Transfer Pricing & OECD Guidelines - Australia readying for a makeover

By N.V. Balaji and R. Subhashree

In a recent landmark case, the Full Federal Court of Australia in *FC of T* v. *SNF (Australia) Pty Ltd* (SNFA) - [2011] FCAFC 74, ruled in favour of the tax payer and held against the adjustments sought to be made in respect of the transactions with parent. The Commissioner had considered that the transactions required adjustment, as they were not at arm's length. SNFA was suffering loss continuously and the Commissioner had considered that the same was on account of higher purchase prices for the supplies effected by the related party. The taxpayer had established that the transactions were at arm's length, by demonstrating that its overseas supplier (related party) had transacted for the same group of products and had charged prices in such transactions which are higher than what SNFA had paid. The Federal Court found that a global market existed for the products supplied by the related party and supplies to independent third parties are comparable. The Federal Court held that that tax-payer had proved that transactions had been conducted at arm's length prices and there was no case for the Revenue to resort to its powers under Division 13 (transfer pricing provisions) to ascertain the correct consideration.

The decision analysed various key issues on transfer pricing, which included:

- Whether the comparables submitted by SNFA are comparable transactions
- Interpretation of the phrase "between independent parties dealing at arm's length"
- Usage of OECD guidelines in interpreting Australian Tax Laws

Comparability

SNFA had established before the trial court that the comparables chosen by it were companies distributing identical products at their respective market. SNF argued that they had attempted to show that the entities occupied similar places in the supply chain and that global nature of the market for industrial chemicals paved way for some distortions in price. SNFA, by adjusting the prices of material to ex-works prices, had substantially complied with the methodology to effect adjustments in consideration for 'material factors'. The court held that 'functional comparability' had been established and no contractual disparities were brought into evidence. On the strength of the evidence presented by it, SNFA was able to show that most of the other comparable transactions had been at same, if not higher prices than those at which it had purchased the material from its related party.

The Commissioner contended that the only comparables sharing the same characteristics as that of the taxpayer (apart from its non-independence from the group), could be considered as lawfully comparable. The Commissioner's argument was that the comparables did not have the same characteristic as that of SNFA, since ordinary independent parties would not have supported an entity making loss for successive years and continued to run into loss. The

Commissioner attributed the motive of trying to pass on losses to the entity in Australia as a reason for this. The ruling, calling for a balanced approach to interpreting the provisions, says that to set the bar of comparison too high expecting crystalline perfection in matching the compared entities would be unrealistic. The correct approach is to determine if the transaction has taken place at arm's length prices and the onus was on the tax payer to prove the same.

The Federal Court found that two of the three sets of comparables considered by the trial court were appropriate and accordingly rejected the Commissioner's argument for rejecting the Comparable Uncontrolled Price (CUP) method and adopting Transactional Net Margin Method (TNMM).

Independence

The Commissioner had argued that arm's length consideration should be "the consideration that might reasonably be expected to have been given or agreed to be given in respect of the acquisition if the property had been acquired under an agreement between independent parties dealing at arm's length with each other in relation to the acquisition". Connecting the definition of arm's length consideration and the operative provision, it was contended that the phrase "between independent parties dealing at arm's length" should include SNFA as one of the parties. However, the Federal Court held that all that the provision requires was a comparison between price which was actually paid by the taxpayer (SNFA) and an arm's length consideration. It also held that, arm's length consideration did not further require that the consideration should not only be at arm's length but that the arm in question should be attached to the taxpayer (SNFA).

OECD Guidelines

For the proposition that an analysis involving an inquiry into what a purchaser in identical circumstances to those of the taxpayer would have paid, but for its membership of the group is required for arm's length price, the Commissioner relied on OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the "guidelines"). Though the suppliers of SNFA are located in countries with whom Australia had entered to tax treaties and such treaties are part of tax laws of Australia, the Federal Court rejected the reliance on the guidelines, noting that they are mere guidelines. It observed that under Article 31(3) of Vienna Convention on the Law of Treaties, "any subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions" or "any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation" could only be taken into account in interpreting treaties. The usage of guidelines would be permissible only if those States had agreed to apply the portion of the guidelines relied upon in their performance of the equivalent of Article 9 of each agreement or that it was their practice to do so. In the absence of such evidence in this case, the usage of guideline was rejected.

Future action

Despite the Revenue's loss at the Federal Court, it is not a Lady Macbeth moment for the Australian Taxation Office (ATO) to lament that 'All the perfumes of Arabia will not sweeten this little hand'. What emerged in the SNFA case was the strength of evidence proving prices transacted at arm's length and invalid objections rather than insufficient laws. The judgement also does not pass a verdict on superiority of the Comparable Uncontrolled Price Method (CUP) over the Transactional Net Margin Method (TNMM).

In the light of the judgement, the ATO decided to realign their transfer pricing laws, in tune with the updated OECD model convention. It has released a Consultation Paper titled 'Income Tax: Cross Border Profit Allocation - Review of Transfer Pricing Rules' on November 1, 2011. The paper discusses the need to bring clarity and conformity of Australia's transfer pricing laws, in line with OECD Guidelines. The paper draws from the experience/practice in New Zealand and India which incorporate the elements of the Guidelines by replicating them in their domestic legislation. Though the consultation paper talks of *Roche* and *SNFA Pharmaceutical* cases, the move to overhaul is not, in effect, a verdict on the transfer pricing laws themselves.

It is pertinent to note that the OECD Guidelines, 2010 do not favour a hierarchy of methods to be applied, rather they advise on comparability analysis to select the best suited method. The Consultation Paper states that new provisions will not restrict operation of profit based allocation rules. The Consultation Paper also states that the rules would continue to apply only to international dealings and the obligation to substitute an arm's length price or profit for a transaction or series of transactions in place of the actual price or profit will only arise when the non-arm's length price or profit has been detrimental to Australian revenue.

But what will change is the inclusion of clear identification of the purpose of profit allocation rules in the objects clause and incorporation of OECD's arm's length principle in the operative rules of law along with criteria for selection of most appropriate method of determining arm's length price. The design of the new rules is envisaged to incorporate provision which rather than being overly prescriptive would be supported by reference to the 2010 OECD Guidelines and supplemented where necessary by rulings. To bring an element of certainty it is also proposed to bring in time- limit to the ATO's powers to make an initial amendment to give effect to the adjustments.

The final draft of rules will be decided after receiving comments by 30th November, 2011, from the public and stake holders. However, the extent to which it will reduce litigation remains to be seen given that revenue authorities all over contest comparability of data presented in case of CUP or whether a particular item is allowable as operating expense or not in case of TNMM and in any case, seek to safeguard revenue.

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