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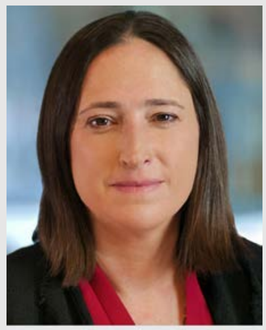
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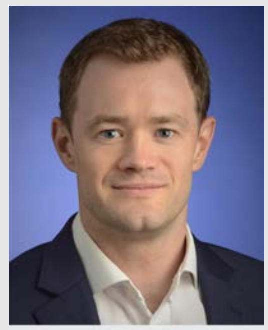
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In this article, the fifth in a series, the authors summarize their findings from a KPMG member firm survey of how tax authorities around the world are applying the OECD control of risk framework and the transfer pricing guidelines on development, enhancement, maintenance, protection, and exploitation of intangibles. This installment is focused on Australia and China.

In 2015 the OECD reached an agreement on revised guidance regarding transfer pricing[1] as part of base erosion and profit-shifting actions 8-10. It can be difficult to get a comprehensive global view of how different tax authorities are applying this guidance. KPMG has surveyed its member firms from around the world to better understand how local tax authorities are approaching the control of risk and development, enhancement, maintenance, protection, and exploitation (DEMPE) frameworks. In this article, the fifth in a series, we focus on Australia and China.[2]

[1]OECD, "Aligning Transfer Pricing Outcomes With Value Creation, Actions 8-10 — 2015 Final Reports" (2015) (including guidance related to intangibles, risk, capital transfers between group entities, and other high-risk transactions).

[2]For previous installments in this series, see Mark R. Martin et al., "A Global Survey on the Application of the Control of Risk and DEMPE Frameworks: The U.S. and U.K.," *Tax Notes Int'l*, May 8, 2023, p. 705; Olivier Kiet et al., "A Global Survey on the Application of the Control of Risk and DEMPE Frameworks: France, Italy, and Spain," *Tax Notes Int'l*, June 5, 2023, p. 1327; Julia Bürkle et al., "A Global Survey on the Application of the Control of Risk and DEMPE Frameworks: Germany, the Netherlands, and Sweden," *Tax Notes Int'l*, June 26, 2023, p. 1743; and Carlos Pérez Gómez et al., "A Global Survey on the Application of the Control of Risk and DEMPE Frameworks: Mexico and Canada," *Tax Notes Int'l*, July 17, 2023, p. 251.

Australia

Australia's transfer pricing legislation[3] incorporates the OECD guidelines by requiring that the arm's-length conditions be identified to best achieve consistency with this guidance material.[4] This reference is updated periodically and currently refers to the 2017 version of the OECD guidelines, which includes the changes made as part of actions 8-10 of the OECD's base erosion and profit-shifting initiative, but not the more recently finalized "Revised Guidance on the Application of the Transactional Profit Split Method" or Chapter X of the "Transfer Pricing Aspects of Financial Transactions." This reference provides the Australian Taxation Office with the legal basis to apply the control of risk and DEMPE frameworks.

The ATO regularly undertakes reviews and audits of the transfer pricing policies of multinationals operating in Australia. For arrangements involving intangibles, the performance of DEMPE functions in Australia is frequently identified as an area requiring further investigation. The ATO has also historically been focused on the transfer pricing returns associated with distribution activities — in particular, whether these entities are being appropriately compensated for the activities performed onshore. In broad terms, the argument is that Australia's relative geographical isolation means that local distributors typically perform more value-adding functions and manage and control more risks than may be observed by related-party distributors operating in other countries.

In Australia, transfer pricing reviews, audits, and advance pricing agreements are undertaken by the ATO's engagement and assurance teams. However, these teams rely on specialist transfer pricing advice provided by the ATO's Economist Practice. They are a group of specialist transfer pricing professionals who undertake the economic analysis associated with any transfer pricing workstream. This includes establishing characterization of the entities within the value chain (through a multisided functional analysis) as well as selecting and applying the most appropriate method. In its work, the Economist Practice relies heavily on the OECD guidelines within the context of Australia's transfer pricing legislative framework. While the Economist Practice may start with the intercompany contract, its focus will be on understanding the commercial rationale and the economic substance of the arrangement (having reference to DEMPE concepts) before considering the appropriateness of the pricing profit outcomes. Interestingly, in contrast to the U.S. IRS, advance pricing agreements and mutual agreement procedure negotiations are undertaken by a separate competent authority area, though these competent authorities rely on the Economist Practice's transfer pricing position as a starting point for negotiation.

DEMPE and Intangibles

Transfer pricing relating to intangible arrangements is a focus area for the ATO. It has issued extensive guidance to signal to businesses which arrangements could result in non-arm's-length outcomes.[5] This guidance explicitly references the OECD guidelines' DEMPE framework, though interestingly does not refer to the revised guidance on control of risk.

In TA 2020/1, the ATO identified three types of arrangements that created potential cause for concern:

- In the first scenario, AusCo (a resident of Australia) owns an existing intangible asset and enters into an arrangement with ForCo (a nonresident entity) to develop a new intangible asset, which the ATO asserts is linked to the existing intangible. On a go-forward basis, AusCo receives remuneration for the existing intangible but, given that there is no continued development of the existing intangible, its value declines over time. The taxpayer asserts that AusCo now performs contract research and development services related

[3] Income Tax Assessment Act 1997, sections 815-135 and 815-235.

[4] This section was written in conversation with Sophie Lewis of KPMG Australia.

[5] *See* ATO, "Non-Arm's Length Arrangements and Schemes Connected With the Development, Enhancement, Maintenance, Protection and Exploitation of Intangible Assets," TA 2020/1 (2020); *see also* ATO, "Draft Practical Compliance Guideline: Intangibles Arrangements," PCG 2021/D4 (2021).

to the new intangible owned by ForCo and is remunerated with a cost-plus return. The guidance states that AusCo's remuneration does not reflect the substance of the arrangement because the new intangible and AusCo's existing intangible are "intrinsically" linked.

- In the second scenario, AusCo enters into a cost contribution arrangement with other international related parties. AusCo is entitled to exploit all intangible assets associated with the arrangement in Australia, and the other parties hold the rights to exploit the intangibles in other countries. The guidance notes that if AusCo performs significant DEMPE functions associated with this arrangement, it may be under-remunerated because the expected benefits received by AusCo may not reflect the value of AusCo's contributions.
- In the third scenario, AusCo receives a cost-plus markup for contract R&D activities performed on behalf of ForCo that contribute to the development of an intangible. The example states that ForCo has limited substance and that AusCo performs these functions, uses assets, and assumes risks with minimal direction and oversight from ForCo. AusCo is then charged a royalty to exploit this intangible in the Australian market. Like the first example, the guidance states that AusCo's remuneration does not reflect the substance of the arrangement and is not arm's length in nature.

In each scenario, the guidance notes that Australia's general antiavoidance rule or diverted profits tax may also be applicable, emphasizing the range of tools available to the ATO to challenge a group's transfer pricing — tools that will only expand if draft legislation denying deductions for payments to low-tax jurisdictions relating to intangible assets are implemented.

The ATO has also published a longer, draft practical compliance guideline (PCG) on intangible arrangements, focused on arrangements connected with performing DEMPE functions and the migration of intangibles.[6] This document builds on TA 2020/1 summarized above, including additional examples and more details on the types of arrangements that the ATO considers likely to be high or medium risk. Though currently in draft, the guidance (when finalized) will be applied prospectively and retroactively.

What does all this mean for taxpayers? The ATO has had long-standing concerns about arrangements resulting in the transfer of income from intangibles owned in Australia to other jurisdictions, as well as payments for intangibles from Australia to lower-tax jurisdictions. Our experience is that taxpayers that enter these types of relatively common arrangements should expect the ATO to ask questions and potentially initiate a review or audit. This does not mean that adjustments are inevitable. The ATO will want to understand the commercial rationale underpinning any new arrangement and the economic substance of the arrangement with a focus on DEMPE activities. An effective way to rebut the ATO concerns is through contemporaneous two-sided documentation focused on:

- the options realistically available to the relevant Australian entity or entities;
- the economic substance of the arrangement — specifically, Australia's DEMPE contributions; and
- the intangibles with specificity and their relative value within the supply chain.

Inbound Distribution Arrangements

The PCG for transfer pricing issues related to inbound distribution arrangements was finalized in 2019 and sets out the ATO's compliance approach for inbound distributors, including a risk assessment framework based on the level of profit earned by a distribution entity.

For distributors in both the life sciences as well as the information and communication technology sectors, there is a different risk assessment framework for different value-adding categories of distributor. Category 1 distributors

[6] ATO, "Draft Practical Compliance Guideline, Intangibles Arrangements," PCG 2021/D4 (2021).

perform more routine activities, and category 2 and 3 distributors perform more "value-adding" activities. Again, it is notable that the categorization of distributors is based on the activities an entity performs rather than the risks it manages or controls. For example, a life sciences distributor in category 1 performs detailing and marketing as well as logistics and warehousing activities. A distributor in category 2 performs those activities in addition to "regulatory approval, market access or government reimbursement activities." A distributor in category 3 additionally performs "specialized technical services" that may include training associated with medical devices.

As mentioned, the PCG focuses on activities undertaken in Australia (through employees) rather than the traditional focus on functions, assets, and risks. This deliberate choice is not a reflection that the ATO does not consider functions, assets, or particularly risk management and control (or the risk control framework) to be relevant to distributor returns. Rather, it is an acknowledgement that a taxpayer's self-assessment of their transfer pricing risk using the PCG framework, relying on the activities performed (and roles of its employees), is a more objective measure and less open to interpretation than the ATO determining whether a distributor manages and controls risks in line with OECD guidance.

The ATO has not published any guidance on the OECD's risk control framework and relies on the concepts of management and control of risks rather than the new language within Chapter I. As mentioned, the ATO's Economist Practice has long held the view that there are very few true limited risk distributors operating in Australia and often cites Australia's geographic isolation from other countries as a key reason for this approach. When the ATO considers a distributor's characterization, it considers whether employees within the Australian entity manage and control the relevant risks through their day-to-day activities and whether the Australian entity incurs the financial effects of these risks (for example, foreign exchange losses, customer credit risk, or inventory obsolescence are observed in the Australian entity's financial statements). The ATO does not accept that a guaranteed return or the reimbursement of costs actually incurred by the Australian entity sufficiently limits or mitigates risks in related-party arrangements by itself.

Unlike some other tax administrations, the ATO rarely argues that an Australian distributor's value-adding activities entitle it to a portion of the nonroutine return through profit-split method application (unless the Australian entity makes unique and valuable contributions, like through intangibles). Instead, the ATO has been focused on increasing the profit allocated to the Australian distributor by arguing a higher point in the interquartile range or by adding more value-adding comparables to the set, thereby increasing the range of results. In some cases, and when cross-checked with other methods/approaches, this approach has resulted in a significant proportion of a group's system profits from the Australian market being allocated to the Australian distribution entity, effectively under-remunerating value-creating and entrepreneurial activities offshore.

Interaction With Domestic Legislation

Finally, when performing a transfer pricing analysis for a group's Australian operations, it is important to consider both Australia's domestic transfer pricing rules and the OECD guidelines. Australia updated its transfer pricing rules in 2013, partly drawing from the 2010 version of the OECD guidelines. As a result, Australia's domestic transfer pricing rules have what is known as a reconstruction provision. This includes a "basic rule" stating that arm's-length conditions are met when they are (a) based on the commercial or financial relations in connection with which the actual conditions operate; and (b) have regard to both the form and substance of those relations, unless at least one of three exceptions is met.[7] The exceptions (or reconstruction provisions) are met where (1) the substance of a transaction differs from the transaction that has purportedly occurred, (2) an independent entity would have entered into a different transaction, or (3) an independent entity would not have entered into a transaction at all. These exceptions allow the ATO to reconstruct the

[7] Income Tax Assessment Act 1997, section 815-130.

actual arrangement and determine an arm's-length price for the hypothetical arrangement.

The exceptions summarized above provide an additional legal basis for the ATO to challenge a group's transfer pricing arrangements, which may be particularly relevant for the ATO's focus on intangibles arrangements and DEMPE activities.

China

The State Tax Administration's (STA's) position on transfer pricing issues is set out in the U.N.'s 2021 practical manual[8] in a section on China's country practices.[9]

This section acknowledges that some elements of the OECD's BEPS initiative have been adopted into domestic law. However, it also emphasizes the importance of respecting a country's sovereignty and that "more flexibility is also essential for [developing countries] to play on a level field with developed countries."[10]

Though China has not formally adopted the OECD guidelines and rarely cites them during mutual agreement procedures, it has incorporated elements of the guidelines into domestic law. In 2017 the STA released a public notice[11] highlighting the importance of DEMPE and promotion when pricing intragroup transactions involving intangibles. The additional reference to "promotion" is clear evidence that the STA considers that these activities — particularly in the consumer-facing industries — should attract returns that are commensurable to the Chinese distributor's contribution and local marketing intangibles that may have been created, which often go above those that would be allocated to routine sales and marketing activities. Though China has not incorporated the OECD's control of risk framework into its legislation or regulations, these concepts are also used by the STA to review multinationals' approach to transfer pricing.

Many large multinationals perform a range of activities in China, including contract R&D, manufacturing, as well as sales and marketing. Multinationals frequently employ large numbers of people in China; the STA typically looks at these employees' performance regarding the functions performed by group management at its principal company or companies when considering if the returns allocated to China are arm's length. When a multinational purports to exercise control over the economically significant risks in China through its principal(s) but the entity has few, albeit very senior, employees, the STA is likely to challenge whether the entity has a sufficient level of active involvement in its Chinese operations for the entity to actively exercise control over risks. Generally, the STA often places equal, if not more, emphasis on the people functions that actively assume and manage the risks daily vis-à-vis those that set the risk control framework.

For example, a common arrangement between a multinational's principal and its Chinese operations is the so-called contract R&D arrangement, under which the Chinese organization is remunerated on a cost-plus basis. The principal would claim economic ownership of the intangibles and reap its rewards by charging royalties to its worldwide operations. The STA has, over the years, paid attention to this setup, particularly with cases in which there is a risk of "round-tripping," meaning that the intangibles are developed (through a contract R&D arrangement) and later licensed back to China. In these cases, the STA closely examines the substance of the principal to assess whether the contract R&D arrangement can indeed be delineated as a contract R&D transaction or is more appropriately delineated as the headquarters providing financing and thus should receive a financing return only with the Chinese operation enjoying the economic return from the developed intangibles.

When a multinational licenses intangibles to its Chinese operation and charges a royalty fee, the Chinese tax authorities expect this arrangement be reviewed regularly, with royalty rates adjusted as appropriate. For example, if a

[8] U.N., "United Nations Practical Manual on Transfer Pricing for Developing Countries, 2021" (2021).

[9] This section was written in conversation with Mimi Wang of KPMG China.

[10] U.N., *supra* note 8, at 557.

[11] STA, "Public Notice of the State Administration of Taxation on Issuing the 'Administrative Measures of Special Tax Investigation and Adjustment and Mutual Agreement Procedure,'" Public Notice [2017] No. 6.

Chinese manufacturing operation improves the manufacturing process, there could be an expectation that the STA will lower the rate of royalties. When a know-how royalty is charged, it is also common to expect this to subside over time as the manufacturing operation internalizes the know-how and develops its own.

In consumer-facing industries, distributors and retailers generally carry out a range of local marketing activities to promote their goods. It can be uncertain whether the local marketing activities are simply routine localization of global marketing intangibles or if the distributor creates local marketing intangibles. Given the subjective nature of transfer pricing, it would not be uncommon for the STA to argue that Chinese distributors should be allocated a significant return on sales because of the nonroutine exploitation and promotion activities they perform and to reflect the market premium that Chinese consumers place on foreign brands.

Though, as with other tax administrations, the STA generally focuses on situations in which Chinese entities have been under-remunerated for their activities. It has also used the concepts of control of risk as well as DEMPE and promotion to argue that losses incurred in China should be borne by a foreign counterparty. For example, the Chinese subsidiary of a multinational that provided finance leasing incurred losses because of unforeseen changes in regulations in China. The STA attempted to argue that these losses should be attributed to the foreign parent because it exercised control over the group's Chinese operations, even though the parent was not responsible for and had little oversight over the day-to-day decision-making of the Chinese subsidiary.

Many multinationals are considering restructuring to increase their footprint outside China, to diversify their supply chains and increase resilience. When conducting this restructuring, groups should consider the transfer pricing implications, because we anticipate that the STA may look to apply "exit charges" when significant operations are moved overseas. China's transfer pricing regulations do not have a specifically defined concept of exit charges. Instead, the Chinese tax authorities are likely to delineate the transactions — for example, transfer of tangibles or intangibles — that occurred as part of the restructuring and tax the transactions accordingly.

In China, there are 720,000 tax officials and 36 provincial-level tax offices. For transfer pricing cases, the STA has established a three-level internal approval procedure, in which audits are initially conducted by the in-charge tax administration, which then sets up a special task team to undertake an investigation. The task team formulates an opinion that is then submitted to a provincial-level specialist for approval. Large cases must also be submitted to a national-level panel of experts for approval. Although these efforts to establish a consistent assessment method have been effective, there is still some variation in approaches across different parts of the tax administration. Disputes between taxpayers and the STA over the concepts of control of risk and DEMPE and promotion can arise at every level.

China has a unique interpretation of the OECD's control of risk and DEMPE and promotion framework. This means that there would be a significant benefit to consulting with local advisers, who are familiar not only with China's transfer pricing legislation and regulations but also with the concerns and positions typically adopted by the STA.[12] ■

[12]The foregoing information is not intended to be "written advice concerning one or more Federal tax matters" subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230. The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser. This article represents the views of the author(s) only, and does not necessarily represent the views or professional advice of KPMG LLP.