



Decision Impact Statement

Roche Products Pty Ltd v Commissioner of Taxation

Court Citation(s):

[2008] AATA 639
2008 ATC 10-036
70 ATR 703

Venue: AAT**Venue Reference No:** NT 2005/7 & 56-65**Judge Name:** Downes, J President**Judgment date:** 22 July 2008

Appeals on foot:

No

Administrative Treatment (Implication on current Public Rulings and Determinations)

Relevant Rulings/Determinations:

- TR 92/11
- TR 94/14
- TR 97/20
- TR 98/11
- TR 2001/13

Subject References:

TAXATION

income tax

transfer pricing

application of Division 13 of Part IIIA, Income Tax Assessment Act 1936 or international treaties

conferral of power by international treaties to assess for tax

"arm's length" prices for pharmaceutical products

transfer pricing methods

comparable transactions

conflicting expert opinions

assessment excessive

assessment set aside



This document is not a public ruling, but provides a statement of the Commissioner's position in relation to the decision and how the law will be administered as a consequence of the decision. Any proposals for changes in the law are matters for government and it is not appropriate for the Commissioner to comment.

Précis

Outlines the Tax Office view in relation to this decision which was the first decision by an Australian tribunal or court in a substantive transfer pricing matter involving the application of the current Division 13 of the Income Tax Assessment Act 1936.

Brief Summary of Facts

The Applicant is an Australian subsidiary of the Roche Group, the parent company of which is a resident of Switzerland. Roche is a major pharmaceutical corporation with integrated operations in many countries. It carries on research and development, manufacturing, marketing, selling and distribution of pharmaceuticals, vitamins, chemicals, diagnostic and other products. During the 1993 to 2003 income years (the relevant income years) the Applicant carried on business in Australia marketing, selling and distributing Roche products through three divisions: the Prescription Division (dealing in prescribed drugs), the Consumer Health Division (dealing in over the counter pharmaceuticals) and Diagnostic Products (dealing in diagnostic equipment and supplies).

The Commissioner audited the transfer prices of the Roche products acquired by the Applicant as trading stock during the relevant income years from related companies located in Switzerland and Singapore and formed the view that those prices were excessive.

The Commissioner issued assessments increasing the Applicant's taxable incomes in the relevant income years by a total of approximately \$126 million by:

- 1) increasing the amount of profit of the Applicant pursuant to the associated enterprises articles of the Swiss Double Tax Agreement (Swiss DTA) and Singapore Double Tax Agreement (Singapore DTA) ; and
- 2) determinations pursuant to Division 13 of the Income Tax Assessment Act 1936 (Division 13, ITAA 1936) disallowing deductions claimed by the Applicant for the portion of the purchases that were considered to exceed the arm's length consideration.

The Applicant objected to the assessments. In determining the objections the Commissioner reduced the adjustments to a total of approximately \$110 million for the 1993-2003 income years. The Applicant then sought a review of the Commissioner's objection decisions by the Administrative Appeals Tribunal. The application was heard by the President, Downes J.

Before the Tribunal both parties sought to support their case as to the determination of the arm's length consideration for the products acquired by the Applicant by evidence from economists with expertise in transfer pricing. While the economists' evidence was consistent in most respects with general OECD principles relating to the economic methods used to apply the arms length principle, their choice and application of the various methods were not aligned and their conclusions on the data used by them differed.

The first economist (engaged by the Commissioner prior to the litigation to assist in determining the objections) used the resale price method, the cost plus method (although not by reference to actual sales or transactions) or the Transactional Net Margin Method (TNMM), to calculate the adjustments for each division.

The second economist (engaged by the Applicant in the course of the litigation) used the Comparable Uncontrolled Price (CUP) method on some transactions which he extended into a Resale Price analysis for other dealings of the Prescription Division. In the absence of transactional data he used TNMM for Consumer Health. No method was used for Diagnostic Division but he opined that the outcome was arm's length.

The third economist (engaged by the Commissioner in the course of the litigation) used the CUP/Resale Price extension approach of the second economist but he obtained a different result after making different judgments about some of the data. He used TNMM for Consumer Health and Diagnostics.

The first economist agreed in principle that a CUP method is to be preferred for determining arm's length prices but disagreed with the other economists that that method could be properly applied on the transactional data presented. Each expert's application of TNMM produced a different answer because of the different data, judgments and assumptions they used. The evaluation of and weight to be given to the expert opinion was further complicated by the emergence during the hearing of certain evidence from the witnesses of fact, including evidence relating to agreements made by the Applicant's parent company with independent third parties for the sale of Roche pharmaceutical drugs in Australia.

His Honour gave a decision on 2 April 2008 that the Applicant's taxable incomes should be adjusted by reference to a gross profit margin within the Applicant's Prescription Division of 40%. In relation to the other

Divisions, the decision set aside the Commissioner's transfer pricing adjustments. The result was a substantial reduction in the overall transfer pricing adjustment for the period under review. However, the decision implied an increase in the transfer pricing adjustment and liability to tax in three of the eleven years under consideration.

The Tribunal's reasons of 2 April 2008 were handed down in a preliminary form and the parties given leave to make further submissions on a limited range of matters affecting the final orders. With the benefit of further written and oral submissions, His Honour handed down his final decision on 22 July 2008. In the result the aggregate transfer pricing adjustment reduced to approximately \$45 million.

Issues decided by the Court

Issues

1. Whether Article 9 of the Swiss DTA and Article 6 of the Singapore DTA authorise the Commissioner to make transfer pricing assessments, independently of Division 13;
2. Whether the Commissioner correctly made determinations for the purposes of Division 13 by reference to the correct considerations;
3. Whether the Tribunal is empowered to make a decision resulting in increases in the assessments in particular years, and whether the Commissioner would be empowered to give effect to those assessments, pursuant to the previous form of amendment powers contained in subsections 170(2), (7), (9B) and (9C) ITAA 1936;
4. Whether by reference to the evidence adduced including the evidence of expert economists, it could be concluded that:
 - (a) the profits of the Applicant were consistent with the profits that could have been expected to have accrued; and / or
 - (b) the prices paid by the Applicant for trading stock purchased from other entities within the Roche Group were consistent with the prices the Applicant would have paid if the Applicant had been dealing at arm's length with the other entities within the Roche Group.

Answers to Issues

1) Treaty Power

Not necessary to decide: It was common ground that Division 13 applied and His Honour dealt with the matter on that basis. However he commented: "...I note that there is a lot to be said for the proposition that the treaties, even as enacted as part of the law of Australia, do not go past authorising legislation and do not confer power on the Commissioner to assess. They allocate taxing power between the treaty parties rather than conferring any power to assess on the assessing body."

2) Division 13

Subsection 136AD(3) of Division 13 applied. However, the arm's length consideration for the relevant property acquired by the Applicant was less than that determined by the Commissioner.

3) Power to Increase Assessments

Subsection 170(7) did not confer on the Tribunal power that the Commissioner did not have at the time that the objection decisions under review were decided. The Tribunal in exercising its function under subsection 43(1) of the AAT Act could properly order an increase in the assessments for the 2002 and 2003 years as the period under section 170(2) for the issue of an amended assessment increasing liability had not expired

when the relevant objections were decided. That was not the position in relation to the 1997 year. The amendment period under subsection 170(2) having expired, the Commissioner raised the 1997 assessment in reliance on subsection 170(9B), which authorises amendment to implement transfer pricing adjustments at any time, subject to subsection 170(9C). At the time that he determined the objection, the Commissioner was precluded by subsection 170(9C) from amending the assessment to increase the liability with respect to the same transfer pricing matters. The Tribunal was similarly constrained.

4) Arm's Length Outcomes

In relation to the Prescription Division, His Honour took an overall view of the material before him and moderated the result of the CUP/Resale Price extension method with the other evidence to arrive at a 40 % gross margin that was applied to all acquisitions by the prescription division.

In setting the gross margin percentage he had regard to:

- expert evidence (particularly that of the second and third economists who used some adjusted CUP data to calculate a Resale Price Margin);
- evidence of dealings with generic supplier Alphapharm;
- the 60-65% gross margin for a new patented drug Inhibace which was licensed to Bayer;
- the involvement of the tax department of Roche in Switzerland; and the low level of profitability of the Applicant, but this was given relatively little weight.

There were no comparable sales for the Consumer Health Division and the expert evidence analysed the outcome using TNMM. A question arose as to whether it was more appropriate to analyse the Division as a whole or by reference to sub-categories of products within the Division. The experts took differing approaches. His Honour's decision was that the proper conclusion, accepting that the overall operating profit of the Consumer Division was well in the arm's length range, was that the acquisition prices for the relevant products from the least profitable subcategory were acceptable.

For the Diagnostic Division the Commissioner's assessment was supported by expert evidence using a profit based approach as no comparable product sales were available. Evidence for the Applicant concerned commercial factors impacting upon the diagnostics business and gave reasons for the lack of profits over the period. The totality of the evidence satisfied His Honour that the prices for which the Diagnostic Division acquired the products were not excessive.

Tax Office view of Decision

The tax office has not appealed against the Tribunal's decision.

Treaty Power - The Commissioner is not bound by the observations made by His Honour on this point and will continue to adhere to the position outlined in TR 92/11, TR 94/14 and TR 2001/13 that the business profits or associated enterprises article of a DTA may provide a separate basis for assessing transfer pricing adjustments, independently of Division 13

Division 13 - The Tribunal was entitled, on the evidence before it, to form its own view of the amount of the arm's length consideration for the relevant property and decide that subsection 136AD(3) applied. If warranted, the Tribunal had the power to apply subsection 136AD(4) to determine the arm's length consideration.

Power to Increase Assessments - The reasoning regarding the Tribunal's power to order an increase in the liability is accepted. It should be noted that the provisions of the ITAA 1936 that authorise amendment of assessments were amended in 2005 and this may have a bearing on the position in circumstances to which the amended provisions apply.

Arm's Length Outcomes - The conclusions reached in relation to the determination of the arm's length consideration were open on the evidence before the Tribunal. The decision is confined to the facts of the

case.

Administrative Treatment

The legislative provisions considered in this matter have been present in the Act for many years and during that period the Commissioner has maintained a focus on transfer pricing issues as part of audit programs. While this decision has assumed some importance as the first substantive consideration of the application of the present form of Division 13 of the ITAA 1936, in essence it concerns the determination of the arm's length consideration for the acquisition of property under an international agreement in the particular circumstances of this case. All things considered it is seen as having limited significance for the administration of transfer pricing laws generally.

His Honour's comments about the broad consideration of CUPs and the concerns expressed about the application of indirect profit based methods such as the TNMM as a means of determining the arm's length consideration is consistent with and highlights the need in the particular circumstances to identify the available data that may establish an arm's length consideration for each of the dealings and for the dealings taken in their entirety, as per Step 2 of the process described in TR 98/11. In this step it is important to ascertain the extent and reliability of the uncontrolled data that is available.

Implications on current Public Rulings & Determinations

No amendments to current public rulings & determinations are warranted.

Implications on Law Administration Practice Statements

No PS(LA)s affected.

Your comments

We invite you to advise us if you feel this decision has consequences we have not identified, or if a precedential decision such as a Public Ruling or an ATO ID requires reconsideration or amendment. Please forward your comments to the contact officer by the due date.

Date Issued:	23 January 2009
Due Date:	20 March 2009
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Legislative References:

Taxation Administration Act 1953

14ZYA

14ZZ

14ZZK

14ZZL(1)

Income Tax Assessment Act 1936

136AD(3)

136AD(4)

170(2)

170(7)

170(9B)

170(9C)

170(14)

International Tax Agreements Act 1953

Schedule 5

Schedule 5A

Schedule 15

Patents Act 1952

93(b)

Administrative Appeals Tribunal Act 1975

43(1)

Case References:

Bayer AG v. Minister for Health
(1988) 96 FLR 50

Fletcher v. Commissioner of Taxation

(1988) 19 FCR 442
19 ATR 1765
88 ATC 4834

Green v. Minister for Immigration and Citizenship
[2008] FCA 125

Jones v. Dunkel
(1959) 101 CLR 298

McDonald v. Director General of Social Security
(1984) 6 ALD 6
1 FCR 354

Shi v. Migration Agents Registration Authority
(2007) 158 FCR 525
[2007] FCAFC 59

Spencer v. The Commonwealth
(1907) 5 CLR 418

Stevenson v. Commissioner of Taxation
(1991) 29 FCR 282
22 ATR 56
91 ATC 4476

W R Carpenter Holdings Pty Ltd v. Federal Commissioner of Taxation
(2007) 161 FCR 1
66 ATR 336
2007 ATC 4679

Other References

Agreement between Australia and Switzerland for the Avoidance of Double Taxation with respect to Taxes on Income [1981] ATS 5 Article 9;

Agreement between the Government of Australia and the Government of the Republic of Singapore for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income [1969] ATS 14 Article 6;

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