expert	Mr Kowal was asked to prepare a report addressing questions 1 and 2 provided to Mr Ingelbinck.[27]
Mr David van Homrigh A financial analysis expert	A report setting out his analysis and advice on the financial affairs of Cobar Management, considering aspects such as: • whether the mine was profitable; • to what extent there was uncertainty as to the profitability of future copper concentrate mining operations at the Cobar mine; • whether Cobar Management required bank or other financing and the nature of such financing; and • the nature and benefits to Cobar Management of financial arrangements which were in place.

[26] At [216].

[27] Although the outcome did not turn on whether one expert's evidence was to be preferred over another, Justice Davies did note that if she was required to express such a preference, the reliability of Mr Kowal's evidence (as an expert) was in doubt, as it was unclear whether the opinions expressed in his report were in fact his own At [403]-[404].

Contact us

Frank Putrino
Partner
KPMG Melbourne
T: +61 3 9838 4269
E: fputrino@kpmg.com.au

Glen Hutchings
Partner
KPMG Sydney
T: +61 2 9335 8634
E: ghutchings1@kpmg.com.au

Angela Wood
Partner
KPMG Melbourne
T: +61 3 9288 6408
E: angelawood@kpmg.com.au

Jane Rolfe
Partner
KPMG Melbourne
T: +61 3 9288 6341
E: janerolfe@kpmg.com.au

Tim Keeling
Partner
KPMG Sydney
T: +61 2 9455 9853
E: tkeeling1@kpmg.com.au

Sarah Dunn
Partner
KPMG Sydney
T: +61 2 9335 8464
E: sdunn2@kpmg.com.au

Jeremy Capes
Partner
KPMG Sydney
T: +61 2 9335 7665
E: jeremycapes@kpmg.com.au

Michael Fortmann
Executive Director
KPMG Perth
T: +61 8 9263 7444
E: mfortmann@kpmg.com.au

Angelina Lagana
Partner
KPMG Melbourne
T: +61 3 8663 8650
E: alagana@kpmg.com.au

Tony Gorgas
Partner
KPMG Sydney
T: +61 3 9335 8851
E: tgorgas@kpmg.com.au

Jon Thorsteinsson
Director
KPMG Brisbane
T: +61 7 3233 9469
E: jthorsteinss@kpmg.com.au

Keith Swan
Partner
KPMG Sydney
T: +61 2 9455 9261
E: keithswan@kpmg.com.au

Annemarie Wilmore
Director
KPMG Sydney
T: +61 2 9346 5463
E: awilmore1@kpmg.com.au

KPMG.com/au/taxnow

KPMG Tax Now is a digital media website that brings together industry-leading tax news, insights and more from our global network of experts.

We are passionate about providing insightful and relevant information to you regarding tax in Australia and overseas, shining the light on ideas not covered elsewhere.

Stay informed of important policy and legislation changes, and what it means to you and your business.

Subscribe to our KPMG Tax Now website to receive regular updates, access to exclusive content, receive invitations to special events and become involved in our community.

More information on KPMG Tax Now can be found here.