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UNDERSTANDING AND APPLYING THE ‘ARMS-LENGTH’ PRINCIPLE TO RELATED PARTY DEALINGS

2017 APPEA TAXATION AND COMMERCIAL CONFERENCE

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Cameron Rider, Special Counsel, +61 3 9288 1832, cameron.rider@greenwoods.com.au

THE OLD ARM'S LENGTH PRINCIPLE

"The principle requires that transactions between associated enterprises are priced as if the enterprises were independent, operating at arm's length and engaging in comparable transactions under similar conditions and economic circumstances. Where the conditions of the transaction are different to those between third parties in comparable circumstances, adjustments to the profits may be needed for tax purposes."

\- BEPS Actions 8-10: 2015 Final Reports

THE *CHEVRON* REFORMULATION

"One could well accept, without difficulty, that a stand-alone company with CAPHL's balance sheet which borrowed AUD 2.5 billion unsecured for five years with no operational or financial covenants would pay a significant interest rate, and in all likelihood on the evidence, above 9%."

- Allsop CJ, *Chevron*

THE BEPS REFORMULATION

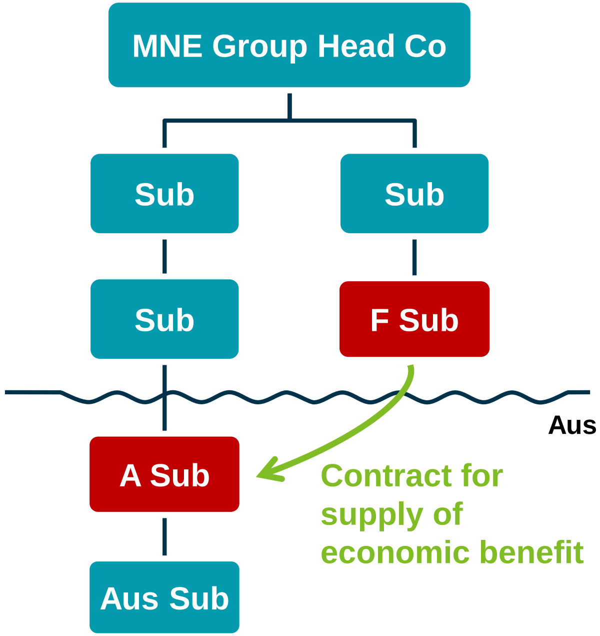
"The arm's length principle has proven useful as a practical and balanced standard for tax administrations and taxpayers to evaluate transfer prices between associated enterprises, and to prevent double taxation. ***However, with its perceived emphasis on contractual allocations of functions, assets and risks, the existing guidance on the application of the principle has also proven vulnerable to manipulation. This manipulation can lead to outcomes which do not correspond to the value created through the underlying economic activity carried out by the members of an MNE group****. Therefore, the BEPS Action Plan required the guidance on the arm's length principle to be clarified and strengthened ..."*

- BEPS Actions 8-10: 2015 Final Reports

*Aligning Transfer Pricing Outcomes with Value Creation**

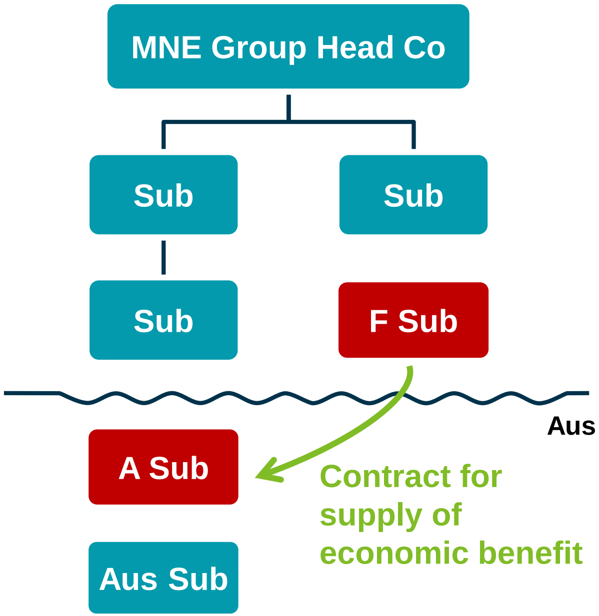
* Now incorporated in OECD 2017 Transfer Pricing Guidelines

THE ISSUES



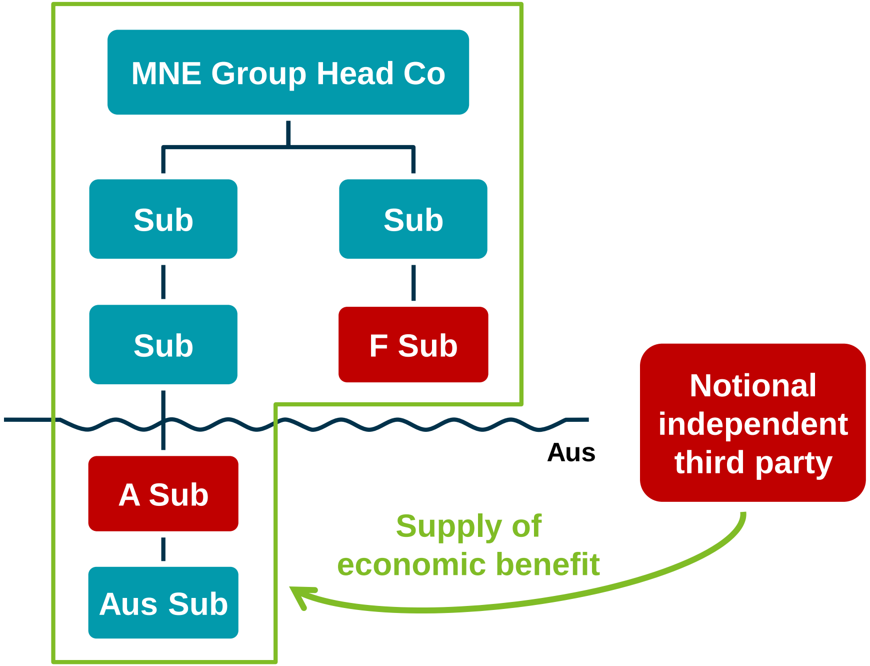
1. What is meant by independent?
   (a) Do you hypothesise that A Sub and F Sub are stand-alone entities rather than members of an MNE group?
   (b) Or do you hypothesise what price would be set if independent third parties entered the same contract?
2. Do you price the actual contract or do you price a hypothetical notional contract between independent third parties?
   (a) *Chevron* seems to say the latter.
3. If you hypothesise independent third parties, to what extent do you attribute to them the actual financial and commercial profile of A Sub and F Sub?
   (a) If you do attribute, does the attributed profile include their membership of the MNE group?
   (b) *Chevron* says ‘yes’.

TRADITIONAL OECD APPROACH



If A Sub and F Sub were independent enterprises, and entered the contract at arm's length, how would <u>that</u> contract be <u>priced</u>?

AUSTRALIAN POST-*CHEVRON* APPROACH?



If the MNE group had obtained the economic benefit from an independent third party, what would have been the <u>terms</u> of the contract, and, <u>on those terms</u>, how would it be <u>priced</u>?

IMPLICATIONS OF THE NEW AUSTRALIAN APPROACH?

Traditional approach	**New Australian approach?**
1. Look to pricing of external comparables, then adjust to reflect (1) actual terms of the internal contract and (2) actual financial and commercial profile of A Sub and F Sub considered as stand-alone entities. • If internal terms alter risk compared to external comparables, adjust price. • If 'stand-alone' profile of A Sub or F Sub differs from profile of parties to external comparables, adjust price.	1. Adjust internal price to align with pricing of external comparables? • Cannot use terms of internal contract to justify deviation from pricing of external comparables? • Cannot use 'stand-alone' financial and commercial profile of A Sub to justify deviation from pricing of external comparables? [And stand-alone profile of F Sub is irrelevant?] • [This approach may align with new BEPS guidance on risk and transfer pricing.]
2. Alternative pricing methods often likely to be more reliable than adjusted CUPs.	2. Adjusted CUPs are the privileged method?

IMPLICATIONS OF THE NEW AUSTRALIAN APPROACH? (cont.)

Traditional approach	New Australian approach?
3. Internal contract between A Sub and F Sub must have arm's length price on stand-alone basis, regardless of associated transactions with other members of MNE group.	3. In determining what would be pricing of deal between A Sub and notional independent third party (NITP), is permissible to hypothesise that other members of MNE group may have entered associated transactions with NITP that affected the pricing of deal between A Sub and NITP?
4. Absent exceptional circumstances, should not reconstruct terms of internal contract.	4. Purpose of TP rules is to reconstruct internal contract to match terms and pricing of notional contract with NITP?

ARM’S LENGTH PRINCIPLE AFTER BEPS ACTIONS 8-10

- The actual contract between the actual MNE group parties is no longer determinative of how profits from a transaction are allocated between members of an MNE group.
- New approach is to focus on <u>conduct</u>, not <u>contracts</u>: you allocate profits according to the ‘economic significance’ of the actual underlying business activities of all the members of the MNE group:
  - so no longer permissible to simply focus on A Sub and F Sub;
  - also no longer permissible to simply focus on the terms of the actual contract between A Sub and F Sub.

RELEVANT ACTIVITIES INCLUDE ACTUAL CONDUCT AND DECISION-MAKING WITHIN THE MNE GROUP

*“**The analysis focuses on what the parties actually do and the capabilities they provide. Such activities and capabilities will include decision-making, including decisions about business strategy and risks**. For this purpose, it may be helpful to understand the structure and organisation of the MNE group and how they influence the context in which the MNE operates. **In particular, it is important to understand how value is generated by the group as a whole, the interdependencies of the functions performed by the associated enterprises with the rest of the group, and the contribution that the associated enterprises make to that value creation**. It will also be relevant to determine the legal rights and obligations of each of the parties in performing their functions. While one party may provide a large number of functions relative to that of the other party to the transaction, **it is the economic significance of those functions** in terms of their frequency, nature, and value to the respective parties to the transactions **that is important**.”*

SOME IMMEDIATE OUTCOMES OF BEPS ACTIONS 9-10

1. Contractual re-allocations of risks are no longer effective.	Risks (and profits) contractually allocated to a party that does not (1) in fact exercise meaningful and specifically defined control over the risks, and (2) have the financial capacity to assume the risks, will be re-allocated to the MNE group member that does exercise such control and does have the financial capacity.
2. For intangibles, legal ownership does not generate a right to all (or indeed any) of the return that is generated by the exploitation of the intangibles.	Instead returns will be re-allocated to the members of the MNE group that actually perform the 'DEMPE' functions – development, enhancement, maintenance, protection and exploitation of intangibles.
3. Low-activity 'cash boxes' are no longer entitled to risk-based financial returns.	Cash-boxes that provide funding but perform few activities will not be allocated profit associated with the financial risks: will be entitled to no more than a risk-free return.
4. Synergy benefits have to be allocated to the MNE group members who contribute to obtaining the benefits.	E.g. discounts generated by the volume of goods purchased by group members must be allocated to the group members in proportion to purchases.

PRACTICAL IMPLICATIONS?

1. Look for external dealings of MNE group to use as comparables.
2. Has MNE group <u>obtained</u> same/similar economic benefit from independent third parties?
3. Has MNE group <u>supplied</u> same/similar economic benefit to independent third parties?
4. Are there examples of other ‘real world’ contracts between independent MNE groups for supply of this kind of economic benefit?
5. Be more prepared to use external dealings to test pricing, rather than reject on basis not sufficiently comparable due to different terms, stand-alone profiles of parties.
6. Identify which MNE entities are performing the actual underlying business activities.
7. Identify which MNE entities are actually making <u>the decisions</u> about which activities are conducted, how they are conducted, and why they are conducted – including decisions about <u>risk</u> and strategy.
8. Consider if any part of the profit has to be re-allocated from the actual parties to the contract to other members of the MNE group.
9. The three C’s: it’s not the contract; CUPs and conduct are now the key.

GREENWOODS
+ HERBERT
SMITH
FREEHILLS

SYDNEY
ANZ Tower, 161 Castlereagh Street
Sydney NSW 2000
T +61 2 9225 5955
F +61 2 9221 6516

MELBOURNE
101 Collins Street
Melbourne VIC 3000
T +61 3 9288 1881
F +61 3 9228 1828

PERTH
QV.1 Building, 250 St Georges Terrace
Perth WA 8000
T +61 8 9211 7770
F +61 8 9211 7755

www.greenwoods.com.au