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Transfer Pricing Risk Assessment

ATO risk framework approach now available

The ATO has now made public its approach in allocating resources to interact with inbound distributors.

Distributors that are part of a global group have always been exposed to jurisdictional Transfer Pricing (TP) risks. Approximately 60% of the Advanced Pricing Arrangement (APA) cases previously provided by the ATO were in relation to the purchase and sales of goods.

How will the ATO assess risk?

On 13 March 2019, the ATO released the Practical Compliance Guideline 2019/1 – Transfer pricing issues related to inbound distribution arrangements (known as the PCG), which sets out the framework to assess the TP risk of inbound distributors.

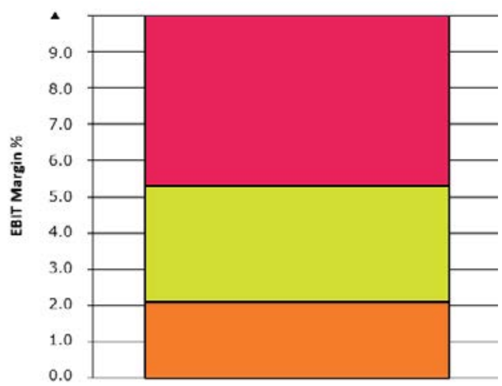
The framework covers three specific industry segments and inbound distributors generally. The Earnings Before Interest and Tax (EBIT) margin (EBIT relative to sales) is used as the key profit indicator to assess tax risk. Inbound distributors include:

- Taxpayers that distribute goods purchased from related foreign entities and resale in Australia
- Taxpayers that distribute digital products or services where the intellectual property in those products or services is owned by related foreign entities.

Risk Assessment Frameworks

General distributors risk assessment framework

High risk | Medium risk | Low risk



Risk level	Percentage
High risk	Below 2.1%
Medium risk	Between 2.1 – 5.3%
Low risk	Above 5.3%

Life Science sector risk assessment framework

High risk | Medium risk | Low risk

	Category 1	Category 2	Category 3
High risk	Below 3.6%	Below 5.5%	Below 7%
Medium risk	Between 3.6 – 5.1%	Between 5.5 – 8.9%	Between 7 – 10%
Low risk	Above 5.1%	Above 8.9%	Above 10%

Source: PCG 2019/1

Whether a distributor falls within category 1, 2 or 3 will depend on the functions performed by the distributor. The ATO will update the profit markers based on future benchmarking work as required. The risk framework will be directly linked to ATO's compliance approach.

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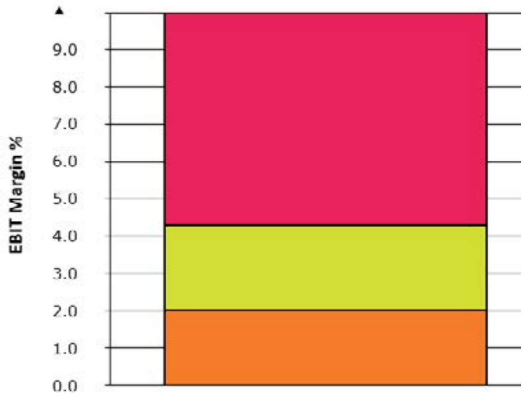
ICT sector risk assessment framework

■ High risk ■ Medium risk ■ Low risk

	Category 1	Category 2
High risk	Below 3.5%	Below 4.1%
Medium risk	Between 3.6 – 5.1%	Between 4.1% – 5.4%
Low risk	Above 4.1%	Above 5.4%

Motor vehicles risk assessment framework

■ High risk ■ Medium risk ■ Low risk



Risk level	Percentage
High risk	Below 2%
Medium risk	Between 2 – 4.3%
Low risk	Above 4.3%

Source: PCG 2019/1
In appl;ying the PCG, the ATO warns that:
1. Profit markers should not be used as a safe harbour
2. Profit markers are not directly linked to whether the actual TP arrangements of taxpayers are in line with the arm's length principle.

Risk zone	Low	Medium	High
ATO's compliance approach to TP risk	**Limited to confirming taxpayers' characterisation as an inbound distributor.**	**Monitor arrangements, may contact taxpayer to better understand circumstances before conducting an in-depth investigation.**	**Actively monitor inbound distribution arrangements, may commence a review or audit. Taxpayers need to consider adjusting the current TP policy.** **(Taxpayers in an overall loss position for the aggregate of the current and previous two income years are the key targets.)**
Possibility of APA application	**High** Eligible to request a pre-qualified unilateral APA process	**Slightly lower** Eligible to request a pre-qualified unilateral APA process	**Lowest** Not eligible to request a pre-qualified unilateral APA process

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How should taxpayers manage any uncertainties?

1. Regardless of the level of risk, taxpayers should consider preparing TP documentation. The TP documentation can help taxpayers to justify the rationality of its related party arrangements during the ATO review process. This will mitigate transfer pricing risks, provide for a reasonably arguable position and demonstrate stronger tax governance and controls.

2. Taxpayers should not limit their focus to the profit level itself, but also consider the following matters:

    - Industry characteristics
    - Key drivers for the profit outcome in particular the commercial drivers for any poor performance (which are unrelated to the pricing of international related party transactions).

    Fluctuations in profit levels frequently originate from industry and market conditions. For example, the Australian automotive industry is highly competitive, and new car distributors often experience low profit levels as they attempt to penetrate the market and gain market share. According to historical data released by Australian Automotive Intelligence, Kia spent seven years to reach a 2% market share, while it took Peugeot more than ten years to reach 1%.

3. 'Non-high-risk' taxpayers may consider applying for pre-qualified APA in due course in order to minimize the TP risks in future years. This will provide a greater level of certainty with respect to their TP arrangements.

4. The ATO suggests that High-risk taxpayers may consider adjusting the current TP policy. Within the 12-month transition period granted by the PCG (from 13 March 2019), the ATO will consider remitting penalties and reducing interest charges, provided taxpayers adjust their TP arrangements to fall within the low risk zone. However, it is noted that falling outside the low risk zone does not mean that international related party transactions are not priced based on arm's length principles.

Conclusion

The PCG expressed the ATO's regulatory position on distributors, but it should not be used as a basis for determining whether a TP arrangement is reasonable or not.

Taxpayers should establish their own compliance programs according to their own and macro (such as industry) conditions and make their own decisions.

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