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Court limits Australian Taxation Office's power to reconstruct related party transactions in transfer pricing disputes

In recent years, the Australian Taxation Office (**ATO**) has identified transfer pricing as a major focus of its compliance and review processes. In a speech delivered on 14 August 2019, Second Commissioner of Taxation Jeremy Hirschhorn reaffirmed that "transfer pricing (and avoiding transfer mis-pricing) is a key focus of the ATO given its criticality to the Australian taxation system."[1]

Since the ATO's win in the landmark 2017 Chevron case (*Chevron Australia Holdings Pty Ltd v Commissioner of Taxation* [2017] FCAFC 62), the ATO has asserted that it has a broad power to reconstruct and re-price related party transactions under Australia's transfer pricing rules.

In that case, the Full Federal Court rejected the taxpayer's argument that the ATO was limited to working out an arm's length interest rate on a Chevron intra-group loan by reference to the actual terms of the related party loan entered into by the parties, but could price it by adding terms as to security and repayment that arm's length parties would be expected to adopt. The case remains the leading authority on Australian transfer pricing law, but its application to other cases is not straightforward given the specific facts of the case.

On 3 September 2019, in the first major transfer pricing decision since the *Chevron* case, *Glencore Investments Pty Ltd v Commissioner of Taxation* [2019] FCA 1432 (Justice Davies), the Federal Court indicated the Commissioner's reconstruction power is much more limited than he may have thought.

Background

The main issue in the *Glencore* case was the pricing of an offtake agreement entered into by an Australian subsidiary to sell copper concentrate produced from its Australian mine to its Swiss parent company, Glencore.

The ATO took issue with Glencore changing from a 'market-related' contract to a form of agreement known as a 'price sharing agreement'.

Glencore was able to show that this form of contract was used in copper markets by unrelated parties. Nonetheless the ATO argued that an independent miner in the position of the Australian subsidiary would not have entered this kind of contract with an unrelated party.

The price sharing agreement included several features that the ATO argued would not have been agreed to by an independent miner, which the ATO said led to the Australian entity being underpaid almost AUD 241 million for its copper concentrate over three years. The ATO assessed it to additional tax, interest and penalties exceeding AUD 92 million.

[1] Jeremy Hirschhorn, 'Transfer pricing a key focus for ATO' (14 August 2019): https://www.ato.gov.au/Media-centre/Speeches/Other/Transfer-pricing-a-key-focus-for-ATO/

The ATO in effect sought to displace the actual 'price sharing' agreement entered into between the parties with a hypothetical, 'reconstructed' 'market-related' transaction that it argued would have been entered into by independent entities dealing with each other at arm's length.

The judge disagreed with the ATO, delivering a decision that has brought into question the ATO's approach in addressing other cases under its review, audit or subject to objections by taxpayers. At the date of writing, it has been suggested that the ATO will appeal the decision.

The arm's length principle and reconstruction

The arm's length principle in the OECD Transfer Pricing Guidelines uses the behaviour of independent parties as a guide or benchmark to determine the pricing of goods and services in international related party dealings. The ATO interprets the principle to mean that it involves comparing what a business has done and what an independent party would have done in the same or similar circumstances, and that this permits reconstruction of the terms of transactions where appropriate.

In *Glencore*, Justice Davies cautioned that the interpretation of Australia's domestic transfer pricing rules should be consistent with the arm's length principle outlined in OECD Transfer Pricing Guidelines. The judge referred to the OECD Transfer Pricing Guidelines, which limit a 'reconstruction' of the transaction to 'exceptional circumstances' such as where the form of the arrangement differs from the substance, or where the actual arrangement differs from those that would have been adopted by independent enterprises. The judge held that neither of these exceptions were applicable to this case.

Glencore argued that its agreements were consistent with copper concentrate market pricing structures and it tendered agreements between unrelated parties for the sale of copper concentrate with terms comparable to those adopted by Glencore. The judge held that this evidence had probative value and that, in this case, there was nothing to suggest that the pricing outcomes were inconsistent with outcomes under arm's length dealings between independent parties. The judge appeared to be persuaded by evidence that the price sharing arrangement was consistent with industry practice as a means of sharing and minimising risk at a time when market prices were unpredictable and volatile.

The key finding of the decision is that the ATO did not have the general power to assess the taxpayer based on a hypothetical agreement between 'abstract independent parties' that was different from the actual transaction entered into by the parties – the so-called power of 'reconstruction' was not available or appropriate on the facts.

In arriving at this conclusion, the judge made some important observations:

- It is sufficient if the actual price is within an arm's length range for the taxpayer to discharge its burden of proof – the pricing does not have to be perfect.

- Australia's transfer pricing rules do not require an inquiry into the commercial prudence of the actual related party transaction entered into by the parties.

- Hindsight cannot be used to second-guess the commercial judgment of the parties at the time. The price sharing agreement was a reasonable contract when entered. The fact that in retrospect it could be seen that the Australian entity may have made more profit if it had not moved to a price sharing agreement was irrelevant.

Broader implications for the mining and resources industry

More broadly, the decision brings into question the ATO's approach of relying heavily on a reconstruction approach in existing review, audit and objection cases before the ATO. On the facts of this case, at least, the circumstances did not satisfy the OECD Guidelines threshold for the ATO to adopt such an approach. Miners with offtake agreements that are consistent with industry practice, and which are priced within an arm's length range, may take some comfort from this case. However, miners with cross-border related party transactions should continue to comply with best practice transfer pricing documentation whilst all avenues of judicial appeal in this case have not yet been exhausted.

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