

[CONTACT US](#) | [DOWNLOAD](#) | [FORWARD](#) | [WEBSITE](#)

## Multinational supply chains and intangible assets under the Australian Taxation Office's microscope

The ATO has released two pieces of guidance focusing on Australian cross border supply chains, particularly involving distribution operations and the recognition of intangibles in global supply chains. Over the past 18 months, it is widely known that such structures have been subject to scrutiny, as a consequence of the evolution of BEPS as well as in the context of unilateral Australian tax measures like the Multinational Anti-Avoidance Law (MAAL) and Diverted Profits Tax (DPT).

The accompanying ATO press release notes the ATO's "concerns about multinational taxpayers inappropriately pricing goods in their supply chains or mischaracterising intangible assets, with the ultimate effect of understating profits in Australia". For multinationals operating through an Australian distributor or which have recently restructured their supply chains, this presents an additional layer which they should consider in order to prudently mitigate their risk profile in Australia.

As a beneficiary of inbound foreign multinational sales, Australia is being proactive in considering the tax profile of such structures, asserting its view on value creation and characterisation of supply chains selling into Australia.

The ATO in its press release notes: "Assets such as intellectual property, manufacturing know how, trademarks and brand need to be recognised, especially for those taxpayers where intangible assets make up a significant proportion of the inherent value of the goods sold in Australia." Further, the ATO notes Australia has "one of the strongest transfer pricing regimes in the world."

Any approach to Australian characterisation and transfer pricing should therefore be considered from a holistic perspective (commerciality, substance, tax and legal factors) and needs to be well attuned to the rigour that will be applied by the ATO on greater scrutiny.

Two practical points which multinationals operating through Australian distributors should consider as a result of the ATO's recent guidance include:

- whether the return earned by the Australian distributor would be considered as low, medium or high risk according to the new draft PCG; and
- critically evaluating whether the payments made to related parties are accurately characterised, in particular, whether there is a possible royalty withholding tax obligations on such payments in light of the ATO's new taxpayer alert.

We have outlined the two new documents in more detail in this alert.

### Australian Distributors: ATO issues its views on profit guidance and high risk transfer pricing arrangements (Draft PCG 2018/D8)

The ATO has provided its most clear public statement yet on expected transfer pricing outcomes for Australian inbound distributors.

The ATO has released draft PCG 2018/D8, setting out a risk assessment framework to assist taxpayers in considering the possible transfer pricing risks associated with their Australian distribution operations. As part of this risk framework, the ATO sets out its view of the expected profits for distributors operating in a number of industries, including pharmaceutical and life sciences, information communications and technology (ICT) and automotive. The draft PCG also provides a "general distributors" classification covering distributors in all other industry sectors.

The draft PCG sets out a number of "profit markers" which are expressed as EBIT margins. It provides the opportunity for taxpayers to assess their Australian distribution EBIT margins against the ATO's profit markers, in order to determine whether the ATO would view their distribution arrangements as low, medium or high risk.

The ATO describes the consequences of the three risks zones as follows:

Distribution Risk Zone	ATO approach
Low Risk (green)	Where taxpayers fall in the low risk zone, the ATO indicates that it will generally not allocate compliance resources to review the transfer pricing position of the taxpayer's distribution operations.  The ATO will be open to early engagement for an advance pricing arrangement (APA). Taxpayers in the green zone may also be eligible for a pre-qualified APA.
Medium Risk (yellow)	Taxpayers in the medium zone will face increased ATO monitoring, and may be requested to provide the ATO with a better understanding of their specific circumstances in order for the ATO to determine whether it should allocate further compliance resources.  The ATO will be open to APA discussions with medium risk taxpayers, and it may be possible for the taxpayer to request a pre-qualified APA, however the ATO may also review the transfer pricing position for prior years.
High Risk (red)	For taxpayers in the high risk zone, the ATO will consider appropriate 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 taxpayers distribution arrangements or commencing a review or audit.

#### What is an inbound distributor?

The ATO defines an inbound distributor as a business which is predominately involved in 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 related parties outside of Australia.

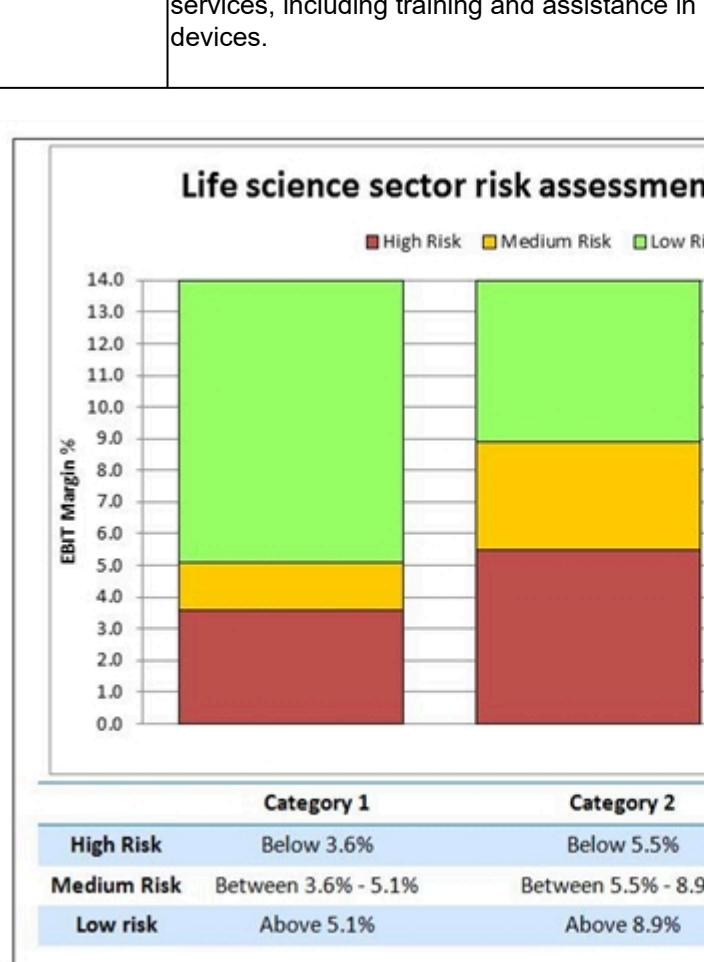
Such inbound distribution subsidiaries, which purchase from offshore related parties and resell in the Australian market, are relatively common amongst multinational groups. The ATO considers that such inbound distributors play an important role as a value-adding link between foreign entity suppliers and Australian customers.

The ATO notes that the principles in the PCG apply to all inbound distributors, regardless of whether the company describes itself as a routine distributor, a limited risk distributor or a marketer-distributor.

#### ATO profit markers

##### General Distributors (Schedule 1)

The general distributor category is a catch-all classification. Distributors which do not fall into any of the identified industry segments (ICT, Health Sciences or Automotive) are considered to be general distributors.

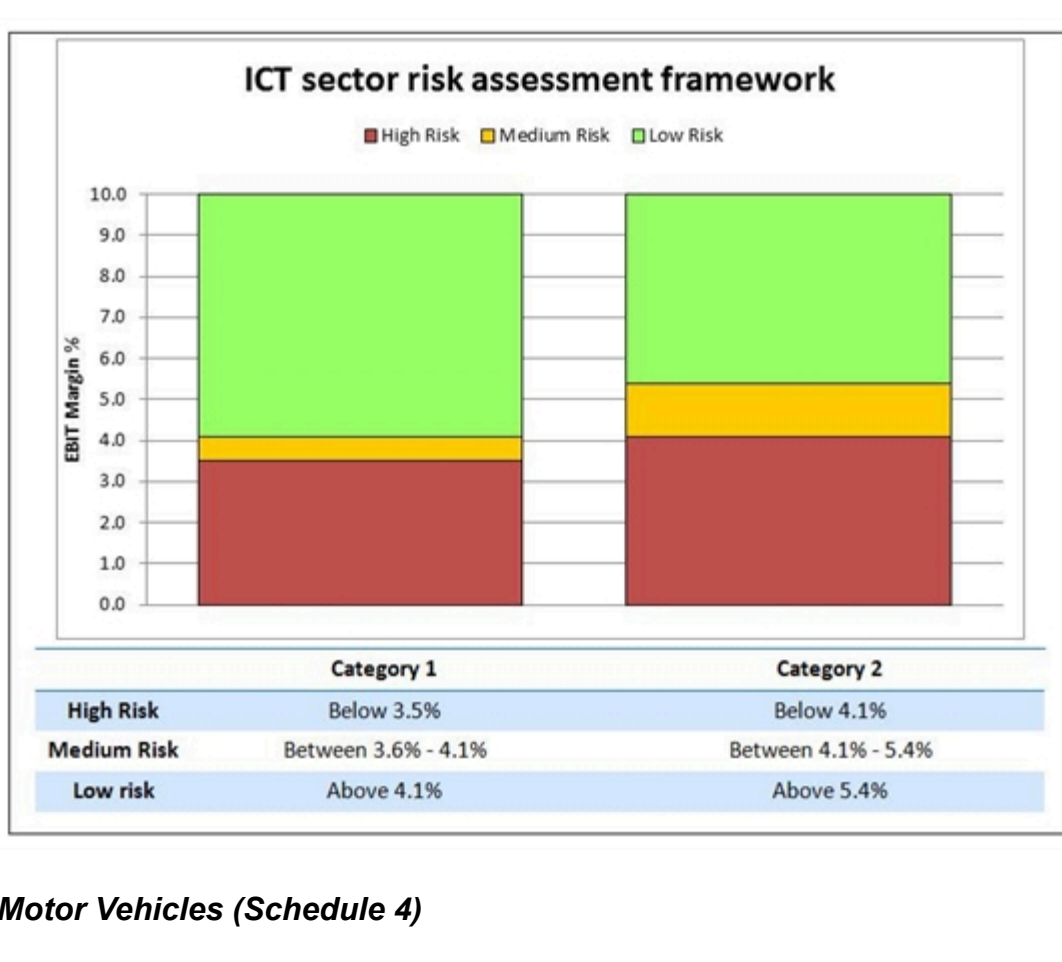


##### Life Science (Schedule 2)

The ATO defines this broad industry category to include entities involved in the discovery, development, production and sales, and marketing of medicine. This includes innovative or patented products, medical equipment and devices, generic or biosimilar, over-the-counter products and animal health.

The risk rating framework differentiates between three categories of inbound distribution activity. The ATO considers that these categories incrementally generate value:

Category	Activities that incrementally generate value
1	Distribution of life science products. This may include detailing and marketing as well as logistics and warehousing functions.
2	Activities listed in Category 1, plus functions relating to regulatory approval, market access or government reimbursement activities including relationship management activities with regulatory bodies, interpreting clinical trial data and generating data and product awareness through engaging with the scientific and medical community.
3	Activities listed in Category 1 and Category 2, plus functions relating to specialised technical services, including training and assistance in conducting surgical procedures involving medical devices.

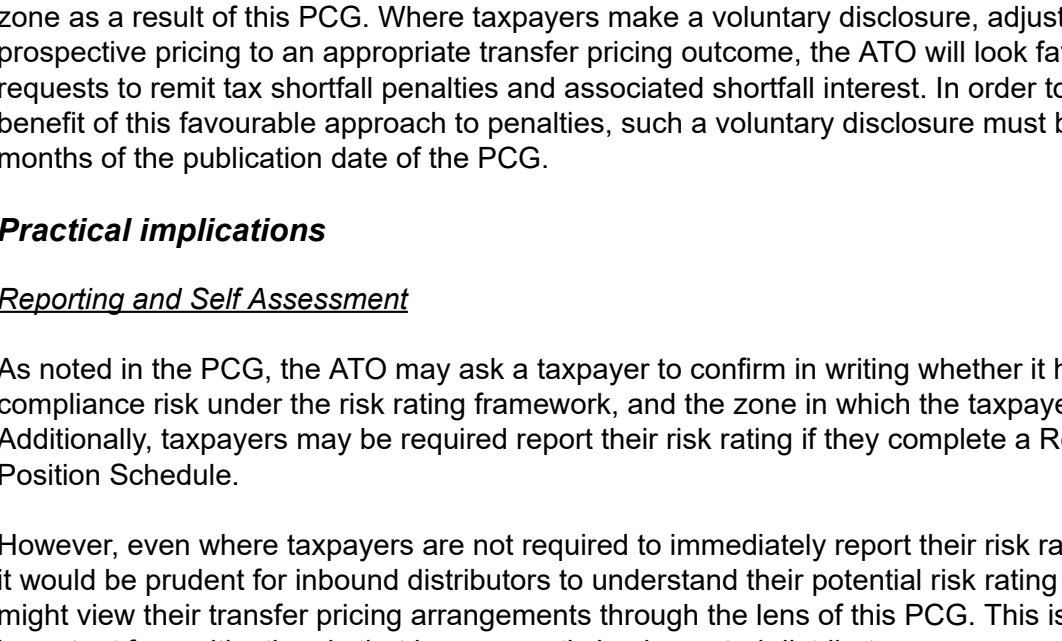


##### ICT Sector (Schedule 3)

The ICT industry definition is again framed extremely broadly, to include all types of consumer and enterprise computer hardware and software products, digital communication devices, applications, IT solutions and ancillary services that enable interaction through technology.

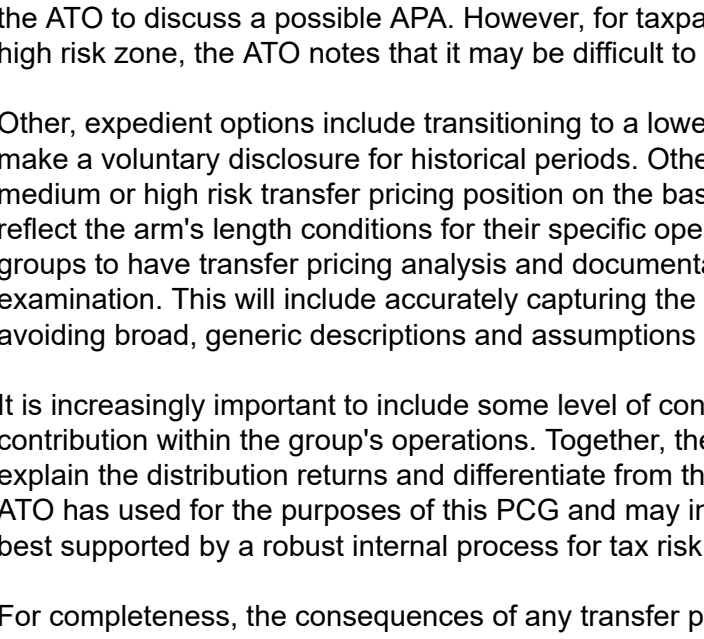
The risk rating framework differentiates between three categories of inbound distribution activity, which the ATO considers incrementally generate value:

Category	Activities that incrementally generate value
1	Distribution of ICT products. This may include any of the following:  <b>Sales and marketing</b> activities such as the execution, development or localisation of sales and marketing plans, the management of partner relationships with intermediaries, and the general promotion of ICT products and services.  <b>Pre and/or post-sales</b> services such as pre-sale consultation services, product demonstrations, training, technical support, maintenance (including spare parts and repairs) and warranty services.  <b>Logistics and warehousing</b> functions depending on the nature of the product.
2	Activities listed in Category 1, plus functions relating to:  <b>Complex sales</b> processes such as a customisable product portfolio, specialised local technical expertise, solution building, developing proof of concepts, and providing bespoke offerings.  <b>Direct selling</b> activities which support or supplement predominant distribution activities such as partner-led assisted retail activities and branded retail activities.  <b>Large customer relationship management</b> such as enterprises and/or government organisations including tendering, contract negotiation processes and ongoing relationship management.



##### Motor Vehicles (Schedule 4)

The ATO considers that the motor vehicle industry comprises entities which trade in passenger vehicles, trucks, buses, motorcycles or other recreational motorised vehicles or their associated parts. In contrast to the ICT and Health Sciences industries discussed above, the ATO does not identify specific activities for motor vehicle distributors which are considered to generate incremental value. As a result, there is a single profit marker category which the ATO uses to assess transfer pricing risk for all motor vehicle distributors.



#### Transitioning to low risk zone

The ATO notes that some taxpayers sitting in higher risk zones may wish to transition to the low risk zone as a result of this PCG. Where taxpayers make a voluntary disclosure, adjusting historical and prospective pricing to an appropriate transfer pricing outcome, the ATO will look favourably upon requests to remit tax shortfall penalties and associated shortfall interest. In order to obtain the benefit of this favourable approach to penalties, such a voluntary disclosure must be made within 12 months of the publication date of the PCG.

#### Practical implications

##### Reporting and Self Assessment

As noted in the PCG, the ATO may ask a taxpayer to confirm in writing whether it has reviewed its compliance risk under the risk rating framework, and the zone in which the taxpayer believes it sits. Additionally, taxpayers may be required report their risk rating if they complete a Reportable Tax Position Schedule.

However, even where taxpayers are not required to immediately report their risk ratings to the ATO, it would be prudent for inbound distributors to understand their potential risk rating and how the ATO might view their transfer pricing arrangements through the lens of this PCG. This is particularly important for multinationals that have recently implemented distributor arrangements, particularly in the ICT sector.

##### Profit Markers

Clearly, the profit markers identified by the ATO are not aligned with the historical market transfer pricing convention from an Australian transfer pricing perspective. As a consequence, in many cases the historical margins earned by Australian inbound distributors will place them in the medium or high risk categories. Furthermore, the ATO is clearly indicating its intention to disregard characterisation and naming conventions of "limited risk" and "routine" distributors, asserting that there is a spectrum of activities that may have a marked impact on the return of an inbound distributor. These assertions are consistent with a trend observed under recent ATO reviews (for instance MAAL and DPT) which the ATO clearly wants to extend to other multinational groups that are not yet affected by these newer laws.

##### Managing Potential Transfer Pricing Risk

Taxpayers need to have a clear strategy on how they will manage their Australian transfer pricing position in light of this new guidance. The PCG notes that taxpayers have the option of approaching the ATO to discuss a possible APA. However, for taxpayers wishing to maintain a position in the high risk zone, the ATO notes that it may be difficult to reach agreement on the terms of an APA.

Other, expedient options include transitioning to a lower risk band and/or approaching the ATO to make a voluntary disclosure for historical periods. Otherwise, in order to maintain an ATO-asserted medium or high risk transfer pricing position on the basis that it continues to most appropriately reflect the arm's length conditions for their specific operations, it will be important for multinational groups to have transfer pricing analysis and documentation which is capable of standing up to ATO examination. This will include accurately capturing the scope of the Australian operations and avoiding broad, generic descriptions and assumptions about industry and group factors.

It is increasingly important to include some level of contextual analysis of the Australian company's contribution within the group's operations. Together, these elements can be used to defend and explain the distribution returns and differentiate from the higher value-adding comparables that the ATO has used for the purposes of this PCG and may initially assert are applicable. This analysis is best supported by a robust internal process for tax risk management and governance.

For completeness, the consequences of any transfer pricing adjustments or alterations in compensation do not exist. In particular, any change in the pricing of tangible goods may also have GST and customs duty implications. It is therefore important that transfer pricing and indirect tax positions are closely aligned.

#### Taxpayer Alert; TA 2018/2: Mischaracterisation of activities or payments in connection with intangible assets

The ATO has put taxpayers on notice that it is currently reviewing international arrangements that mischaracterise intangible assets and/or other activities or conditions connected with intangible assets.

Although the media release issued on this subject makes references to "Intangibles Migration", the Taxpayer Alert indicates that the ATO's primary focus is mischaracterisation and not migration. More specifically, the concern is whether intangible assets have been appropriately recognised for Australian tax purposes and whether Australian royalty withholding tax implications have been analysed.

In particular for related party transactions, the ATO is concerned about whether:

- the amount deducted by the Australian entity meets the requirements of the Australian transfer pricing provisions; and
- the functions performed, assets used and risks managed by the Australian entity are appropriately compensated in accordance with arm's length principles.

Importantly, the alert does not apply to international arrangements involving an incidental use of an intangible asset. The ATO notes for example, it does not apply to resellers of finished tangible goods where the activity of reselling the goods involves incidental use of a brand name that appears on the goods and related packaging.

This guidance highlights that proper characterisation of intercompany transactions is an important step in performing transfer pricing analysis. There may be circumstances where a whole-of-entity profit based transfer pricing method (such as TNMM) needs to be revisited to address the ATO's concerns on mischaracterisation.

While the ATO guidance is generally useful to understand their perspective, it is unfortunate that the guidance focuses on examples that involve Australian manufacturing which is often not applicable in the context of the distribution of tangible goods in Australia, and does not provide guidance on situations that involve reselling intangible products and services (e.g. SaaS) which is where some uncertainty may be arising anecdotally.

[DOWNLOAD ALERT](#)

#### Contact us



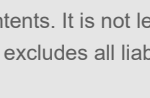
**Simone Bridges**  
Partner  
[Simone.Bridges@bakermckenzie.com](mailto:Simone.Bridges@bakermckenzie.com)



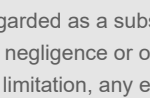
**Dixon Hearder**  
Partner  
[Dixon.Hearder@bakermckenzie.com](mailto:Dixon.Hearder@bakermckenzie.com)



**Miles Hurst**  
Partner  
[Miles.Hurst@bakermckenzie.com](mailto:Miles.Hurst@bakermckenzie.com)



**John Walker**  
Partner  
[John.Walker@bakermckenzie.com](mailto:John.Walker@bakermckenzie.com)



**Thomas Brennan**  
Director Economics  
[Thomas.Brennan@bakermckenzie.com](mailto:Thomas.Brennan@bakermckenzie.com)

