www.pwc.com.au

MTAA / PwC

Understanding the ATO's new Inbound Supply Chain – where to from here?

December 2018

pwc

MTAA Medical Technology ASSOCIATION OF AUSTRALIA

Agenda

1. Background
2. Overview of the Practical Compliance Guideline (**PCG**)
3. Implications for taxpayers and the industry
4. Case study
5. Taxpayer Alert on mischaracterisation of payments in connection with intangible assets
6. Q&A

Background

The journey so far

Senate enquiries into pharma

- **2015:** The Senate enquiries into pharmaceutical companies.

Review of pharmaceutical companies

- **2016 - 2017:** ATO announces review into the tax performance and transfer pricing policies of the "life sciences" industry over concern that Australia's profits was not reflective of the contribution made by Australian operations.

Focus on large taxpayers

- **2017:** The ATO raises concerns on the income tax compliance of large corporate groups (turnover > AUD 250m)
- The ATO contemplate issuing a Taxpayer Alert on 2 issues, being the profitability and embedded royalties within the pharma industry. Following discussions with MA this is dropped.

Proposed PCG for pharmaceutical distributors

- **July 2018:** We consulted with the ATO on their proposed a 'inbound supply chain' (**ISC**) PCG which will outline profit indicators expected to be earned by distributors in Australia.
- Proposed PCG covers 4 areas; general distributors, pharmaceutical distributors, IT distributors, automotive distributors.

Draft PCG and Taxpayer Alert released

- **November 2018:** The ATO releases its draft PCG 2018/D8 for inbound distribution arrangements for public consultation as well as TA 2018/2 on mischaracterization of payments in connection with intangible assets.

Overview of the PCG

Who does the PCG apply to?

The PCG sets out the ATO's expectations regarding the profit to be earned by Australian distributors, by setting profit markers for certain distributor groups. The PCG is an indicator of the ATO's assessment of a taxpayer's transfer pricing risk, by comparing the profit levels of the taxpayer with the profit markers.

Definition of distributor

- Business "predominantly" involves distribution of goods purchased from a related party for resale
- Sell B2B

Applies to distributors of any scale

- Simplified record keeping option for distributors still available if you meet the criteria, but if you do not elect to apply the STPRKO, then you will fall within this PCG

No differentiation between "limited risk distributor" or any other kind of distributor

Does **NOT** apply if you have an APA, settlement, or court decision covering your TP outcomes, or if the ATO has reviewed your distribution arrangements and provided a low risk or high assurance rating for those arrangements.

Life Sciences

The ATO has set out profit markers for the following groups of distributors:

- **Life sciences;**
- Information and Communication Technology;
- Motor Vehicles; and
- General distributors (all other distributors not in the above categories)

Definition of 'life sciences' – The ATO has broadly defined 'life sciences' to include entities involved in the discovery, development, production, sales and marketing of medicine. The five sub-sectors include: **innovative / patented**; **medical equipment and devices**; **generic / biosimilar**; **over-the-counter**; and **animal health** distributors.

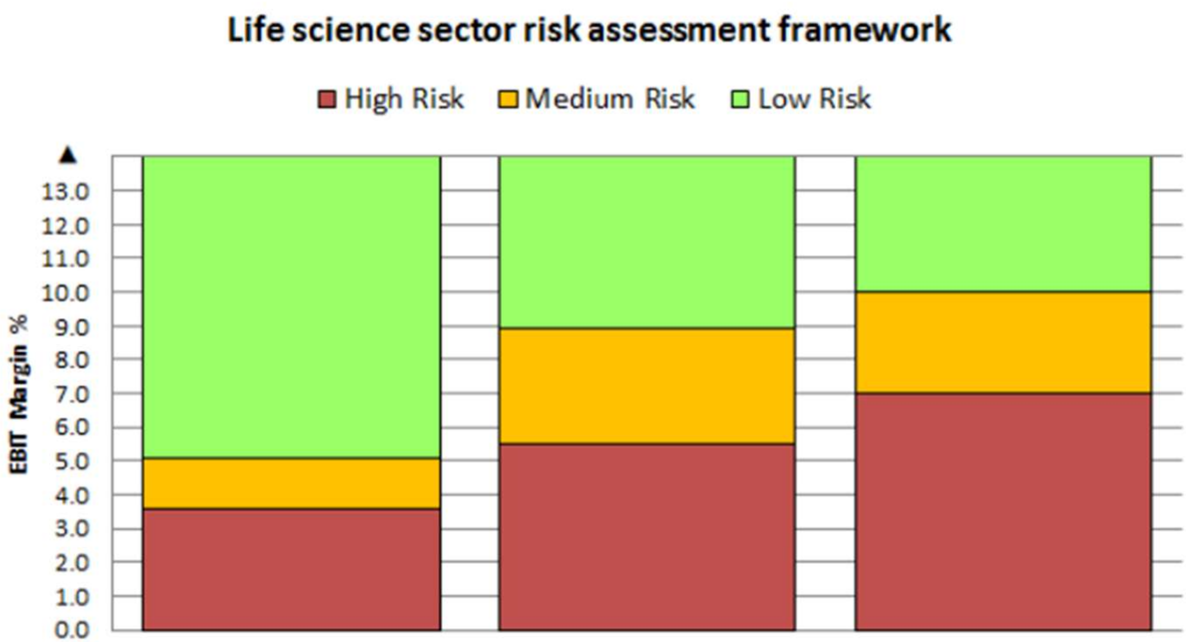
Life Sciences sub-categories

Within the 'life sciences distributors', there will be sub-categories of distributors, characterised **only** according to functions performed.

- **Category 1:** Distributors which only perform **'routine' functions** (defined as sales, distribution, marketing and detailing).
- **Category 2:** Category 1 distributors + distributors which perform activities such as **more complex / functionally intense** functions (defined as performing additional regulatory functions such as TGA / PBS approvals).
- **Category 3:** Category 1 and 2 distributors + distributors which provide **specialised technical services** (such as assistance in conducting surgical procedures involving medical devices).

PCG Profit Markers

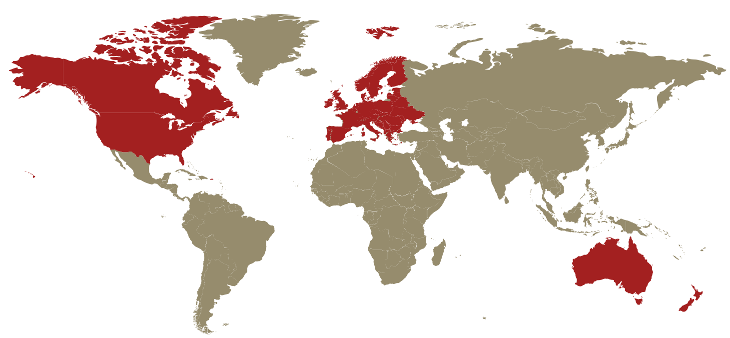
Indicators of risk – The PCG sets out the low, medium and high-risk profit markers. Based on the comparison between these markers and the actual margin earned by a distributor, companies will be awarded a risk zone rating, ranging from a **green** zone (low risk), **amber** zone (medium risk) and **red** zone (high risk).



	Category 1	Category 2	Category 3
High risk	Below 3.6	Below 5.5%	Below 7%
Medium risk	Between 3.6% - 5.1%	Between 5.5% - 8.9%	Between 7% - 10%
Low risk	Above 5.1%	Above 8.9%	Above 10%

Benchmarking of profit markers

- The ATO's profit markers and ranges are based on benchmarking analyses performed by the ATO.
- We believe these benchmarking studies have been performed by the ATO through current live risk review and audit cases, in addition to gauging returns through data analytics of taxpayer data.
- The ATO will **not** releasing details of the benchmarking analyses performed.
- From our experience, due to the vertically integrated nature of the industry resulting in limited comparables in the Australian market, the benchmarking studies will be based on distributors operating in the North America, Europe and ANZ regions - the ATO considers distributors in these regions to have **similar** operating and macroeconomic conditions to distributors in the Australian market



Implications of PCG for Taxpayers and the Industry

Implications of the risk rating

- Risk ratings may need to be calculated based on **segmented results** if the distributor performs other functions (e.g. as R&D and manufacturing – ATO will consider these separately and will not fall within the scope of this PCG)
- The risk ratings are **risk indications only** – they will assist the ATO determine the resources which should be invested in reviewing the taxpayer's transfer pricing position, and will help distributors self-assess their risk and prepare for potential engagement with the ATO.
- The profit markers are **not** intended to provide any conclusion on the arm's length nature of the distribution function and are **not** safe harbours which can be relied on. A taxpayer will still need to prepare a detailed transfer pricing analysis and documentation to support its position.
- From our experience with the debt PCG, a 'red zone' rating is likely to attract significant ATO attention resources; may result in a formal audit process.

Implications of the risk rating continued

Risk zone	**ATO approach**
Low	• Generally will not allocate compliance resources to assess TP outcomes • Open to entering APA discussions, including a pre-qualified APA
Medium	• ATO will monitor arrangements and may contact taxpayer to seek a better understanding of the taxpayer's circumstances before deciding whether to allocate compliance resources • Open to entering APA discussions. Eligible to request pre-qualified APA but prior year outcomes may be reviewed.

High	• ATO will consider treatment options and recommend that taxpayer review TP policy. This may involve:
	    • Writing to express concern
	    • Actively monitoring the taxpayer
	    • Commencing a review or audit.
	• When deciding on the approach, ATO will consider the taxpayer's global supply chain, the tax profile of related parties, and the amount of tax at risk.
	• Taxpayers that consistently suffer losses pose a very high risk and will be prioritised for review.
	• Taxpayer can seek to enter APA discussions but will not be eligible for pre-qualified APA.

Other tax compliance implications: RTP

- Distributors will be required to report **red** zone positions in the new **Reportable Tax Position (RTP)** schedule, as part of the Income Tax Return – *regardless* of whether transfer pricing documentation is in place

- This applies to taxpayers with a turnover greater AUD 250m, and will begin for income years ending on or after **30 June 2018**

The RTP schedule is a schedule to the company income tax (CIT) return and requires large business to disclose their most contestable and material positions

ATO will use the schedule to:

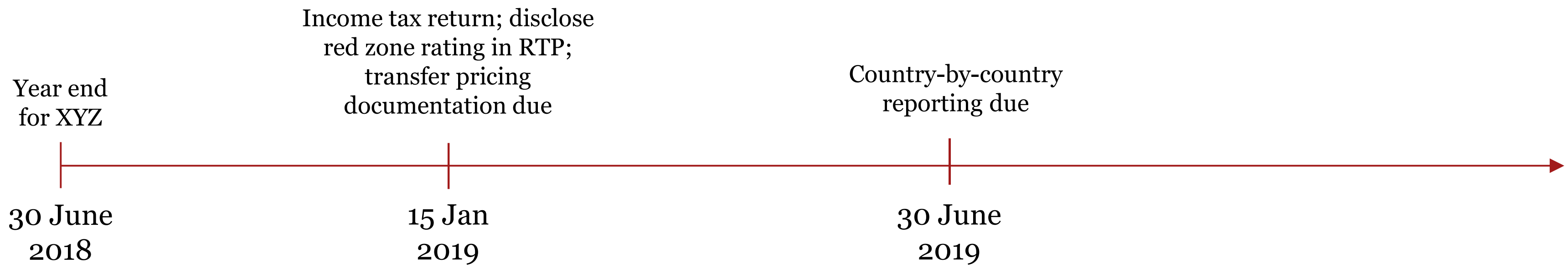
Taylor engagements and focus in high risk arrangements	Identify areas to provide further clarification / certainty on the correct treatment of transactions	Better understand tax risk for taxpayers, industries and the large market	Improve dialogue with large business about their risk profile and corporate governance

Case study

Case Study

- **XYZ Pty Ltd** (**XYZ**) is an Australian distributor of medical devices, whose employees provide demonstrations of the device to surgeons before and during surgery.
- **XYZ** has a 30 June 2018 year end and has an Australian turnover greater than AUD 250 million
- **XYZ** has prepared global transfer pricing (**TP**) documentation with a Big 4 firm for the past 10 years – they currently have a global TP policy of 4% return on sales for distributors
- The **XYZ** head of TP is keen for global consistency, given risk reviews and audits in other jurisdictions, as well as disclosures in CbC reporting

Questions:
1. What are XYZ's tax compliance obligations?
2. XYZ will fall within the red risk zone – what are their options?



Your options

We do not believe many distributors will fall in the **green** zone of the PCG. We foresee your options to be:

Transition

Update your transfer pricing policy to fall into a lower risk zone. This will be the most difficult to implement, with global consistency of TP policy and country-by-country reporting to consider.

Support

Support your transfer pricing position by preparing transfer pricing documentation which is robust and includes an appropriate arm's length analysis.

Certainty

Apply for an advanced pricing agreement (**APA**) with the ATO and / or potentially bilateral APAs with other jurisdictions

Taxpayer Alert on mischaracterisation of payments in connection with intangible assets (TA 2018/2)

What's the issue?

- The ATO is concerned there may be arrangements between related parties which "mischaracterise" payments related to intangibles (resulting in failure to properly apply withholding tax)
  - We are also aware of the ATO investigating this issue on a third party transaction

- The alert does not provide any technical analysis of the law, but identifies the following potential concerns:
  - The transfer pricing rules (in relation to both quantum and character)
  - Withholding tax obligations under Subdivision 12-F of Schedule 1 of the Admin Act
  - Deductibility of the payments under s26-25 of the ITAA 1997
  - Part IVA and/or diverted profits tax

What should be considered?

The Taxpayer Alert notes that:

This Taxpayer Alert (Alert) ***does not apply to international arrangements which involve an incidental use of an intangible asset.*** *For example, this Alert does not apply to resellers of finished tangible goods where the activity of reselling the goods involves an incidental use of a brand name that appears on the goods and related packaging. Whether a use is incidental in this sense will depend on an analysis of the true relationship and activities of the parties. The fact that an arrangement fails to expressly provide for the use of an intangible asset does not, in itself, determine that a use is incidental.*

Key question for the medical devices industry: do your arrangements present an embedded royalty and WHT risk?

Questions…?

Contact us

Edwin Baghdasarayan

Transfer Pricing Partner

Direct: +61 (2) 8266 3974
Email: edwin.baghdasarayan@pwc.com

Jenny Elliot

Transfer Pricing Partner

Direct: +61 (3) 8603 3753
Email: jenny.elliott@pwc.com