
Australia: Final guidance released on assessing the transfer pricing risk of hubs and centralized operating models

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In brief

The Australian Tax Office (ATO) has released its Practical Compliance Guideline ([PCG 2017/1](#)) “*ATO compliance approach to TP issues related to centralised operating models involving procurement, marketing, sales and distribution functions*” (the Guidance). This finalizes the guidance issued in a draft discussion paper in August 2016.

The Guidance, applicable to all new and existing hubs from January 1, 2017, provides a framework to self-assess the transfer pricing risk of centralized operating models or ‘hubs’. The guidance has evolved following a number of significant audits the ATO has conducted in this area and is intended to set clear boundaries around a ‘low risk’ zone that taxpayers are encouraged to operate in. Taxpayers within the low risk zone should not be subject to ATO scrutiny, while taxpayers outside this zone can expect the ATO to closely examine the transfer pricing arrangements of their hub. Taxpayers outside the low risk zone should ensure they maintain documentation in accordance with the Guidance at an audit-ready standard.

In detail

The Guidance sets out the principles of a ‘hub risk framework’ to assist taxpayers to:

- Assess the compliance risk associated with the hub and the resultant compliance activity the ATO will adopt in relation to the hub;
- Understand the nature and extent of documentation the ATO will require when

testing the outcomes achieved by the hub; and

- Understand how taxpayers can engage with the ATO if they are outside the low risk ‘green’ zone to achieve certainty in relation to their dealings with offshore hubs.

The Guidance is applicable to any type of ‘hub’ or principal structure such as marketing hubs and procurement hubs. The definition of marketing hub included in the Guidance is very broad and extends beyond what

would ordinarily be considered a marketing hub to include any offshore distribution entity that sells goods purchased from an Australian related party (or acts as agent for such sales). Australian multinationals with routine offshore distributors may inadvertently find they have an offshore marketing hub, and while it would be expected that such distributors would fall within the low risk zone, there may be disclosure requirements associated with these arrangements.

The ATO recommends that taxpayers perform a self-assessment of the transfer pricing risk of any offshore hub that they deal with. This is not compulsory but choosing not to self-assess a risk rating increases the likelihood of the ATO rating the taxpayer as high risk.

The risk framework

The framework provides various risk rating categories, ranging from white (risk assessment not required)/green (low risk) to red (very high risk). The main factor influencing a taxpayer's risk rating will be a 'low risk benchmark'. For a marketing hub, the low risk benchmark is a hub profit of less than 100% of the hub's operating expenses, which the ATO refers to as the hub's 'cost plus indicator.'

Operating expenses are defined within the Guidance so that there is little room for interpretation as to what would and would not be an operating expense for the types of marketing hubs the ATO has been scrutinizing. Further, low risk benchmarks are expected to be issued for other types of hubs such as procurement hubs. The ATO notes that the low risk benchmark is not a safe harbour and they will be monitoring to ensure taxpayers under the low risk benchmark do not drift upwards towards it.

If a taxpayer's hub profit is higher than the low risk benchmark, the risk rating will depend on the tax impact of the hub (i.e. the materiality of the tax on the hub profits above the low risk benchmark), the quality of the taxpayer's transfer pricing documentation, and the extent to which the taxpayer has voluntarily cooperated with the ATO in relation to the hub.

The ATO has responded to feedback on the discussion paper from the taxpayer community with some pragmatic changes to broaden the low

risk categories to cover taxpayers who have agreed on their transfer pricing outcomes with the ATO (the 'white zone' category of taxpayer), and hubs which are subject to full attribution under Australia's controlled foreign company (CFC) rules.

Practical consequences of being outside the low risk zones

Taxpayers falling outside the low risk zone are encouraged to engage with the ATO and/or consider changing their pricing to transition into the low risk zone. Taxpayers willing to adjust their pricing to fall within the green zone may be able to settle on prior year outcomes with the ATO with the potential for remission of penalties and interest.

Taxpayers with a hub that is outside the white or green zones can expect close scrutiny from the ATO, which may include detailed information requests, yearly reviews of the transfer pricing outcome of their hub, and in some cases may result in tax audits. Information about a taxpayer's hub will be required to be disclosed on the International Dealings Schedule and/or as part of the Local File, where applicable. Taxpayers who are required to complete a Reportable Tax Position (RTP) Schedule will likely be required to report information about their hub to the ATO in that Schedule. Currently only a small number (approximately 100) of taxpayers are required to submit an RTP Schedule to the ATO but this disclosure requirement is planned to be expanded to all taxpayers with turnover of more than AUD 250 million in 2018 (which is approximately 1,000 taxpayers).

The ATO's expectations for the documentation and evidence available to support a hub arrangement that falls outside the green zone extend well beyond the level of detail typically included in transfer pricing

documentation. The ATO expects taxpayers to maintain evidence including extensive source documents (e.g., role descriptions, key performance indicators, evidence of decision making). The Guidance is also transparent about the key issues of contention between the ATO and taxpayers in relation to what is an arm's-length return for the activities of marketing hubs, including:

- The use of third-party commission rates as comparable uncontrolled prices (CUPs), without a thorough comparability analysis;
- Reliance on a single transfer pricing method (such as a CUP analysis of third party commission rates) without testing outcomes using alternate PLI's (e.g., a mark-up on costs) to review whether the overall outcome is reasonable;
- The management and control of risk associated with the sale of commodities/products; and
- A lack of regard to industry factors in setting and reviewing pricing.

The takeaway

Many taxpayers with marketing hubs have already engaged in some way with the ATO and will already have a good sense of the level of risk the ATO perceives for their hub and the areas of dispute. Taxpayers with a hub that has not previously been reviewed by the ATO should consider the ATO guidance carefully and may wish to consider the merits of engaging with the ATO if they fall into one of the higher risk categories. The Guidance also will be of interest to taxpayers with other forms of hubs — most particularly procurement hubs — as low risk benchmarks for procurement hubs will no doubt be introduced.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

Transfer Pricing

Nick Houseman, *Sydney*
+61 2 8266 4647
nick.p.houseman@pwc.com

Jenny Elliott, *Melbourne*
+61 3 8603 3753
jenny.elliott@pwc.com

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

Transfer Pricing Global and US Leaders

Isabel Verlinden, *Brussels*
Global Transfer Pricing Leader
+32 2 710 44 22
isabel.verlinden@be.pwc.com

Horacio Peña, *New York*
US Transfer Pricing Leader
+1 646 471 1957
horacio.pena@us.pwc.com

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