# *TR 95/D23 - Income tax: international transfer pricing - practical issues associated with setting, reviewing and documenting transfer pricing - application of Division 13 of Part III (international profit shifting) and Australia's comprehensive double taxation agreements*

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# Draft Taxation Ruling

Income tax: international transfer pricing - practical issues associated with setting, reviewing and documenting transfer pricing - application of Division 13 of Part III (international profit shifting) and Australia's comprehensive double taxation agreements

**other Rulings on this topic**

**IT 2514; TR 92/11; TR 94/14; TR 95/23; TR 95/D11; TR 95/D22; TR 95/D24**


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## What this Ruling is about

### Class of person/arrangement

1. This Ruling provides guidelines on the application of certain concepts outlined in Taxation Ruling TR 94/14 (*Income tax: application of Division 13 of Part III (international profit shifting*)) and in Australia's comprehensive double tax agreements ('Australia's DTAs') which have been included as schedules to the *International Tax Agreements Act 1953* relating to international transfer pricing. It does not deal with matters explained in detail in TR 94/14 and in TR 92/11.

2. This Ruling is divided into two parts. Part 1 focuses principally on:

(a) reasons why taxpayers should keep contemporaneous documentation showing that prices used in their international dealings with associated enterprises are arm's length for tax purposes;

(b) the documentation issues that arise for taxpayers in selecting and applying the most appropriate transfer pricing methodology for ascertaining the arm's length

consideration of their international dealings with associated enterprises for tax purposes;

(c) how the Australian Taxation Office ('ATO') reviews any processes implemented by taxpayers and the resulting transfer prices to check compliance with the arm's length principle; and

(d) access to information by the ATO and taxpayers.

3. Part 2 discusses a number of specific topics in international transfer pricing which may present difficulties for taxpayers and the ATO alike. These are as follows:

(a) considerations when sustained losses are being incurred;

(b) market penetration strategies;

(c) marginal costing;

(d) the use and relevance of global price lists;

(e) set-off arrangements; and

(f) safe harbours.

4. This Ruling should be read having regard to the principles in TR 95/D22 (*Income tax: using arm's length transfer pricing methodologies in international dealings between associated enterprises*).

5. This Ruling is generally stated in relation to dealings between separate legal entities, with a particular focus on dealings between companies. Certain documentation issues which arise in dealings between different parts of the same legal entity (e.g., the allocation of income and expenses for permanent establishments) are not specifically dealt with in this Ruling and reference should be made in this regard to TR 95/D11 (*Income tax: application of Division 13 of Part III (international profit shifting) - basic concepts underlying the operation of Division 13 for permanent establishments and circumstances in which subsection 136AE(4) will be applied*). However, more general issues such as statutory requirements to keep documentation, documenting the selection and application of particular arm's length methodologies, and the description of a four step process for setting transfer prices addressed in this Ruling also have application to dealings between different parts of the same legal entity.

6. While the main focus of the Ruling is in respect of companies, the same principles apply where individuals, partnerships and trusts engage in dealings with separate legal entities.

7. Where the word 'associate' or the expression 'associated enterprises' have been used in the Ruling, this has been done for ease of explanation and should not be interpreted as implying that Division 13 of Part III of the *Income Tax Assessment Act 1936* ('Division 13') cannot be applied unless companies are associated in some way, or that these terms in some way limit the operation of the Associated Enterprises Articles of Australia's DTAs (also see paragraphs 273 - 302 of TR 94/14).

8. Similarly the expressions 'dealings' and 'goods or services' have been selected to encompass all of the notions of trade, investment, finance and exchange to which the arm's length provisions of the tax laws refer. This includes the reference in the Associated Enterprises Articles of Australia's DTAs to the conditions that operate between the two enterprises in their commercial or financial relations, and also the concept contained in Division 13 of property supplied or acquired under an international agreement (paragraphs 214 - 272 of TR 94/14).

9. The term 'international profit shifting' is used in its broadest sense to cover arrangements that have the effect of denying Australia its fair share of tax (also see paragraph 154 of TR 94/14).

10. A glossary of terms commonly used in this Ruling is provided at paragraphs 588 - 617.

11. In providing these guidelines, there is no intention of laying down any conditions to restrict officers in the exercise of any discretion. Each case must be decided on its merits.

# Date of effect

12. This Ruling applies to years commencing both before and after its date of issue. However, the Ruling does not apply to taxpayers to the extent that it conflicts with the terms of a settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

# Ruling

## PART ONE

### Introduction

13. Taxpayers should assess their need to keep documentation to show compliance with the arm's length principle in relation to their international dealings with associated enterprises on the same prudent business management principles that would govern the process of

evaluating a business decision of a similar level of complexity and importance **(paragraphs 154 and 294)**.

14. Application of prudent business management principles will require the taxpayer to prepare or refer to written materials that could serve as documentation of the efforts undertaken to comply with the arm's length principle, including the information on which the transfer pricing was based, the factors taken into account, and the method selected **(paragraphs 156 and 294)**.

15. The arm's length principle imposes requirements on associated enterprises that would not be required of independent enterprises dealing at arm's length. Some documents that might reasonably be used or relied upon in determining arm's length transfer pricing for tax purposes may be of the type that would not have been prepared or obtained other than for tax purposes, including the obtaining of documents from foreign associated enterprises **(paragraphs 155 and 288)**.

16. The keeping of sufficient and relevant contemporaneous documentation will assist taxpayers in lodging correct tax returns **(paragraph 156)**.

**Reasons for keeping documentation**

17. Taxpayers should create and keep contemporaneous documentation recording the application of the arm's length principle in setting the prices or the terms of their international dealings with associated enterprises for tax purposes because:

(a) there are statutory requirements to keep documentation **(paragraphs 162 to 175)**;

(b) higher penalties may apply where taxpayers have not taken reasonable care or do not have a reasonably arguable position **(paragraphs 176 to 184)**;

(c) the burden of proof rests with taxpayers in the event of disputation **(paragraphs 185 to 190)**; and

(d) commercial reasons compel the maintenance of documentation **(paragraphs 191 to 199)**.

***Statutory requirements to keep documentation***

18. Division 13 and Australia's DTAs together with the record keeping requirements of section 262A of the *Income Tax Assessment Act 1936* ('the ITAA') and the associated penalty provisions contained in section 225 of the ITAA are seen as a legislative code which

imposes an indirect obligation on taxpayers to give consideration to the arm's length principle in setting transfer prices in their international dealings with associated enterprises and to adequately document that consideration **(paragraphs 162, 168, 170, 173 and 200)**.

19. Section 262A imposes obligations on taxpayers to retain records created in the process of setting and reviewing transfer prices **(paragraph 168)**.

20. In determining the amount of costs for the purpose of applying the cost plus method or the relevant expenses incurred for the purpose of applying a profit split or profit comparison method, section 262A would require documenting the basis of the calculation used to explain the figure for costs or the relevant expenses for the profit split methods **(paragraph 168)**.

21. In determining the combined profit for the purposes of applying a profit split method or the net profit for the purposes of applying a profit comparison method, an explanation of the basis used for determining the relevant revenue and expenditure items leading to the amounts for combined profit or net profit would need to be recorded and kept **(paragraph 169)**.

22. Subsection 262A(2) requires taxpayers, when allocating indirect costs between controlled transactions and other transactions entered into by the taxpayer for the purpose of applying an arm's length methodology, to keep documents explaining the allocation basis used **(paragraph 169)**.

*Taxpayers having international dealings with associated enterprises must provide certain information with their income tax returns*

23. A taxpayer which has engaged in international transactions with an associated enterprise during a year of income is required to complete a Schedule 25A pursuant to Regulation 15 of the Income Tax Regulations and lodge it with its income tax return. The information required to be provided in the Schedule 25A, from the 1995 year of income onwards, also imposes obligations on a taxpayer to consider whether the outcomes of its dealings with associated enterprises have been reported on an arm's length basis for tax purposes **(paragraphs 174 and 175)**.

***Higher penalties may apply where taxpayers have not taken reasonable care or do not have a reasonably arguable position***

24. The existence of adequate documentation would be an important indicator of reasonable care on the part of a taxpayer and would be a

mitigating circumstance when considering what (if any) level of penalty should be imposed in the event of a transfer pricing adjustment. Conversely, the lack of adequate documentation will be taken by the ATO as demonstrating an absence of reasonable care and in some cases may lead to the conclusion that the taxpayer was reckless for the purposes of section 226H of the ITAA **(paragraph 176)**.

### *The burden of proof rests with taxpayers in the event of disputation*

25. In order to discharge the burden of proof under sections 14ZZK and 14ZZO of the *Taxation Administration Act 1953* the taxpayer needs to show not only that the Commissioner's assessment was made on a wrong basis but also to show what correction should be made to make it right or more nearly right **(paragraphs 187 and 188)**.

### *Commercial reasons compelling the maintenance of documentation*

26. Where taxpayers have kept adequate documentation and voluntarily produce such documents to the ATO to enable an informed decision to be made on the taxpayer's processes and procedures, the likelihood of extensive enquiries and adjustments by the ATO will be diminished **(paragraph 192)**.

27. A lack of sufficient and relevant contemporaneous documentation will, in the first instance, increase the risk of an ATO audit and, in the second instance, increase the risk of a transfer pricing adjustment and the risk of culpability penalties being imposed **(paragraph 194)**.

28. It will be more difficult for taxpayers to convince the ATO that their associated enterprise dealings were priced on an arm's length basis where after the event analyses are relied upon. The ATO will regard contemporaneous documentation as more reliable than a subsequent review **(paragraph 199)**.

### The need to keep 'contemporaneous documentation' for international transfer pricing between associated enterprises

29. 'Contemporaneous documentation' means books, records, studies, analyses, conclusions and other written material, existing or brought into existence at the time the taxpayer was developing or implementing any arrangement, that might raise transfer pricing issues and which record the information relevant to transfer pricing decisions **(paragraph 203)**.

30. It is expected that taxpayers will have carried out an analysis in accordance with the arm's length principle at the time of setting their prices or engaging in dealings that raise transfer pricing issues. Where transactions with associated enterprises have not been conducted on an arm's length basis, it is expected that consideration would be given to the appropriate prices for income tax purposes at the time the dealing is being contemplated or at the time the transaction is entered into and that the necessary documentation is created at this time also **(paragraph 205 and 206)**.

31. In most cases relevant documentation will not need to be produced to the ATO until the time of a transfer pricing review. Where information is required from taxpayers at the time of lodgment of tax returns in relation to international dealings with associated enterprises, this will be restricted to the minimum necessary to make a reasonable assessment of which taxpayers ought to be the subject of further examination **(paragraphs 209 and 210)**.

### How the ATO reviews the processes used by taxpayers for setting and reviewing transfer prices

32. The initial stage of an ATO transfer pricing review concentrates on an appraisal of a taxpayer's processes and documentation in order to determine the level of risk to the revenue. In certain cases this will proceed to the next stage where an audit of the taxpayer's pricing outcomes will be undertaken with the real prospect of a transfer pricing adjustment being made by the ATO in cases of understatement of tax **(paragraphs 212 to 214)**.

### The risk of a transfer pricing audit

33. ATO resources on transfer pricing cases will be allocated on the basis of the perceived risk of taxpayer non-compliance with the arm's length principle. Taxpayers are generally grouped by the ATO according to a number of broad risk categories. Taxpayers should assess their needs and consider the level of certainty they wish to achieve having regard to the impact of international dealings with

associated enterprises on their overall business and other relevant factors. This assessment will determine the level of risk to which the taxpayer is prepared to be exposed **(paragraphs 225 to 238)**.

### Documenting a process for setting international transfer prices

34. Taxpayers who have developed and implemented a thorough process for setting their transfer prices between associated enterprises are less likely to find themselves exposed to transfer pricing adjustments. The standard of an enterprise's pricing policies and processes is relevant in three ways. First, it is relevant to the decision as to whether an ATO review proceeds beyond an examination of process. Second, it is relevant to the size of any adjustment to the consideration or profit returned if such an adjustment is found to be necessary. Third, it is relevant to the imposition and size of any penalty **(paragraphs 240 to 242)**.

#### *Step 1: understand the cross-border dealings between associated enterprises in the context of the business*

35. This requires the adequate documentation of the analysis undertaken to obtain a broad understanding of the enterprise and the business it conducts. Adequate documentation of the preliminary steps taken to analyse the functions undertaken, assets utilised and risks borne by the business in relation to the controlled dealings should also be prepared during this step. This step requires the adequate documentation of the functional analysis of the enterprise, which is mainly carried out at this time. This analysis should be retained by the taxpayer indefinitely **(paragraphs 244 to 256)**.

36. A detailed analysis may not be required in every case and needs may vary subject to the complexity and importance of the associated enterprise dealings involved. These factors will determine what is adequate documentation in the facts and circumstances of each case **(paragraphs 257 to 262)**.

#### *Step 2: selection of the methodology or methodologies*

37. Documentation of the process of selecting the appropriate pricing methodology or methodologies and the rejection of other pricing methodologies is required in this step. Documentation of the preliminary identification and analysis of comparable data should also be prepared or acquired in this step **(paragraphs 263 to 265)**.

### *Step 3: application of the methodology or methodologies*

38. This step requires the adequate documentation of the process used to identify, analyse and apply comparable data which is predominantly undertaken during this step. Any documentation created or acquired in supplementing and extending the functional analysis in order to ensure proper application of the pricing methodology or methodologies is also included in this step. In the case where application of the assessment of comparability suggests that there is a range of arm's length outcomes, documentation detailing all of the outcomes in the range and the most appropriate point in the range selected by the enterprise is required **(paragraphs 266 to 268)**.

### *Step 4: determine the arm's length consideration and review the process if factors change*

39. Documentation outlining the application of the company's functional analysis and comparability study to the determination of the pricing outcome, is relevant in this step, which is the conclusion of the processes of analysis and documentation outlined in earlier steps. If data is available, a review of the pricing outcome to ensure that it is commercially realistic should be undertaken and documented. Documentation outlining the performance reports generated by the enterprise which may be used to verify the arm's length outcome of the pricing system will be of great assistance **(paragraphs 269 to 271)**.

40. The process of selecting and applying an arm's length methodology does not end with determination of an arm's length consideration for the relevant controlled transactions but must, as appropriate, include ongoing monitoring by the taxpayer of its process for setting arm's length transfer pricing. Taxpayers should document their monitoring process and its outcomes **(paragraph 273)**.

41. A detailed review should be undertaken where there has been a significant change in factors important to the conduct of an enterprise's business or a shift in the critical assumptions which form the basis for selection and application of the methodology and appropriate adjustments should be made to its process as a result of such a review. The initiation, conduct and outcome of the review must be adequately documented **(paragraph 274)**.

42. It is not accepted that a taxpayer's process in selecting and applying a methodology or methodologies does not have to be monitored or reviewed once it is implemented **(paragraphs 272 to 276)**.

*Revisions or renegotiations of existing arrangements often raise special documentation issues*

43. Where taxpayers revise or renegotiate existing dealings with associated enterprises documentation should be created and retained to detail and support:

(a) the terms of the new agreement;

(b) the changed circumstances which have led to the need for the revision or renegotiation;

(c) the analysis undertaken to support the revised transfer price or terms of the arrangement including adequate detail of external benchmarking undertaken and the pricing methodology used;

(d) the basis on which it is considered that the approach taken is consistent with what arm's length parties would have done in the same or similar circumstances

**(paragraphs 281 and 282)**.

**Does the taxpayer properly implement its own process in setting prices and conditions for cross-border transactions?**

44. Contemporaneously documented processes would have little impact on a taxpayer's level of risk if they have not been properly implemented by the taxpayer. In this regard, as part of the ATO's risk assessment analysis of a taxpayer, we will be seeking to test any process established by the enterprise in order to be satisfied that the process has been properly implemented. Proper implementation by a taxpayer of its process for the setting of its transfer prices with associated enterprises for tax purposes would require that the ATO be able to establish amongst other things that:

(a) the taxpayer has relied on the outcomes generated by application of its process for the purposes of lodging a correct tax return;

(b) the taxpayer has applied its process to all its associated enterprise dealings; and

(c) the taxpayer has undertaken reviews of its process when these are needed and made appropriate changes as necessary to its process

**(paragraphs 283 and 284)**.

45. Where processes have not been properly implemented, this will be a significant factor in the ATO decision to proceed beyond a review of the taxpayer's processes **(paragraph 285)**.

**Is documentation adequate to support a correct selection and application of transfer pricing methodologies?**

46. The obligations imposed on taxpayers by the law to comply with the arm's length principle in relation to their international dealings with associated enterprises mean that records over and above those kept by the taxpayers in the ordinary course of business will ordinarily need to be created or obtained in order to satisfy these obligations. However, the ATO will limit additional documentation requirements to the minimum necessary to ensure compliance with the arm's length principle. It is not accepted that documentation to support a correct selection and application of transfer pricing methodologies is limited to documents created by the taxpayer in the ordinary course of business **(paragraphs 287 to 291)**.

47. Documentation to support a correct selection and application of transfer pricing methodologies in relation to international dealings between associated enterprises falls into five broad categories:

(a) documents created by the taxpayer in the ordinary course of transacting its business;

(b) documentation created or obtained to support a study of the enterprise's significant business functions, business strategies, the assets utilised in pursuit of that business and the risks associated with the business activity;

(c) documentation created or acquired to support an analysis of methodologies available in a particular case and their relative worth, the process of selection or rejection of one or more methodologies and the rationale for that selection or rejection;

(d) documentation created or acquired to support the application of the methodology to specific or generalised dealings as they occur and a reasonable sample checking of results; and

(e) documentation created or acquired in the course of any review of the taxpayer's process for setting transfer prices in relation to international dealings between associated enterprises

**(paragraphs 286 and 297)**.

48. Where taxpayers have not adequately documented the types of comparability factors which influence pricing and profits in their particular markets, the ATO will have to undertake an analysis of the factors which influence prices and profit outcomes in the market in which the enterprise is operating and form its own view as to what an

arm's length party might reasonably have been expected to have paid or received in respect of the relevant dealings **(paragraph 298)**.

## Documentation relevant to the application of particular pricing methodologies

### *Documentation relevant to applying a Comparable Uncontrolled Price methodology*

49. A Comparable Uncontrolled Price ('CUP') methodology bases its comparison directly on price and requires that goods or services transferred be comparable in both controlled and uncontrolled dealings and that the dealings being compared should have occurred in comparable circumstances. Taxpayers should document the basis for comparison including physical features of the property and other features impacting on comparability. The identification of any differences that may have a material effect on price and quantification of the adjustments made in respect of these differences should be documented. This will be the case whether the CUPs used are in relation to the taxpayer's dealings with independent enterprises (internal CUPs) or in relation to dealings between two independent enterprises (external CUPs) **(paragraphs 304 to 311)**.

50. The proper application of the CUP method requires an analysis of the functions performed by the parties being compared and this analysis should be adequately documented. The extent of the analysis will depend on the relative importance, nature and complexity of the dealings, its associated terms and conditions and whether the taxpayer has internal comparables **(paragraph 312)**.

51. The ATO accepts that there will be relatively rare occasions where it will be sufficient for taxpayers to document the application of pricing policies rather than each individual transaction. In such a case the taxpayer would need to document that

(a) the competitor's products were comparable and/or that differences which could materially affect price were adjusted for; and

(b) the conditions affecting the dealings, including contractual terms, market and other key factors were comparable or material differences, that have a material effect on price, were identified and adjusted for

**(paragraphs 312 to 314)**.

***Documentation relevant to applying a resale price methodology***

52. The resale price ('RP') method focuses on functional comparability rather than product comparability as is the case with the CUP method. The RP method therefore relies heavily on a comparison of functions performed by the enterprise and the comparable parties (either internal or external comparison). Adequate documentation of the functional analysis of the enterprise and the comparability analysis is therefore most important to the application of this method **(paragraph 316)**.

53. This method also relies heavily on comparison of the gross margin achieved by the enterprise from associated enterprise dealings with gross margins from uncontrolled dealings. It is therefore most important to document any adjustments made to the uncontrolled margin to improve comparability. The decision making process used in arriving at the selection of the method should also be documented **(paragraphs 316 to 325)**.

54. Differences in accounting treatment which have an effect on the gross profit (or other profit level) to be used as the basis of comparison between the taxpayer and any potential benchmarks, need to be reconciled and the basis of such reconciliation adequately documented **(paragraph 321)**.

55. Where it is not possible, in applying the RP method, to find independent enterprises selling comparable property in a comparable market, the process of selecting the general type of product or broadening further into other product types should be documented. In particular, taxpayers need to concentrate their documentation on the process undertaken to ensure that there is functional comparability and, where differences occur, make quantifiable adjustments **(paragraph 321)**.

56. In cases where a taxpayer has adopted a methodology which adopts a margin which is calculated as a certain percentage of resale price where the percentage chosen is not benchmarked against external comparables, that is, in cases where no other approach is reasonably open, the taxpayer should document:

(a) the rationale for the selection of this methodology including reasons for its use in preference to arm's length methodologies; and

(b) how the fixed percentage has been calculated to produce a result that fairly reflects the functions performed, assets employed and risks undertaken

**(paragraphs 323 and 324)**.

***Documentation relevant to applying a cost plus methodology***

57. The cost plus ('CP') method also focuses on functional comparability and so, as with RP method, the adequate documentation of the analysis of functions, assets and risks of the enterprise and the comparable parties is of prime importance. The method also focuses on the enterprise's costs and so adequate documentation of the components of the cost base should be available. This cost base will normally include a proportion of indirect costs and the calculations and method of apportionment of those costs should be documented. In most cases this documentation will be created in the ordinary course of business **(paragraphs 325 to 327)**.

58. Below the line costs will need to be apportioned between the controlled transactions and the other business enterprises of the taxpayer on an appropriate basis and the basis of such allocation should be adequately documented and retained **(paragraph 330)**.

59. The method also relies on comparison of gross margins by the enterprise from associated enterprise dealings with gross margins from comparable uncontrolled dealings. Any adjustments made to the uncontrolled margin to improve comparability should be adequately documented **(paragraphs 326 to 332)**.

60. In cases where a taxpayer has used a methodology which applies a fixed percentage mark-up to a relevant cost base where the percentage mark-up is not benchmarked against external comparables, that is, in cases where no other approach is reasonably open, the taxpayer should:

(a) document the rationale for the selection of this methodology including reasons for its use in preference to other arm's length methodologies; and

(b) document how the fixed percentage has been calculated to produce a result that fairly reflects the functions performed, assets employed and risks undertaken (the intention always being to reasonably approximate an appropriate return for the economic value added)

**(paragraphs 333 and 334)**.

***Documentation relevant to applying a profit split methodology***

61. In applying a profit split adequate documentation would be required in relation to a number of issues including:

(a) reasons why the taxpayer is applying a profit method, which is accepted by the ATO as a method of last resort, instead of a traditional transactional method;

(b) the level at which the profit split is being undertaken, for example on a transactional or an aggregated dealings basis;

(c) how the combined profit was calculated, including the basis used to allocate the indirect costs and the relevant general administrative and selling expenses of each of the associated enterprises;

(d) whether the profit to be split is net or gross profit;

(e) the effects on the calculation of the profits to the split attributable to differences in accounting treatment of profit between jurisdictions or to the effects of currency need to be identified, reconciled and the profit to be split equalised as between the taxing jurisdictions involved;

(f) the functional analysis undertaken in respect of all parties to the dealings, including the identification of significant economic contributions to the combined profit; and

(g) in the case where the combined profit to be split is a projected profit, the basis used for such projection and details of its estimation would be required

**(paragraphs 335 - 345)**.

62. In cases where a profit split using a contribution analysis is undertaken the basis for any allocations of value to any features which contribute to the combined profit to be split would need to be adequately documented as would the basis for any external benchmarking used **(paragraph 346)**.

63. In cases where a profit split using a residual profit basis is used the identification and ascribing of value to the basic functions and the allocation of profit to each of the enterprises would need to be adequately documented and any external benchmarking detailed. The basis of attribution of economic value to the elements of the dealing giving rise to the residual profit should also be adequately documented **(paragraphs 347 to 350)**.

### *Documentation relevant to applying a profit comparison methodology*

64. In applying a profit comparison methodology ('PCM'), adequate documentation would be required in relation to:

(a) reasons why the taxpayer is applying a profit method, which is accepted by the ATO as a method of last resort, instead of a traditional transactional method;

(b) identification of the aggregated method being applied, in particular the ratio or ratios being used. This should include reasons why the particular ratios used were selected and why other ratios were discarded. Similar documentation should be provided in respect of any other ratios used to check the reliability of the primary approach;

(c) the process used to identify, analyse and apply comparable uncontrolled data and any adjustments made to the uncontrolled data to improve comparability;

(d) ensuring appropriate accounting and measurement consistency exists in relation to the application of the selected ratio for the taxpayer and any comparable independent enterprises;

(e) any multi-year data of both the taxpayer and any comparable independent enterprise(s) used in the analysis;

(f) the process used to isolate the comparison to the taxpayer's cross-border dealings with associated enterprises;

(g) in cases where the application of ratio analysis resulted in the creation of a range of arm's length outcomes, details of all points in the range and the taxpayer's process in selecting the most appropriate outcome in the range;

(h) how the relevant amount for costs was ascertained in cases where PCM is used on a net cost plus basis; and

(i) calculations and supporting reasoning used to apportion indirect costs in relation to the controlled transactions in cases where PCM is applied on a net cost plus basis

**(paragraphs 351 to 365)**.

### Does the application of the methodology give a commercially realistic outcome?

65. A decision on whether to proceed to a full review of pricing outcomes will be made by the ATO taking into account all relevant circumstances. One relevant circumstance in this regard would be

whether the outcome of the taxpayer's pricing process yields a commercially realistic result. In this regard, taxpayers should expect that the outcomes of their pricing policies are likely to be subject to some checking by the ATO at an early stage in any review **(paragraph 366)**.

66. Where a taxpayer has well documented processes in place for determination of its transfer prices with associated enterprises for tax purposes and yet consistently returns losses or profits significantly below industry averages over time, it may be expected that the ATO will consider whether the outcome can be explained by reference to market factors **(paragraphs 367 to 368)**.

67. Where a taxpayer consistently returns losses over a period of time (irrespective of industry averages), the taxpayer's pricing outcomes could be expected to be subject to detailed analysis on the basis that commercial reality would necessitate outcomes which reflected an adequate rate of return on capital invested having regard to the functions undertaken, assets used and risks being borne **(paragraph 368)**.

68. In considering whether outcomes can be explained on the basis of market factors, the ATO would initially look to whether the outcomes could reasonably be explained by reference to the taxpayer's business and marketing strategies, or to market factors which may have affected other taxpayers operating in the relevant market and distorted the outcome **(paragraph 369)**.

### The risk of a transfer pricing adjustment

69. The initial focus of an ATO review will be on the process established and documentation kept by the taxpayer in relation to international dealings with associated enterprises. Where relevant and adequate contemporaneous documentation is not available, or where the taxpayer has well documented processes in place but the result does not give a commercially realistic outcome, the ATO may proceed beyond a review of process to a transfer pricing audit. The extent of further enquiries will also be dependent on the level of perceived risk **(paragraphs 370 and 371)**.

70. Where taxpayers have limited access to data for setting their transfer prices on dealings with associated enterprises, this fact alone will **not** preclude an adjustment being made where their transfer prices differ materially from the arm's length pricing outcome. The arm's length principle is an objective test and is not dependent on whether taxpayers have access to sufficient information. However, taxpayers making full use of available information in considering the application of the arm's length principle, and adequately documenting that

consideration, will increase their chances of arriving at an arm's length outcome and reduce the risk of transfer pricing adjustment by the ATO **(paragraphs 194 and 371 to 374)**.

71. Where the ATO commences a transfer pricing audit and the results of our arm's length pricing analysis when compared with the taxpayer's results indicates that a difference exists which is not minor or marginal, which cannot be explained by reference to an arm's length range of outcomes or by commercially realistic business strategies, then there exists a real risk of a transfer pricing adjustment being made to the taxpayer's assessment **(paragraph 375)**.

### How the ATO reviews compliance with the arm's length principle

72. For the purpose of reviewing a taxpayer's compliance with the arm's length principle, the ATO would generally include the following steps as part of our process of review:

(a) Step 1: understand the business of the taxpayer, and conduct a preliminary analysis of functions, assets and risks;

(b) Step 2: broadly assess the availability of data on comparable independent transactions and enterprises, and select the most appropriate method;

(c) Step 3: collect more detailed data to supplement the analysis commenced in the earlier steps; and

(d) Step 4: determine the arm's length consideration

**(paragraph 377)**.

73. In cases where the ATO proceeds to an audit of the taxpayer's pricing outcomes it may be expected that a range of external enquiries will be made and the ATO will select the most appropriate arm's length pricing methodology in light of those external enquiries and any expert opinions obtained **(paragraphs 380 and 381)**.

74. It may not be necessary to perform all of the above enquiries in every case, particularly in respect of smaller enterprises or where the international dealings cover only a small proportion of an enterprise's overall business activities. In general, the ATO approach will be based on an application of appropriate resources to the areas of perceived greatest risk **(paragraph 382)**.

75. Where the ATO needs to make enquiries to develop its own analysis, or test what a taxpayer has done, this could include the use of some or all of the following:

(a) section 263 of the ITAA;

(b) section 264 of the ITAA;

(c) the Exchange of Information Articles of Australia's DTAs;

(d) section 264A of the ITAA (offshore information notices); or

(e) simultaneous tax examinations by Australia and a relevant DTA partner

**(paragraph 384)**.

### Is the ATO view different from the taxpayer's?

76. Adjustments by the ATO to correct a misallocation of income or expenses in the case of international associated enterprise dealings will generally be made when a review of the taxpayer's pricing outcomes reveals a material difference between those outcomes and an arm's length outcome. A material difference in the sense used here is one which is sufficiently significant in dollar terms to make and which is not minor or marginal, which cannot be explained by reference to an arm's length range, or by commercially realistic business strategies **(paragraph 388)**.

77. Where a taxpayer has selected and applied a methodology for the purpose of setting the terms or prices of its international dealings with associated enterprises, the ATO is not precluded from adopting another pricing methodology as part of a transfer pricing audit **(paragraph 389)**.

78. Where a taxpayer adopts well documented pricing processes that, in its view, are 'about as likely as not' to yield an arm's length pricing outcome, the ATO is not precluded from adjusting the taxpayer's transfer prices if it is subsequently found that the pricing outcome differs from an arm's length outcome **(paragraphs 390 to 400)**.

### Access to information

#### *Introduction*

79. 'Third party data' refers to information, documentation and all forms of records obtained or sought by the ATO from parties other than the specific taxpayer under review or audit **(paragraph 405)**.

80. The voluntary production of documents by taxpayers facilitates examinations by the ATO of a taxpayer's transfer pricing and improves the persuasiveness of a taxpayer's approach to transfer pricing. It is in

the interests of taxpayers to provide as much documentation as possible which demonstrates its consideration and application of the arm's length principle in setting and reviewing prices between associated enterprises and making this information available to the ATO at the earliest opportunity **(paragraphs 406 and 407)**.

### *Access to documentation held by an associated enterprise*

81. The Commissioner has a statutory obligation to ensure there is compliance with the arm's length principle. To avoid undue delays in this process, it would be prudent business management for taxpayers to ensure all the associated enterprise documentation necessary to support their transfer pricing policies is readily available **(paragraph 408)**.

82. While section 262A of the ITAA does not require taxpayers to actually store the records they have kept for the purpose of complying with the requirements of the section in Australia, there is a requirement for those records to be made available in Australia, when requested **(paragraph 409)**.

83. Where the ATO needs to made enquiries to develop its own analysis, or to test what a taxpayer has done, normally enquiries involving associated enterprises will initially be made with the Australian taxpayer. Depending on the circumstances other steps to obtain information may need to be taken **(paragraph 412)**.

### *Section 264A of the ITAA*

84. The use of offshore information notices is a standard part of procedures in international audits though their exercise requires judgment as to whether other approaches will enable all the relevant information to be obtained within a reasonable time frame. The notice may be used at any stage in an audit **(paragraph 414)**.

### *Exchange of Information*

85. The use of Exchange of Information ('EoI') articles contained in Australia's DTAs is not necessarily a 'last resort' approach however, the ATO will normally, in the first instance, seek information from the taxpayer in respect of any offshore information **(paragraphs 416 and 417)**.

86. Information obtained under the provisions of Australia's DTAs is generally secret and will be released only to the extent that such release is permitted under the terms of the specific treaty and by law **(paragraphs 418 and 419)**.

### *Access to documents (accountants' advice papers guidelines)*

87. In a review of a taxpayer's transfer pricing policies, most documents discussed in this ruling would fall into the category of 'source' documents to which the Commissioner can exercise his right of access without restriction under the Access to Professional Accounting Advisors' Papers guidelines ('accountants' advice papers guidelines') **(paragraph 422)**.

88. The ATO's initial review of a taxpayer's processes in setting transfer prices with associated enterprises in accordance with the arm's length principle, all documents which evidence a taxpayer's consideration of this principle in setting or reviewing associated enterprise prices will assist in assigning a level of risk. The ATO will seek to examine all documents which evidence these processes **(paragraph 423)**.

89. Where documents are 'non source' or 'restricted source' documents under the accountants' advice papers guidelines and access to them is denied by the taxpayer or the advisor, the ATO will observe the procedures outlined in the guidelines. Where access has been denied, the ATO will still need to make an assessment of the level of risk in which to place the taxpayer having regard to the documentation that is available to the ATO at that time **(paragraphs 422 to 426)**.

### *Collection, use of and access to third party data by the ATO*

90. In determining arm's length consideration, the process requires an analysis that focuses on particular functions, assets and risks relative to a particular taxpayer and other relevant enterprises. In pursuing such a process there will be a need to access and analyse third party data. The purpose of such enquiries is the acquisition of documentation and information that has a direct bearing on the discharge of the Commissioner's statutory obligation to establish what is the arm's length outcome in a particular case. This statutory objective cannot be achieved where the ATO voluntarily restricts itself to limited sources of data. The ATO therefore rejects the suggestion that it should be limited to publicly available third party information **(paragraphs 428, 429 and 435 to 441)**.

91. The ATO may conduct third party enquiries through written questionnaires, surveys and interviews or any combination of these. Such enquiries will be aimed at establishing the characteristics of the third party's business, its strategies, operational framework and the risks peculiar to its business for the purpose of identifying comparables and achieving as high a level of comparability as possible

with the controlled dealings of the taxpayer under review **(paragraph 430)**.

92. The ATO will seek, as much as possible, to utilise data already available to it through taxpayer information and/or the publicly available sources utilised internally. When it is considered that external enquiries are necessary to properly test international dealings between associated enterprises, or to clarify and expand upon internal data used as independent benchmarks, such enquiries will be made **(paragraph 431)**.

93. It should be noted that the ATO will generally have a need to access third party data in cases where it is necessary to go further than an examination of the taxpayer's documented processes **(paragraph 432)**.

94. In utilising third party data ATO recognises that:

(a) third party data requires close scrutiny to ensure comparability;

(b) taxpayers are not always in a position to obtain sufficient competitor's information, particularly in relation to pricing data;

(c) the information may not have been available to taxpayers at the time the transfer price was established. Taxpayers do not have the benefit of hindsight (although periodic reviews can and should be undertaken); and

(d) the secrecy provisions in the Act may prevent the ATO from disclosing the third party data to taxpayers

**(paragraph 438)**.

95. In the context of initial reviews, the ATO will restrict its access to broad type data and to documentation created or obtained by the taxpayer in support of its processes. Broad third party data includes data available from both public sources and any sources internal to the ATO, but excludes the high level comparability analysis necessary if a full review of the taxpayers' transfer pricing policies and outcomes was necessary **(paragraphs 444 and 445)**.

### *Taxpayer access to third party data*

*Public policy considerations*

96. Information obtained by the ATO which relates to the taxation affairs of taxpayers is protected by section 16 of the ITAA, exclusions

to the *Freedom of Information Act 1982* ('the FOI Act') and, in some cases, by the provisions of the *Privacy Act 1988* **(paragraph 446)**.

97. The ATO recognises its obligations to protect the interests of parties providing commercially sensitive information to us, particularly where the release of such sensitive data may adversely affect the interests of the third parties. It can also be expected that the ATO will take steps to promote the view that commercially sensitive information should not be released to taxpayers because such information is subject to privilege based on grounds of public interest immunity **(paragraph 450)**.

*Release under the Freedom of Information Act*

98. Section 38 of the FOI Act prevents disclosure of the affairs of another taxpayer where section 16 of the ITAA applies. Section 43 of the FOI Act prohibits release of documents which may result in disclosing trade secrets or other valuable commercial information or which could reasonably be expected to adversely affect a lawful business. It is therefore expected that any applications for release of such third party data under the FOI Act will not be successful **(paragraphs 452 to 458)**.

*Release as part of tribunal or court hearings*

99. A taxpayer's right to know the case it has to answer does not override other considerations, including privacy and confidentiality that should be afforded to commercially sensitive third party data or where the interests of third parties may be affected **(paragraph 462)**.

100. The public policy considerations which underlie the ITAA establish the parameters of the Commissioner's approach in releasing third party data in court and tribunal proceedings. In any proceedings on such matters, the ATO will take steps to promote the view that natural justice extends to the providers of information to the ATO as well as taxpayers affected by the use of the data **(paragraphs 464 and 466)**.

101. Where the release of third party data may adversely affect the interests of third parties, the ATO will advise such parties of the potential use of the information in any forum which may require its public release **(paragraph 465)**.

*Equity considerations*

102. Information obtained from third parties will only be released to taxpayers, prior to the issue of an assessment, in very limited

circumstances where the identity of the third party can be kept secret **(paragraph 467)**.

### General industry information and publicly available sources of data

103. Publicly available databases may not on their own give 'the correct answer' in terms of arm's length consideration or profit relevant to a taxpayer's associated enterprise dealings. Many databases provide both aggregated and disaggregated information which, although being generally indicative of trends in a particular industry segment, lack the element of focused comparability on which the arm's length principle is based. The many differences affecting taxpayers means that adjustments will need to be made by taxpayers to establish comparability with their particular circumstances and any such adjustments should be adequately documented **(paragraphs 472 to 474)**.

104. Taxpayers might use publicly available databases in cases where the information they provide gives them a degree of comparability, appropriate to their circumstances. However, it would not be appropriate to use such data as the sole basis for comparison where, for instance, a taxpayer has comparable uncontrolled dealings which could be used as a benchmark for its controlled dealings or where a taxpayer has specific information about uncontrolled competitors prices or outcomes which enable a more focused and direct comparison to be made **(paragraphs 475 and 476)**.

105. In the selection of a method, the availability of data about comparable independent dealings will need to be considered. It is expected that, as a part of their selection of a methodology taxpayers will consider their documentation needs and outline their attempts to access and source public data **(paragraph 479)**.

106. Many databases tend to provide aggregated data about prices and/or profit outcomes and therefore lack a focused level of comparison. The arm's length principle requires as focused a level of comparison as is possible. Another feature of these databases is that they will contain data about dealings between associated enterprises which will limit their usefulness **(paragraphs 480 and 481)**.

107. The lack of publicly available data in respect of services and intangibles will impact on the level at which comparisons can be made, and may limit taxpayers to measures of profit performance **(paragraph 485)**.

108. The ATO rejects the suggestion that a formulated check list should be compiled by the ATO setting out the minimum amount of

public data that a taxpayer must take into account in identifying comparables. Such an approach is inconsistent with the arm's length principle **(paragraphs 488 to 490)**.

### Documentation requirements for small business or entities with low levels of international dealings

109. The legislative code requiring taxpayers having international dealings with associated enterprises to comply with the arm's length principle for tax purposes does not admit the possibility of introducing special rules of conduct for specific classes of taxpayers. In particular, the introduction of *de minimus* rules for documentation which obviate the need for smaller taxpayers to keep any explanatory material at all, may erode the value of what is recognised as an internationally accepted principle. A degree of flexibility in the type and extent of documentation to be created or obtained by smaller taxpayers exists based on principles of prudent business management **(paragraphs 491 to 494)**.

110. The legislation does not require a taxpayer to go beyond what is reasonable in terms of documentation. What is reasonable will be determined on the basis of what a reasonable business person in the taxpayer's circumstances would do, having regard to the complexity and importance of the transfer pricing issues that arise in the taxpayer's case **(paragraphs 491 to 498)**.

111. In applying principles of prudent business management, the greater the significance of the dealings to the entity's overall business (in terms of quantum and/or proportionality) or the greater the complexity of the dealing, the greater will be the need to create contemporaneous documentation to explain the basis of the dealing. This will impact on the extent of documentation to be created or obtained by small taxpayers or taxpayers with relatively low levels of international dealings with associated enterprises. Such taxpayers will not be unreasonably burdened with documentation requirements beyond the minimum necessary to ensure compliance with the arm's length principle. However, some documentation, in addition to that created in the ordinary course of business, will need to be prepared in all cases. Even in cases where internal benchmarks exist, a rudimentary functional analysis combined with an assessment of any external data available about price and/or performance, will provide a greater degree of certainty and a reduced risk of adjustment by the ATO **(paragraphs 495 to 501)**.

112. Notwithstanding issues of complexity, proportionality and quantum, taxpayers should select a transfer pricing methodology that

gives results, for tax purposes, which reflect the application of the arm's length principle **(paragraph 502)**.

## PART TWO

### Considerations when sustained losses are being incurred

113. It is recognised that independent enterprises can sustain genuine losses for a variety of economic and business reasons. However, it is not accepted that independent enterprises would be prepared to incur such losses on an indefinite basis without taking appropriate action to return the enterprise to profitability **(paragraph 505)**.

114. Where an enterprise incurs sustained losses in relation to its dealings with associated enterprises, it will be very difficult for taxpayers to defend these losses unless it can be demonstrated that this would have been the outcome between independent enterprises dealing at arm's length in comparable circumstances **(paragraph 506)**.

115. Irrespective of the reasons for incurrence of sustained losses, it will be incumbent upon taxpayers to show that the losses would have been incurred in an arm's length situation **(paragraph 507)**.

116. Where an entity is pursuing a business strategy which directly results in, or is contributing to, losses, such losses would only be acceptable if the objective of the business strategy was to lead to increased profits within a reasonable period of time. In this regard, it is expected that taxpayers would have created the necessary supporting documentation at the time that the relevant transactions/business strategy was being contemplated or implemented **(paragraphs 508 and 509)**.

117. Any analysis undertaken by the entity in support of its contention that the business strategy implemented is an arm's length activity which would have been undertaken by an independent entity acting at arm's length, should be adequately documented **(paragraph 510)**.

118. The ATO will not accept sustained losses resulting principally from transactions with associated enterprises of a multinational enterprise group ('MNE group') where the MNE group as a whole is profitable and the Australian loss-making entity is not being adequately compensated for the benefits it provides to the MNE group **(paragraph 511)**.

**Market penetration strategies**

119. Market penetration strategies take many forms, but, essentially, all implement conditions whereby parties to a transaction temporarily agree to the foregoing of profits in return for more substantial profits in the future. The term 'market penetration strategies' is used in this Ruling to include market expansion strategies **(paragraph 513)**.

120. In order to establish whether a market penetration strategy as between associated enterprises is consistent with the arm's length principle, it will be necessary to establish whether independent enterprises dealing at arm's length in fact have, or would have, accepted the terms and conditions of the strategy in the same or similar market circumstances **(paragraph 514)**.

121. A feature of market penetration strategies when implemented by parties dealing at arm's length is an expectation that, as a result of foregoing profits in the short term, there is a definable outcome in terms of a reasonably held expectation of increased returns in the future, with the aim of recouping original costs associated with the strategy and, further, enhancing future profits **(paragraph 517)**.

122. Generally, the longer that a market penetration strategy is claimed to be in place and profits are consequently reduced or extinguished, the greater is the presumption that independent parties dealing at arm's length would **not** have entered into such an arrangement, and the more difficult it will be to establish that such a strategy, and its consequential effect on profits, should be accepted. It is not expected that a market penetration strategy would be an ongoing arrangement **(paragraph 523)**.

123. Documentation relevant to market penetration strategies generally be classified into two categories. First, information about the target market and, secondly, information about the strategy itself, including formulation, implementation and desired outcomes **(paragraph 525)**.

124. In relation to the first category, the ATO would expect contemporaneous documentation to have been created or obtained which analyses:

(a) the market sought to be penetrated;

(b) the level of penetration sought as a percentage of any existing market;

(c) expected demand for the product or service in this market before, during and after implementation of the strategy;

(d) niche opportunities within that market;

(e) information about competitors in that market including their respective market shares, and information about their products;

(f) any plans to counter competitors' responses to the strategy; and

(g) the impact of government policies, subsidies and regulations and their effects on profitability and pricing

**(paragraphs 526 and 527)**.

125. With regard to the second category, the ATO would expect taxpayers to prepare or obtain contemporaneous documentation which:

(a) outlines the strategy and its aims including a detailed sales plan;

(b) identifies and quantities anticipated costs associated with the strategy;

(c) provides reasons for variances where actual sales and costs deviate from plan;

(d) outlines the duration of the strategy, how costs are to be shared and the means of effecting that sharing between the parties to the strategy;

(e) specifies the benefits that are sought;

(f) identifies anticipated time it will take to realise the benefits or profits to the respective parties to the strategy;

(g) provides cost/benefit analysis and cash flow projections clearly indicating the intention for all parties to the strategy to derive increased profit within a reasonable time from the commencement of the market penetration strategy; and

(h) records all relevant details of studies where external benchmarking activities are undertaken

**(paragraphs 528 and 529)**.

### Marginal costing

126. Marginal costing is often used by companies and MNE groups for internal cost accounting purposes and for internal management control purposes. However, its use for the purpose of setting transfer prices on international dealings between associated enterprises for tax purposes, can only be considered as acceptable where pricing on the basis of marginal costs represents an arm's length outcome for the

transfer of goods or services into the particular market **(paragraph 532)**.

127. Marginal costing would only be acceptable where it can be demonstrated that the same price might reasonably have been expected to have been charged by an independent enterprise dealing at arm's length in comparable circumstances **(paragraph 533)**.

128. In an arm's length relationship a marginal costing strategy would not be applied other than in relation to short term arrangements and that the 'marginal production' would not represent a significant proportion of the taxpayer's overall production **(paragraph 534)**.

129. On occasions pricing at marginal cost may occur where a taxpayer's manufacturing base is not being fully utilised. However the mere existence of under utilised capacity would not be determinative of the ATO accepting marginal costing as an appropriate basis for setting transfer prices **(paragraph 536)**.

130. While recognising that sound commercial reasons may require the temporary adoption of such a business strategy, the ATO considers that arm's length parties would give due consideration to its implementation. Such deliberations would give rise to a plan including documentation which outlined the basis and rationale for implementing the strategy, the nature of the costs to be recovered and the anticipated duration of the strategy **(paragraph 539)**.

### The use and relevance of global price lists

131. Global pricing may occur in two situations. First is the case where particular goods or services are sold at a specific price to all purchasers of that good or service on a global basis. Secondly, the policy may be implemented by consistent application of an internationally recognised transfer pricing methodology to all such sales globally. The global pricing strategy may be applied to associated enterprises only, or alternatively, a mix of associated and independent enterprises **(paragraphs 541 and 542)**.

132. In the case where the global pricing strategy is implemented exclusively intra-group, the procedure that the ATO will adopt to review the taxpayer's processes will be the same whether a global pricing policy exists or not **(paragraph 543)**.

133. The mere existence of a global pricing policy will not in itself indicate adherence to the arm's length principle. In the case where the global pricing strategy does not incorporate sales to independent enterprises at the same price or where the enterprise has not undertaken an analysis to determine whether outcomes achieved are

supportable as arm's length, the ATO will consider the taxpayer as falling into one of the higher risk categories **(paragraph 544)**.

134. In cases where the policy is applied both intra-group and to independent enterprises dealing at arm's length, this may be broadly indicative of an arm's length price for the goods or services if the independent enterprise sales are into Australia. The ATO will still need to satisfy itself that conditions affecting associated and independent enterprises are truly comparable **(paragraphs 545 and 546)**.

135. Even where comparisons are sought to be made with benchmarks in the same markets, documentation which establishes the functional comparability (functions, assets and risks) relative to that of independent enterprises which are the subject of the global pricing policy will still be required **(paragraph 548)**.

136. The existence of a global pricing policy creates certain documentation requirements in dealings between associated enterprises. These requirements apply equally to cases where goods or services are traded exclusively intra-group and to cases where there may be comparable external sales. The general types of documents which need to be created would include:

(a) an analysis of the market they are operating in and whether such terms as the global price and the terms surrounding the supply of goods or services would enable them to return outcomes over the period of the agreement, that is, the impact on their profit expectation in the market represented by the set price; and

(b) an analysis of whether this profit is commensurate with the expectations of parties dealing at arm's length operating under similar conditions and performing similar functions, assets and risks. This will require a functional analysis and benchmarking of their profit expectations against comparable arm's length parties dealing in the same or similar circumstances

**(paragraph 551)**.

### Set-off arrangements

#### *Intentional set-offs*

137. As a general rule, independent entities deal on the basis of actual cash flows and flows of goods and services, rather than engaging in set-offs. Arm's length parties would also want to know the value of any set-off prior to entering into such an arrangement. The ability to quantify value would be a key feature of arm's length dealings. In any

event, the overriding consideration that will govern acceptance by the ATO of intentional set-off arrangements between associated enterprises, is the arm's length principle **(paragraph 557)**.

138. The ATO would generally allow intentional set-offs where **all** the following preconditions are met:

(a) the set-off arrangements are on terms and conditions that would be acceptable to independent enterprises dealing at arm's length;

(b) they occur as an intentional, not coincidental, feature of international dealings between the associated enterprises;

(c) there is a predetermined strategy which assesses and quantifies the outcomes for the respective parties to the dealings and identifies what the respective benefits and detriments to the individual parties to the transaction are. This will require that the ATO is given access to documentation recording such strategies and outcomes from all parties to the transaction. All such documentation relating to intentional set-offs should be created contemporaneously with or prior to the dealing and retained by the Australian taxpayer;

(d) the set-off arrangement and strategy are fully quantified, measured and tested against any arm's length outcome in comparable circumstances. The methodology used in this process must also be adequately documented; and

(e) taxpayers should disclose the existence of intentional set-offs built into dealings between associated enterprises by making adjustments to the relevant components of their taxable profits at the time of lodging a tax return and have the necessary documentation to demonstrate that the offsetting amounts are equal in value. Where this documentation is not available the ATO will have no basis on which to allow the 'intentional' set-off

**(paragraph 561)**.

139. Outcomes flowing from a set-off arrangement should crystallise within a reasonable period of time of the arrangement being entered into, conforming to the expectation of arm's length parties dealing in comparable circumstances **(paragraph 562)**.

140. Intentional set-offs which have the effect of altering the characterisation of payments or receipts, so as to alter the incidence of

tax or where the set-off arrangement effectively reduces the taxpayer's, or the relevant MNE group's, overall Australian tax liability will not be accepted. Any such tax liability extends beyond income tax to withholding taxes that may be levied. In addition, set-off arrangements which encourage international tax avoidance will not be countenanced **(paragraph 563)**.

### *Unintentional set-offs*

141. The ATO requires associated enterprises to specifically address the question of set-offs, including quantification, benchmarking and documentation, at the time, of or prior to entering into the set-off arrangement. An independent enterprise dealing at arm's length would not be involved in an unintentional set-off **(paragraphs 566 and 567)**.

142. Because of questions about the arm's length nature of unintentional set-offs, their effects could present serious risks to the Australian revenue. Accordingly, the ATO will only consider such arrangements and their effects in the context of the Mutual Agreement Procedure process under Australia's DTAs **(paragraph 570)**.

### Safe harbours

143. The term 'safe harbour' is usually applied in a transfer pricing context, to an administrative practice by a tax authority which accepts a process or outcome (profit or consideration) as automatically discharging a taxpayer's obligations to comply with the arm's length principle **(paragraph 571)**.

144. The introduction of a safe harbour may have the effect of reducing the tax otherwise payable in another tax jurisdiction and favouring the jurisdiction implementing the safe harbour. There is a likelihood of increased inter-jurisdictional disputation which will affect taxpayers as well as tax administrations. Given the international consensus that safe harbours do not parallel arm's length outcomes, there is also an increased risk that Australia's treaty partners would not provide correlative relief in such cases, thus leaving the process open to double taxation **(paragraphs 578 and 579)**.

145. An application of arm's length principle requires as direct as possible a benchmarking of international dealings by associated enterprises, and all their attendant conditions, against comparable dealings by independent enterprises acting at arm's length. The Commissioner may depart from this approach only in certain specified circumstances **(paragraph 585)**.

146. It is not accepted that published market data on prices in certain industry segments, such as petroleum and metals, form a natural safe

harbour. Two reasons for not accepting this proposal are that any general acceptance of a market price would not reflect the individual features of a particular dealing and some markets are so controlled that prices alone give no indication that an enterprise dealing at the prevailing price will have an outcome which adequately rewards its significant economic functions **(paragraphs 581 and 582)**.

147. Market prices may still be useful for taxpayers as a starting point in reviewing whether their associated enterprise prices satisfy the arm's length principle **(paragraph 583)**.

148. The incompatibility of a safe harbour regime with the spirit of Australia's tax law taken together with the potential costs and risks associated with the implementation of a safe harbour regime, is sufficient basis for rejecting a safe harbour system and therefore the ATO does not favour the implementation of safe harbours **(paragraph 587)**.

# Explanations

## PART ONE

### Introduction

149. Australia, like other member countries of the Organisation for Economic Co-operation and Development ('OECD') and many non-OECD countries, has a legislative framework which is designed to ensure that it is not deprived of its fair share of taxation on income, its tax revenues reduced by a misallocation of expenses, or its withholding taxes avoided as a result of the way the international business activities of enterprises subject to its jurisdiction are arranged. In Australia, the anti-profit shifting legislative framework centres around Division 13 of the ITAA and the Business Profits and Associated Enterprises Articles of Australia's DTAs which adopt the arm's length principle as the basis for determining whether Australia has been denied its fair share of tax (also see paragraphs 154 to 168 of TR 94/14; paragraphs 88 to 100 of TR 95/D11, and paragraphs 7 to 14 of TR 95/D22.

150. This legislative framework, in conjunction with the record-keeping and penalty provisions of the ITAA and Australia's self-assessment system, is seen as imposing obligations on taxpayers to conform with the arm's length principle for tax purposes in respect of their international dealings with associated enterprises (also see paragraphs 110 and 384 of TR 94/14).

151. TR 95/D22 discusses in detail the issues that arise in relation to the application of the various methodologies which have found

international acceptance for the purpose of showing conformity with the arm's length principle. This Ruling focuses, amongst other things, on the documentation needed to support a correct selection and application of transfer pricing methodologies.

152. It should not, however, be assumed that taxpayers need only maintain a good set of records. The actual conduct of the associated enterprises in relation to their international dealing is also relevant. In this respect, regard should be had to the discussion at paragraphs 45, 46 and 261 to 263 of TR 94/14 on 'Evidence of a course of conduct'.

153. The ATO will be seeking to act consistently with approaches endorsed at the international level (for example, the OECD publication '*Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations'*, 1995, OECD ('the 1995 OECD Report')). In this regard, both the ATO and the OECD have stated that taxpayers should not be expected to have prepared or obtained documents beyond the minimum needed to enable a reasonable assessment to be made of whether their dealings with associated enterprises comply with the arm's length principle (paragraphs 102 and 373 of TR 94/14; paragraph 5.7 of the 1995 OECD Report).

154. Consistent with approaches endorsed at the international level, taxpayers should assess their need to keep documentation on the same prudent business management principles that would govern the process of evaluating a business decision of a similar level of complexity and importance (paragraph 5.4 of the 1995 OECD Report).

155. However, it is also acknowledged that the arm's length principle imposes requirements on associated enterprises that would not be required of independent enterprises dealing at arm's length and that some documents that might reasonably be used or relied upon in determining arm's length transfer pricing for tax purposes may be of the type that would not have been prepared or obtained other than for tax purposes, including the obtaining of documents from foreign associated enterprises (paragraph 5.6 of the 1995 OECD Report).

156. In this respect, we agree with the statement at paragraph 5.4 of the 1995 OECD Report which says:

> 'It would be expected that the application of (prudent business management) principles will require the taxpayer to prepare or refer to written materials that could serve as documentation of the efforts undertaken to comply with the arm's length principle, including the information on which the transfer pricing was based, the factors taken into account, and the method selected. It would be reasonable for tax administrations to expect taxpayers when establishing their transfer pricing for a particular business activity to prepare or to obtain such materials regarding the

> nature of the activity and the transfer pricing, and to retain such material for production if necessary in the course of a tax examination. Such actions should assist taxpayers in filing correct tax returns.'

157. The ATO also agrees with the view expressed by the OECD in its 'Summary of Recommendations on Documentation' at paragraph 5.28 of the 1995 OECD Report, where it says:

> 'Documentation requirements should not impose on taxpayers costs and burdens disproportionate to the circumstances.'

158. The situation of taxpayers with relatively low levels of international dealings with associated enterprises (in terms of quantum and/or proportionality) is relevant in this regard. For example, the ATO would not expect a taxpayer selling $200,000 worth of trading stock to a foreign associated enterprise to incur expenditure of $100,000 on an industry study to establish the existence of comparable independent enterprises for the purpose of benchmarking its transfer price. The incurrence of such expenditure would clearly be disproportionate to the circumstances. On the other hand, the application of prudent business management principles (see paragraphs 286 to 298 of this Ruling) might suggest that the incurrence of such expenditure on an industry study by a taxpayer selling trading stock to a foreign associated enterprise, which it values at $50,000,000, would be quite appropriate and proportionate to the risk of a transfer pricing adjustment being made by the ATO.

159. In this respect, a prudent business manager would also have regard to the significance of the dealings to the entity's overall business (in terms of quantum and/or proportionality) and to the fact that the more complex the dealing, the greater will be the need to create or obtain contemporaneous documentation to explain the basis of the dealing (see paragraphs 491 to 503 below which discuss documentation requirements for small businesses or entities with low levels of international dealings with associated enterprises).

160. One mechanism by which taxpayers can keep record-keeping to the minimum necessary is by considering the benefits to them of entering into an Advance Pricing Arrangement ('APA'). Taxation Ruling TR 95/23 provides guidelines in relation to the ATO's APA Program.

### Reasons for keeping documentation

161. There are four main reasons why taxpayers should create and keep contemporaneous documentation recording the application of the arm's length principle in setting the prices or the terms of their international dealings with associated enterprises for tax purposes:

(a) statutory requirements to keep documentation (paragraphs 162 to 175);

(b) higher penalties may apply where taxpayers have not taken reasonable care or do not have a reasonably arguable position (paragraphs 176 to 184);

(c) the burden of proof rests with taxpayers in the event of disputation (paragraphs 185 to 190); and

(d) commercial reasons compelling the maintenance of documentation (paragraphs 191 to 199).

***Statutory requirements to keep documentation***

162. The obligation to keep documentation for the purpose of showing conformity with the arm's length principle may be inferred from a number of provisions in the ITAA and in Australia's DTAs. In our view, when read together, these provisions form a code which requires taxpayers to conform to the arm's length principle for tax purposes and to document the processes adopted and the outcomes reached which evidence that conformity.

163. The OECD in its 'Summary of Recommendations on Documentation' contained within the 1995 OECD Report expresses a similar view at paragraph 5.28, where it is stated that:

> 'Taxpayers should make reasonable efforts at the time transfer pricing is established to determine whether the transfer pricing is appropriate for tax purposes in accordance with the arm's length principle. Tax administrations should have the right to obtain the documentation prepared or referred to in this process as a means of verifying compliance with the arm's length principle.'

164. A statement of the arm's length principle is found in the Associated Enterprises Article of Australia's DTAs. This article seeks to adjust profits by reference to conditions which might be expected to operate between independent enterprises dealing at arm's length under comparable circumstances. The arm's length principle as embodied in Australia's DTAs generally conforms with that found in paragraph 1 of Article 9 of the OECD Model Tax Convention.

165. The arm's length principle has been re-affirmed in the 1995 OECD Report. As stated in paragraph 14 of TR 95/D22, we see the 1995 OECD Report as providing some very practical guidelines to both MNEs and tax administrations. In releasing the revised guidelines, the OECD Council recommended to the Governments of Member countries that:

> 'their tax administrations follow, when reviewing, and if necessary, adjusting transfer pricing between associated enterprises for the purposes of determining taxable income, the consideration and methods set out in the Report referred to above for arriving at arm's length pricing for transactions between associated enterprises.'

166. The arm's length principle is also incorporated into Division 13 through the definition of arm's length consideration found in paragraphs 136AA(3)(c) and (d) of the ITAA. Division 13 enables the Commissioner to make an adjustment to an item of income or a deduction claimed in a taxpayer's return on the basis of what might reasonably be expected to have passed between independent enterprises dealing at arm's length with each other (refer paragraphs 64 to 78 and 310 to 327 of TR 94/14).

167. Division 13 and Australia's DTAs are seen as clearly establishing that the consideration or profits arising from international dealings with associated enterprises that are not calculated in accordance with the arm's length principle for tax purposes may be adjusted by the ATO to reflect this principle. In an environment of self-assessment, taxpayers should therefore have regard to the arm's length principle when setting prices or terms with associated enterprises. This obligation becomes clearer when Division 13 and the DTAs are considered together with other relevant provisions of the ITAA, including section 262A and the penalty provisions.

168. The ATO's view on the effect of section 262A has been discussed at paragraphs 368 and 369 of TR 94/14. It is the ATO view that section 262A also imposes an obligation on taxpayers to retain records created in the process of setting and reviewing transfer prices. For example, in determining the amount of costs for the purpose of applying the cost plus method or the relevant expenses incurred for the purpose of applying a profit split or profit comparison method, section 262A would require documenting the basis of the calculation used to explain the figure for costs or the relevant expenses for the profit methods.

169. Similarly, in determining the combined profit for the purposes of applying a profit split method or the net profit for the purposes of applying a profit comparison method, an explanation of the basis used for determining the relevant revenue and expenditure items leading to the amounts for combined profit or net profit would need to be recorded and kept. Subsection 262A(2) would require taxpayers allocating indirect costs between controlled transactions and other transactions entered into by the taxpayer for the purpose of applying an arm's length methodology to keep documents explaining the allocation basis used.

170. Where Division 13 or a corresponding provision of a DTA has been applied and the result is an increase in the amount of tax assessed to a taxpayer, a statutory penalty is imposed pursuant to section 225 of the ITAA. This statutory penalty makes it clear that the intention of the Parliament when introducing the legislation was to require taxpayers to have regard to the arm's length principle when setting and reviewing prices for tax purposes and to lodge their tax returns on this basis.

171. This interpretation of Parliament's intention was publicly stated by the then Second Commissioner, Mr Trevor Boucher, in his address to the 1983 Taxation Conference of the Australian Mining Industry Council on 25 March 1983:

> 'If I can put our reading of the Parliament's intention another way, it is that the penalty provisions represent a signal that firms ought to be steering clear of transfer pricing practices or, at least, from reliance on them in presentation of their annual tax returns.
>
> In other words, there is a discernible desire that tax conduct in this area should attain a standard where the provisions do not need to be invoked; where the tax administration does not have to devote resources to ferreting out the arm's length prices that should form the basis for Australian taxation.
>
> ...The legislation is saying in effect that returns ought to be prepared and lodged on a basis that responds to the call for pricing to be on an arm's length basis.'

172. This interpretation of Parliament's intention was reiterated by the ATO in Taxation Ruling IT 2311 which issued on 18 June 1986 and also in TR 95/D24 (*Income tax: international transfer pricing - penalty tax guidelines*).

173. It is the ATO's view that the penalty provisions contained in section 225 comprise part of the statutory code requiring taxpayers to consider the application of the arm's length principle in their international dealings with associated enterprises.

*Taxpayers having international dealings with associated enterprises must provide certain information with their income tax returns*

174. A taxpayer which has engaged in international transactions with an associated enterprise during a year of income is required to complete a Schedule 25A pursuant to Regulation 15 of the Income Tax Regulations and lodge it with its income tax return. This regulation governs the making and furnishing of returns and the information and documentation to be provided with those returns. Failure to complete the Schedule 25A where this is required may

attract penalties or prosecution action. Taxation Ruling IT 2514 (*Income tax: company Schedule 25A: information return for companies that transact business with related overseas entities*) which issued on 12 January 1989 provides guidelines on when taxpayers may be required to lodge a Schedule 25A.

175. For the 1995 year of income, taxpayers having international dealings with associated enterprises are required to answer a question in the Schedule 25A about whether they used arm's length methodologies to set or review the transfer prices in their international dealings with associated enterprises. The information required to be provided in the Schedule 25A also imposes obligations on taxpayers to consider whether the outcomes of their dealings with associated enterprises have been reported on an arm's length basis for tax purposes.

***Higher penalties may apply where taxpayers have not taken reasonable care or do not have a reasonably arguable position***

176. The existence of adequate contemporaneous documentation would be an indicator of reasonable care on the part of a taxpayer and would be a mitigating circumstance when considering what (if any) level of penalty should be imposed in the event of a transfer pricing adjustment. Conversely, the lack of adequate documentation will be taken by the ATO as demonstrating an absence of reasonable care and in some cases may lead to the conclusion that the taxpayer was reckless for the purposes of section 226H of the ITAA.

177. This is reflected in the new system of penalties for understatements of income tax which were introduced into the law as a result of amendments made by the *Taxation Laws Amendment (Self Assessment) Act 1992* as part of the move to self assessment. The new penalty provisions are based on the requirement that taxpayers exercise reasonable care in carrying out their tax obligations and also introduce a reasonably arguable position test. The reasonably arguable position test is relevant to the level of penalty which may be imposed where a transfer pricing adjustment is made under either the operative provisions of Australia's DTAs or Division 13.

178. The standard required of business taxpayers to show that they have taken reasonable care is expressed at page 81 of the Explanatory Memorandum to the Taxation Laws Amendment (Self Assessment) Bill 1992 ('the Self Assessment EM') in the following terms:

> 'For business taxpayers, reasonable care would require the putting into place of an appropriate record keeping system and other procedures to ensure that the income and expenditure of the business is properly recorded and classified for tax purposes.'

179. Later sections of this Ruling (see paragraphs 239 - 282) provide guidelines to taxpayers about a four step process that could be implemented by them and discussion on the nature and type of documentation that should be kept in relation to the selection and application of arm's length transfer pricing methodologies. Taxpayers who have in good faith established a similar process and kept sufficient and relevant contemporaneous documentation to show compliance with the arm's length principle would have strong grounds for claiming that they have taken reasonable care.

180. The post self-assessment penalty provisions introduced a sliding scale of culpability in the event that transfer pricing adjustments are made. The lowest end of the scale imposes a 10% culpability component where the taxpayer has a reasonably arguable position that its tax treatment of a dealing reflects an arm's length outcome (sub-section 225(1A) and section 222C of the ITAA).

181. The amendments made by the *Taxation Laws Amendment (Self Assessment) Act 1992*, signal Parliament's clear intention that the keeping of sufficient and relevant documentation is seen as having a direct bearing on the level of culpability imposed in the event of a transfer pricing adjustment. The implications of such a hierarchy of penalties is that Parliament intended that cases where taxpayers do not pay proper attention to the arm's length principle in the setting of transfer prices on international dealings with associated enterprises for tax purposes, would attract a higher culpability penalty.

182. Adequate documentation in this area is integral to risk management by both taxpayers and ATO staff. From the taxpayer's point of view, it will be much easier to convince the ATO that they have a reasonably arguable position if they maintain contemporaneous documentation. In arriving at prices or outcomes which are arm's length, the Self Assessment EM states, at page 90:

> 'A taxpayer would be best placed to show that its prices were "arm's length" if it maintained documents that were brought into existence as part of the process of determining the prices.'

183. Where contemporaneous documentation (refer to paragraphs 203 to 211 below) does not exist, taxpayers could still strengthen their claims for a reasonably arguable position by reviewing their pricing policies at the time of preparation of their tax returns to ensure that they comply with the arm's length principle. A review prior to lodgment of the tax return would also be an indicator that reasonable care has been taken by taxpayers to properly review the data available to them and to adjust dealings with associated enterprises (where necessary) in accordance with the arm's length principle.

184. Additional guidelines in respect of the imposition and remission of penalties under Part VII of the ITAA as a result of a transfer pricing adjustment having been made are provided in TR 95/D24.

***The burden of proof rests with taxpayers in the event of disputation***

185. Where the ATO makes a transfer pricing adjustment, the taxpayer has the burden of proving that the assessment raised by the Commissioner is excessive, in the event of disputation, by virtue of sections 14ZZK and 14ZZO of the *Taxation Administration Act 1953* ('TAA') (refer to paragraphs 371 and 378 to 385 of TR 94/14). This does not, however, remove from the ATO the need to use reasonable endeavours in arriving at an arm's length outcome and to ensure that any transfer pricing adjustments made are soundly based in law.

186. The ATO agrees with the view expressed in paragraph 4.16 of the 1995 OECD Report which says:

> 'the burden of proof should not be misused by tax administrations or taxpayers as a justification for making groundless or unverifiable assertions about transfer pricing. A tax administration should be prepared to make a good faith showing that its determination of transfer pricing is consistent with the arm's length principle even where the burden of proof is on the taxpayer, and taxpayers similarly should be prepared to make a good faith showing that their transfer pricing is consistent with the arm's length principle regardless of where the burden of proof lies.'

187. The burden imposed on the taxpayer by the TAA of proving that an assessment raised on a reasonable basis by the Commissioner is excessive requires the taxpayer to do more than simply show that the Commissioner's assessment was made on a wrong basis. The substantive liability imposed by the assessment will have to be challenged (*FC of T v. Dalco* (1990) 168 CLR 614; *C of T v. ANZ Savings Bank Ltd* (1994) 181 CLR 466).

188. The general rule that a taxpayer must show not only negatively that the assessment is wrong, but also positively what correction should be made in order to make it right or more nearly right was stated by Latham CJ in *Trautwein v. FC of T* (1936) 56 CLR 63. It would appear to be very difficult for taxpayers to discharge positively their burden of proof where the ATO raises a transfer pricing adjustment based on reasonable endeavours and little or no effort is made by the taxpayer to show that the taxable income should be a lesser amount than the figure assessed by the Commissioner.

189. The OECD has commented in similar terms at paragraph 4.13 of the 1995 OECD Report, where it is stated:

> 'In the context of litigation in countries where the burden of proof is on the taxpayer, the burden of proof is often seen as a shifting burden. Where the taxpayer presents to a court a reasonable argument and evidence to suggest that its transfer pricing was arm's length, the burden of proof may legally or *de facto* shift to the tax administration to counter the taxpayer's position and to present argument and evidence as to why the taxpayer's transfer pricing was not arm's length and why the assessment is correct. On the other hand, where a taxpayer makes little effort to show that its transfer pricing was arm's length, the burden imposed on the taxpayer would not be satisfied where a tax administration raised an assessment which was soundly based in law.'

190. In the event of a dispute, taxpayers will therefore be better placed to discharge their burden of proof where they have developed and implemented arm's length transfer pricing policies at the time of setting and reviewing their transfer prices and have fully and contemporaneously documented these policies.

### *Commercial reasons compelling the maintenance of documentation*

191. In addition to the obligations imposed on taxpayers under the law to comply with the arm's length principle for tax purposes and to document the processes adopted and the outcomes reached which evidence that compliance, application of principles of prudent business management (discussed in paragraphs 286 to 298 of this Ruling) would suggest that there are also sound commercial reasons why taxpayers should document compliance with the arm's length principle. The keeping of such documentation is a prudent business measure for taxpayers to take in mitigating their risk of disputation with the ATO. The processes outlined in paragraphs 225 to 238 of this Ruling provide guidelines on how taxpayers can reduce their level of risk.

192. Adequate documentation and the voluntary production of these documents will enable the ATO to make an informed decision on the taxpayer's processes and procedures. Where these are soundly based, the likelihood of extensive enquiries and adjustments by the ATO will be diminished.

193. In the absence of contemporaneous documentation both the taxpayer and the ATO are in the position of trying to reconstruct an accurate picture of events that may have occurred some years before. This has the inherent risk that the information will be incomplete and result in less precise conclusions. Taxpayers, since they are more familiar with their businesses than anyone else and are the decision

makers on issues, like pricing, should record the factors affecting their decisions.

194. It makes good commercial sense for taxpayers to record the relative merits of their basis for the pricing of dealings between associated enterprises by the creation of relevant contemporaneous documentation in order to reduce the risk of an audit. A lack of sufficient and relevant contemporaneous documentation is seen as increasing the risk of an ATO audit in the first instance, and in the second instance, increasing the risk of a transfer pricing adjustment and the risk of culpability penalties being imposed.

195. The reality of intervention by tax administrations to ensure compliance with the arm's length principle especially in cases where documentation is incomplete was highlighted in paragraphs 105 and 376 of TR 94/14. The same point has again been made by the OECD in the 1995 OECD Report at paragraph 5.14, where it is stated:

> 'Taxpayers should recognise that notwithstanding limitations on documentation requirements, a tax administration will have to make a determination of arm's length transfer pricing even if the information available is incomplete. As a result, the taxpayer must take into consideration that adequate record-keeping practices and the voluntary production of documents can improve the persuasiveness of its approach to transfer pricing.'

196. Where the ATO is confronted with inadequate or incomplete information, each of Australia's DTAs includes a mechanism whereby the Commissioner may apply the domestic law to deem an amount as the arm's length consideration (pages 68 and 69 of the Explanatory Memorandum referring to the application of subsection 136AD(4)). The Commissioner has a statutory obligation to ensure compliance with the transfer pricing rules and to form a view as to whether an adjustment should be made to a taxpayer's taxable income, regardless of whether the taxpayer retains and produces documentation to support its outcomes.

197. The implications of a lack of information and documentation in this area are summarised in paragraph 372 of TR 94/14 which states:

> 'If taxpayers have not maintained appropriate records the process of checking compliance with the arm's length principle becomes far more difficult and ATO auditors are forced to rely on less evidence on which to apply a methodology, thus requiring a greater degree of judgment.'

198. This is not to say that the Commissioner will exercise these functions other than in accordance with sound administrative law principles. However, it is in the best interests of taxpayers to facilitate any transfer pricing examination and thus to reduce risk of adjustment,

through maintaining specific documentation that reconciles the taxpayer's transfer pricing decisions with the arm's length principle.

199. After the event justifications of transfer prices are a time consuming, less precise and a more expensive way of attempting to satisfy the Commissioner that the basis of any pricing decision is in accordance with the arm's length principle. It will clearly be more difficult for companies to convince us that the dealings were on an arm's length basis where after the event analyses are relied upon than would be the case if the taxpayer had documented the relevant analysis and application of a transfer pricing method prior to, or at the time, the dealing was entered into (refer to paragraphs 105 and 376 TR 94/14). The accurate recording of events on a contemporaneous basis and the behaviour of the parties involved will always be the best evidence.

### *Conclusion*

200. Division 13 and Australia's DTAs together with the record-keeping requirements of section 262A and the associated penalty provisions contained in section 225 are seen as a legislative code that requires taxpayers to give consideration to the arm's length principle in setting transfer prices in their international dealings with associated enterprises. This obligation, and the consequent need to consider and implement the arm's length principle for tax purposes, stems from the scheme of the Act, which incorporates the series of measures introduced by Parliament, discussed above.

201. In the light of this obligation, taxpayers should take reasonable care to ensure that they adhere to the internationally accepted arm's length principle in their international dealings with associated enterprises for tax purposes so that the overall effect of their dealings is not to deny Australia its fair share of tax (refer paragraphs 10 and 154 of TR 94/14).

202. Where taxpayers have not set their actual prices in accordance with the arm's length principle, an adjustment should be made, for tax purposes, at the time of preparation of their tax returns. Establishing transfer prices in conformity with the arm's length principle and documenting this should ideally be done at the time actual prices are set, but at the latest, when the relevant tax return is being prepared (refer to paragraphs 203 to 211 of this Ruling and paragraphs 110 and 384 of TR 94/14).

**The need to keep 'contemporaneous documentation' for international transfer pricing between associated enterprises**

203. 'Contemporaneous documentation' means books, records, studies, analyses, conclusions and other written material, existing or brought into existence at the time the taxpayer was developing or implementing any arrangement, that might raise transfer pricing issues and which record the information relevant to transfer pricing decisions.

204. This is supported by the 1995 OECD Report at paragraphs 5.3, 5.4 and 5.28 respectively:

> '(A) taxpayer ordinarily should give consideration to whether its transfer pricing is appropriate for tax purposes before the pricing is established. For example it would be reasonable for a taxpayer to have made a determination regarding whether comparable data from uncontrolled transactions is available.'
>
> 'It would be reasonable for tax administrations to expect taxpayers when establishing their transfer pricing for a particular business activity to prepare or to obtain such materials regarding the nature of the activity and the transfer pricing, and to retain such material for production if necessary in the course of a tax examination.'
>
> 'Taxpayers should make reasonable efforts at the time transfer pricing is established to determine whether the transfer pricing is appropriate for tax purposes in accordance with the arm's length principle.'

205. Taxpayers need to keep contemporaneous documentation so they can evaluate their international dealings against the arm's length principle at the time of lodging their income tax returns. This is simply a prudent business practice to ensure the returns are accurate. As a basis for this review, it is expected that taxpayers will have carried out an analysis in accordance with the arm's length principle at the time of setting their prices or engaging in dealings that raise transfer pricing issues.

206. Even though taxpayers may not be obliged under general law to conduct their dealings on an arm's length basis - though there are certain responsibilities on directors under company law - an evaluation of whether the arm's length requirements of the tax law have been met should be made and documented either at the time the relevant arrangements are being developed or in the course of implementing them. Where transactions with associated enterprises have not been conducted on an arm's length basis, it is expected that consideration would be given to the appropriate prices for income tax purposes at the time the dealing is being contemplated or at the time the

transaction is entered into and that the necessary documentation is created at this time also (refer paragraph 376 of TR 94/14).

207. Where taxpayers keep adequate contemporaneous documentation, an evaluation at the time of lodgment of the return may often be more reliable than a prudential review done after the event at the time the tax return is being prepared where little or no contemporaneous documentation is available. This would also help minimise the use of hindsight should a review of a taxpayer's transfer pricing be undertaken by the ATO.

208. The nature and type of documentation to be kept will vary with the methodology employed. However, regardless of the methodology used, taxpayers will still need to carry out the necessary analysis and documentation thereof prior to or at the time transfer prices are set (refer to the section titled '**Documentation relevant to the application of particular methodologie***s*' at paragraphs 301 to 364 of this Ruling).

209. The above discussion focuses on the point in time when the relevant documentation should be created. A distinction needs to be drawn between this and the point in time when such documentation should be produced to the ATO. While in most cases the relevant documentation will not need to be produced to the ATO until the time of a transfer pricing review, there may be some instances where limited documentation may need to be provided at the time of lodgment of the tax return, for example Schedule 25A. In cases where documentation is required prior to the conduct of a transfer pricing review, the ATO agrees with the views expressed in paragraph 5.15 of the 1995 OECD Report.

210. Consistent with the principles of self-assessment and the 1995 OECD Report, the ATO will ordinarily limit the information required from taxpayers at the time of lodgment of tax returns in relation to their international dealings with associated enterprises to the minimum necessary to make a reasonable assessment of which taxpayers ought to be the subject of further examination (also see the section titled '**The risk of a transfer pricing audit**' at paragraphs 225 to 238 of this Ruling). Regardless of whether information is required by the ATO at the time of lodgment of the tax return or at the time of a transfer pricing review, creation of the relevant documentation will, in accordance with the guidelines set out in this Ruling, need to be undertaken contemporaneously with the relevant international dealing and not left until such time as the ATO commences a transfer pricing review.

211. Where there is no documentation available at the time an audit is commenced, the taxpayer cannot satisfy the ATO that attempts have been made to develop and implement transfer pricing policies which

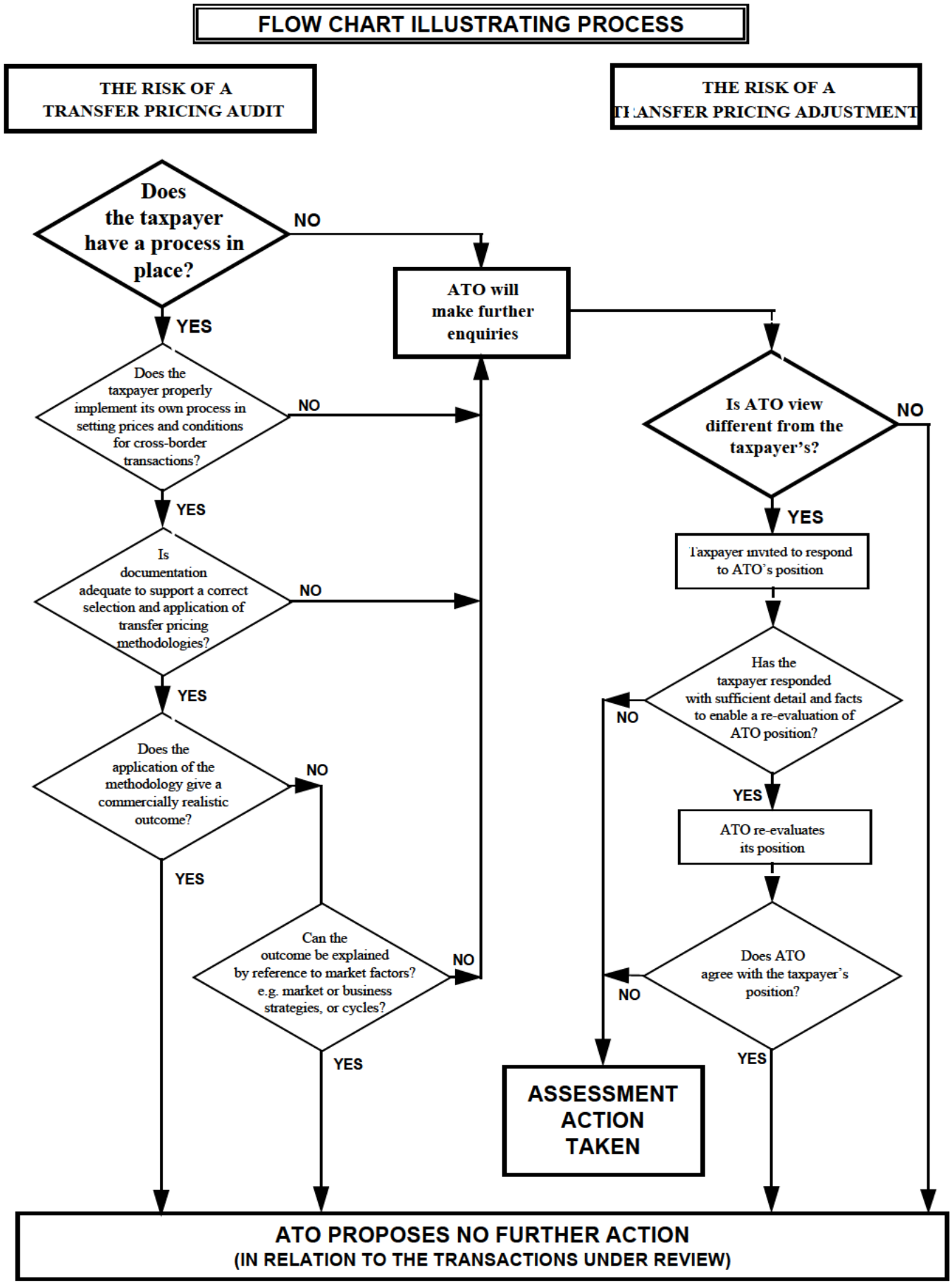
conform with the arm's length principle. In such cases, an adversarial situation is created for both the taxpayer and the ATO. In many cases, the international transactions have been undertaken for many years prior to the years under review. It is therefore essential to the conduct of an efficient and effective audit and quick resolution of the issues involved that taxpayers analyse and document the basis upon which their dealings with associated enterprises are undertaken contemporaneously with the dealings being contemplated or carried out.

**Flowchart illustrating how the ATO reviews the processes used by taxpayers for setting and reviewing transfer prices**

212. In the ATO's experience, taxpayers can conduct their international dealings with associated enterprises in ways which can reduce both their risk of a transfer pricing audit, and the risk of an adjustment and the imposition of penalties as a consequence of an ATO audit of their international dealings. Both these issues are discussed in greater detail later in this Ruling. At one level, there is risk of the ATO undertaking a transfer pricing audit of the taxpayer, and at a second level after the ATO has commenced a transfer pricing audit, there is the risk of an adjustment to the taxpayer's taxable income or liability to collect and remit withholding tax.

213. The initial stage of an ATO transfer pricing review generally involves a review of a taxpayer's processes and documentation in order to determine the level of risk to the revenue. In certain cases this will proceed to the next stage where an audit of the taxpayer's pricing outcomes will be undertaken with the real prospect of a transfer pricing adjustment being made by the ATO in cases of understatement of tax.

214. The following diagram illustrates the way in which the ATO is likely to approach a review of a taxpayer's international dealings with associated enterprises to establish that there has been compliance with the arm's length principle. The flowchart also outlines the process and circumstances in which the ATO would ordinarily propose that no further action be taken in relation to the specific transactions under review.


FLOW CHART ILLUSTRATING PROCESS
THE RISK OF A TRANSFER PRICING AUDIT
THE RISK OF A TRANSFER PRICING ADJUSTMENT
Does the taxpayer have a process in place?
NO
YES
ATO will make further enquiries
Does the taxpayer properly implement its own process in setting prices and conditions for cross-border transactions?
NO
YES
Is documentation adequate to support a correct selection and application of transfer pricing methodologies?
NO
YES
Does the application of the methodology give a commercially realistic outcome?
NO
YES
Can the outcome be explained by reference to market factors? e.g. market or business strategies, or cycles?
NO
YES
Is ATO view different from the taxpayer's?
NO
YES
Taxpayer invited to respond to ATO's position
Has the taxpayer responded with sufficient detail and facts to enable a re-evaluation of ATO position?
NO
YES
ATO re-evaluates its position
Does ATO agree with the taxpayer's position?
NO
YES
ASSESSMENT ACTION TAKEN
ATO PROPOSES NO FURTHER ACTION
(IN RELATION TO THE TRANSACTIONS UNDER REVIEW)

**Outline of how the ATO reviews the processes used by taxpayers for setting and reviewing transfer prices**

215. In broad terms, the following paragraphs provide an outline of each of the steps illustrated in the above diagram and also provide reference to the subsequent paragraphs of Part 1 of this Ruling dealing with the relevant step in more detail.

***The risk of a transfer pricing audit***

216. Generally, the ATO will only conduct a transfer pricing audit where the perceived level of risk to the revenue warrants such action. Taxpayers can be grouped according to a number of broad risk categories ranging from 'highest risk' to 'lowest risk'. This section of the ruling contains a discussion of each risk category and a diagrammatic representation of the risk ranking highlighting the main characteristics of each category **(paragraphs 225 to 238)**.

***Does the taxpayer have a process in place?***

217. This section of the ruling focuses on the use of a four step process for setting transfer prices between associated enterprises for tax purposes. The discussion focuses on the process and documentation issues involved in each step **(paragraphs 239 to 282)**.

***Does the taxpayer properly implement its own process in setting prices and conditions for cross-border transactions?***

218. Processes developed by taxpayers for setting transfer prices with associated enterprises will be tested by the ATO to check that they have in fact been put into place **(paragraphs 283 to 285)**.

***Is documentation adequate to support a correct selection and application of transfer pricing methodologies?***

219. This section of the ruling sets out guidance for taxpayers on the type of documentation that should be created or referred to in applying specific transfer pricing methodologies. The extent to which pricing outcomes between associated enterprises are documented will be dependent on the taxpayer's particular circumstances. Application of prudent business management principles which had regard to the importance (in terms of complexity and quantum) of the dealings to the taxpayer's business would be relevant in this respect **(paragraphs 286 to 364)**.

### *Does the application of the methodology give a commercially realistic outcome?*

220. Where processes have been implemented and contemporaneously documented, and yet do not give rise to a commercially realistic outcome, a taxpayer may still be subject to an ATO transfer pricing audit **(paragraphs 365 to 368)**.

### *Can the outcome be explained by reference to market factors, e.g., market or business strategies or cycles?*

221. In making further enquiries on the basis of outcomes not being commercially realistic, the ATO would first look to the taxpayer's marketing and business strategies, or business cycles. Part 2 of this Ruling deals with some market and business strategies which may impact on a taxpayer's pricing outcomes with associated entities.

### *The risk of a transfer pricing adjustment*

222. The preceding steps outline the process the ATO will ordinarily adopt in reviewing the processes put in place by taxpayers to set the transfer prices of their international dealings with associated enterprises for tax purposes. Whether the ATO makes further enquiries will depend upon each of the factors discussed in the above steps. Where further enquiries are made, the ATO will generally seek to develop its own analysis in reviewing whether the taxpayer's outcomes comply with the arm's length principle. Guidance as to how the ATO may do this and the type and extent of enquiries it may make to assist in this analysis is provided in the section of this Ruling titled '*How the ATO reviews compliance with the arm's length principle*' **(paragraphs 376 to 385)**.

### *Is ATO view different from the taxpayer's*

223. Where an ATO audit reveals an outcome that *prima facie* differs from an arm's length outcome, the ATO will advise the taxpayer that it proposes to make a transfer pricing adjustment. Transfer pricing adjustments will generally be made by the ATO where the difference between the taxpayer's outcomes and the arm's length outcome is material. This part of the Ruling also discusses the ATO approach in making adjustments to taxpayers' pricing outcomes where pricing processes adopted are 'about as likely as not' to yield an arm's length outcome. Taxpayers will have an opportunity to respond to a proposal by the ATO to make a transfer pricing adjustment **(paragraphs 385 to 400)**.

### *Procedural issues involved in finalising a transfer pricing audit*

224. The remaining steps in the flowchart outline the process involved in finalising a transfer pricing review after the ATO proposes making a transfer pricing adjustment. This Ruling does not address the issues associated with these steps as they are of a procedural nature relating to the conduct of reviews of taxpayers and are subject to publicly available guidelines **(refer paragraph 400)**.

## The risk of a transfer pricing audit

225. ATO resources on transfer pricing cases will be allocated on the basis of the perceived risk of taxpayer non-compliance with the arm's length principle. Taxpayers are generally grouped by the ATO according to a number of broad risk categories. These may be described as follows:

### *Highest risk*

226. The highest risk/highest priority category involves enterprises which deliberately structure their international dealings with associated enterprises so as to avoid Australian tax. These cases often involve aggressive tax planning strategies including:

(a) the use of tax havens for reinvoicing (where there is no economic value added);

(b) the use of back to back arrangements;

(c) the use of trusts in which the beneficiaries cannot be identified; or

(d) complex and circular arrangements with little or no business purpose.

### *High risk*

227. High risk/high priority cases would be those where there are significant international dealings with associates and there is no process or documentation to check the selection and application of transfer pricing methodologies for tax purposes. In these cases there is usually either no authority to bargain or no real bargaining has occurred. It is not possible for the ATO to test the transfer price setting processes of taxpayers in such cases. Other cases falling into this category include taxpayers who establish the price and terms of their international dealings with associated enterprises for tax purposes without regard to whether comparable arm's length international

dealings exist or whether the overall results are in accordance with the arm's length principle.

228. In both the above situations, there are no processes in place to ensure arm's length transfer pricing policies are developed and implemented. These cases do not reflect the due care and diligence that is expected of a reasonable business person. Taxpayers in this category can reduce their level of risk by undertaking and documenting a prudential review and putting processes (including adequate record keeping) in place for the future.

### *Medium to high risk*

229. Medium to high risk cases include taxpayers who undertake (or are only permitted) limited bargaining. Such taxpayers may appear to have the power to bargain but there is no, or limited, real bargaining with associated entities. There may be some contemporaneous documentation but no analysis of functions, assets, risks, market conditions or business strategies. The ATO is generally unable to test the transfer price setting processes of taxpayers in such cases. These taxpayers need to analyse their contribution to the profit of the group and ensure that this is properly reflected on an arm's length basis in their tax returns.

### *Medium risk*

230. The medium level risk category includes taxpayers undertaking only rudimentary arm's length analyses when setting pricing policies or determining the terms and conditions of international dealings. There may be evidence of some limited efforts to develop and implement transfer pricing setting policies for tax purposes, although these would not be sufficiently developed or properly implemented having regard to the complexity and importance of the particular transfer pricing issues in the case. While some level of bargaining may be evident in these cases, there is an inadequate analysis of functions, assets, risks, market conditions and business strategies and no external benchmarking.

231. Taxpayers may have relied on data that is broadly comparable although they would not have sought to refine it to their circumstances or used it in conjunction with an adequate comparability analysis. There may be some contemporaneous documentation but it provides only limited scope for the ATO to test the taxpayer's transfer price setting processes. While these cases generally do not represent the same degree of risk to the revenue as the previous risk categories, these taxpayers should nonetheless refine their analyses and processes and review their tax returns to further reduce their risk of audit

adjustments and statutory penalties for cases where there is a lack of reasonable care. Of course, what constitutes reasonable care will depend on the facts and circumstances of the case, having regard to the significance of the cross-border dealings with associated enterprises.

### *Low-medium risk*

232. Low to medium risk cases are those where taxpayers consider their international dealings with associated enterprises. Taxpayers in this category would carefully undertake arm's length pricing analyses (and appropriate future monitoring) using available data about independent enterprises or third party international dealings (having regard to comparability), but may be confronted with limitations on data availability which are beyond their control.

233. These taxpayers would have undertaken a sound analysis of functions, assets, risks, market conditions and business strategies that are fully supported by contemporaneous documentation and relied on this information in preparing their tax returns. The ATO would be able to carry out full testing of the taxpayer's process and analyses. These taxpayers will be regarded as having exercised reasonable care and used best endeavours to comply with the law.

### *Low risk*

234. Low risk cases would be those where taxpayers:

(a) engage in real bargaining;

(b) consider their international dealings with associated enterprises carefully;

(c) undertake arm's length pricing analyses (and appropriate future monitoring) using sufficient data about independent enterprises or third party international dealings (having regard to comparability) - this would include undertaking a sound analysis of functions, assets, risks, market conditions and business strategies;

(d) establish and implement a process which the ATO can readily test;

(e) support the analysis and processes with contemporaneous documentation; and

(f) prepare their tax returns on the basis of their analysis.

235. Like the preceding risk category, these taxpayers will be regarded as having exercised reasonable care and best endeavours to

comply with the law. An example of a low risk case would be where a taxpayer has extensive dealings with independent enterprises in open market conditions and dealings with associated enterprises are of a similar kind and on similar terms and conditions. Another example would be a transaction with an associated enterprise which is narrowly confined, e.g., a loan, and the consideration has been set by reference to a market rate of interest. These cases would be low risk subject to the above steps being satisfied.

### *Lowest risk*

236. The lowest risk category cases are where an Advance Pricing Arrangement ('APA') has been concluded with the taxpayer. These arrangements contain 'critical assumptions' about factual matters which need to be met (possibly within a range of tolerances) in order to maintain the validity of the APA (refer to TR 95/23). There may also need to be some checking that the terms of the APA have been implemented as originally agreed.

### *Diagram illustrating ATO risk ranking*

237. The above comments on risk levels are illustrated in the following diagram. The main elements of a taxpayer's risk ranking are represented in the boxes and can be used by taxpayers and ATO staff as a practical guide to risk assessment. The characteristics of particular risk levels shown in the boxes are only indicative and are not arrayed in descending order of importance. They are provided for practical guidance. The ATO recognises that a taxpayer may still fall into one of the lower risk levels even though it has not satisfied every characteristic shown in the diagram. For example, it is possible that a taxpayer could be low risk even where no real bargaining occurred. In this circumstance, the ATO would give consideration to each of the other requirements of the low risk category to ensure that the taxpayer had allocated its income and expenditure in accordance with arm's length principles.

## MINIMISING THE TAXATION RISKS IN INTERNATIONAL ASSOCIATED PARTY DEALINGS

| 1 | 2 | 3 | 4 | 5 | 6 | 7 |
|---|---|---|---|---|---|---|
| **HIGHEST RISK** | **HIGH RISK** | **MEDIUM-HIGH RISK** | **MEDIUM RISK** | **LOW - MEDIUM RISK** | **LOW RISK** | **LOWEST RISK** |
| | No authority to bargain or no real bargaining occurs | Authority to bargain, but limited real bargaining occurs | Authority to bargain, and some real bargaining occurs | Authority to bargain, and real bargaining occurs | Authority to bargain, and real bargaining occurs | Methodology agreed in advance with advance with ATO |
| | | | Broad inexact comparables used | Comparability based on limited data from independent dealings | Comparability based on adequate data from independent dealings | No change in critical assumptions |
| **Deliberate tax avoidance** | | No analysis of functions, assets, risks, market conditions & business strategies | Inadequate analysis of functions, assets, risks, market conditions & business strategies | Sound analysis of functions, assets risks, market conditions & business strategies | Sound analysis of functions, assets risks, market conditions & business strategies | APA properly implemented and monitored |
| | | Limited effort to develop & implement arm's length transfer pricing policies | Limited effort to develop & implement arm's length transfer pricing policies | Genuine effort to develop & implement arm's length transfer pricing policies | Genuine effort to develop & implement arm's length transfer pricing policies | |
| | No taxpayer documentation or processes to enable a check on selection & application of methodologies | Insufficient taxpayer documentation or processes to enable a check on selection & application of methodologies | Choice & implementation of method supported with some contemporaneous documentation | Choice & implementation of method fully supported with contemporaneous documentation | Choice & implementation of method fully supported with contemporaneous documentation | |
| | | | Taxpayer's records & processes permit limited scope for testing | Taxpayer's records & processes can be readily tested | Taxpayer's records & processes can be readily tested | |

***Taxpayers should assess the level of risk they want in their dealings with associated enterprises***

238. Taxpayers will need to assess their needs in this area and consider the level of certainty they wish to achieve having regard to the impact of international dealings with associated enterprises on their overall business and other relevant factors.

**Documenting a process for setting international transfer prices**

239. This section complements and should be read in conjunction with the corresponding discussion in paragraphs 186 to 235 of TR 95/D22. The emphasis in this Ruling is on documenting the process of setting transfer prices.

240. As stated in paragraphs 225 to 238 of this Ruling, taxpayers who have developed, implemented and documented a thorough process for setting their transfer prices between associated enterprises are less likely to find themselves exposed to transfer pricing adjustments.

241. The standard of an enterprises pricing policies and processes is considered to be relevant in three ways. First, it is relevant to the decision as to whether an ATO review proceeds beyond an examination of process. Secondly, if the review does proceed beyond the process, the size of any discrepancy between the consideration or profit returned from the dealings with associated enterprises and the arm's length consideration or profit is likely to be smaller. This is because the higher the standard of the process the closer the outcome is likely to be to an arm's length outcome. Thirdly, the standard of a taxpayer's process is also relevant to considerations of the level of penalty, if any, to be imposed in the event of a transfer pricing adjustment, as the standard of a taxpayer's pricing policies and processes will be relevant to whether they have taken reasonable care or have a reasonably arguable position.

242. Paragraph 186 of TR 95/D22 discusses a four step process which could be used by taxpayers for setting the prices and terms of their international dealings with associated enterprises. In suggesting this four step process, the following points need to be made:

(a) the four step process and the data collection and analysis outlined in this section are neither mandatory nor prescriptive approaches to adopt;

(b) the approach outlined below assumes that the nature of the international dealings between the associated enterprises are fairly extensive and necessitate a thorough analysis. Such a process would not be

appropriate in all cases (refer to discussion at paragraphs 259 to 262); and

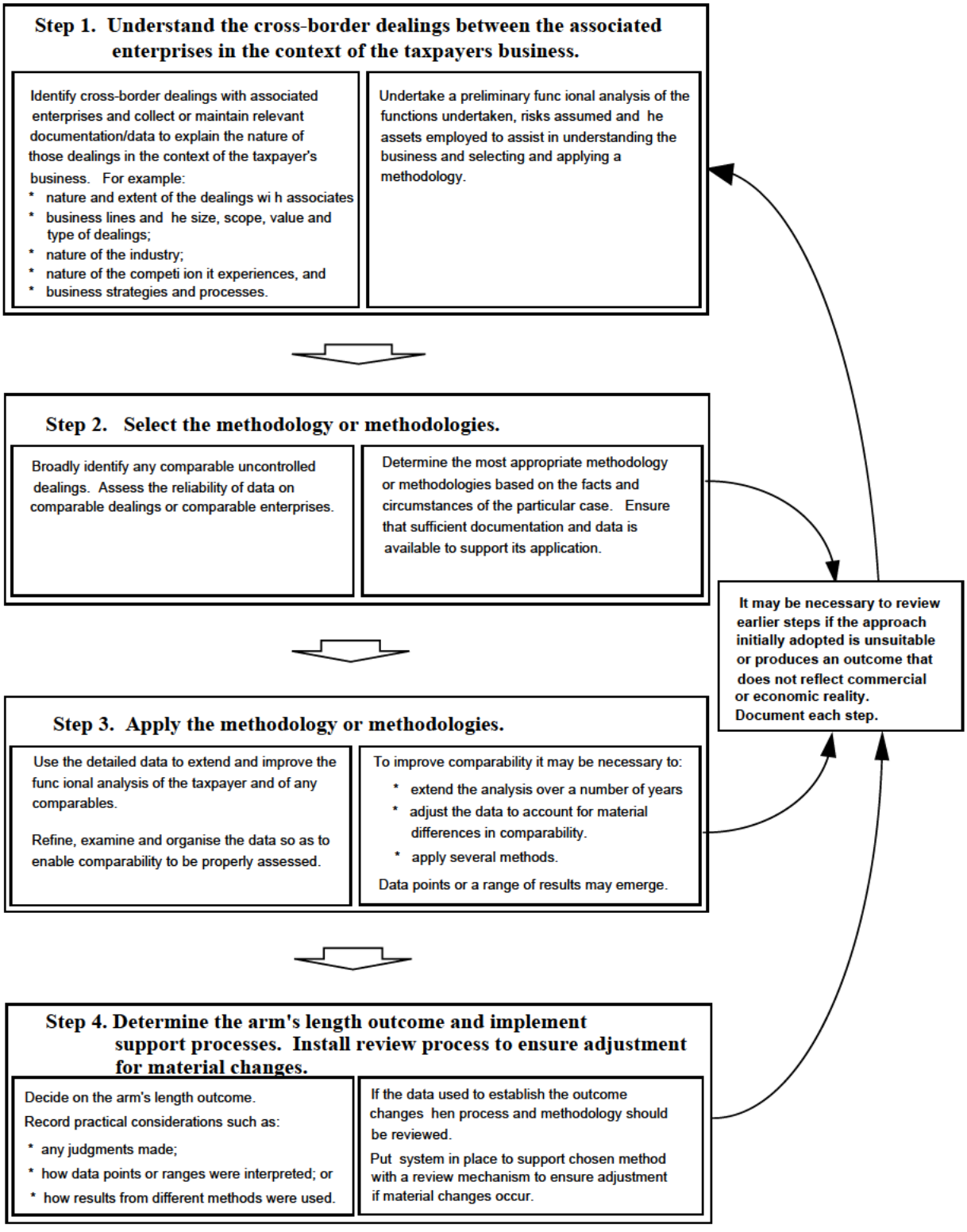
(c) the analysis outlined in this section is predicated on the basis that much of the relevant documentation will have been created in the ordinary course of business by the taxpayer. Guidance is then provided about the type of additional documentation that will be of assistance.

### *Flowchart illustrating a four step process for setting international transfer prices*

243. The following flowchart illustrates the four step process. Each step in the process should be viewed as having some degree of overlap with, rather than being viewed in isolation from, the other steps (see diagram on next page).

### The Four Step Process

The following chart is an illustration of the four step process for setting or reviewing transfer prices between associated enterprises. If this process is properly undertaken, the taxpayer should have a lower risk of audit adjustment or penalty.



### *Step 1 understand the cross-border dealings between associated enterprises in the context of the business*

244. The arm's length principle is based on a view that, in arm's length dealings, each party would seek to maximise its overall value from the economic resources available to or obtainable by it, and would enter into a transaction only if there was no alternative transaction clearly more attractive (see TR 94/14 at paragraphs 154 to 168 and 310 to 327, and the 1995 OECD Report at paragraphs 1.6 to 1.17).

*Documenting the dealing in the context of the taxpayer's business*

245. In terms of collection of a broad range of data it is expected that documentation created or acquired by the company in analysing the nature of the industry or industries in which it competes, the competitive situation in those industries and any other broader economic or other factors considered relevant should be retained. The amount of documentation necessary in this regard cannot be specified as a general rule and will depend on factors such as the complexity and importance of the associated enterprise dealings and the extent to which these factors are likely to affect the determination of arm's length consideration or profit.

246. The size, scope and type of the enterprise's international dealings with associated enterprises should also be documented as part of this step. In this regard, it is expected that contracts or agreements in respect of international dealings between associated enterprises for goods or services will be retained. This is the case even where these may have been entered into many years ago if the goods or services are still being transferred under their terms. It is also expected that the key terms of any unwritten agreements between associated enterprises should be documented at the time that the agreements are entered into. This should include details of any set-off arrangements entered into as part of the unwritten agreement (refer to the discussion on '**Set-off arrangements**' at paragraphs 552 to 570 of this Ruling). Documentation should also be retained which explains the economic merits and justification for entering into the particular international dealing.

247. Another issue where retention of documentation is expected relates to the business strategies of the enterprise. This will include marketing and pricing strategies, cross subsidisation strategies and broader corporate objectives. Relevant documentation in this regard may include copies of the company's Memorandum and Articles of Association, mission statements, corporate plans and divisional business plans, reports proposing and recommending such strategies

and relevant records of meetings of Boards of Directors or corporate management groups where recommendations for the implementation of these strategies were considered and approved.

248. In particular, retention of any document where the relevant pricing policy of the taxpayer is outlined would be advisable as would be the pricing policy for the MNE group as a whole. The ATO has sighted pricing policy documents operative for both an MNE group's Australian operations and for the MNE group worldwide. Availability of both of these types of documents is strongly recommended. Even in cases where the pricing policies came into existence many years ago it is recommended that the document be retained where consideration between associated enterprises is still being set in accordance with that policy.

249. In terms of documentation relevant to the operation of the enterprise, it is expected that documents outlining the organisation structure of the taxpayer and the structure of the corporate group both in Australia and worldwide will be retained. Other relevant documentation will include outlining the company's internal procedures and controls which are in place to ensure that arm's length consideration is consistently determined and applied to its international dealings with associated enterprises. This will include manuals and written instructions drawn up by the company in the ordinary course of carrying on its business.

*Documenting the preliminary functional analysis*

250. The preparation of a preliminary analysis of functions, assets and risks is undertaken during this step. In terms of documenting this preliminary functional analysis, the types of documents which may need to be created or obtained is clear from the discussion in TR 95/D22 and will not be repeated here. It is expected that all documentation created or acquired in completing the functional analysis will be retained. This documentation should be retained at least until a new functional analysis is completed, and preferably for as long as possible after this to detail the major functions, assets and risks of the enterprise over time.

251. In this regard documentation that evidences a change in the business circumstances of a taxpayer so that the evolution of the business, and business relationships can be traced, should be retained. This may mean retention beyond the statutory period, where such changes extend over a number of years and represent a major shift in the position of the enterprise. This documented series of analyses will be of great assistance to an enterprise in the event of a transfer pricing review by the ATO.

252. It is appreciated that the costs of completing a functional analysis may be significant, particularly where complex issues are involved. It is not, therefore, expected that a new functional analysis should be carried out within a prescribed time frame. A revision of the functional analysis will only be necessary where there is a material change in any of the elements that make up the functional analysis (i.e., functions, assets, risks) which has a significant impact on the taxpayer's business. In this regard, refer to the discussion at paragraphs 272 to 282 and paragraphs 283 to 285 of this Ruling.

253. While there can be no prescription of when such a review will be required, it is expected that taxpayers will monitor the relevance of the functional analysis to the circumstances of their business and to document the on going process of review.

254. The functional analysis may be performed with varying levels of detail. In this regard, it is expected that documentation will be created, and retained, which outlines reasons why the particular level of the analysis was conducted, for example, a product or divisional level, a whole of enterprise level or a corporate group level.

255. One of the major assets which may need to be considered in compiling a functional analysis is a taxpayer's human resources, in particular its skilled and experienced staff. Documentation which would be relevant here includes details of staff levels, experience, educational qualifications, remuneration, performance evaluation and duties of key operational staff. This would include performance agreements and statements of performance indicators for key staff. Any written statements provided by key staff and used by the company in determining the functions, assets and risks of the enterprise as part of the functional analysis should also be retained.

256. Documentation created in the course of dealing with arm's length parties, such as documentation created by the enterprise in tendering for work, including curriculum vitae of key staff members and areas of particular expertise should be retained. The purpose of this analysis is to identify the human resource asset and from the information obtained draw some conclusions as to the importance of the skilled and experienced staff to the enterprise's activities. This analysis will be particularly relevant in cases where profit split is the methodology adopted. This analysis may be used by enterprises in service industries where the skill and experience of the human resources is the major asset exploited for profit, but is of general relevance to all enterprises. While it may not be necessary to extend the analysis to all staff of an enterprise, the extent of such analysis will depend on the facts and circumstances of the case.

*Usefulness of a proforma functional analysis*

257. The ATO has given consideration to providing guidance to taxpayers seeking to undertake a functional analysis by providing a pro-forma to assist them in the analysis necessary in formulating /reviewing their pricing policies and procedures.

258. It is the ATO's view that taxpayers are in the best position to know their business, their risks and their expectations of profit outcomes and therefore to design a functional analysis to suit their circumstances. A 'tick the box' approach would not have regard to the peculiarities of particular businesses' functions and risks, or the relative contribution to profits as represented by the level of economically significant activity attributable to the respective members of the MNE group. Accordingly, it is not our intention to provide such a pro-forma in this Ruling.

259. It is important to note, however, that a detailed functional analysis is not required in every case and would vary subject to the complexities involved. The nature of this type of analysis and its scope is extensively discussed in TR 95/D22. That Ruling confirms that complexity may be indicative of the extent and detail needed of the analysis.

260. A detailed analysis may not be necessary where, for example, a taxpayer has internal benchmarks for dealings between associated enterprises. A taxpayer dealing in the production of goods may have a series of dealings for a specific product line both with associated and independent enterprises at the international level. Assuming that there are no other dealings apart from trade in tangible goods, the level of detail needed in a functional analysis would only require a study of whether the conditions affecting both the associated enterprise dealings and the potential external benchmarks were in fact comparable.

261. Another situation where a detailed functional analysis would not be required may be where dealings between associated enterprises are narrowly confined, for example, a loan transaction. In such a case where it is accepted that independent enterprises would have entered into a loan arrangement (refer TR 92/11), market data about interest rates could be used to determine an appropriate arm's length interest rate. The dealings would still require some level of analysis and documentation to establish that the market rates used were truly comparable to the conditions affecting the associated enterprise dealings, e.g., risk, currency, duration and other loan terms. If necessary, any adjustments for such differences should be quantified and documented but a detailed functional analysis, as described in TR 95/D22, would not be required.

262. The level of complexity in completing a functional analysis would increase where, for example, a taxpayer performs manufacturing functions as well as distribution functions and has a mix of related and unrelated inbound and outbound international dealings. In this more complex example the scope and detail in the functional analysis will increase with the need to identify significant economic functions, assets and risks as a basis for selecting an appropriate methodology and benchmarks against which to assess the associated enterprise dealings.

### *Step 2 selection of the methodology or methodologies*

*Documenting the process*

263. With regard to the selection of an appropriate transfer pricing methodology it is expected that the company will document the process used in selecting the methodology, including reasons why the particular methodology was selected. While a taxpayer is not required to exhaustively consider and eliminate methodologies using a form of hierarchy, it is expected that the company will document its process in considering and discarding other methodologies, including reasons why other methodologies were discarded.

264. In cases where the taxpayer has applied different pricing methods to different parts of its operations documentation outlining reasons for concluding that this is the most appropriate course of action for the enterprise, rather than, for instance, applying one method to all of its operations would be of assistance.

265. It is also pointed out that in the course of this step some assessment of the availability of comparable data should take place. It is of assistance if all data obtained during the course of assessing comparability is retained. More detail on the types of relevant documentation here will be discussed in Step 3.

### *Step 3 application of the methodology or methodologies*

*Documenting the process*

*(i) Undertake an assessment of comparability*

266. Documentation regarding all steps in the process undertaken by the company in assessing comparability would be highly relevant. These steps will include:

(a) the search for comparable transactions or enterprises;

(b) identification of sources of information used in searching for comparables;

(c) adoption of transactions or enterprises as comparables;

(d) rejection of other transactions or enterprises as comparables;

(e) where adjustments have been made to outcomes from independent transactions or enterprises so they are comparable, reasons for adjustment and quantification of the adjustment; and

(f) application of the pricing method, and any other methods used for checking the result, such as a sample of transactions to ensure the accuracy of the method.

267. In the case where application of the assessment of comparability suggests that there is a range of arm's length outcomes that may be applied, documentation detailing all of the outcomes in this range, the point in the range which the taxpayer considers most appropriate and reasons for selecting this point will be highly relevant.

*(ii) Collect supplemental data*

268. With regard to the extension of the functional analysis in this step, data on profit projections would be relevant and should be retained. Documentation created or acquired during this stage to supplement the analysis of comparability and functional analysis should also be retained. Any supplementary data collected to more accurately calculate financial performance ratios as part of the application of the chosen pricing method should also be retained and all written calculations of these ratios will be relevant.

### *Step 4 determine the arm's length consideration and review the process if factors change*

*Documenting the determination of arm's length consideration*

269. Documentation outlining the application of the company's functional analysis and comparability study to the determination of the pricing outcome is relevant in this step, which is the conclusion of the processes of analysis and documentation outlined in earlier steps. Little additional documentation should need to be created in this stage. If availability of data to apply pricing methodologies has been recognised as a problem then preparation of documentation outlining the nature of these data problems and their impact on selection and application of the pricing methodology would be of assistance.

270. If data is available it is also recommended that a review of the outcome be conducted and documented to ensure it is commercially realistic. If, for example, the application of the selected methodology

to the transactions in question gives rise to a rate of return for the business that is significantly lower than publicly available industry standards then some analysis of reasons for this difference should be undertaken and documented.

271. Documentation outlining the performance reports generated by the enterprise which may be used to verify the arm's length outcome of the pricing system between the associated enterprises will be of great assistance. These reports may be used to conduct test checking of the pricing processes. Any of the enterprise's arm's length dealings selected and used as comparables should be identified and documented including:

(a) identification of any dealings with associated enterprises to which the arm's length dealings are considered to be comparable;

(b) any adjustments made to the independent price to take account of relevant differences; and

(c) reasons as to why the independent transactions are considered comparable.

*Documenting the review of the process if factors change*

272. It is the ATO view that any process established by a taxpayer to set arm's length transfer pricing for tax purposes in respect of its international dealings with associated enterprises must be relevant to the business of the enterprise at the particular point in time at which the dealing occurs. In this respect, before a methodology is selected and applied by a taxpayer in relation to a particular dealing, the taxpayer needs to have regard to the business environment in which it is operating at that point in time so as to show the relevance of its process for setting arm's length transfer pricing to the particular dealing. Paragraph 5.3 of the 1995 OECD Report makes the same point where it says:

> 'The taxpayer also could be expected to examine, based on information reasonably available, whether the conditions used to establish transfer pricing in prior years have changed, if those conditions are to be used to determine transfer pricing for the current year.'

273. Accordingly, the four step process described in paragraphs 239 to 282 does not end with the determination of an arm's length consideration for the relevant controlled transactions, but must also include an ongoing monitoring by the taxpayer of its process for setting arm's length transfer pricing. Taxpayers should document the steps taken to monitor the continuing relevance of any process for

setting arm's length transfer pricing. Where this monitoring evidences that a change in the process may be required, the factors that lead to this conclusion should also be documented, as should the review of the process itself and any adjustments to the parameters of the process that arise as a result of the review.

274. There can be no prescription for how often a review by a taxpayer of its process should be undertaken, or what changes in circumstances would make a review of a taxpayer's process necessary. As a general rule, where there has been a significant impact on factors important to the conduct of an enterprise's business, or any shift in the critical assumptions which form the basis for the selection and application of a methodology, a detailed review of process would generally be required.

275. The types of questions that may need to be addressed and documented as part of any such review include the following:

(a) **What has changed?** For example, new competition in an existing market or entry into a new market, development of new products or know-how, new business strategies, impact of economic conditions on a specific market or business segment, change in the incident of risk;

(b) **What impact do these changes have on a business, its expected outcomes, pricing policies, selection of methodology, and the application of that methodology?** Market share analysis, profit forecasts, revised mission statements, business plans, statements of objectives and other strategic documentation would assist in establishing the significance of changed circumstances to an enterprise's overall business. Any documentation created when pricing methodologies are reconsidered is of particular importance;

(c) **Does this change also affect other enterprises which form the basis for arm's length comparisons?** In such cases changes have a material effect on arm's length comparables, it may be necessary to reconsider the appropriate pricing methodology or its application. Any process of reconsideration should be adequately documented.

276. Representations have been made that if a taxpayer has selected a methodology which appears to be appropriate and suited to the circumstances of a particular segment of the taxpayer's business, then the process of selection and application of such a method need not be continuously reviewed by the taxpayer and the reviews documented.

It has been further suggested that if a taxpayer selects and applies a methodology and then maintains business in line with that methodology, then no further documentation requirements should be necessary to support the selection and application of the method chosen by the taxpayer. These views are not accepted. Business does not operate in a static environment nor does the arm's length principle operate without having regard to the possibility of changed circumstances.

277. In carrying on business, independent enterprises generally display some degree of flexibility in their business strategies by seizing opportunities available in the markets in which they operate or by establishing additional markets. Adapting to a changing business environment on a global scale could see business enterprises developing new products, exploiting skills or resources and developing new markets. This process may create new assets or cause an enterprise to undergo major structural changes and could lead to a revision in its expectations of outcomes in accordance with any opportunities that emerge.

278. For example, a subsidiary of a foreign MNE may initially be established in Australia as the sole distributor of the products of the MNE group of which it is a member. The Australian subsidiary may, at the time of its establishment, undertake no manufacturing activities and act simply as a wholesaler or retailer of the products of the MNE group. In such a case, the taxpayer's process for setting its transfer prices may suggest that a resale price method using gross margins benchmarked against those obtained from entities undertaking comparable wholesaling or retailing functions to be the most appropriate method. Some years later, the nature of the Australian subsidiary's business may have materially changed as a result of it undertaking manufacturing activities in Australia which add significant economic value to the products of the MNE group, or having embarked upon a strategy of exporting its products to the Asia/Pacific region, in addition to continuing to act as a wholesaler or retailer of the products of the MNE group. As the nature of the taxpayer's business has materially changed, it would not necessarily be the case that a resale price method would continue to be the most appropriate method to use. A taxpayer's process for setting international transfer prices with associated enterprises for tax purposes would need to have regard to material changes in the nature of its business and be able to adjust transfer prices and methodologies as appropriate.

279. The process of adaptation and change will manifest itself in many ways within an enterprise. These features could include the following:

(a) change in significant economic functions which impact on contributions to the profit of an enterprise;

(b) changes in the capital/debt structures of an enterprise;

(c) devaluation of income producing assets and creation of new assets to replace them;

(d) entry into new markets on a domestic or international scale and/or withdrawal from unprofitable market segments;

(e) alteration to the incidence of risks associated with the business strategies of an enterprise.

280. The above list is not exhaustive and there may be other factors impacting on the way in which an enterprise conducts its business. The purpose of the above discussion is to demonstrate that, given the dynamics of trade in a global economy, the processes used to set transfer prices must be monitored on an ongoing basis.

*Revisions or renegotiations of existing arrangements often raise special documentation issues*

281. In cases where associated enterprises agreed to revise or renegotiate the transfer price or the terms of an existing arrangement with an associated enterprise, a number of documentation issues arise. For example, such situations may arise in respect of the price charged for the supply of minerals or metals in a long term supply contract, the royalty rate charged to an associated enterprise for the right to use valuable intangible property, or the costs allocated to an associated enterprise for the provision of services to it by other members of an MNE group. Paragraph 5.27 of the 1995 OECD Report indicates some documents which may be helpful in showing that revised or renegotiated prices comply with the arm's length principle.

282. As stated in paragraphs 76 and 325 of TR 94/14, the likely absence of a divergence of interest between the associated enterprises means that close examination will be given by the ATO to the changed circumstances leading to any revision or renegotiation of an existing arrangement. Where taxpayers are involved in revisions or renegotiations of existing international dealings with associated enterprises, any process established by them for setting transfer prices for tax purposes in relation to their international dealings with associated enterprises would also need to be able to provide relevant details and supporting documentation of:

(a) the terms of the new agreement;

(b) the changed circumstances which have led to the need for the revision or renegotiation;

(c) the analysis undertaken to support the revised transfer price or terms of the arrangement including adequate detail of external benchmarking undertaken and the pricing methodology used; and

(d) the basis upon which it is considered that the approach taken is consistent with what arm's length parties would have done in the same or similar circumstances (i.e., that it would be usual for arm's length parties to revise or renegotiate the terms of a comparable arrangement and that the approach adopted is similar to what arm's length parties would have done).

**Does the taxpayer properly implement its own process in setting prices and conditions for cross-border transactions?**

283. Contemporaneously documented processes would have little impact on a taxpayer's level of risk if they have not been properly implemented by the taxpayer. In this regard, as part of the ATO's risk assessment analysis of a taxpayer, we will be seeking to test any process established by a taxpayer in order to be satisfied that the process has been properly implemented.

284. Proper implementation by a taxpayer of its process for the setting of its transfer prices with associated enterprises for tax purposes would require that the ATO be able to establish amongst other things that:

(a) the taxpayer has relied on the outcomes generated by application of its process for the purposes of lodging a correct tax return;

(b) the taxpayer has applied its process to all its associated enterprise dealings; and

(c) the taxpayer has undertaken reviews of its process when these are needed and made appropriate changes as necessary to its process.

285. Where the ATO, as part of a transfer pricing review of the taxpayer, is not satisfied that the taxpayer has properly implemented its process, this will be a significant factor to consider when deciding whether or not to move beyond a review of process to a transfer pricing audit of the taxpayer.

**Is documentation adequate to support a correct selection and application of transfer pricing methodologies?**

286. Only general guidelines can be given on the type of documentation that taxpayers should create or refer to when selecting or applying specific transfer pricing methodologies. It is not possible, or desirable, to provide a formulated check list outlining documentation requirements for any particular methodology because of the range of possible situations encountered in practice. Broadly speaking, documentation to support a correct selection and application of transfer pricing methodologies in relation to international dealings between associated enterprises falls into five categories:

(a) documents created by the taxpayer in the ordinary course of transacting its business (see paragraphs 299 and 300);

(b) documentation created or obtained to support a study of the enterprise's significant business functions, business strategies, the assets utilised in the pursuit of that business, and the risks associated with the business activity. More detail on this type of study is provided in TR 95/D22 in its discussion on functional analysis at paragraphs 209 to 214 (broadly, Step 1 of the four step process);

(c) documentation created or obtained to support an analysis of methodologies available in a particular case and their relative worth, and the process of selection or rejection of one or more methodologies and the rationale for that selection or rejection, having regard to the enterprise's business and market circumstances, the nature of the relevant activities and the arm's length principle (broadly, Step 2 of the four step process);

(d) documentation created or obtained to support the application of the methodology to specific or generalised dealings as they occur and a reasonable sample checking of results against any performance criteria to determine whether the methodology has achieved an arm's length result (broadly, Steps 3 and 4 of the four step process); and

(e) documentation created or obtained in the course of any review of the taxpayer's process for setting transfer pricing for tax purposes in relation to their international dealings with associated enterprises.

287. Representations have been made that documentation to support the price and terms of international dealings between associated

enterprises should be confined to the first category of documents referred to in the previous paragraph. The ATO agrees that associated enterprises should not be unnecessarily and unreasonably burdened with documentation keeping requirements. However, the obligations imposed on taxpayers by the law to comply with the arm's length principle for tax purposes in relation to their international dealings with associated enterprises means that records over and above those kept by the taxpayer in the ordinary course of business will ordinarily need to be created or obtained in order to satisfy those obligations. The requirement to keep records over and above those kept by the taxpayer in the ordinary course of business arises because of the special relationship that exists between associated enterprises. In checking compliance with the arm's length principle, the ATO will, as stated in paragraph 373 of TR 94/14, seek to rely as much as possible on documentation created in the ordinary course of business.

288. The ATO's approach in this regard is consistent with that recommended in the 1995 OECD Report, at paragraph 5.6, where it is said that:

> 'In considering whether transfer pricing is appropriate for tax purposes, it may be necessary in applying principles of prudent business management for the taxpayer to prepare or refer to written materials that would not otherwise be prepared or referred to in the absence of tax considerations, including documents from foreign associated enterprises.'

289. The OECD also recognises that considerable costs could be incurred by taxpayers for the purposes of creating or obtaining documentation to show compliance with the arm's length principle if a balance is not able to be reached between the needs of tax administrations and the additional burden imposed on taxpayers. In this respect, paragraph 5.6 of the 1995 OECD Report also says:

> 'When requesting submission of these types of documents, the tax administration should take great care to balance its need for the documents against the cost and administrative burden to the taxpayer of creating or obtaining them.'

290. The ATO accepts that a key issue is one of striking an acceptable balance between the need to keep compliance costs to the minimum necessary to ensure compliance with the arm's length principle and the legitimate concern of the ATO to see that Australia is not denied its fair share of tax. In trying to reach this balance, paragraph 373 of TR 94/14 states that the ATO will limit requirements to the minimum necessary to ensure compliance with the arm's length principle.

291. The ATO approach is again consistent with the approach recommended by the OECD at paragraph 5.7 of the 1995 OECD Report which states that:

> '(W)hile some of the documents that might reasonably be used or relied upon in determining arm's length transfer pricing for tax purposes may be of the type that would not have been prepared or obtained other than for tax purposes, the taxpayer should be expected to have prepared or obtained such documents only if they are indispensable for a reasonable assessment of whether the transfer pricing satisfies the arm's length principle and can be obtained or prepared by the taxpayer without a disproportionately high cost being incurred. The taxpayer should not be expected to have prepared or obtained documents beyond the minimum needed to make a reasonable assessment of whether it has complied with the arm's length principle.'

292. The amount and type of documentation which should be created or obtained by a taxpayer over and above that created in the ordinary course of business in relation to a taxpayer's international dealings with associated enterprises will depend on the facts and circumstances of each case.

293. The ATO is not suggesting that all the types of documentation mentioned in this draft Ruling need to be kept for every international dealing between associated enterprises. The issue is a practical one having regard to what a prudent business person would do in the same circumstances.

294. In assessing compliance with the arm's length principle, taxpayers need to exercise commercial judgment about the nature and extent of documentation appropriate to their particular circumstances. In this regard, paragraph 5.4 of the 1995 OECD Report (with which the ATO agrees) states:

> 'The taxpayer's process of considering whether transfer pricing is appropriate for tax purposes should be determined in accordance with the same prudent business management principles that would govern the process of evaluating a business decision of a similar level of complexity and importance. It would be expected that the application of (prudent business management) principles will require the taxpayer to prepare or refer to written materials that could serve as documentation of the efforts undertaken to comply with the arm's length principle, including the information on which the transfer pricing was based, the factors taken into account, and the method selected.'

295. Paragraph 5.14 of the 1995 OECD Report highlights the advantages to taxpayers as a result of good record-keeping practices,

and recognises the practical reality that tax administrations have obligations to ensure compliance by taxpayers within their jurisdiction with the arm's length principle. It is there stated that:

> 'Taxpayers should recognise that notwithstanding limitations on documentation requirements, a tax administration will have to make a determination of arm's length transfer pricing even if the information available is incomplete. As a result, the taxpayer must take into consideration that adequate record-keeping practices and the voluntary production of documents can improve the persuasiveness of its approach to transfer pricing. This will be true whether the case is relatively straightforward or complex, but the greater the complexity and unusualness of the case, the more significance will attach to documentation.'

296. The 1995 OECD Report does not anticipate the creation of specific types of documentation by taxpayers, but rather recognises that taxpayers should make commercial judgments about the amount and type of documentation created, with the efforts made being commensurate with the importance of the dealings to the taxpayer's overall business.

297. Without attempting to be exhaustive or prescriptive, some of the documentation and records which have been used by taxpayers in the past to support their approach and to which the ATO has given weight - include:

(a) documents evidencing real bargaining and arm's length outcomes in relation to the taxpayer's international dealings with associated enterprises;

(b) pricing policies, documents relating to product profitability, relevant market information and profit contributions of each party;

(c) documents establishing the reasons for entering into significant international dealings with associated enterprises;

(d) documents establishing the reasons for the taxpayer's selection of a particular pricing methodology or methodologies;

(e) where other methodologies have been considered and rejected, details of these other methodologies, including reasons for their rejection. Ideally, these documents should be created contemporaneously with the decision - making;

(f) documentation establishing the structure and nature of the company and the MNE group to which it belongs;

(g) documentation establishing the taxpayer's sales and operating results and the nature of its dealings with associated enterprises;

(h) documentation setting out the taxpayer's marketing and pricing strategies, including market penetration strategies, etc.

298. The ATO recognises that enterprises operating in the Australian market may be in a better position than the ATO to know the types of comparability factors which influence prices and profit in their particular market. Accordingly, it is the ATO's expectation that these factors, as they affect the choice and application of transfer pricing methodologies, will be adequately documented. Where these are not adequately documented, the ATO will have to undertake an analysis of the factors which influence prices and profit outcomes in the market in which the enterprise is operating and form its own view as to what an arm's length party might reasonably have been expected to have paid or received in respect of the relevant dealings. In this regard, reference should be made to the discussions on '**The risk of a transfer pricing audit**' at paragraphs 225 to 238, and '**The risk of a transfer pricing adjustment being made**' at paragraphs 369 to 384 of this Ruling, where the ATO process is more fully discussed.

***Documents created in the ordinary course of business***

299. It is expected that a reasonable business person carrying on business in Australia would:

(a) analyse the market/s in which they operate and record the results (ie know their market);

(b) develop business plans and strategies;

(c) monitor products and services;

(d) create documents and keep records to satisfy various reporting requirements related to taxation (e.g., income tax, sales tax, PAYE, withholding tax), including the presentation or the making available of such information to external auditors;

(e) create documents and keep records to satisfy various reporting requirements not related to taxation (e.g., the Australian Securities Commission, the Australian Stock Exchange in relation to listed companies, the Australian Customs Service), including the presentation or the making available of such information to external auditors;

(f) create documents and keep records for internal management purposes (e.g., cost accounting and financial accounting information, marketing analysis, etc);

(g) create documents and keep records which record agreements, arrangements, transactions, etc with unrelated and related enterprises.

300. These types of documents and records are all created in the ordinary course of carrying on business and are collectively referred to in this Ruling as 'documents created in the ordinary course of business'.

**Documentation relevant to the application of particular transfer pricing methodologies**

301. The following section deals with specific documentation issues that emerge from an application of the methodologies described in TR 95/D22.

302. In describing the extent of documentation required for each of the elements of the various methods, it should be recognised that there may be instances where the extent of the information required to practically apply a method needs to be tailored to reflect the relative importance and frequency of the dealings between associated enterprises. For example, a taxpayer may have a large volume of routine transactions which occur on a regular basis. The documentation implications relating to the application of a methodology will vary according to the method selected. Under this scenario, the application of a CUP methodology and consequential documentation requirements may occur on the basis of an overall pricing policy (refer to paragraphs 312 to 314 below).

303. Alternative approaches such as resale price and cost plus methodologies are based on an assessment of profit margins with the emphasis being on functional comparability rather than price. Profit comparison methods (including transactional net margin method) also use profit margins at various levels, or other profit indicators, and require functional comparisons to be made in their application. Profit splits generally require the establishing of the respective economic contribution to profit by associated enterprises involved in particular dealings at the transactional or aggregated level. These methods will also require the identification of the respective parties functions, assets and risks which are significant contributors to the combined profit to be split and, where possible, external comparisons to be made which would assist in determining how independent enterprises dealing at arm's length may have split the combined profit in comparable

circumstances. These methods are less sensitive to the frequency and volume of relevant transactions although frequency of dealings may impact on comparability in some cases. The various features and levels of documentation required for these methods are also outlined below.

### *Documentation relevant to applying a Comparable Uncontrolled Price methodology*

304. The features of a Comparable Uncontrolled Price methodology ('CUP method') are discussed in TR 95/D22 at paragraphs 83 to 88. CUPs are generally capable of being established at two levels using either internal comparable dealings (internal CUPs) or external comparable dealings (external CUPs). The use of these types of comparisons and their relative merits are also discussed in the above mentioned Ruling. Subject to that discussion, both of these types of CUPs are theoretically capable of producing results that accord with the arm's length principle. The approaches adopted require different bases of comparison and attract substantially different documentation requirements.

#### *Documentation issues associated with internal CUPs*

305. As discussed in TR 95/D22, a CUP bases its comparison directly on price and requires that goods or services transferred be comparable in both related and unrelated dealings and that the dealings being compared should have occurred in comparable circumstances. Where there are differences in the goods or service which have a material effect on price, and the differences are capable of being identified and quantified with reasonable accuracy, a CUP method can still be used if reliable adjustments can be made.

306. Taxpayers wishing to use such a methodology would need to document the basis for comparison, including physical features and any other factors impacting on comparability. Where there are differences and these have been analysed for their impact on price, taxpayers should document this analysis and the basis on which any adjustments were quantified. Taxpayers will also need to have regard to other features of the dealing which may impact on comparability. These features will include contractual terms such as finance, credit terms (e.g., interest free periods), costs of carriage, warranties and other services which may be directly related to the transfer of goods.

307. Volumes of goods to be supplied and duration of contracts may also have an impact on price as will differences in the geographic markets into which goods or services are sold. Other factors such as business strategies (like price competition for market share) and

marketing intangibles (like brand names) may also have an impact on price. Some or all of these features may be present in the dealings which are the subject of comparison.

308. Where differences such as those referred to in the previous paragraph exist in relation to the controlled situations as compared to the uncontrolled dealing being considered as a potential comparable, they need to be identified and quantified and the process documented. In this regard, it may be that some aspects of this analysis have been documented by cost accounting and marketing areas in the ordinary course of business and need not be specially generated for the purpose of a transfer pricing analysis (see paragraph 299 of this Ruling).

*Documentation issues associated with external CUPs*

309. External CUPs seek to use prices external to the enterprise as benchmarks for comparison. Such a comparison may present practical difficulties which are discussed in TR 95/D22 at paragraphs 44 to 49. In order to establish that the price paid or received for uncontrolled dealings is a realistic benchmark for purposes of the arm's length principle, taxpayers will need to address and document the following issues:

(a) The physical identity of the products being compared. In the case of complex, high value products, this could include establishing technical differences in the specifications of the benchmark product and the impact of these differences on the operation and effectiveness of the product in an end-use situation.

(b) Differences in the quality of the products being compared. This could extend to identifying any differences in the raw materials used and the manufacturing processes and their impact on quality.

(c) The value of any manufacturing or marketing intangibles associated with the products being compared and their impact on price. Manufacturing intangibles can enhance functionality and quality and hence price. Even though the physical characteristics and quality of the products may be almost identical, the marketability of a particular trademark may have an impact on the sale price of such products. Taxpayers would need to identify and quantify the impact of any valuable intangibles associated with the sale of a physical good.

(d) Whether any services are supplied in relation to the product. There may be training, after sales service or

warranty arrangements that differ between the two situations being compared. These should be analysed and quantified and each step adequately documented.

(e) Conditions other than product differences that may impact on comparability. These could include business strategies, contractual conditions, differences in markets and other features of the dealings or enterprises being compared, as discussed in paragraphs 305 to 308 above in the context of internal CUPs.

310. These and other factors may have a direct impact on price as a comparable. The effect of these factors on dealings between associated and independent enterprises used as benchmarks must be analysed, quantified and any adjustment made to a price before that price becomes a reliable comparable. This analysis needs to be adequately documented. Even where the analysis shows that there is no CUP or that one uncontrolled situation is a more reliable CUP than another, these evaluations should be adequately documented since they may avoid disputes between taxpayers and the ATO and reduce compliance costs associated with ATO checks on compliance with the arm's length principle.

311. While the above comments are generally focused on goods, a similar analysis should be done in relation to services that are being compared. The extent, nature and quality of a service will have an impact on price. There will also be issues about intangibles and the market may pay a premium for certain suppliers on the basis of their reputation. Other factors like business strategies and payment arrangements could also affect price and should be evaluated and documented where relevant.

*Functional analysis and CUPs*

312. It will be apparent from the above discussion that the proper application of the CUP method (even the determination that it is the appropriate method) requires an analysis of functions (including assets used and risks assumed) performed by the parties being compared. The extent of the functional analysis necessary will depend on the relative importance of the dealing to the taxpayer's overall business, the nature and complexity of the dealing, its associated terms and conditions, and whether the taxpayer has internal comparables. For example, where a dealing is narrowly focused and not significant in overall terms, or the taxpayer has similar dealings in similar circumstances with independent enterprises, a rudimentary functional comparison may be sufficient (paragraphs 260 and 261 in this Ruling discuss documentation requirements for functional analysis). The

basis for any decision not to pursue an exhaustive functional analysis and the reasons for limiting the level to which a functional analysis is taken also needs to be adequately documented.

*Documenting the development and application of pricing policies*

313. Conceptually, CUP is a transaction based methodology, and therefore, there are strong arguments that every transaction using a CUP methodology must be adequately documented, including quantification and adjustment for differences having a material effect on price as discussed above. The ATO accepts there are instances where taxpayers may wish to price on the basis of an overall pricing policy rather than on the basis of developing CUPs suited to the individual circumstances of distinct transactions. For example, a taxpayer may develop a pricing policy which aggregates the selling prices of four independent and unrelated competitors in a particular market and uses a weighted average of these to set transfer prices for tax purposes.

314. In these circumstances, the ATO may accept such a pricing policy where a detailed analysis outlining the basis for the establishment of the policy is prepared and contemporaneously documented. In such a case the ATO would need to be satisfied and the taxpayer would need to document that:

(a) the competitors' products were comparable and/or differences that could materially effect price were identified and adjusted for; and

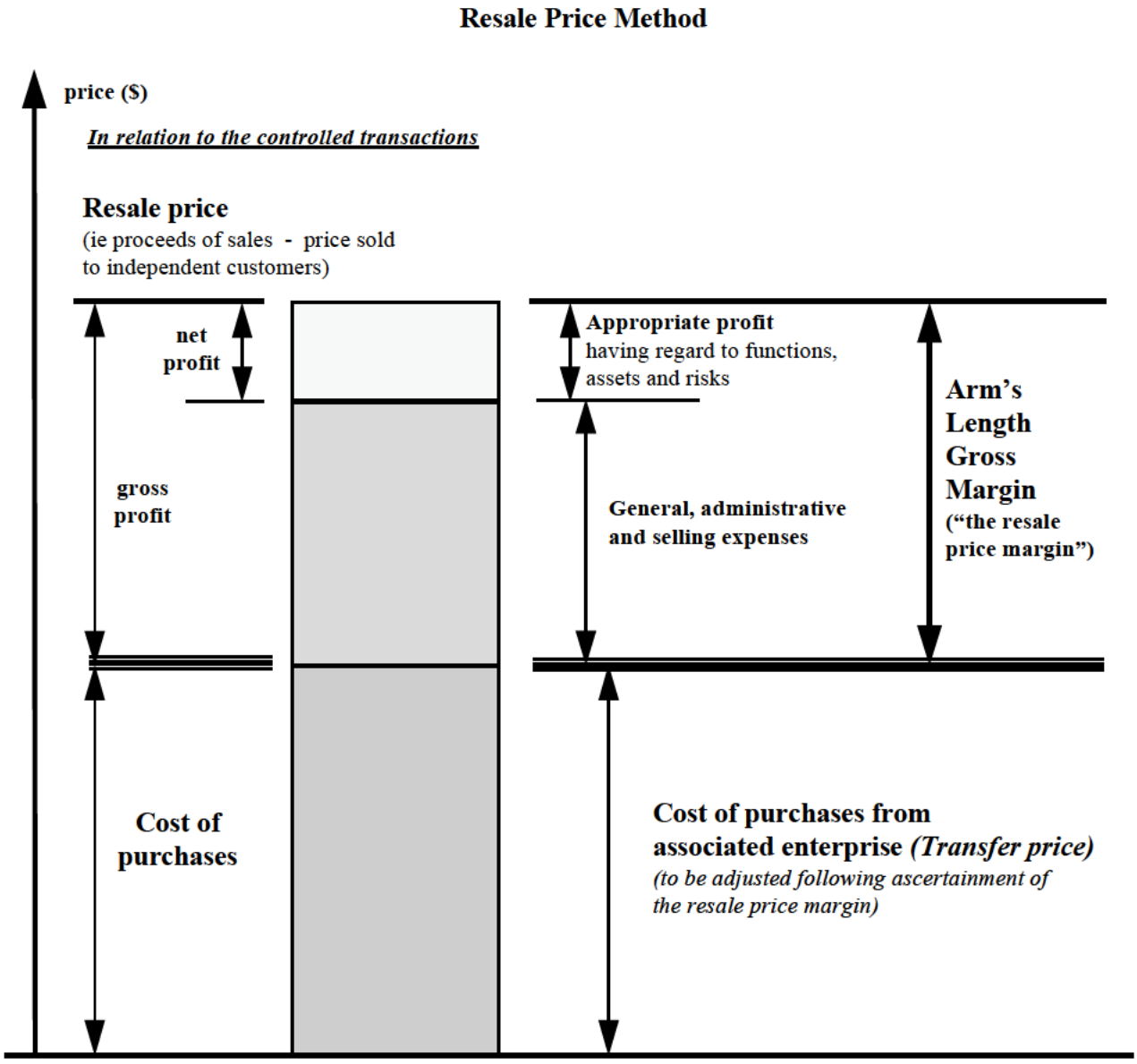
(b) the conditions affecting the dealings, including contractual terms, market and other key factors, discussed above, were comparable or differences that have a material effect on price have been identified and appropriate adjustments made.

315. It must also be noted that circumstances where the ATO would expect that the application and documentation of such pricing policies will be relatively rare.

***Documentation relevant to applying a resale price methodology***

316. The resale price method ('RP method') is explained in paragraphs 359 - 362 of TR 94/14, paragraphs 95 to 109 of TR 95/D22 and paragraphs 2.14 - 2.31 of the 1995 OECD Report. These discussions explain that the resale price method focuses on functional comparability rather than on product comparability as is the case with the CUP method.

317. The following diagram broadly illustrates the RP method.




318. Documentation would need to explain the decision making process in arriving at the acceptance of the resale price method. Naturally, a functional analysis is required of the controlled transactions. This analysis is to fully document the functions performed, assets utilised, risks assumed and economic circumstances faced by the reseller.

319. The method requires the reseller to either compare the functions and the resulting gross margin obtained in their controlled dealings against those of its comparable uncontrolled transactions or in most

cases the reseller will need to make a comparison with an independent enterprise(s) which undertake(s) comparable functions in order to distribute their property and the gross margin obtained.

320. Documenting the search for comparables and the evaluation method used to determine comparability, including any adjustments having a material effect on the margin made to a comparable or the reseller, is part of the decision making process. However, in some cases, the taxpayer may be limited by the extent of information available and may need to rely on a broad analysis to determine comparability. Where this is the case, it will be expected that the limitations or knowledge gaps are identified and documented. Such an analysis will require documenting the functions undertaken, assets employed and risks assumed by the comparable entity. This analysis is then compared to the resellers functional analysis. Where differences occur the process undertaken to adjust for differences is required to be documented.

321. TR 95/D22 identifies other factors besides functions, assets and risks that need to be taken into account when determining comparability eg contractual terms, geographic market, market penetration strategies, stock levels, marketing, finance and other operating expenses. These factors and the analysis associated with determining their effect on comparability should be adequately documented. Differences in accounting treatment which have an effect on the gross profit (or other profit level) to be used as the basis of comparison between the taxpayer and any potential benchmarks, need to be reconciled and the basis of such reconciliation adequately documented.

322. Where it is not possible, in applying the RP method, to find independent enterprises selling comparable property in a comparable market the process of selecting the general type of product or broadening further into other product types should be documented. In particular, taxpayers need to concentrate their documentation on the process undertaken to ensure that there is functional comparability and, where differences occur, make quantifiable adjustments.

323. The end result of RP method is to have available documentary evidence of the decision making process. How a controlled party arrives at an arm's length gross profit margin which compensates it for the performance of its functions, the coverage of its investment in assets and risks assumed in providing those functions, should be clearly documented.

324. As stated in paragraph 107 of TR 95/D22, a methodology which adopts a margin which is calculated as a certain percentage of the resale price (for the purpose of determining the appropriate transfer

price), where the percentage chosen is not benchmarked against comparable independent dealings, is not a resale price methodology.

325. Where such a methodology has to be used in cases where no other approach is reasonably open, the taxpayer should:

(a) document the rationale for the selection of this methodology including reasons for its use in preference to other arm's length methodologies; and

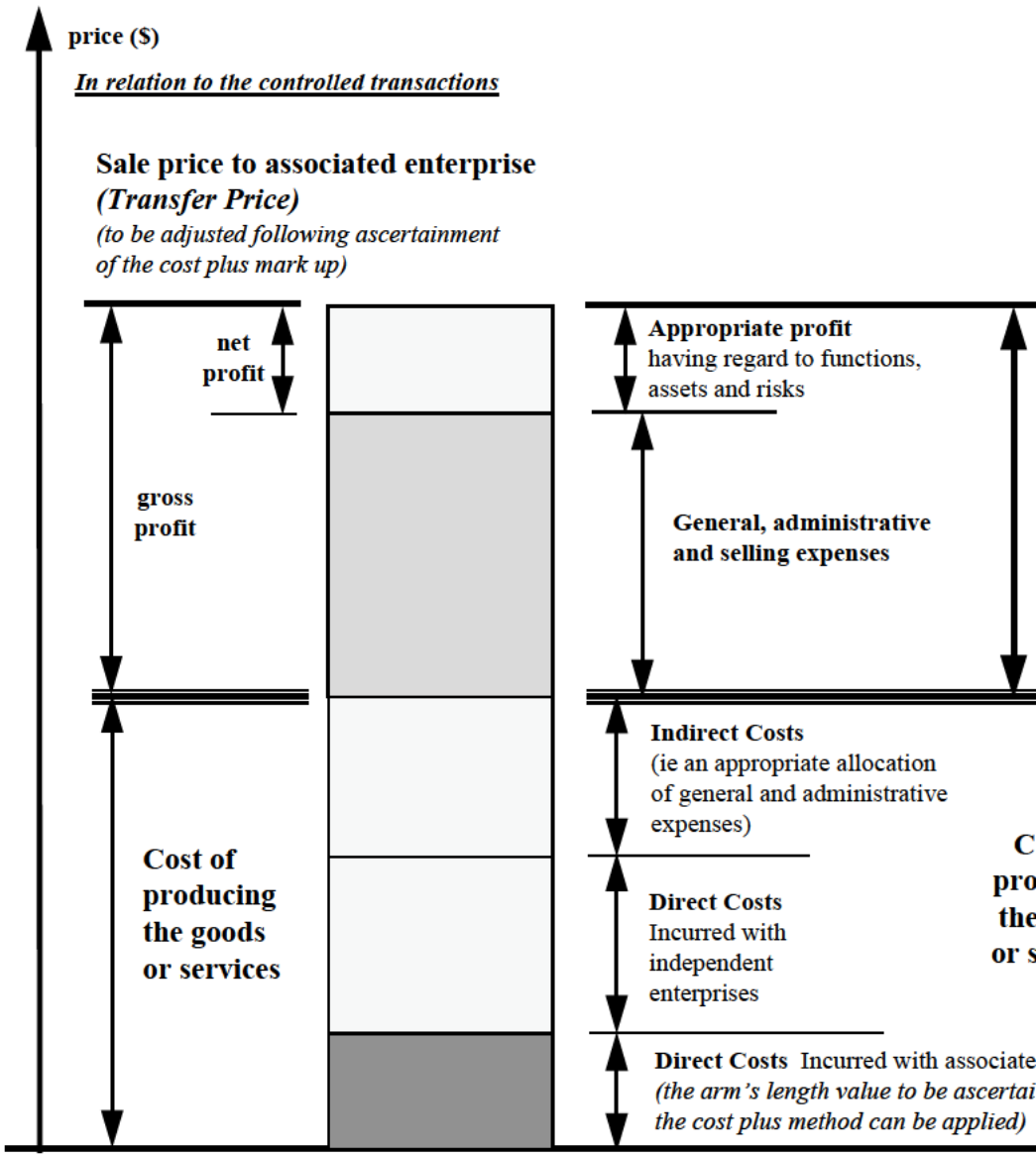
(b) document how the fixed percentage has been calculated to produce a result that fairly reflects the functions performed, assets employed and risks undertaken (the intention always being to reasonably approximate an appropriate return for the economic value added).

***Documentation relevant to applying a cost plus methodology***

326. The Cost Plus Methodology ('CP method') is explained at paragraphs 363 to 365 of TR 94/14, paragraphs 110 to 128 of TR 95/D22 and paragraphs 2.32 to 2.48 of the 1995 OECD Report. The cost plus ('CP') method also focuses on functional comparability and so, as with RP method, the adequate documentation of the analysis of functions, assets and risks of the enterprise and the comparable parties is of prime importance.

327. The following diagram broadly illustrates the cost plus methodology.

**Cost Plus Method**




*Documenting the determination of costs when using the cost plus method*

328. Determination of the costs involved in controlled transactions (to which the arm's length gross margin will be applied) may in most cases present few documentation difficulties for taxpayers as the relevant costs will generally be able to be equated to the calculation of cost of goods sold used for the trading stock provisions of the ITAA, or deductible cost for service providers. In most cases relevant expenditure will have been incurred in Australia in dealings with independent enterprises (for example, the cost of direct labour and

direct materials) and the documentation relevant to these arm's length dealings would be documents created in the ordinary course of business. The relevant cost base will normally include a proportion of indirect costs and the calculations and method of apportionment of those costs should be documented. In most cases this documentation will also be created in the ordinary course of business.

329. There may however be occasions, for example where purchases of direct materials used in manufactured products are made from associated enterprises, where questions would arise as to whether the expenditure incurred in relation to such acquisitions were at arm's length prices. In these cases, and before such costs were incorporated into the value of costs for the purposes of the cost plus methodology, an analysis would need to be undertaken and documented to ascertain what an arm's length price for the associated enterprise acquisitions would be.

*Documenting the choice of an arm's length gross margin for the cost plus method*

330. The arm's length gross margin is intended to cover an appropriate portion of expenses incurred below the line including general, administrative and selling expenses and to allow an appropriate profit to be earned having regard to the functions undertaken, assets employed and risks borne by the manufacturing entity / service provider. Many of the costs which the margin is designed to cover are also incurred in Australia to arm's length parties and as with the case of ascertaining the cost of the relevant controlled transactions, the documentation in relation to such transactions would constitute documents created in the ordinary course of business.

331. The below the line costs will need to be apportioned between the controlled transactions and the other business activities of the taxpayer on an appropriate basis. The basis of allocation used would need to be documented and retained by the taxpayer.

332. Many taxpayers also have transactions with associated enterprises other than just in relation to the controlled transactions under review which may effect the above the line or below the line costs of the controlled transactions. The nature of such transactions and whether they are on an arm's length basis would be relevant to determining comparability between the controlled transactions and the comparable independent dealings. An analysis of these other dealings between associated enterprises and documentation thereof would therefore be necessary.

333. As stated in paragraph 124 of TR 95/D22, a methodology which applies a fixed percentage mark-up to a relevant cost base where the

percentage chosen is not benchmarked against comparable independent dealings is not a cost plus methodology.

334. Where such a methodology has to be used in cases where no other approach is reasonably open, the taxpayer should:

(a) document the rationale for the selection of this methodology including reasons for its use in preference to other arm's length methodologies; and

(b) document how the fixed percentage has been calculated to produce a result that fairly reflects the functions performed, assets employed and risks undertaken (the intention always being to reasonably approximate an appropriate return for the economic value added).

### *Documentation relevant to applying a profit split methodology*

335. The nature of profit splits and their application are discussed in TR 95/D22 at paragraphs 136 to 155. As acknowledged in paragraph 451 of that Ruling, a possible difficulty in attempting to undertake a profit split is obtaining the required information from foreign enterprises or tax administrations so that the combined profit can be determined. The types of documentation that will need to be created in such circumstances depends on the type of profit split effected and whether the profit split is conducted with a narrow focus, that is, at the transactional level, or on a wider scale, involving limited aggregation of dealings or alternatively a profit split conducted on a total aggregation of all associated enterprises international dealings.

#### *Scope of the profit split*

336. Taxpayers will need to document the level at which they seek to split profits. For example, where the split is to be effected at an aggregated transactional level, documentation that explains the rationale for undertaking the split at this level would have to be created. The relationship or nexus between the dealings justifying the aggregation and the combined profit that emerges from the dealings should also be adequately documented. Any direct and indirect costs and an appropriate proportion of general administrative and selling expenses associated with the dealings together with a proportion of the general organisational costs not specifically attributable, would need to be identified and the basis of such allocation be fully explained.

337. Conversely, where there exists a range of dealings between associated enterprises which should be the subject of aggregation in accordance with the principles outlined in TR 95/D22 (paragraphs 48 to 52 and 305 to 312), yet the taxpayer has selected an isolated

transaction as the basis of the profit split, then the reasons for this approach need to be documented. In such cases a well documented functional analysis will assist the taxpayer and the ATO to place the dealings and the taxpayer's decision to implement a profit split at a particular level into their proper context.

*Functional analysis*

338. Regardless of the level at which a profit split is conducted or the types of profit splits employed, a functional analysis will be required. The purpose of such an analysis is to identify the significant economic contributors to profit of the respective parties to the dealing. The types of documentation required for such an exercise has been previously discussed in this Ruling at paragraphs 250 to 256. It must be emphasised that, in order to assess effectively the basis on which profits are to be split, a adequately documented and consistently applied functional analysis needs to be in place for all parties to the dealings (including associated enterprises based overseas). This will require sufficient documentation to be created so as to enable the Australian taxpayer (and the ATO) to understand the business of the foreign enterprise/s to the dealing. In such circumstances discussions on the four step process and documentation relevant to the various steps would provide some assistance.

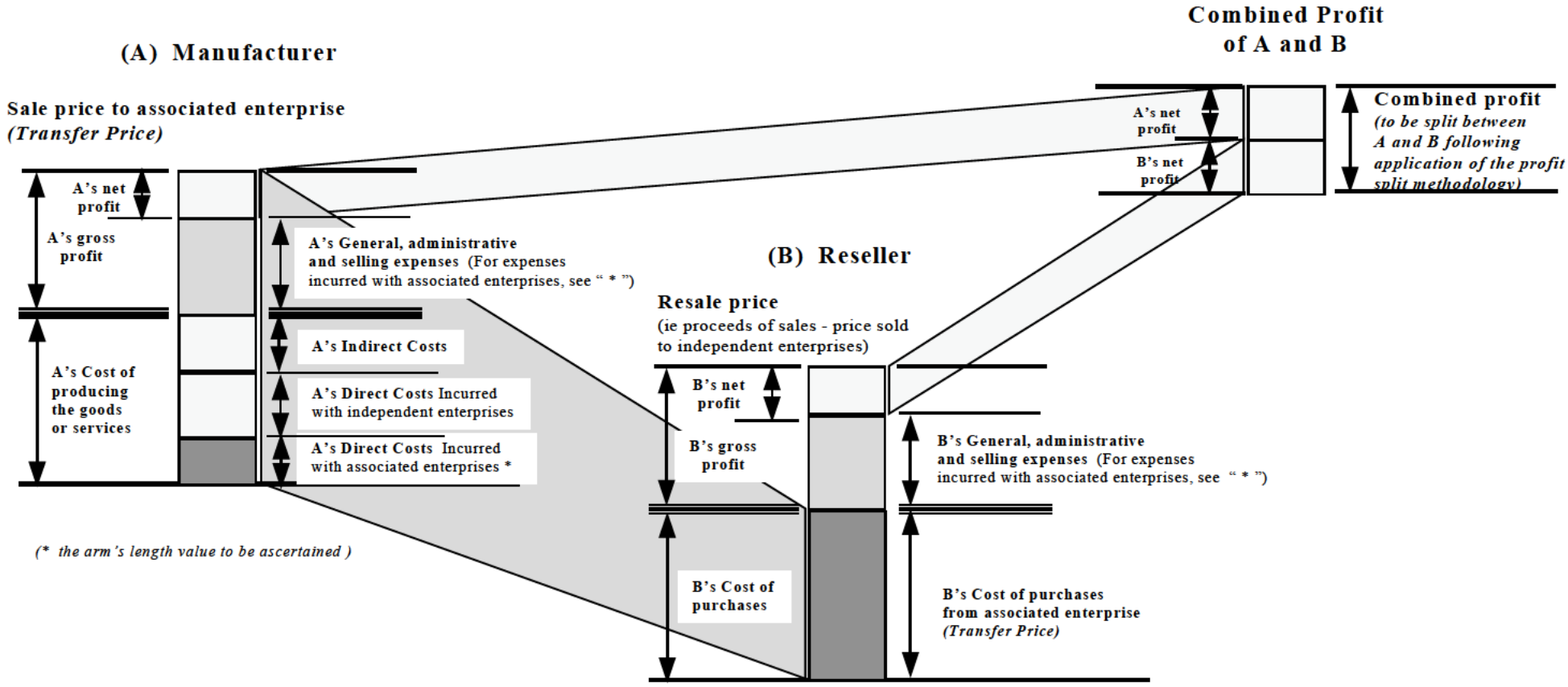
*Ascertaining the combined profit which is to be split*

339. The combined profits generated by the dealings with associated enterprises, at whatever level, needs to be identified and its basis of calculation adequately documented. Any effects on the calculation of the combined profit to the split attributable to differences in accounting treatment of profit between jurisdictions or to the effects of currency need to be identified, reconciled and the profit to be split equalised as between the taxing jurisdictions involved. This process also needs to be adequately documented.

340. The following diagram illustrates how the combined profit is calculated when the profit split method is applied on a net profit basis.

## Profit Split Method (net profit split)

**Determining the combined profit in relation to the controlled transactions**



341.The level at which the profit (or loss) is to be divided also needs to be identified ie. gross or net profit, and the basis for deciding that a particular level of profit is to be utilised as the basis for the split also needs to be documented.

*Projected profits as the basis for the profit split*

342. The use of projected profits for profit splits is discussed in TR 95/D22 at paragraphs 141 and 452. Documentation that would need to be prepared in contemplating such an approach would include:

(a) the duration of the strategy;

(b) the basis of the profit projections used;

(c) the basis for the methodology to be used in splitting the profit;

(d) costs associated with the strategies and the methodology for allocating these costs between the parties to the dealings; and

(e) an analysis of past profit experience on comparable dealings and how this experience may impact on future profit projections.

343. The basis of such decisions needs to be supported by an adequately documented functional analysis which identifies significant economic contributors to profit by the respective parties to the dealing and allocates values to same.

344. Where the implementation of such a strategy fails to produce profits as anticipated, it is expected that taxpayers will analyse why this is so and make any necessary modifications to the agreement to reflect changes in circumstances and the basis for changes in profit sharing and cost allocation, commensurate with what arm's length parties would do in the same or similar circumstances.

*Documentation issues associated with different types of profit splits*

345. It is considered that the documentation issues raised above concerning the level of profit split, the quantum of the profit to be allocated and the scope of the functional analysis, are common to all types of profit split. This documentation needs to be retained in Australia to enable verification of the integrity of the application of such methodologies by the ATO.

*Additional documentation needed for contribution analysis*

346. As the name implies, the contribution analysis seeks to identify the respective economic contributions to profits by the respective parties to a dealing, and to allocate values to those contributions. Taxpayers would need to document the basis for any allocations of values to any features which contribute to the profit to be split. Taxpayers would need to complete a functional analysis with external benchmarking where possible. This benchmarking would need to be relevant to the markets in which the respective parties are dealing. When completing external benchmarking, taxpayers would need to document the sources of their data and the basis for selecting particular benchmarks. In order to be certain of the comparability of the benchmarks, an analysis of their functions assets and risks would need to be developed and adequately documented. Where differences have a material effect in terms of outcomes and/or functional differences, as between the benchmark selected and the taxpayers own circumstances and outcomes (including differences in the markets in which they operate), then such differences need to be quantified and adjusted for with the basis of the adjustment being adequately documented.

*Additional documentation for a residual profit split*

347. The two stage process described in TR 95/D22 raises documentation issues which closely parallel those described above both generally and in relation to external benchmarking in a contribution analysis.

348. A residual profit split attempts to allocate arm's length returns to the basic functions of the respective party to the dealing thus absorbing part of the profit or loss from the overall transaction. The remaining 'residual' profit or loss is deemed to be attributable to the economic ownership by one or both parties of such items as intangible assets, location savings or special market elements favouring one or other of the parties.

349. The first step of the process will require the documenting of the basic functions that will give rise to the first cut allocation of the overall profit. Values need to allocated to these functions preferably through the use of external comparables. Again, differences having a material effect between benchmark data and the particular circumstances of the respective parties to the dealing need to be quantified and if necessary adjusted for. The process of allocation of the first stage profit split also needs to be documented and the remaining profit or loss identified.

350. The second step requires identification of the elements of the dealing or the assets of the respective parties that gives rise to the remaining profit or loss to be allocated. This methodology also presupposes that these features can be attributed a particular economic value. The basis of any such allocation of values, together with any external benchmarking that is used to determine comparability of any allocation that would occur as between parties dealing at arm's length, would also need to be documented with differences having a material effect identified and appropriate adjustments made.

### *Documentation relevant to applying a profit comparison methodology*

*Introductory comments*

351. The profit comparison method (referred to in the 1995 OECD Report as the 'transactional net margin method') is explained in paragraphs 156 to 172 and 470 to 489 of TR 95/D22 and in paragraphs 3.26 to 3.48 of the 1995 OECD Report. These discussions explain that the profit comparison method ('PCM') is a methodology which begins with a ratio analysis of (generally) the net profit that the taxpayer under examination makes in relation to the controlled transactions relative to an appropriate base. Depending on the facts and circumstances of the particular case, an appropriate base may be the costs involved (e.g., cost of purchases, or general, administrative and selling expenses), the proceeds of sales obtained, the value of the assets employed, etc, relative to the controlled transactions.

352. The most appropriate net profit ratio for the taxpayer under examination (referred to in the 1995 OECD Report as 'the net margin') is then compared with the equivalent ratio (referred to in the 1995 OECD Report as 'the arm's length net margin') that independent enterprises have earned in relation to comparable dealings. On occasions, more than one ratio may be used to check the reliability of the taxpayer's approach as is explained in paragraph 477 of TR 95/D22. PCM cannot be applied on a basis where the only net profit ratios used are those based solely on the internal data of the taxpayer. Application of the methodology in this way does not have regard to the same net profit ratios derived from comparable dealings between independent enterprises and therefore would not be an arm's length methodology.

353. The one-sided approach of PCM (see paragraphs 3.28 and 3.31 of the 1995 OECD Report) can make this method easier to apply than a profit split method in situations where there is insufficient data available from the associated enterprise involved in the controlled transactions to ascertain the amount of the combined profit.

354. As discussed in paragraphs 159 and 474 of TR 95/D22, it is important to ensure that the profit comparison is confined to the net profit from the cross-border dealings with associated enterprises other than in those circumstances where it is appropriate to aggregate particular transactions. It would therefore not be appropriate to apply PCM on the basis of the net profit margin made by the taxpayer under examination on all its transactions whether with associated enterprises or with independent enterprises.

355. Ordinarily, multi-year data for both the taxpayer under examination and the comparable independent enterprises should be used for the purposes of applying PCM (see paragraphs 1.49 - 1.51 and 3.44 of the 1995 OECD Report).

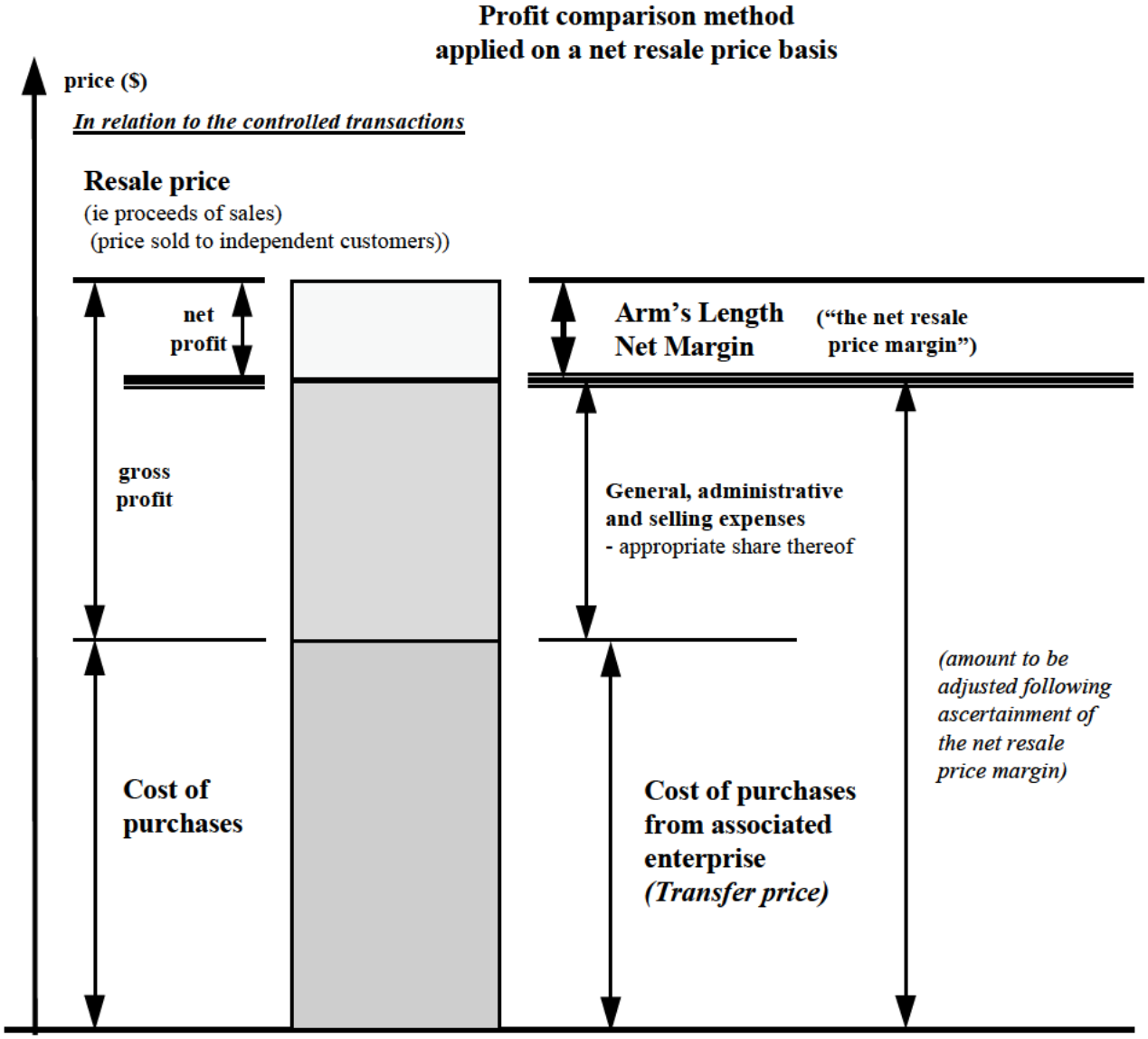
*The reasons for selecting a particular net profit margin need to be documented*

356. When choosing the most appropriate net profit margin to use, it needs to be remembered that the relative usefulness of the various ratios available will depend on the facts and circumstances of each case and the extent and reliability of the data available for benchmarking (see paragraphs 162 to 168 and 477 to 484 of TR 95/D22). When, in cases of last resort, taxpayers use PCM, they should document the factors they had regard to when choosing a particular net profit margin as representing the most appropriate net profit margin in the circumstances of the particular case.

*(i) Comparing PCM and the resale price method*

357. As discussed in paragraphs 95 to 109 and 376 to 399 of TR 95/D22, the resale price method uses a gross margin calculated in relation to the controlled transactions which can be expressed as **the ratio of gross profit to sales**, for the purposes of ascertaining an arm's length price for the transfer of goods or services to the taxpayer under examination from an associated enterprise. By way of comparison, PCM applied on a basis similar to the resale price method (ie a net resale price method) requires a comparison of net margins calculated in relation to the controlled transactions based on **the ratio of net profit to sales**.

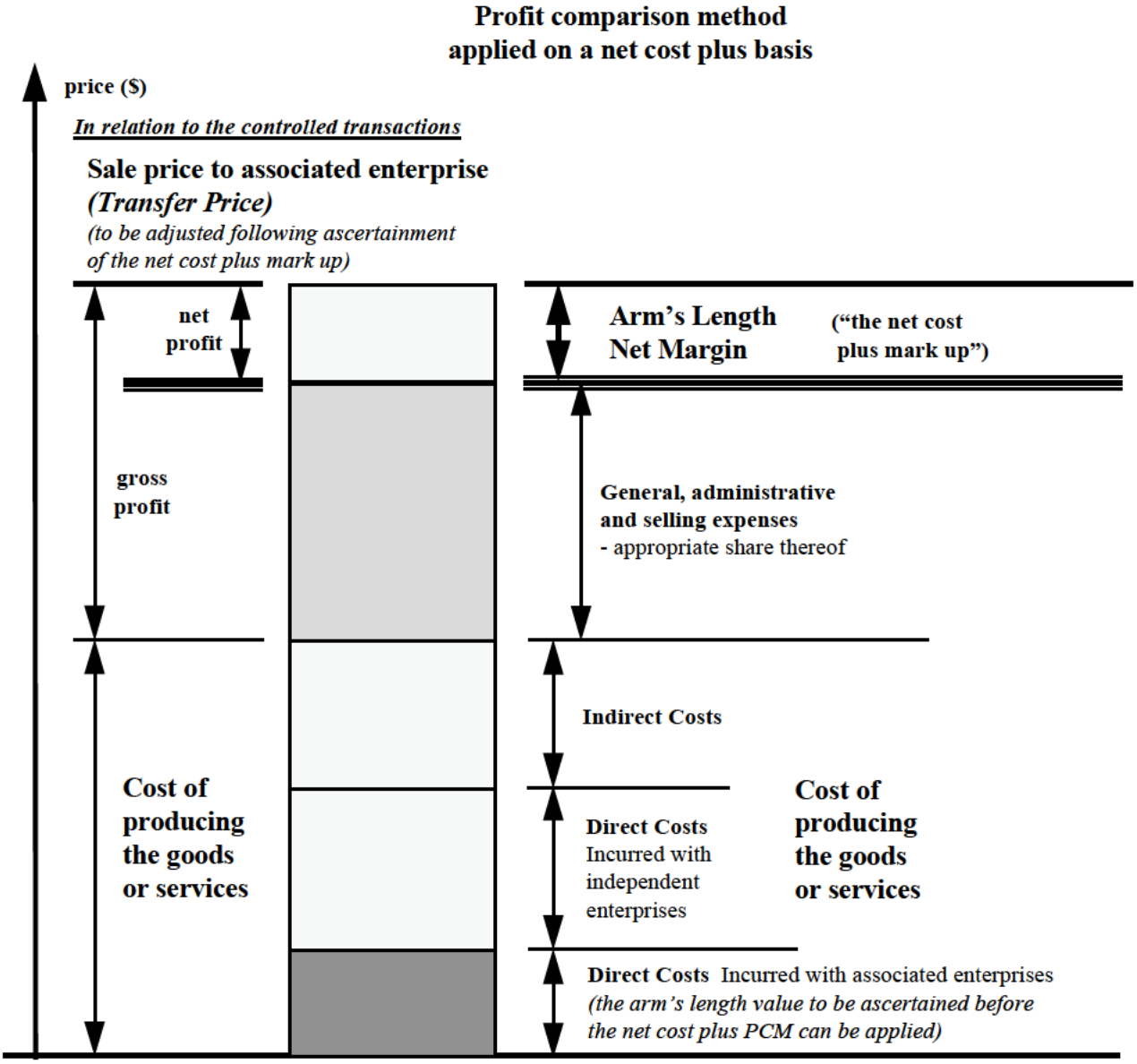
358. The following diagram broadly illustrates PCM being applied on a net resale price basis.




*(ii) Comparing PCM and the cost plus method*

359. As also discussed in paragraphs 110 to 128 and 402 to 434 of TR 95/D22, the cost plus method uses a gross margin calculated in relation to the controlled transactions which can be expressed as **the ratio of gross profit to the cost of producing the goods or services**, for the purposes of ascertaining an arm's length price for the transfer of goods or services from the taxpayer under examination to an associated enterprise. By way of comparison, PCM applied on a basis similar to the cost plus method (ie a net cost plus method) requires a comparison of net margins calculated in relation to the controlled transactions based on **the ratio of net profit to the cost of producing the goods or services**.

360. The following diagram broadly illustrates PCM being applied on a net cost plus basis.




*Net profit ratios need to be calculated on a consistent basis and supported by relevant documentation*

361. Once the most appropriate net profit ratio has been selected, having had regard to the particular facts and circumstances of the case and to the availability of comparable independent data, there is a need to ensure that a valid comparison of the selected net profit ratio for the taxpayer can be made with the same net profit ratio obtained from comparable dealings between independent enterprises to enable benchmarking to occur. The special need to establish comparability in

relation to the net profit ratios used when applying PCM arises chiefly for two reasons.

362. First, as indicated in paragraphs 3.34 - 3.39 of the 1995 OECD Report, for the purposes of establishing comparability, there is a need to have regard to forces operating in the particular industry and to competitive advantage. In this respect, paragraph 3.39 of the 1995 OECD Report states:

> 'Thus where differences in the characteristics of the enterprises being compared have a material effect on the net margins being used, it would not be appropriate to apply the transactional net margin method without making adjustments for such differences.'

363. A second reason is the need to ensure accounting and measurement consistency in relation to the application of the selected net profit ratio. In this respect, paragraph 3.40 of the 1995 OECD Report states:

> 'The net margins must be measured consistently between the associated enterprise and the independent enterprise. In addition, there may be differences in the treatment across enterprises of operating expenses and non-operating expenses affecting the net margins such as depreciation and reserves or provisions that would need to be accounted for in order to achieve reliable comparability.'

364. Taxpayers therefore need to ensure that appropriate adjustments are made to the amounts calculated for net profit and the relevant base being used (in the selected net profit ratio) in respect of the taxpayer and/or the comparable independent enterprises so that comparability can be established for the purpose of comparing net profit ratios. Any adjustments made by the taxpayer for this purpose would need to be documented.

365. When using PCM on a net cost plus basis, documentation showing how the relevant amount for costs was ascertained would need to kept. In addition, the calculations and supporting reasoning used to apportion indirect costs in relation to the controlled transactions in respect of both the cost of purchases and an appropriate portion of general, administrative and selling expenses should be documented. In this respect, reference should be made to the discussion in TR 95/D22 on '**Acceptable bases for apportionment of indirect costs**' at paragraphs 115 to 120 and 412 to 419.

**Does the application of the methodology give a commercially realistic outcome?**

366. A decision on whether to proceed to a full review of the terms or pricing of international dealings between associated enterprises will be made by the ATO having regard to relevant circumstances. One relevant circumstance is whether the outcome of the taxpayer's pricing process yields a commercially realistic result. In this regard, taxpayers should expect that the outcomes of their pricing processes are likely to be subject to some checking by the ATO at an early stage in any review. Refer to paragraphs 162 to 167, 205 to 208, 477 to 483 and 540 to 544 of TR 95/D22 for relevant ratios which may be used to compare performance levels against industry averages.

367. For example, if a taxpayer has well documented processes in place for determination of its transfer prices with associated enterprises for tax purposes and yet consistently returns losses or profits significantly below industry averages over time, it may be expected that the ATO will make further enquiries beyond just a review of processes.

368. Where a taxpayer consistently returns losses over a period of time (irrespective of industry averages), the taxpayer's pricing outcomes could be expected to be subject to detailed analysis on the basis that commercial reality would necessitate outcomes which reflected an adequate rate of return on capital invested having regard to the functions undertaken, assets used and risks being borne (reference should also be made to the discussion in **Part 2** of this Ruling in relation to '**Sustained losses**'). Paragraph 166 of TR 94/14 provides guidance in this respect on how the arm's length principle would apply in such circumstances, when it poses the question:

> 'what would a reasonable business person do in the circumstances of the taxpayer in order to protect and advance their own economic interest?'

369. In making further enquiries on the basis of outcomes not being commercially realistic, the ATO would initially look to whether the outcomes could reasonably be explained by reference to the taxpayer's business and marketing strategies, or to market factors which may have affected other taxpayers operating in the relevant market and distorted the outcome. Reference should also be made to the discussion in **Part 2** of this Ruling.

**The risk of a transfer pricing adjustment**

370. As stated in paragraph 213 of this Ruling, the ATO will commence a review of a taxpayer's transfer pricing by analysing the process established and documentation kept by the taxpayer in relation

to its international dealings with associated enterprises. An important, but not the sole, aspect of the ATO's general approach is to confirm that the taxpayer's process is supported by relevant and adequate contemporaneous documentation to enable the pricing of dealings with associated enterprises to be effectively reviewed by the ATO (see the discussion at paragraphs 365 to 367 above). Where relevant and adequate contemporaneous documentation is not available, or where as stated in paragraph 366, there is documentation but the result of the pricing process between the associated enterprises does not give a commercially realistic outcome, the ATO may proceed beyond a review of process to a more detailed transfer pricing audit.

371. The extent of further enquiries will also be dependent on the level of perceived risk. A factor which may affect the level of risk is the availability of relevant information, particularly information available to a taxpayer in respect of comparable consideration or profits. Representations have been made to the ATO that, in the reality of business life, there are many situations where comparable pricing information is inadequate or unavailable. It is accepted that availability of information may impose a constraint on a taxpayer in selecting and applying an appropriate arm's length pricing methodology in some circumstances. It is the ATO view that taxpayers making full use of available information in considering the application of the arm's length principle, and adequately documenting that consideration, will increase their chances of achieving an arm's length outcome and reduce the risk of a transfer pricing adjustment by the ATO. However, no guarantee or undertaking can be given that such an adjustment will **never** be made.

372. Several points may, however, be made in relation to this situation. First, the more thorough an enterprise's processes are for ensuring compliance with the arm's length principle and the documentation of that process, the less likely the enterprise is to be exposed to a transfer pricing adjustment. Moreover, any transfer pricing adjustment is likely to be smaller than would be the case if the taxpayer had not attempted to comply with the arm's length principle. Also, the higher the standard of taxpayers' processes, the more likely it will be that they will be regarded as having acted with reasonable care or can demonstrate that they have a reasonably arguable position for the purposes of the penalties provisions (see also paragraphs 176 to 182 above).

373. Secondly, such cases are more likely to arise where the taxpayer has access to limited data but the ATO has access to more detailed or refined data. The arm's length principle depends on an analysis of the taxpayer's behaviour against the benchmark of what an independent business person would do in the same or similar circumstances if acting independently. This is an objective test and it does not depend

on whether the taxpayer has access to sufficient information. The underlying legislative policy is to ensure that the right amount of Australian tax is paid for the economic value added by the taxpayer in Australia (see also paragraphs 12 and 154 of TR 94/14). This policy would be defeated where taxpayers were able to prevent corrective action in circumstances where they may have had limited access to adequate relevant information.

374. Accordingly, transfer pricing adjustments may still need to be made where an ATO audit shows that the outcome of a taxpayer's international dealings with associated enterprises differs from an arm's length outcome.

375. In the event that a transfer pricing audit is commenced, we will develop our own analysis of the controlled transactions having regard to comparable dealings between independent enterprises in accordance with the arm's length principle. The results of such an analysis will then be compared with the taxpayer's results. Where such a comparison indicates that a difference exists which is not minor or marginal, which cannot be explained by reference to an arm's length range of outcomes or by commercially realistic business strategies, then there exists a real risk of a transfer pricing adjustment being made to the taxpayer's assessment. The next section discusses in broad terms the nature and type of enquiries that the ATO may undertake in developing its own analysis.

### How the ATO reviews compliance with the arm's length principle

376. The following discussion indicates in broad terms how the ATO may go about reviewing compliance with the arm's length principle. The procedures and processes described are not meant to be prescriptive and it should not be assumed that all of them will be applied in every case. The discussion does, however, give some perspective of the nature and type of enquiries that could be undertaken by the ATO when reviewing the terms or pricing outcomes of a taxpayer's international dealings with associated enterprises for the purposes of establishing compliance with the arm's length principle.

377. A process similar to the four step process discussed in paragraphs 239 to 282 above would generally be followed by the ATO for the purposes of reviewing a taxpayer's compliance with the arm's length principle. This can be briefly summarised as follows:

(a) Step 1: understand the business of the taxpayer, and conduct a preliminary analysis of functions, assets and risks;

(b) Step 2: broadly assess the availability of data on comparable independent transactions and enterprises, and select the most appropriate method;

(c) Step 3: collect more detailed data to supplement the analysis commenced in the earlier steps; and

(d) Step 4: determine the arm's length consideration.

378. In the first place, it can be expected that the ATO will acquire a good knowledge of the business of the enterprise. Without attempting to be exhaustive, the ways in which the ATO may acquire a broad understanding of the enterprise, its structure and business and determining its competitive advantage may include:

(a) examining the worldwide structure of the MNE group to which the taxpayer belongs to establish the roles played by the taxpayer and the associated enterprise(s);

(b) interviewing a selection of the taxpayer's staff to establish functions performed, assets employed, and risks borne. Staff interviewed will normally include operational and managerial staff as well as finance and accounting staff;

(c) testing the taxpayer's pricing process, if any, and ascertaining its, skills base, and competitors;

(d) ascertaining in broad terms any comparable uncontrolled dealings, the assets employed and risks borne by any comparable uncontrolled enterprises. This would normally be refined as part of a comparability analysis; and

(e) examining the documents outlining the enterprise's strategic direction, pricing documentation and marketing strategies and examining the documentation for specific international transactions, where necessary. This will also include an examination of all arrangements with associated enterprises and the interrelationship of those arrangements. Performance reports may also be examined to isolate any products or services that warrant particular attention.

379. It should be noted that some of the above information may have been sought during the initial review of the enterprise's documented processes. Whether, and how much, of this information is collected during the initial process review stage will depend on the facts and circumstances of the particular case.

380. In selecting the most appropriate arm's length methodology the ATO may also consult with:

(a) technical advisers and international experts;

(b) economists, market and industry experts and experts on the relevant law.

381. The ATO would generally also conduct sufficient enquiries to:

(a) identify comparable dealings, products or services, business segments and/or enterprises; and

(b) obtain information on the operation of an industry and the taxpayer's functions in dealing with suppliers, customers, joint venturers and industry bodies.

(See also the section titled the '**Collection, use of and access to third party data**', particularly paragraphs 427 to 432).

382. It may not be necessary to perform all of the above enquiries in every case, particularly in respect of smaller enterprises or where the international dealings cover only a small proportion of an enterprise's overall business activities. In general, the ATO approach will be based on an application of appropriate resources to the areas of perceived greatest risk.

383. The Commissioner has a statutory obligation to ensure there is compliance with the arm's length principle. In doing so, the ATO will make reasonable attempts to obtain the necessary data through informal approaches. However, delays and frustrations to this process may mean that the ATO will have to take more formal steps in order to obtain sufficient relevant information within a reasonable time frame.

384. Where the ATO needs to make enquiries to develop its own analysis, or test what a taxpayer has done, this could include the use of some or all of the following:

(a) section 263 of the ITAA;

(b) section 264 of the ITAA;

(c) the Exchange of Information Articles of Australia's DTAs;

(d) section 264A of the ITAA (offshore information notices); or

(e) simultaneous tax examinations by Australia and a relevant DTA partner (Paragraphs 4.84 to 4.93 of the 1995 OECD Report discusses the concept and use of simultaneous tax examinations).

385. Paragraphs 111 to 113 and 387 to 389 of TR 94/14 also discuss issues associated with the ATO gaining access to relevant information. A more detailed discussion of this issue is also provided in this Ruling in the section titled '**Access to information**' at paragraphs 401 to 471.

**Is the ATO view different from the taxpayer's?**

386. Where an ATO audit of a taxpayer's international dealings with associated enterprises gives rise to a prima facie view being held by the ATO that a transfer pricing adjustment should be made in relation to the taxpayer, we will advise the taxpayer, usually in writing, of the result of our enquiries.

387. The Commissioner, having general power of administration of the ITAA, is required to exercise his statutory discretions to ensure that taxpayers lodge correct returns. When lodging tax returns, taxpayers will need to have regard to the arm's length principle as a feature of all aspects of their international dealings with associated enterprises including transfer prices, withholding taxes and other conditions which may impact on their profitability in Australia. Where taxpayers have not done this and Australian tax has been underpaid, the Commissioner can make appropriate adjustments or impose penalties on taxpayers.

388. Accordingly, adjustments by the ATO to correct a misallocation of income or expenses in the case of international dealings between associated enterprise will generally be made when a review of a taxpayer's pricing outcomes reveals a material difference between those outcomes and an arm's length outcome. A material difference in the sense used here is one which is sufficiently significant in dollar terms to make and which is not minor or marginal (cf paragraph 1.68 of the 1995 OECD Report), which cannot be explained by reference to an arm's length range, or by commercially realistic business strategies. It is not used in the sense of an external auditor for the purposes of the *Corporations Law* forming a view on whether financial information is properly stated in all material respects.

389. Representations have been made to us that where a taxpayer has selected and applied a methodology for the purpose of setting the terms or prices of its international dealings with associated enterprises, the ATO should be precluded from adopting some other methodology as part of a transfer pricing audit of a taxpayer. This view is not agreed with. In general, the ATO will give appropriate regard to methodologies selected and applied by taxpayers, but as stated in paragraphs 87 and 344 of TR 94/14, the Commissioner is under no obligation to accept the particular method chosen by companies

unless, on an objective analysis, it produces the most accurate calculation of the arm's length consideration in the particular case.

390. Representations have also been made that where a taxpayer has implemented a process under which the taxpayer has a reasonable expectation that the resultant price will be an arm's length price, and that such a reasonable expectation will arise if the taxpayer's process for setting a transfer price is about as likely as not to establish an arm's length price, there should be no scope for the ATO to dispute the price set by the taxpayer. It is suggested that this interpretation flows from the definition of 'arm's length consideration' in paragraphs 136AA(3)(c) and (d) of the ITAA and is broadly consistent with each of the Associated Enterprises Articles under Australia's DTAs.

391. There are a number of reasons why this view is not accepted. In the first place, the suggestion is predicated on the basis of the taxpayer forming its own view as to what is a suitable process to give rise to a reasonable expectation that its process is about as likely as not to establish an arm's length price. Such an approach is based on the subjective view of the taxpayer and is inconsistent with the objective nature of the definition of arm's length consideration. If such a position was accepted, it would allow taxpayers to assert that any process they had established would conclusively establish compliance with the arm's length principle and prevent the review of the processes and outcomes by the ATO.

392. The term 'arm's length consideration' in Division 13 is modelled on the arm's length principle, which also forms the foundation of the Associated Enterprises Articles of Australia's DTAs. This principle is modelled on notions of comparison and predication about what independent parties dealing at arm's length might reasonably be expected to have done in the taxpayer's situation. This necessarily involves that consideration be given to the outcome of the dealing and is not confined to an examination of a taxpayer's process (refer to paragraphs 54 and 289 of TR 94/14).

393. The inclusion of the terms 'might reasonably be expected' in paragraphs 136AA(3)(c) and (d) of the ITAA, and 'might be expected' in the Associated Enterprises Articles of Australia's DTAs provides some latitude in interpretation and, in appropriate circumstances, allows for the possibility of a range of arm's length outcomes, but it does not reduce the application of the arm's length principle to a question of probability (see paragraphs 73, 74, 322 and 323 of TR 94/14).

394. A reasonable expectation has been generally interpreted to require more than a possibility. Thus, in considering the meaning of 'might reasonably be expected' in the context of Part IVA of the ITAA, the High Court in *FC of T v. Peabody* (1994) 181 CLR 359 at 385

noted the decision of the New South Wales Supreme Court in *Dunn v. Shapowloff* [1978] 2 NSWLR 235 at 249 per Mahoney JA and said:

> 'A reasonable expectation requires more than a possibility. It involves a prediction as to events which would have taken place if the relevant scheme had not been entered into or carried out and the prediction must be sufficiently reliable for it to be regarded as reasonable.'

395. It is the ATO view that the context in which the terms 'might reasonably be expected' appearing in Division 13, and 'might be expected' appearing in the Associated Enterprises Articles of Australia's DTAs do not allow the conclusion to be drawn that a taxpayer's pricing outcomes should be 'about as likely as not' to be correct for them to be accepted as arm's length consideration.

396. Secondly, Division 13 and Australia's DTAs give the Commissioner a statutory obligation to determine on an objective basis whether the terms or prices of a taxpayer's international dealings with associated enterprises are on an arm's length basis, and to adjust such outcomes to an arm's length outcome where this is not the case. This is necessary to give effect to the legislative purpose underlying Division 13 and the Associated Enterprises Articles of Australia's DTAs which is to be able to counter non-arm's length transfer pricing or international profit shifting arrangements in order to protect the Australian revenue.

397. The need for the Commissioner to make transfer pricing adjustments in appropriate cases cannot be precluded because a taxpayer holds the view that its price setting process is about as likely as not to establish an arm's length outcome. Where the ATO is of the view that an arm's length outcome has not been established, an appropriate adjustment under Division 13 or Australia's DTAs will need to be made (also see the discussion on '**The risk of a transfer pricing adjustment**' at paragraphs 369 to 374 above).

398. In this regard, it is noted that the ATO position is consistent with the view expressed at paragraph 1.3 of the 1995 OECD Report, where it is said:

> 'When transfer pricing does not reflect market forces and the arm's length principle, the tax liabilities of the associated enterprises and the tax revenues of the host countries could be distorted. Therefore OECD member countries have agreed that for tax purposes the profits of associated enterprises may be adjusted as necessary to correct any such distortions and thereby ensure that the arm's length principle is satisfied.'

399. Thirdly, the context in which the expressions 'might reasonably be expected' or 'might be expected' appearing respectively in Division

13 or in Australia's DTAs is different to considerations of whether a taxpayer has a reasonably arguable position for penalty purposes. In that case, reasonably arguable position is statutorily defined as one that is 'about as likely as not correct' (subsection 222C(1) of the ITAA). Where the taxpayer has a reasonably arguable position, the penalty provisions only impose a lower penalty rate. This clearly indicates that an amendment is not precluded where the pricing processes are 'about as likely as not' to achieve arm's length pricing. In this regard, reference is made to the comments of Hill J in the Federal Court in *Peabody v. FC of T* (1992) 112 ALR 247 at 256:

> 'These cases indicate what would presumably be, in any event, obvious that the meaning of words such as "reasonable expectation" depend upon the context in which they appear.'

400. This is not to say that the ascertainment of arm's length consideration or profit is a precise science and cases need to be approached by taxpayers and ATO staff with a degree of flexibility and common sense (refer paragraphs 74 and 323 of TR 94/14).

401. This Ruling does not address the largely procedural issues associated with finalising a transfer pricing audit as publicly available guidelines already exist for many of the procedures involved. In this respect, it is noted that there are publicly available guidelines in relation to the conduct of reviews of large business taxpayers which outline procedures adopted by the ATO in finalising such reviews (including transfer pricing reviews).

## Access to information

### *Introduction*

402. In a self-assessment environment, the success of the Australian tax system depends, in part, on the ATO having access to information to enable a review of a taxpayer's taxation affairs and to determine the level of compliance with the tax laws. To this end, the ATO will be relying on the access and information gathering powers of sections 263, 264 and 264A of the ITAA to obtain sufficient information to review a taxpayer's level of compliance with the arm's length principle.

403. This part of the Ruling addresses a number of issues related to the ATO's powers to access information or documentation and the taxpayer's rights of access to information collected by the ATO. It should be emphasised that this part of the Ruling discusses access in the context of a transfer pricing review or audit and does not discuss the access issue in its broader sense.

404. It should be noted that while this Ruling discusses use of the Commissioner's statutory powers of access to obtain information from taxpayers and third parties, collection of this information may be achieved through a number of means, ranging from informal agreement between the ATO and the taxpayer or third parties for supply of the information to use of formal notices requiring production of documentation and supply of information. The discussion on ATO access in this part of the Ruling encompasses all of the above means of provision of information.

405. This part of the Ruling contains a detailed discussion on collection, use of and access to third party data. In this Ruling, the term 'third party data' refers to information, documentation and all forms of records obtained or sought to be obtained by the ATO from parties other than the specific taxpayer under transfer pricing review or audit.

406. The OECD sees the voluntary production of documents by taxpayers as a means of facilitating examinations and the resolution of transfer pricing issues and improving the persuasiveness of a taxpayer's approach to transfer pricing (refer to paragraphs 5.28 and 5.29 of the 1995 OECD Report).

407. It is therefore considered to be in the interests of taxpayers to provide as much documentation as possible which demonstrates its consideration and application of the arm's length principle in setting and reviewing prices between associated enterprises. There are real advantages to the taxpayer in making this information available to the ATO at the earliest opportunity.

### *Access to documentation held by an associated enterprise*

408. The Commissioner has a statutory obligation to ensure there is compliance with the arm's length principle. To avoid undue delays in this process, it would be prudent business management for taxpayers to ensure all the associated enterprise documentation necessary to support their transfer pricing policies is readily available.

409. While section 262A of the ITAA does not require taxpayers to actually store the records they have kept for the purpose of complying with the requirements of section 262A in Australia, there is a requirement for the taxpayer to be able to make those records available in Australia. It would be reasonable to expect that such records would then be made available to the ATO when requested.

410. The expectation that such documentation will be made available in a timely manner is reflected in paragraph 5.5 of the 1995 OECD Report:

> 'Because the tax administration's ultimate interest would be satisfied if the necessary documents were submitted in a timely manner when requested by the tax administration in the course of an examination, the document storage process should be subject to the taxpayer's discretion.'

411. In respect of information which is not in the taxpayer's possession or under its control (although regard should be had to the comments in paragraph 408 above), the ATO accepts the view expressed by the OECD in paragraph 5.10 of the 1995 OECD Report:

> 'Tax administrations further should not require taxpayers to produce documents that are not in the actual possession or control of the taxpayer or otherwise reasonably available, e.g., information that cannot be legally obtained, that is not actually available to the taxpayer because it is confidential to the taxpayer's competitor or because it is unpublished and cannot be obtained by normal enquiry or market data.'

412. Where the ATO needs to make enquiries to develop its own analysis, or test what a taxpayer has done, normally enquiries involving associated enterprises will initially be made to the Australian enterprise. However, depending upon the circumstances that exist at the time (e.g., undue delays or poor co-operation), other steps may have to be taken including having recourse to the statutory access provisions discussed in paragraphs 382 and 383 of this Ruling.

### *Section 264A of the ITAA*

413. This provision was inserted into the ITAA to overcome difficulties the ATO was having in getting timely access to information held offshore. A feature of section 264A is the evidentiary sanction in cases where the taxpayer does not comply with a section 264A notice.

414. The use of offshore information notices is a standard part of audit procedures for international audits, although its exercise requires judgment as to whether other approaches will enable all the relevant information to be obtained within a reasonable time frame. The notice may be used at any stage during an audit. Examples of where the issue of a section 264A notice should be considered are set out in paragraphs 111 to 113 and 387 to 389 of TR 94/14.

### *Exchange of information*

415. Each of Australia's DTAs incorporates an Exchange of Information ('EoI') Article which provides for the exchange of information between the treaty partners for purposes consistent with

the purpose of the DTA. In the context of a transfer pricing review or audit, the ATO may seek information from a treaty partner under EoI where this facilitates the process of reviewing a taxpayer's compliance with the arm's length principle.

416. The use of EoI Articles contained in Australia's DTAs is not necessarily a 'last resort' approach. The 1995 OECD Report at paragraph 5.29 states:

> 'Taxpayers should be forthcoming with relevant information in their possession, and tax administrations should recognise that they can avail themselves of Exchange of Information Articles in certain cases so that less need be asked of the taxpayer in the context of an examination.'

417. However, in an attempt to avoid unnecessary delays in finalising transfer pricing audits, the ATO will normally, in the first instance, seek information from the taxpayer in respect of any offshore information. It is also pointed out that it is not always possible for the ATO to obtain such information from treaty partners due to the operation of specific EoI Articles contained in particular DTAs. Also, administrative practices differ between treaty partners in the extent to which information is provided under their treaties. Such exchanges may be limited by the domestic laws of one or more of the treaty partners. For this reason, the ATO will seek taxpayer co-operation in the supply of offshore data to ensure all relevant documentation is considered in order to achieve a proper outcome in the application of the arm's length principle.

418. Information obtained under the provisions of Australia's DTAs is generally secret and will be released only to the extent that such release is permitted under the terms of the specific treaty and by law. This position is supported by the judgment of Wilcox J of the Federal Court of Australia in *Nestle Australia v. Federal Commissioner of Taxation* (1986) 67 ALR 128 at 134. Although discovery of a number of documents had previously been granted, an important issue in this case surrounded the Commissioner's claim for privilege on the basis of public interest immunity regarding some specific documents containing information supplied in confidence by various foreign governments. It was held that privilege did apply in such a case because to permit disclosure of the documents would contravene the understanding reached by Australia with the various foreign governments and would be contrary to the interests of Australia.

419. This position is also supported by the New Zealand Court of Appeal decision in *C of IR v E R Squibb & Sons (NZ) Ltd* (1992) 14 NZTC 9146; (1992) 17 TRNZ 97 where a New Zealand taxpayer was prevented from obtaining access to information provided to the New

Zealand Commissioner of Inland Revenue by the ATO under the then existing Australia/New Zealand DTA. In that case it was held that:

> '(T)here was no justification in the language, scheme or purpose of para 2 for diluting the confidentiality obligations under the Article and requiring information exchanged in confidence to be released in pre trial discovery to a litigant in judicial proceedings. To do so would contravene the understanding reached with the Commonwealth of Australia and would be contrary to the well-grounded express objection of the Australian Tax Office.'

***Access to documents (accountants' advice papers guidelines)***

420. The ATO's general right of access to documents is subject to the common law doctrine of legal professional privilege. For example, guidelines have been issued by the ATO setting out the procedures to be followed by ATO staff when seeking access to documents held on lawyers premises which may be subject to claims of legal professional privilege ('*Access to Lawyers Premises*').

421. The ATO has also issued guidelines governing the exercise of access and information gathering powers to certain accountants' papers titled '*Access to Professional Accounting Advisors' Papers*' (accountants' advice papers guidelines). The guidelines are an administrative concession voluntarily adopted by the Commissioner to respect as far as practicable accountant-client confidentiality. They apply only to documents prepared by external professional accounting advisors who are independent of the taxpayer and grant to certain categories of advice papers and opinions a similar level of protection as legal advisors' papers (although unlike legal professional privilege, this is not a form of protection which can be enforced in law). Access to documents categorised as 'non-source' and 'restricted source' is restricted in the first instance, and these documents can only be obtained by ATO staff by following the procedures outlined in the guidelines.

422. It is envisaged that, in a review of a taxpayer's transfer pricing policies, most documents discussed in this ruling would fall into the category of 'source' documents to which the Commissioner can exercise his right of access without restriction under the guidelines. In the case of 'restricted source' and 'non-source' documents, auditors will observe the procedures outlined in the guidelines.

423. In reviewing a taxpayer's transfer prices to determine whether they have complied with the arm's length principle, the ATO will be focusing on the processes and procedures adopted by the taxpayer and, ultimately, whether the taxpayer's outcomes are arm's length. Initially,

the ATO's objective will be to assess the taxpayer's level of risk. All documents which evidence that a taxpayer has addressed the question of whether their transfer pricing policies comply with the arm's length principle, including documents prepared in connection with the analysis, selection, application and review of a methodology, will therefore assist the ATO in assigning a level of risk to a taxpayer.

424. Accordingly, while the relevant documents could fall into categories which afford them some form of restricted access, it may be in the taxpayer's interest to facilitate these reviews by providing timely access to documents which will assist in demonstrating that their transfer pricing is appropriate for tax purposes.

425. Where access to such documents is denied in reliance upon the guidelines, the ATO will consider the facts and circumstances of the case and will assess the taxpayer's level of risk based on the documentation available for review. The practical implications of withholding such documents may mean that conclusions about the taxpayer's processes and procedures cannot be made. This may result in the ATO assigning a higher level of risk to the taxpayer and could also lead to a more detailed review of the taxpayer's international dealings with associated enterprises.

426. Where the ATO undertakes a more detailed review, by way of a transfer pricing audit, documents which are relevant to the ascertainment of arm's length outcomes will be equally relevant at this stage. It will again be in the taxpayer's interest to provide the documents as early as possible.

### *Collection, use of and access to third party data by the ATO*

*Introduction*

427. For the purposes of testing compliance with the arm's length principle in relation to a taxpayer's international dealings with associated enterprises, the ATO has stated that it will use the methodology which provides the highest practicable degree of comparability with the dealings of independent enterprises in the same or similar circumstances (see also paragraphs 86 to 88 and 343 to 348 of TR 94/14). This may require the Commissioner to compare and analyse such factors as products and markets, business strategies and distribution networks of comparable, independent enterprises.

428. The process of testing compliance with the arm's length principle invariably requires an analysis by the ATO that focuses on particular functions, assets and risks relative to the particular taxpayer and the relevant associated enterprise(s), and compares the results of this analysis across a range of industries or specific industry groups in order to identify comparables. The testing process may need to cover

industry and economic cycles and enquiries therefore may have to cover a number of relevant businesses and years.

429. Testing compliance with the arm's length principle also requires access to and analysis of third party data for the purposes of identifying comparable independent enterprises and for benchmarking. The purpose of such enquiries is the acquisition of documentation and information having a direct bearing on the discharge of the Commissioner's statutory obligation to establish what is the arm's length outcome in a particular case. The legislative authority for the ATO making third party enquiries can be found in the Commissioner's general powers of access in sections 263 and 264 of the ITAA and under the EoI Articles of Australia's DTAs.

430. The ATO may conduct third party enquiries through written questionnaires, surveys and interviews or any combination of these. Such enquiries will be aimed at establishing the characteristics of the third party's business, its strategies, operational framework and the risks peculiar to its business for the purpose of identifying comparables and achieving as high a level of comparability as possible with the controlled dealings of the taxpayer under review. The use of questionnaires/surveys by the ATO is a valid form of information gathering and will be used in appropriate cases having regard to the relative size of the entities and/or the complexity of the issues involved.

431. Subject to the requirements imposed by enactment of the arm's length principle into the law, the ATO will seek, as much as possible, to utilise data already available to it through taxpayer information and/or the publicly available sources utilised internally. When it is considered that external enquiries are necessary to properly test international dealings between associated enterprises, or to clarify and expand upon internal data used as independent benchmarks, such enquiries will be made. The ATO will also seek to avoid unnecessary duplication of enquiries.

432. The ATO will ordinarily need to access third party data in cases where it is necessary to go further than an examination of a taxpayer's documented processes. These will generally be in those higher risk categories outlined and ranked (1) to (4) in the ATO's risk ranking at paragraph 237 of this Ruling where:

(a) taxpayers have made little or no attempt to adequately document their transfer pricing policy;

(b) there is insufficient data available to determine what the arm's length consideration should be; or

(c) attempts to establish and implement a process have been made but the outcome is not commercially

realistic. In such cases the ATO will utilise whatever information is available to determine arm's length consideration or profit.

*Use of non-publicly available data by the ATO*

433. The ATO possesses a range of information which can provide various performance indicators across a variety of industries. This data includes information extracted from tax returns and other enquiries and databases. It also includes information obtained from publicly available databases. The data available can be modified to provide a broad based analysis of outcomes across industries, or alternatively can be more highly focused taking in specific groups or even individual taxpayers.

434. The use of broad industry data including average figures and financial ratios may act as pointers to what an arm's length dealing might be. Alternatively, in the absence of more detailed data about comparable arm's length dealings, this information could form the basis of a determination by the Commissioner under subsection 136AD(4) of the ITAA to deem an arm's length amount (cf *Gamini Bus Co Ltd v. Commissioner of Income Tax (Colombo)* [1952] AC 571 at 578 - 581). As stated in paragraphs 82, 83, 338 and 339 of TR 94/14, any such determination would have to be supported by sufficient relevant information to demonstrate that an informed and reasonable decision has been reached in the circumstances of the case.

435. Representations have been made that the ATO should be restricted to using only publicly available data which was reasonably available to taxpayers at the time transfer prices were set in determining the arm's length consideration or profit. Such a suggestion has implications for the way in which the Commissioner discharges his statutory obligations to apply, as far as practicable, the arm's length principle in transfer pricing examinations. It would seem by enacting such a provision into the law, that Parliament intended the ATO to use data about comparable independent transactions in the benchmarking process.

436. The aim is to achieve the highest practicable degree of comparability. This outcome cannot be achieved where the ATO voluntarily restricts itself to particular sources of data. The public policy intention of the anti-avoidance provisions in ensuring that Australia receives its fair share of tax must also be taken into consideration.

437. We agree with the view of Richardson J in *C of IR v. E R Squibb & Sons (NZ) Ltd*, which in our view is equally applicable in an Australian context, where he said at NZTC 9159:

> 'In discharging the obligation to see that every taxpayer is assessed to tax the Commissioner cannot always and simply rely on the taxpayer's returns. The Commissioner must often have regard to any other sources of information including data derived from the records of other taxpayers or third parties.'

438. In utilising third party data, however, the ATO recognises that:

(a) third party data requires close scrutiny to ensure comparability;

(b) taxpayers are not always in a position to obtain sufficient competitor's information, particularly in relation to pricing data;

(c) the information may not have been available to taxpayers at the time the transfer price was established. Taxpayers do not have the benefit of hindsight (although periodic reviews can and should be undertaken); and

(d) the secrecy provisions in the Act may prevent the ATO from disclosing the third party data to taxpayers.

439. However, as determination of the arm's length consideration is not an exact science, the ATO is of the view that it would be unrealistic not to utilise **all** information available to it. The enactment of the arm's length principle into Australian laws imposes certain statutory requirements on taxpayers and on the Commissioner. The taxpayer's statutory requirements are discussed at paragraphs 18 to 23 of this Ruling. Central to the application of the arm's length principle is the concept of comparability. Comparability is extensively discussed in TR 95/D22.

440. In examining the rationale for such comparisons in the context of the arm's length principle, the OECD has said at paragraph 1.15 of the 1995 OECD Report:

> 'Application of the arm's length principle is generally based on a comparison of the conditions in a controlled transaction with the conditions in transactions between independent enterprises. In order for such comparisons to be useful, the economically relevant characteristics of the situations being compared must be sufficiently comparable.'

441. In view of the above considerations, the ATO rejects the suggestion that it should be limited to publicly available third party information.

*Taxpayer access to ATO databases*

442. Representations have been made that the ATO should make available generalised and broadly based pricing/profit data to assist taxpayers in determining whether their international dealings with associated enterprises achieve arm's length outcomes. It is the ATO's view that the value of this type of information, maintained by the ATO for taxpayers to use, would be limited. Apart from issues associated with the administrative costs of maintaining such a database, there are a number of concerns with such a proposal, including:

(a) **The historical nature of the data**. This may impose limitations on the use of the database given economic cycles and the fact that taxpayers are required to make decisions about pricing and methodologies at the time of entering into their associated enterprise dealings with reference to current market conditions;

(b) **Concerns about secrecy and confidentiality**. To protect the integrity of the source of the information, any database could only provide, at best, aggregated information. The process of aggregation may distort the relevance of the information and minimise its value as a benchmark against what is arm's length.

(c) **Aggregated figures may not assist taxpayers in particular cases**. The type of broad based data which could be made available may provide an indicator of generalised outcomes but lacks the detail to enable taxpayers to make judgements about the individual circumstances of particular cases.

443. As previously stated, it is the ATO's view that there is an onus on both the Commissioner and taxpayers to attempt to achieve the highest practicable degree of comparability in the course of setting or reviewing transfer prices in particular cases. A generalised database lacks the elements of focused comparability envisaged by the law and embodied in the arm's length principle. Accordingly, it is not proposed to develop a database for general taxpayer use. In any event, some of this information is already accessible from various publicly available sources.

*In what circumstances will the ATO limit its access to third party data?*

444. In the context of initial reviews, the ATO will generally restrict its access to broad type data and to documentation created or obtained by the taxpayer in support of its processes. Broad third party data

includes data available from both public sources and any sources internal to the ATO, but excludes the high level comparability analysis necessary if a full review of the taxpayers' transfer pricing policies and outcomes was necessary.

445. Where a taxpayer has minimised the risk of a transfer pricing audit by placing itself in a 'low risk' or 'low-medium risk' category in the ATO's risk ranking (see paragraph 237 of this Ruling), the ATO will generally limit its enquiries, in the context of initial reviews, in accordance with the flow chart at paragraph 214 of this Ruling. Where the taxpayer's documented process leads to it falling into one of these two categories of risk and the process gives rise to a commercially realistic outcome, the ATO would generally not need to access high level detailed third party data at the initial review stage.

### *Taxpayer access to third party data*

*Public policy considerations*

446. All information obtained by the ATO, either internally or from third parties, which relate to the taxation affairs of taxpayers, is protected by section 16 of the ITAA, exclusions to the *Freedom of Information Act 1982* ('the FOI Act') and, in some cases, by the provisions of the *Privacy Act 1988*.

447. Subsection 16(2) of the ITAA contains the general prohibition against divulging information about taxpayers' affairs obtained during the course of ATO enquiries. Other subsections of the provision allow for limited release of such information in a variety of circumstances. This includes release of information to a court (subsection 16(3)) or to the Administrative Appeals Tribunal (paragraphs 16(4)(b) and (c)). The effect of section 16 on the release of third party data is discussed in more detail below.

448. Richardson J in *C of IR v. E R Squibb & Sons (NZ) Ltd* at 14 NZTC 9159, discussed two public interest considerations underlying the New Zealand income tax legislation which call for the use by the Commissioner of third party information and require that the identity of the third parties not be disclosed to the litigant taxpayer. Both of the public interest considerations referred to by Richardson J are equally applicable in an Australian context. Richardson J described these as:

> 'One is the public interest in the Commissioner's continuing ability to have resort to third party taxpayer information as an important independent source of objective material from which to carry out independent investigations to verify the correctness of returns of taxpayers and, where appropriate, to make re-

> assessment. The other is the public interest in ensuring that the Department will preserve the secrecy of taxpayer's affairs.'

449. There is also Australian judicial support for this position in the judgement of Wilcox J of the Federal Court of Australia in *Nestle Australia v. Federal Commissioner of Taxation* 86 ATC 4499 at 4504; (1986) 67 ALR 128 at 134. After inspecting the documents claimed by the ATO to be privileged, Wilcox J concluded that:

> '(T)he claim for immunity is, in my opinion, generally well founded...It is not difficult to see that disclosure of this information to Nestle might commercially disadvantage the company supplying the information.'

450. The ATO recognises its obligations to protect the interests of parties providing commercially sensitive information to us, particularly where the release of such sensitive data may adversely affect the interests of the third parties. It can also be expected that the ATO will take steps to promote the view that commercially sensitive information should not be released to taxpayers because such information is subject to privilege based on grounds of public interest immunity.

*Release under the Freedom of Information Act*

451. Two provisions of the FOI Act, section 38 and subsection 43(1), are especially relevant to whether third party information can be released to taxpayers.

452. Section 38 of the FOI Act provides that a right of access to documents is not granted if there is in force an enactment applying specifically to information of a kind contained in the document and prohibiting persons referred to in the enactment from disclosing information of that kind. Section 16 of the ITAA is a provision of an enactment prohibiting certain persons from disclosing information. The interaction between section 16 of the ITAA and section 38 of the FOI Act was considered in *FCT v. Swiss Aluminium Australia Limited and Ors (No 2)* 86 ATC 4364; (1986) 17 ATR 645 where the Full Federal Court affirmed that section 38 of the FOI Act prevented disclosure of the affairs of another taxpayer where section 16 of the ITAA specifically prohibited the release of such information (per Bowen CJ at ATC 4368, ATR 648.

453. Further, in *Re Mann and FC of T* 87 ATC 2010; (1987) 18 ATR 3671, the Administrative Appeals Tribunal ('the AAT') held that if a document contains third party information about the business affairs of a taxpayer which is protected by section 16 of the ITAA, then to that extent, section 38 of the FOI Act would prevent its disclosure.

454. Information obtained by the ATO under the EoI provisions of Australia's DTAs would also constitute exempt documents for the purposes of section 38 of the FOI Act: *Association of Mouth and Foot Painting Artists Pty Ltd v. FC of T* 87 ATC 2020 at 2028 - 2030; 18 ATR 3800 at 3810 - 3812.

455. Subsection 43(1) of the FOI Act specifically prohibits release of documents which would have the result of disclosing trade secrets, or other valuable commercial information which could be devalued by the release of the information or other documents which reveal the business affairs of a person with adverse consequences. Sub-paragraphs 43(1)(c)(i) and (ii) of the FOI Act were considered by the AAT in *Re Kingston Thoroughbred Horse Stud and the ATO* 86 ATC 2030; (1986) 17 ATR 62 and in *Re Briggs (No 1) and the ATO* 86 ATC 2034. The Tribunal held that these provisions preclude release of information about the business affairs of a third party where it could reasonably be inferred that such release would adversely impact upon the lawful business affairs of that person.

456. The concern of Parliament to balance the interests of persons providing commercially sensitive information with the interests of persons wishing to legitimately pursue their legal rights to documents pursuant to the FOI Act are apparent in section 27 of the FOI Act. This provision operates in conjunction with the exemption in section 43 of the FOI Act.

457. The scheme of section 27 requires a decision maker dealing with a request which is likely to cover commercially sensitive data provided by a third party to advise that party about the freedom of information request, where it is apparent to the decision maker that any documents covered by the request could reasonably be contended to be exempted from production under section 43 of the FOI Act. The effect of the mechanisms within section 27, is to allow the third party to make submissions to the decision maker about whether such exemptions apply to the documents and for the decision maker or agency to rule on such submissions.

458. In summary, it may be expected that requests under the FOI Act for access to information of the above type obtained by the ATO and used in determining arm's length consideration or profit will not be successful.

*Release as part of tribunal or court hearings*

459. In its decision in *Mobil Oil Australia Ltd v. The Commissioner of Taxation* (1962-1963) 113 CLR 475, the majority of the High Court agreed that nothing in section 16 precluded an officer, with the authority of the Commissioner, to communicate any information to a

Board of Review (Dixon CJ, McTiernan and Taylor JJ). On the other hand, Kitto J said that in his view, an officer may be in breach of section 16 in revealing the affairs of another taxpayer to a tribunal unless specifically required by that Tribunal to make such a disclosure. This is a very fine distinction, one which turns on whether the exclusions to section 16 operate of their own force or require specific compulsion by a tribunal.

460. In his judgment, Kitto J reflects on the problems arising in such cases (the former Division 13) where the conflicting interests of various parties to the proceedings may arise, including those parties providing information to the Commissioner, in good faith, in order for the Commissioner to properly exercise his statutory obligations and the interests of taxpayers who have the right to know the case against them. The problems inherent in applying principles of natural justice equitably to all parties are highlighted in the following passage from his judgment at pages 501-502.

> 'These answers, I realise, fall far short of solving the whole of the Board's problems; indeed they only throw into relief the central difficulty. The Board, or at least the Chairman, is faced with the necessity of deciding as part of the handling of the reference whether to allow the taxpayer's representatives to know what information respecting the affairs of other persons is before the Board and is likely to be taken into consideration against the taxpayer. It is generally true, as the Court observed in *Sutton v The Commissioner of Taxation* (1959) 100 CLR 518, at p 524 that natural justice requires that the taxpayer shall know the course that is taken and what is placed before the Board; *but the Court was not there deciding as a matter of law that the Board is bound to disclose to the taxpayer every scrap of material that it takes into consideration*. A decision that the Board is so bound in a case under s.136 would involve two steps, first that the nature of the Board's function in such a case is (to use a convenient though inexact expression) quasi judicial, and secondly that the general proposition stated in *Sutton's case* is absolute, or at least applies without qualification to such a case. Unless both steps are to be taken, the Board has an unfettered discretion as to what it will and what it will not disclose to the taxpayer; and while its sense of fairness will no doubt lead it to make what disclosure it considers can reasonably be made it will have to decide in relation to particular pieces or classes of evidence, as a matter of purely discretionary judgment, whether and to what extent considerations of fairness *to other people* and the readily understandable and highly important policy which is reflected in s.16 should deter it from

> doing all that natural justice might otherwise suggest' (emphasis added).

461. This balancing of interests is still relevant today to applications for review under the *Administrative Appeals Tribunal Act 1975* ('the AAT Act'). This Act also allows for parties who are potentially affected by decisions of the Tribunal to be joined to the proceedings (section 27 of the AAT Act).

462. Kitto J's observations highlight that the policy considerations that underpin section 16 may lead a tribunal to interpret rules of natural justice more narrowly. This part of his judgment suggests that, in such cases, where the interests of other parties may be affected, the exceptions to the prohibitions under section 16, as it relates to release of information to courts or tribunals, may not be treated as absolute. This means that a taxpayer's right to know the case it has to answer does not override other considerations, including privacy and confidentiality that should be afforded to commercially sensitive third party data or where the interests of third parties may be affected.

463. The ATO is aware of concerns regarding the release of commercially sensitive information to competitors. This aspect was recently considered in *Consolidated Press Holding Limited & Ors v. FC of T & Anor* 95 ATC 4231; (1995) 30 ATR 390 in the Federal Court by Lockhart J who stated:

> 'In the long run the duty of the Commissioner to accord procedural fairness to the applicants is directly referable to the proper administration of the Act because it is not conducive to the confidence of taxpayers if highly sensitive and important information about their finances and affairs may be revealed to persons or bodies outside the ATO...'

464. It may be inferred from the above that the public policy considerations which saw the introduction of the secrecy provisions into the ITAA and the specific exclusions to the FOI Act discussed above, establish in general terms the parameters of the Commissioner's administrative approach in this sensitive area. These parameters find their general expression in Kitto J's judgment in the *Mobil* case and were considered in the specific context of the exclusions to the prohibition found in section 16, by Lockhart J in *Consolidated Press Holding Limited v. FC of T*.

465. The ATO recognises its obligations to protect the interests of parties providing commercially sensitive information, particularly where the release of such sensitive data may adversely affect their interests. To that end, the ATO will advise such parties of the potential use of the information in any forum which may require public release of the data. In these proceedings, it will ultimately be

the decision of the court or tribunal what information is released and what form this release takes. However, it can be expected that the ATO will take steps to promote the view that natural justice extends to the providers of information to the ATO as well as taxpayers affected by the use of that data.

466. It may also be expected that the ATO will, in any proceedings, seek to protect the secrecy and confidentiality of commercially sensitive third party data. In any such proceedings, the ATO will seek ways in which all parties' interests can be promoted in accordance with the principles outlined by the judgment of Kitto J in the *Mobil* decision. The release of third party data by the ATO, even when the company names have been deleted, is not acceptable if the possibility of identification exists.

*Equity considerations*

467. The ATO acknowledges the obligations placed on taxpayers under the self assessment regime. To that end, and to encourage future compliance, the ATO will endeavour to provide as much information to the taxpayer as is permitted by law. However, in view of the constraints imposed by the secrecy provisions and exclusions to the FOI Act outlined above, information obtained from third parties could only be released to a taxpayer the subject of a transfer pricing audit prior to the issue of an assessment where it was impossible to identify individual third parties.

468. With regard to taxpayer access to third party data subsequent to the issue of an assessment where the taxpayer has preserved rights of objection, the ATO will take all steps necessary to seek to preserve the secrecy and confidentiality of the data consistent with the Commissioner's statutory obligations.

469. The ATO recognises the difficulty this presents, particularly in view of the fact that the TAA places on taxpayers the burden of proving that an assessment is excessive.

470. The question of natural justice also arises. In this regard, the interests of the taxpayer needs to be balanced with the ATO's responsibility for ensuring that assessments are consistent with comparable arm's length data and with the interests of the enterprises providing information to the ATO on a bona fide basis. As it is imperative that the secrecy provisions be adhered to, the ATO can only point to existing procedures that provide taxpayers with the opportunity to test any proposed adjustment.

471. As part of the audit process and prior to the raising of assessments, the ATO has introduced various review processes which are designed to assist taxpayers to understand, within the limits of the

law, the case that is being prepared by the ATO and to afford taxpayers the fullest opportunity to present evidence and argument in support of their position. The ATO's internal review process is not an avenue for taxpayers to seek to circumvent legislative provisions designed to protect the privacy of other taxpayers' information or to access commercially sensitive information held by the ATO.

### General industry information and publicly available sources of data

472. This part is aimed at giving taxpayers an indication of ways they may find information that will allow them to gain some confidence that their transfer pricing satisfies the arm's length principle. The discussion is premised on the ATO view that any publicly available databases may not on their own give 'the correct answer'. The many differences affecting taxpayers, including their structure, the markets they operate in, the relevance of intangibles to a taxpayer's business and a multitude of other factors means that taxpayers will need to make adjustments to any data used, to establish comparability with their particular circumstances.

473. Where taxpayers seek to utilise such data and adjust same to suit there particular circumstances, it will still be a requirement to document both the analysis of the information and the basis of any adjustments thereto. Paragraphs 442 and 443 of this Ruling discuss the relative merits of the ATO maintaining a database and publishing pricing and profit data as a means of enabling taxpayers to comply with their statutory obligations. It is felt that the concerns raised in that discussion precludes the ATO providing such a database, excepting those reports which are currently presented to Parliament and consequently published for public information (TAXSTATS).

474. The arm's length principle as embodied into our domestic laws requires a reasoned comparison of what independent enterprises dealing at arm's length in the same or similar circumstances, may have achieved. Many databases provide both aggregated and disaggregated information which, although being generally indicative of trends in a particular industry segment, lack the element of focused comparability on which the arm's length principle is based.

475. This is the strict standard, yet the ATO recognises that it may not be possible for taxpayers to achieve absolute precision in attempting to comply with the arm's length principle which demands the highest practicable degree of comparison, based on the individual circumstances of the case. Accordingly, taxpayers might use publicly available databases in cases where the information they provide gives them a degree of comparability, appropriate to their circumstances.

476. It would not be appropriate to use such data as the sole basis for comparison where, for instance, a taxpayer has comparable uncontrolled dealings which could be used as a benchmark for its controlled dealings or where a taxpayer has specific information about uncontrolled competitors prices or outcomes which enable a more focused and direct comparison to be made. In the event that such directly comparable data exists, taxpayers might still use public databases as a means of checking the validity of their internal information.

### *Determining requirements for publicly available data*

477. Taxpayers will need to make their own commercial judgments about how to mitigate the risk of a transfer pricing adjustment based on their own particular circumstances. Before reaching such a decision taxpayers will have, or should have completed at least a basic assessment of their key functions, the assets utilised in their business and the risks encountered.

478. The way in which a functional analysis is implemented, and the issues surrounding its implementation, are more fully discussed in TR 95/D22 which outlines a four step process for selecting and applying methodologies. TR 95/D22 also highlights that the process of selection and application of methodologies may not necessarily be a sequential one, in that, the 'steps' may be re-traced, different methods considered and tested in light of the business dynamics of an enterprise and the market it operates in. The specific documentation issues pertaining to this process are discussed in paragraphs 239 to 282 above.

479. An extremely important consideration in the selection of a method will be the availability of data about comparable independent dealings. It is expected that, as a part of their selection of a methodology, taxpayers will consider their documentation needs, if necessary outlining their attempts to access and source public data. It is expected that taxpayers' knowledge of their business, the market they are operating in and their competitors within that market, would assist taxpayers to better focus any enquiries made of public databases. Such an approach would enhance the value of any comparisons made pursuant to an analysis of such information.

### *Qualifications to the use of public databases*

480. The limited usefulness of comparisons based on public data have been discussed above at paragraph 326 and these centre around the application of the arm's length principle. Taxpayers will need to have regard to their own particular circumstances in assessing the quality

and the detail of data that is accessed. Many databases tend to provide aggregated data about prices and/or profit outcomes. It is the ATO view that statutory principles require as focused a level of comparison as is possible. Aggregated data may lack such a focus.

481. To obtain a better level of comparability, it may be more appropriate to access information which gives disaggregated results, or prices, based on various business segments or product lines within various industry classifications. A feature of both aggregated and disaggregated databases is that they will contain data about dealings between associated enterprises. This may limit the usefulness of any comparisons based on this data, especially where a particular industry segment is dominated by multinational enterprises which essentially deal intra-group, without significant levels of independent dealings.

482. Many of the public databases provide profit information and other financial ratios such as return on assets and other performance indicators. Yet other databases provide discrete information on commodities and manufactured goods. It may be useful for taxpayers to secure information about both comparable prices and profits within a market segment, and, if possible, focusing enquiries to known competitors. This would enable a 'top' (price) down and a 'bottom' (profit outcome) up approach using discrete sources of information to assess outcomes.

483. A further source of data is published market information. Despite reservations about the usefulness of such information from a safe harbours perspective, information about commodities and financial services could be used as a general indicator which may be used in conjunction with more specifically targeted data sources described above. Taxpayers should consider the ATO's views on the value of such market data (paragraphs 581 to 584 in this Ruling) and the relevance thereof to their particular circumstances.

484. The approaches described above may provide several levels of comparison with external databases. The usefulness of such information may be limited to taxpayers dealing in tangible goods and, perhaps, some dealing with standardised financial products which have a known and published market price.

485. International trade in tangible goods is well documented and maintained by various customs authorities around the world. Much data is gathered on price and volume, globally, and some publicly available databases offer access to this information with data recovery based on the specific needs of individual enquirers. However, dealings in services and intangibles are not well documented and taxpayers may find very limited pricing data in this area. This may impact on the level at which the comparisons can be made, limiting taxpayers to measures of profit performance.

486. The ATO is of the opinion that it would be inappropriate to provide a specific list of publicly available databases in a public binding ruling. Some of the issues considered in arriving at this conclusion are:

(a) it is not ATO policy to endorse any specific product or organisation;

(b) continual technology advancement may result in any databases quickly becoming obsolete;

(c) new databases coming onto the market after the publication of this ruling may be superior to those listed; and

(d) continual update to the Ruling would be needed to accommodate these changes and this would be impractical.

487. Accordingly, although the ATO acknowledges the existence and usefulness of such databases, and points to them as possible sources of comparable data, the ATO must stop short of any endorsement.

488. It has been suggested that the ATO should formulate a checklist, as part of this Ruling, setting out the minimum amount of public data that a taxpayer must take into account in identifying comparables. Such a question may only be answered by applying principles of prudent business management to the facts and circumstances of each case. Such a checklist would not, in our view, be appropriate as the extent of information sought from public databases will depend on several factors including:

(a) the nature of the taxpayer's dealings;

(b) the scale and frequency of the dealings; and

(c) the perceived level of risk from ATO audit activity.

489. Taxpayers will need to have regard to the significance of international dealings (proportionality and quantum) to their overall business and the level of certainty they require in determining the extent to which public databases are used as the sole basis for comparability.

490. To utilise the information provided by public databases as determinative of comparability, and to grant taxpayers what is, effectively, a safe harbour on process, vastly overstates the usefulness of this type of information in the setting and reviewing of transfer prices in accordance with the arm's length principle. Paragraphs 576 to 580 of this Ruling deal with the costs and benefits associated with safe harbours. As highlighted in that part, given the diversity of business in the Australian environment and the varying documentation

needs of taxpayers, it is neither desirable nor realistic from an administrative perspective, to formulate such a checklist.

**Documentation requirements for small business or entities with low levels of international dealings**

491. As stated in paragraph 23, Division 13 and Australia's DTAs form a legislative code requiring taxpayers having international dealings with associated enterprises to comply with the arm's length principle for tax purposes. Subject to the general observations below, this code does not contain special rules for specific classes of taxpayers.

492. Parliament has given the Commissioner the general administration of the anti-profit shifting laws with provisions designed to cover a wide range of circumstances and industries where such activity may arise. There is no provision in the law allowing the Commissioner to administer the law in this area by creating different rules for compliance with that law for different categories of taxpayer.

493. In particular it is felt that the introduction of *de minimus* administrative rules in relation to the documentation keeping requirements of the ITAA to enable smaller taxpayers to keep a lower standard of explanatory material, would contribute to the erosion in the value of the arm's length principle which has broad international acceptance.

494. The Documentation Chapter contained in the 1995 OECD Report does not advocate special rules for taxpayers with relatively low levels of international dealings with associated enterprises. The 1995 OECD Report, however, does countenance a degree of flexibility in the type and extent of documentation created or obtained by taxpayers. The degree of flexibility that is recommended by the OECD is that taxpayers should determine the nature, type and extent of documentation they should keep based on principles of prudent business management (refer paragraph 5.4 of the 1995 OECD Report). As stated in paragraph 154 above, the ATO agrees with this approach.

495. In applying principles of prudent business management, it is the ATO view that the greater the significance of the dealings to the entity's overall business (in terms of quantum and/or proportionality), or the greater the complexity of the dealing, the greater will be the need to create or obtain contemporaneous documentation to explain the basis of the dealing.

496. Accordingly, in applying prudent business management principles, taxpayers with relatively small levels of international dealings in terms of quantum and/or proportionality to the entities

overall business, could reasonably expect that they would not need to create or obtain large amounts of supporting documentation beyond the minimum necessary to establish compliance with the arm's length principle. However, it should be pointed out that this minimum requirement would generally necessitate the creation or obtaining of some supporting documentation in addition to that created by the taxpayer in the ordinary course of business.

497. Without seeking to set down special rules concerning the level and nature of documentation to be created by small enterprises, the following general observations about areas where such taxpayers may rationalise the need for documentation can be made:

(a) **Functional analysis**. Where transactions are narrowly focused, for example, a loan transaction, a lower level comparability analysis, rather than an extensive functional analysis, may be the only requirement (paragraph 261 above). Further, where such dealings are infrequent, or even if frequent the critical assumptions that underlie the analysis do not change, then only a study that documents the ongoing relevance of any such analysis would need to be documented (paragraphs 252 and 272 to 280).

(b) **Benchmarking with publicly available data**. Where small enterprises have international dealings with associated enterprises for which a market price is publicly available, such a price may be a useful indicator of what is arm's length. Subject to qualifications about comparability (paragraph 472) and the fact that market prices do not constitute a safe harbour (paragraph 490), such data may give a degree of comfort in some routine areas such as commodities and financial services but is unlikely to provide reliable indicators in cases involving more complex, interrelated dealings, including dealings involving intangibles (paragraphs 483 to 485).

### *De minimus conclusions*

498. The level of documentation in any case needs to also be considered in the light of the relative complexity of the dealings. The basis of any significant dealings, in terms of proportionality and quantum, needs to be documented. These criteria for assessing the levels of documentation needed, will impact on small taxpayers and large taxpayers alike. Although the extent and form of documentation needed will vary, it can generally be said that all taxpayers dealing

with associated enterprises would need to create or obtain some supporting documentation in addition to that created by the taxpayer in the ordinary course of business.

*Analysis of external benchmarks for small businesses*

499. Paragraphs 472 to 490 of this Ruling deal with sources of publicly available data where taxpayers may find broad indicators of price and performance in certain categories of goods and services. Subject to certain qualifications about the nature of such generalised outcomes in light of the arm's length principle, these sources may provide taxpayers with a degree of comfort about whether their outcomes satisfy the internationally accepted standard.

500. Again the complexity and proportionality criteria will impact on how far taxpayers need to go. Taxpayers would need to determine the level of risk that they wish to operate at in accordance with a commercial judgment based on their own circumstances.

501. It is felt that the circumstances in which a taxpayer will not require at least some level of analysis of external data upon which to base any comparison of its dealings with associated enterprises, would be very limited. Even in cases where internal benchmarks exist, a rudimentary functional analysis combined with an assessment of any external data available about price and/or performance, would provide a greater degree of certainty and a reduced risk of adjustment by the ATO.

*Selection of transfer pricing methodology for small businesses*

502. It is the ATO view that, notwithstanding issues of complexity, proportionality and quantum, and having regard to the legislative code obliging taxpayers to have regard to the arm's length principle for tax purposes, taxpayers should be able to provide documentary evidence of the written materials that they have prepared or referred to indicating the efforts undertaken to comply with the arm's length principle, including the information on which the transfer pricing was based, the factors taken into account, and the method selected. This view is consistent with that expressed by the OECD paragraph 5.4 of the 1995 OECD Report.

503. The basis of a taxpayer's selection of method and the details of how it was applied should be also be documented. Taxpayers would also need to consider and document such issues as the nature and extent of any functional analysis or comparability analysis undertaken, and the data relied upon to enable benchmarking of outcomes emerging from the application of the methodology selected.

# PART TWO

504. This part of the Ruling addresses a number of specific issues relating to transfer pricing. A common feature with all except safe harbours is the need for contemporaneous documentation.

### Considerations when sustained losses are being incurred

505. It is recognised that independent enterprises can sustain genuine losses for a variety of economic and business reasons. It is not, however, accepted that independent enterprises would be prepared to sustain such losses on an indefinite basis without taking appropriate action to return the enterprise to profitability. To do otherwise would be contrary to fundamental business objectives of seeking to achieve an adequate return on the capital invested in the business, taking into account the risks involved (see also paragraphs 66 to 68 and 315 to 318 of TR 94/14 and paragraphs 1.52 - 1.54 of the 1995 OECD Report).

506. Where an enterprise incurs sustained losses in relation to its dealings with associated enterprises there are prima facie, good grounds for questioning the arm's length nature of the associated enterprise dealings. This would be particularly so in the case where the MNE group, of which the taxpayer is a member, was as a whole profitable (cf paragraph 1.52 of the 1995 OECD Report). Ordinarily, it will be very difficult for taxpayers to defend such losses unless it can be demonstrated that this would have been the outcome of comparable dealings between independent enterprises dealing at arm's length in comparable circumstances.

507. Some of the reasons why taxpayer's dealing at arm's length may suffer losses include start-up losses, market penetration strategies, market or product risks, downturns in the business cycle, the emergence of more competition in the market, or unfavourable economic conditions. Irrespective of the reasons concerned, it will be incumbent upon the taxpayer to show that the losses would have been incurred in an arm's length situation.

508. Where an entity is pursuing a business strategy which directly results in, or is contributing to losses, such losses would only be acceptable if the objective of the business strategy was to lead to increased profits within a reasonable period of time. This view is consistent with that stated in paragraph 1.54 of the 1995 OECD Report where it is said:

> 'However, specially low prices should be expected for a limited period only, with the specific object of improving profits in the

longer term. If the pricing strategy continues beyond a reasonable period, a transfer pricing adjustment may be appropriate, particularly where comparable data over several years show that the losses have been incurred for a period longer than that affecting comparable independent enterprises.'

509. In this regard, it would be expected that taxpayers would have created the necessary documentation at the time the relevant transaction/business strategy was being contemplated or implemented in order to show that the pricing accorded with the arm's length principle.

510. This would involve an analysis of the business strategy including such factors as anticipated period of implementation and expected time frame for a return to profitability. Any analysis undertaken by the entity in support of its contention that the business strategy implemented is an arm's length activity which would have been undertaken by an independent entity acting at arm's length, should also be adequately documented. This could include, for example, comparative studies showing:

(a) the period which comparable independent enterprises would be prepared to endure the losses for; or

(b) the prices which independent enterprises dealing at arm's length would have been prepared to sell for in the same or similar circumstances.

511. The ATO will not accept sustained losses resulting principally from transactions with associated enterprises of an MNE group where the MNE group as a whole is profitable and the Australian loss-making entity is not being adequately compensated for the benefits it provides to the MNE group. An independent enterprise would not participate in such an arrangement unless it was receiving adequate compensation for its contribution. In this respect, we agree with the view expressed in paragraph 1.53 of the 1995 OECD Report where it is stated:

'Therefore, one way to approach this type of transfer pricing problem would be to deem the loss enterprise to receive the same type of service charge that an independent enterprise would receive under the arm's length principle.'

**Market penetration strategies**

512. A broad outline of the issues surrounding market penetration strategies was discussed in TR 94/14 (paragraphs 138 to 141 and 445 to 449) and is also discussed in the 1995 OECD Report at paragraphs 1.32 - 1.35. That Ruling and the OECD recognise that such strategies

could be a feature of a market affecting both controlled and uncontrolled parties.

513. Market penetration strategies take many forms, but, essentially, all implement conditions whereby parties to a transaction temporarily agree to the foregoing of profits in return for more substantial profits in the future. So, for example, parties to such a strategy may charge lower prices to gain market share on entering a market. The term 'market penetration strategies' is also used in this Ruling to include market expansion strategies. So, for example, a situation where parties expend higher than usual amounts for advertising or the provision of subsidies to consumers in order to gain market share from a competitor would be included. Both strategies generally have the effect of temporarily reducing profitability for a limited period of time.

514. In order to establish whether a market penetration strategy as between associated enterprises is consistent with the arm's length principle, it will be necessary to establish whether independent enterprises dealing at arm's length in fact have, or would have, accepted the terms and conditions of the strategy in the same or similar market circumstances.

515. Apart from factual issues of how arm's length parties would approach such a strategy in terms of pricing, allocation of costs, or division of profits, other factors which should be considered include:

(a) **Whether, in substance, a market penetration strategy is being pursued**. For example, where price concessions between associated enterprises are a key feature of the market penetration strategy, it would be expected that such discounting would be reflected in the price of products or services to the end user (see also paragraph 141 of TR 94/14 and paragraph 1.34 of the 1995 OECD Report);

(b) **Whether a market penetration strategy is appropriate given the substance of the business relationship between the parties and the nature of the market**. For example, being in a strong market position to supply a valuable product or service for which there is no readily available substitute and for which there is strong demand would not support a discounting strategy;

(c) **Whether the outcomes of the dealings reflect the respective contributions of the parties**. So for example, a supplier of goods or services may agree with a subsidiary that the responsibility (the functions and risks) of developing a market will rest with the

subsidiary. In that case, the risks and rewards associated with the implementation of such a strategy would 'belong' to the subsidiary and the sole undertaking of those risks would ultimately be reflected in the correct allocation of profits that derive from that activity. Another example might be where the above parties shared the risks of such a strategy through a division of the costs of marketing via an agreed formula or the putting into place of off-setting arrangements which would adequately compensate supplier and reseller. On the other hand in arm's length dealings a company acting solely as a sales agent with little or no responsibility for long term market development would not normally bear the cost of a market penetration strategy;

(d) **Whether the arrangement is intended to be in place for a specific and limited period**.

516. Whatever the method of implementation, it is expected that the strategy will reflect the substance of the relationship between the parties.

***Duration of a market penetration strategy***

517. The ATO is reluctant to prescribe how long a market penetration strategy should operate. The terms of the strategy, including timing, will depend on such questions as the features of the market and the product or service which is the subject of the strategy and the extent of the competition in the market. A feature of any such strategy when implemented by parties dealing at arm's length is an expectation based on a reasonable belief that, as a result of foregoing profits in the short term, there is a definable outcome in terms of increased returns in the future, with the aim of recouping original costs associated with the strategy and, further, enhancing future profits.

518. For example, an Australian distributor of a product manufactured by its foreign parent has not been returning a profit for a period in excess of ten years. When subject to an ATO review of its dealings with associated enterprises, the taxpayer claims that it was pursuing a long term market penetration strategy. The distributor appears to bear all the costs and risks associated with the strategy. Its position is not supported by any documentation prepared at the time of implementing the market penetration strategy. It is highly unlikely that the ATO would accept that the taxpayer is pursuing a valid market penetration strategy in such a case.

519. In its recently published revised guidelines, the OECD has outlined what criteria may be used to determine what a reasonable time may be in the following terms (paragraph 1.35 of the 1995 OECD Report):

> 'In determining what period of time an independent enterprise would accept, tax administrations may wish to consider evidence of the commercial strategies evident in the country in which the business strategy is being pursued. *In the end, however, the most important consideration is whether the strategy in question could plausibly be expected to prove profitable within the foreseeable future (while recognising that the strategy might fail), and that a party operating at arm's length would have been prepared to sacrifice profitability for a similar period under such economic circumstances and competitive conditions*' (emphasis added).

520. The ATO also notes a decision of the Federal Finance Court of Germany ('Bundesfinanzhof') (BFH Decision of 17 February 1993) dealing with how long a market penetration strategy could be implemented and still be considered to satisfy the arm's length principle. The court in that case held that, excepting very unusual situations, 'start-up' losses should not exceed three years.

521. The ATO further notes the US Transfer Pricing Regulations in relation to market share strategies which hold that, to be acceptable under the regulations, the strategy must be pursued only for a period of time that is reasonable, taking into consideration the industry and product in question (Reg 1.482-1(d)(4)(i)(B)). The ATO agrees that factors such as the nature of the industry and the features of the product in question are relevant in considering how long independent enterprises dealing at arm's length would accept a market penetration strategy.

522. In determining whether a market penetration strategy is acceptable, the ATO will consider what period an arm's length party, pursuing a similar strategy in a similar market with a comparable product, would consider to be reasonable in the circumstances.

523. Generally, the longer that a market penetration strategy is claimed to be in place and profits are consequently reduced or extinguished, the greater is the presumption that independent parties dealing at arm's length would **not** have entered into such arrangements, and the more difficult it will be to establish, to the satisfaction of the ATO, that such a strategy, and its consequential effect on profits, should be accepted.

### *Documenting a market penetration strategy*

524. The commercial rationale for undertaking a market penetration strategy is premised on a reasoned expectation that the party or parties charged with its implementation will be able to absorb the financial impact of the strategy and return a profit therefrom within a reasonable time. When considering the implementation of such a strategy, taxpayers would need to have regard to the types of issues discussed above, including the duration and anticipated benefits, delivery through price and/or marketing expenditure and product differentiation.

525. Documentation relevant to market penetration strategies can generally be classified into two categories. First, information about the target market and, secondly, information about the strategy itself including formulation, implementation and desired outcomes. There may be other categories and this broad outline is not intended or designed to provide an exhaustive list of what documentation may need to be created.

#### *Information about the target market would need to be documented*

526. The ATO would expect contemporaneous documentation to have been created or obtained which analyses:

(a) the market sought to be penetrated;

(b) the level of penetration sought as a percentage of any existing market;

(c) expected demand for the product or service in this market before, during and after implementation of the strategy;

(d) niche opportunities within that market;

(e) information about competitors in that market including their respective market shares, and information about their products; and

(f) any plans to counter competitors responses to the strategy.

527. The market may be impacted upon by government policies, subsidies and regulations which could affect the nature of the product or service sought to be delivered into that market and its associated costs of production. Any such policy and its effects on profitability and pricing would need to be addressed.

*Information about the strategy would need to be documented*

528. The ATO would also expect taxpayers to prepare or obtain contemporaneous documentation which:

(a) outlines the strategy and its aims including a detailed sales plan;

(b) identifies and quantifies anticipated costs associated with the strategy;

(c) provides reasons for variances where actual sales and costs deviate from plan;

(d) outlines the duration of the strategy, how costs are to be shared and the means of effecting that sharing between the parties to the strategy;

(e) specifies of the benefits that are sought;

(f) identifies the anticipated time it will take to realise the benefits or profits to the respective parties to the strategy; and

(g) provides cost/benefit analysis and cash flow projections clearly indicating the intention for all parties to the strategy to derive increased profit within a reasonable time from the commencement of the market penetration strategy.

529. In addition to factual information about the market being targeted and details of the plan and its method of implementation, it would assist taxpayers to establish the arm's length nature of the conditions which are a feature of the strategy itself by independent benchmarking. Any such comparability studies would need to be adequately documented, either prior to the formulation of the strategy or, at the latest, prior to implementation.

530. If any set-off arrangements are to be put in place to give effect to the strategy, the nature of the documentation created would also have to meet the pre-conditions specified at paragraphs 561 to 565 of this Ruling.

**Marginal costing**

531. An issue which may arise where an Australian taxpayer manufactures goods and sells these goods to an overseas associated enterprise is the use of marginal costing (also known as variable or direct costing) for transfer pricing purposes. This will occur where the taxpayer has only included marginal or direct costs in the cost base in determining the appropriate transfer price.

532. Marginal costing is often used by companies and MNE groups for internal cost accounting purposes and for internal management control purposes. However, its use for the purpose of setting transfer prices on international dealings between associated enterprises for tax purposes, can only be considered as acceptable where pricing on the basis of marginal costs represents an arm's length outcome for the transfer of goods or services into the particular market. As stated in paragraphs 409 to 440 of TR 95/D22, the ATO requires the use of absorption costing where the cost plus method is being used for transfer pricing purposes.

533. The ATO view is that marginal costing would only be acceptable where it can be demonstrated that the same price might reasonably have been expected to have been charged by an independent enterprise dealing at arm's length in comparable circumstances (refer also to paragraph 320 of TR 94/14). This view is consistent with that expressed in the 1995 OECD Report in its discussion on losses at paragraph 1.54, which says:

> 'Further, tax administrations should not accept specially low prices (e.g. pricing at marginal costs in a situation of underemployed production capacities) as arm's length prices unless independent enterprises could be expected to have determined prices in a comparable manner.'

534. In this respect, it is also considered that in an arm's length relationship such a strategy would not be applied other than in relation to short term arrangements and that the 'marginal production' would not represent a significant proportion of the taxpayer's overall production.

535. Representations have been made to the ATO that we should recognise that marginal costing is an appropriate basis for setting transfer prices given that:

(a) Australian industry has a substantial degree of under utilisation of plant facilities because of its relatively low population;

(b) overhead costs may not be fully absorbed against regular domestic sales; and

(c) there is a resulting surplus of overhead costs which may impact on profits

with the result that the impact of this cost surplus may be sought to be alleviated by a number of means including competitively pricing goods into foreign markets by using a marginal cost plus basis for setting export prices.

536. The ATO accepts that on occasions pricing at marginal cost may occur where a taxpayer's manufacturing is not being fully utilised. However, the mere existence of underutilised capacity would not be determinative of the ATO accepting marginal costing as an appropriate basis for setting transfer prices. Other factors which would be taken into account in evaluating a claim that pricing at marginal costs should be accepted as representing an arm's length price have been outlined at paragraph 2.44 of the 1995 OECD Report:

> 'Factors that could be taken into account in evaluating such a claim include information on whether the taxpayer has any other sales of the same or similar products in that particular foreign market, the percentage of the taxpayers production (in both volume and value terms) that the claimed "marginal production" represents, the term of the arrangement and details of the marketing analysis that was undertaken by the taxpayer or MNE group which led to the conclusion that the goods could not be sold at a higher price in that foreign market.'

537. The ATO would take a similar approach to that outlined above by the OECD. The overriding factor which the ATO will have regard to in determining whether a marginal costing pricing strategy represents an arm's length price is whether independent enterprises could have been expected to have set their transfer prices in a comparable manner. For example, the ATO would also have regard to whether there are any sales of the same or similar products in the foreign market by other taxpayers and the relevant price and volume thereof.

538. While it is difficult to provide specific instances where marginal costing would be accepted, a company pricing at marginal cost and actually building new production facilities to manufacture the product (that is, incurring additional fixed costs which they would not be covering from the resultant sales) would not be accepted by the ATO as pricing at arm's length.

539. While recognising that sound commercial reasons may require the temporary adoption of such a business strategy, the ATO considers that arm's length parties would give due consideration to its implementation. Such deliberations would give rise to a plan including, documentation which outlined the basis and rationale for implementing the strategy (including the factors outlined by the OECD in paragraph 536 above), the nature of the costs to be recovered and the anticipated duration of the strategy (including reasons for any extensions or deviations from the planned time frame).

540. The ATO expects that a marginal costing pricing policy would be adequately documented in accordance with the principles outlined in this Ruling and take into account the factors outlined above and any

other relevant factors. Where marginal costing is used in conjunction with other business strategies, such as market penetration, the same types of documents outlined in paragraphs 524 to 530 would need to be created.

**The use and relevance of global price lists**

541. Global pricing may occur in two situations. First, is the case where particular goods or services are sold at a specified price to all purchasers of that good or service on a global basis. Secondly, the policy may be implemented by consistent application of an internationally recognised transfer pricing methodology to all such sales, globally, which will result in the seller achieving a known profit margin. This latter approach is only acceptable if it is distinguishable from formulary methodologies which are discussed at paragraphs 505 to 508 of TR 95/D22.

542. Such pricing policies stem from the nature of an MNE group and its global strategies to maximise profits without necessarily having regard to how that profit should be allocated between the various entities within the group. The pricing strategy may be applied to associated enterprises only, or alternatively, a mix of associated and independent enterprises.

543. Where a global pricing policy is implemented exclusively intra-group, the price set needs to be assessed in accordance with the arm's length principle having regard to whether arm's length parties dealing under the same or similar circumstances would have accepted this price. This will require the impact of such a strategy to be assessed against independent benchmarks. In this respect, the process that the ATO will adopt to review the taxpayer's processes and whether general outcomes parallel those which would operate between independent parties dealing at arm's length in the Australian market, will be the same whether a global pricing policy exists or not.

544. The mere existence of a global pricing policy will not in itself indicate adherence to the arm's length principle. In the case where the global pricing strategy does not incorporate sales to independent enterprises at the same price or where the enterprise has not undertaken an analysis to determine whether outcomes achieved are supportable as arm's length, the ATO will consider the taxpayer as falling into one of the higher risk categories.

545. The situation may be different where a global pricing policy is effected both intra-group and also applied to independent enterprises dealing at arm's length. Such a strategy may be broadly indicative of an arm's length price for the goods or services if the independent enterprise sales are into Australia.

546. The ATO will still need to satisfy itself that the conditions that affect associated and independent enterprises are truly comparable. Such features as the volume of sales, the market conditions, any special conditions affecting the relationship and the contractual terms imposed will need to be considered in determining whether any such independent dealings can constitute a benchmark for associated dealings.

547. Where, for instance, the independent dealings occur in a different market, it will be necessary to determine whether the economic conditions are such as to enable a valid comparison to be made. Some of the circumstances that would need to be documented and quantified in order to make valid comparisons across markets are outlined in the 1995 OECD Report at paragraph 1.30 where it is stated:

> 'Economic circumstances that may be relevant to determining market comparability include the geographic location; the size of the markets; the extent of competition in the markets and the relative competitive positions of the buyers and sellers; the availability or risk of substitute goods and services becoming available; the levels of supply and demand in the market as a whole and in particular regions, if relevant; consumer purchasing power; the nature and extent of government regulation of the market; costs of production, including the costs of land, labour and capital; transport costs; the level of the market, e.g., retail or wholesale; the date and time of transactions; and so forth.'

548. Even where comparisons are sought to be made with benchmarks in the same markets, documentation which establishes the functional comparability (functions, assets and risks) relative to that of independent enterprises which are the subject of the global pricing policy will be required. Where the nature of the functions, assets and risks or the contractual terms under which a potential benchmark operates does differ from that of the associated enterprise seeking to justify the arm's length basis of the pricing, then valid comparisons cannot be made and in the absence of other compensating factors, the price will not be considered to be an arm's length price.

549. For example, an MNE group prices goods according to a price list of $US60 FOB per unit to associated and independent enterprises on a global basis. In Australia, the MNE group has established a subsidiary and several independent sales agents in various major cities to market and on-sell the goods. The sale price of the goods to the Australian subsidiary and the independent sales agents is determined according to the global pricing policy. Volume of sales has no bearing on the price, and no discounts apply. The Australian subsidiary is

responsible for all national advertising and expends significant amounts in developing a marketing strategy and establishing a service division with expert technical staff in each major city in which distribution occurs. The independent sales agents are responsible for local advertising only which they must meet out of their proceeds from sale of the goods.

550. In this example, although the Australian subsidiary and the independent sales agents are broadly comparable in that they each undertake distribution activities, the Australian subsidiary is exposed to significantly greater risks and undertakes other significant functions beyond simply distribution. This would mean that the price to the independent sales agents would not constitute a valid benchmark for comparison, in the absence of other compensating factors. Such compensating factors could include a subsidy to the Australian subsidiary from the MNE group for advertising and marketing costs, a reimbursement by the MNE group of any initial outlay and ongoing costs of maintaining a service division. Such features would place the subsidiary close to or on a par with the sales agents. In such circumstances, the effects of the subsidies would be to shift costs and risks away from the Australian subsidiary thus making a valid comparison possible.

### *Documentation issues surrounding global pricing policies*

551. The existence of a global pricing policy creates certain documentation requirements in dealings between associated enterprises. These requirements apply equally to cases where goods or services are traded exclusively intra-group and to cases where there may be comparable external sales. The general types of documents which need to be created would include:

(a) an analysis of the market they are operating in and whether such terms as the global price and the terms surrounding the supply of goods or services would enable them to return outcomes over the period of the agreement, that is, the impact on their profit expectation in the market represented by the set price; and

(b) an analysis of whether this profit is commensurate with the expectations of parties dealing at arm's length operating under similar conditions and performing similar functions, assets and risks. This will require a functional analysis and benchmarking of their profit expectations against comparable arm's length parties dealing in the same or similar circumstances.

## Set-off arrangements

### *Intentional set-offs*

552. The OECD defines intentional set-offs in the following terms at paragraph 1.60 of the 1995 OECD Report:

> 'An intentional set-off is one that associated enterprises incorporate knowingly into the terms of the controlled transactions. It occurs when one associated enterprise has provided a benefit to another associated enterprise within the group that is balanced to some degree by different benefits received from that enterprise in return. These enterprises may claim that the benefit each has received should be set off against the benefit each has provided as full or part payment for those benefits so that only the net gain or loss (if any) on the transactions needs to be considered for purpose of assessing tax liabilities.'

553. This benefit could relate to contractual terms, timing of payment and interest-free periods, or provisions of other goods and services at no or low cost, as a whole or partial off-set.

554. The ATO accepts that there are occasions when intentional set-offs are used in international trade in dealings between both associated and independent enterprises. The scope and complexity of intentional set-off arrangements vary greatly and may depend on the relative negotiating positions of the parties to the dealings at the time that the agreement is entered into. A feature of such arrangements is that the parties to the agreement may look to an overall outcome from a series of dealings rather than having regard to the implications of individual features of a transaction.

555. So, for example, a producer of manufactured goods may accept a lesser margin on those goods from a purchaser, if the latter undertakes to pay the manufacturer immediately upon sighting a Bill of Lading rather than waiting for a set period after the shipping of goods. Another example might be where a supplier of raw materials accepts a lower price from a manufacturer in return for the supply of finished goods at a price below the manufacturer's normal profit margin above cost.

556. In paragraph 1.61 of the 1995 OECD Report, the OECD highlights potential limitations to recognition of certain arrangements:

> 'Intentional set-offs may vary in size and complexity. Such set-offs may range from a simple balance of two transactions (such as a favourable selling price for manufactured goods in return for a favourable purchase price for the raw material used in

producing the goods) to an arrangement for a general settlement balancing all benefits accruing to both parties over a period. Independent enterprises would be very unlikely to consider the latter type of arrangement unless the benefits could be accurately quantified and the contract created in advance. *Otherwise, independent enterprises normally would prefer to allow their receipts and disbursements to flow independently of each other, taking any profit or loss resulting from normal trading*' (emphasis added).

557. Two inferences can be drawn from the final two sentences. First, there may be some types of set-offs that would not normally be a feature of dealings between independent entities dealing at arm's length, and as a general rule, independent entities deal on the basis of actual cash flows and flows of goods and services, rather than engaging in set-offs. Secondly, arm's length parties would want to know the value of any set-off prior to entering into such an arrangement. The ability to quantify value would be a key feature of arm's length dealings. In any event, the overriding consideration that will govern acceptance by the ATO of set-off arrangements between associated enterprises, is the arm's length principle.

558. In all cases involving claims of an intentional set-off arrangement existing, the ATO will be seeking an answer to the question of what, given the factual circumstances, might reasonably have been expected to have occurred between independent enterprises dealing at arm's length in comparable circumstances.

559. This approach is consistent with that advocated by the OECD. Paragraph 1.62 of the 1995 OECD Report re-states the general principle and highlights the need for specific documentation to evidence consistency with what arm's length outcomes would be.

'Recognition of intentional set-offs does not change the fundamental requirement that for tax purposes the transfer prices for controlled transactions must be consistent with the arm's length principle. It would be helpful for taxpayers to disclose the existence of set-offs intentionally built into two or more transactions between associated enterprises and demonstrate (or acknowledge that they have relevant documentation and have undertaken sufficient analysis to be able to show) that, after taking account of the set-offs, the conditions governing the transactions are consistent with the arm's length principle at the time of filing.'

560. The topic of set-off arrangements is also addressed in the Documentation Chapter of the 1995 OECD Report where at paragraph 5.20 it is stated in the context of companies keeping documentation in

relation to special circumstances which might exist in their dealings with associated enterprises:

> 'Special circumstances would include details concerning any set-off transactions that have an effect on determining the arm's length price. In such a case, documents are useful to help describe the relevant facts, the qualitative connection between the transactions, and the quantification of the set-off.'

### *Qualifications to the acceptance of intentional set-offs*

561. The ATO would generally allow set-off arrangements where all the following pre-conditions are met:

(a) The set-off arrangements are on terms and conditions that would be acceptable to independent enterprises dealing at arm's length;

(b) They occur as an intentional, not coincidental, feature of international dealings between the associated enterprises;

(c) There is a pre-determined strategy which assesses and quantifies the outcomes for the respective parties to the dealings and identifies what the respective benefits and detriments to the individual parties to the transaction are. This will require that the ATO is given access to documentation recording such strategies and outcomes from all parties to the transaction. All such documentation relating to intentional set-offs should be created contemporaneously with or prior to the dealing and retained by the Australian taxpayer;

(d) The set-off arrangement and strategy are fully quantified, measured and tested against any arm's length outcome in comparable circumstances. The methodology used in this process must also be adequately documented; and

(e) Taxpayers should disclose the existence of intentional set-offs built into dealings between associated enterprises by making adjustments to the relevant components of their taxable profits at the time of lodging a tax return and have the necessary documentation to demonstrate that the offsetting amounts are equal in value. Where this documentation is not available the ATO will have no basis on which to allow the 'intentional' set-off.

562. Additional matters which would impact on the acceptance of set-off arrangements by the ATO include:

(a) **Frequency**. Generally, arm's length parties would prefer to deal in terms of 'receipts and disbursements' for goods and services rather than contractual quid pro quos. So, although set-offs are known to occur, they are not normally a regular feature of trade in open market conditions by arm's length parties. If they become a common feature of international dealings between associated enterprises, the ATO and taxpayers may find their quantification difficult because of the lack of external benchmarks;

(b) **Nexus**. Set-off arrangements are usually limited to a particular dealing or series of dealings as between two parties. As such, the set-off is directly related to the subject matter of the contract and does not usually involve other participants beyond the principal contracting parties, or subject matter not covered in the contract. Because of the nexus to the subject matter of the dealing, the contract participants in arm's length situations can readily ascertain the impact that the set-off will have on their overall outcomes before the agreement is acted upon. The greater the complexity of a set-off and the more parties providing or receiving value under such arrangements, the greater the difficulty in documenting and quantifying their effect for purposes of assessing the acceptability of transfer prices. The existence of such complexities will create practical problems for taxpayers wishing to discharge their onus of proof, especially in relation to the ATO requirements for benchmarking;

(c) **Timing**. Outcomes flowing from a set-off arrangement should crystallise within a reasonable period of time of the arrangement being entered into, conforming to the expectation of arm's length parties dealing in comparable circumstances. Set-offs involving timing issues which may have the effect of avoiding Australian tax would not be accepted by the ATO; and

(d) **Equivalence**. There is an expectation that the benefits flowing from such arrangements are equivalent so as to give rise to mutually agreed outcomes from the perspective of the parties engaging in the set-off. Where the effects of the set-off cannot be quantified or where there is a significant imbalance between the

respective parties' outcomes as a result of entering into the arrangements, the ATO will not accept the set-off as satisfying the arm's length principle.

563. The ATO will also not recognise set-offs where their acceptance has the effect of altering the characterisation of payments or receipts, so as to alter the incidence of tax or where the set-off arrangement effectively reduces the taxpayer's, or the relevant MNE group's overall Australian tax liability. Any such tax liability extends beyond income tax to withholding taxes that may be levied. In addition, set-off arrangements which encourage international tax avoidance will not be countenanced.

564. An example involving an alteration in the incidence of tax is as follows. AUSTCO manufactures and exports trading stock to FORCO, an associated enterprise. Trading stock transferred in the year under review totalled $10M. AUSTCO has an outstanding loan to FORCO which generated interest income of $20M in the same income year. The 'set-off' arrangement entered into by the entities originated from a realisation by AUSTCO some years ago (following an analysis of the transfer price of trading stock to determine whether it conformed with the arm's length principle) that the arm's length price of the trading stock being exported was significantly higher than that being charged to FORCO. Following some discussion and negotiation on this matter, it was agreed that FORCO would, in future years, compensate AUSTCO for the underpayment of trading stock by paying a higher than arm's length rate of interest on the loan outstanding to AUSTCO. In the year under review, consideration for trading stock was undervalued by $2M and this was offset by a $2M increase in interest paid to AUSTCO (total interest paid to AUSTCO by FORCO was $20M). AUSTCO has a foreign loss (interest income class) available for deduction in the same year of $20M and deducts this loss against the foreign interest income received.

565. In this situation, the ATO would not accept the 'set-off' as the incidence of tax has been altered by changing the nature of the income from foreign sales income to foreign interest income, thus allowing AUSTCO to deduct an additional foreign loss of $2M which would not have been deductible in that year if the set-off arrangement had not been entered into.

### *Unintentional set-offs*

566. The ATO position outlined above, which is consistent with the OECD approach, requires associated enterprises to specifically address the question of set-offs including quantification, benchmarking and

documentation, at the time of or prior to entering into the set-off arrangement.

567. This reflects the view that sound business management principles would dictate that independent enterprises dealing at arm's length would take steps to ensure that their respective interests and outcomes would be adequately protected. It is the ATO view that an independent enterprise dealing at arm's length would not be involved in an unintentional set-off.

568. The following example has been provided to the ATO as an unintentional set-off arrangement which should be allowed. A company has an existing licence agreement under which royalties are payable quarterly. At the time of entering into the agreement there was no intentional set-off arrangement in place. Some years after the original agreement was entered into, it was agreed that services were to be provided by the licensee for which a service fee would be payable by the licensor. The company considers that it would make commercial sense to offset the amounts due, however, the company is concerned that it did not consider entering into a set-off at the time of commencing the original agreement. The company believes that provided the offset is not detrimental to tax revenue (e.g., by reducing withholding tax), the off setting of cash flows should be allowed as a commercial transaction regardless of when the idea of offset was canvassed.

569. The ATO would consider the above example as an accounting set-off rather than as a transfer pricing set-off as described in paragraph 405 above. All that the associated enterprises are achieving in this situation is an 'offsetting of cash flows'. The full amount of the income derived from the arm's length royalty (assuming the licensor is an Australian company) would still need to be returned as assessable income and an allowable deduction for the full amount of the expense incurred for the arm's length service fee would be claimable by the company. It would not be acceptable to off set the royalty against the service fee leaving only the withholding tax on the royalty being paid to the other tax authority (assuming withholding tax is payable) and the net amount of the off set being returned as either assessable income or an allowable deduction in the company's tax return.

570. Because of questions about the arm's length nature of unintentional set-offs, their effects could present serious risks to the Australian revenue. Accordingly, the ATO will only consider such arrangements and their effects in the context of the Mutual Agreement Procedure process under Australia's DTAs. This approach is also consistent with that suggested in the 1995 OECD Report at paragraph 1.64.

## Safe harbours

### *Defining the term*

571. In the context of international dealings between associated enterprises, the term 'safe harbour' is usually applied to an administrative practice by a tax authority which accepts a process or outcome (profit or consideration) as automatically discharging taxpayers' obligations to comply with the arm's length principle (see also paragraph 4.95 of the 1995 OECD Report).

572. The 'defining event' in activating a safe harbour may include:

(a) low incidence or values of international dealings (*de minimus* rules); or

(b) specific processes being followed in setting and reviewing international dealings between associated enterprises (safe harbour on process); or

(c) prices or outcomes falling within a pre-determined range (safe harbour on outcomes).

573. There are many variations on the way in which a safe harbour may be constructed and administered. The treatment which may be afforded to dealings falling within the parameters of a safe harbour will vary depending on the circumstances. This will range from automatic acceptance of a transfer price, through to concessional treatment and modified rules for compliance of certain categories of dealings.

574. The 1995 OECD Report has an extensive discussion on safe harbours as an aid to compliance with a discussion of the possible scope of safe harbours at paragraphs 4.95 and 4.96 of the 1995 OECD Report.

575. Whatever the parameters of the safe harbours may be, or the defining events which may activate their operation, their application tends to measure individual enterprises' performance against pre-determined processes or aggregated outcomes, without regard to the particular circumstances of those enterprises.

### *Safe harbours - costs and benefits*

576. The ATO has received a number of representations on the costs and benefits of safe harbours. The view reflected in many of these comments is that safe harbours are capable of providing a degree of certainty from the perspective of taxpayers and administrative simplicity for the ATO. The ATO considers that such representations have generally understated the potential difficulties inherent in

introducing and maintaining such a regime, particularly from the viewpoint of the role of the ATO.

577. A particular concern of the ATO is that the parameters of any safe harbour need to be regularly monitored and updated in order to attempt to parallel open market conditions. In order to be meaningful and useful to a wide range of taxpayers, this parameter setting would have to cover a number of key industries and transaction types. Agreeing on the parameters of a safe harbour across various industries would also require a large number of additional resources to be dedicated on an ongoing basis. Such consideration and additional administrative burdens could largely eliminate any cost savings offered by the introduction of safe harbours.

578. From a taxpayer's perspective, safe harbours may not provide the degree of certainty that has been attributed to them. A pre-condition to the implementation of such a regime would be that its introduction should not have a detrimental effect on the Australian revenue base. Accordingly, the ATO would need to set conservative parameters, to ensure that Australia's revenue base was not eroded and to introduce measures to prevent avoidance through the use of safe harbours.

579. The introduction of a safe harbour may have the effect of reducing the tax otherwise payable in another tax jurisdiction and favouring the jurisdiction implementing the safe harbour. There is a likelihood of increased inter-jurisdictional disputation which will affect taxpayers as well as tax administrations. Given the international consensus that safe harbours do not parallel arms length outcomes (see below), there is also an increased risk that Australia's treaty partners would not provide correlative relief in such cases, thus leaving the process open to double taxation.

580. Other practical concerns with the implementation of safe harbours and their hidden costs are discussed at length in the 1995 OECD Report at paragraphs 4.103 to 4.120. Accordingly, the ATO considers that the attractiveness of safe harbours is largely superficial and their introduction could create a multitude of administrative difficulties and compliance costs for both the ATO and taxpayers.

### *Market prices as safe harbours*

581. Representations have been made that the burden of compliance on taxpayers may be relieved if the ATO accepts published market data on prices in certain industry segments as a safe harbour. For example, commodities such as petroleum, metals and published data on financial products such as prevailing interest rates. This view has some problems as the so called 'market' price may not reflect the individual features of a particular dealing.

582. It is the ATO's experience that some markets are so controlled that prices alone give no indication that an enterprise dealing at the prevailing price will have an outcome which adequately rewards its significant economic functions. At paragraph 4.105 of the 1995 OECD Report it is noted:

> 'Some sectors where goods, commodities or services are standard and market prices are widely publicised such as, for example, the oil and mining industries and the financial services section, could conceivably apply a safe harbour with a higher degree of precision and, thus, a lesser departure from the arm's length principle. But even these industry segments produce a wide range of results which a safe harbour would be unlikely to be able to accommodate to the satisfaction of the tax administrations.'

583. Although published market prices may not constitute a safe harbour, taxpayers may still consider them useful as a starting point in reviewing whether their transfer prices satisfy the arm's length principle.

584. Taking such data as a starting point, taxpayers would need to have regard to any features of their own dealings which may impact on the relevance of the published data, with adjustments being made accordingly. In this regard refer to the discussion above in relation to public sources of data which gives some general guidance on sources of information which may assist taxpayers to review their dealings allowing measurement of their outcomes against the arm's length standard.

### *Safe harbours and the arm's length principle*

585. A key feature of Australia's DTAs and Division 13 is that, in administering same, the Commissioner is directed to have regard to the consideration that independent enterprises dealing at arm's length would have received in the same or similar circumstances. An application of this principle requires as direct as possible a benchmarking of international dealings by associated enterprises, and all their attendant conditions, against comparable dealings by independent enterprises acting at arm's length. It can be inferred from the Explanatory Memorandum introducing Division 13 into the law, that Parliament intended that the Commissioner move away from this approach only in certain specified circumstances (subsection 136AD(4) of the ITAA refers).

586. In paragraph 4.120 of the 1995 OECD Report the major concerns with the introduction of safe harbours (with which we agree) are summarised as follows:

> 'The foregoing analysis suggests that whilst safe harbours could accomplish a number of objectives relating to the compliance and administration of transfer pricing provisions, they raise fundamental problems. They could potentially have perverse effects on the pricing decisions of enterprises engaged in controlled transactions. They may also have a negative impact on the tax revenues of the country implementing the safe harbour as well as on the countries whose associated companies engage in controlled transactions with taxpayers electing a safe harbour. *More importantly, safe harbours are generally not compatible with the enforcement of transfer prices consistent with the arm's length principle*' (emphasis added).

587. The incompatibility of a safe harbour regime with the spirit of Australia's tax law taken together with the potential costs and risks associated with the implementation of a safe harbour regime, is sufficient basis for rejecting a safe harbour system and therefore the ATO does not favour the implementation of safe harbours.

# Glossary

588. With the exception of definitions marked '*' the definitions used here are from the 1995 Report of the OECD Committee on Fiscal Affairs, '*Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*'.

### *Arm's length principle*

589. The international standard that OECD Members have agreed should be used for determining transfer prices for tax purposes. It is set forth in Article 9 of the OECD Model Tax Convention as follows:

> '(where) conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would but for those conditions have accrued to one of the enterprises, but by reason of those conditions have not so accrued, may be included in the profits of that enterprise and taxed accordingly.'

### *Arm's length range*

590. A range of figures that are acceptable for establishing whether the conditions of a controlled transaction are arm's length and that are derived either from applying the same transfer pricing method to

multiple comparable data or from applying different transfer pricing methods.

### *Associated enterprises*

591. Two enterprises are associated enterprises with respect to each other if one of the enterprises meets the conditions of Article 9, subparagraphs 1 (a) or 1(b) of the OECD Model Tax Convention with respect to the other enterprise.

* The expression also includes enterprises which do not meet the conditions of Article 9 but whose dealings can be adjusted under Division 13 of the ITAA. These enterprises may reside in non treaty countries. The consideration used in dealings between uncontrolled enterprises who do not deal at arm's length with one another may also be adjusted in some circumstances and the term 'associated enterprises' is intended to extend to these dealings. TR 94/14 discusses this situation at paragraph 50.

### *Comparability analysis*

592. A comparison of a controlled transaction with an uncontrolled transaction or transactions. Controlled and uncontrolled transactions are comparable if none of the differences between the transactions could materially affect the factor being examined in the methodology (eg., price or margin), or if reasonably accurate adjustments can be made to eliminate the material effects of any such differences.

### *Comparable uncontrolled price (CUP) method*

593. A transfer pricing method that compares the price for property or services transferred in a controlled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances.

### *Contribution analysis*

594. An analysis used in the profit split method under which the combined profits from controlled transactions are divided between the associated enterprises based upon the relative value of the functions performed (taking into account assets used and risks assumed) by each of the associated enterprises participating in those transactions, supplemented as much as possible by external market data that indicate how independent enterprises would have divided profits in similar circumstances.

***Controlled transactions***

595. Transactions between two enterprises that are associated enterprises with respect to each other.

***Cost plus mark-up***

596. A mark-up that is measured by reference to margins computed after the direct and indirect costs incurred by a supplier of property or services in a transaction.

***Cost plus (CP) method***

597. A transfer pricing method using the costs incurred by the supplier of property (or services) in a controlled transaction. An appropriate cost plus mark-up is added to this cost, to make an appropriate profit in light of the functions performed (taking into account assets used and risks assumed) and the market conditions. What is arrived at after adding the cost-plus mark-up to the above costs may be regarded as an arm's length price of the original controlled transaction.

***Direct costs***

598. Costs that are incurred specifically for producing a product or rendering a service, such as the cost of raw materials.

***Enterprise****

599. An entity organised for commercial purposes.

***Functional analysis****

600. An analysis of the functions performed, assets used and risks assumed by each associated enterprise in controlled transactions as a basis for examining the comparability of dealings by independent enterprises or for developing a view as to the economic significance of the taxpayer's activities.

***Gross profits***

601. The gross profits from a business are the amount computed by deducting from the gross receipts of the transaction the allocable purchases or production costs of sales with due adjustment for

increases or decreases in inventory or stock-in-trade, but without taking account of other expenses.

***Independent enterprises***

602. Two enterprises are independent enterprises with respect to each other if they are not associated enterprises with respect to one another.

***Indirect costs***

603. Costs of producing a product or service which although closely related to the production process may be common to several products or services (e.g., the costs of a repair department that services equipment used to produce different products).

***International dealings with associated enterprises****

604. Dealings pursuant to an international agreement where one party participates directly or indirectly in the management, control or capital of another enterprise.

***Multinational enterprise group (MNE group)***

605. A group of associated companies with business establishments in two or more countries.

***Multinational enterprise (MNE)****

606. An enterprise that is part of an MNE group.

***Mutual agreement procedure****

607. A procedure provided for in all of Australia's Double Tax Agreements (DTAs) through which the ATO, at the behest of a taxpayer or on its own account, consults with other tax administrations to resolve disputes regarding the application of Australia's DTAs. The procedure can be used to eliminate double taxation that could arise from a transfer pricing adjustment.

***Profit Comparison method****

608. A transfer pricing methodology based on comparisons at the net profit level, on a single transaction level or in relation to some aggregation of dealings between associated enterprises or between the

taxpayer and independent parties dealing wholly independently in relation to a comparable transaction or dealing. See also transactional net margin method.

### *Profit split method**

609. A transfer pricing method that identifies the combined profit to be split for the associated enterprises from a controlled transaction (or controlled transactions that it is appropriate to aggregate under the principles set out in TR 95/D22) and then splits those profits between the associated enterprises according to an economically valid basis that approximates the division of profits that would have been anticipated and reflected in an agreement made at arm's length between independent parties.

### *Real bargaining*

610. Real bargaining between related parties could be expected to be achieved where the conditions in which the bargaining is undertaken are similar to those that would exist between independent enterprises dealing at arm's length (refer paragraphs 55 and 290 of TR 94/14).

### *Resale price margin*

611. A margin representing the amount of which a reseller would seek to cover its selling and other operating expenses and, in the light of the functions performed (taking into account assets used and risks assumed), make an appropriate profit.

### *Resale price (RP) method*

612. A transfer pricing method based on the price at which a product that has been purchased from an associated enterprise is resold to an independent enterprise. The resale price is reduced by the resale price margin. What is left after subtracting the resale price margin can be regarded, after adjustment for other costs associated with the purchase of the product (e.g., customs duties), as an arm's length price of the original transfer of property between the associated enterprises.

### *Residual analysis*

613. An analysis used in the profit split method which divides the combined profit from the controlled transactions under examination in two stages. In the first stage, each participant is allocated sufficient profit to provide it with a basic return appropriate for the type of

transactions in which it is engaged. Ordinarily this basic return would be determined by reference to the market returns achieved for similar types of transactions by independent entities. Thus, the basis return would generally not account for the return that would be generated by any unique and valuable assets possessed by the participants. In the second stage, any residual profit (or loss) remaining after the first stage division would be allocated among the parties based on an analysis of the facts and circumstances that might indicate how this residual would have been divided between independent enterprises.

***Transactional net margin method****

614. OECD terminology for a transfer pricing method that examines the net profit margin relative to an appropriate base (e.g., costs, sales, assets) that a taxpayer realises from a controlled transaction (or transactions that it is appropriate to aggregate in accordance with the principles in TR 95/D22). See also profit comparison method.

***Transactional profit method****

615. OECD terminology for a transfer pricing method that examines the profits that arise from particular controlled transactions of one or more of the associated enterprises participating in those transactions. The term is limited to the profit split method and the transactional net margin method.

***Uncontrolled transactions***

616. Transactions between enterprises that are independent enterprises with respect to each other.

***Whole of enterprise basis****

617. A basis of analysis whereby the business operations of an entity are examined in their entirety rather than segmenting them into transactions or product, service or business lines.

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# Your comments

619. If you wish to comment on this Draft Ruling, please send your comments by Friday 22 December 1995 to:

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PO Box 9990
Brisbane QLD 4001.

620. Wherever possible, comments should include a reference to the specific paragraph to which the comments relate. Comments intended to express an alternative view to that expressed in the Draft Ruling should also include the reasoning upon which such view was formed - to enable the matter to be considered in detail.

**Commissioner of Taxation**

29 September 1995

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