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Robust comparables: Success for Glencore in the Full Federal Court

The Full Federal Court handed down its decision in Commissioner of Taxation v Glencore Investment Pty Ltd [2020] FCAFC 187 (Glencore decision) on 6 November 2020, with Glencore largely successful. The Commissioner's appeal was allowed in only one confined respect, relating to a freight allowance. Aside from this, Glencore's success at first instance stands.

Summary

In the technically complex and lengthy judgment (amounting to 114 pages), the Full Federal Court considered a number of matters including the statutory questions posed respectively under Division 13 of Part III of the *Income Tax Assessment Act 1936* (**Div 13**) and Subdivision 815-A of the *Income Tax Assessment Act 1997* (**Subdiv 815-A**)).

Middleton, Steward and Thawley JJ dismissed the Commissioner's appeal against the decision of Davies J in *Glencore Investment Pty Ltd v Commissioner of Taxation* [2019] FCA 1432 (except for the one issue involving a freight allowance). Middleton and Steward JJ provided a joint judgment, and although Thawley J provided a separate judgment with some different reasoning, all three judges agreed with the ultimate decision. In support of the taxpayer, the Full Federal Court found that this matter was:

> "… *a case where reasonable minds have reasonably differed within a range of commercially acceptable arm's length outcomes*".[1]

[1] At [213].[2] At [186].

KPMG observations

Key practical lessons can be gleaned from the case to assist taxpayers in managing the pricing of cross border arrangements:

- where taxpayers have good reference points to demonstrate that cross-border arrangements are set on a commercial basis (e.g., based on what independent entities actually do), this is very relevant to analysing arm's length outcomes;
- third party comparable arrangements do not need to be perfect comparables, but should provide a good indication of what might be close to the market, or what is not out of the market;
- identifying an arms' length outcome does not require taxpayers necessarily to choose the outcome that maximises profits. Other considerations such as risk appetite and commercial or market factors that exist at a relevant time may also play an important role;
- taxpayers in a dispute with the Commissioner regarding the application of the transfer pricing rules should look to carry out several key tasks in preparing the necessary evidentiary support required to successfully defend positions taken and to withstand scrutiny.

Background

During the 2007 to 2009 income years, Cobar Management Pty Ltd (**CMPL**), an Australian resident entity sold copper concentrate to its ultimate Swiss parent, Glencore International A.G. (**GIAG**). It did so pursuant to an agreement entered into in February 2007 (**2007 Agreement**) which amended the terms of the then existing agreement between the parties for the supply of copper concentrate. Two material changes were agreed:

- To adjust the pricing mechanism, so that the parties would no longer rely upon benchmark and spot market charges for treatment and refining charges (**TCRCs**). Instead, the parties agreed to fix the relevant TCRCs at a rate of 23 percent of the relevant copper price (referenced to the London Metal Exchange) and averaged over a period (the quotational period) for three years (**referred to as price sharing**);
- To provide GIAG greater choice in selecting the quotational period (**referred to as quotational period optionality with back pricing**).

The Commissioner's case was that the consideration GIAG paid CMPL for its copper concentrate was not an arm's length price. The Commissioner raised amended assessments relying upon both Div 13 and Subdiv 815-A to increase the consideration GIAG paid CMPL for its copper concentrate.

Justice Davies heard the case at first instance in the Federal Court and found in favour of Glencore, concluding that:

- Glencore had discharged its onus of proof that the amended assessments raised by the Commissioner under Div 13 and Subdiv 815-A were excessive;

- the Commissioner's primary case was rejected as it was a misapplication of the provisions of Div 13 and Subdiv 815-A; and

- on the evidence, the terms operating between the Australian copper mine and its Swiss trader parent to calculate the price at which the mine sold its entire copper concentrate production were within an arm's length range.

The Commissioner then appealed to the Full Federal Court relying on the following main grounds of appeal:

- the agreement in place between CMPL and GIAG prior to February 2007 had been on arm's length terms and no party acting independently and at arm's length would ever have agreed to such detrimental changes;

- in relation to the quotational period optionality change in 2007, Glencore had failed to discharge its onus of proving that an independent party would have agreed to such a clause without any quid pro quo; and

- Glencore did not demonstrate that the payment for freight allowance in 2009 was an arm's length allowance and therefore, failed to discharge its onus.

A more detailed analysis of the background and the first instance decision can be accessed here.

Analysis

The Glencore case provides several key technical insights into the interpretation and application of Div 13 and Subdiv 815-A as discussed below. However, as these provisions relate to Australia's previous transfer pricing rules, rather than the current transfer pricing rules in Subdivision 815-B of the *Income Tax Assessment Act 1997* (**Subdiv 815-B**), care is needed before applying the views expressed in the case to matters that are subject to Subdiv 815-B.

- **Substitution and limits to reconstruction:** In applying the statutory test for the purposes of Div 13 and Subdiv 815-A, the ability of the Commissioner to reconstruct the transaction has limits. Principally, the Commissioner is permitted to substitute different contractual terms, or methodologies he considers will result in arm's length consideration. The focus on substitution is an evolutionary development in Australia's transfer pricing case law in respect of Div 13 and Subdiv 815-A, providing clarity to the limits of reconstruction under these provisions and refocusing the primary analysis on the words of the statute.

- **Framing the hypothetical agreement or conditions:** The Glencore case again highlights the challenges faced by taxpayers and the Commissioner in identifying the

hypothetical agreement between independent parties dealing at arm's length. In this respect, Middleton and Steward JJ agreed with the view of Allsop CJ in *Chevron Australia Holdings Pty Ltd v Commissioner of Taxation* [2017] FCAFC 62 (***Chevron***), that the extent of depersonalisation depends upon what is appropriate to the task of determining an arm's length consideration in a particular case*. As such, it is not unrealistic to anticipate the Commissioner* may *seek to test the limits of what is* appropriate in active compliance cases involving Div 13 and Subdiv 815-A, particularly in cases where good comparable agreements are less apparent.

- **Onus of proof:** The Commissioner, as he is entitled to under the legislative framework for tax disputes, required Glencore to discharge the statutory onus of proof borne by all taxpayers to prove that the Commissioner's amended assessments are excessive. In considering the practical difficulties faced by both taxpayers and the Commissioner in finding evidence in transfer pricing cases and that Div 13 and Subdiv 815-A, the Full Court acknowledged that flexibility and pragmatism as well as common sense is required when approaching the task of considering comparable contracts to ascertain an arm's length price.[2]

- **Evidence:** There are several key tasks to be undertaken in the preparation of expert evidence so that it will withstand scrutiny. This case goes beyond the lessons learnt from *Chevron* in terms of evidence preparation, both in respect of the question on which experts are asked to opine, and in the utility of joint expert evidence. Taxpayers engaged in a transfer pricing dispute with the Commissioner should take care in carrying out these tasks and preparing expert evidence in order to support positions.

- **Comparability:** The joint judgment of Middleton and Steward JJ notes that much time was spent by the Commissioner's experts and by the Commissioner in distinguishing the independent party contracts put forward by Glencore to demonstrate that the terms upon which CMPL sold copper concentrate to GIAG in the 2007 to 2009 years were arm's length in nature (e.g. at [98]). In their Honours' view, many of the differences identified by the Commissioner were important and diminished the probative value of the contracts said to be comparable. Nevertheless, their Honours described the contracts put forward by Glencore as valid "*reference points*" and as a "*sounding board*" and that:

  > *"(t)hey confirmed the joint opinion of the experts that there was nothing in the pricing formula adopted from February 2007 that did not also exist in contracts between independent market participants. They also demonstrated that price sharing of 23 percent was not out of the market*." [3]

These key themes are explored in more detail below.

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[2] At [186].
[3] At [193].

Substitution and limits to reconstruction

A key focus of the Full Federal Court was the statutory test to be applied. The Full Federal Court unanimously endorsed the principle that in the context of Div 13 and Subdiv 815-A, the Commissioner only has the power to substitute terms or conditions of the actual agreement which directly bear upon the price payable for the goods or services for purpose of determining the arm's length consideration. However, in this case, it was considered inappropriate to use a substituted price, method or formula given the evidence provided by the taxpayer showed an alignment of the actual agreement (particularly terms related to pricing) with agreements entered between independent parties dealing at arm's length.

While there is some difference in views between Middleton, Steward JJ and Thawley J, as to which terms can be substituted (by narrow reference to pricing terms or conditions only or a broader reference to all terms and conditions), the overarching reference should be to an agreement that independent parties dealing at arm's length might reasonably be expected to have agreed.[4]

Thawley J noted that substitution has limits and that the greater the substitution of terms or the more different the hypothetical agreement is from the international agreement, the less likely it is that the hypothetical agreement is probative of the arm's length consideration or conditions.[5]

Framing the hypothetical agreement or conditions

Middleton and Steward JJ sought to reconcile the different positions reflected in the Full Federal Court's decisions in *Chevron* and its earlier decision in *Commissioner of Taxation v SNF (Australia) Pty Ltd* [2011] FCAFC 74 (**SNF**) in relation to hypothesising the agreement that would exist between independent parties dealing at arm's length. Their Honours largely agreed with the views of Allsop CJ in *Chevron*, that Div 13 and Subdiv 815-A do not permit or require the construction of a hypothetical agreement between abstract or "*utterly disembodied*" independent parties and further that:

> *"(t)he degree and extent of the 'depersonalisation' will be dictated by what is appropriate to the task of determining an arm's length consideration – that is one that satisfactorily replaces what the taxpayer gave by what it should be taken to have given had it been independent of its counterparty."*[6]

They further emphasised that the hypothetical must be made to work, that is, one is required to draw upon the commercially rational practices adopted by independent parties operating in a particular market for goods and services.[7] Having regard to these considerations, Middleton and Steward JJ then set out seven propositions they considered

[4] At [212] per Middleton and Steward JJ; at [266-270] per Thawley J.
[5] At [262]
[6] At [172].
[7] At [173].

should determine the extent of the depersonalisation to apply in the instant case with respect to the hypothetical agreement between independent parties.[8]

- The hypothetical seller should have only those attributes or features which can affect the consideration to be received.[9]
- Only include objective attributes or features – for example, all of the objective circumstances of the actual mine, such as the means of production, the levels of production, the costs of production, the size of the mine, its location, and any problems arising from the location (e.g. water supply issues), and so on.[10]
- It is appropriate to exclude any considerations that are the product of the taxpayer's non-arm's length relationship with its related party and the broader group, such as attitudes or policies formed about the issue of risk in relation to sales.[11]
- Glencore was entitled to support the appropriateness of the pricing formula chosen in February 2007 by reference to which an independent party in the position of CMPL might have done to address risk in the copper concentrate market at the time. Glencore did so by reference to independent expert evidence. Their Honours noted that risk was bound to the pricing method or formula for determining consideration payable and that parties could adopt a more conservative approach to risk (and thereby foregoing potential profits) as long as it was commercially rational to do so, and was consistent with what an independent party dealing at arm's length might reasonably be expected to have done. There is no obligation to maximise profitability at the expense of all else.[12]
- The possibility of a range of arm's length outcomes, each of which would be sufficient to answer the statutory test, is supported by authority: see *SNF* at [125].[13]
- The key matter that controls the range of acceptable arm's length outcomes is the concept of what might reasonably be expected. As Pagone J observed in *Chevron,* that concept calls for evidence which supports a sufficiently reliable prediction which can be seen as reasonable.[14]
- Finally, a degree of flexibility and pragmatism is required.[15]

Thawley J approached the issue of considering the hypothetical somewhat differently. His focus was on the extent to which the terms of the actual agreement could be substituted to enable the statutory task to be undertaken by reference to "*an agreement*" which is different from the "*international agreement*". Thawley J agreed that:

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[8] At [176]-[187].
[9] At [177.
[10] At [178].
[11] At [180]. It was noted that this is why the taxpayer's failure to lead evidence about CMPL's risk appetite or the Glencore Group's policy about risk taking was not fatal.
[12] At [182].
[13] At [183].
[14] At [184].
[15] At [186].

> "*The hypothetical agreement needs to be framed in a way to determine whether the consideration paid or received, was one which might reasonably be expected to have been received or receivable as consideration under an agreement between independent parties dealing at arm's length with each other in relation to the supply;*"[16]

but said that:

> "[t]*he more the hypothetical agreement required to be posited … departs from the terms of the international agreement, … the less the hypothetical agreement is apt to reveal 'the consideration that might reasonably be expected to have been received or receivable …'*"[17]

As a warning to taxpayers, Thawley J also noted that "*whilst related parties might be expected to enter into agreements which might not be found between independent parties dealing at arm's length, Div 13 does not furnish parties carte blanche to structure transactions in a way which dictates uncommercial or non-arm's length prices;*"[18]

and that:

> "a *reasonable expectation about consideration might not be able to be formed on the basis of an agreement which could not reasonably be expected to exist between independent parties dealing at arm's length*"[19]

Onus of proof

The Full Federal Court found that Glencore had successfully discharged its onus of proof by relying on its own expert evidence and by demonstrating that the Commissioner's expert evidence was not to be preferred. [20]

In particular, it was said that "*The onus on a taxpayer is to show that an assessment issued to it is excessive. No part of that onus necessarily requires a taxpayer to lead evidence to negate positive claims put up by the Commissioner in defence of an assessment*"[21].

Evidence

As key lessons, expert evidence in transfer pricing matters should focus on:

- *Asking the right question*. It was apparent from *Chevron*, and in the way the Commissioner asked the question of his expert Mr Ingelbinck in this case, that an

[16] At [262]
[17] At [262].
[18] At [259].
[19] At [260]
[20] At [230] and [247] relying on *Allied Pastoral Holdings Pty Ltd v. Federal Commissioner of Taxation* [1983] 1 N.S.W.L.R. 1 at 10-11.
[21] At [230]

opinion addressing a question which is not aligned to the statutory test will be flawed, and thus of little utility in assessing the arm's length price. Because of the way the questions were put to Mr Ingelbinck, his evidence was focussed on the amendments made to the terms of the agreement between CMPL and GIAG, the pre-existing terms and conditions to that agreement and whether it made sense to agree to the amendments made in February 2007. [22] Rather, the question that should have been put to Mr Ingelbinck was whether the consideration received by CMPL under the international agreement as it stood on 2 February 2007 was an arm's length consideration within the meaning of Div 13 and Subdiv 815-A for the copper concentrate in fact supplied.[23]

- *Selecting an expert with the relevant expertise, qualifications and experience*. Glencore's expert, Mr Wilson was found by the Full Federal Court and Davies J to have detailed and extensive knowledge of the copper market that was regularly relied upon by participants in the market. [24] A similar position was reached in relation to Mr Ingelbinck, expert for the Commissioner, who had extensive practical experience in relation to mining and trading in non-ferrous metals. [25] In contrast, the same could not be said about Mr Kowal, one of the Commissioner's experts in the trial before Davies J. Davies J had reservations about whether the opinions expressed by Mr Kowal were wholly or substantially based on specialist knowledge based on his training, study or experience as required by section 79 of the *Evidence Act 1995* (Cth). [26] Reliance upon the evidence of Mr Kowal was not pressed by the Commissioner on appeal.

- *Grounding the expert opinion in objective evidence, not speculation.* The speculative nature of certain aspects of Mr Ingelbinck's evidence was highlighted in the judgment of Middleton and Steward JJ from expressions used such as "*I am confident that a more thorough review of the timing will show…"* and "*I suspect the more likely situation was that…".*[27] More fundamentally, Mr Ingelbinck was not asked by the Commissioner to consider what the rate of price sharing should have been, and he gave no alternative rate. Middleton and Steward JJ considered that it was speculation for him to consider that a rate of less than 23 percent might be expected to have been chosen. [28] By way of contrast, Mr Wilson was able to support his conclusion that the price sharing mechanism was commercial and prudent given the volatile nature of the copper market by referencing examples of contracts in the market of which he was aware. [29]

- *Robust testing of assumptions used by the expert in forming the opinion*. Middleton and Steward JJ noted for example, the deficiencies in the assumptions used by Mr Ingelbinck in relation to matters such as assuming that production would be constant,

[22] At [62].
[23] At [188] per Middleton and Steward JJ; at [272] per Thawley J.
[24] At [39].
[25] At [55].
[26] At [90], referring to [404] of the decision below.
[27] At [85] and [86].
[28] At [346] to [354] of Davies J judgment, as noted by Middleton and Steward JJ at [111] and [194]
[29] At [50].

and assuming, with the benefit of hindsight, the use of revenue actually forgone, rather than forecast figures at the time of the tested transaction (February 2007). [30]

- *Clearly defining the arm's length price*. This was a key area of distinction when comparing the two expert reports of Mr Wilson and Mr Ingelbinck. The price used by Glencore in relation to the 2007 Agreement was in the middle of the range presented by Mr Wilson. It is noted that the Commissioner never challenged the accuracy of that range, nor did his expert, Mr Ingelbinck, opine on what the range should be (which, as noted above, was a fundamental flaw in his approach).

It is also noteworthy to consider the role that the joint expert evidence played in this case. The joint report noted consistencies between the clauses used by Glencore and those that existed in contracts between independent market participants. This was important in that it supported Glencore's position, namely that the terms of the international agreement were ones which might be reasonably expected between independent parties, in the position of CMPL and GIAG, dealing with each other at arm's length. The use of joint expert evidence which sets out the matters in which experts agree and disagree may be required in narrowing and resolving issues in a transfer pricing dispute.

Given the current environment, taxpayers are well advised to collate and prepare evidence to support transfer pricing positions in light of the above commentary, in order to preserve positions.

Comparability

The Commissioner sought to render the contracts, said by Glencore to be comparable to the 2007 agreement, irrelevant by pointing to differences such as the size of tonnage, the time when the agreements were entered into, the stage in production, the role of financiers and further, that there was no evidence of any attempt by Glencore or by its witnesses to make adjustments for these differences.[31] As mentioned above, Middleton and Steward JJ described the contracts as valid "*reference points*" confirming that there was nothing in the pricing formula adopted from February 2007 that did not also exist in contracts between independent market participants and that they also demonstrated that price sharing of 23 percent was not out of the market.

The above findings are a welcome reinforcement for taxpayers who have good Comparable Uncontrolled Price (**CUP**) agreements, but may be of limited value to those taxpayers who are unable to provide evidence of comparable dealings entered between independent entities. In cases where the taxpayer and the Commissioner have differences in views regarding whether the available agreements between independent entities are comparable to the tested transaction, robust expert evidence that can withstand scrutiny may assist in demonstrating why the taxpayer's comparable agreements satisfy the statutory test in Div 13 and/or Subdiv 815-A.

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[30] At [77].
[31] At [192].

Freight allowance

In a very brief analysis, overturning the decision of the primary judge, Middleton and Steward JJ held that Glencore had not satisfied its onus of proof in respect of the freight allowance.[32] As a result, China freight costs should have been used by Glencore rather than Indian freight costs. Thawley J agreed with Middleton and Steward JJ.[33]

Additional observations

The Glencore decision also provided commentary on a number of other matters relevant to the application of Div 13 and Subdiv 815-A:

- *The use of a range to determine arm's length pricing is acceptable.* As prior cases have noted, the *Glencore* decision repeats the message that transfer pricing is "*not an exact science*", and should be approached with a degree of common sense[34] and that Div 13 and Subdiv 815-A should not be applied pedantically or inflexibly[35]. There will ordinarily be a range of rational commercial behaviours that a taxpayer may legitimately wish to pursue (e.g. different rational parties will make different decisions about how to allocate and manage risk depending on appetite and capability). Hence, it may often be the case that more than one price or a range of prices may represent an arm's length price. In the current case, picking a mid-point in the range of data was considered sound, a sufficiently reliable choice and accorded with common sense. In this respect, Middleton and Steward JJ said: "*the Court must take care not to make the task of compliance with Australia's transfer pricing laws an impossible burden when a revenue authority may, years after the controlled transaction was struck, find someone, somewhere, to disagree with a taxpayer's attempt to pay or receive arm's length consideration*".[36]

- Use of the *OECD* Transfer Pricing *Guidelines (OECD Guidelines).*[37] While in this case the Full Federal Court found that it was unnecessary to consider the OECD Guidelines in any detail as the Commissioner (and taxpayer) did in fact apply Subdiv 815-A and Div 13 to the transaction actually undertaken, both judgments made observations with respect to the relevance of the OECD Guidelines in applying Div 13 and Subdiv 815-A. In Middleton and Steward JJ's view, the OECD TP Guidelines are only a guide as to how a revenue authority or a taxpayer might apply the arm's length principle. In that respect, they can be contrasted with the much greater rigour usually found in domestic legislation. While Subdiv 815-A obliges the court to work out whether an entity has obtained a transfer pricing benefit consistently with the OECD Guidelines, they are only relevant to the extent that it can be done consistently with the drafting of Subdiv 815-A.[38]

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[32] At [236].
[33] At [240].
[34] At [203].
[35] At [169].
[36] At [203].
[37] *The Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations,* Organisation for Economic Cooperation and Development, 1995, by application of s. 815-5 of the *Income Tax (Transitional Provisions) Act 1997 (Cth.)*.
[38] At [153].

In Thawley J's view, the interpretation of expressions such as "*arm's length consideration*" in Div 13 are resolved by reference to its terms read in context and that no serious attempt was made by either party to show how the 1995 Guidelines could be regarded as throwing significant light on the correct interpretation of Div 13.[39] In relation to Subdiv 815-A, Thawley J suggested that the provisions must be applied according to its terms and one could not give effect to the OECD Guidelines if to do so would be inconsistent with the terms of Subdiv 815-A or would fail to allow its operation according to its terms.[40] Thawley J also noted that while the OECD Guidelines list two exceptional circumstances in which a revenue authority may reconstruct arrangements or deviate from the controlled transaction entered, the two situations identified are not the only situations which might be regarded as *"exceptional"* and Subdiv 815-A is not limited in this regard.[41]

- Hindsight and use of ex post data should be avoided. As discussed above, the Full Federal Court was critical of the use of hindsight and ex post data by the Commissioner's expert, Mr Ingelbinck. While this might seem appropriate to taxpayers who only have the information and financial data available at the time decisions are made and prices set, we draw attention to the OECD's recent report on Hard to Value Intangibles and note that there may be situations in which ex post data could be applicable notwithstanding that this report is not specified guidance material for purposes of Subdiv 815-B.[42]

- *Purpose or motive is not relevant to application of Div 13.* Thawley J observed that the Commissioner's argument (i.e. independent parties would not have altered their existing agreement) hints at a case under Pt IVA of the ITAA 1936. While Pt IVA and Div 13 were introduced at a similar time, unlike the General Anti-Avoidance provision, Div 13 does not require an investigation or consideration of purpose or motive.[43]

[39] At [273].
[40] At [293].
[41] At [294]
[42] Guidance for Tax Administrations on the Application of the Approach to Hard-to-Value Intangibles", OECD 2018.
[43] Guidance for Tax Administrations on the Application of the Approach to Hard-to-Value Intangibles", OECD 2018.

Contact us

Angela Wood
Regional Lead Partner, Tax Dispute Resolution & Controversy
KPMG Melbourne
T: +61 3 9288 6408
E: angelawood@kpmg.com.au

Annemarie Wilmore
Director, Tax Dispute Resolution & Controversy
KPMG Sydney
T: +61 2 9346 5463
E: awilmore1@kpmg.com.au

Frank Putrino
National Lead Partner, Global Transfer Pricing Services
KPMG Melbourne
T: +61 3 9838 4269
E: fputrino@kpmg.com.au

Glen Hutchings
Partner, Global Transfer Pricing Services
KPMG Sydney
T: +61 2 9335 8634
E: ghutchings1@kpmg.com.au

Jeremy Capes
Partner, Global Transfer Pricing Services
KPMG Sydney
T: +61 2 9335 7665
E: jeremycapes@kpmg.com.au

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