
Australia: Offshore marketing hubs – ATO releases draft discussion paper

August 21, 2016

In brief

On August 10, 2016, the Australian Taxation Office (ATO) released for public comment a 29 page draft discussion paper (DP)¹ that outlines the ATO compliance approach to transfer pricing issues related to centralized operating models or ‘hubs’. The focus of the DP is offshore marketing hubs² but the ATO plans to issue guidance in relation to other hubs³.

Overall, the DP confirms that the ATO will continue to heavily scrutinize marketing hubs which is unsurprising given the extensive media attention on these structures over the last twelve months. The proposed safe harbor or ‘green zone’ (of a mark-up on costs of 100%) is unlikely to apply to a number of taxpayers that are the subject of the DP, which brings into question whether and to what extent the draft guidance is of practical use to a number of taxpayers. However, the DP does provide some insights in relation to current ATO thinking.

In detail

The DP is a “practical compliance guide,” a relatively new approach by the ATO, designed to help taxpayers understand how the ATO will assess the transfer pricing risks of a hub and the compliance approach the ATO will adopt. However, the DP does not provide guidance on the technical interpretation or application of Australia’s transfer pricing rules and does not address other Australian tax rules that may be relevant to a hub (the DP highlights capital gains tax, controlled foreign company, general anti-avoidance, and the

proposed diverted profits tax as possibilities).

In summary, subject to demonstrating that the hub has the appropriate commercial and economic substance (no guidance in the DP on what this requires), a taxpayer will be considered ‘low risk’ or ‘green’ zone if its offshore hub has derived less than a 100% profit mark-up on its operating costs and meets the ‘commercial realism’ indicator. The commercial realism indicator is not yet defined in the DP and therefore the green zone test is incomplete. The ATO generally will not apply compliance

resources to taxpayers in the green zone.

Where the two indicators are not satisfied, the level of risk for taxpayers (five zones ranging from green to red) is determined based a number of factors, including but not limited to:

- The level of hub profits above the cost-plus 100% benchmark not taxable in Australia (i.e., the “net tax impact”).
- Certain behavioral criteria, including for example: preparation of the appropriate transfer pricing

analysis and documentation, taxpayer evidence supporting its functional analysis and pricing outcomes, timely disclosure of the taxpayer's position, and co-operation with the ATO.

Taxpayers will be expected to 'self-assess' which zone they are in and additional reporting requirements are proposed to provide more information to the ATO that are relevant to the risk rating criteria. Taxpayers that choose not to self-assess will be automatically put in the highest risk 'red zone'.

For certain taxpayers that want to reduce their risk rating, the ATO is proposing that they may make a voluntary disclosure to bring their arrangements into the 'green zone' with concessions provided around penalties and interest.

Put simply, the guidance is a message to taxpayers that they can operate within the ATO's indicators or face ATO scrutiny commensurate with the assessed risk zone. For example, taxpayers in the red zone will not be eligible for the APA program and are more likely to be subject to formal information gathering powers by the ATO.

Observation: The DP has been released in the context of a broader, public debate about the tax issues related to marketing hubs. Media reports indicate that 30 taxpayers in the resources sector will be affected. It is very likely that any of the taxpayers which this DP targets are already well aware of the ATO's position and have well considered and documented positions from a transfer pricing perspective. Therefore, the DP is possibly more useful in signaling to the broader taxpayer community the approach that the ATO plans to take in relation to areas it regards as high risk.

Despite our observation that the DP is likely to provide little benefit to a number of taxpayers, we would highlight the following issues:

- There is a threshold question regarding the appropriateness of using a cost based methodology for sales and marketing activities as a risk indicator or an appropriate method to assess an arm's-length outcome. The DP does not address this critical issue. For example, the DP acknowledges that commission rates based on third-party comparables are often used by taxpayers as comparable uncontrolled prices (CUPs) for hubs, but warns that these may not be sufficient to meet the Australian transfer pricing rules because of a lack of comparability. On the other hand, the DP states that the ATO is not advocating a cost based method as the primary price setting transfer pricing method. It is unfortunate that the ATO has chosen not to elaborate on their thinking regarding this critical issue which is at the heart of transfer pricing disputes regarding certain hubs.
- The documentation expectations of the ATO do not appear to be consistent with earlier guidance from the ATO and the OECD in relation to business restructures. There is a strong emphasis in the DP on the taxpayer being able to produce primary evidence of costs and benefits to the Australian entity of the particular hub structure. The ATO and OECD has consistently recognized in the past that taxpayers should not be expected to have such documents (in the form of primary evidence) and it is accepted that the

commercial rationale for a principal or hub structure may be at the level of the multinational as a whole. This is particularly concerning given a failure to have these documents could result in a taxpayer being denied access to an APA and put in the 'red zone.'

- The DP does not address the practical issues associated with adopting the ATO's proposed non-arm's length cost based approach to hub pricing and risk assessment. In particular, the ATO green zone may be a red zone for the revenue authority of the hub which would lead to double taxation outcomes and a need for mutual agreement procedures (MAP). There is no indication that treaty partners have been consulted and it is informing to note that in describing possible approaches to resolving disputes, MAP is not mentioned.
- The DP recognizes that Australia's transfer pricing laws continue to remain the relevant standard to determining arm's-length conditions for marketing hubs and that a taxpayer's analysis may well support a different outcome to the cost plus 100% green zone mark-up. However, there is a real risk that the ATO's framework will influence ATO audit teams in their application of the transfer pricing laws to cases where hub profits exceed the green zone requirement. It is important that the ATO's risk framework be used in accordance with its intended purpose, i.e., to identify risk as opposed to overriding the arm's-length principle.
- The DP applies to offshore entities undertaking sales and marketing

activities and suggests a cost based transfer pricing approach. In other cases, where sales and marketing activities occur in Australia, the ATO is seeking to argue that a method tied to sales is more appropriate (and rejecting a cost based approach). We believe the ATO should elaborate on this issue and reconcile the approaches being suggested for activities in Australia and outside Australia.

- The calculation of *costs* for the net tax impact calculation will remain an area of controversy. The DP adopts a more narrow view of costs than that considered appropriate by some taxpayers and advisers. Freight costs are the most contentious because these typically constitute a significant portion of the cost base and the ATO's view is that these should be excluded.
- The role of 'behavioral' indicators presents an interesting dynamic particularly by introducing a very subjective element into the risk rating. Taxpayers should be aware that the ATO's 'behavioral' indicators can influence their overall risk rating.

Feedback on the DP has been requested by September 30, 2016.

The takeaway

The DP will be of little use to a number of taxpayers with existing hubs or plans to centralize functions. From the perspective of the ATO, the DP does confirm that the ATO will continue to heavily scrutinize hubs and appears to set a framework for compliance officers to follow in determining the way in which the ATO will approach the issues with taxpayers.

Unfortunately that approach is likely to be heavily skewed towards audits

which are likely to be protracted unless greater emphasis is given to arm's-length principles and OECD guidance early in the risk assessment process.

Endnotes:

1. Discussion Paper: ATO compliance approach to transfer pricing issues related to centralized operating models involving procurement, marketing, sales and distribution functions.
2. Marketing hub is defined as a green fields establishment or brownfields use of an offshore entity which acts as a principal/agent in relation to the marketing or sale of goods or commodities on behalf of related Australian residents without substantially altering the goods or commodities.
3. Other hub is defined as centralized operating models involving marketing, sales, and distribution functions.

Let's talk

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

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