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REPORT

Transfer Pricing in Australia: The Roche Case

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A decision has been handed down in the Administrative Appeals Tribunal[1] that for the first time involves judicial review of a substantive transfer pricing issue in Australia. The decision, although preliminary, is of significant interest to Australian taxpayers with international related-party transactions.

The preliminary judgment is interesting for several reasons. For Australian taxpayers (and the Australian Tax Office), it raises a number of questions about how transfer pricing analyses should be done. There is commentary (without conclusion) on two of the major areas of contention about the application of Australia's transfer pricing legal framework, and the decision also highlights the potential discord between a legalistic interpretation of Australia's transfer pricing law and the economic concepts that underpin the OECD transfer pricing guidelines and Australia's transfer pricing taxation ruling regime.

In the context of the Roche case, the second issue is explored in this article. While the argument takes place in the context of Australia's domestic law, it is also relevant to the ongoing global debate in transfer pricing about the use of profit-based methods to establish arm's-length outcomes.

Facts of the Case

The case centers on a transfer pricing audit of Roche Products Pty Limited (Roche Australia), covering eleven years to 2002. Roche Australia is a subsidiary of Roche Holdings Ltd of Basel, Switzerland. Globally, the Roche group carries on the business of selling and supplying pharmaceutical and diagnostic products. Reflecting the main operating divisions of the Roche Group, Roche Australia had three operating divisions during the audit period:

- the prescription pharmaceuticals division, involving the import and sale of Roche prescription pharmaceuticals (the largest division of Roche Australia);
- the consumer (over-the-counter (OTC)) pharmaceuticals division; and
- the diagnostic products division, involving the import and sale of diagnostic equipment and reagents.

The approach taken by the ATO in making the assessments relied largely on net profit comparisons using independent third-party comparables (adjusted to

[1] *Roche Products Pty. Ltd. v. Comr.*, AATA 261, preliminary decision issued 4/2/08. The court found that Roche had paid its Swiss parent more than arm's-length prices, but not to the extent that the Australian Taxation Office had assessed (16 *Transfer Pricing Report* 867, 4/10/08).

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take into account factors such as functional differences between the tested party and the comparables). In his conclusion, Justice Garry Downes found the ATO's assessments in all three operating divisions to be excessive.

Specifically, Justice Downes found pricing for the consumer and diagnostic divisions to be arm's length, and that therefore the assessments made by the ATO were excessive, on the basis that poor results in these divisions flowed from operating expense levels and not product acquisition prices. For the largest operating division, the prescription pharmaceuticals division, Justice Downes determined that the original assessment should be reduced based on a gross margin analysis.

Australia's Transfer Pricing Framework

The relevant domestic law provisions for transfer pricing are contained in Division 13 of the Income Tax Assessment Act 1936. Section 136AD enables the Australian Commissioner of Taxation to make transfer pricing adjustments once certain conditions are satisfied, in particular when:

- a taxpayer has supplied or acquired property under an international agreement;
- the Commissioner is satisfied the parties to the agreement were not dealing at arm's length with respect to the supply or acquisition; and/or
- consideration given by the taxpayer for the property acquired exceeded the arm's-length consideration, or was less than the arm's-length consideration for the property supplied.

Notably, there is no mention of "profitability" in Australia's domestic law. In the preliminary judgment, Justice Downes highlighted the two key aspects of the section, namely that it applies to acquisitions, and employs a test that operates with reference to arm's-length consideration (*i.e.,* the third point above).

The other relevant part of the legislative framework concerns Australia's double tax agreements (DTAs), and their implications for amending assessable income in Australia. The ATO's view is that Article 9 of Australia's DTAs represents a separate taxing power—a view not shared by all practitioners and commentators, but one that is yet to be tested in the Australian courts. On this issue, Justice Downes commented there was "a lot to be said" for the proposition that the treaties do not go further than authorising legislation and "do not confer power on the Commissioner to assess."

While the law has remained virtually unchanged since its introduction in 1982, since that time the ATO has provided guidance in the form of more than a dozen transfer pricing Taxation Rulings, as well as a series of booklets on specific topics. When it comes to transfer pricing methods, ATO Taxation Rulings closely follow the OECD guidelines in most respects. One point of contrast with the OECD guidelines is that ATO Taxation Rulings do not explicitly endorse a hierarchy of methods. Australia's primary Taxation Ruling on transfer pricing methods (TR97/20) requires the "method that is most appropriate or best suited to the circumstances of each particular case" must be adopted (TR97/20¶ 3.5). The ATO then advises that the choice of the most appropriate method or methods should be based on:

- the nature of the activities being examined;
- the availability, coverage, and reliability of the data;
- the degree of comparability that exists between the controlled and uncontrolled dealings or between enterprises undertaking the dealings including all the circumstances in which the dealings took place; and
- the nature and extent of any assumptions (TR97/20¶ 3.6).

In the preliminary judgment, Justice Downes outlined briefly the recognised transfer pricing methods as set out in the OECD transfer pricing guidelines, but made no reference to any of Australia's transfer pricing Taxation Rulings, and notably no reference to the factors outlined above.

In summary, over a long period of time many practitioners have noted the contrast between Australia's black letter transfer pricing law emphasising concepts of "consideration" and "acquisition," and the ATO's Taxation Rulings, which are based an understanding of the context of the business and the transactions—and which clearly envisage the use of profit-based methods (based on an understanding of the activities of the business) where it is considered impractical to apply a more direct transfer-pricing method.

Preliminary Nature of the Decision

The April 2 preliminary decision of the Administrative Appeals Tribunal found that Roche Products Pty. Ltd. (Roche Australia) had paid its Swiss parent more than arm's-length prices, but not to the extent that the Australian Taxation Office had assessed, for pharmaceutical products during 1992-2002.

The judge found the ATO's proposed AU$130 million (US$120 million) adjustment to the company's assessable income excessive and determined that the adjustment instead should be AU$58.7 million (US$54.5 million).

The preliminary ruling gave both parties one month to submit further evidence before the final ruling, and also allowed for the judge's conceded possibility of his own error in understanding economic or accounting concepts, as well as an inherent difficulty in determining arm's-length benchmarks. "Pharmaceutical companies rarely sell their products through third parties," Judge Downes said. "That means that there is generally no free market in which the products in question are sold. It also means that there is generally no free market for even potentially comparable products."

Profit Methods

The main areas of disagreement among and between practitioners and revenue authorities around the world concern the extent to which the use of open market prices to set controlled prices can be supplanted by the use of proxies—in particular, the use of profits from open market dealings to set controlled prices. The les-

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son from economics is that the theoretical answer on the most appropriate transfer pricing method is clear. A pure comparable uncontrolled price (CUP) is the most direct way of setting a price for the same transaction occurring between related parties, because it is based on an open market price below which the seller is not prepared to sell and above which the buyer is not prepared to buy. It can also be said to be the most theoretically correct method as it mimics the way markets work, and the way independent parties operating at arm's length usually deal with each other.

However, this theoretical answer is very much an "other things being equal" approach. The problem is that the other things are rarely (if ever) equal, and this has meant in practice that it is not always possible to find an open market price that either exactly matches or closely resembles the controlled transaction. Importantly, for the theoretical answer to hold, not only does the product need to be the same (or very similar), but the circumstances of the sale also need to be the same (or very similar).

The open market price even for the same product may vary for a number of reasons (such as volume, scope, and complexity of related-party dealings within a multinational enterprise, or the unique nature of related-party dealings that occur within an MNE). This means that even if a business sells the same product to a number of independent purchasers, those transactions may be priced differently if the circumstances of the sales are different. By extension, therefore, the arm's-length principle does not automatically require the same product to have the same transfer price—unless the circumstances of those transactions are the same.

While it is recognized that the transactional methods require a high level of comparability to be reliable, where the product and circumstances of the sale are not the same (or substantially similar), it may be possible to make adjustments to improve the level of comparability for transfer pricing purposes. For example, it may be possible to make adjustments for certain differences, such as those attributable to trade terms or volume.

Often though, the differences will not be that simple, and any proposed adjustments will require a series of economic and practical judgments. At that point, in addition to the theoretical considerations, it will be necessary to make practical judgments about the reliability of the imperfect transactional method relative to an answer implied by the application of profit-based methods.

The use of profit margins introduces other issues, which are often complex (such as the existence of intangible property), and require an understanding of the factors driving value (and profit) in the value chain. The use of profit methods—referring here to the transactional net margin method (TNMM) and the U.S. equivalent, comparable profits method (CPM)—is heavily criticised in some quarters as not likely to give arm's-length outcomes (giving rise to the potential for "presumptive taxation" and "income creation"); and in others for being overused and inappropriately applied. It is arguable, however, that there is no theoretical reason why profit comparisons cannot give rise to arm's-length outcomes.

Profit Methods and the Roche Case

As noted above, the preliminary judgment raises a number of issues in the context of Australia's transfer pricing provisions. It also raises broader questions about the fundamental question of whether profit-based methods can result in arm's-length outcomes—or perhaps at a minimum, circumstances in which a profit-based method based on third-party comparables will not be preferred.

In the Roche case, Justice Downes preferred third-party transactions (involving sales of product from Roche Basel to independent Australian distributors) as the basis for establishing an arm's-length price (or rather an arm's-length gross margin) for Roche Australia's related-party purchases. In so doing, Justice Downes explicitly rejected the use of a TNMM analysis based on an evaluation of Roche Australia's activities and benchmarked with reference to third-party comparables. Justice Downes also made several observations regarding the use of net profit margins, including that one of the "problems" with a profit-based method is that (in the context of a transfer pricing analysis) it "inevitably" attributes any loss to the pricing. He also criticised the fact that the TNMM typically relies on profit data from a number of comparable companies and that "*these produce statistical averages and not real or actual results*." [emphasis added]

For one of Roche Australia's divisions, the consumer division, the various expert economists' arguments centered on the appropriate product grouping to which a TNMM benchmarking analysis could be applied (*i.e.*, whole of division vs. separate product groupings). However, the judge was highly critical that they did not perform gross margin analysis. In his view, a comparison of the gross margins and net margins for each of the products showed that operating expenses caused potentially profitable operations to incur losses (for certain product lines). This viewpoint will challenge the view within the ATO, (also held by other tax administrations), that operating expenses are a reflex of functional activity, for which a profit reward should typically be attributed.

What is unclear in the preliminary judgment is the extent to which Justice Downes actively considered the "comparability factors" in determining that this transaction-based analysis ensured an arm's-length outcome that was more reliable than an analysis based on consideration of Roche Australia's activities, measured with reference to third-party comparables undertaking similar activities. In that regard, the OECD transfer pricing guidelines and ATO transfer pricing Taxation Rulings make it clear that all transfer pricing methods require comparability, which in turn depends on the functionality of the parties, the assets used and the risks assumed.

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Another issue raised in the decision is the appropriateness of applying an aggregated approach to a net margin-based analysis. That is, the ATO's expert economist identified the key functions performed by Roche Australia, benchmarked the returns for each identified function, and aggregated the identified profit returns to determine an overall profit level for the relevant division. For example, for the sales and marketing functions, the ATO's expert economist separately benchmarked the selling (*i.e.*, detailing) function and the marketing function. Arm's-length levels (ranges) of operating profit were then calculated for each function and aggregated to develop a total operating profit level for the sales and marketing function.

Justice Downes had difficulty accepting the reliability of this approach, and specifically commented that profitability likely would be overstated if the company carries out both activities in-house, without any apparent internal division. This ''functional separation'' approach is commonly applied around the world, and the Judge's comments will therefore instigate further discussion about how appropriate this approach is.

Conclusion

International consensus on the arm's-length principle as the recognised basis for the pricing of related-party transactions has not resulted in a uniform application of the principle around the world. Conflicts about the application of the arm's-length principle—in particular, the relative reliability of the recognized transfer pricing methods—exist between tax administrations and their taxpayers; and between different tax administrations.

In Australia, the preliminary judgment in the Roche case has highlighted some of the issues associated with one of the significant points of difference in how transfer pricing analyses are conducted around the globe. In the context of Australia's transfer pricing law, a product-based analysis was favoured by the Administrative Appeals Tribunal over an analysis based on functional analysis and benchmarking at the net profit level with reference to third-party comparables. Several of the concerns that exist globally with the use of net profit-based analyses have been highlighted by this preference.

This decision is of significant interest to Australian taxpayers with international related-party transactions. It suggests, at a minimum, that Australian taxpayers need to consider more than ever a transactional-based transfer pricing analysis—one that is based on even broadly comparable transactions, and that all comparable transactions should at least be considered as potentially relevant price points.

The preliminary decision also raises a number of questions for further consideration. It is interesting to speculate how the AAT may have viewed the net profit analysis had information regarding the sales of Roche products to independent Australian distributors not been available. In terms of Australian law, it is also interesting to consider how broadly the discretionary provision of Australia's transfer pricing law (s.136AD(4) of the Income Tax Assessment Act 1936) may be interpreted in future cases regarding the use of net profit-based analyses.

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