Tax update - Transfer pricing

ATO internal distributor risk guidance finalised

March 2019

Final guidance on inbound distributors.

On 13 March 2019, the Australian Taxation Office (ATO) released *PCG 2019/1 Transfer pricing issues related to inbound distribution arrangements* (the PCG) The PCG represents the finalised version of draft Practical Compliance Guideline PCG 2018/D8. The PCG takes immediate effect, and will apply to existing and new inbound distribution arrangements. The finalised PCG 2019/1 is relatively unchanged from the draft PCG save for some minor amendments.

As per the draft, the PCG outlines the ATO's approach to risk rating based on profit level and functional factors for Australian inbound distributors, and at what profit levels it may dedicate resources to investigate further their transfer pricing arrangements.

Consistent with previous ATO PCGs released for marketing hubs (PCG 2017/1) and intra-group debt arrangements (PCG 2017/4), the PCG provides a high, medium and low risk coloured zoning classification based on the Earnings Before Interest and Tax (EBIT) margin achieved by the inbound distributor. As such, the PCG represents a new and additional tool for the ATO in its attempts to shape and influence the behaviour of multinationals with respect to their transfer pricing distribution arrangements in Australia.

The PCG results in numerous considerations for Australian inbound distributors, both in the application of the PCG and how taxpayers may choose to respond.

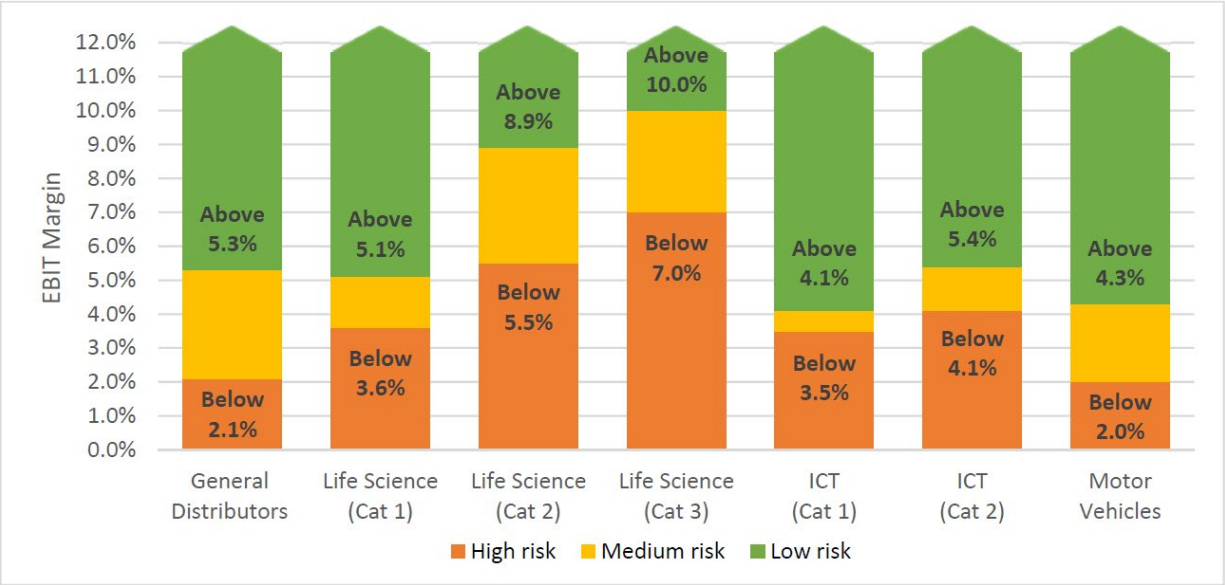
The ATO has divided inbound distributors into four key industry categories, being:

1) Life Sciences (including Pharmaceuticals);
2) Information and Communication Technology (ICT);
3) Motor Vehicles; and
4) A 'catch-all' General Distributor category.

The Life Sciences industry is further divided into three categories whilst the ICT industry is divided into two categories. The categories are driven by the functions / activities undertaken by the inbound distributor, with the key incremental activities to move into LCT category 2 including market access, regulatory functions and government reimbursement. LCT category 3 would include those activities within LCT category 2 plus activities such as training and assistance in conducting surgical procedures involving medical devices.

For the ICT industry, the key activities that will shift an inbound distributor into ICT category 2 include complex sales processes (such as customising the product portfolio, providing bespoke product offerings and specialised local technical expertise) as well as direct selling activities and large customer relationship management (such as partner-led assisted retail and branded activities and large customer tendering).

The ATO EBIT margins for each industry (which should be calculated on a 5 year weighted average basis) are summarised below.



In short, the ATO has made it clear that taxpayers that fall outside their relevant low risk zone can expect some form of ongoing monitoring and compliance activity on their inbound distribution transfer pricing arrangements, and can likely be expected to provide their PCG assessment to the ATO in due course, whether it be through the Reportable Tax Position (RTP) schedule or via direct correspondence from the ATO.

In terms of the expected ATO approach to each risk zone:

- **High risk taxpayers** can expect a strong likelihood of ATO review or audit, with taxpayers that have made losses in the past 3 years to be given the highest priority. The ATO has also noted that inbound distributors with substantial debt arrangements such that there are variances between their EBIT and profit margins can expect attention (although the debt arrangement may be risk-assessed separately under PCG 2017/4).

- **Medium risk taxpayers** can expect potential contact by the ATO to seek clarity on their position before determining whether further resources should be allocated.

- **Low risk taxpayers** will generally not have ATO compliance resources dedicated to assess their distribution arrangements.

As further incentive for taxpayers to shift away from the high risk zone, the ATO has indicated that low and medium risk taxpayers may also be eligible for a 'pre-qualified' / streamlined APA process, and the ATO has also offered a 12 month transitional period where penalties and reduced interest will apply for inbound distributors that shift to the low risk zone for the current year as well as past and future years where the distribution arrangements have or will apply.

For completeness, the PCG emphasises that a low risk rating does not mean the ATO will consider a taxpayer's arrangements or supporting transfer pricing documentation to be of a reasonably arguable position (RAP). Further, a low risk rating does not preclude the ATO from using its reconstruction powers under s815-130 of the *Income Tax Assessment Act 1997*.

KPMG's key observations

- The PCG is a game changer and combined with a number of other major initiatives introduced by the ATO (such as the Justified Trust program), represents a clear and distinct shift in how the ATO will view the transfer pricing arrangements of inbound distributors, and the initial profit expectations that the ATO may have when initiating compliance activity

- A number of questions arise in the application of the PCG. This includes questions as to:
  - How taxpayers may be defined where there is cross over, such as between ICT and Life Science industry categories, and
  - Whether the PCG will form part of Categories A and B, or Category C of the RTP schedule.

- The low risk EBIT margins put forward by the ATO appear to align at the higher end of arm's length ranges that might typically be observed. As such, inbound distributors will need to carefully consider if the ATO's low risk EBIT margins may create significant transfer pricing risk with the relevant counterparty's tax authority.

- Furthermore, multinationals will need to consider the EBIT margins in the context of any global transfer pricing policies that may be in place, and the flow-on impacts that any changes made for Australian purposes may have on other jurisdictions where distributors are present, particularly if comparisons can be made by tax authorities using Country-by-Country reporting data.

- We anticipate that many inbound distributors will fall within the high and medium risk zones. As such, it is important that inbound distributors revisit and confirm the arm's length nature of their distribution arrangements and ensure that any transfer pricing documentation is in place or appropriately enhanced such that it accords to Australian requirements (which go beyond OECD Local File requirements). This will not only be necessary to provide support for the outcomes reached in the event of ATO review, but to ensure that the transfer pricing documentation is of RAP standard per TR 2014/8 such that penalty protection is not precluded in the event of an ATO adjustment.

- As a result, inbound distributors may need to consider enhancing their transfer pricing documentation to account for factors such as local comparable benchmarking data, the use of corroborative transfer pricing methods, and local industry analyses to ensure that the functional profile of the inbound distributor (and in particular the value connected with any functions which the ATO may consider provide incremental value) is appropriately supported.

Please contact your KPMG transfer pricing advisor should you have any queries or would like to discuss further.

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