We use cookies. Learn More Accept

Transfer Pricing
May 1, 2020, 5:00 PM GMT+10

INSIGHT: Australian Tax Office Appeals ‘Glencore’ Transfer Pricing Decision

By Paul McNab

The Australian Tax Office is appealing Glencore Investment Pty. Ltd.'s September 2019 transfer pricing victory in the Federal Court of Australia. The decision was significant in part because there is little transfer pricing case law in Australia, says Paul McNab of DLA Piper. The author explains the importance of the decision and the ATO’s (last-minute) appeal.

This year we will see further litigation in Australia concerning the operation of our transfer pricing rules. The appeal in the Glencore dispute, in particular, is likely to be heard by the

Full Federal Court in its sittings Aug. 3-28, 2020.

The dispute in this matter has already taken some unusual turns.

On the Sept. 3, 2019, judgment by Justice Jennifer Davies was handed down in favor of the taxpayer in the Federal Court of Australia in *Glencore Investment Pty. Ltd.v. Commissioner of Taxation of the Commonwealth of Australia* [2019] FCA 1432. Under the Federal Court Rules 2011 (R 36.03) the Australian Tax Office (ATO) then had 28 days to file an appeal. It has been reported that the ATO was six minutes late in filing its appeal.

On Oct. 8, 2019, the ATO filed, with the court, a request for extension of time to file an appeal. This was granted at a hearing before Justice Nye Perram on Nov. 28, 2019.

We can now see the outline of the ATO’s appeal grounds, however, in the notice of appeal filed by him on Nov. 29, 2019. Below I set out a summary of the decision at first instance and discuss the focus of the notice of appeal.

The Dispute

The taxpayer was the head of an Australian “consolidated tax group.” A group member company, Cobar Management Pty. Ltd. (CMPL) sold concentrate to its Swiss parent, Glencore International AG (GIAG). At Paragraph 132 the court noted that there was no dispute that conditions operating between the companies differed from those that might be expected to operate between independent parties dealing wholly at arm’s-length with each other.

The dispute concerned the application of Australia's taxation transfer pricing rules to the sales of copper concentrate. The years under review and the increase in income in each year by the ATO were:

- 2007, AU$49.2 million ($32.2 million)
- 2008, AU$83.2 million ($54.5 million)
- 2009, AU$108 million ($71.2 million)

The ATO also imposed a total of just over AU$20 million ($13.1 million) in interest charges. It appears no additional tax by way of penalty was imposed.

The decision is important for a number of reasons:

- There has been little case law in Australia dealing with the operation of our transfer pricing rules. This has made taxpayers cautious about litigating, as they are uncertain about judicial responses to many of the issues raised by the Australian rules. This judgment is an important addition to the patchwork of law on the topic.
- The judgment continues a pattern of judicial acceptance of the relevance of imperfect comparable evidence.
- The decision was a win for the taxpayer. Positions taken by the Australian Taxation Office are not always correct in law, and taxpayers should continue to carefully consider what is being put to them in their own disputes.
- The decision gives guidance on how Australian courts may approach a number of issues of broad application, including the important question of when "recharacterization" of an actual transaction might be permitted and the interplay between our transfer pricing rules and our General Anti-Avoidance Rule (Part IVA) which includes our Diverted Profits Tax.
- The decision concerns a group who replaced their existing intercompany agreements in a manner that the ATO believes (especially with the benefit of hindsight) reduced Australian tax in future years.

The parties will have an ability to appeal "by leave" to the High Court from the Full Federal Court decision.

The decision also shows a willingness by Australian courts to consider foreign judgments where those are directly relevant.

The Facts

The ATO was concerned by a change in the method of pricing of concentrate sales from February 2007. Prior to this period, the sales were "market-related" sales.

After 2007 the sales terms were shifted to a "price-sharing agreement." At Paragraph 147 the court noted that the evidence suggested that the change led to an immediate negative financial impact on CMPL.

Under the "price-sharing agreement", the sales in the relevant years were then priced using an official London Metal Exchange price, averaged over a "quotational period." The "quotational period" was, at the purchaser's option either linked to the month of shipment from the loading port of embarkation or the month of arrival at the port of disembarkation. Within each alternative, the purchaser had the option to elect one of three periods, to be declared prior to each shipment. The purchaser would be aware of the average prices in at least one of the periods available for selection at this time (known as "quotational period optionality with back pricing" in the industry).

A deduction was also made from the copper reference price for treatment and copper refining charges (TCRCs) which were fixed at 23% in the period.

The ATO's amended assessments:

- Removed the effect of the 23% TCRC adjustment and replaced it with a 50% benchmark/50% spot TCRC, which the ATO identified as the "rate previously used by CMPL"

- Adjusted the price between the parties to reflect a "consistently applied quotational period".

At the heart of the case is the question of what the ATO can do about a group that changes its intercompany contracting in a way the ATO dislikes. There are a number of provisions in the Act that, in various circumstances, allow the ATO to set aside part or all of an arrangement that a taxpayer has entered into. The ATO here only chose to take the approach of using just the basic transfer pricing rules and arguing that parties acting at arm's-length would have continued the essential structure of the pre-2007 arrangement and modified it. Rather than making the more extensive changes actually made by the taxpayer.

The taxpayer argued that both the old and new arrangements were ones found in dealings between arm's-length parties.

The court essentially found that the decision in *Chevron* required it to apply the rules to the agreements actually entered into by the parties, and that the transfer pricing provisions could only be used to set these aside in very limited circumstances.

It is important that the court here accepted that it was enough for the taxpayer to prove their pricing "was within an arm's-length range" (Paragraph 6). It was not necessary for the taxpayer to show that the pricing was within a particular part of that range.

The Appeal

In an Australian taxation dispute the taxpayer bears the burden of proving the correctness of the returns they filed. It is not enough to simply show that the ATO's case is flawed.

On appeal the ATO continues its attack on the 2007 changes. The first part of the ATO's appeal grounds relate to the identification of the "relevant hypothetical comparable agreement." The office presses again the argument that the proper approach was to consider what modifications arm's-length parties would have continued to make to the pre-2007 agreement (see especially Paragraph 7 of the notice of appeal. The court's conclusion that the post-2007 agreement should be accepted and tested for price is rejected. The ATO argues that the taxpayer has not shown evidence of arm's-length parties actually amending their agreements in the manner of the changes made in 2007 (at Paragraph 20 of the notice of appeal). The office goes on to attack any conclusion that the evidence supports a conclusion that the post-2007 arrangement was one that arm's-length taxpayers in the same circumstances would have entered into, in any event.

The ATO also takes issue with the court's conclusion that there was evidence of agreements that were sufficiently similar to be comparable. The office points to factual differences that prevent that conclusion. In my opening summary I noted that the question of exactly how similar an agreement has to be to be comparable continues to be explored in Australia, although the court in Glencore noted, (at Paragraph 344) with approval, the observation of the Full Court in Commissioner of Taxation v. SNF (Australia) Pty. Ltd. (2011) 193 FCR 149; [2011] FCAFC 74 that too strict a comparability test sets an impossibly high bar for the taxpayer.

The Law

In the relevant years our previous transfer pricing provisions of the Income Tax Assessment Act operated (being Division 13 and Subdivision 815-A.) Our present provisions in Subdivisions 815-B to 815-D operate for years commencing on or after June 29, 2013).

The court considered the decisions in Chevron (*Chevron Australia Holdings Pty. Ltd.V. Federal Commissioner of Taxation (No 4)* (2015) 102 ATR 13; [2015] FCA 1092, *Chevron Australia Holdings Pty. Ltd. v Federal Commissioner of Taxation* (2017) 251 FCR 40; [2017] FCAFC 62).

At Paragraphs 12 and 23 of the judgment, the court summarized the approach it said *Chevron* required:

- Posit a hypothetical agreement, being the actual agreement but unaffected by the lack of independence and the lack of arm's-length dealing.
- Determine, on the evidence (including factual and expert witness), what price would have been paid under the hypothetical agreement.

The question, the court said, was "from the evidence (what is) the consideration that might reasonably be expected to have been given or agreed to be given by a party in the position of the taxpayer?"

It was the taxpayer's case that the agreed price-sharing percentage of 23% was one that might be expected in an arm's-length dealing, or was "within the range of price-sharing percentages that might be expected to be agreed" by independent parties in an arm's-length transaction.

The ATO argued that the law required an enquiry into what **sort of transaction** unrelated parties might have entered into, unrestrained by the actual terms in the agreements before the court. The office identified the hypothetical transaction as being one where there was a long-term contract for the period, amended and continued from time to time with prices being negotiated and amended on an annual basis. The ATO continues this argument in the notice of appeal (Paragraphs 1 and 2).

The court said (at Paragraph 45):

"Chevron thus makes it clear that the positing of a hypothetical agreement is not for the purposes of pricing a hypothetical supply to a hypothetical buyer (or a hypothetical acquisition from a hypothetical seller) and the provisions do not permit or require the construction of an abstract hypothetical agreement between abstract independent parties. The function of the hypothesis is to identify a reliable substitute consideration for the actual consideration which was given so that the reliability of the substitute consideration depends upon the hypothetical agreement being sufficiently like the actual agreement to be a sufficiently comparable transaction against which to evaluate whether an arm's length consideration was given under the actual transaction (Division 13) or an amount of profits which might have been expected to accrue did not accrue (Subdivision 815-A). "

In effect, the form of the transaction used by the parties should generally be respected, with only those aspects of it which relate to a lack of independence and a lack of arm's-length dealing being adjusted.

The court held at Paragraph 172 (see also Paragraph 181 and 314) that:

"the consideration that might reasonably be expected to be received by an independent seller of copper concentrate in the position of CMPL must therefore be determined on the hypothesis of an independent buyer of copper concentrate in the position of GIAG acquiring the whole of CMPL's copper concentrate for the life of the mine and providing logistical and marketing support to the seller of the copper concentrate, and on the hypothesis of an independent seller of copper concentrate in the position of CMPL selling the whole of its production of copper concentrate to an independent buyer for the life of the mine, and with no need for a marketing department or logistics expertise."

The court, helpfully, also considered and contrasted the two exceptions referred to in the 1995 Guidelines (in C.1.37) where it is said that the structure adopted by the taxpayer may be disregarded (and the actual transaction may be "recharacterized").

It found that there was no evidence that the form and substance of the arrangement differed, or that tax considerations drove the terms of the 2007 agreement. In fact the agreement was one of a form seen in the marketplace.

The evidence that similar contracts were entered into by arm's-length parties in 2007 was critical. The court concluded (at 332) it was "irrelevant to compare the extent to which the results achieved under the price-sharing contract entered differed from those that would have been achieved under an alternative agreement based upon benchmark TCRC's and to do so with the benefit of hindsight."

It also declined to treat the decision to change the contractual arrangements in 2007 as one that could be set aside as inconsistent with an arm’s-length party who wished to make as much profit as possible.

The Evidence

It is also interesting to consider the witnesses used and their use in the matter. Witness evidence was important in:

- Establishing the structure of the copper concentrate market (which assisted in determining what transactions might be viewed as comparable),
- establishing the way contracts for copper concentrate are structured and priced (including whether the terms of the taxpayer agreements were found in other transactions in the market),
- Whether the terms of the taxpayer agreements could be found in contracts between independent parties (from the joint expert report),
- The consequences to the taxpayer of the change of contract basis, and whether (after considering its operating environment) the change made commercial sense, and
- The advantages and disadvantages to each party of the change in contract terms in 2007.

The Taxpayer’s Witnesses

David Kelly was a “lay” witness (an employee of the taxpayer group) giving evidence as to other agreements which contained price-sharing and quotational period back-pricing, and as to the circumstances of the market and the mine during the relevant period. The ATO argued that “he was not an independent witness, he had overstated parts of his evidence, his evidence included matters about which he did not have personal knowledge or relevant experience to give evidence on, and his recollection of events in 2006 to 2007 was shown to be sketchy and unreliable.” Davies said that “(s)ome of those criticisms were shown to have foundation,” but in the end the affected material was not critical.

Richard Wilson was an expert in market analysis of the global copper concentrate industry. He gave evidence as to whether the relevant agreements differed from what independent parties might have entered into.

Tony Samuel was a forensic accounting expert who gave evidence about the ATO’s financial evidence.

The ATO’s Witnesses

Marc Ingelbinck was a mining industry expert addressing whether the relevant agreements differed from what independent parties might have entered into.

Leonard Kowal was another mining industry expert addressing whether the relevant agreements differed from what independent parties might have entered into.

David van Homrigh was a financial analysis expert commenting on the financial circumstances of the mine.

Although the two mining experts addressed similar questions in their initial expert reports, they did not address identical questions. The mining and financial experts also prepared joint mining and joint financial expert reports for the court.

In Australia, independent experts "assist the court" rather than advocate a taxpayer's position (see especially Paragraph 403). The process (noted in Paragraph 185) of requiring the experts to meet in conference and identify matters "where they agree and where they disagree and their respective reasons for that agreement and disagreement" is then particularly helpful. This process is sometimes referred to as "hot-tubbing the experts."

The court's judgment focused on disagreements between the witnesses as to whether:

- the level of copper payable percentage,
- the TCRC deduction as a percentage of copper,
- the degree of optionality conferred by the quotations period clause, and
- the delivery clause terms.

were not arm's-length.

The court also focused on the question of whether the mine was profitable, and the nature of the financial risks it faced in 2007. In the end, it concluded that the evidence of the financial experts was not relevant.

The parties put into evidence a number of contracts, which were said to demonstrate features that were found in the taxpayer's agreements.

The court accepted that at least some of these showed that independent parties acting at arm's-length entered into agreements with the relevant clauses.

Importantly, at 344 et seq, the court approved an earlier decision's (that in SNF) warning against adopting a standard of comparability which set the bar "at an unattainable height."

This column does not necessarily reflect the opinion of The Bureau of National Affairs, Inc. or its owners.

Author Information

Paul McNab is a partner at DLA Piper in Sydney.

© 2023 Bloomberg Industry Group, Inc. All Rights Reserved