


ST 2374 - SALES TAX : SALES BETWEEN ASSOCIATED ENTITIES SALES BY INTERPOSED ENTITIES SALE OF GOODS NOT AT ARM'S LENGTH

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TAXATION RULING NO. ST 2374

SALES TAX : SALES BETWEEN ASSOCIATED ENTITIES
SALES BY INTERPOSED ENTITIES
SALE OF GOODS NOT AT ARM'S LENGTH

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F.O.I. INDEX DETAIL

REFERENCE NO:	SUBJECT REFS:	LEGISLAT. REFS:
I 1010127	SALES BETWEEN ASSOCIATED ENTITIES	SALES TAX ASSESSMENT ACTS: (NO.1): SUB-SECTION 18(4), 18(5B)
	SALES BY INTERPOSED ENTITIES	(NO.2): SUB-SECTION 4(4) (NO.3): SUB-SECTION 4(4)
	SALE OF GOODS NOT AT ARM'S LENGTH	(NO.6): SUB-SECTION 4(2) (NO.7): SUB-SECTION 4(2)

PREAMBLE The general principle underlying sales tax is that it is a single-stage tax on goods designed to fall at the wholesale level on the value of goods at the time of their final sale by wholesale, i.e. by a wholesaler to a retailer.

2. A retailer may sometimes attempt to defer the payment of sales tax from the time the goods are purchased to the time they are sold, by interposing a related wholesale entity between itself and its normal wholesale suppliers. The interposed wholesaler purchases goods under quotation of certificate and releases them under a bailment/consignment arrangement to the retailer. The sale by the interposed wholesaler to the retailer (which is the transaction attracting the payment of sales tax) is delayed until after a retail purchaser has been found, but immediately before the actual retail sale. The goods are often sold by the interposed wholesaler to the retailer for the same amount paid to the independent wholesale supplier, and that is the amount on which sales tax is paid. In other cases the goods may be marked up by a small margin to cover the costs of the interposed wholesaler.

3. Deferral of sales tax is not the only reason for entering into these or similar types of arrangements. Sometimes there is an element of attempted tax minimisation involved; in other cases tax avoidance has been present. An example of the former is the case where a manufacturer, formerly selling its goods exclusively by retail, interposes an associated retail entity between itself and its customers. This converts the position to that of a manufacturer selling by wholesale. The sale value of the manufactured goods, previously (broadly speaking) the equivalent wholesale value of the goods

under sub-paragraph 18(1)(b)(ii) of Assessment Act (No.1), becomes the actual selling price to the associated retailer, under paragraph 18(1)(a). Tax can be minimised by the associated retail company bearing costs associated with the manufacture of the goods with the result that the sale value on which tax is payable, i.e. the selling price from the manufacturer to the associated retailer, is suppressed. Tax avoidance arrangements have included those in which associated entities have interposed between themselves a third party which, at least as far as shareholding and control are concerned, is associated with neither the vendor nor the purchaser. Tax is avoided by suppressing the sale value through the shedding of profits to the associated retail entity. That is, the goods are sold to the interposed company at a suppressed price which in turn sells to the associated retail company at the same price, the retail company taking all of the profit.

4. These and similar arrangements (which have become increasingly widespread in recent times) bring into play the application of certain sale value provisions in the sales tax law, i.e. sub-section 18(4) of the Sales Tax Assessment Act (No.1), 4(4) of the Sales Tax Assessment Acts (Nos 2 and 3) or 4(2) of the Sales Tax Assessment Acts (Nos 6 and 7). These provisions are referred to in this Ruling as "the relevant provisions". This Ruling is concerned with the general principles to be taken into account when determining the sale value of goods sold in circumstances where the relevant provisions apply.

LEGISLATION

5. The relevant provisions were introduced into the sales tax law in 1978. They were enacted to strengthen the previous law which related solely to sales between associated entities. Sub-section 18(4) reads :-

"Where -

- (a) goods (in this sub-section referred to as the "relevant goods") have been sold after 20 September 1978 by the manufacturer by wholesale to an unregistered person or to a registered person who has not quoted his certificate in respect of the sale;
- (b) the Commissioner is satisfied that, having regard to any connection between the manufacturer and the purchaser of the relevant goods or to any other relevant circumstances (including circumstances arising out of any agreement entered into between the manufacturer and the purchaser, or out of any other agreement, that was related, directly or indirectly, to the sale of the goods), the manufacturer and the purchaser were not dealing with each other at arm's length in relation to the transaction; and
- (c) the Commissioner is also satisfied -
 - (i) that the amount for which the relevant goods were sold is less than the amount (in this

sub-section referred to as the "arm's length price") for which, in the opinion of the Commissioner, the relevant goods could reasonably be expected to have been sold if the manufacturer and the purchaser had been dealing with each other at arm's length in relation to the transaction; or

(ii) that -

(A) the purchaser could have purchased identical goods from another manufacturer by wholesale and obtained delivery of the identical goods at or about the time when the purchaser obtained delivery of the relevant goods; and

(B) the amount for which the relevant goods were sold is less than the amount (in this sub-section referred to as the "alternative price") for which, in the opinion of the Commissioner, the identical goods could reasonably be expected to have been sold to the purchaser, the Commissioner shall alter the sale value of the relevant goods to the amount ascertained in accordance with the following paragraphs :

- (d) if the Commissioner is satisfied as to the matter mentioned in sub-paragraph (c)(i) but not as to the matters mentioned in sub-paragraph (c)(ii) - an amount equal to the arm's length price;
- (e) if the Commissioner is satisfied as to the matters mentioned in sub-paragraph (c)(ii) but not as to the matter mentioned in sub-paragraph (c)(i) - an amount equal to the alternative price;
- (f) if the Commissioner is satisfied as to the matter mentioned in sub-paragraph (c)(i) and also as to the matters mentioned in sub-paragraph (c)(ii) - an amount equal to the lesser of -
 - (i) the arm's length price; and
 - (ii) the alternative price."

There are minor differences in expression in the other Assessment Acts to take into account the transactions the particular Act is dealing with but broadly the relevant provisions are expressed in similar terms to sub-section 18(4).

6. Put simply the provisions require the Taxation Office to alter the sale value of taxable goods where certain conditions apply to a sale between parties who are not dealing with each other at arm's length in relation to the particular transaction. If the selling price is less than the arm's length price but is not found to be less than the alternative price, then the sale value is required to be altered to the arm's length price. If the selling price is less than the alternative price but is not found to be less than the arm's length price, then the sale value is required to be altered to the alternative

price. If the selling price is less than both the arm's length price and the alternative price, then the sale value is required to be altered to the lesser of the arm's length price and the alternative price.

7. The purpose for which the particular arrangements have been made is not a material factor in considering whether the relevant provisions apply. Whether the purpose is tax deferral, tax minimisation, tax avoidance or some other purpose, and whether or not the arrangements are commercially justifiable, the relevant provisions apply if each of paragraphs (a), (b) and (c) is satisfied.

RULING **The Arm's Length Price**

8. The arm's length price is defined in the relevant provisions as "the amount...for which, in the opinion of the Commissioner, the relevant goods could reasonably be expected to have been sold if [the vendor] and the purchaser had been dealing with each other at arm's length in relation to the transaction".

9. The arm's length price of goods would generally be expected to bear as close a relationship as possible to the prices that are or would be charged for actual arm's length sales. Factors such as the circumstances in which the sale is made, the buying power of the customer and other relevant factors that may affect the price of goods should be taken into account in determining the appropriate arm's length price.

10. Not all prices charged to unrelated purchasers are suitable for adoption in respect of sales to an associated retailer. Some prices may be influenced by special factors in the trading arrangements between the taxpayer and the customer, or in the circumstances of the taxpayer's business operations. Where, for example, a taxpayer sells to unrelated customers at certain prices which return a reasonable level of profit, but because of idle capacity or the need to reduce the level of inventory, negotiates with another unrelated customer a lower price which does not return the normal level of profit (or may not break even), this latter price would not be a suitable arm's length price for the purposes of the relevant provisions.

11. The arm's length price needs to be determined according to the facts of the particular case. Where a retailer has interposed a related wholesaler between itself and its former suppliers, or a manufacturer has interposed a related retailer between itself and its former customers, the arm's length price would generally be expected to be sufficient to cover all expenses of conducting the manufacturing or wholesaling operation (including, where appropriate, expenses borne by the retailer which relate to the manufacturer's or the wholesaler's business) and a reasonable level of profit. The level of profit sought to be achieved by a competitor (roughly equivalent in size, turnover, and range of activity) in its dealings with unrelated customers is one of the material factors to be taken into account in determining what, in all the circumstances, amounts to a reasonable level of profit. An interposed wholesale entity, or a manufacturer, which sells goods at cost to its associated retailer would normally be considered to be selling at a price which is less than the arm's length price of

the goods. A taxpayer could not reasonably be expected to sell goods, on a regular and on-going basis to parties with whom it is dealing at arm's length, for the same price as that for which it purchased or produced them.

The Alternative Price

12. Only if the purchaser "could have purchased identical goods from another [vendor] by wholesale and obtained delivery of the identical goods at or about the time when the purchaser obtained delivery of the relevant goods" can there be an alternative price, defined as "the amount...for which, in the opinion of the Commissioner, the identical goods could reasonably be expected to have been sold to the purchaser".

13. A reference to identical goods is to be read as a reference to goods identical in all material respects with the goods in relation to which the expression is used : sub-sections 18(7) of Assessment Act (No.1), 4(8) of Assessment Acts (Nos 2 and 3) and 4(5) of Assessment Acts (Nos 6 and 7). It is not necessary for the goods to be identical in all respects but they must be identical in all material respects.

Of course, if the very same goods are available, then they will fit the description "identical goods" and no further enquiry on this aspect of the "alternative price" question will be necessary. However, if the very same goods are not available, then the quality and reputation, as well as the physical characteristics, of the other goods should be taken into account in determining whether they are "identical goods" for the purposes of sub-paragraph (c)(ii) of the relevant provisions.

14. A taxpayer (or the purchaser from a taxpayer) who is able to establish the existence of identical goods, is next required to establish that delivery of the identical goods could have been obtained at or about the time when the purchaser obtained delivery of the relevant goods. Delivery takes place when (but not only when) physical possession of goods is transferred from one person to another. However, in the case of bailment/consignment arrangements of the kinds referred to in paragraph 2 above, there is not only an actual delivery of the goods when they are first bailed to the retailer; there is also a constructive delivery to the retailer when the retailer becomes the owner of the goods (i.e. immediately before the retailer sells to customers). In this special case where a bailment/consignment arrangement was in force between the interposed wholesaler and the retailer, it is at or about the time when the retailer obtained constructive delivery under the contract of sale with the wholesale supplier that it must be established that the retailer could have obtained delivery of the identical goods.

15. The third requirement is the existence of an eligible alternative supplier. The view taken by the Taxation Office is that an alternative supplier will be eligible only where, if that supplier were to sell identical goods to the purchaser from the taxpayer, the supplier would be liable to sales tax under the same Assessment Act as the taxpayer. It follows that, where a retailer has interposed a wholesale merchant between itself and its previous suppliers, those previous suppliers to the retailer will generally stand too early in the marketing chain and will therefore be ineligible as alternative suppliers.

Furthermore, an alternative supplier will be accepted as eligible only if -

- (a) the supplier is at arm's length from, and deals at arm's length with, the retailer; or
- (b) where the supplier and the retailer do not deal with each other, indications are that if they did, they would deal at arm's length.

16. In summary, then, there are three pre-requisites for an alternative price : first, the existence of identical goods, by reference to the criteria mentioned in paragraph 13; secondly, the availability of those goods at or about the time of delivery of the relevant goods to the retailer (paragraph 14); and thirdly, the existence of an eligible alternative supplier, by reference to the criteria mentioned in paragraph 15. Failure to satisfy any one or more of these pre-requisites will result in a finding that there is no alternative price.

17. However, in the event that all three pre-requisites are satisfied, there will be an alternative price of the relevant goods. In arriving at that price, it will be proper to take into account, in an appropriate case, any or all of the following matters:-

- (a) whether the price of the relevant goods has risen since the retailer became the bailee of them;
- (b) whether the retailer, because the identical goods would be purchased in small quantities, might not be entitled to discounts for quantity purchases;
- (c) whether the retailer might be expected to pay a surcharge for immediate delivery of goods from an alternative supplier; and
- (d) any other relevant matter which could reasonably be expected to affect the price of the identical goods.

CONCLUSION

18. The end result is that in virtually all cases the cost price of goods to the vendor will not be an acceptable sale value for sales between associated entities. It is considered that the application of the relevant provisions requires a sale value above cost. The amount by which the sale value will exceed cost will depend on the facts of the case as applied to the principles outlined above. However, a broad indication of an acceptable sale value to the Taxation Office for sales between associated entities where the interposed wholesaler is at arm's length with the supplier will be the purchase price of the goods plus costs incurred by the interposed wholesaler in dealing with those goods (e.g. inwards freight, insurance, financing costs, administrative costs and other company costs) plus 10%. While this value would be acceptable in most cases it is not an absolute value. In some cases an acceptable sale value may exceed the amount of cost plus expenses plus 10% because the goods concerned are ordinarily subject to higher margins. It will be a matter of determining whether on the

facts of the case a 10% mark-up is too low. On the other hand a 10% mark-up may be excessive, particularly in industries which operate on low profit margins. Again it will be a question of establishing whether the 10% is excessive and, if so, what an appropriate mark-up would be.

19. Where the interposed wholesaler is involved directly in the importing of goods, again a broadly acceptable sale value for sales to the associated retailer will be landed cost plus costs incurred by the interposed wholesaler as outlined above plus 10%, subject to the position that in particular fact situations a higher or lower percentage mark-up may be more appropriate.

20. Nothing in paragraphs 18 or 19 is intended to affect the position in those industries which operate interposed wholesale companies but where sales tax is paid on a sale value (sometimes referred to as a "uniform sale value") determined by agreement with the Taxation Office. An example of such an agreement is that which exists in the motor vehicle industry, where tax is paid on passenger vehicles, for example, on a sale value equal to list price less 22.5%. The agreement between the motor vehicle industry and the Taxation Office although not in writing is comparable to a sub-section 18(5B) agreement. Sub-section 18(5B) allows the Commissioner to enter into an agreement with a taxpayer on the fixing of sale values and an agreement reached under sub-section 18(5B) overrides all other sale value provisions. The uniform sale value determined for the motor vehicle industry is therefore not affected by the operation of sub-section 18(4).

21. Where associated entities interpose between themselves a third party which is associated with neither the vendor nor the purchaser, cost price to the interposed entity will often be a meaningless value because the essence of the scheme is to understate the value of the goods when sold to that entity under quotation of certificate. The selling price of the goods when sold by the interposed entity would normally be less than both the arm's length price and the alternative price (if there is one) and in this event the sale value will be increased to the lesser of the two. In these instances the sale value will be determined on the facts of each case. There is no scope for an across-the-board sale value because of the variable cost base.

COMMISSIONER OF TAXATION
26 November 1987