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Transfer Pricing: Hypothetical Agreement Used to Determine Arm's Length Price in Cross-Border Transaction

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The Full Federal Court of Australia in *Commissioner of Taxation of the Commonwealth of Australia v Glencore Investment Pty Ltd* [2020] FCAFC 187 had recently held that the taxpayer's transaction with its related party was at arm's length.

This alert discusses the key points in this Australian transfer pricing case *Glencore* on the application of the transfer pricing rules governing transactions within multinational groups.

Salient Facts

The CSA mine in New South Wales was acquired by Glencore Group in 1998. Cobar Management Pty Ltd (CMPL) has been managing and operating the mine since 1999. Glencore Investment Pty Ltd (the taxpayer was the provisional head company of a multiple entry consolidated group) whilst CMPL was a subsidiary member of that group.

In 2007, 2008 and 2009 (the relevant years), CMPL sold the production of copper concentrate business to its ultimate parent company, Glencore International AG (GIAG) which is a resident of the Swiss Confederation. Since 1999, GIAG and CMPL had entered into a series of offtake agreements for the sales of copper concentrate.

In February 2007, CMPL and GIAG entered into a price sharing agreement which is a fundamentally different from the offtake agreement. Amongst others, a new pricing mechanism of "quotational period optionality with back pricing" was added to the agreement in determining the price of the copper concentrate.

As such, GIAG has the option to choose the period making reference to the official London Metal Exchange (LME) price for copper averaged over a quotational period. The back pricing element would allow GIAG to choose at least one of the quotational periods where the average copper prices which were made aware. Furthermore, a deduction of the

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copper reference price for treatment and copper refining chargers (TCRCs) was then fixed at a fixed rate of 23% of the LME copper price (which was the pricing sharing mechanism).

The Commissioner of Taxation (The Commissioner) took the position that the consideration paid by GIAG to CMPL was less than the prices that might have reasonably expected in arm's length dealing between independent parties. Therefore, it was contended that CMPL's profit had been understated by AUD$241million during the relevant years. The Commissioner subsequently raised amended assessments for the relevant years against the taxpayer where the amount of additional tax in dispute including interest is approximately AUD$92 million.

Parties' Arguments Before The Federal Court

Being aggrieved by the Commissioner's decision, the taxpayer filed an appeal to the Federal Court. Amongst others, the Commissioner argued that the hypothetical transaction should not be constrained by one pricing mechanism adopted in the price sharing agreement (i.e. fixed at 23%) for 3 years in determining the price of TCRC. Such conduct was unrealistic, artificial and contrary to the transfer provisions which would lead to "*a commercially unrealistic outcome controlled by the taxpayer*".

The Commissioner alleged that the taxpayer postulated statutory hypothesis by failing to establish evidence to show that independent mine producers with the characteristics of CMPL might be expected to have agreed to price sharing in 2007 and the quotational period optionality term. As such, the failure to renegotiate the long-term contracts for the sales of copper concentrate every year was "a consequence of distortion of commercial reality brought about by the lack of independence between CMPL and GIAG".

In response, the taxpayer submitted that there was no basis to assume a wholly different agreement for the sale of copper contrate where parties had in fact agreed. In brief, the taxpayer argued that:

(i) The terms governing the prices charged and received between CMPL and GIAG for the relevant years were ones that existed in contracts for the sale of copper concentrate between independent market participants, and thus, these constitute terms that

might be expected to be found in the agreement between the relevant hypothetical parties.

(ii) The issue at hand can be distinguished from *Chevron Australia Holdings Pty Ltd v Federal Commissioner of Taxation* [2017] FCAFC 62, where the terms of the loan diverged from the terms which might be expected between independent parties dealing at arm's length with each other.

Federal Court

The question to be determined by the Federal Court was whether the hypothetical agreement is to be a price sharing contract (taxpayer's contention) or a market-related contract (Commissioner's contention) for the purpose of the comparative analysis of the price of copper concentrate.

At first instance, the Federal Court held the taxpayer's favour held that the concentrate sales were conducted at arm's length and thus, the assessments issued by the Commissioner were excessive for the following reasons, amongst others:

(a) The positing of a hypothetical agreement is not for the pricing of a hypothetical to a hypothetical buyer.

(b) Further, the provisions do not permit 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.

(c) The Commissioner's approach impermissibly restructures the actual contract entered into by the parties into a contract of a different character. *Chevron* made it clear that hypothetical transactions should be based on the form of the actual transaction entered into between the associated companies on the assumption that parties are independent and dealing at arm's length to identify a reliable substitute arm's length consideration.

(d) The hypothetical transaction based upon different commercial considerations and a different commercial

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structure to that which was actually entered into does not constitute a market-related contract.

Commentary

Being dissatisfied, the Commissioner filed an appeal to the Full Federal Court. Having considered the submissions, the Full Federal Court had upheld the Federal Court's decision and dismissed the Commissioner's appeal. The Full Federal Court also accepted that the pricing methodologies used by the taxpayer in determining the price of coal concentrate are at arm's length.

It is observed that the court had adopted a pragmatic approach in deciding *Glencore* where it was held that "*transfer pricing is not an exact science… it was a sufficiently reliable choice and accorded with common sense*." In this regard, the Full Federal Court urged the Commissioner not to place the bar of compliance with the pricing laws so high.

To date, there is no case law with a similar factual matrix in Malaysia. The rulings in *Glencore* and *Chevron* provide useful guidance in determining arms-length considerations involving cross-border transactions. It should be noted that the Australian Federal Court held that the taxpayer had discharged its burden of proof by providing sufficient documentation in supporting its methodology to determine arm's length price. Therefore, taxpayer is urged to ensure proper documentation to support its pricing. Taxpayers in Malaysian must take note that where a taxpayer who fails to furnish contemporaneous transfer pricing documentation will be subject to a penalty ranging from RM20,000 to RM 100,000 and/or imprisonment. Hence, it is important for the taxpayers to ensure the transfer pricing framework is appropriately and adequately documented to mitigate tax risk.

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