

ATO issues final non-core procurement guidance on offshore hubs

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In brief

On 11 October 2018 the Australian Taxation Office (ATO) finalised a new Schedule focused on Australian tax risk assessment for offshore non-core procurement arrangements, which is included as an update to Practical Compliance Guideline [PCG 2017/1](#). It remains substantially consistent with the draft Schedule issued on 27 June 2018 for public comment.

The new Schedule applies to 'non-core procurement' hubs which are defined as the centralised procurement of goods or services that support the operations of a business but are not converted to a finished item or resold. The definition also excludes items required to perform the "core operations" of a business. Several examples are provided. The plant of a manufacturer, heavy equipment and fuel used in mining operations, and skilled labour acquired by a professional services firm are all cited as "core" items and therefore excluded from the guidance.

Similar to the January 2017 version of PCG 2017/1 (which specifically focused on offshore marketing hubs), the ATO provides a framework for taxpayers to assess the risk of a centralised offshore non-core procurement arrangement ranging from "green zone" (low risk) to "red zone" (high risk). The key drivers of risk to be assessed under this framework are the offshore hub's profit margin on its operating expenses and the materiality of the Australian tax deductions claimed.

In detail

Offshore hubs are one of the ATO's focus areas for transfer pricing and international tax risk. PCG 2017/1 was released in January 2017 with initial guidance focusing on 'marketing hubs', i.e. offshore entities that market and/or sell goods or services to customers on behalf of an Australian entity. When PCG 2017/1 was released, the ATO foreshadowed that further Schedules would be added to the PCG in the future to cover other types of hubs. Schedule 2 on non-core procurement hubs is the first additional Schedule released.

Under the ATO guidance, a non-core procurement hub will exist where a related offshore entity or permanent establishment acts as an agent or principal in relation to the procurement of "indirect" or "non-core" goods or services (non-core product) to support the operations of a related Australian business, and procures and supplies the non-core product without substantial alteration. Non-core product includes any goods or services that do not form part of the goods or services delivered to customers, e.g. travel, office equipment, IT, professional services, etc.

The ATO's risk assessment framework sets a 'low risk benchmark' based on the profit margin that the hub derives on its operating costs. To fall into the low risk zone, the profit margin on hub costs (excluding the cost of the non-core product itself, pass through costs and all other expenses not connected to earning non-core procurement revenue) must be no greater than 25 per cent. If the hub profit exceeds 25 per cent of hub costs, the risk rating will then depend on the materiality of the annual Australian tax impact. Broadly, the tax impact is calculated according to the Australian corporate tax rate multiplied by the difference between the hub profit and the profit outcome that arises when applying the cost plus indicator. Annual tax impacts above AUD5 million are classed as high priority for ATO review. Tax impacts not determined, or unable to be determined, are classed as "red zone" with highest priority for ATO review. If the hub is a controlled foreign company (CFC) of an Australian entity and its profits are fully subject to Australian tax under the CFC rules, it is classed as "green zone" (low risk). There is a pro-rata adjustment mechanism for profits partly subject to Australian tax under the CFC rules.

PwC observations

Centralised procurement arrangements are very common because of the commercial benefits that can be realised by coordinating these activities centrally. Accordingly, many businesses have established co-located procurement as an organisational function and an important overall company competence, with core and direct material spend receiving understandable strategic and management attention. Updated PCG 2017/1 leaves open the question as to why "core" procurement arrangements are not (yet) addressed. The ATO accepts that reasonable allocations may be required to distinguish the costs and revenues of offshore procurement operations as they relate to non-core products, distinct from core products. In our view, such allocations will be necessary in many instances, given the common focus on both core and non-core procurement within the same function and jurisdiction.

In practice, although many procurement functions relating to non-core products may adopt transfer pricing policies that will fall within the green zone, it may be challenging for some Australian entities to access the information required to be able to perform a risk assessment to confirm this. This has implications for the disclosures expected by the ATO in regards to PCG 2017/1. For example, the ATO inserted a new question in the 2018 International Dealings Schedule (IDS) (Question 28b), which requires taxpayers to report dealings subject to any of the Schedules in PCG 2017/1. The only Schedule in the PCG 2017/1 that was in effect for the 2017 calendar year was Schedule 1 which applied to marketing hubs. Now that both Schedule 1 and 2 (non-core procurement) are active, dealings covered by both Schedules will need to be disclosed in tax filings for income years beginning on or after 1 January 2018.

The [instructions](#) to the 2018 IDS list six categories of hub types indicating that the ATO will release future additional Schedules in the PCG 2017/1 to focus on core procurement, shipping, services and sales.

Schedule 2 (non-core procurement hubs) reproduces the statement made within Schedule 1 (marketing hubs) that the low risk benchmarks have been determined by the ATO 'having regard to all available information, including data collected as part of ATO compliance activities'. The PCG notes that this data will not be released on the grounds of commercial sensitivities. Within both Schedules, the ATO notes that the low risk indicators are not provided for the purposes of determining arm's methods or outcomes. The appropriate arm's length methods for the centralised operating models under focus in PCG 2017/1 are likely to continue to be a key area of dispute, resulting, in essence, from the significantly different outcomes which can result from cost based transfer pricing profit level indicators compared to transfer pricing measures based on profit margins.

The takeaway

Many multinational groups will have procurement arrangements in place that fall within the non-core procurement definition and should therefore consider the risk rating that might apply under the ATO's risk assessment framework. The Schedule applies for income years beginning on or after 1 January 2018. Taxpayers will be required to report relevant hub dealings in the International Dealings Schedule lodged with the Australian company income tax return. Additionally, for those taxpayers required to prepare a Reportable Tax Position (RTP) Schedule, the self-assessed risk ratings will need to be reported to the ATO

in the RTP Schedule. Currently, businesses with an annual turnover greater than AUD250 million who have been notified in writing (including email) by the ATO are required to complete the RTP Schedule.

Consistent with its approach to marketing hubs in Schedule 1 of PCG 2017/1, Schedule 2 sets out a transitional 12 month period whereby businesses can voluntarily change their non-core procurement arrangements to come within the “green zone”, with concessional treatment of penalties and interest. The transitional period ends on 11 October 2019. Updated PCG 2017/1 notes that the transitional period for marketing hubs ended on 16 January 2018.

Let's talk

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

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