ATO's profit guidance for Australian distributors - are you in the danger zone?

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In brief

The Australian Taxation Office (**ATO**) has released a draft Practical Compliance Guideline (**PCG**), 2018/D8, which sets out its profit expectations for Australian distributors. Guidance is provided for specific industry segments (pharmaceutical and life sciences, information and communications technology (**ICT**), and automotive), as well as a general distribution category for distributors in all other industry segments.

The draft PCG provides a framework for inbound distributors to assess their transfer pricing risk as high, medium, or low. In many cases, the low risk 'green zones' published by the ATO require profit margins significantly higher than taxpayers may be applying in their own transfer pricing studies, and there could be quite a number of taxpayers with margins that fall within the ATO's high risk zone. Taxpayers in this position will need to carefully consider how they manage their position in light of the high likelihood of ATO scrutiny in the near future.

In detail

A large number of multinational groups operate in Australia through a subsidiary that imports and distributes products purchased from overseas related entities. The transfer pricing arrangements of inbound distributors are therefore a key tax risk monitored by the ATO and have been a focus of the ATO's compliance activities over many years.

The draft PCG released by the ATO is a continuation of the ATO's recent strategy of encouraging taxpayers to 'swim between the flags'. The guidance provides 'profit markers' which allow taxpayers to assess whether their risk profile is high, medium or low. The guidance only covers transfer pricing and does not address other risks such as the characterisation of payments.

The profit markers published by the ATO do not represent safe harbours. Taxpayers must still self-assess their compliance with the transfer pricing rules and prepare supporting documentation. A taxpayer within the green zone may still have transfer pricing risk, and, similarly, a result within the red zone does not mean that a taxpayer's transfer pricing is incorrect.

As explained in PCG 2016/1, the legal status of a PCG is different from a public ruling. A public ruling is a written ruling explaining the Commissioner of Taxation's view on the application of the law in relation to a particular legislative provision or topic. PCGs, on the other hand, are not prepared for the primary purpose of expressing a view on the way a tax law provision applies. They represent guidance material on how the ATO will allocate its compliance resources according to assessments of risk.

Who does the new guidance apply to?

The ATO defines an inbound distributor as a business which primarily involves the distribution of goods purchased from related parties for resale, or the distribution of digital products or services where the intellectual property in those products or services is held by international related parties. The focus is on selling business to business, rather than to final consumers. An inbound distributor may have some retail operations but this will not be the primary sales channel.

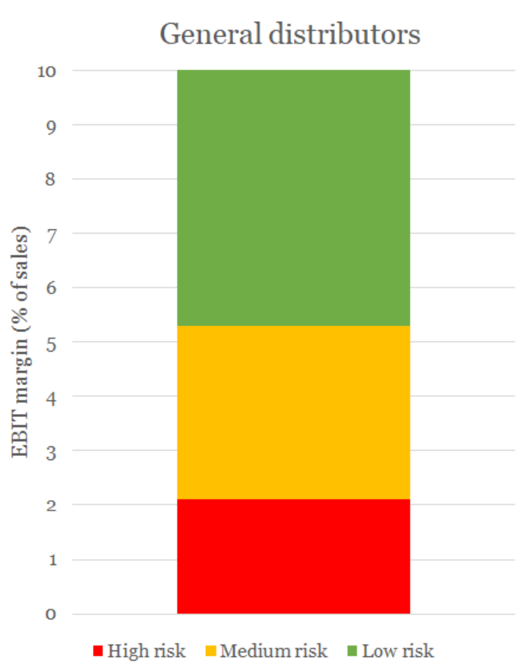
The draft PCG applies to distributors of any scale. The ATO's existing simplified transfer pricing record keeping guidance for small distributors in PCG 2017/2 remains available for distributors with turnover of less than AUD50 million. However, small distributors who choose not to apply the guidance in PCG 2017/2 (or who are ineligible to rely on this guidance, e.g. because they have made losses), may have their risk profile assessed under the new guidance.

The guidance does not apply to taxpayers if their distribution arrangements are covered by any of the following in a particular income year:

1. An advance pricing arrangement (APA)
2. A settlement agreed between the taxpayer and the ATO
3. A court or Administrative Appeals Tribunal decision involving the taxpayer as a party
4. The ATO has reviewed the taxpayer's distribution arrangements and has issued a low risk rating.

What are the profit markers?

The profit markers for general distributors, that are not covered by any of the specific industry sectors, are summarised as follows.



For general distributors, a return on sales (ROS) of less than 2.1 per cent will be considered high risk, and an operating margin of more than 5.3 per cent will be considered low risk.

The general distributor category is applicable for all distributors who do not fall within one of the other three specific industry segments.

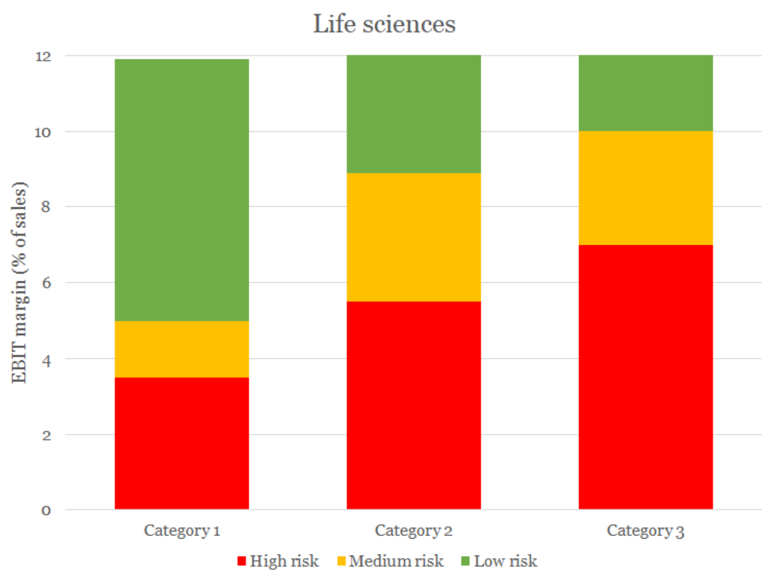
The ATO does not distinguish between 'limited risk' distributors and other kinds of distributors. Although the ATO does not explicitly say so, this may be due to a perception that the label 'limited risk distributor' is sometimes used in order to target a lower profit margin.

Life sciences sector

The ATO includes distributors of pharmaceuticals, medical devices, and animal health products in this segment. The segment is further divided into three sub-categories based upon activities the ATO considers to incrementally add value:

1. Distribution, including **detailing and marketing**, logistics and warehousing activities.
2. Category 1 activities plus **regulatory approval, market access or government reimbursement activities** such as regulatory applications, certifications and registrations, relationship management activities with regulatory bodies (such as the Therapeutic Goods Administration (TGA) and Pharmaceutical Benefits Advisory Committee (PBAC)), interpreting clinical trial data and generating data and product awareness through engaging with the scientific and medical community.
3. Category 1 and 2 activities, **plus specialised technical services** such as training and assistance in conducting surgical procedures involving medical devices.

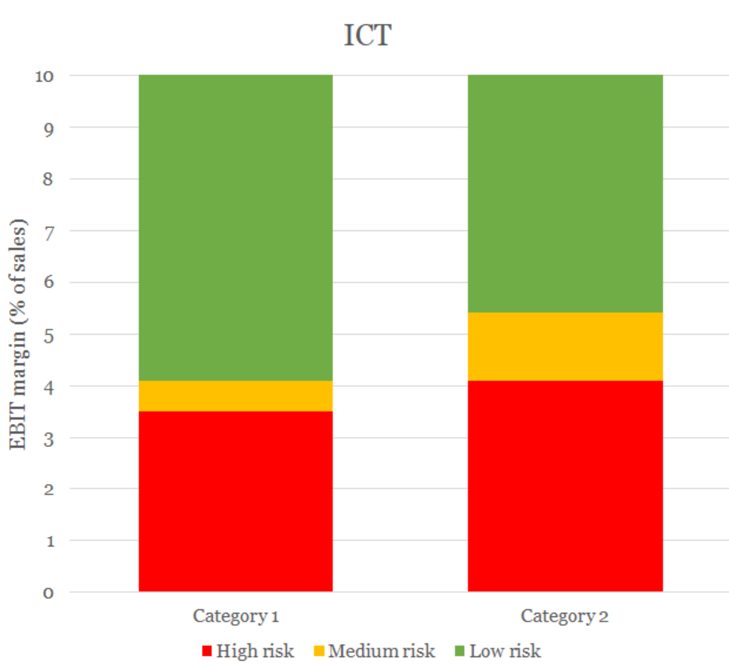
The profit markers for each of these categories are summarised below:



The high risk benchmarks in this sector, particularly for Category 2 and 3, are set very high. Profits below 3.6 per cent are high risk for entities in Category 1. For entities in Category 2, profits lower than 5.5 per cent are high risk, and profits lower than 7 per cent will be considered high risk for entities in Category 3. The low risk benchmarks, of 5.1 per cent for Category 1, 8.9 per cent for Category 2, and 10 per cent for Category 3, respectively, are the highest of all of the sectors covered by the ATO in the draft PCG.

ICT sector

This sector includes distributors of all types of consumer and enterprise hardware and software products, digital communications devices, applications, IT solutions and associated services that enable interaction through technology.



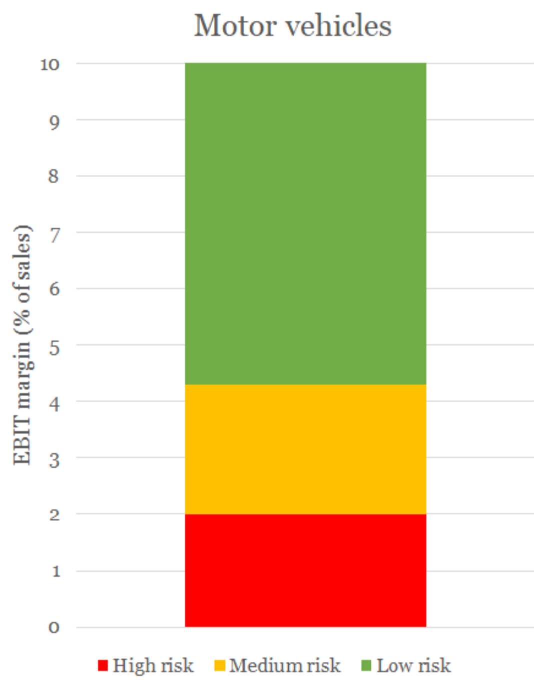
The ATO has divided this sector into two sub-categories:

1. Distribution, including sales and marketing, pre and/or post-sales services, and logistics and warehousing functions.
2. Category 1 activities, plus complex sales processes, direct selling activities and/or large customer relationship management.

For Category 1, a profit margin of less than 3.6 per cent will be considered high risk, and a profit margin of 4.1 per cent will be low risk. In category 2, a profit margin of less than 4.1 per cent will be high risk, and a margin of 5.4 per cent or more will be low risk.

Motor vehicles sector

This sector includes distributors of passenger vehicles, trucks, buses, motorcycles, or other recreational motorised vehicles and/or associated parts.



Although profitability on spare parts is often higher than the profitability on vehicles, the ATO has not differentiated its profit expectations for vehicles and parts distribution.

The profit markers for the industry indicate that a margin of lower than 2 per cent will be considered high risk and a margin of more than 4.3 per cent is required to be considered low risk.

Data sources

We understand the ATO's profit markers are based on data sets of independent distributors that the ATO has identified in economic analysis prepared for audits, APAs, and other casework. The ATO does not intend to publish details of the comparables that underpin the profit markers. We understand that the sets include Australian and foreign comparables.

The ATO has analysed its comparable sets over a five year period. The comparables have been analysed on an earnings before interest and tax (EBIT) to sales basis. We understand the ATO will compare this to the profit before tax (PBT) data of taxpayers, based on an ATO assumption that distributors will generally not have substantial debt in place and therefore the difference between EBIT and PBT should not be material.

Risk zone consequences

The ATO's approach to taxpayers in each risk zone will be as follows:

- **Low risk zone taxpayers:** the ATO will generally not allocate resources to reviewing the transfer pricing outcomes of these taxpayers. Taxpayers in the low risk zone may be able to request a 'pre-qualified' APA.
- **Medium risk zone:** the ATO will monitor the outcomes of these taxpayers using available data and may contact taxpayers to seek a better understanding of their circumstances before deciding whether to allocate compliance resources. The ATO may be open to APA discussions with these taxpayers. It may be possible to request a pre-qualified APA but prior years may be reviewed.
- **High risk zone:** the ATO will consider treatment options and may recommend that the taxpayer review its transfer pricing policies. This may involve the ATO writing to the taxpayer, actively

monitoring the taxpayer’s distribution arrangements, or commencing a review or audit. The ATO will prioritise reviews of distributors that have incurred losses continuously for three or more years. The taxpayer may be able to request an APA, but not a pre-qualified APA.

What should taxpayers do?

All distributors should review the ATO guidance and consider where they currently sit on the ATO’s risk spectrum. For taxpayers in one of the sectors divided into different sub-categories, this will include forming a view on which category best reflects the taxpayer’s profile. We anticipate very few taxpayers will fall into the low risk zone, and the majority will be either medium or high risk.

The ATO’s decision not to publish details of the underlying comparables presents problems for taxpayers. Taxpayers who have performed their own economic analysis and identified a substantially different profit range, may find themselves in the ATO’s high risk zone, despite their best efforts to comply with the transfer pricing rules. Moving into the ‘green zone’, without access to the underlying comparables, may create transfer pricing risk on the other side of the transaction, and therefore may not be an attractive option.

Taxpayers who are medium or high risk will have three options:

1. Transition to the green zone
2. Maintain current position (and consider preparing additional supporting documentation)
3. Seek certainty by applying for an APA.

Option 1 - Transitioning to the green zone

The ATO is encouraging taxpayers to adjust their transfer pricing policies to transition into the low risk zone prospectively. The ATO is incentivising taxpayers to do so by offering to remit penalties and interest on prior year amendments if taxpayers make a voluntary disclosure within 12 months of the ATO publishing the PCG. It is not clear if this period will be from the date of the draft or final PCG.

No doubt the ATO will hope to see some medium and high risk taxpayers voluntarily move towards lower risk positions, however, it is important to remember that a high risk rating does not mean that a taxpayer’s transfer pricing is wrong. Multinationals reviewing their Australian position will also need to manage the transfer pricing risk on the other side of the transaction, and a position in the ATO’s green zone may not be appealing if this is at odds with the group’s global policies and benchmarking, positions agreed with other revenue authorities, or represents a disproportionately high share of global value chain profits. With global transparency on profit outcomes afforded through the Country-by-Country report, many multinational groups will be reluctant to adopt an Australian position that could create an ‘outlier’ compared to other countries they operate in.

Option 2 - Maintain current position

Some taxpayers may choose to continue with their current position even if it falls within a high risk zone. These taxpayers will need to consider whether additional documentation or evidence supporting the current position should be prepared in readiness for future ATO attention. This may involve, for example, a deeper analysis of the comparables in the taxpayer’s documentation, analysis of other industry and business factors impacting the taxpayer’s financial outcomes, careful analysis of the taxpayer’s function and risk profile, and analysis of the profitability across the value chain.

Those taxpayers who are required to file a Reportable Tax Position (RTP) Schedule with the ATO will likely be required to explicitly report a risk assessment of their position against the PCG. Broadly, a taxpayer will need to file a RTP Schedule if its Australian revenue exceeds AUD250 million. There are already extensive reporting obligations in the RTP Schedule in relation to transfer pricing positions, particularly any arrangements which are not supported by transfer pricing documentation that fully complies with the Australian legislative requirements and is signed off by an ‘appropriately experienced professional’ that the positions adopted are ‘reasonably arguable’. After the PCG comes into effect, it is likely that distributors will need to report high risk ratings in the RTP Schedule even if they do have comprehensive transfer pricing documentation in place. This could be as soon as the RTP Schedule required for the 31 December 2018 year (which will need to be lodged with the income tax return in July 2019).

Option 3 - applying for an APA

Taxpayers wanting certainty will be able to apply for an APA. The draft PCG introduces the concept of a pre-qualified APA. The ‘pre-qualified’ APA product will only be available to taxpayers who are currently in the medium or low risk zones, and who are willing to agree to a go-forward position in the green zone. The pre-qualified APA process is intended to be a streamlined unilateral APA process as the taxpayer will not be required to prepare any benchmarking. There may still be work required to review the taxpayer’s functional profile and to determine the extent of its incrementally value-adding activities in order to determine which industry sub-category, or what position within the arm’s length range, is appropriate.

Taxpayers who are low risk may not consider that an APA is necessary (given that the risk of their transfer pricing being challenged is low), although it can provide the added benefits of potentially obtaining clearance from the ATO on the diverted profits tax (DPT) and other collateral issues, which some taxpayers may consider to be valuable. Pre-qualified APAs will only be available as unilateral APAs, which means that it would be required to be reported in the Group’s Master File (if the group is required to prepare a Master File). This will no doubt be one of the factors multinational groups will weigh up when assessing the pros and cons of an APA.

A taxpayer that is currently in the red zone, and/or wishes to agree to a position with the ATO which is not in the green zone, will not be eligible for a pre-qualified APA, but can still request a ‘traditional’ APA. Similarly, anyone seeking a bilateral APA will need to follow the traditional process. Taxpayers considering this path should be aware that it may be challenging to reach agreement with the ATO on a position that falls significantly below the green zone.

The takeaway

The PCG will provoke much debate. The low risk profit markers are generally higher than prior ATO expectations and this reflects the ATO’s stated intention to ‘recalibrate’ profit expectations for Australian subsidiaries of multinational groups. Adopting a position in the green zone is unlikely to be palatable for many groups who seek to apply consistent policies globally. This will leave a significant number of taxpayers who will now need to consider how they will manage their Australian transfer pricing risk. The ATO has access to extensive data that will enable it to quickly identify high risk taxpayers, so taxpayers should approach their transfer pricing policies and documentation with a mindset of ‘when’ not ‘if’ they will be reviewed by the ATO.

Let's talk

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

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