

Transfer Pricing e-Alert

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Hypothetical Agreement And The Determination Of Arm's Length

In a significant decision, the Federal Court of Australia recently held in favour of a taxpayer company in *Glencore Investment Pty Ltd v Commissioner of Taxation of the Commonwealth of Australia* [2019] FCA 1432 (**Glencore**). It was held that Glencore's related party transaction was at arm's length. Tax adjustments had been made by the Australian Taxation Office (**ATO**) by restructuring the contract the taxpayer had entered into as a market-related contract instead of a price sharing contract. In this case, the court examined whether it was permissible for the ATO to adopt such an approach for the purposes of applying transfer pricing provisions.

Importantly, this case also provides guidance on the application of the principles established in the landmark decision of *Chevron Australia Holdings Pty Ltd v Federal Commissioner of Taxation* [2017] FCAFC 62 (**Chevron**) by the Full Federal Court of Australia. We have previously discussed the *Chevron* case in our transfer pricing alert, "[Transfer Pricing and Interest from Intercompany Loans](#)".

Facts

The taxpayer was assessed as the head of a multiple entry consolidated group for Australian tax purposes, of which Cobar Management Pty Ltd (**CMPL**) is a member. In the relevant years, CMPL — which managed and operated a mine in Cobar, New South Wales — sold 100% of the copper concentrate produced at the CSA mine to its Swiss parent, Glencore International AG (**GIAG**). The sales were carried out pursuant to a price sharing agreement entered into by CMPL and GIAG.

The ATO raised assessments on the basis that the consideration paid by GIAG to CMPL for the copper concentrate was not at arm's length. The ATO argued that the transaction favoured GIAG to the detriment of CMPL and that an independent mine producer with CMPL's characteristics

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would not have agreed to price sharing at all. Instead, an independent mine producer might reasonably have been expected to have sold its production in the relevant years under a life of mine agreement on market-related terms.

Arguments Before Federal Court

Among other key principles, *Chevron* had held that the application of the Australian transfer pricing provisions requires a comparison between the consideration for the property supplied (or acquired) with the arm's length consideration of a comparable hypothetical agreement. The taxpayer's primary case was that, unlike in *Chevron*, the terms governing pricing under the contractual arrangements were terms that existed in contracts for the sale of copper concentrate between independent market participants. Thus, the terms were something which might be expected to be found in an agreement between the relevant hypothetical parties.

The ATO, on the other hand, argued that the hypothetical transaction should not be constrained by the actual terms under which CMPL supplied copper concentrate to GIAG in the relevant years. Those terms were explicable by reference to GIAG's relational and financial control of CMPL. The ATO submitted that to constrain the hypothetical transaction to one which adopted price sharing was unrealistic, artificial, and contrary to the purpose of the transfer pricing provisions and would result in "a commercially unrealistic outcome... controlled by the taxpayer".

In addition, the ATO argued that the evidence did not establish that an independent mine producer with the characteristics of CMPL might be expected to have agreed to price sharing in the relevant years. The ATO urged the court to reject the taxpayer's contention that price sharing was to be taken as the pricing mechanism in order to postulate the statutory hypothesis.

In response, the taxpayer argued that there was no basis in fact or in law to assume a wholly different agreement for the sale of copper concentrate to that which the parties in fact agreed.

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Thus, the question to be answered by the court was whether the hypothetical agreement, for the purposes of the comparative analysis, is a price sharing contract (as the taxpayer contended) or a market-related contract (as the ATO contended).

Decision

The court held that *Chevron* made 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. The provisions do not permit or require the construction of an abstract hypothetical agreement between abstract independent parties.

Instead, the function of the hypothesis is to identify a reliable substitute consideration for the actual consideration which was given. This would depend on the hypothetical agreement being sufficiently like the actual agreement to be a comparable transaction against which to evaluate whether an arm's length consideration was given under the actual transaction. For the hypothetical agreement to be sufficiently comparable to the actual agreement, the characteristics and attributes of those parties which are relevant to the pricing of the property supplied or acquired should be taken into account.

The court explained that the ATO's approach impermissibly restructures the actual contract entered into by the parties into a contract of a different character. In order to identify a reliable substitute arm's length consideration, *Chevron* made it clear that the hypothetical should be based on the form or structure of the actual transaction entered into between the associated enterprises, but on the assumption that the parties are independent and dealing at arm's length.

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In supporting its decision, the court cited the 1995 OECD Transfer Pricing Guidelines, which stated for the purposes of comparative analysis, the actual transaction should not be disregarded or other transactions substituted other than in exceptional circumstances. The two exceptional cases outlined in the 1995 Guidelines are as follows:

- where the economic substance of the transaction differs from its form.
- where, while the form and substance of the transaction are the same, the arrangements made in relation to the transaction, viewed in their totality, differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner and the actual structure practically impedes the tax administration from determining an appropriate transfer price.

The court held that the present case was not a case falling within either of the exceptions. The economic substance of what the parties transacted did not differ from the legal rights and obligations created by the agreement. Further, there was no suggestion at all that tax considerations rather than normal commercial conditions shaped the terms of the agreement.

In fact, the price sharing agreement was a form of agreement seen in the market between independent enterprises in the relevant years. As illustrated by the comparable contracts, the price sharing methodology adopted by the parties under that agreement was a recognised, legitimate and accepted way for copper concentrate to be priced. The methodology was also one which other independent market participants and dealing at arm's length adopted at the time in respect of the supply of concentrate by a mine producer to a trader. There was nothing in the structuring of the actual agreement that would "skew" the statutory inquiry or "be inconsistent with commercial reality".

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Our Comments

It is clear from *Glencore* that the taxpayer's agreement or business arrangement should not be arbitrarily restructured or disregarded for the purposes of determining the comparably arm's length consideration, except in exceptional circumstances.

It remains to be seen whether the Special Commissioners of Income Tax or our Malaysian courts will adopt the same approach in *Glencore* and the principles in *Chevron*. However, it is notable that the Inland Revenue Board of Malaysia's Transfer Pricing Guidelines 2012 (**TP Guidelines**) are substantially based on the OECD Guidelines, which constitutes the international standard in respect of transfer pricing. In this regard, the principles established in *Glencore* could offer guidance should taxpayers find their transactions restructured for transfer pricing purposes in situations where there are no exceptional circumstances. Although the TP Guidelines have no legal effect, it would be helpful if the principles enunciated in the *Glencore* and *Chevron* are incorporated in the said guidelines to provide further clarity to taxpayers.

If you have any queries pertaining to transfer pricing disputes, please contact **Datuk D P Naban** or **S Saravana Kumar** at tax@lh-ag.com

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