Chapter 17
Case Study

The Weight Resources group is a multinational group resident in Wonderland, a low-tax jurisdiction. The group is in the business of developing, manufacturing and distributing weight loss supplement products. One of their products is a weight loss pill registered under the trademark “Less is More”. It is the crème de la crème of weight loss supplement products, and has proven to be one of the group’s best sellers. It contains a secret active ingredient, known as “Minimynox”.

Facts:

– The parent company of Weight Resources Group (resident in Wonderland) discovered Minimynox (the active ingredient) at its research facilities. It also developed the Less is More product in its commercial form there, obtained the necessary patents, conducted all trials, invented the technology for the manufacture of the active ingredient, was the first to launch the product outside Wonderland and has developed the worldwide marketing strategy.

– LocalCo is a company resident in the case study country, and a distributor of Less is More. It purchases the product in market-ready form directly from its parent company. There is a licence agreement between LocalCo and its parent company, under which LocalCo pays the parent a royalty (7% of sales) for the exclusive distribution rights in the case study country.

– LocalCo took the lead in acquiring approval of regulatory authorities for bringing Less is More to the local market. It also implemented the marketing strategies established by the parent company and introduced the product on the local market by conducting on-site sales activities using its sales staff. The customer base includes first-tier (upper-end market) shops, private clinics and wellness centres. Regulatory approval was obtained in 2005, and LocalCo began selling the product in 2006.

– Profits for LocalCo are as follows (all figures in millions):


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<td>-13.3</td>
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Australia – Case Study

Where Wonderland has a tax treaty with Australia

1. Based on the above facts, looking back, what action could LocalCo have taken to address the transfer pricing risks when it first established operations and/or began to distribute “Less is More” through LocalCo (documentation, APA, etc.)? What would be the relative advantages or disadvantages?

The ATO has earmarked the pharmaceutical industry as an area of current focus (see country chapter Australia, at 2.2.). Accordingly, in order to minimize the risk of a transfer pricing audit, LocalCo would need to consider whether to:

- rely on contemporaneous transfer pricing documentation, ensuring that the degree and quality of documentation deliver an appropriate (low) risk rating (see country chapter Australia, at 2.3.2.). Having the right documentation in place from the start could avoid an audit. The preparation of robust documentation will, in most instances, be cheaper and easier than entering into an APA; or

- seek to enter into an APA. The APA may be either unilateral (between the ATO and LocalCo) or (where there is a treaty in place between Wonderland and Australia) bilateral (see country chapter Australia, at 5.1.).

This decision may be a trade-off between certainty, and the upfront cost and time of the process (see country chapter Australia, at 5.6.).

2. Which transfer pricing method is likely to be most acceptable to the tax authorities based on the above facts, and why? What factors are critical in making this judgement?

As indicated in the country chapter, at 1.1., Division 13 does not prescribe a particular method for determining the arm’s length price. While the ATO
recognizes the methods set down in the OECD Guidelines and requires the “best method” to be adopted,1 the Australian courts and the Administrative Appeals Tribunal have shown a clear preference for direct transfer methodologies where sufficient information is available (see country chapter Australia, at 3.3.4.). In light of this, the potential methods that could be applied are:

– **CUP method.** This method will be appropriate where reliable, independent comparables are available from internal or external sources. In this case, it is not clear that there is a global market for the product. As LocalCo is the first to sell this product in Australia, it may be difficult to identify comparables from external sources. However, appropriate comparables may be available from internal sources if the Weight Resources Group sells its products to independent third parties (as was the case in *Re Roche* and *SNF*; see country chapter Australia, at 3.3.2. and 3.3.3.);

– **resale price method.** The resale price method is likely to be appropriate in similar circumstances to the CUP method, but where the comparables are not exactly the same (e.g. where the product sold is the same or similar but is marketed under a different brand); and

– **profit-based method.** Subject to the discussion of the concerns raised in the recent cases (see country chapter Australia, at 3.3.4.), it may be appropriate to use a profit-based method in this case because the product in question “is unique or contains out-of-the-ordinary intangibles”.2 The most likely option would be the TNMM. The ATO considers the TNMM to be useful in valuing profit attributable to intangibles, in particular in situations involving the licensing of intellectual property. In practice, the TNMM is by far the most commonly applied pricing method.3 However, the ATO has also warned that care is needed where (as in this case) one party owns a manufacturing intangible and the other has developed a marketing intangible. In such cases, the ATO considers that the return on the intangibles needs to be allocated between the different intangible assets that are used.4

3. **Could LocalCo apply for an APA in Australia? If so, which facts would be taken into consideration and which requirements and documentation should be met/provided?**

1. TR 97/20, country chapter Australia note 32.
2. Id. at Para. 3.52.
4. TR 97/20, country chapter Australia note 32, at Paras. 3.83–3.87.
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LocalCo could apply to the ATO for an APA. The fact scenario would appear to be an appropriate one for the ATO to accede to an APA request. LocalCo and the Weight Resources Group would need to determine if a unilateral or bilateral APA is preferred, having regard to the desired level of certainty.

4. If the tax authorities were to look at LocalCo’s transfer pricing, what would be the process?

The process for the ATO in looking into LocalCo’s transfer pricing would be:

– a risk review focused on examination of the quality of the taxpayer’s documentation and the commerciality of its profit outcome;
– audit of the taxpayer, in which the ATO compares its view of the arm’s length price with the view taken by the taxpayer;
– the issue of an ATO position paper (with the opportunity for the taxpayer to respond); and
– if agreement cannot be reached, the issue of an assessment (see country chapter Australia, at 2.3.2.).

Any dispute would then be dealt with in accordance with the usual dispute resolution process; the taxpayer could object to the assessment or seek review of the decision by the Administrative Appeals Tribunal or appeal to the Federal Court (see country chapter Australia, at 3.2.).

5. What would be the areas of concern for the Australian tax authorities?

The ATO will be focused on determining whether the 7% royalty adequately reflects the role of the Australian subsidiary and its contribution to the profit generated by the sale of the “Less is More” product. The ATO’s concerns will likely focus on the:

– initial losses;
– average return over the period in question;
– location of the related party, in a low-tax jurisdiction; and
– adequacy of the taxpayer’s documentation.

6. Is it likely that the Australian tax authorities would make a primary adjustment? If so, why and based on what factors? What other actions might they take?

In Australia, the likelihood of the Commissioner making a primary adjustment depends largely on the evidence that LocalCo is able to present to the ATO and whether, based on that evidence, the ATO considers that the transactions provide a “commercially realistic result”.

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In the event that an adjustment results in an increase in the amount of tax due, a statutory penalty of between 10% and 50% may also be imposed, and interest would be charged.

7. If a primary adjustment is made by the local tax authorities, what options would realistically be available for LocalCo if (a) it does not agree with the adjustment or (b) it does agree with the adjustment but does not wish to be subject to double taxation?

If LocalCo does not agree with the adjustment, it could object against the assessment and, failing resolution, seek review of the adjustment by the Administrative Appeals Tribunal or appeal the ATO’s decision to the Federal Court (see country chapter Australia, at 3.2.).

Alternatively, where a treaty exists, LocalCo could seek to engage the MAP, which may be more successful if the treaty provides for arbitration.

**Where Wonderland has no tax treaty with Australia**

Where no treaty exists between Australia and Wonderland, the Commissioner is still entitled to make a transfer pricing adjustment under Division 13. The key difference is that the Commissioner may not rely on the “Associated enterprises” article of a treaty. There is considerable debate in Australia about whether the Commissioner’s powers are the same, or more limited, under Division 13 (see country chapter Australia, at 1.2.).

Another consequence of there being no treaty between Australia and Wonderland would be that there is no agreed MAP procedure (and therefore, no procedure for entering into bilateral or multilateral APAs).

**Whether an EU country or not**

In practice, it should make no real difference whether Wonderland is located in an EU country. However, where the other state is a PATA member, LocalCo may be able to rely on the more established MAP PATA procedures agreed between participating states (see country chapter Australia, at 4.1.).

**Brazil – Case Study**

1. Based on the above facts, looking back, what action could LocalCo have taken to address the transfer pricing risks when it first established operations and/or began to distribute “Less is More” through LocalCo