AUSTRALIAN TRANSFER PRICING ALERT

SPECIALITY
Transfer Pricing

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EXECUTIVE SUMMARY

ON 5 OCTOBER, THE OECD ISSUED THE FINALISED 15 ACTION PLANS THAT ARE EXPECTED TO FUNDAMENTALLY CHANGE THE COURSE OF INTERNATIONAL TAXATION AND TRANSFER PRICING FOR ALL MULTINATIONAL BUSINESSES

Whilst the OECD should be commended for the progress made over the past two years in addressing perceived base erosion and profit shifting risks, the reality is the global tax world has just become more complicated. The OECD has recommended a number of actions be implemented but, other than a limited number of areas identified as 'minimum standards', most are at the option of each country to adopt and implement within their own domestic laws. This means many countries will 'wait and see' what others do and some may go beyond the intent of the changes for their own self interest. Australia has already indicated it supports many of the recommendations and has been actively engaged during the process.
The main areas of change for Australian multinationals are likely to include:

- Hybrid arrangements will no longer be effective with interest deductions denied where income is not taxed elsewhere.
- Tax structures to minimise withholding taxes could be subject to treaty shopping rules that limit the benefits where the purpose of an intermediate entity is mainly to obtain a tax benefit.
- Smaller and medium sized online groups are likely to be impacted by changes to the digital economy. If you have a presence in Australia, such as a large warehouse or business development team, this can now create a permanent establishment ('PE') of an offshore e-retailing business.
- Commissionaire arrangements where an agent receives a small commission for sales that are concluded offshore will now create a PE where the agent regularly is generating leads for the offshore parent.
- The thin cap rules could be tightened up to an income based ratio of net interest to EBITDA and potentially further limited to the ratio of net interest expense to EBITDA of the group as a whole. This could be substantially less generous than Australia's current thin cap rules if implemented.
- Transfer pricing rules align profits with value creation. Risks and intangibles will follow the parties making the critical decisions. Fly-in fly-out arrangements will not be effective or companies with little or no substance.
- The OECD is introducing the Master file/country file concept and Country by Country Reporting for larger groups. This has already been endorsed by Australia.

We would reccommend that you discuss the above changes with your local BDO contact. We have included below more details on each of the key actions and our comments.

Action 1: The digital economy

It has been possible to avoid a PE through preparatory or auxiliary activities or by concluding sales offshore. There will now be stricter definitions of preparatory or auxiliary so a large warehouse delivering online sales could create a PE. The rules also allow for a local sales force potentially to create a PE of an offshore entity.

BDO COMMENT

This brings the OECD rules closer to the recent UK/Australian avoidance proposals for the digital economy. However, importantly if legislated, they would impact online groups regardless of size rather than a AUD $1 billion threshold.

Action 2: Neutralising the effects of hybrid mismatch arrangements

The recommended approach is that countries deny deductions for a payment to the extent that it is not included in the income of the counterparty jurisdiction.

BDO COMMENT

It has been quite common for large groups to use 'double dip structures' or redeemable preference share hybrid instruments for financing structures. Many of these structures may now be unwound. For example, it may not make financial sense to put debt into Australia from a higher tax country such as the US. These recommendations will be easy to implement and it is expected most jurisdictions will adopt these rules.

Action 3: Developing Effective Controlled Foreign Company Rules

The OECD are setting common standards for the definition of a CFC, exemptions, definition of income, computation of income, attribution of income and elimination of taxation.

BDO COMMENT

Australia already has a sophisticated CFC regime covering most of the Action 3 points. It is unlikely that we will see major changes arising from this Action.

Action 4: Limiting Base Erosion Involving Interest Deductions and Other Financial Payments

The key recommendation is to limit the net interest expense deductions to 10-30% of EBITDA (including related and third party debt). This can be further supplemented by a limit based on the ratio of net interest to EBITDA of the group as a whole. There can be some de minimis exemptions and the carry forward of non utilised interest expenses against future earnings to guard against volatility.

BDO COMMENT

Australia's thin capitalisation rules are currently an asset test allowing debt up to 60% of assets which is very generous by world standards. Endorsing Action 4 could substantially change the landscape for intra group funding if implemented in Australia.

Action 5: Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance

The OECD is reviewing harmful tax regimes. The OECD is proposing to allow the patent box tax regimes to be in place where there is a 'nexus'. This would occur where R&D is conducted in the country where the IP is to be held at a beneficial tax rate.

BDO COMMENT

This change could still provide opportunities for group's to structure their activities to take advantage of talent and a low tax rate in a patent box, e.g. the UK. With the change of leadership and a focus on business competitiveness in Australia, we could see Australia introducing a patent box regime especially to boost the non mining sector of our economy.

Action 6: Preventing the granting of treaty benefits in inappropriate circumstances

This Action is focused on treaty shopping. There are likely to be limitation of benefits clauses introduced similar to those introduced by the US together with a general anti avoidance rule where a transaction or structure is implemented just to obtain treaty relief.

BDO COMMENT

This could have a fundamental impact on the tax structuring of international groups which are typically structured to avoid withholding taxes on interest, royalties and dividends. It will be necessary for groups to review their structures to consider what substance is in place to support any intermediate holding companies to minimise withholding taxes and whether these are still effective. Without careful planning this could significantly increase the effective tax rates of global groups.

Action 7: Preventing the Artificial Avoidance of a PE status

This is targeted at Commissionaire arrangements where a contract is concluded offshore and the local agent receives a commission. Under current rules this arrangement would not create a PE. Now where a local agent performs activities that will result in a regular conclusion of contracts offshore, a PE will arise.

BDO COMMENT

It will be much more difficult to have agents rewarded on a limited cost plus marketing reward or a commission. It is likely that an agent generating business for a parent offshore will now be treated as a distributor and subject to the expectation of higher profit levels in Australia. More work is to be done on the new definition of PEs and we will likely see the current day definition cast a much wider net on what constitutes a taxable presence today. Given this work will continue into 2016 – and require the multi-lateral instrument to take effect – it is likely the Australian government will proceed with its proposed multi-national avoidance legislation in the meantime.

Actions 8 – 10: Aligning Transfer Pricing Outcomes with value creation

The new guidelines will ensure transfer pricing secures outcomes that ensure operational profits are allocated to the economic activities that generate them. This requires the consideration of the contractual relations between parties with their actual conduct, i.e. substance over form. Where there is insufficient commercial rationale, the transactions can be disregarded.

There is a key focus on Risks and Intangibles. A party may legally bear the risk of the transaction but if they do not in fact exercise meaningful and defined control over the risks or have the financial capacity to assume the risks then the risk will be allocated to the party that actually manages the risks.

For intangibles, including intellectual property, legal ownership alone will not automatically generate a right to a reward. If a group member provides funding for a project but contributes little to the development of the IP, then it will be entitled to no more than a risk free return. The OECD has emphasised that fly-in fly-out directors will not constitute sufficient substance.

To the extent there are synergistic benefits such as group purchasing power, this cannot be allocated to one party but will need to be shared amongst all members creating that benefit.

BDO COMMENT

It's interesting to see the OECD approach to transfer pricing mirroring somewhat the new Australian transfer pricing rules that compares contractual terms with actual conditions. This has been an economic principle argued by the ATO for some time. Many Australian groups have utilised companies in countries such as Singapore and Hong Kong to hold IP or locates as sales hubs. SMEs may not have the financial resources to employ key operational staff offshore and often rely on FIFO arrangements. This will not be effective going forward and groups will need to carry out a cost benefit analysis of supporting vs unwinding existing structures where the requisite substance cannot be demonstrated.

Action 11: Measuring and monitoring BEPS

There are six key indicators of BEPS including higher than average profits in low tax countries where the effective tax rates are 4 to 8.5% lower than domestic only groups and the separation of taxable profits from the location of the value creating activity particularly with Intellectual Property and debt concentrated in high tax countries.

BDO COMMENT

This mirrors the approach that the ATO is already taking when reviewing IDS schedules in income tax returns and selecting groups for a risk review or an audit including their work on global effective tax rates.

Action 12: Mandatory disclosure rules

The OECD is encouraging the introduction of disclosure for international tax regimes. This could include specific hallmarks such as confidentiality clauses or premium fees.

BDO COMMENT

Australia is embarking on its own form of mandatory disclosure with regard to revenue and tax paid for groups with turnover greater than $100 million. The OECD appears to be copying UK and US disclosure regimes.

Action 13: Transfer Pricing Documentation and Country By Country Reporting

This introduces the concept of the master file and local file for large groups together with Country by Country Reporting providing key analytics to tax authorities on the types of activities conducted, turnover, profits, tax paid and number of employees.

BDO COMMENT

Australia has already issued an exposure draft for legislation to implement Action 13 from 1 January 2016 for groups with a turnover above AUD $1 billion. These groups will issue a statement to the Commissioner including the above information (unless obtained through the exchange of information). Australia has taken a tougher line on Action 13 than most other countries that will only require the Country by Country report to be submitted upfront.

Action 14: Making dispute resolution more effective:

Mutual agreement procedures should be resolved in a timely manner. This should be supported by administrative procedures and binding arbitration to resolve bilateral cases.

BDO COMMENT

Australia is one of many countries that has agreed to binding arbitration to involve MAP cases which could make it easier for taxpayers to resolve double taxation in a more timely manner with less cost.

Action 15: Developing a multilateral instrument to modify bilateral tax treaties

There is a desire to create an instrument that could be more easily adapted to future and ongoing amendments. The intent is that many of the actions will be adopted through such a multilateral instrument, however this will take some time to progress and will continue through 2016.

BDO COMMENT

This seems to be a good idea although it is still very much in development at this stage. A number of countries (90) have agreed to such an instrument and a working party is developing and will be negotiating what this looks like in practice. The intent is that the instrument will be ready for signing during 2016 and this seems an ambitious target.

SUMMARY

The OECD should be commended for the progress it has achieved in just two years. However, MNCs will now need to be on top of their game to know which countries have/will adopt the recommendations as they do business globally. The global tax environment is likely to remain complex with increased tax disputes as some countries adopt new rules and others don't. These rules impact all Australian companies operating globally and these measures are not limited to the big end of town. SMEs will also need to know what they can and can't do offshore and this is likely to be more challenging given their often scarce resources. Whilst the OECD has good intentions and much progress has been made, unfortunately a level of tax uncertainty will continue.

Many of the transfer pricing concepts will be incorporated into the OECD guidelines dealing with intangibles, risk and substance. These are not new concepts but the OECD has provided more guidance and more sophisticated principles to be adopted. Arguably Australia is ahead of the game here with its new law dealing with reconstruction and 'actual conditions versus arm's length conditions' which in itself are substance tests. Country by Country Reporting has already been endorsed by many countries including Australia and the intent is to change MNCs behaviour. This is likely to have an impact as many large groups want to avoid risk assessment by tax authorities which results in further audits, adjustments and reputational risk.

MORE INFORMATION

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