Federal Court overturns ATO positions on transfer pricing

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In brief

On 3 September 2019, the Federal Court (Davies J) handed down its decision in Glencore Investment Pty Ltd v Commissioner of Taxation of the Commonwealth of Australia [2019] FCA 1432 (*Glencore* case) in favour of the taxpayer. This judgment is important because it provides clarity in relation to Australia's transfer pricing rules and, in particular, aspects of the Full Federal Court's 2017 decision in the *Chevron* case. Subject to the outcome of any appeal, this latest transfer pricing decision is expected to have a significant impact on a broad range of outstanding transfer pricing disputes.

In detail

Background to recent transfer pricing disputes in Australia

The Australian Taxation Office (ATO) has recently explained that transfer pricing is a focus given its criticality to the Australian taxation system and that its key areas of focus are related party loans, marketing "hubs" and inbound "distributor" supply chains. In addition, the ATO has described a range of "transfer mis-pricing traps".

In an endeavour to provide greater levels of certainty, the ATO has provided in recent years a number of Practical Compliance Guidelines (PCGs). In broad terms, these PCGs set the ATO perspective on what it considers are safe "green zone" arrangements in relation to transfer pricing issues as well as risky "red zone" arrangements. While these PCGs are designed as risk assessment tools only, in some circumstances a practical difficulty with these safe-harbours is that when individual transactions are assessed they do not align with international transfer pricing guidelines. Ultimately, this lack of alignment could lead to double taxation that will need to be resolved through bilateral dispute resolution mechanisms which is a costly, uncertain and time consuming exercise.

The ATO's focus on transfer pricing follows the Full Federal Court decision in the *Chevron* case which involved the application of Australia's transfer pricing rules to a related party loan. A confidential settlement was reached in 2018 before the High Court heard the taxpayer's special leave application.

Glencore Decision

The Federal Court's decision in the Glencore matter concerned transfer pricing aspects of the acquisition of copper concentrate under an offtake agreement (the contract) by Glencore International AG (buyer) (GIAG) from its subsidiary, Cobar Management Pty Ltd (seller) (CMPL), an Australian company which owned and operated the mine in Australia. The evidence heard by the Court was that in 2007 there was uncertainty in future copper prices and higher costs associated with the mine and in that context the pricing arrangement in the contract was changed.

The case considered whether the Commissioner was able to take a "flexible" approach to identifying the substitute hypothesis for arm's length purposes, including inserting additional clauses and changing the structure of the pricing arrangement between the parties. In particular, the Commissioner sought to replace the pricing mechanism, agreed in 2007 to be set at 23% of the copper reference price on the London Metals Exchange, with the historical benchmark previously used by the parties. In effect, the Commissioner's approach sought to reconstruct the arrangement to what the Commissioner considered independent parties would have agreed rather than re-price the actual arrangement entered into. The Commissioner issued amended assessments to reflect the mechanism previously used and increased consideration paid under the contract by AUD241 million over the 2007 and 2009 years.

Davies J allowed the taxpayer's appeal in full (with costs). The 127-page judgment sets out a number of key principles regarding the Australian transfer pricing provisions (former Division 13 of the Income Tax Assessment Act 1936 and Subdivision 815-A of the Income Tax Assessment Act 1997) and the Chevron decision, which are summarised below:

- The threshold for reconstruction - flexible does not mean unconstrained. The transfer pricing analysis "should be based on the form of the actual transaction entered into" and the Commissioner is unable to simply "recast" the transaction "as a different transaction". Davies J rejected the Commissioner's reliance on the term "flexible comparative analysis" by Allsop CJ in the Chevron decision. Instead, any reconstruction is limited to the exceptional circumstances referred to in the Organisation for Economic Cooperation and Development (OECD) guidelines. The Commissioner cannot "flexibly" reconstruct the terms of an agreement for the purposes of conducting the comparative analysis and must generally respect the actual transaction entered into between the parties.

  It is important to highlight that the Commissioner has endeavoured to rely on this reconstruction approach in numerous taxpayer disputes and the decision may significantly impact these disputes. The OECD's "exceptional circumstances" are limited to arrangements where the substance and form of the transaction are not aligned, or where the form and substance of the transaction are the same, however the arrangements viewed in their totality, differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner and the actual structure practically impedes the tax administration from determining an appropriate transfer price.

- The two step process of the arm's length principle. Her honour established that neither Division 13 nor Subdivision 815-A directs an inquiry into the commercial prudence of the non-arm's length contract or transaction entered into. The inquiry directed is a comparative analysis of the consideration given under the actual agreement with a comparable "real world" arm's length consideration. That is, the task at hand is not for the Commissioner to determine the transaction that "might reasonably be expected" to have been entered into and then use this as the benchmark, rather the actual transaction is to be respected (other than in exceptional circumstances) (step 1) and then comparables to this actual transaction should be identified to test the arm's length outcome (step 2).

- It must be analysed through the lens of the parties (absent non-arm's length conditions). Her Honour indicated that the analysis should not occur between "abstract independent parties" and that "the actual characteristics of the taxpayer must, therefore, ordinarily serve as the basis in the comparable agreement".

- It is a "but for" analysis for Subdivision 815-A purposes. It is not enough for the Commissioner to identify the non-arm's length conditions (e.g. no evidence of negotiations between the parties), there must be a "causal relationship" between the identified conditions and the profit that would otherwise be expected to accrue. Her Honour confirmed the reasoning of Pagone J in Chevron that the analysis is an objective determination.

- Subjective motivations are not relevant. Her Honour reinforced the findings in W R Carpenter Holdings that the analysis under Division 13 and Subdivision 815-A does not "introduce, or involve, any investigation or consideration of purpose or motive" because these concepts are more appropriately found in other provisions such as the general anti-avoidance rules. She rejected the Commissioner's argument that CMPL would not have agreed to renegotiate the terms in 2007 given the group's motivation to maximise profitability.

- Hindsight reasoning is not relevant. Her Honour applied the reasoning in a Canadian judgment (Cameco Corporation v The Queen (2018) TCC 195) to reject the relevance of hindsight that CMPL would have been more profitable if the alternative benchmarks were used instead of a 23% price sharing contract.

- Comparability standards and satisfying the onus of proof within the arm's length range. A taxpayer will discharge its burden of proof if the actual price was within an arm's length range reinforcing the decision in the SNF case that the relevant comparable does not need to be identical and variations in comparables, producing variations in price, are acceptable. In SNF, the Court concluded that the proposed ATO approach would mean that a taxpayer could never succeed in a transfer pricing case because "the bar would be set at an unattainable height" and be "deeply impractical".

  The comparables put forward by the taxpayer in *Glencore* were based on contracts it had negotiated with third parties, which whilst not identical, provided a reference point of between 20% and 27.5% for price sharing percentages. The Commissioner's own expert had supported a range of between 21% and 26% as the normal range of price sharing.

- International arm's length standard to be applied. Her Honour found it necessary to highlight the international context in which the internationally accepted arm's length principle has been adopted as the measure by which countries may bring to tax within their jurisdiction an appropriate share of tax revenue from the international dealings of multinational enterprises. She further warned that a construction and application of the Australian rules by applying some different measure for determining the arm's length price other than one based on the arm's length equivalent of the transaction actually entered into, would not give effect to the policy objective. This supports an approach to Australia's transfer pricing rules which accords with the OECD's transfer pricing guidelines.

  The references to the OECD commentary, including those made in the Chevron case which were recast again by her Honour in the judgment, will touch many issues that are currently in dispute or under review with the ATO. This includes the OECD approach to guarantee fees, recognition in the OECD guidance that multinational groups can enter into transactions that are arm's length despite these transactions not being found between true independent parties as well as the two exceptional circumstances in which transactions should be reconstructed.

- Expert evidence. Although the decision did not ultimately turn on differences of opinions between the experts, Davies J reinforced that the factual inquiry in transfer pricing must be based on the probative evidence which will include, where appropriate, the use of expert evidence to find a reliable substitute for the actual considerations.

- Lay witness evidence. Her Honour accepted the evidence of the mine's asset manager (who subsequently was a director of CMPL) at various parts of the judgment. This evidence appeared to be highly influential in her Honour's findings by providing context around the relevant facts and contemporaneous documents filed in the proceedings.

It is not yet known if the ATO will appeal this decision. In its press release, the ATO identified that "aspects of the Commissioner's interpretation of the relevant transfer pricing rules" were rejected and indicated that it is considering the decision including whether an appeal is appropriate.

The case involved the application of Australia's former transfer pricing rules. However, the principles established by the *Glencore* decision should also be applicable to the current transfer pricing rules (Subdivision 815-B applicable from 29 June 2013) which require the arm's length conditions to be identified in a way that is consistent with guidelines on arm's length principles developed by the OECD.

The takeaway

The *Glencore* decision provides helpful clarity in relation to the operation of Australia's transfer pricing rules and, in particular, reinforces their alignment with international standards which reduces uncertainty and the risk of double taxation and assists in minimising compliance and administration costs.

Taxpayers who are setting, reviewing or defending their Australian transfer pricing arrangements at the risk review or audit stage will need to carefully assess their circumstances in light of the *Glencore* decision and consider the precedential impact of this seminal decision.

Let's talk

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

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