ATO revises simplified transfer pricing record keeping guidance

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In brief

The Australian Taxation Office (ATO) has updated its simplified transfer pricing record keeping guidance in Practical Compliance Guideline (PCG) 2017/2. The guidance is intended to provide relief from preparing full transfer pricing documentation for small taxpayers and/or low risk transfer pricing arrangements.

The revised guidance brings both good and bad news. Welcome changes include the removal or relaxing of certain technicalities which have precluded some taxpayers from relying on the measures previously. Less welcome changes include the tightening of the eligibility criteria for some of the options, and a significantly lower interest rate permitted under the low-level inbound loan option.

In detail

Background

The ATO introduced the simplified transfer pricing (TP) measures in 2014 in recognition that the 'full' TP record keeping requirements may create a disproportionate compliance burden for small taxpayers with limited resources to manage their TP compliance. Although the 'full' documentation requirements are not compulsory, taxpayers are liable to increased penalties (25% or 50% depending on group size) on any transfer pricing shortfall amount if their transfer pricing positions are not adequately covered by Australian compliant transfer pricing documentation.

By contrast, where a taxpayer is eligible for one of the ATO's simplified TP measures, the ATO will not devote compliance resources to reviewing the taxpayer's transfer pricing arrangements, other than confirming the taxpayer's eligibility. The simplified measures therefore can greatly reduce the compliance burden for taxpayers who are eligible. Taxpayers who rely on one or more of the simplified options should report this in their International Dealings Schedule and/or Local File.

Timing

The updated PCG 2017/2 is available to be applied for years beginning on or after 1 July 2018. There will be a one year transition period where the old guidance can also continue to be applied (for years beginning between 1 July 2018 and 30 June 2019), but for the first income year beginning on or after 1 July 2019, taxpayers can only apply the new guidance.

Overview of the new guidance and key changes

The new guidance removes some technicalities which previously prevented taxpayers from being eligible. In particular:

- There is no longer any restriction on the tax jurisdiction of the taxpayer's related parties (previously taxpayers were ineligible if they had entered into dealings with related parties in certain "specified countries")
- Taxpayers who have immaterial royalty, licence fee, or research and development (R&D) transactions will not be automatically excluded. Provided the combined value of these types of transactions does not exceed AUD 500,000 (approximately USD 360,000), taxpayers can still be eligible for the simplified measures (subject to meeting the other relevant criteria). However, even then, the simplified measures will not specifically apply to the royalty, licence fee or R&D transactions themselves, so the taxpayer would still be expected to maintain documentation supporting its transfer pricing position for those transactions separately.

  ***Observation**:* These changes are positive, although the expectation for immaterial royalty, licence fee and R&D transactions to be documented separately somewhat limits the usefulness of introducing the de minimis threshold for these types of transactions.

There are seven options that will be available under the new guidance. The following eligibility criteria apply to all options:

- The taxpayer has not incurred sustained losses (defined as consecutive losses over a three year period including the current year)
- The taxpayer did not undergo a restructure during the year
- The taxpayer has self-assessed its compliance with the transfer pricing rules.

There are other criteria which are specific to each of the options. These are summarised below.

Option	**Eligibility criteria**	**Key changes**
Small taxpayers	• Annual turnover of the "Australian economic group" is less than AUD 50 million • Combined value of royalties, licence fees and R&D transactions does not exceed AUD 500,000 • "Specified service" related party dealings do not exceed 15% of turnover • The entity is not a distributor.	• Increase in turnover threshold from AUD 25 million to AUD 50 million • Removal of exclusion for dealings with "specified countries" • Exclusion for royalties/licence fees/R&D arrangements replaced by the AUD 500,000 threshold. • Broader definition of "specified services" ***Observation:*** The definition of "specified services" is broad and will need to be reviewed carefully by taxpayers seeking to apply this option.
Distributors	• The entity is a distributor and has reported a Wholesale Trade industry code as its main business activity on its income tax return • Annual turnover of the "Australian economic group" is less than AUD 50 million • Profit before tax ratio of at least 3 per cent of total income. Consistent with the prior guidance, this ratio is to be calculated based on total income and total expenses as reported within the income tax return, on a weighted average basis over a three year period including	• Removal of exclusion for dealings with "specified countries" • Exclusion for royalties/licence fees/R&D arrangements replaced by the AUD 500,000 threshold. ***Observation:*** Distribution entities that are ineligible for, or choose not to apply for, the simplified measures, will need to consider the ATO's draft guidance in PCG 2018/D8. The 'low risk' PBT/income thresholds in that guidance are higher than the 3 per cent threshold in the simplified record keeping option.

	the current year. • Combined value of royalties, licence fees and R&D transactions does not exceed AUD 500,000.	
Materiality	• Total international related party dealings is less than 2.5 per cent of total turnover for the "Australian economic group" • Annual turnover of the "Australian economic group" is not more than AUD 100 million • Combined value of royalties, licence fees and R&D transactions does not exceed AUD 500,000.	• Introduction of AUD 100 million turnover limit. ***Observation:*** The turnover cap introduced by the ATO will be disappointing for large taxpayers. Any business with Australian turnover of more than AUD 100 million that had previously relied on the materiality option will need to reconsider their approach for supporting their transfer pricing arrangements.
Low value adding intra-group services	• The value of the taxpayer's "low value adding intra group services" is either: ○ AUD 2 million or less (including all services provided and received), or ○ The amount charged for services received does not exceed 15 per cent of total expenses of the Australian economic group, and ○ The amount charged for services provided is not more than 15 per cent of total revenue of the Australian economic group • The low value adding intra-group services expenses do not exceed 25% of profits before the charge • The mark-up on costs is 5 per cent or less for services received, or 5 per cent or more for services provided.	• This option effectively combines and replaces the previous "management and administration services" and general "intra-group services" options. • Increase in the de minimis dollar value from AUD 1 million to AUD 2 million • Introduction of the "25% of profits" test ***Observations:*** This option is similar to the OECD's guidance for low value adding services, so may be beneficial for groups who have implemented policies that follow the OECD guidance. Removal of the general "intra-group services" category, which permitted 'unbenchmarked' mark-ups of 7.5 per cent on eligible services charges, may give several taxpayers pause for thought, as the ATO has endorsed a 7.5 per cent mark-up in guidance dating back to 1999, and there are a number of taxpayers who have implemented policies aligned with this. The new pre-charge profit test also introduces an additional element of complexity and practical uncertainty for taxpayers.
Technical services	• Income and expenditure on technical services does not exceed 50 per cent of the total international related party dealings of the Australian economic group • The mark-up on costs is not more than 10 per cent on technical services received and is not less than 10 per cent on technical services provided.	• No specific changes (apart from the removal of the "specified country" exclusion).
Low level inbound loans	• Combined cross-border loan balance (inbound and outbound) of	• The interest rate permitted is much lower than before. Under the previous guidance,

	no more than AUD 50 million at all times throughout the year • The loans are in AUD and this is reflected in the agreements • The associated expenses are paid in AUD • The interest rate did not exceed 3.76 per cent in the 2019 income year.	the ATO permitted an interest rate that did not exceed a particular Reserve Bank of Australia indicator lending rate (which, for example, was 6.45 per cent throughout the 2018 calendar year). ***Observation**:* Taxpayers who had entered into loans relying upon the previous guidance may need to revisit their arrangements if they wish to continue to rely upon the simplified measures in the future.
Low level outbound loans	• Combined cross-border loan balance (inbound and outbound) of no more than AUD 50 million at all times throughout the year • The loans are in AUD and this is reflected in the agreements • The associated expenses are paid in AUD • The interest rate was at least 3.76 per cent in the 2019 income year.	• No specific changes. ***Observation:*** Guidance on how the ATO sets the interest rate permitted under this option is available on the ATO website. This will be of increasing relevance now that the interest rates permitted for inbound and outbound loans are aligned.

Overall observations

There continues to be complexity in the guidance, with the new tests for low-value adding services increasing the existing complexity in the terminology and definitions. This means that assessing whether a taxpayer is eligible for the simplified measures can sometimes be far from simple. In light of this, taxpayers who wish to rely on the simplified measures should carefully consider their eligibility based on all relevant criteria, and it is advisable to document this process and the conclusions reached.

For the transition year (commencing between 1 July 2018 and 30 June 2019), taxpayers will have the choice to apply whichever version of the guidance is more favourable to them.

There are other ATO recent guidance products, PCG 2017/1 (which focuses on offshore hubs) and PCG 2017/4 (which focuses on related party financing), which state that taxpayers falling in the low risk zone of those guidance products should be able to adopt a simplified record keeping approach. The revised PCG 2017/2 provides no further guidance on how the simplified record keeping measures are expected to be applied in practice by taxpayers in these circumstances.

The takeaway

All taxpayers who have relied on the simplified measures should review the changes to consider the impact on their position. It is important to thoroughly consider all of the relevant eligibility criteria before relying on the simplified measures.

Some taxpayers who previously have been ineligible for the simplified measures have the opportunity to consider whether they might now qualify for any of the revised options. Those who were previously eligible but are not anymore will need to consider whether to prepare additional supporting documentation or take the risk of exposure to higher penalties in the event of a dispute with the ATO.

Let's talk

For a deeper discussion of how these issues might affect your business, please contact:

Greg Weickhardt, Melbourne
+61 (3) 8603 2547
greg.weickhardt@pwc.com

Michael Bona,
+61 (7) 3257 5015
michael.bona@pwc.com

Sarah Stevens, Sydney
+61 (2) 8266 1148
sarah.m.stevens@pwc.com

Jenny Elliot, Melbourne
+61 (3) 8603 3753
jenny.elliott@pwc.com

Edwin Baghdasaryan, Sydney
+61 (2) 8266 3974
edwin.baghdasarayan@pwc.com