PCG 2017/1 - ATO compliance approach to transfer pricing issues related to centralised operating models involving procurement, marketing, sales and distribution functions

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Relying on this Guideline

This Practical Compliance Guideline sets out a practical administration approach to assist taxpayers in complying with relevant tax laws. Provided you follow this Guideline in good faith, the Commissioner will administer the law in accordance with this approach.

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Offshore Marketing Hub Risk Assessment Framework Attachment A

Offshore Non-Core Procurement Hub Risk Assessment Framework Attachment B

What this Guideline is about

1. This Practical Compliance Guideline (Guideline) sets out the Australian Taxation Office's (ATO's) compliance approach to transfer pricing issues related to the location and relocation of certain business activities and operating risks into a centralised operating model.

2. The type of activities commonly centralised include marketing, sales and distribution functions although centralised operating models are not necessarily limited to these functions. For the purposes of this Guideline, these centralised operating models are referred to as 'hubs'. Hubs' as defined are multi-faceted arrangements and we recognise that hubs will differ.

3. The ATO understands that the overall structure of hubs, the transactions that flow in and out and the diversity and sophistication of a hub's dealings contribute to increased complexity and higher costs for tax compliance. This Guideline is designed to help you manage the compliance risk and therefore the compliance costs associated with your hub.

4. You can use the framework set out in this Guideline to:

   (a) assess the compliance risk of the transfer pricing outcomes of your hubs in accordance with the ATO's risk framework

   (b) understand the compliance approach that the ATO will likely adopt having regard to the risk profile of your hub

   (c) work with the ATO to mitigate the transfer pricing risk in relation to your hub and be confident you have reduced your risk exposure, and

   (d) understand the type of analysis and evidence the ATO would require when testing the outcomes of your hub.

5. This Guideline provides a self-assessment risk framework that allows you to assess your transfer pricing outcomes using the ATO's risk framework. You will not need ATO input or sign off on your risk rating. However, you may be asked to tell us if you have self-assessed your rating and if so, what your risk rating is. This will allow the ATO to differentiate risk, prioritise our compliance resources and tailor our engagement with you according to your hub risk profile.

6. Our engagement with you will be tailored having regard to your hub's risk rating. If your hub is assessed as being in the low risk zone you can expect that the ATO will not generally apply compliance resources to test and assess the transfer pricing outcomes of your hub. If your hub falls outside the low risk zone, you can expect that the ATO will monitor, test and/or verify the transfer pricing outcomes of your hub. Hubs with a high risk rating will be reviewed as a matter of priority.

7. There is no presumption that because your hub is outside the low risk zone that your transfer pricing outcomes are incorrect, rather it means that the ATO considers that you are at risk of obtaining a transfer pricing benefit and therefore the ATO may conduct further compliance activity to test the outcomes of your hub. In these circumstances you should ensure that you have transfer pricing documentation and supporting evidence commensurate to the risk profile of your hub. As a general proposition, the higher your risk rating the more detailed and comprehensive we would expect your transfer pricing documentation and supporting evidence to be.

8. The transfer pricing methods used in the risk framework in this Guideline are for risk assessment purposes only and there is no requirement that you use these methodologies when pricing your hub arrangements. Consistent with the *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010* (OECD guidelines), when pricing your arrangements you should use the transfer pricing methodology (or combination of methodologies) that is most appropriate and reliable for your circumstances.[1] If your hub is subject to further review you can expect that we will test the actual pricing outcomes of your arrangement and will apply the most appropriate transfer pricing methodology for your particular circumstances (which may be different from the methodologies used as the risk benchmarks in this Guideline). The ATO is not limited by this risk framework when testing the actual conditions and pricing of your hub.

9. The ATO prefers to take a 'prevention before correction' compliance approach and we are committed to working with you to help you to mitigate your transfer pricing risks. Therefore, if you are unsure about your transfer pricing treatment or you would like certainty in relation to your arrangements, you should contact the ATO for assistance.

Structure of this Guideline

10. This Guideline is structured as follows:

(a) Part A sets out the general indicators and principles of the hub risk framework. These principles are relevant to all types of offshore hubs and apply to both outbound and inbound goods and commodity flows

(b) Part B provides guidance to assist you when preparing your transfer pricing analysis if you are outside the green zone, and

(c) schedules attached to this Guideline set out specific indicators relevant to particular types of hubs.

11. You will need to read and apply the general principles set out in Part A of this Guideline together with the specific risk indicators relevant to your type of hub.[2] For example, Schedule 1 applies to offshore marketing hubs. If you have an offshore marketing hub (as defined in the schedule) you can use the indicators in that schedule, together with the principles in this Guideline, to risk assess your hub. However, the indicators only apply to offshore marketing hubs and cannot be used to risk assess other types of hubs. It is intended that over time additional schedules will be added for other types of hubs (for example, procurement hubs).

12. This Guideline does not provide advice or guidance on the technical interpretation or application of Australia's transfer pricing rules.

[1] Paragraph 2.2 of the OECD guidelines.
[2] These schedules will be developed and added over time (that is, there may not currently be a schedule relevant to your type of hub).

Date of effect

13. This Guideline will have effect from 1 January 2017 and will apply to existing and newly created hubs.

14. The schedules will have effect from the date of effect stated in each schedule.

15. The use and application of this Guideline will be under continuous review over the next three years. Any revisions to improve its efficacy will be made at the end of the review period or on an 'as necessary' basis. We will consult with you in relation to proposed material changes.

PART A: THE HUB RISK FRAMEWORK

The business models

16. The structures put in place to facilitate centralised operating models may take a wide range of legal forms. For hubs the basic business models involve the 'greenfields' establishment or 'brownfields' use of a related party entity (or entities), which acts as a principal or agent in relation to the procurement or sale of goods or commodities by or on behalf of an Australian resident multi-national enterprise (MNE) without substantially altering the goods or commodities. Activities undertaken and risks assumed by the related party hub entity are usually rewarded by way of a fee or discount on the price of the underlying goods or commodities being purchased or sold.

17. It is usually the case that the arrangement is predicated on a commercial rationale.[3] For example:

(a) efficiencies and synergies for the global group through centralisation of activities by, for example, the removal of duplication of the procurement or sales functions in multiple jurisdictions

(b) an ability to access economies of scale in the procurement of third party services (such as freight) or other production inputs, and

(c) benefits associated with key staff being located 'close to market' – for example, where aspects of the 'marketing function' (broadly defined) are centralised and conducted through an intermediary located in a jurisdiction closer to major markets and customers.

18. The specific legal form and underlying substance of a given arrangement are critical to an understanding of the appropriate tax treatment. Although compliance with Australia's transfer pricing rules is the primary tax risk in focus in this Guideline, it may be the case that other provisions (such as Australia's capital gains tax; controlled foreign corporations, the general anti-avoidance rules and the proposed diverted profits tax) are also relevant.

19. Significantly, this Guideline is premised on the basis that your hub has commercial and economic substance. The comments and guidance provided by Taxation Ruling TR 2014/6 *Income tax: transfer pricing – the application of section 815-130 of the Income Tax Assessment Act 1997* will assist you in this regard. In particular, you should pay close attention to whether any of the exceptions to the basic rule apply to your circumstances and consider adjusting your arrangement as appropriate (refer to paragraphs 44 to 61 of TR 2014/6).

[3] There is no separate discussion here setting out differences in the commercial drivers and impact of inbound (for example, procurement hubs) and outbound (for example, marketing and sales hubs) service. Questions regarding the commercial drivers and impact may be different (for example, for procurement hubs, questions may arise as to how the synergistic benefits to the MNE group from the 'group buying' activities of a procurement hub should be accounted for). The different models may also involve different tax issues.

20. If your arrangement is one that independent entities would not have entered into or one that would have been entered on different commercial or financial relations, then this Guideline will not apply to your circumstances.

The ATO's role

21. The 2013 amendments to Australia's transfer pricing rules place an onus on Australian taxpayers to self-assess their compliance with these rules on the basis that the arrangement represents a set of 'arm's length conditions' and do not result in the Australian taxpayer getting a transfer pricing benefit.

22. In the first instance, Australian taxpayers are required to structure and price their commercial arrangements in a way that reflects the commercial and financial conditions and self-assess whether these conditions differ from a set of 'arm's length conditions'; the role of the ATO as the administrator is to test the outcomes of taxpayers' arrangements to ensure compliance with the transfer pricing rules. Testing the results implied by a taxpayer's transfer pricing method through the use of a different transfer pricing method, and/or through the examination of different comparable arrangements or entities, is standard administrative practice when conducting transfer pricing risk analyses.

The ATO's compliance approach

23. The ATO intends to concentrate its efforts on international related party dealings that pose the highest risk of not complying with the transfer pricing rules.

24. We understand that many of you who undertake dealings via a hub want to comply and want to be confident that how you have complied will not increase your exposure to costly compliance examination of your transfer pricing treatment. We are committed to assisting you to assess your risk exposure to compliance action and to work with you to mitigate any potential risk of not complying with Australia's transfer pricing rules.

25. This Guideline identifies and describes the features and attributes (scenarios) of hubs that are considered by us as low risk of not complying with the transfer pricing rules.[4] Following this Guideline does not limit or waive the operation of the law[5] but acknowledges that should you choose to follow this Guideline and align your hub, or your hub already aligns, with the specific low risk indicators set out in this Guideline and associated schedules then we will generally not allocate compliance resources to examine the transfer pricing outcomes of your hub.

26. Importantly this Guideline does not constitute a 'safe harbour' and the information provided in this Guideline does not replace, alter or affect in anyway the ATO interpretation of the relevant law as discussed in various taxation rulings. It does not relieve you of your obligation to self-assess your compliance with all relevant taxation laws but is designed to give you confidence that if you follow this Guideline we will generally not allocate compliance resources to test the transfer pricing outcomes of your hub.

27. Australia's transfer pricing rules set out in domestic law (Subdivisions 815-B, 815-C and 815-D of the *Income Tax Assessment Act 1997* (ITAA 1997)) do not differentiate between inbound and outbound dealings. It is therefore important to emphasise that the ATO's interpretation and application of the provisions does not (because it cannot) differentiate between scenarios involving inbound or outbound arrangements and transactions.

[4] Guidance to ATO officers on the exercise of the Commissioner's powers of general administration is set out in Law Administration Practice Statement PS LA 2009/4 *When a proposal requires an exercise of the Commissioner's general powers of administration*.

[5] Specifically, this document is not a public ruling for the purposes of Division 358 of Schedule 1 to the *Taxation Administration Act 1953 (TAA)*.

THE HUB RISK ASSESSMENT FRAMEWORK

28. If you have a hub you are able to use the principles in this Guideline to self-assess your compliance risk. The hub risk framework is made up of six risk zones:

(a) White zone – self-assessment of risk rating unnecessary

(b) Green zone – low risk

(c) Blue zone – low to moderate risk

(d) Yellow zone – moderate to high risk

(e) Amber zone – high risk, and

(f) Red zone – very high risk.

29. You work out your risk rating for your hub having regard to a number of factors including pricing indicators, possible tax at risk and the quality of your transfer pricing documentation. These are discussed in more detail below.

Do you need to self-assess your risk rating?

30. In certain circumstances, it is not necessary to self-assess the risk rating of your hub. Generally speaking, this will be the case where the ATO has already reviewed your hub and the transfer pricing outcomes have been agreed, are considered low risk or are otherwise resolved.

31. More specifically, it will not be necessary to self-assess the risk rating of your hub if in relation to your hub one of the following applies:

(a) you have an Advance Pricing Arrangement (APA) that applies to the current year, or

(b) there is a settlement agreement between you and the ATO that applies to the current year, or

(c) a court decision was handed down within the last two years dealing with the transfer pricing outcomes of your hub, or

(d) the ATO has conducted a review of your hub in the last two years and provided you with a 'low risk' rating,

AND

There has not been a material change in pricing, comparability factors and/or the functions, assets and risks of the hub since the period reflected in the agreement, decision or review.

32. When determining if you have received a low risk rating from the ATO (as per paragraph 31(d) of this Guideline), you should only consider risk ratings provided after this Guideline has come in to effect. A risk rating may be provided by the ATO through traditional review or audit activities or alternatively, via 'sign-off' letters provided under programs such as an Annual Compliance Agreement or a Pre-lodgment Compliance Review. You will satisfy the criteria if the letter explicitly provides a low risk rating for the transfer pricing aspects of your hub.

33. If you meet one of the criteria above you do not need to apply the self-assessment framework in this Guideline and you will be taken to be in the white zone.

34. If you are in the white zone, ATO compliance activity will depend on your particular circumstances. For example, if you have an APA you may be subject to the Annual Compliance Review process. Ordinarily you will be advised by the ATO of what future activities may be conducted at the conclusion of your matter. If you are unsure you should discuss your circumstances with the ATO.

35. You will also be in the white zone and therefore you will not need to self-assess your risk rating, if you meet the criteria for the simplified transfer pricing record keeping materiality option and you have notified the ATO via the international dealings schedule (IDS) that you have opted in for the current year.[6] Other simplified transfer pricing record keeping options that may be relevant to specific types of hubs will be addressed in the schedule relevant to that type of hub as necessary.

36. Even if you are in the white zone, you are still required to assess your compliance with the transfer pricing rules in Division 815 of the ITAA 1997.

37. If you do not meet the criteria for being in the white zone you should consider the following sections on how to work out the risk rating for your hub.

How to work out if you are in the green zone

38. To assess if you are in the green zone, you will need to test your arrangements using the methodology set out in the schedule relevant to your type of hub and compare the outcomes against the ATO risk benchmarks provided in that schedule. For example, if you have an offshore marketing hub you will apply the low risk benchmark in schedule 1 to your hub.

39. It is important to note that although the schedules set out methodologies to test the pricing outcomes of your hub, the use of these methods do not imply that the ATO is advocating the use of that particular method as a preferred price-setting transfer pricing method. Rather, it is used as a way for the Commissioner to cross-check the reliability of other methods and the reasonableness of the outcomes of your price-setting method. In accordance with OECD principles, when conducting your transfer pricing analysis you should use the method (or combination of methods) that is most appropriate and reliable for your circumstances.

40. If the outcome of the testing process is equal to or less than the low risk benchmark for your particular type of hub, you will be taken to be in the green zone for the year.

41. If your pricing outcomes are below the low risk benchmark this does not suggest that you can reprice your arrangement up to the benchmark. The ATO will monitor outcomes for hubs to ensure that there isn't a 'drift' up to the benchmark. If we identify a drift, we may seek to understand the facts of your hub further. If we see an increase across the market more broadly we may also revisit the risk benchmark, however, as noted earlier in this Guideline, we will consult with you if we propose to make changes to the risk benchmark.

42. If the testing process shows outcomes greater than the low risk benchmark, or you are unable to, or choose not to apply the relevant methodology to test your arrangement, you will be taken to be outside the green zone. In these circumstances you should consider the additional risk indicators below to establish the risk rating of the hub.

[6] See Practical Compliance Guideline PCG 2017/2 *Simplified Transfer Pricing Record Keeping Options*.

Outside of the green zone – additional risk indicators

43. If you work out that your hub's potential risk is outside the green zone there is no presumption that your hub arrangement is priced incorrectly. What it means is that we consider you are at risk of getting a transfer pricing benefit. Therefore, we will generally conduct some form of compliance activity to further test the pricing outcomes.

44. To enable us to prioritise and allocate our resources to those cases that exhibit the greatest risk, we further delineate between cases outside the green zone. This further categorisation is determined having regard to the following risk indicators:

(a) the tax impact of your hub arrangements for the relevant year, and

(b) whether you have transfer pricing documents and whether your documents meet the requirements of Division 284-E of Schedule 1 to the TAA.

45. The tax impact of your arrangement will provide your 'base rating'. However, this rating may be adjusted having regard to your transfer pricing documents to give you your final risk rating. The final rating will be the risk rating of your hub.

46. This process is discussed in more detail below and is also set out in the relevant risk assessment diagrams in the schedules.

Determining your base rating

Calculating the tax impact

47. The tax impact provides an indication of the potential tax at risk. You will need to determine the tax impact for each of your hubs separately.

48. Where you have multiple hubs the ATO may take into account the total combined tax impact of your hubs when prioritising our compliance resources.

49. Further details as to how to calculate the tax impact are provided in the relevant schedules.

Unable to apply the ATO risk methodology or calculate the tax impact

50. If you are unable to apply the ATO risk benchmarks set out in the schedules or calculate the tax impact for your hub, you are encouraged to contact the ATO to discuss your arrangement. If you do nothing your hub will be rated as being in the red zone, meaning it will be rated as being 'very high risk'.

51. The ATO recognises that some taxpayers may not be able to apply the methodologies for sound reasons and that it may be inappropriate to rate these arrangements as being in the red zone. For example, if you have a global offshore marketing hub that does not have differentiated cost accounting records in terms of Australia or geographic regions, you may find it cost prohibitive to apply the risk benchmark. In these circumstances you are able to reduce your risk rating if you satisfy certain criteria.

52. Specifically, you are able to reduce your risk rating from the red zone to the amber zone if you:

(a) meet the transfer pricing criteria in paragraphs 55 to 59 of this Guideline

(b) provide a copy of your transfer pricing documentation (including details of your global value chain) to the ATO on or before you lodge your income tax return for the current year, and

(c) provide all other information requested by the ATO.

53. The ATO's purpose in obtaining the above information is to allow us to conduct further risk assessment activities and prioritise our compliance resources accordingly.

54. Further details are provided at paragraph 130 of this Guideline as to how you can contact the ATO to discuss your arrangement and or provide relevant documents. You should also consider the section dealing with transfer pricing documentation in Part B of this Guideline.

Adjusting the base rating

Transfer pricing analysis and supporting documentation

55. Whilst there is no statutory requirement for you to have transfer pricing documentation beyond your normal record keeping obligations[7], if you do not meet the transfer pricing documentation requirements in Subdivision 284-E of Schedule 1 to the TAA and the Commissioner makes a transfer pricing adjustment, you will be taken to a have an undocumented transfer pricing treatment and precluded from taking a reasonably arguable position in regard to that transfer pricing treatment for the purposes of administrative penalties.[8]

56. The Commissioner views Subdivision 284-E of Schedule 1 to the TAA as an incentive for taxpayers to make a serious and genuine effort to correctly self-assess their tax positions under the transfer pricing rules and for that effort to be evidenced by documenting the transfer pricing treatment before filing their income tax returns for a given year.

57. Consistent with this approach the Commissioner regards the existence and quality of transfer pricing documents as being critical to the assessment of risk related to hubs that are outside the green zone.

58. You will satisfy this indicator if you have transfer pricing documentation and your documents meet the requirements set out in TR 2014/8. For the purposes of the hubs risk framework in this Guideline, whether you meet the requirements in TR 2014/8 is self-assessed by you.

59. If you do not have transfer pricing documents or they do not meet the criteria in TR 2014/8, the Commissioner considers that you are at high risk of not correctly self-assessed your tax position. In these circumstances, if your base rating is in the yellow or amber zones you will move to the red zone. If your base rating is in the blue zone you will be taken to be in the yellow zone (rather than the red zone).

How to decrease your risk rating

60. If you are outside the green zone and would like to decrease your risk rating, you are able to do so by engaging cooperatively and constructively with the ATO to gain greater confidence in relation to the transfer pricing outcomes of your hub. You will be able to move to the white zone if your case is resolved in a way that meets the criteria for the white zone (refer to paragraph 31 of this Guideline). If you move to the white zone it is not necessary for you to self-assess your risk rating for a period of time[9] as the ATO has already assured the outcomes in relation to your hub.

61. You may engage with the ATO in a number of ways, including (but not limited to):

(a) applying for an APA, or

[7] Section 262A of the *Income Tax Assessment Act 1936* (ITAA 1936). See paragraph 12 of Taxation Ruling TR 2014/8 *Income tax: transfer pricing documentation and Subdivision 284-E*.

[8] For the purposes of applying administrative penalties, section 284-250 of the TAA provides that Division 284 has effect as if the entity's transfer pricing treatment was not reasonably arguable. TR 2014/8 provides further guidance about the transfer pricing documentation requirements.

[9] Assuming there is no change in pricing, comparability factors and/or the functions, assets and risks of the hub.

(b) if you have a client engagement team, working with this team to achieve a low risk rating.

62. An APA is 'an arrangement that determines, in advance of controlled transactions, an appropriate set of criteria (for example, method, comparables and appropriate adjustment thereto, critical assumptions as to future events) for the determination of the transfer pricing of those transactions over a fixed period of time'.[10] The Commissioner's practice and procedures in relation to APAs, including criteria to enter the APA program is set out in Law Administration Practice Statement PS LA 2015/4 *Advance Pricing Arrangements*. The APA program will take a 'whole of client' 'whole of code' approach, meaning that all risks (not just hub risks) will be reviewed as part of the APA process.

63. Your risk rating will not preclude you and the Commissioner from entering into an APA. The level of analysis and supporting documentation you provide should reflect the complexity and materiality of tax at risk of your arrangement. In practice, we would expect that the higher your risk rating, the more in depth and comprehensive your analysis would be. If you provide insufficient evidence, such that the Commissioner considers there is a low likelihood of reaching agreement without expending considerable additional effort to properly understand the functions, assets and risks of the hub and other relevant circumstances you will not be able to enter the APA program.

64. You may also engage with your client engagement team, who will work with you to provide you with confidence in relation to your hub's compliance. At the conclusion of this review, the team will provide you with an ATO assessed risk rating. The level of information required through this process will be tailored according to your specific circumstances and the risk profile of your hub. However, practically speaking, again, the higher your risk rating the more evidence you will be expected to provide to help us understand and test the transfer pricing outcomes of your hub. For further details in relation to ATO reviews see paragraphs 111 to 113 of this Guideline.

65. When preparing your supporting documentation and analysis you should consider the guidance in Part B of this Guideline, which deals with the preparation of your transfer pricing analysis.

Transitioning existing arrangements to the green zone

66. The Commissioner recognises that the publication of this Guideline may cause taxpayers to review their hubs with the effect that some taxpayers may adjust the pricing of their hub dealings going forward to come within the green zone.

67. If you have an existing arrangement and you intend to adjust your pricing to move within the green zone going forward, the Commissioner is willing to work with you to resolve the 'back years' in a co-operative and practical manner.

68. For the period specified in the relevant schedule to this Guideline, we will consider remission of shortfall penalties[10A] to nil and shortfall interest charge[10B] to base rate when you make a voluntary disclosure in relation to all income years where the arrangements are in place and adjust your historic and prospective pricing to come within our green zone. If you do so, we will consider this as a strong factor in favour of exercising the Commissioner's discretion to remit, which means that we will remit unless there are compelling reasons not to.[11A]

[10] Paragraph 4.123 of the OECD guidelines as at 22 July 2010.
[10A] Division 284 of Schedule 1 to the TAA.
[10B] Division 280 of Schedule 1 to the TAA.
[11] [Omitted.]
[11A] The Commissioner's guidelines on remission of shortfall penalties are set out in PS LA 2011/30 *Remission of administrative penalties relating to schemes imposed by subsection 284-145(1) of Schedule 1 to the Taxation Administration Act 1953*, PS LA 2012/4 *Change of trustee*, PS LA 2012/5 *Administration of penalties for making false or misleading statements that result in shortfall amounts*, PS LA 2014/2

69. This undertaking is conditional on:

(a) your hub having commercial and economic substance and not otherwise coming within the exceptions in paragraph 19 of this Guideline, and

(b) you making a full and true disclosure of the arm's length conditions based on the commercial or financial relations in connection with which the actual conditions of your arrangement operate.

70. [Omitted.]

71. If you are not proposing to adjust your back years to come within the green zone, you should contact us to discuss your arrangement as the ATO will need to consider the particular facts and circumstances of your case. The Commissioner accepts that adjustments made to pricing to come within the green zone going forward do not create a presumption that the pricing of the arrangement for the back years is non-arm's length. However, you bear the onus to support your position with appropriate evidence. Approaching the ATO voluntarily may also reduce your penalty and interest exposure should the Commissioner determine that you obtained a transfer pricing benefit.

72. If you choose to take no action regarding your back years, you will be subject to the usual compliance approach for those years (that is, the approach outlined in this Guideline for hubs outside of the green zone).

73. If your voluntary disclosure results in double taxation you may have access to the mutual agreement process. If this is relevant to you, you should discuss your circumstances with the ATO.

Reporting your risk rating

74. We may ask you to tell us whether you have assessed the risk rating of your hub and what your risk rating is. Self-assessing your risk rating is voluntary, but if you opt out or are unable to self-assess we will ask you to advise us accordingly. You will only be able to self-assess a risk rating, and therefore, report your risk rating if one of the schedules to this Guideline applies to your hub.

75. If you are a large market taxpayer you may be asked to tell us your risk rating via the Reportable Tax Position schedule. Alternatively, we may write to you directly to ask you.

OUTCOMES OF YOUR RISK RATING

76. The following sections will help you to understand how our engagement with you will be tailored having regard to your risk rating.

What you can expect if you are in the green zone

77. If you are in the green zone, we will treat your arrangement as being at lower risk of not complying with Australia's transfer pricing provisions. This means that:

Administration of transfer pricing penalties for income years commencing on or after 29 June 2013, PS LA 2014/4 *Administration of the penalty imposed under subsection 284 75(3) of Schedule 1 to the Taxation Administration Act 1953* and PS LA 2016/2 *Administration of scheme penalties arising from the application of Subdivision 815-A for income years which started on or after 1 July 2004 and before 1 July 2012 (transition period)*. The Commissioner's guidelines on remission of shortfall interest charge are set out in PS LA 2006/8 *Remission of shortfall interest charge and general interest charge for shortfall periods*.

[12] [Omitted.]

[13] [Omitted.]

(a) we will generally not apply compliance resources to the arrangement (other than to confirm certain facts and to check your eligibility) - minimising your compliance costs and providing practical certainty for your arrangement, and

(b) you will be eligible to access the simplified record-keeping option - minimising your record keeping costs.

Limited compliance activity

78. If your arrangement is in the green zone, the ATO will generally not apply compliance resources to examine the transfer pricing outcomes of your hub. However, as per paragraph 26 of this Guideline, this will not waive the operation of the statutory test and will not constitute a safe harbour. It is important to note that falling within the green zone does not relieve you of your obligation to comply with the transfer pricing rules. Your self-assessment responsibilities require you to consider whether or not you get a transfer pricing benefit from your hub.

79. The ATO will generally only apply resources to hubs in the green zone to:

(a) verify your eligibility (that is, factually confirm that the pricing outcomes are less than the relevant low risk benchmark)

(b) confirm that you have performed all calculations in accordance with our guidance (for example cost calculations), and

(c) confirm that the hub has economic substance (for example that you have employees in your hub, that key management responsibility for the relevant activities rests with the hub or that the hub performs activities which can be linked to dealings with third party customers or suppliers). To do this, we will review documents such as those provided under country-by-country reporting, annual reports, management accounts, organisational charts or documentation of organisation procedures.

80. It would only be in exceptional circumstances, that the ATO would apply compliance resources to review your hub beyond the factual checks outlined above. An example of an exceptional circumstance would be where we apprehend that your hub likely lacks economic substance.

81. The low risk benchmark is not a proxy for an arm's length outcome and does not entitle you to increase your existing hub commission or remuneration to meet the low risk benchmark. The ATO will monitor the movement of pricing outcomes and if your pricing has increased over the period the ATO may seek to understand why.

Simplified record keeping

82. If you are in the green zone, documenting your transfer pricing in a way that meets all of the requirements of Subdivision 284-E of Schedule 1 to the TAA 1953 may impose an administrative burden on you that is disproportionate to your risk of not complying with the transfer pricing rules. If you are in the green zone you are eligible to adopt the simplified transfer pricing record keeping option.[14] Therefore, if your hub is rated as being in the green zone you can opt to minimise your transfer pricing record-keeping and compliance costs in relation to your hub.

[14] See PCG 2017/2.

83. If you are eligible and wish to apply the simplified record keeping option you will need to tell us that you have opted to do so. To notify us, use the IDS that forms part of your entity's income tax return materials and include code 7 at the percentage of documentation label code. This confirms that you have self-assessed your situation as complying with the transfer pricing rules and advised us that a simplification option has been applied to your record keeping.

84. The record-keeping requirements for you under these circumstances will be the general requirements in section 262A of the ITAA 1936 together with evidence of the applicability of the relevant eligibility criteria (refer to the factual checks in paragraph 79 of this Guideline).

APA program if within the green zone

85. Being in the green zone does not preclude you and the ATO from entering into an APA. We do note however that if you are in this zone you may be less likely to request an APA in relation to your hub.

What to expect if your arrangement is outside of the green zone

86. The ATO approach for arrangements outside of the green zone will differ depending on whether your arrangement is within the blue, yellow, amber or red zones. The zone will determine:

(a) the priority and manner in which the ATO will deal with your matter, and

(b) the level of analysis and supporting evidence that we may seek from you.

87. If your arrangement is outside of the green zone you will also have increased disclosure requirements and you will be required to provide additional data in relation to your hub on a yearly basis.

Disclosure requirements

88. If your hub is rated as being outside of the green zone, you will be required to make additional disclosures. The purpose of the additional disclosures is to allow us to:

(a) assess the level of risk associated with your hub

(b) prioritise our compliance resources to those cases with the most material risks, and

(c) facilitate monitoring of your potential risk over time (if immediate compliance activity is not undertaken).

89. It is intended that the IDS will be amended to enable you to make the required disclosures. As there is a time lag for these changes to take effect, in the interim, the ATO may contact you directly to request this information.

90. For income years where country-by-country (CbC) applies to you, you may not need to make the additional disclosures in the IDS if you satisfy certain criteria for CbC reporting. Further information in relation to CbC reporting and the proposed administrative solution to avoid duplication can be found on the ATO website.[15]

[15] Refer to https://www.ato.gov.au/business/international-tax-for-business/in-detail/transfer-pricing/country-by-country-reporting/ and https://www.ato.gov.au/Business/International-tax-for-business/In-detail/Transfer-pricing/Local-File---High-Level-Design/

Review and audit proceedings

What you can expect from our compliance activities

91. The ATO will prioritise its compliance resources to deal with hubs that are assessed as having the highest risk of obtaining a transfer pricing benefit. The ATO uses a variety of products to review and assess the risk associated with your hub. Compliance approaches may include monitoring, risk reviews and audits.

92. We will monitor the outcomes of your arrangements each year (as well as the trend over time) using the additional data that you will supply each year and other relevant information. This monitoring will take into account situations where a group has multiple Australian tax entities that each transact with offshore hub(s). The likelihood of compliance activity may increase if we see your tax impact increasing over time.

93. Generally, we will conduct a risk review to test and further assess the level of risk associated with your hub before a decision is made to proceed to audit or not. Reviews and audits have separate review processes and considerations to the risk framework set out in this Guideline (which provides the initial risk assessment). When the ATO reviews your hub it is not limited by the principles or methodologies set out in this Guideline or the accompanying schedules.

94. During a risk review we will assess the transfer pricing risk associated with your hub in accordance with Australia's transfer pricing rules (including the OECD guidelines) and whether it represents a significant risk. The most common types of reviews are comprehensive reviews where we review all of your business activities and specific reviews, where we review a single issue (such as the transfer pricing outcomes of your hub). The type of review will depend on your particular circumstances.

95. Regardless of the type of review, when reviewing your hub we will look to get an understanding of your:

(a) business context and environment

(b) global value chain, and

(c) transfer pricing treatment.

96. As part of this exercise the ATO examines all relevant information, starting with primary information in the form of any executed legal and contractual agreements and supporting information such as analysis set out in your transfer pricing documents including details of potentially comparable transactions that have been rejected under your transfer pricing analysis. Financial and commercial indicia are also evaluated to assess whether or not your arrangement and application of your selected transfer pricing method result in an outcome consistent with the statutory test. The framing questions at paragraph 111 of this Guideline outline in further detail the type of questions and areas of focus that you can expect from the ATO. You will also have the opportunity to discuss your arrangement with the ATO and where necessary, our transfer pricing specialists.

97. At the end of review, we will decide whether the risk that you have obtained a transfer pricing benefit has been resolved or whether the risk requires closer examination through an audit. Broadly, audits involve a more intense scrutiny of the facts and evidence. During our audits you can expect that we will obtain more detailed information about the hub. If we decide to proceed to audit, we will explain the reasons to you.

98. During reviews and audits, we may obtain information from third parties such as your suppliers and customers. We will generally attempt to obtain information from you on an informal basis rather than using our formal information gathering powers, although in some circumstances this may not be possible. If you are not dealing with us in a co-operative, constructive and transparent manner it is likely that we will use our formal information gathering powers to obtain information and will not take an informal approach. The ATO may seek to engage external experts when developing its position.

99. At the audit stage, once the ATO has developed a position it will be communicated to you via an audit position paper. Generally, you are given the opportunity to respond to this position before the ATO provides you with a Statement of Audit Position. If you disagree with some, or all, of the Statement of Audit Position you may be eligible to request an independent review. Further information about independent review, including eligibility criteria can be found at ato.gov.au.

100. If you disagree with the ATO decision you have the right to object. An independent officer from our Review and Dispute Resolution Business line will determine your objection. If you are dissatisfied with the outcome you may be able to seek a review in the Administrative Appeals Tribunal or Federal Court of Australia. Further information can be found at ato.gov.au.

Options for resolving disputes

Resolving hub issues outside of litigation

101. The ATO is committed to working with you to resolve issues associated with your hub as early and cooperatively as possible. We will take a principle based approach to settling transfer pricing disputes in relation to hubs to ensure that we have consistency of treatment across the market.

102. The ATO has an obligation to administer the taxation system in an efficient and effective way balancing competing considerations and applying discretion and good judgement. Settlement is an important element of the administration of the tax system and it is our preference to resolve disputes as quickly as possible at minimal cost to all parties. Agreeing a settlement is one way that this may be achieved.

103. Every settlement is based on the particular facts and circumstances of a given hub arrangement. Any contemplated settlement will need to be evidence based, fair, efficient, sustainable and able to contribute to justified trust in your tax affairs going forward.

104. If settlement is unable to be achieved through direct negotiation, Alternative Dispute Resolution (ADR) may also be used to help resolve or settle your transfer pricing dispute or alternatively limit the facts in dispute. The type of ADR will depend on the circumstances of your case. Generally though, the process would involve engaging a facilitator or mediator to help the parties identify and assess options to resolve the dispute.

105. Where appropriate, the Commissioner may also consider the use of advisory or determinative ADR processes in an attempt to resolve the matter before proceeding to litigation or as an alternative to litigation. Early neutral evaluation[16], or expert determination[17] are two methods that may be considered and depending on the circumstances, may be binding or non-binding on both parties. It should be noted that these types of processes are often difficult where there is disagreement about the facts and they can also be expensive and lengthy. The Commissioner will need to consider whether these processes represent the simplest, fairest and most cost-effective way to resolve the dispute taking into account the merits and risks associated with the particular facts of the case.

106. Settlement negotiations and ADR are able to be proposed by either you or the ATO at any time during the dispute, including before the issue of amended assessments. However, generally, the ATO will only be able to agree to a settlement or ADR process once we understand the facts of your hub and the issues have crystallised.

[16] Early neutral evaluation is where an ADR practitioner assists the parties by providing a non-binding opinion in relation to the dispute.

[17] Expert determination is where both parties agree to have an independent expert determine the pricing outcome and are bound by the determination.

107. If you are interested in settling your dispute or engaging in ADR, you should discuss this with your case manager. You should also consider Law Administration Practice Statement PS LA 2015/1 *Code of settlement* and Law Administration Practice Statement PS LA 2013/3 *Alternative Dispute Resolution (ADR) in ATO disputes* as we will follow these principles when negotiating a settlement with you or when engaging in ADR.

Litigation

108. Generally the ATO endeavours to resolve disputes as early as possible. However, where early resolution of disputes is not possible and the dispute has become intractable, the ATO may seek to litigate the matter.[18] In the context of the model litigant policy, we may also seek to litigate in circumstances where:

(a) there is a contentious or uncertain point of law which requires clarification and it is in the public interest to seek law clarification through litigation

(b) the behaviour is such that we need to send a strong message to the community that we won't sit idly by, and/or

(c) the dispute is intractable, alternative means of resolving the dispute have been attempted but have not produced an acceptable outcome.[19]

PART B: GUIDANCE FOR PREPARING YOUR TRANSFER PRICING ANALYSIS

Preparing your transfer pricing analysis – areas of focus

109. Part B provides guidance to assist you with your transfer pricing analysis if your risk rating is outside the green zone. This part does not form part of the risk assessment process but rather is designed to help you to understand the types of enquiries that you may receive from the ATO if your hub is subject to review and potential areas of concerns. It is envisaged that being open and transparent about these matters, will enable you to identify and address possible areas of concern prior to dealing with the ATO.

110. Importantly this part provides general guidance only and owing to the unique nature of hubs not all aspects will be applicable or relevant to all circumstances. Similarly, a matter may arise in relation to your hub that is not discussed in this part. This part does not provide advice or guidance about the technical interpretation or application of Australia's transfer pricing rules and does not in any way limit the operation of these rules or the information which the ATO is able to consider in your circumstances.

Testing and evidencing the outcomes of your hub

111. The following framing questions are indicative of the issues that the ATO will consider when reviewing your hub. Accordingly, you should consider these questions when conducting your transfer pricing analysis and preparing the associated documentation[20]:

(a) Commerciality of the hub

(i) What are the arm's length commercial and financial relations with respect to the particular hub arrangement?

[18] Law Administration Practice Statement PS LA 2009/9 *Conduct of ATO litigation and engagement of ATO Dispute Resolution* sets out the guiding principles as to how the ATO will conduct litigation.

[19] See for example Chris Jordan, AO, *Commissioner's speech to the Tax Institute's 30th national convention*, Thursday, 19 March 2015, Royal Pines Resort, Gold Coast.

[20] You should also consider TR 2014/8 which provides further guidance about transfer pricing documentation requirements.

(ii) In arrangements between independent parties dealing wholly independently, how is the pricing determined, say on a cargo by cargo basis for marketing hubs, or on a product by product basis for procurement hubs?

(iii) What is the economic substance and commercial purpose of a separate and/or centralised hub (that is, an entity separated from the principal production entity or the manufacturer as a user of hub procured goods)?

(iv) What is the evidence these activities add value to the global value chain?

(v) Is there evidence of increased sales prices or volumes; or specific synergistic or other benefits to the global group, directly attributable to the activities of the hub?

(vi) Is there evidence of 'market conduct' that resembles the structure of the arrangement between the associated enterprises?

(b) Functions of the hub

(i) What evidence is there to substantiate that key decision making is occurring in the hub?

(ii) Where functions have been transferred from Australia to an offshore hub, what is the evidence that those functions are no longer physically performed in Australia?

(iii) Does the hub perform activity for related party and third party interests of the underlying joint venture production asset(s)?

(c) Evidence regarding the risks assumed by the hub

(i) What is the evidence that support which risks are economically significant to the value chain?

(ii) What is the nature of the risk borne in substance by the hub?

(iii) What evidence is there to substantiate the cost and consequence of the risk, together with the ability of the hub to control or manage as well as bear the financial consequences of the risk?

(iv) What evidence is there by way of specific documentation (for example, international agreement) and/or commercial conduct of the effective transfer of risk?

(v) What is the evidence that the hub has the financial capacity to bear the risks that it is purported to bear (excluding the ability to call on the financial resources of other members of the group)?

(vi) Where commodity or financial markets increase or decrease substantially, what is the evidence that the financial outcomes of those movements align with an arm's length allocation of risks under the arrangement?

(d) Commerciality/arm's length nature of the pricing arrangements

(i) Based on the analysis of the legal form and the economic substance, does the profit accruing in the hub reflect the true economic contribution made by this part of the global business?

(ii) If there is evidence of 'market conduct' that resembles the structure of the arrangement between the associated enterprises, is there other evidence that demonstrates the profit outcomes are

appropriate in the specific circumstances of the associated enterprises?

(iii) When profits in the hub are measured, can they be reconciled with reference to profit outcomes observed in other similar independent entities with reference to a range of profit level indicators (PLIs) (that is, those based on sales; operating costs; operating assets)?

(iv) If one or more of the PLIs cannot be reconciled having regard to open market outcomes, what evidence explains the reason for the divergence?

(v) If a range of results has been identified, what is the most appropriate point in the range and why? To what extent have the comparables been adjusted for identifiable differences such as economic cycle, product or commodity volume, market price and other conditions that typically would be, or would reasonably be expected to be, considered by arm's length parties in determining the arm's length conditions?

(vi) What is the evidence that shows regular review of the price setting mechanism to ensure ongoing compliance with the statutory test?

(vii) Is there any evidence that the benefits of the arrangement to the Australian entity exceed the costs of the arrangement, for example versus a decision to 'in-source' the function?

112. The ATO expects that you will have appropriate evidence to support your transfer pricing treatment and analysis. As far as is practicable your supporting evidence should be in the form of primary documents as opposed to narratives. For example your primary evidence should include the legal agreements, financial outcomes (for example, management accounts, profit and loss statements), job descriptions, key performance indicators and cost/benefit analysis rather than merely a narrative description of those documents.

113. The degree of detail and comprehensiveness required in your transfer pricing documentation will be different depending on the level of complexity and the materiality of the risk related to your hub.[21] You should consider what is reasonable and what makes practical and commercial sense in your circumstances. Generally, we would expect that the higher your risk rating, the more detailed your transfer pricing documentation would be and the more supporting evidence you would have.

Current compliance hot spots

114. This section provides background of some areas of dispute between taxpayers and the ATO that have arisen in some (but not all) cases. We have included this information to assist you to understand possible areas of difference when dealing with the ATO and to enable you to make informed choices and decisions. This part does not provide advice or guidance about the technical interpretation or application of Australia's transfer pricing rules.

115. We acknowledge that hubs are unique and therefore the transfer pricing analysis and outcomes vary. We are willing to work with you to understand your hub and the appropriateness of your **actual** transfer pricing outcomes.

116. The following issues arose from cases related to offshore marketing hub arrangements in the energy and resource sector; however learnings from these examples will also be informative for other types of hubs and industries.

[21] TR 2014/8 at paragraph 27.

Use of third party commission rates

117. Taxpayers have asserted that commission rates used by third parties in marketing different commodities or in different purchasing arrangements are evidence of compliance with the statutory test. Conceptually, reliable comparable uncontrolled prices (CUPs) are the most direct transfer pricing method, acknowledging that the comparability standard to establish reliability is higher than other transfer pricing methods.

118. The ATO's concern has been the absence of supporting information – in particular, information that addresses the OECD 'factors determining comparability' – to establish the market indicators relied upon by taxpayers as representing reliable CUP information.

119. The ATO will always consider the applicability of CUP information, noting that the comparability standard (as defined by the OECD factors determining comparability[22]) to be applied requires evidence that goes further than demonstrating merely a similar arrangement. For example, consideration of the factors determining comparability would also require determining whether or not factors such as differences in the underlying commodity, product or commodity volumes, geographic markets, hedging, trading or other profit making opportunities connected to the physical product, or timing of the proposed comparable instrument require potential adjustment to improve the degree of comparability. Subject to the specific facts in any given case, the existence of open market arrangements suggestive of a course of conduct and form of remuneration that aligns with aspects of the controlled arrangement are not, of themselves, sufficient to meet the statutory test in Australia's transfer pricing rules.

Testing transfer prices – using alternative PLIs

120. In certain scenarios, the ATO has found that the results implied by a taxpayer's transfer pricing method vary significantly depending on which PLI is applied. This has arisen in the following circumstances:

(a) the taxpayer's chosen transfer pricing method relies on the application of a sales commission, derived from arrangements or entities considered to be comparable by the taxpayer

(b) this is then applied to the value of the intermediary's third party sales (in the case of a marketing business), or third party purchases (in the case of a procurement business) to derive the 'arm's length' remuneration for the intermediary, or

(c) when other PLIs are examined as part of the analysis, while a sales-based commission appears reconcilable with broadly comparable arrangements or entities, cost-based PLIs are not able to be reconciled with market-based outcomes (for example, it produces profitability exceeding top Australian Stock Exchange performers). In these scenarios, the tested entities' operating costs, when measured as a proportion of revenue, are significantly lower than observed in comparable entities with an implication that the level of profitability in the hub entity is disproportionately higher (in the context of the cost base) than that observed in broadly comparable entities.

121. Taxpayers have asserted that it is not appropriate for the ATO to be using cost-based transfer pricing methods to test whether or not the outcomes can be considered arm's length because this further analysis is not appropriate, and the cost base does not reflect the selling effort or level of risk in the business.

[22] Paragraph 1.38 of the OECD guidelines.

122. It is important to re-emphasise that examination of the results implied by the application of a cost-based transfer pricing method in this scenario does not imply that the ATO is advocating the use of a cost-based method as the primary price-setting transfer pricing method. Rather, price testing and cost based outcomes introduce an important consideration regarding the reliability of the taxpayer's price-setting method having regard to all of the comparability factors. Further, whilst we acknowledge that taxpayers generally do not rely on a cost based method we note that the outcomes are able to be converted into an equivalent commission rate which is generally the method relied upon by taxpayers.

123. Further, the Commissioner recognises that an entity's operating cost base may not in all cases capture the full extent of the economic contribution of the entity. In the current context, taxpayers have highlighted the impact of different forms of commercial risk on expected returns, and in the circumstances where the hub is responsible for the management and control of various forms of commercial risk across the value chain, the operating cost base will not be an accurate indicator of functional intensity or informative with respect to expected returns. In these scenarios, the ATO would look to the taxpayer to provide evidence in support of the proposition that management and control of risk were integral and costly to the entity's operations, the value chain and therefore expected returns, and that the Australian entity, acting rationally as part of a group, would seek to transfer those risks and rewards to a third party.

124. Where management and control of risk is determined by taxpayers to be a key driver of expected returns, the ATO would expect a commensurate focus in taxpayers' supporting documentation and evidence that demonstrates the significance of management and control of risk as the key driver of expected returns, including:

(a) the specific nature of the risk(s)

(b) how these risks are managed and controlled

(c) evidence of mitigation strategies and outcomes

(d) evidence of the financial capacity to bear the risk, and

(e) evidence that the management of risk produces a valuable economic contribution to profit.

Failure to revisit the price setting mechanism in response to significant changes in the external environment

125. As has been well documented, the Australian economy benefited from a global 'commodities boom' starting from the early 2000's. Among other things this resulted in significant price and volume increases for a number of Australia's exported mineral commodities. Despite marked changes in the external environment, a number of Australian taxpayers did not revisit their transfer price-setting mechanisms or approaches to determine whether or not the profit results continued to represent an arm's length outcome given the functions, assets and risks in the hub. We would expect taxpayers to take into account changes in market conditions in their price-setting processes and revisit their policies in a timely fashion.

Liquefied natural gas

126. There are a number of existing projects for liquefied natural gas (LNG) and other hydrocarbons in Australia, of which a significant proportion of production is exported. We expect LNG volumes to increase as projects currently under development enter production phase. We understand that the LNG market is undergoing structural change impacting potential price indices, spot market liquidity and importance of long term offtake to buyers.

127. Whilst we accept the implementation of business strategies to manage commercial risks, we are concerned that taxpayers are using these changes in the industry to introduce arrangements with offshore hubs that inappropriately shift profits. We are particularly concerned where sales of LNG have previously been sold by the Australian production entity directly to third party customers or where the LNG volumes have been pre-committed to third parties via off-take agreements entered prior to the (group's) final investment decision being made. In these circumstances, the ATO will be seeking evidence to support that an arm's length party acting wholly independently would be selling its LNG through a hub.

128. We will also continue to focus on arrangements where the sale of LNG through a hub involves atypical pricing structures and related party agreements that are not supportable by reference to contemporaneous market evidence.

129. Having regard to the above, compliance activity in this area will have a continued focus on understanding the OECD 'factors determining comparability' and the impact on transfer prices. As part of preparing transfer pricing analyses for sales of LNG to related parties, we encourage taxpayers to also collate evidence which supports how contemporaneous industry changes impact the OECD 'factors determining comparability' and their transfer prices. For assistance in this regard see TR 2014/6 and TR 2014/8.

Who to contact

130. The ATO has a dedicated team responsible for the oversight and management of hub risks. If you wish to discuss your hub with the ATO you may contact us at offshorehubs@ato.gov.au

131. Alternatively, if you have a dedicated relationship manager you may approach them directly for assistance with your case.

SCHEDULE 1 – OFFSHORE MARKETING HUBS

132. This schedule sets out the ATO risk assessment framework, including the low risk benchmark for offshore marketing hub arrangements. The diagram included at Attachment A provides an overview of the framework.

133. The risk indicators in this schedule are relevant only to offshore marketing hubs and cannot be relied upon for other types of hubs.

134. The quantitative benchmarks used in this schedule are for risk assessment purposes only. Although we use a particular transfer pricing method for this process, you are not required to use this methodology when pricing your arrangements. Consistent with OECD guidelines, you should use the most appropriate and reliable transfer pricing method (or combination of methods) for your circumstances.

Do you have an offshore marketing hub?

135. If you are an Australian resident selling goods or commodities via, or supported by, offshore related parties and your arrangement has commercial and economic substance, you will need to consider if you have an **offshore marketing hub**. For the purposes of this schedule an offshore entity will be an offshore marketing hub if it satisfies the following:

(a) the entity is a related offshore entity or a permanent establishment of a related Australian entity or related foreign entity

(b) the entity act(s) as agent or principal in relation to the marketing or sale of goods or commodities sourced (directly or indirectly) from Australia, and

(c) the entity on-sells the goods or commodities without substantial alteration, although the entity may also facilitate refining, casting or similar processes.

136. For the avoidance of doubt, offshore marketing hubs may come in varying business models, from routine service providers through to full risk marketers and traders.

137. The definition of offshore marketing hub is intended to be broad and should not be read prescriptively. If you are unsure if your arrangement would be characterised as an offshore marketing hub, you should contact the ATO. We will work with you to understand your circumstances and assist you to determine whether this framework applies to you.

Date of effect

138. This schedule has effect for income tax years commencing on or after 1 January 2017.

Transitioning existing arrangements

138A. For arrangements covered by this schedule transitioned to come within the green zone, the concessional treatment of penalties and interest[22A] ended on 16 January 2018.

The low risk benchmark

139. Your offshore marketing hub will be assessed as being in the green zone if it satisfies the low risk benchmark. The low risk benchmark is based on the cost plus methodology (the 'cost plus indicator').

140. Where you have dealings with multiple offshore marketing hubs, you should apply the low risk benchmark to each hub separately.

141. The low risk benchmark has been determined having regard to all available information, including data collected as part of ATO compliance activities. As the indicators are provided for the purpose of risk assessment (rather than determining arm's length methods or outcomes) and include commercially sensitive data, the ATO will not be releasing the supporting data that forms the basis of the indicators.

142. Publishing the low risk benchmark does not constitute a proxy for an arm's length outcome and does not limit or waive the operation of the law, but provides a means for you to self-assess your risk of non-compliance as relatively low and thereby mitigate your costs of compliance.

143. The cost plus indicator, is:

Hub profit **is less than or equal to** 100% mark-up of hub costs

144. The low risk benchmark applies to all offshore marketing hubs. Owing to the varying profiles of offshore marketing hubs we would expect different hubs to be at different points along this spectrum (for example, not all hubs will be at the upper end of the benchmark).

145. To risk assess your offshore marketing hub arrangement you will need to:

(a) At the end of the income year apply the cost plus methodology to the actual accounting results of your offshore marketing hub for the relevant year adjusted as per paragraphs 149 to 162 of this Guideline (if required).

(b) Compare the results to the cost plus indicator.

146. If your results are below the cost plus indicator, you will be in the green zone.

[22A] See paragraph 1 of this Guideline.

147. If your result is higher than the cost plus indicator you may still be in the green zone depending on your outcomes under Australia's CFC rules. To assess whether your circumstances meet these criteria you should refer to paragraph 163 of this schedule.

148. If your offshore marketing hub made a loss for the income tax year, you will not need to apply the cost plus indicator. Provided you have calculated revenues and costs of your offshore marketing hub in accordance with this schedule you will be taken to be in the green zone. If you haven't or are unable to calculate revenues and costs of your offshore marketing hub you should contact the ATO for assistance as to how to apply the risk framework.

Calculating costs and hub profit

149. When applying the cost plus indicator, the mark-up should only apply to costs related to the performance of the sales and marketing activities.[23] This will require you to review the accounts of the offshore marketing hub and exclude any costs not related to the marketing and sales activities. When adjusting operating costs for these items appropriate adjustments should also be made to revenues to reflect the extent revenue is earned from a separate function.

150. When applying the cost plus indicator you should include operating costs related to the marketing and sales activities of the hub, for example salary and employee stock ownership plans[24] of hub employees. Costs to be excluded from your cost base include:

(a) the cost of the commodity itself in instances where the tested hub has taken title to the goods or commodities before they are on-sold

(b) pass through costs, and

(c) costs that relate to the generation of revenues separate from the sales and marketing function (for example, shipping).

151. Pass through costs include costs incurred by the hub on behalf of other group members, such as the Australian producer, which are costs that the group members would have incurred directly had they been independent and for which the hub does not provide any 'value add'. It may be appropriate that these costs are passed on to group members however they should not be included in the cost base when determining the mark-up under the cost plus indicator.

152. Costs charged to the offshore marketing hub by associate entities for activities that are required by the hub in the performance of its own value add marketing activities, are able to be included in the cost calculation provided these are charged on an arm's length basis. However, you should retain evidence supporting your arm's length outcomes.

153. As discussed above all costs that relate to the generation of revenues separate from the marketing function should be excluded from the cost base. For example, although some offshore marketing hubs or related companies may be responsible for shipping services such as chartering vessels to deliver goods and commodities, shipping activities are considered a separate function that is to be excluded (and separately examined) when risk assessing the offshore marketing hub and applying the risk benchmarks. Separate guidance will be provided at a later stage to assist you to risk assess the outcomes of your shipping arrangements.

[23] Paragraph 7.36 of the OECD guidelines.
[24] Employee stock ownership plans should only be included if they are required to be disclosed under the accounting standards.

154. In the example of an offshore marketing hub that takes title, for risk assessment purposes you should exclude from the cost base, the cost of the commodity being traded and direct shipping costs if it is a delivered ex ship (DES) arrangement[25] such as charter fees, despatch charges, fuel costs, etcetera. Costs such as salary and wages incurred by the hub to manage logistics are not considered a direct shipping cost and can be included in the cost base.

155. The Commissioner recognises that some offshore marketing hubs sell product from several sources and not just Australia and therefore it is necessary to conduct a cost allocation for the Australian sourced products. In these circumstances, you should make a considered and reasonable allocation of costs to the Australian related transactions and retain the evidence to substantiate the adopted approach.

156. Consistent with this being a risk assessment framework, provided that your cost base calculation is conducted on a reasonable and 'best efforts' basis, the Commissioner accepts that your calculation may not be precise. The ATO may seek to review your cost calculations so you should retain copies of any working papers that you have prepared.

157. The following examples show how to calculate costs in different scenarios.

Example 1: offshore marketing hub that does not take title to commodity

158. *Calculation of the marketing activities should only capture the operating revenue and costs related to the marketing function. Shipping activities, derivatives, financing incomes and expenses, non-operating incomes and expenses, intercompany sales and pass through costs are a separate function and are excluded for the purposes of assessing the offshore marketing hub's mark-up on costs.*

	$ million
Marketing Revenue	60
~~Freight Revenue~~	~~40~~
TOTAL Revenue	100
Operating costs	
Salary	10
Rent	2
~~Freight~~	~~35~~
~~Despatch~~	~~3~~
TOTAL Costs	50
Profit	50
Marketing function	
Marketing revenue	60
Operating costs	
Salary	10
Rent	2
(A) TOTAL Costs	**12**
(B) Profit	**48**
Mark-up above cost on marketing function (B) / (A)	**48 / 12 = 400%**

[25] Also referred to as Cost and Freight (CFR) or Cost, Insurance and Freight (CIF).

159. *To isolate the costs relating to the marketing function, direct costs related to the shipping activities have been excluded resulting in an effective mark-up on the marketing function of 400%. In this example the hub entity would be outside of the green zone.*

Example 2: offshore marketing hub that takes title to commodity on DES

160. *In this arrangement, the offshore marketing hub effectively earns 5% margin or commission on its commodity sales by purchasing commodities from the production entity at a price that's 95% of the final price charged to third party customers.*

161. *Calculation of the marketing activities should only capture the operating revenue and costs related to the marketing function. Subtracting the commodity expense from the revenues will give an effective marketing revenue. Similar to the previous example, shipping revenue and expenses are excluded for the purposes of assessing the offshore marketing hub's mark-up on costs.*

	$ million
Commodity revenue	1000
~~Freight Revenue~~	~~40~~
TOTAL Revenue	1040
Expenses	
Cost of goods sold	950
Salary	10
Rent	2
~~Freight~~	~~35~~
~~Despatch~~	~~3~~
TOTAL Costs	1000
Profit	40
Marketing function	
Commodity revenue	1000
Cost of goods sold	950
Marketing Revenue	50
Operating costs	
Salary	10
Rent	2
(A) TOTAL Costs	**12**
(B) Profit	**38**
Effective mark-up above cost for marketing function (B) / (A)	**38 / 12 = 317%**

162. *Isolation of the marketing costs results in an effective mark-up on the marketing function of 317% and therefore it would be outside of the green zone.*

Full CFC attribution – move to the green zone

163. The Commissioner recognises that if you attribute income of your offshore marketing hub via the CFC provisions your tax risk profile may be reduced. Accordingly, you may move to the green zone notwithstanding that you do not satisfy the low risk benchmark if you include the income from sales and marketing activities of the offshore marketing hub in your assessable income.

164. Specifically, you will be in the green zone if under the CFC provisions you have a 100% attribution percentage[26] in relation to the offshore marketing hub and you include the income related to the sales and marketing activities of the hub in your assessable income for Australian tax purposes (that is, this income is 'tainted').

165. We recognise that there may be a reduction in your Australian tax liability if your offshore marketing hub is subject to foreign income tax and you are eligible for a foreign income tax offset. However, provided there is no reduction in total tax payable, your offshore marketing hub will be viewed as being low risk and you are able to rate your hub as being in the green zone.

166. If you do not meet these criteria or the low risk indicator, you will not be in the green zone. In these circumstances you will need to apply the additional indicators to assess which zone you will be in. The next step is to determine the tax impact of your hub.

Outside of the green zone – how to calculate the tax impact of your hub

167. If you are outside of the green zone you will need to consider the additional indicators to determine your rating. To assess your base rating you will need to calculate the tax impact of your offshore marketing hub.

168. Broadly, the tax impact is the difference between the hub profit and the profit outcome that arises when applying the cost plus indicator.

169. You will need to use the following formula to determine your tax impact for your offshore marketing hub for a particular income tax year:

> Tax impact = [Hub profit **less** 100% mark-up above costs] x non-attributed income ratio x Australian company tax rate
>
> - **Hub profit** is the amount calculated and used for the purposes of the cost plus indicator.
> - **Costs** are the amount calculated and used for the purposes of the cost plus indicator.
> - **Non-attributed income ratio** is that part of hub profit that is not attributed back to and taxed in Australia under Australia's CFC provisions, as a proportion of hub profit.

170. Following on from examples 1 and 2 above, the following table shows an example of the tax impact calculation where 40% and 50% of income is attributed under Australia's CFC provisions respectively:

[26] As defined in section 362 of the ITAA 1936.

Tax impact	$ million	
	Example 1	Example 2
Profit from hub marketing activity	48	38
Less 100% mark-up on marketing function	12	12
	36	26
Non-attributed income	60%	50%
Tax impact (at 30%)	6.48	3.9

171. In these examples, the offshore marketing hubs would have a base rating in the yellow and blue zones respectively.

172. Once you have calculated your tax impact and determined your base rating you will need to consider whether your base rating should be adjusted having regard to the criteria in relation to transfer pricing documentation in paragraphs 55 to 59 of this Guideline.

SCHEDULE 2 – OFFSHORE NON-CORE PROCUREMENT HUBS

173. The final report under Actions 8-10 of the OECD's plan on Base Erosion and Profit Shifting (BEPS 8-10 report)[27]and the OECD guidelines focus on guidance designed to align transfer pricing outcomes with value creation. [28] In line with that approach, this schedule sets out the ATO's risk assessment framework, including the low risk benchmark for certain offshore procurement hub arrangements. The quantitative benchmarks used in this schedule are for risk assessment purposes only.

174. The risk indicators in this schedule are only relevant to **non-core procurement hubs**, that is, offshore procurement hubs that supply 'indirect' or 'non-core' goods or services (**non-core product**) to an Australian entity. The low risk benchmark and indicators cannot be relied upon for other types of hubs or international related party dealings.[29]

175. Non-core procurement hub arrangements will be assessed as low risk and in the green zone where the hub profit is less than or equal to a 25% mark-up of hub costs.

176. The low risk benchmark can be used to test the pricing outcomes of all non-core procurement hubs, notwithstanding their varying functional profiles that may change over time. We expect that different hubs will have profit outcomes along a spectrum.

[27] OECD, 2015, *OECD/G20 Base Erosion and Profit Shifting Project, Aligning Transfer Pricing Outcomes with Value Creation, 2015 Final Reports Actions 8-10,* OECD Publishing, Paris.

[28] ibid, *Chapter VII Low Value-Adding Intra-Group Services* provides guidance on centralised services. Paragraph 7.14 has examples of services that may be centralised in a group member.

[29] PCG 2017/2 articulates the Commissioner's administrative practice for certain arrangements believed to be low risk international related party dealings; paragraphs 27 to 42 provide guidance regarding intra-group services for taxpayers that meet the eligibility criteria. Paragraphs 7.44 to 7.51 of the BEPS 8-10 report discuss categorising activities as 'low value-adding intra-group services' for the simplified approach outlined in Chapter VII. How a non-core procurement hub's activities are characterised will depend on the relevant facts and circumstances.

177. Although we use a particular transfer pricing method for this process, you are not required to use this methodology when pricing or setting your arrangements. You should use the most appropriate and reliable transfer pricing method (or combination of methods) for your circumstances.[30]

178. You will not need to use this schedule to self-assess your risk rating if the circumstances in paragraphs 30 to 37 of this Guideline apply.

179. An overview of the risk assessment framework is provided at Attachment B.

Non-core product

180. **Non-core products** are goods and services that support the operations of a business; they are not converted into a finished item or resold. Examples may include office equipment, consumables, packaging, fuel, advertising, travel management and professional services.[31] It excludes items required to perform the core operations of a business, for example:

- goods purchased for resale by a distributor or retailer
- production inputs or plant and equipment employed by a manufacturer to produce goods
- heavy equipment and fuel used in mining operations, or
- skilled labour acquired by a professional services firm.

Do you have a non-core procurement hub?

181. A **non-core procurement hub** is an international related party whose procurement activities include the supply of non-core products to an Australian business. If you are an Australian business who has incurred costs to acquire non-core products from or through dealings with an international related party, and your arrangement has economic or commercial substance, you need to consider whether you have a non-core procurement hub arrangement.

182. This risk assessment framework applies to a non-core procurement hub to the extent that the activities performed by the hub, in procuring a non-core product, whether from related parties or otherwise, satisfy the benefits test in regards to the Australian entity. This benefit test is independent of the economic or commercial value of the non-core product procured by the Australian business.

183. Under the arm's length principle, an intra-group service satisfies the benefits test when the activity performed provides economic or commercial value to enhance or maintain the recipient's business position, such that an independent enterprise in comparable circumstances would be willing to pay for it.[32]

184. The definition of non-core procurement hub is intentionally broad and should not be read prescriptively. If you are unsure whether your arrangement can be characterised as a non-core procurement hub, contact the ATO. We will work with you to understand your circumstances and assist you to determine whether this framework applies to you.

185. For the purposes of this schedule an offshore entity will be a **non-core procurement hub** if it:

[30] See OECD guidelines, paragraphs 2.1 to 2.11 and BEPS 8-10 report at paragraphs 7.31 to 7.34.
[31] The connection to your core business operations of the goods or services acquired will determine whether they are a non-core product in your particular circumstances.
[32] See BEPS 8-10 report paragraphs 1.157 to 1.173 for guidance on multi-national enterprise (MNE) group synergies and paragraphs 7.6 to 7.8 for guidance on the benefits test.

(a) is a related offshore entity or a permanent establishment of a related Australian entity or related foreign entity

(b) acts as agent or principal in relation to the provision of non-core product, whether sourced from Australia or offshore

(c) is engaged in the procurement of a non-core product to support the operations of the Australian business, and

(d) procures and supplies the non-core product without alteration.

186. Non-core procurement hubs can be structured using various different business models, support different geographical boundaries, and perform a variety of functions, including strategy and significant decision-making. Examples of the types of procurement activities that may be outsourced or the models used are strategic sourcing, the identification, assessment and relationship management of suppliers, contract negotiation, quality control, processing purchase orders, accounts payable function, warranty management, supply chain management, centralised expenditure, and category managers.[33]

Date of effect

187. This schedule has effect for income tax years commencing on or after 1 January 2018.

Transitioning existing arrangements

188. For arrangements covered by this schedule transitioned to come within the green zone, the concessional treatment of penalties and interest[34] ends on the 11 October 2019.

Low risk benchmark

189. Your non-core procurement hub will be assessed as being in the green zone if it satisfies the low risk benchmark. The low risk benchmark is based on the cost plus methodology (the 'cost plus indicator').

190. Where you have dealings with multiple non-core procurement hubs, apply the low risk benchmark to each hub separately.

191. The low risk benchmark takes into account all information available to the ATO, including data collected during compliance activities. As the indicator is provided for the purpose of risk assessment (rather than determining arm's length methods or outcomes) and relies on commercially sensitive data, we will not be releasing the data that forms the basis of the indicator.

192. The low risk benchmark is not a proxy for an arm's length outcome and does not limit or waive the operation of the law. Instead, it provides a means for you to self-assess your risk of non-compliance and to understand how the ATO is likely to assess and respond to the transfer pricing risk associated with your non-core procurement hub arrangements.

193. The cost plus indicator is:

Non-core procurement hub profit ***less than or equal to a 25%*** *mark-up on hub costs*.

[33] Characterisation is a matter of facts and circumstances, including comparability. An entity performing a limited number of low level administrative activities is more likely to be properly characterised as a service centre and not a procurement hub.

[34] See paragraph 68 of this Guideline.

194. As the low risk benchmark can be used to test the profit outcomes of all non-core procurement hubs, it can assist you to better manage your transfer pricing risk, record-keeping requirements and costs of compliance.

195. As non-core procurement hubs may have varying functional profiles and their activities and value creation can change over time, we expect that different hubs will have profit outcomes along a spectrum (that is, not all non-core procurement hubs will be at or near the cost plus indicator used as the low risk benchmark). Your transfer pricing documentation should support the hub's profit outcome as being consistent with comparable arm's length outcomes.[35] Further information to assist you with applying the arm's length principle is available in other OECD and ATO publications.[36]

196. To risk assess your non-core procurement hub arrangement:

(a) at the end of the income year, apply the cost plus methodology to the actual accounting results of your hub that are relevant to your non-core product (see paragraphs 200 to 218 of this schedule), and

(b) compare the result to the cost plus indicator.

197. If your result is equal to or below the cost plus indicator, your base risk rating is the green zone.

198. If your result is higher than the cost plus indicator you may still be in the green zone depending on your outcomes under Australia's controlled foreign company (CFC) rules. To assess whether your circumstances meet these criteria, refer to paragraphs 219 to 223 of this schedule.

199. If your non-core procurement hub made a loss for the income tax year, you do not need to apply the cost plus indicator.[37] Provided you have calculated the revenues and costs of your non-core procurement hub in accordance with this schedule, you are taken to be in the green zone. You can contact the ATO for assistance with applying the risk assessment framework.

Calculating hub revenue, costs and profit

200. When applying the cost plus methodology to the actual costs to calculate the hub mark-up and the cost plus indicator, apply the mark-up only to hub operating costs related to non-core product procurement activities.[38] To do this:

(a) review the accounts of the non-core procurement hub

(b) calculate the hub's revenues to only reflect revenue earned in connection with your non-core product (**hub revenue**)

(c) calculate the operating costs related to earning hub revenue (**hub costs**)

(d) subtract the hub costs from hub revenue to calculate the **hub profit**

(e) divide the hub profit by the hub costs to calculate the hub mark-up, and

(f) determine whether the hub mark-up exceeds the cost plus indicator of 25%.

[35] See BEPS 8-10 report guidelines on comparability and comparability analysis in Chapter I, Section D.1 and OECD guidelines Chapter III.
[36] See the guidance regarding the centralisation of group purchasing in BEPS 8-10 report paragraphs 1.157 to 1.163, 1.168 and 1.169, and TR 2014/6.
[37] BEPS 8-10 report paragraphs 7.35 and 7.36 provide guidance on circumstances when an independent enterprise may not realise a profit from the performance of services alone.
[38] See OECD guidelines paragraphs 2.83 to 2.91, 2.98 to 2.102 and BEPS 8-10 report paragraph 7.34.

201. When applying the cost plus indicator, the hub's cost base includes operating costs related to performing its non-core product procurement activities. Examples of hub operating costs are overheads such as office rent or supplies, accounting services, IT and employee costs like payroll and travel. A hub's operating costs may include outlays for services provided by a related party. As a business enterprise does not incur costs unnecessarily, the hub's cost base should only include related party costs that an independent party in comparable circumstances would be willing to incur.[39]

202. Where the hub's costs need to be allocated or apportioned to exclude costs that are not attributable to the hub's non-core product procurement activities, the result of the method used must be consistent with that of comparable independent enterprises.[40] Cost allocation and apportionment may require a degree of estimation.[41] Where an allocation key is used to apportion hub costs, it must make sense in the circumstances.[42] For example, an appropriate method of allocating overheads (for example, rental expenses, utilities) would likely be headcount. Items like legal costs may be better allocated between different activities based on the time spent by staff working on specific matters (for example, drawing up supplier contracts, attending negotiations with suppliers).

203. Hub expenses to be excluded from your hub costs:

(a) where the tested hub has taken title to products before they are on-sold, the direct costs incurred by the hub in acquiring products that are a non-core product of an Australian entity

(b) pass through costs[43], and

(c) all other expenses that are not connected to earning hub revenue (for example, incurred in the procurement and supply of goods and services other than non-core product or shipping activities).

204. Pass through costs are expenses incurred by the hub on behalf of other group members, such as the Australian customer:

(a) that the group members would have incurred directly had they been independent, and

(b) for which the hub does not provide any 'value add'.

Examples of pass through costs may include freight, insurance and customs duties related to transporting goods from a supplier to the Australian entity.

205. You can include in hub costs the expenditure the hub incurs to carry on its own value add activities regarding the non-core product. [44] Expenses for goods or services provided by a related entity can be included in hub costs provided they satisfy the benefits test and are charged on an arm's length basis. The hub should retain evidence that supports the arm's length nature of its profit outcomes.

[39] BEPS 8-10 report paragraph 7.2.
[40] See OECD guidelines paragraph 2.58 and BEPS 8-10 report paragraph 7.24.
[41] See BEPS 8-10 report paragraph 7.23.
[42] See OECD guidelines paragraphs 2.140 to 2.151 and BEPS 8-10 report paragraphs 7.24, 7.25, 7.59 and 7.60.
[43] See OECD guidelines paragraphs 2.99 to 2.100 and BEPS 8-10 report paragraphs 7.59 and 7.61.
[44] See OECD guidelines paragraphs paragraph 2.98.

206. Exclude from hub costs all expenses that relate to the generation of revenue other than the non-core product procurement function. For example, although some non-core procurement hubs or related companies may be responsible for shipping services (such as chartering vessels to deliver goods), shipping activities[45] are considered a separate function to be excluded when risk assessing the non-core procurement hub and applying the low risk benchmark. Other examples of items to be excluded from the calculation are derivatives, financing income and expenses, non-operating income and expenses, and intercompany sales.

207. In the example of a non-core procurement hub that takes title to a product, for risk assessment purposes, the hub costs should exclude the cost of the goods and direct shipping costs (such as charter fees, despatch charges, fuel costs) if it is a DES arrangement.[46] Employee related costs such as salary and wages and other operating costs incurred by the hub to manage logistics can be included in hub costs provided they are not connected to a separate revenue generation activity.

208. The Commissioner recognises that some non-core procurement hubs supply items to several destinations, not just Australia. In these circumstances, it is necessary to conduct a cost allocation for non-core product supplied to Australian customers. Consistent with the guidance in paragraph 202 of this schedule, you should make a considered and reasonable allocation of costs to the transactions related to Australia that is consistent with comparable uncontrolled transactions. Retain evidence to substantiate your approach.

209. Being a risk assessment framework, provided your cost base calculation is conducted on a reasonable and 'best efforts' basis, the Commissioner accepts that your calculation may not be precise. As the ATO may seek to review your cost calculations you should retain, as part of your record keeping, copies of any working papers you have prepared. You may become liable to a transfer pricing penalty where the ATO reviews your arrangements and you do not have contemporaneous documentation that meets the reasonably arguable threshold.[47]

210. The following examples show how to calculate hub revenue, hub costs and hub profit to test the hub mark-up against the cost plus indicator (the low risk benchmark) in different scenarios.

Example 3: non-core procurement hub that does not take title to goods

211. *In this example the procurement hub's activities include acting as an agent on behalf of customers to procure goods and services. Revenue from its non-core product activity was $25 million and it is estimated that approximately 20% of staff were involved in procuring non-core product. Shipping is arranged for its customers and the shipping charges are reimbursed by them.*

212. *Calculation of the procurement activities should only capture the operating revenue and selling, general and administrative costs related to the non-core product procurement function. Headcount is used as an allocation key for costs.*

	$m
Revenue	
Procurement fees	90
Shipping	10
Interest	2

[45] A separate schedule to this Guideline will be published to provide guidance on shipping activities.
[46] Other examples of Incoterms are Cost and Freight (CFR) or Cost, Insurance and Freight (CIF).
[47] See paragraphs 68 to 70 of this Guideline and paragraphs 55 to 59 of PS LA 2014/2.

Total revenue	**102**
Expenses	
Salary	24
Rent	6
IT	5
Shipping	10
Interest	1
Total expenses	**46**
EBIT (total revenue less total costs)	**56**
Procurement function	
Non-core product revenue	25.0
Operating costs	
Salary	4.8
Rent	1.2
IT	1.0
(A) Hub costs	**7.0**
(B) Hub profit (EBIT)	**18.0**
Hub mark-up equals (B) / (A)	18 / 7 = **257%**

213. *To ascertain the mark-up on costs for benchmarking purposes, we exclude revenue and costs, direct and allocated indirect operating costs, not connected to earning the $25 million non-core product revenue. Finance revenue and expenses, and pass through shipping outgoings and receipts are not taken into account. The mark-up on the costs applicable to the non-core product procurement function is 257%. As the hub mark-up is above the cost plus indicator, the hub entity would be outside the green zone.*

Example 4: non-core procurement hub that does not take title to goods and operates a shipping business

214. *In this scenario, 75% of staff is estimated to be dedicated to the non-core product procurement function. The entity has a shipping business, which incurred hedging costs, and it made a profit on the sale of an investment. Headcount is used to allocate* costs.

	$m
Revenue	
Procurement fees	100

Shipping	40
Non-operating gain	5
Total revenue	**145**
Expenses	
Salary	30
Rent	6
IT	4
Shipping	20
Hedging	3
Total expenses	**63**
EBIT (total revenue less total costs)	**82**
Procurement function	
Hub revenue	100.0
Operating costs	
Salary	22.5
Rent	4.5
IT	3.0
(A) Hub costs	**30.0**
(B) Hub profit (EBIT)	**70.0**
Hub mark-up equals (B) / (A)	70 / 30 = **233%**

215. *To isolate the costs relating to the non-core procurement function, the revenues, direct and indirect costs related to the shipping business, the non-operating gain and hedging costs have been excluded from the calculation. The mark-up on costs for the non-core products supplied to an Australian business is 233%. As the hub mark-up is above the cost plus indicator, the hub entity would be outside the green zone.*

Example 5: non-core procurement hub that takes title to goods on DES

216. *In this arrangement, the hub effectively earns a 5% margin or commission on its sales by selling at a price that is 105% of the purchase price charged by its third party suppliers. It sells both non-core products and other goods on the same pricing terms. Custom duties incurred on behalf of its customers are reimbursed. It is estimated that 10% of the hub's staff are involved in providing non-core product to an Australian entity.*

217. *Calculation of the mark-up should only capture the operating revenue and costs related to non-core product procurement activities. Subtracting the cost of goods sold from sales will compute procurement revenue. Pass through costs and operating shipping revenue and expenses are excluded for the purposes of measuring the non-core procurement hub's mark-up on costs. Headcount is used to allocate costs.*

	$m
Revenue	
Sales	420
Customs duties	1
Shipping	9
Total revenue	**430**
Expenses	
Cost of goods sold	400
Salary	4
Rent	2
Utilities	1
Shipping	5
Customs duties	1
Total expenses	**413**
EBIT (total revenue less total expenses)	**17**
Procurement function	
Sales revenue	42
Cost of goods sold	40
Hub revenue	**2**
Operating costs	
Salary	0.4
Rent	0.2
Utilities	0.1
(A) Hub costs	**0.7**
(B) Hub profit (EBIT)	**1.3**
Hub mark-up equals (B) / (A)	1.3 / 0.7 = **185%**

218. *An analysis of the revenue and expenses connected with the procurement function identifies a mark-up on the procurement function costs of 185%. Therefore, it would be outside the green zone.*

Full CFC attribution – move to the green zone

219. The Commissioner recognises that, if you attribute income of your non-core procurement hub via the CFC provisions, your tax risk may be reduced. Accordingly, you may move to the green zone, notwithstanding that you do not satisfy the low risk benchmark, if you include the income from procurement activities of the non-core procurement hub in your Australian assessable income.

220. Specifically, unless an exception in paragraph 221 of this schedule applies, you will be in the green zone if, under the CFC provisions, you have a 100% attribution percentage[48] in relation to the non-core procurement hub and you include the income related to the procurement activities of the hub in your assessable income for Australian tax purposes, that is, the income is 'tainted'.

221. You will not move to the green zone if one of the following circumstances applies to your non-core procurement hub arrangement:

(a) The tainted income of the non-core procurement hub is reduced by transactions that are not in accordance with arm's length conditions.

(b) The ATO publishes a statement that it has a concern about a risk or issue that may apply to your non-core procurement hub.[49]

222. We recognise there may be a reduction in your Australian tax liability if your non-core procurement hub is subject to foreign income tax and you are eligible for a foreign income tax offset. However, provided there is no reduction in total tax payable, your non-core procurement hub will be viewed as being low risk and you are able to rate your hub as being in the green zone.

223. If you do not meet these criteria or the low risk indicator, you will not be in the green zone. In these circumstances you will need to apply the additional indicators to assess which zone you will be in. To assess your base rating you need to calculate the tax impact of your non-core procurement hub, as per paragraphs 224 to 225 of this schedule.

Outside of the green zone – how to calculate the tax impact of your hub

224. Broadly, the tax impact is the difference between the hub profit and the profit outcome that arises when applying the cost plus indicator.

225. You will need to use the following formula to determine your tax impact for your non-core procurement hub for a particular income tax year:

tax impact = [hub profit less 25% mark-up above hub costs] × non-attributed income ratio × Australian company tax rate

The non-attributed income ratio is that part of hub profit that is not attributed back to and taxed in Australia under Australia's CFC provisions, as a proportion of hub profit.

226. The table below uses the earlier examples to illustrate the tax impact calculation where nil, 40% and 50% of hub non-core product procurement activity income is attributed under Australia's CFC provisions respectively.

	Example 3 ($m)	***Example 4 ($m(***	***Example 5 ($m)***

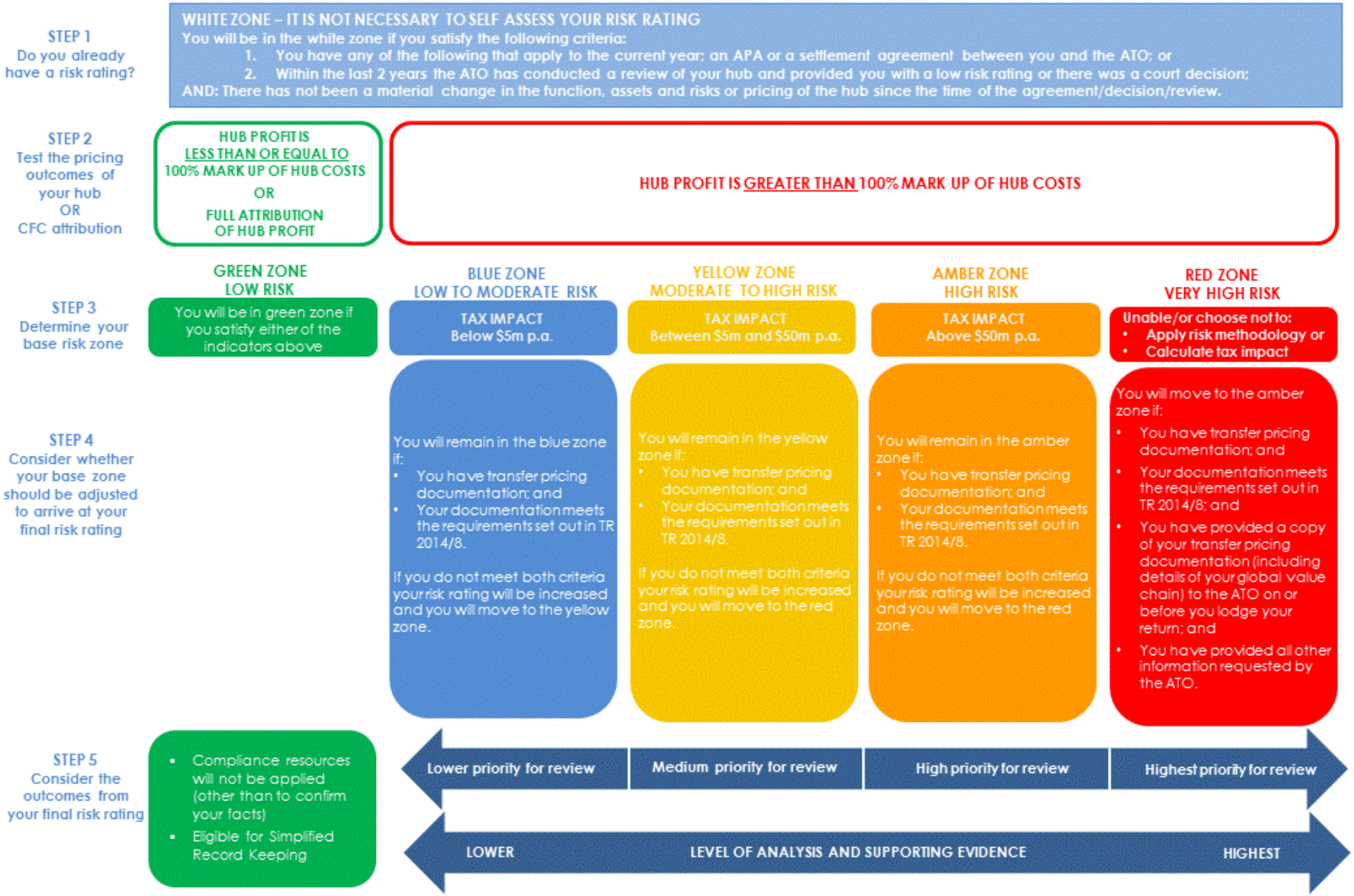
[48] As defined in section 362 of the ITAA 1936.
[49] For example, Taxpayer Alert TA 2015/5 *Arrangements involving offshore procurement hubs*.

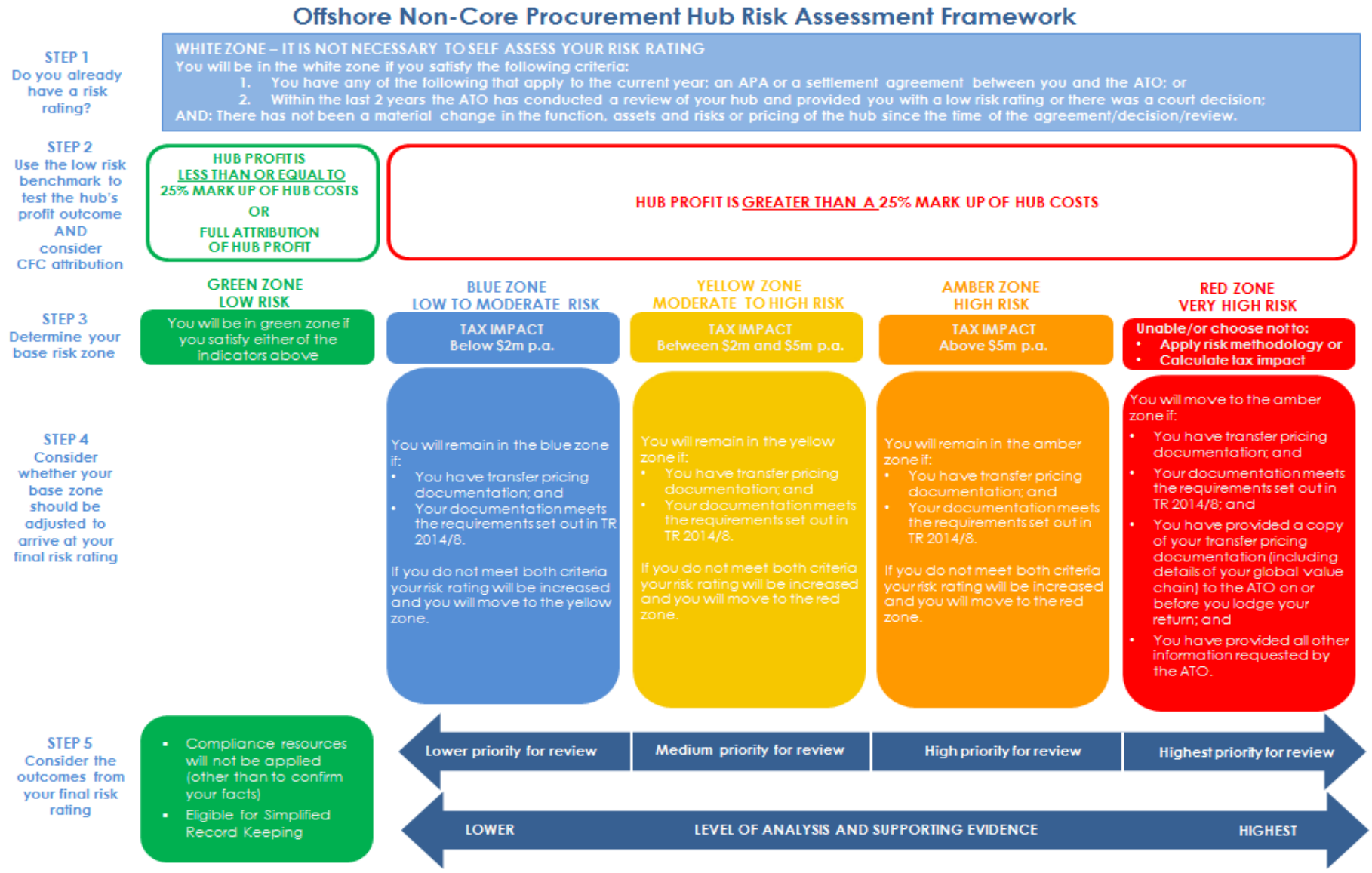
Hub profit	*18.00*	*70.00*	*1.30*
Less 25% mark-up on costs	*1.75*	*7.50*	*0.18*
	16.25	*62.50*	*1.12*
Non-attributed income ratio	*100%*	*60%*	*50%*
Non-attributed income	*16.25*	*37.50*	*0.56*
Tax impact (at 30% tax rate)	*4.88*	*11.25*	*0.17*
Base risk zone	*Yellow*	*Amber*	*Blue*

227. Once you have calculated the tax impact and determined the base risk zone, consider whether your base risk zone should be adjusted according to the criteria for transfer pricing documentation in paragraphs 55 to 59 of this Guideline.

Commissioner of Taxation
16 January 2017

Offshore Marketing Hub Risk Assessment Framework




Offshore Non-Core Procurement Hub Risk Assessment Framework
STEP 1
Do you already have a risk rating?
WHITE ZONE – IT IS NOT NECESSARY TO SELF ASSESS YOUR RISK RATING
You will be in the white zone if you satisfy the following criteria:
1. You have any of the following that apply to the current year; an APA or a settlement agreement between you and the ATO; or
2. Within the last 2 years the ATO has conducted a review of your hub and provided you with a low risk rating or there was a court decision;
AND: There has not been a material change in the function, assets and risks or pricing of the hub since the time of the agreement/decision/review.
STEP 2
Use the low risk benchmark to test the hub's profit outcome AND consider CFC attribution
HUB PROFIT IS LESS THAN OR EQUAL TO 25% MARK UP OF HUB COSTS
OR
FULL ATTRIBUTION OF HUB PROFIT
HUB PROFIT IS GREATER THAN A 25% MARK UP OF HUB COSTS
STEP 3
Determine your base risk zone
GREEN ZONE
LOW RISK
You will be in green zone if you satisfy either of the indicators above
BLUE ZONE
LOW TO MODERATE RISK
TAX IMPACT
Below $2m p.a.
YELLOW ZONE
MODERATE TO HIGH RISK
TAX IMPACT
Between $2m and $5m p.a.
AMBER ZONE
HIGH RISK
TAX IMPACT
Above $5m p.a.
RED ZONE
VERY HIGH RISK
Unable/or choose not to:
• Apply risk methodology or
• Calculate tax impact
STEP 4
Consider whether your base zone should be adjusted to arrive at your final risk rating
You will remain in the blue zone if:
• You have transfer pricing documentation; and
• Your documentation meets the requirements set out in TR 2014/8.
If you do not meet both criteria your risk rating will be increased and you will move to the yellow zone.
You will remain in the yellow zone if:
• You have transfer pricing documentation; and
• Your documentation meets the requirements set out in TR 2014/8.
If you do not meet both criteria your risk rating will be increased and you will move to the red zone.
You will remain in the amber zone if:
• You have transfer pricing documentation; and
• Your documentation meets the requirements set out in TR 2014/8.
If you do not meet both criteria your risk rating will be increased and you will move to the red zone.
You will move to the amber zone if:
• You have transfer pricing documentation; and
• Your documentation meets the requirements set out in TR 2014/8; and
• You have provided a copy of your transfer pricing documentation (including details of your global value chain) to the ATO on or before you lodge your return; and
• You have provided all other information requested by the ATO.
STEP 5
Consider the outcomes from your final risk rating
• Compliance resources will not be applied (other than to confirm your facts)
• Eligible for Simplified Record Keeping
Lower priority for review
Medium priority for review
High priority for review
Highest priority for review
LOWER
LEVEL OF ANALYSIS AND SUPPORTING EVIDENCE
HIGHEST

Amendment history

Date of amendment	Part	Comment
10 October 2018	Table of Contents	Inserted new paragraphs. Headings corrected
	Paragraph 68	Amended description of administrative law principles.
	Paragraph 138A	Inserted new paragraph as Schedule 1 transitional period has ended.
	Schedule 2	Schedule 2 added and published as final.
27 June 2018	Schedule 2	Schedule 2 added and published as draft for comment
17 March 2017	Footnotes 6, 14 & 15 Whole document	Updated referenced document and links. Updated style in accordance with corporate requirements.

References

Legislative references	ITAA 1936 ITAA 1936 262A ITAA 1936 Pt III Div 13 ITAA 1936 362 ITAA 1997 ITAA 1977 Div 815 ITAA 1997 Subdiv 815-B ITAA 1997 Subdiv 815-C ITAA 1997 Subdiv 815-D ITAA 1997 815-130 TAA 1953 TAA 1953 Sch 1 Div 280 TAA 1953 Sch 1 Div 284 TAA 1953 Sch 1 Subdiv 284-E TAA 1953 Sch 1 284-250 TAA 1953 Sch 1 Div 358
Related Rulings/Determinations	TR 1999/1 TR 2014/6 TR 2014/8 PCG 2017/2
Other references	PS LA 2006/8 PS LA 2009/4 PS LA 2009/9 PS LA 2011/30 PS LA 2012/4 PS LA 2012/5 PS LA 2013/3 PS LA 2014/2 PS LA 2014/4 PS LA 2015/1 PS LA 2015/4 PS LA 2016/2 TA 2015/5 OECD Base Erosion and Profit Shifting Project, Aligning Transfer Pricing Outcomes with Value Creation, 2015 Final Reports Actions 8-10 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017
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