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Grasping Australian Transfer Pricing Means Knowing Its Tax Office

By Niv Tadmore, Benjamin Lancaster, and Brianna Steinochr2024-02-19T04:30:20000-05:00

In Australia, gone are the days when tax professionals could confine their analysis of related party transactions to transfer pricing. For companies with Australian connections, the first question isn't what the price should be, but rather what should be priced.

The Australian Taxation Office has increasingly combined transfer pricing methods with other measures, particularly the general anti-avoidance rules, or GAAR, and the diverted profits tax rules and challenges to the characterization of transactions.

The ATO's ability to reconstruct transactions means it can advance an alternative transaction that didn't occur and challenge the pricing of that notional transaction.

The correct characterization of payments is increasingly in dispute, particularly with payments relating to the use of intangibles, where the ATO has a much broader view of the circumstances in which a payment constitutes a royalty than the Organization for Economic Cooperation and Development does. This increases the chances that positions that other revenue authorities have accepted won't necessarily be accepted by the ATO.

The ATO's underlying approach to intangibles can be seen in its 2024 draft ruling on royalties in payments made under software agreements, where it broadly asserts that the electronic distribution of software gives rise to royalties. Its practical compliance guideline for development, enhancement, maintenance, protection, and enforcement, or DEMPE, activities conducted in Australia using foreign intangibles also highlights the breadth of the ATO's inquiries.

As a large and well-resourced organization, the ATO can conduct regular and comprehensive reviews of transfer pricing arrangements. These reviews are often lengthy and typically involve broad information requests, often using formal powers, requiring taxpayers to expend a significant number of resources to comply.

The ATO doesn't confine its focus to taxpayer activities in Australia and will seek to understand the importance of local operations to the global value chain.

These factual inquires have an added significance in Australia, as the burden of proof in dispute proceedings falls on the taxpayer, including in GAAR disputes. We routinely see the ATO approaching audits as if the burden of proof applies at that stage.

It doesn't accept contentious assertions without proof, and the taxpayer's position may be undermined if the taxpayer can't establish the facts with evidence. The ATO will often interview employees directly across both leadership and operational roles to form their views on the facts.

We're also seeing the Australian courts minimize economic analysis. The courts consider that evidence from people who have been involved in similar transactions between arm's-length parties to be the best evidence of what arm's-length parties would have done.

Another relatively recent feature of the Australian landscape is the ATO's practical compliance guidelines. These guidelines set out the ATO's view as to the level of tax risk associated with certain types of transactions.

Rather than interpreting the law, the office sets out risk rating methods that taxpayers must apply to their activities and then share the results with the ATO, which then uses these color-coded risk ratings to determine whether and how it will audit taxpayers.

The ATO aims to have taxpayers weigh the risk of an audit when determining whether to enter, and how to price, arrangements covered by the compliance guidelines.

Most significantly, the guidelines have been issued regarding Australian DEMPE for foreign-owned intangibles, related party financing arrangements, and inbound distribution arrangements. Taxpayers should realize that a low-risk rating from the ATO may cause the transaction to be considered high risk in the counterparty jurisdiction.

Practical compliance guidelines typically apply to both new and existing arrangements, such that taxpayers may have to apply the ATO's new risk assessment frameworks to transactions that have occurred years, or even decades, ago.

Few transfer pricing cases have come before the Australian courts, as many such disputes are settled. Settlements are primarily driven by litigation hazard, namely the outcome risks in any litigation that might ensue.

The ATO is subject to the Independent Assurance of Settlements Program, in which a retired judge reviews each completed settlement and considers whether the settlement process and outcome were fair and reasonable. In other words, the ATO's auditors get audited, which impacts how they handle settlement negotiations—they want to ensure that outcomes aren't criticized.

The ATO's settlement drivers aren't always focused on the settlement amount. In our experience, the office is often motivated by broader considerations and the desire to ensure that similar cases aren't affected.

Companies and tax professionals should always keep the following in mind when dealing with the ATO:

- Don't assume that only the transfer pricing provisions need to be considered—be mindful of the ATO combining transfer pricing with other measures, including anti-avoidance rules.
- Tax reviews in Australia can be a long haul. Taxpayers should take a forensic and strategic approach that accounts not only for the issue at hand but also their overall tax position in Australia.
- Stakeholders should be briefed early on the unique aspects of the Australian tax landscape to avoid unnecessary surprises and enable the organization to best support its tax function.

For ongoing transactions, the ATO values having assurance about its future tax positions. Proactive and frank dialogue are important to understand the ATO's settlement parameters. This can occur at any stage of the review, because there is no single formal settlement opportunity.

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