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Page status: **not legally binding**

Page 1 of 6

Public advice and guidance compendium – PCG 2019/1

This is a compendium of responses to the issues raised by external parties to draft Practical Compliance Guideline PCG 2018/D8 *Transfer pricing issues related to inbound distribution arrangements*.

This compendium of comments has been edited to maintain the anonymity of entities that have commented.

Summary of issues raised and responses

Issue No.	Issue raised	ATO response/Action taken
1	The Practical Compliance Guideline (Guideline) should explicitly state that it does not replace arm's length outcomes based on comparability.	<p>The Guideline provides transparency for the risk assessment framework we adopt for inbound distribution arrangements through the use of profit markers. These profit markers do not represent the arm's length outcome for individual taxpayer's circumstances.</p> <p>Additional statements have been included in the final Guideline to clearly delineate the risk assessment framework in the Guideline from the identification of the arm's length conditions as required under the law (refer to paragraph 9 of the final Guideline).</p>
2	Reliance on a one-sided transfer pricing risk assessment may yield inappropriate outcomes. The ATO should re-assess the Guideline profit markers in the context of global contributions to the value chain and the consolidated financial results of global businesses.	<p>The Guideline describes our current risk assessment practices for the purpose of allocating compliance resources and not the analysis relevant for determining the arm's length conditions.</p> <p>Paragraph 32 of the final Guideline provides that the ATO will take into account additional information, which may include the taxpayer's global supply chain and global profitability, when determining the level of follow-up compliance activity.</p>
3	To provide transparency, the ATO should publish the benchmarking exercise used to develop its profit markers,	We have increased the transparency of our risk assessment framework for inbound distribution arrangements with the publication of the final Guideline. We use the profit markers within

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Page status: **not legally binding**

Page 2 of 6

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	including the independent companies identified.	<p>the Guideline to assess risk for the purpose of allocating compliance resources and do not represent the arm's length outcome for individual taxpayer's circumstances.</p> <p>Publishing the underlying independent company data will increase the risk that the Guideline is wrongly perceived as a safe harbour/pre-determination of the arm's length conditions – without an appropriate benchmarking and comparability analysis as required under the law.</p>
4	The ATO's profit markers should include factors pertaining to the broader structure of the distribution arrangement, such as the location of the foreign associates and/or its treaty status.	The Guideline describes our current risk assessment practices specific to inbound distribution arrangements. Analysis of the functions, assets and risks, the tax profile and treaty status of foreign associates is undertaken as part of the broader risk identification process through other data we collect and will be included in the overall risk assessment framework undertaken by compliance teams.
5	The use of historic benchmarks to assess risk does not take into account the comparability factor of economic circumstances.	<p>As set out in the Guideline, the profit markers are not reflective of a comparability analysis and do not determine arm's length conditions (refer to paragraph 9 of the final Guideline). The ATO considers the use of historic data to be of assistance in assessing transfer pricing compliance risk for inbound distribution arrangements.</p> <p>It is proposed that updated profit markers will be published where analysis or further benchmarking indicates that there is a material movement in the information used to develop the profit markers.</p>
6	The ATO should consider other profit marker ratios, for example, Berry ratio, gross margins, profit before tax and return on expenses.	As set out in the Guideline, it is our view that an EBIT margin provides a reasonable basis for identifying risk associated with inbound distribution arrangements (refer to paragraph 34 of the

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Page status: **not legally binding**

Page 3 of 6

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		final Guideline).
7	The ATO should provide guidance on how the EBIT margin should be determined.	Paragraph 41 of the final Guideline notes that EBIT is based on reasonably reliable financial information that isolates the revenues and costs of the inbound distribution arrangement, which may be supplemented by statutory and/or management accounts (where available) in calculating the five year weighted average EBIT margin.
8	Taxpayers not considered as 'classic' distributors face uncertainty as to whether they fall within the scope of the Guideline.	<p>If the requirements of the Guideline are met, then the Guideline will apply regardless of how an entity describes itself (refer to paragraph 24 of the final Guideline).</p> <p>Paragraph 23 of the final Guideline notes that there is no bright-line test to define an inbound distribution arrangement. However, as with most transfer pricing questions, an element of judgement is ultimately required.</p> <p>Entities contacted by us, based on the risk assessment framework outlined in the Guideline, can notify us of their view on characterisation and the appropriate selection and application of an arm's length method as required under the law.</p>
9	The ATO should confirm if the Guideline applies in situations where an inbound distributor owns any product intangibles and/or undertakes development, enhancement, maintenance, protection and exploitation (DEMPE) activities.	<p>The Guideline may potentially apply where an entity owns or uses intangible assets. However, the Guideline notes that where distributors are undertaking significant DEMPE functions, the ATO may perceive a higher level of risk than suggested by the profit markers (refer to paragraph 46 of the final Guideline). The Guideline can apply where there is an inbound distribution arrangement and it:</p> <ul style="list-style-type: none"> fits the explanation of an inbound distributor in paragraphs 16-22 of the final Guideline, and

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Page status: **not legally binding**

Page 4 of 6

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		<ul style="list-style-type: none"> does not significantly transform goods as described in paragraph 25 of the final Guideline as part of the inbound distribution arrangement.
10	The Guideline should take into account the extent to which the entity carries out activities described in the higher categories.	<p>It is important to note that the Guideline is a risk assessment framework and not an assessment of the arm's length conditions. The Guideline's use of categories reflects our experience in differentiating risk. It is our view that certain activities affect risk for inbound distribution arrangements, in that they incrementally generate value.</p> <p>The industry schedules set out the activities that will prompt an inbound distribution arrangement to fall into the higher categories. The extent and economic significance of the activities will be considered and determined as part of a review of the arm's length conditions based on a comparability analysis.</p>
11	The industry schedules in the Guideline are defined too broadly and it may be difficult to determine the appropriate industry schedule to apply for an inbound distributor. For example, would a distributor selling printers and cameras apply the Information and Communication Technology (ICT) or General Distributor schedule?	<p>By the nature of transfer pricing risk and the challenges in characterisation, it is not possible to provide a bright line test covering every possible scenario. Consequently, any allocation into industry and categories will involve judgement and best endeavours.</p> <p>However, in relation to the example in the question, the ICT schedule is stated to apply to all types of hardware and software 'that enable interaction through technology'. It is unlikely that the ICT schedule will apply to printers and cameras. Rather, it is more likely that arrangements distributing these types of products will be covered by the General Distributors schedule.</p>
12	The ATO should include more guidance on the application of the Guideline for taxpayers needing to complete the	Agreed. We will develop further guidance to help affected taxpayers complete the reportable tax position schedule.

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	reportable tax position schedule.	This guidance will be placed on ato.gov.au .
13	The Guideline's risk zones should not adversely affect the taxpayer's ability to enter into an advance pricing arrangement (APA) with the ATO.	Paragraph 56 of the final Guideline states that regardless of their risk zone, inbound distributor taxpayers are able to seek to enter into discussions with us as part of the early engagement stage – consistent with the APA process as set out in Law Administration Practice Statement PS LA 2015/4 <i>Advance Pricing Arrangements</i> .
14	There is concern that the Guideline could influence the position adopted by the ATO with other revenue authorities for APA/mutual agreement procedure (MAP) cases. The ATO should seek feedback from other key tax authorities regarding the profit markers in the Guideline prior to finalisation.	We have determined the profit markers for the purpose of calibrating risk so as to effectively allocate our compliance resources. The analysis leveraged in setting the profit markers is specific to inbound distribution arrangements, and the profit markers are not designed to have application beyond inbound distribution arrangements in the Australian market. Publishing the final Guideline provides additional information to clients that may assist in forming a view as to whether to, or how best to, approach us in relation to a matter involving an APA or MAP.
15	The ATO should clarify the level of documentation required for each risk level (low/medium/high).	The Guideline does not limit the operation of the law, and it does not create new or different documentation requirements.
16	The Guideline does not acknowledge that losses can be driven by genuine commercial reasons rather than transfer pricing.	The Guideline seeks to provide broad administrative guidance conveying our assessment of relative levels of tax compliance risk. It is beyond the scope of this Guideline to offer a view on the commercial factors that may be relevant to a taxpayer's individual inbound distribution arrangement, as this would form part of a comparability analysis in the application of an appropriate transfer pricing method. Entities in an overall loss position for three or more years will ordinarily be prioritised for review. We encourage such entities to

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Page 6 of 6

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		prepare appropriate transfer pricing analysis and consider whether any adjustment of prior year positions for tax is necessary. This analysis will be taken into account as part of an ATO review.
17	There should be symmetry between the treatment of inbound distribution arrangements and outbound distribution arrangements (as covered in Practical Compliance Guideline PCG 2017/1 <i>ATO compliance approach to transfer pricing issues related to centralised operating models involving procurement, marketing, sales and distribution functions</i>).	The Guideline does not seek to treat the inbound distribution arrangement but rather it identifies potential risk for the purpose of determining the level of follow-up compliance activity. Specifically, the Guideline sets out profit markers that may indicate a risk that inappropriate levels of profit are being recognised in Australia. The benchmarking and industry case experience has assisted in setting the profit markers specific to inbound distribution arrangements. It therefore follows that our view of risk associated with inbound distribution arrangements is necessarily different to our view of risk associated with outbound arrangements, including marketing and procurement hubs.
18	Transitional arrangements require taxpayers to adjust their historic and prospective pricing to reflect 'an appropriate transfer pricing outcome'. Given the heading of the section (<i>Transitioning existing arrangements to the low risk zone</i>), it implies that taxpayers would need to adjust their returns to fall within the low risk zone.	Paragraph 64 of the final Guideline has been amended to refer to an appropriate transfer pricing outcome based on the law.