Australian Government
Australian Taxation Office

Decision Impact Statement

Commissioner of Taxation v SNF Australia Pty Ltd

Court Citation(s):
[2011] FCAFC 74
2011 ATC 20-265
193 FCR 149
82 ATR 680

Venue: Full Federal Court
Venue Reference No: VID 731 of 2010
Judge Name: Ryan, Jessup & Perram JJ
Judgment date: 1 June 2011
Appeals on foot:
No.

Administrative Treatment (Implication on current Public Rulings and Determinations)

Relevant Rulings/Determinations:
- TR 94/14
- TR 97/20
- TR 2010/7
- TR 2011/1

Subject References:
Transfer pricing
International taxation
Arm's length consideration
Comparable uncontrolled price
Relevance of 'Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations' (Organisation for Economic Co-operation and Development (1995)) (OECD Guidelines) to the construction of double taxation treaties and domestic legislation
Probative value of admitted but inadmissible hearsay

Decision Outcome:

Adverse

Précis

The case concerned whether the taxpayer paid more than the arm's length price for products acquired from overseas related parties so that the Commissioner could apply the transfer pricing rules to adjust the purchase price for income tax purposes.

Brief Summary of Facts

The taxpayer was a member of a global group whose headquarters are in France. The taxpayer bought certain chemicals from group companies overseas, and sold them to unrelated end-users in various industries in Australia. From its incorporation in 1990 until 2004, the taxpayer consistently returned tax losses.

The taxpayer was subject to a transfer pricing audit. Determinations were made under Division 13 of Part III of the *Income Tax Assessment Act 1936* to adjust the consideration for the company's international related party transactions to reflect an arm's length amount. For the income years from 1997 to 2003, the Commissioner made determinations under ss136AD(3) and (4) of the Act as to the arm's length price of the chemicals.

The Commissioner issued notices of assessment in 2007, and subsequently disallowed the taxpayer's objections to those assessments.

The taxpayer produced evidence of sales by the overseas suppliers to third party purchasers, which it submitted established comparable uncontrolled prices (CUP) that were as high as or higher than the prices paid by the taxpayer.

Issues decided by the Court

1. Although the trial judge failed to give full reasons for the conclusions he made on the evidence led by the taxpayer at trial, a review of that evidence demonstrated that the trial judge's conclusion that two of the three sets of transactions relied upon by the taxpayer were comparable and so made out a CUP was correct. The Full Court found that the taxpayer had not established comparability of function between the taxpayer and the companies it used for its second CUP analysis. Whilst the Full Court accepted the third CUP analysis, it determined that certain transactions the taxpayer submitted were comparable were in fact not comparable, as the taxpayer had not established functional comparability. There remained sufficient comparables for the Full Court to determine that a CUP had been established.

2. There is a global market for polyacrylamides and this was the basis upon which the Full Court agreed comparability between transactions arose. It was not necessary for the taxpayer to demonstrate the existence of a global price and "price dispersion... did not disprove the existence of that [global] market so long as the dispersion related to competitive rather than local effects."

3. The trial judge did not err in accepting the evidence of the French owner given under cross-examination. The evidence was not contradictory to any documentary or oral evidence led on behalf of the taxpayer.

4. The trial judge's interpretation of the concept of 'arm's length consideration' in s136AD(3) was correct. The phrase 'between independent parties dealing at arm's length' in s136AA(3)(d) is ambiguous, but should not be interpreted as requiring the examination of purchasers in exactly the same position as the taxpayer. The Full Court rejected the Commissioner's submission that the trial judge substituted the inquiry required by s136AD with an inquiry as to valuation.

5. The OECD Guidelines in general "are not a legitimate aid to the construction of the double taxation treaties" and neither are they permissible materials for interpreting the double tax treaties Australia has entered into with treaty partners or domestic legislation. However, this does not foreclose an attempt to show that they are relevant to the interpretation of a particular treaty because of the practice of the state parties to that treaty.

6. The Full Court found that it was not necessary for the taxpayer to establish what the arm's length price was; rather, the taxpayer had to demonstrate that it paid less than an arm's length price, which price could be determined by reference to the taxpayer's CUP analyses.

7. The trial judge failed to deal with the objections on evidence in a manner that left the evidentiary record clear. This necessitated the Full Court reviewing the objections to evidence.

Tax Office view of Decision

Government announcement

The Government has announced that it intends to introduce legislation to reform the transfer pricing rules.1 The following discussion reflects the existing legislation only. Readers should bear in mind that the legal position will probably be materially different if Parliament amends the legislation along the lines proposed.

Interpretation of s 136AA(3)(d)

The Commissioner's submission was that s136AA(3)(d) required one to 'stand in the shoes' of the taxpayer and ask what consideration an entity *in the position of the taxpayer* would have been prepared to give had it been independent of its supplier and dealing at arm's length with it. The Court however interpreted this provision as requiring no more than that the parties to the hypothetical transaction in question be independent of each other; not that the hypothetical purchaser must share the characteristics and circumstances of the actual taxpayer in particular [98].

The Court's reasons for rejecting the Commissioner's interpretation of s136AA(3)(d) are based in part on the proposition that, on the Commissioner's interpretation, it would be almost impossible to identify comparable transactions for the purposes of carrying out a CUP analysis because it would be very hard to find purchasers in exactly the same circumstances as the taxpayer, and the Commissioner's interpretation did not allow the possibility of any adjustment to take into account differences between the circumstances of the taxpayer and a proposed CUP party.

With respect, this was not what the Commissioner intended to submit or understood himself to have submitted. It was never the ATO view that Division 13 precludes the possibility of performing a sufficiently reliable adjustment to reflect any material differences between the circumstances of the actual parties to a transaction and those of the parties to a potentially comparable transaction. The ATO view, however, was that a proposed arm's length consideration must ultimately make commercial sense for the actual taxpayer in its actual circumstances, bearing in mind that, in the Commissioner's view, a number of different transfer pricing methods could be used to determine this - not just the CUP method alone. This was consistent with our submission (which the Court rejected) that the taxpayer's proposed CUP evidence had fatal deficiencies.

By implication from the Court's earlier analysis of the argument surrounding the taxpayer's proposed CUP evidence, and from what it said at paragraph [121], the Court does consider the circumstances in which the actual transaction occurred to be relevant to at least some degree. In particular, the five comparability factors which the taxpayer and its expert witness seemed to accept, and which the Commissioner accepted, were relevant relate to some degree to the circumstances of the taxpayer. Thus, the Court proceeded on the basis that any comparable transaction needed, for example, to have occurred in the same market and to have been on the same terms and conditions as the actual sales, unless suitable adjustments could be made to reflect any material differences.

In view of the above, the ATO does not interpret the Court's rejection of the Commissioner's interpretation of s136AA as meaning that an amount may be less than the arm's length consideration merely because it is less than the prices paid by independent parties generally, regardless of their particular circumstances. As the Full Court's reasons indicate, it is still necessary to have regard to such matters as the economic circumstances of the markets in which the transactions occurred and the business strategies of the proposed comparables.

On the other hand, the ATO accepts that the mere fact that the consideration a taxpayer actually paid for property would leave a hypothetical independent party in the exact same circumstances as the actual taxpayer in a commercially unsustainable position does not by itself entail that the consideration actually paid was more than the arm's length consideration.

Difficult questions may arise for other kinds of transaction in this context. For example, the ATO does not accept, on the strength of the *SNF* decision that the arm's length consideration for a loan of a given amount is necessarily to be determined without regard to the credit rating, and other circumstances, of the actual borrower.

Similarly, how a court would approach the task required by Division 13 if the circumstances had been that, because of its nature, a particular transaction probably would not have taken place at all between unrelated parties remains to be tested in future cases.

Global market

The Court found on the admissible evidence that there was a "global market" for the relevant chemicals, which may in effect be understood as a finding that any variations in the prices charged to independent purchasers by the SNF Group were to be explained by non-geographic factors. This was essentially an empirical question. Any similar suggestion in a future case would need to be tested on the evidence available in that case.

Business strategies

The Court was prepared to accept, although there was no evidence as to this, that the taxpayer's proposed comparable parties probably had a business strategy of trying to make profits in the ordinary way. On this basis, these parties could be regarded as sufficiently comparable. But the Commissioner's case was that here the taxpayer was engaged in a market penetration strategy on behalf of the group, which the Commissioner said was relevant to assessing the comparability of any potential CUP transactions. The Court did not address this argument explicitly. It might be suggested that the Court considered the particular strategies actually adopted by the taxpayer to be irrelevant to the enquiry, consistently with its later comments on s136AA(3)(d). But such a suggestion would seem inconsistent with the Court's treatment of some of the other comparability factors, as discussed above.

The basis for the rejection of the Commissioner's argument on this point does not, with respect, emerge clearly from the judgement. If a similar situation arises in a future case, the ATO will seek clarification of the point.

Relevance of OECD Transfer Pricing Guidelines

The Court's finding that the OECD's Transfer Pricing Guidelines are not a legitimate aid to the construction of either Division 13 or the associated enterprises articles of Australia's Double Tax Treaties as domestically enacted was made subject to a potentially significant qualification.

The qualification is that in a future case it may be possible to demonstrate that the state parties to a particular Treaty have adopted the practice of applying the Guidelines to any of the circumstances in which Article 9 of the Model Law might obtain in their jurisdictions: paragraph [117]. The ATO will consider attempting to demonstrate this in a future case if the occasion arises. However it is not clear whether the Full Court was contemplating that Division 13 might have a significantly different meaning from transaction to transaction depending on whether it can be shown that Australia and the relevant foreign state party have adopted this practice in each given case.

More generally, as a practical matter, to the extent that the Guidelines do not conflict with the legislation or with any decided case, and in the absence of any other reason to alter our views, the ATO will continue to apply the principles of transfer pricing as set out in our public rulings on the subject, which we consider to be essentially consistent with the Guidelines.

Single arm's length consideration or a range?

The ATO accepts that, in a given case, a range of amounts might satisfy the definition of "arm's length consideration", contrary to what a previous Full Federal Court had arguably suggested in an obiter dictum in *WR Carpenter Holdings Pty Ltd v Federal Commissioner of Taxation* (2007) 161 FCR 1.

Implicit agreement to provide services

A possible alternative argument the Commissioner might have put in this case but did not was this: instead of seeking lower prices for the goods it bought, the taxpayer, had it been dealing at arm's length, would have sought separate compensation for the special costs and risks it incurred in prosecuting for the chief long-term benefit of the SNF Group the strategy of building market share in Australia. This would have required the Commissioner to make a separate determination under s136AD(2) rather than, or in the alternative to, that made under s136AD(3).

When similar situations arise in future, the Commissioner will consider taking this approach instead of or in the alternative to the approach taken in this litigation. More generally, future cases examining transactions such as the provision of services or intangibles might well by their nature raise more squarely a wider range of transfer pricing considerations than this case. For example, courts may see a need to address in more detail the most appropriate transfer pricing method or combination of methods. Or, a thorough analysis of the relevant functions, assets and risks assumed by the parties to the transactions concerned may be seen as more pertinent in some such cases.

TNMM and other profit-based transfer pricing methods

The appeal did not resolve the question of whether the Transactional Net Margin Method (TNMM), and by

extension any other profit-based transfer pricing method such as the profit split method, is relevant to the positive determination of the arm's length consideration under Division 13. At first instance, Middleton J said that he rejected "the use and applicability of the TNMM as contended for by the Commissioner in the context of applying Div 13". [129]. Therefore, the ATO must accept that the TNMM is not a valid method of establishing an arm's length consideration for the purpose of s136AA(3).

In cases where it is considered to be not possible or practicable to ascertain the arm's length consideration by other means, the ATO will continue to use profit-based methods in appropriate cases in making determinations under s136AD(4).

Treaties as a separate basis for assessment

This litigation did not resolve the question of whether the Associated Enterprises Articles in Australia's Double Tax Treaties give the Commissioner a basis for making transfer pricing adjustments separately from Division 13. The ATO will maintain its long-held view that they do, and will seek to test this point when a suitable case arises. See paragraphs 39-42 of Taxation Ruling TR 2010/7 (Income tax: the interaction of Division 820 of the *Income Tax Assessment Act 1997* and the transfer pricing provisions)

Administrative Treatment

Implications for ATO precedential documents (Public Rulings & Determinations etc)

Subject to the need to give effect to any amending legislation, the Commissioner will consider whether changes ought to be made to his public rulings in light of the Court's decision, including these:

Taxation Ruling TR 94/14 - Income tax: application of Division 13 of Part III (international profit shifting) - some basic concepts underlying the operation of Division 13 and some circumstances in which section 136AD will be applied

Taxation Ruling TR 97/20 - Income tax: arm's length transfer pricing methodologies for international dealings

Taxation Ruling TR 2010/7 - Income tax: the interaction of Division 820 of the Income Tax Assessment Act 1997 and the transfer pricing provisions

Taxation Ruling TR 2011/1 - Income tax: application of the transfer pricing provisions to business restructuring by multinational enterprises

Implications on Law Administration Practice Statements

None

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:	7 November 2011
Due Date:	1 February 2012
Contact officer:	Jonathan Woodger
Email address:	Jonathan.Woodger@ato.gov.au
Telephone:	03 9285 1682
Facsimile:	03 9285 1943
Address:	Casselden Place 2 Lonsdale Street Melbourne Victoria 3000

Legislative References:
Income Tax Assessment Act 1936
136AA
136AD

International Tax Agreements Act 1953
6
9A
11S
Sch2
Sch11
Sch28

Taxation Administration Act 1953
14ZZO

Case References:
Commissioner of Taxation v. Lamesa Holdings BV
(1997) 77 FCR 597
36 ATR 589
97 ATC 4752

DSG Retail Limited v. Commissioner for Her Majesty's Revenue and Customs
(2009) UKFTT 31 (TC) 1
11 ITLR 869

Estee Lauder Pty Ltd v. Federal Commissioner of Taxation
(1988) 19 ATR 1228
88 ATC 4412

Federal Commissioner of Taxation v. Comber
(1986) 10 FCR 88
17 ATR 413
86 ATC 4171

Fox v. Percy
[2003] HCA 22
214 CLR 118

GlaxosmithKline Inc v. The Queen
[2010] FCA 201

Pascoe v. Commissioner of Taxation
(1956) 30 ALJ 402
(1956) 6 AITR 315

R v. General Electric Capital Canada Inc
[2010] FCA 344

Russell v. Commissioner of Taxation
[2011] FCAFC 10
190 FCR 449
2011 ATC 20-240
79 ATR 315

Seltsam Pty Ltd v. McGuinness
[2000] NSWCA 29
49 NSWLR 262

Thiel v. Federal Commissioner of Taxation
(1990) 171 CLR 338
21 ATR 531

90 ATC 4717

Walker v. Walker
[1937] HCA 44
(1937) 57 CLR 630

WR Carpenter Holdings Pty Ltd v. Federal Commissioner of Taxation
[2007] FCAFC 103
161 FCR 1
66 ATR 336
2007 ATC 4679

WR Carpenter Holdings Pty Ltd v. Federal Commissioner of Taxation
[2008] HCA 33
237 CLR 198
2008 ATC 20-040
69 ATR 29

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