

# Pricing Knowledge Network

Focusing on the impact of major intercompany pricing issues

June 8, 2011

## PKN Alert Australia - Loss for Commissioner in SNF appeal

A Transfer Pricing Publication

The Australian Commissioner of Taxation has been unsuccessful in his appeal against the 2010 Federal Court decision in favour of the taxpayer in *SNF (Australia) Pty Ltd v Commissioner of Taxation*. The appeal decision was handed down by the Full Federal Court on 1 June 2011 with a unanimous judgement that the Commissioner's appeal should be dismissed.

The decision potentially has wide reaching implications for the application of Australia's transfer pricing rules because it calls into question the ATO's interpretation of the arm's length principle. [Click here for a link to the full decision.](#)

The key findings of the Full Federal Court included:

- There were some errors in the approach adopted by the trial judge (Justice Middleton) in his analysis of the evidence; however, after reviewing the evidence itself the appeal Court found that Justice Middleton's conclusions were correct.
- The standard of comparability that the Commissioner asserted was necessary in order to apply the Comparable Uncontrolled Price (CUP) method was unrealistically high. The Court reviewed the comparables presented by the taxpayer and concluded that the taxpayer's evidence of comparable transactions was sufficient to establish that the purchase prices paid by the taxpayer to related parties did not exceed an arm's length consideration.



- 
- A key factual point which the Court considered critical for the taxpayer’s case was that there was evidence of a ‘global market’ for the chemicals imported by the taxpayer from its related parties. The judgement emphasised that a ‘global market’ is not the same as a ‘global price’.
  - Despite having considered them, the Court found that the OECD Guidelines are not law and do not have to be referred to when interpreting Division 13.
  - Poor trading results may be attributable to factors other than transfer pricing. The fact that the taxpayer had incurred losses over a prolonged period did not in itself provide evidence to support the Commissioner’s argument that the prices paid by the taxpayer were excessive.

We have discussed the Court’s comments and the broader implications for Australian taxpayers in more detail below.

## Background

The dispute related to the deductibility of the amounts paid by SNF Australia between the year ended 31 December 1998 and the year ended 31 December 2003 (the 1998 to 2004 income years) for purchases of products from related manufacturing subsidiaries of its parent, SNF France. The manufacturing subsidiaries were resident in France, the United States of America and China.

The Commissioner considered that there were no sufficiently comparable uncontrolled transactions available to enable the CUP method to be applied to SNF Australia’s purchases. The Commissioner applied the Transactional Net Margin Method (TNMM) and proposed adjustments to SNF Australia’s purchase prices that would increase its operating margin to an average of 1.7% for the relevant income years (when in fact it has incurred operating losses over this period).

Further details on the background of the case and the arguments that were presented by the taxpayer and the Commissioner are provided in our PKN Alert on the original judgement dated 28 June 2010 ([click here for details](#)).

## Comparability analysis

The Court conducted a thorough review of the evidence presented by the taxpayer and the Commissioner regarding the validity of potential CUPs. This was uncommon in appeal cases where the focus is generally on the interpretation of the law rather than reviewing the facts of the case. In this appeal, the Court was of the view that there were flaws in the approach taken by Middleton J and therefore it was necessary for the Court to review the evidence and form its own conclusions on the facts.

The Court reviewed the evidence presented by the taxpayer and the Commissioner regarding the comparability of SNF France’s transactions with third parties. This included reviewing the transactions in the context of the five comparability factors set out in the OECD Guidelines (as this was the approach that the taxpayer’s expert witness had taken in his analysis).

The Court outlined its views on what is needed for a taxpayer to prove comparability, particularly in respect of functional comparability. The Court considered that it was sufficient to prove that SNF France’s independent customers were “distributors” (and

---

were not manufacturers or end users) of the products; no more detailed analysis of the functions, assets and risks of the independent parties was required.

The comparable transactions presented by the taxpayer included transactions between SNF France and third party customers in other countries. Consistent with the original judgement, the appeal decision accepted that there was evidence of a global market for the products imported by the taxpayer. On this basis, the Court concluded that the location of the customers would not impact the comparability of the transactions.

The decision noted that the ATO's interpretation of the standard of comparability required by the OECD Guidelines was too strict and would "set the bar at an unattainable height" for taxpayers to ever rely on the CUP method.

## Relevance of OECD Guidelines

The Court questioned the relevance of the guidelines to the interpretation of Australia's law (in the context of both Division 13 and the Double Tax Treaties). The Court confirmed again that the Vienna Convention was the starting point for matters of treaty interpretation. Based on that Convention, in order for the Commissioner to establish that the OECD Guidelines were relevant, it would have needed to provide evidence of one or more of:

- An agreement between the treaty partners which showed they agreed that the OECD Guidelines were relevant for interpretation of the particular treaty
- Evidence that the OECD Guidelines are applied in practice by the treaty partners when they are interpreting and applying the treaty
- Evidence of relevant rules of international law applicable in the relations between the treaty partners.

In this case, the Commissioner did not provide evidence that the OECD Guidelines are applied by the treaty partners in practice. This is not likely to be repeated. In future cases we expect the Commissioner would seek to provide evidence demonstrating that the OECD Guidelines *are* applied in practice by the Commissioner and by Australia's treaty partners when they are applying the Associated Enterprises article of the relevant treaty. This is unlikely to matter, however, because although not required to, the Court found that the OECD Guidelines would in fact result in the same outcome.

## Interpretation of Division 13

The relevant provisions for reviewing whether an acquisition of goods by an Australian taxpayer from an international related party is arm's length are contained within section 136AD of Division 13. Section 136AD(3) enables the Commissioner to make adjustments where the prices paid by a taxpayer "exceeded the arm's length consideration" that would have been agreed between independent parties. Section 136AD(4) provides the Commissioner the discretion to deem an amount as the arm's length consideration "where it is not possible or practicable" to ascertain the arm's length consideration.

---

The Commissioner contended that the “arm’s length consideration” relevant for the application of s136AD(3) must be determined by reference to transactions between independent parties with *all* of the same characteristics of the taxpayer. For example, the Commissioner considered that independent transactions would not be comparable to SNF Australia’s purchase transactions if the purchaser was not making losses.

The Court found that this approach was “deeply impractical” and was not the correct interpretation of s136AD(3) and s136AA(3)(d) (which defines what is meant by “the arm’s length consideration”). The Court supported the approach that comparable transactions do not need to be identical and that adjustments can be made to improve comparability. In fact, the OECD Guidelines acknowledge the possibility of differences when applying the CUP method and suggest that adjustments should be made where possible to create (or improve) comparability.

The Court took the view that the s136AD(3) wording “the arm’s length consideration” should not necessarily be read literally to refer to a single arm’s length price. The burden of proof on the taxpayer is to establish that it paid less than *an* arm’s length price; it does not need to establish a particular price as *the* arm’s length price.

The CUP analysis presented by the taxpayer covered less than 50% of the value of its purchases. The Court considered that, in the absence of any suggestion that transactions had been cherry picked to slant the analysis in the taxpayer’s favour, this was sufficient to form a conclusion for the entire value of related party purchases.

The Court concluded there was sufficient evidence available of comparable transactions to enable the arm’s length consideration to be determined and therefore the Commissioner should have considered this rather than applying the TNMM under s136AD(4).

In addition, the Court observed that the motives of the taxpayer were not relevant when applying Division 13. Rather, Division 13 requires analysis of whether the consideration for the transactions themselves was arm’s length.

## Evidentiary requirements

The judgement made extensive comments regarding the admissibility and sufficiency of evidence submitted by both the taxpayer and the Commissioner. The Court found fault and/or insufficiencies with evidence on both sides, and in some cases with the trial judge’s interpretation of that evidence.

There are lessons to be learned from this for the Commissioner and any taxpayers contemplating litigation in a transfer pricing matter in the future.

## What next

The Commissioner has 28 days to decide whether to seek special leave to appeal to the High Court. If an appeal is made, it would need to be based on the interpretation of the law.

It is standard practice for the Commissioner to issue a Decision Impact Statement, which will summarise the Commissioner’s response to the decision and his views on the wider implications of the decision for future cases. We do not expect this

---

statement to be issued until the Commissioner has decided whether or not to appeal against the decision.

In this case, the decision could have such a dramatic impact on the ATO's transfer pricing administration, guidance and practice that it is possible that the Commissioner will seek to revise the law. The decision has called into question not just the ATO's interpretation of Division 13, but also the more fundamental matter of the ATO's application of the arm's length principle. This suggests that even a change in law may not validate some aspects of the ATO's current practice.

## Practical implications for taxpayers

There is no indication yet that the ATO will change its day-to-day approach to reviewing transfer pricing matters as a result of this decision. It is likely the ATO will continue to use profitability as a key plank of its transfer pricing risk framework. However, it does add some weight to the view that not all of the ATO's transfer pricing views are consistent with the law and OECD Guidelines. This may give taxpayers more hope of being able to successfully challenge some of the positions taken by the ATO.

Taxpayers who have potential internal comparable transactions should review these carefully. There were specific factors which were considered critical for determining the validity of the comparables presented in this case, not least of which was the evidence demonstrating that there was a global market for the products involved in this case. As such, whilst transactional methods such as the CUP may generally be preferred by the Courts, the burden of proof remains on a taxpayer who wishes to apply the CUP method to conduct a thorough analysis to review whether the independent transactions are genuinely comparable. This may be a particularly worthwhile exercise if the taxpayer is subject to some form of transfer pricing review by the ATO.

The application of TNMM still has a place in Australian transfer pricing, even if there is no change to the law. For example, there will be many multinational groups which do not engage in comparable transactions with third parties or where branded products or market differences exist. In this situation, an alternative to the CUP method must be found and the TNMM is one such possibility. The decision gives some insights into the issues taxpayers will face in deciding to challenge a TNMM based assessment in the Australian courts.

This decision reinforces the findings in *Roche Products Pty Ltd v Commissioner of Taxation [2008]* that losses do not necessarily indicate incorrect transfer pricing. Taxpayers who incur losses should document the commercial and economic factors that have contributed to the losses. This decision may also have implications on the ATO's views on the "commerciality" of other related party dealings such as financial transactions.

## Conclusion

The SNF appeal decision is important for Australian taxpayers because it provides further enlightenment on the application of Australia's transfer pricing laws. The decision will be a significant blow to the ATO because it suggests that certain aspects of the ATO's approach to transfer pricing cases are inconsistent with the law and the

OECD Guidelines. While the ATO's response to *SNF* is not yet known, it is possible the ATO will need to revise its approach in light of this. Australian taxpayers should review their own circumstances and may need to reconsider their transfer pricing processes in light of *SNF*'s guidance on the standard of comparability that is required when applying the arm's length principle.

*For more information, please do not hesitate to contact:*

<i>Lyndon James</i>	<i>+61 2 8266 3278</i>	<i>lyndon.james@au.pwc.com</i>
<i>Paul McNab</i>	<i>+61 2 8266 5640</i>	<i>paul.mcnab@au.pwc.com</i>
<i>Zara Ritchie</i>	<i>+61 3 8603 6386</i>	<i>zara.ritchie@au.pwc.com</i>
<i>Ben Lannan</i>	<i>+61 7 3257 8404</i>	<i>ben.lannan@au.pwc.com</i>
<i>Garrick Robinson</i>	<i>+61 8 9238 3020</i>	<i>garrick.robinson@au.pwc.com</i>
<i>Amanda Hocking</i>	<i>+61 8 8218 7082</i>	<i>amanda.hocking@au.pwc.com</i>

This document is for general information purposes only, and should not be used as a substitute for consultation with professional advisors.

SOLICITATION

© 2011 PricewaterhouseCoopers LLP. All rights reserved. In this document, "PwC" refers to PricewaterhouseCoopers LLP, a Delaware limited liability partnership, which is a member firm of PricewaterhouseCoopers International Limited, each member firm of which is a separate legal entity.