TR 1999/1 - Income tax: international transfer pricing for intra-group services

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Taxation Ruling
Income tax: international transfer pricing for intra-group services

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Preamble

The number, subject heading, Class of person/arrangement, Date of effect and Ruling parts of this document are a 'public ruling' for the purposes of Part IVAAA of the Taxation Administration Act 1953 and are legally binding on the Commissioner. Taxation Rulings TR 92/1 and TR 97/16 together explain when a Ruling is a public ruling and how it is binding on the Commissioner.

What this Ruling is about

Class of person or arrangement

1. This Ruling addresses the operation of Division 13 of Part III ('Division 13') of the *Income Tax Assessment Act 1936* ('the ITAA 1936') and the Associated Enterprises Article of Australia's double taxation agreements ('DTAs') with respect to charging for services within a multinational enterprise group ('MNE group'). Specifically, this Ruling addresses the circumstances in which section 136AD of the ITAA 1936[1] or the Associated Enterprises Article of a DTA will be applied resulting in an arm's length consideration being deemed for services provided between separate legal entities.

2. The Ruling is designed to assist taxpayers and ATO officers to determine whether the prices for services or dealings with associated enterprises more generally in relation to services conform to the arm's length principle. Throughout this Ruling, a reference to arm's length prices or charges for services means amounts to be used for tax purposes in order to comply with the arm's length principle. In order to reduce compliance costs, there are circumstances in which the Commissioner is prepared to accept certain specified transfer prices used in tax returns as a reasonable approximation of arm's length prices (see paragraph 75).

3. This Ruling follows the international consensus on the arm's length principle and its application among OECD countries expressed in *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations,* published in July 1995 ('the 1995 OECD Report'). This Ruling reflects how the principles in the 1995 OECD Report, especially Chapter VII: 'Special Considerations for Intra-Group

[1] All subsequent legislative references are to the *Income Tax Assessment Act 1936* unless otherwise indicated.

Services', are considered to apply in the context of the relevant provisions of the Australian income tax law. In the 1995 OECD Report there is less emphasis on attempting to list specific circumstances in which a profit mark-up would be expected to be included in the price for intra-group services than was evident in the 1979 OECD Report '*Transfer Pricing and Multinational Enterprises*' and in the 1984 OECD Report '*Transfer Pricing and Multinational Enterprises: Three Taxation Issues*'.

4. The separate members of a multinational group are in this Ruling referred to as 'associated enterprises'. Although this Ruling is framed in terms of dealings between associated enterprises, the views expressed are, in general, equally applicable to non-arm's length dealings between unrelated parties where those dealings may be adjusted under Division 13 (see paragraphs 50 to 53 of TR 94/14).

5. This Ruling is limited to services in the nature of work performed including administrative, management, technical, financial, marketing, sales or distribution, research and development, and like services. It does not deal, in particular, with the provision of finance or insurance, nor the supply of property or facilities for use or enjoyment (e.g., leasing of equipment), all of which fall within the definition of 'services' in subsection 136AA(1) (see paragraphs 230 to 237 of TR 94/14). This Ruling does not deal with cost contribution arrangements ('CCAs') as described in Chapter VIII of the 1995 OECD Report. However, if a service arrangement does not result in any property being produced, developed or acquired, the principles in this Ruling for dealing with intra-group services apply to that arrangement whether it is described as a CCA or not.

6. The Ruling deals with two broad categories of intra-group activities. It describes those activities ('chargeable services') that are to be taken into account in arriving at an arm's length distribution of profits among associated enterprises and those that are not ('non-chargeable activities'). The first category includes those services that are integral to the core business activities of the group. However, the Ruling concentrates on the application of the arm's length principle to those services that facilitate the business of the group and are typically undertaken by a parent company or special purpose subsidiary for the group as a whole or for particular groups of subsidiary companies.

Date of effect

7. With the modifications noted below, 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 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). The modifications are:

(a) The changes between the 1979 and 1984 OECD Reports and the 1995 OECD Report (as reflected in this Ruling) on the question of whether there should be a mark-up applied to costs in determining the arm's length price for services (see paragraph 69 below) should be taken into account by ATO officers when examining tax returns for the 1995-96 and earlier income years. Where the 1979 and 1984 OECD Reports suggested a mark-up was not required for certain services, a mark-up should not be insisted upon for the relevant services supplied by taxpayers in the years covered by those returns.

(b) The administrative practices discussed at paragraphs 75 to 102 may be taken into account by taxpayers in the preparation of tax returns for the 1997-98 and later years of income. Earlier returns may not be amended by taxpayers to take account of these practices.

Detailed contents list

8. Below is a detailed contents list for this Ruling:

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Ruling and Explanations

9. Multinational enterprise groups usually have internal arrangements for the provision of a wide range of services for the constituent parts of the group. The services may be rendered by a parent company or a special purpose subsidiary, such as a regional holding company. The costs of providing intra-group services may be recovered or accounted for by the enterprise in a number of ways.

10. With respect to services, Division 13 and the DTAs are intended to counter non-arm's length transfer pricing or international misallocation of profits that involves either undercharging (including by not charging at all) or overcharging for such services. In general terms, the practical effect of Division 13 and the Associated Enterprises Articles of Australia's DTAs is to provide for the result that, for taxation purposes, profits related to the cross-border provision of services will be allocated in accordance with the arm's length principle. The application of the arm's length principle by the taxpayer or the ATO results in Australian tax reflecting charges for the services that would have been, or would reasonably be expected to be, levied between independent parties dealing at arm's length for comparable services under comparable circumstances.

Provision of services or expense allocations?

11. The fundamental issue in determining the appropriate taxation treatment for intra-group services is whether expenses incurred by one entity should be apportioned and allocated to other members of the group or whether a charge should be levied by the service provider that reflects the value of the services supplied. More specifically, the issue is whether the costs incurred by an Australian resident service provider or foreign service provider should be considered solely under domestic deduction provisions or whether an arm's length consideration for the services should be included in the assessable income of the service provider or allowed as a deduction for the service recipient.

12. The ATO considers the issue of the allocation of profit between associated Australian and foreign enterprises to reflect the provision of intra-group services or the performance of head office functions should be viewed as properly determined in accordance with the arm's length principle rather than as a matter to be resolved solely under domestic deduction provisions of the income tax law by apportioning expenses. Only by determining taxable profits on the basis that arm's length consideration is given and/or received is it possible to arrive at the profit allocation that would eventuate in arm's length dealings. This approach is consistent with the Commentary on

the OECD Model Tax Convention on Income and Capital and the 1995 OECD Report.

13. The problem with viewing intra-group services solely from the perspective of domestic deduction provisions is the deductions are unlikely to be consistent with the amount determined by application of the arm's length principle. The reason for the inconsistency is that subsection 51(1) of the ITAA 1936 and section 8-1 of the *Income Tax Assessment Act 1997* (the ITAA 1997)[2] and other deduction provisions allow deductions for actual expenditure incurred or for an amount based on actual expenditure incurred (e.g., depreciation). On the other hand, the Associated Enterprises Articles and Division 13 require, for tax purposes, an arm's length consideration for activities conducted by one party for the benefit of another regardless of the amount of expenditure incurred in providing the service or the amount actually paid in respect of services.

Domestic deduction provisions and the arm's length principle

14. *Where services are supplied to foreign associated enterprises for no consideration, or for less than arm's length consideration*, and the taxpayer has not used arm's length prices in the preparation of its returns, the ATO would normally seek to apply Division 13 and/or the Associated Enterprises articles to impute an arm's length consideration for the services provided in determining the assessable income of the taxpayer. Then the deductibility of the expenses incurred in providing the services would be determined. Expenditure incurred in deriving that actual or imputed income would generally be deductible except where it is of a capital nature. It would normally be expected the actual or imputed service charge in this situation would be Australian source income in which case section 79D would have no application.

15. Similarly, *where an Australian company is charged for intra-group services*, for example by its foreign parent, the deductibility of the charge would normally fall for consideration initially under section 8-1 of the ITAA 1997. However, if the services are provided by a person resident in a country with which Australia has a DTA, the extent of the deduction allowable may also be determined under the Associated Enterprises Article and also under Division 13. Where the service provider is resident in a non-DTA country, the quantum of the deduction may be considered under Division 13. If the service charge were found to be greater than the arm's length consideration, the amount otherwise allowed as a deduction would normally be reduced pursuant to a determination under the Division. In either case, if a

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2 Subsequent references to section 8-1 (of the ITAA 1997) are to be read as including a reference to subsection 51(1) (of the ITAA 1936).

service charge isn't levied on the Australian company, a deduction would not be allowed to the Australian group member for a share of the costs incurred by the foreign associate in providing the service (in lieu of a deduction for a service charge).

Whether services have been supplied

16. Adherence to the arm's length principle in relation to intra-group service arrangements would desirably be an integral part of intra-group dealings of an MNE group and would be a focus of internal review or external audit of those dealings. In determining whether services are being or have been provided within an MNE group on an arm's length basis, there are two main tasks to be completed:

(a) identification of chargeable services (paragraphs 17 to 47); and

(b) determination of the arm's length consideration for chargeable services (paragraphs 58 to 74).

17. Whether a service will be supplied by the performance of an activity depends upon whether the relevant activity is expected to confer a benefit on an associated enterprise. Where a taxpayer is reviewing its international dealings for conformity with the arm's length principle or those dealings are being audited, the relevant question is whether the activities of the taxpayer or its associate were, at the time they were undertaken, expected to provide a benefit for one or more other members of the group. See paragraphs 22 and 23 for what to do if those expectations are not or were not realised.

18. In general terms, a benefit is something of economic or commercial value that an independent entity might reasonably expect to pay for, or to obtain consideration for supplying. For example, a benefit is an economic or commercial advantage that would assist the recipient's profitability or net worth by enhancing, assisting or improving its income production, profit making or the quality of its products. Alternatively, a benefit could result in a reduction of the recipient's expenses or otherwise facilitate its operations. The expected benefit must be reasonably capable of being identified and valued, and hence must be sufficiently direct and substantial so that the benefit is comparable to a benefit for which an independent entity would be prepared to pay. See paragraphs 2.28 to 2.56 of TR 97/20 for a discussion of factors affecting comparability. Sometimes, this condition may be satisfied only by considering a number of activities taken together. It is not possible to say that a service is not provided whenever the cost of an activity is less than a threshold amount.

19. If an independent enterprise would, in similar circumstances, be expected to either perform the activity itself or engage an unrelated

party to do so, it follows that some benefit is expected from the activity, a benefit for which an independent enterprise would be prepared to pay some amount. The activity can be particularly for the benefit of one foreign associate (e.g., the provision of taxation advice) or it can be an activity performed for the group as a whole (e.g., the development of an accounting policy for use by all companies in the group). It may well be the case that independent enterprises to not themselves perform or use the same range of activities as are performed in a multinational group. However, that is a matter of comparability that goes beyond determining whether an independent recipient would value the activities sufficiently, either singly or together, to be prepared to pay for them.

20. Where some group members clearly have no need to an activity and would not be willing to pay for it were they independent entities, such an activity does not constitute the provision of a service (i.e., a benefit) to those group members. For example, the maintenance of the share register of the parent company of a group is not an activity that benefits the other group members (except perhaps very indirectly). An activity of the parent company that only duplicates an activity undertaken for another group member by a third party would, in general, not be the supply of a service to that other group member. In deciding whether a member of a MNE group has a need for a particular activity, consideration is to be given to the circumstances at the time the activity is or was performed (see paragraphs 22 and 23).

21. In some cases, it may be necessary to examine broad groups of activities and the benefits expected to be derived over several years. For example, it may be difficult to identify all of the individual benefits that may be expected from the central co-ordination and control functions typically undertaken by a parent company. Documentation of what is done and what associated enterprises are being charged for would assist in identifying the intended benefits.

22. A service is provided if, when the activities are performed, another party is reasonably expected or anticipated to derive a benefit, even if this benefit is not realised in practice. For example, a parent company, either in Australia or offshore, may undertake work on a marketing strategy for a product to be sold by a number of MNE group members, but for various reasons the strategy is never implemented, at least not by the other members. The performance of research and development for other members is another case where the anticipated benefits may not be realised. Again, it is relevant to ask whether a comparable independent entity would be prepared to pay for the activity even though there is some chance the benefits may not be fully realised. If so, compliance with the arm's length principle would require that a related party in a comparable situation pay for the

work performed. This principle applies equally to Australian service providers and service recipients.

23. There would normally be no question, however, of an entity receiving a repayment of amounts already paid for work already done by an independent enterprise just because the expected results were not fully realised (except in the case of fraudulent behaviour or breach of contract). Of course, if there were a history of unfulfilled expectations, an independent enterprise would seriously question whether it ought to pay for any further activities of the same nature. There should be no adjustment for tax purposes of otherwise legitimate charges paid simply because with hindsight it appears that the benefits were not received, unless there is clear evidence that there was no intention between the parties that they ever would be received.

Categorisation of activities

24. It is critical for arriving at the arm's length profit allocation between associated enterprises to be able to distinguish non-chargeable activities from chargeable activities that can benefit individual associated enterprises ('specific benefit activities') or the group as a whole ('centralised services').

(a) non-chargeable activities

25. Activities that do not constitute the rendering of services to foreign associated enterprises may be called 'non-chargeable activities'. Such activities do not constitute the provision of property under Division 13 nor does the failure to charge for them indicate that non-arm's length conditions are operating between the associated enterprises. Included are those functions undertaken by one member of an MNE group exclusively for its own benefit. For example, a parent company may undertake tasks that relate solely to its own business activities, including those conducted in its capacity as a shareholder, or ultimate shareholder, of group companies ('shareholder activities'). If the group members were independent entities dealing at arm's length with a service provider, they would not be prepared to pay for these activities or contribute to meeting their cost. Shareholder activities are not necessarily restricted to group parent companies. Similar functions may be performed by a subsidiary, for example a regional headquarters subsidiary, and would not constitute services provided to other subsidiaries in the group.

26. Shareholder activities are distinguishable from 'stewardship' activities, which refer to a broad range of activities undertaken to protect and enhance the value of the group. However, it is recognised the distinction is not always an easy one to make and the decision needs to be tailored to the particular case. Paragraphs 7.9 and 7.10 of

the 1995 OECD Report discuss this further and contain some examples of shareholder activities.

27. Activities conducted in the capacity of a shareholder, as distinct from the parent company's role as a provider of centralised services, are non-chargeable activities. That is, the costs of such activities should be borne solely by the company that undertakes them. For example, in a decentralised MNE group where the parent company's involvement is limited to monitoring performance of subsidiaries, preparation of consolidated statutory accounts and attendance at annual general meetings of subsidiaries, there would be unlikely to be any identifiable activity that provides sufficient benefit to the subsidiaries to warrant a charge by the parent company. On the other hand, a parent company that actively participates in the management and/or operations of subsidiaries, e.g., centralised co-ordination and control of financial management of the group, marketing and on-call services, cannot be viewed as a shareholder acting solely in its own interests.

28. Even though no charge should be levied by an Australian company on its foreign associated enterprises for non-chargeable activities performed by it, non-capital costs incurred by the Australian company in undertaking those activities would generally be deductible under section 8-1 of the ITAA 1997 where they are necessarily incurred in carrying on its business.

29. If, however, a charge has been levied for any of these activities and it is decided on review that no chargeable activities were performed, an adjustment to the Australian taxpayer's tax return may be necessary. *Where the Australian entity is being charged for non-chargeable activities*, any deduction allowed for the charge may be reduced to nil under section 8-1 of the ITAA 1997 and/or a DTA. Care needs to be taken, where a foreign company is performing a mixture of chargeable and non-chargeable activities, that a charge for the latter is not simply subsumed within a charge for the chargeable activities. On the other hand, in this type of situation care is also needed not to reduce arbitrarily what might be an arm's length charge for the services that are being provided.

30. *If the Australian company was charging its foreign associated enterprises but it was providing them with very little or no benefit*, and another country reduced the deduction for the charge or disallowed it completely for its tax purposes, relief from double taxation may be provided in Australia in accordance with a DTA. That relief would probably take the form of reducing the taxable income of the Australian parent.

(b) specific benefit activities

31. Services performed to meet the specific needs of an associate are referred to as specific benefit activities and a charge would normally be levied if the associated enterprises were dealing at arm's length. Some examples might be:

- the provision of assistance with a specific borrowing proposal of the associate;
- assistance with planning and the raising of funds for an acquisition by a particular group member;
- a subsidiary undertakes investment analysis for particular sub-subsidiaries;
- the performance of certain accounting functions such as compliance with tax laws by a subsidiary;
- the provision of guarantees for borrowings by particular group members; and
- training for employees of a particular associate provided by another associated enterprise.

32. While an activity performed by the parent company of a group for the benefit of one or more particular associates would warrant an arm's length charge to those associates, it may also provide minor benefits to other group members. The ATO adopts the position on incidental benefits taken by the OECD in paragraphs 7.12 and 7.13 of its 1995 Report. It is the difference in the degree of the benefits received by the different group members that justifies some but not others being charged for the same activity: see paragraph 18. An Australian company could justifiably be charged if the operations or structure in Australia of a foreign owned group are being reorganised but probably not if the group's European operations were being restructured.

(c) centralised services

33. Parent companies and regional headquarters companies typically undertake activities that are intended to benefit the group (or a geographical section of it) as a whole. Such activities may not be as readily identifiable with any particular associate as is the case with 'specific benefit activities' because the activities are undertaken primarily for the group as a whole or for particular groups of subsidiaries. The services that are centralised in a particular MNE group, and the extent of benefits conferred on members of the group, depend on factors such as the nature of its business, its organisational structure, and the degree of integration between its individual members. Typical of such activities are central co-ordination and

control functions such as supervision of cash flows, management of foreign exchange and interest rate exposures and co-ordination of group finances, production, marketing and distribution.

34. In general, most centralised activities that are not solely for the benefit of the parent provide a sufficiently non-incidental benefit to the other associated enterprises to justify charging for the services. A charge would clearly be justified where the activity of the parent company benefits an associated enterprise and takes the place of an activity the associate otherwise would have been required to undertake itself or to have performed for it by a third party. However, there will often be questions about the extent of the benefits and whether an independent party would be prepared to pay for them (see paragraph 18) and so the amount of any charge.

35. Some examples of what may be centralised activities are:

- administrative services such as planning, accounting, auditing, legal, and computer services;
- financial services such as management of cash flows and solvency, managing working capital, deposits and liabilities, interest and currency exposures;
- assistance in the fields of production, buying, distribution and marketing;
- a worldwide advertising campaign;
- personnel services such as recruitment and training;
- administration of a share and option scheme for executives, including executives of subsidiaries;
- operation of employee share plans;
- preparation of an environmental policy for general use and supervision of its implementation;
- installation of new telecommunications equipment for use throughout the group;
- special training (e.g., conferences) for senior management of parent;
- analysis of markets for inputs and outputs;
- administration of intangibles; and
- research into and development of manufacturing, warehousing, distribution and marketing technologies.

In particular circumstances, some of these may not be chargeable or they may be specific benefit activities. It is not the name of the activity or its characterisation as a centralised or specific benefit activity that is determinative but whether benefits are expected to be provided to other group members. See paragraph 7.14 of the 1995 OECD Report.

36. A particular type of centralised service is that available to the members of the group 'on-call' (e.g., legal/technical advice and group guarantees). Paragraphs 7.16 and 7.17 of the 1995 OECD Report cover the questions that need to be addressed to determine whether that availability itself constitutes a service.

37. If no charge is levied for centralised services or specific benefit activities, or if a non-arm's length amount is charged, and the taxpayer hasn't used arm's length prices for the services in its tax return, an adjustment by the Commissioner to use an arm's length price, under either a DTA or Division 13, would normally be in accordance with the arm's length principle.

38. *If the Australian company were providing the service*, an arm's length amount would normally be imputed in Australia as income. This approach is to be adopted, rather than simply seeking to deny a deduction to the Australian company for some or all of the expenses incurred in providing the service. The deductibility of those expenses would then be decided after the imputation of income referred to above, when the full picture of assessable income is known. *If the benefits were being conferred on the Australian company by a foreign associated enterprise*, an adjustment would normally only be made in Australia to reduce the amount of the deductible charge to the arm's length amount. If an adjustment were made in either case by a foreign revenue authority to increase the profits of its resident for its tax purposes, relief from double taxation may be available under a DTA for the Australian company.

Determining the extent of chargeable activities in practice

Functional analysis

39. Determination of the activities of a particular company, which constitute the provision of services to group members, and their importance within the group would be facilitated by following the four steps outlined in Chapter 5 of Taxation Ruling TR 98/11. Step 1 would begin with identifying the international dealings of the taxpayer with foreign associated enterprises and developing an understanding of those dealings in the context of the group (paragraphs 5.21 to 5.44 of TR 98/11). Undertaking a functional analysis of the MNE group to identify the functions undertaken by the various group members, the assets, skills and expertise used in undertaking their activities and the

sharing of risks would enable the taxpayer to ascertain which are the most economically important contributions, to the point where judgments could be made about the availability and reliability of comparables or about relative contributions where a profit split might be needed (paragraphs 5.45 to 5.54 of TR 98/11).

40. The extent of any analysis depends upon a number of factors including the size and complexity of the group structure, the degree of intra-group integration and the nature and extent of the intra-group dealings. For example, where only minimal and uncomplicated intra-group services are provided between an Australian company and a foreign associate, a relatively straight-forward analysis would be all that is necessary. Paragraph 78 discusses the degree of analysis required where the administrative practice for non-core services is to be relied upon. On the other hand, where services are closely related with a number of intra-group dealings, the dealings may need to be examined on an aggregated basis and a more thorough functional analysis would be required to determine the services provided to associated enterprises and their economic significance. The analysis could be performed either in Australia or by a foreign parent and would detail what activities are performed for the benefit of other members of the group and which are not, and what other support functions are considered to be directly or indirectly related to those activities.

Australian service provider

41. Where this process indicates the Australian company is a service provider, it would be helpful to identify those activities that are unquestionably non-chargeable activities at an early stage. Such activities would include shareholder activities (see paragraphs 25 to 27 above) and other functions performed solely for the benefit of the Australian company and any Australian resident associated enterprises. Activities that relate exclusively to arm's length dealings with unrelated parties would also not be chargeable to group members.

42. The next step is to identify those activities conducted by the Australian company that clearly are/were expected to confer a benefit on non-resident associated enterprises. These types of activities are generally those described in this Ruling as specific benefit activities but may also include centralised services.

43. Some activities do not themselves provide sufficient benefit to other group members to constitute chargeable activities but are undertaken to support other parts of the parent company (e.g., corporate services areas such as personnel). These activities may be connected with the activities that are providing benefits to other group members and might have to be considered as an indirect

cost when determining the charge for service activities (see paragraph 64 below).

44. The first stages of the analysis will probably not give a definite answer to whether a number of residual activities are expected to provide benefits to any other members of the group. These activities might be referred to as 'potentially chargeable' activities. Examples would generally include the functions of senior management including the Board of Directors, the activities of a treasury department and the activities of administrative and service personnel.

45. The nature of each activity or function of each department/unit that has been classified as potentially chargeable should then be more thoroughly analysed. The activities should be classified as either chargeable or non-chargeable activities. Where chargeable and non-chargeable activities are carried out by the same people or departments, it is necessary to make a realistic assessment of how their activities should be categorised. The activities of non-executive directors, for example, would generally be non-chargeable except where they can be related to specific subsidiaries. On the other hand, the board activities of executive directors are more likely to be an extension of their executive/management duties and to benefit other members of the group and so may be chargeable to some extent.

46. A practical issue to be addressed in undertaking the above analysis is the extent to which the activities of individual personnel need to be accounted for. The ATO will accept reasonable efforts to determine the extent of chargeable and non-chargeable activities within the limitations of the taxpayer's accounting system. Taxpayers are not expected to pursue greater accuracy at all costs but to base their analysis on what would normally be required in 'a proper application of the recognised principles of costing to the particular circumstances' (Kitto J in *BP Refinery (Kwinana) Ltd v. FC of T* (1960) 12 ATD 204 at 208; [1961] ALR 52 at 57). The more disaggregated the taxpayer's accounting system is, the more finely tuned the analysis could be. If information is only available on a very broad divisional or departmental basis, the activities of more personnel may have to be considered.

Australian service recipient

47. Where Step 1 indicates the Australian company is the recipient of services, an examination of all charges by foreign associated enterprises needs to be undertaken by the Australian group company. Fundamentally, any charges by foreign associated enterprises should be set or reviewed having regard to the Australian company's willingness, or that of other parties dealing with independent entities in similar circumstances, to pay an independent entity for the claimed services (evidence of its need for the service and of the benefits or

cost savings that are expected to result). For example, being provided with necessary legal services saves the Australian company having to get them elsewhere. Similarly, paying a retainer fee for on-call IT services saves it having similar arrangements with others or from bearing the costs of not having access to the services when needed (where it has a real expectation of needing such services).

48. The Australian company being charged for services should ascertain what the charges are for (a simple label of 'management services' may not be sufficient to indicate whether benefits are/were expected to be received), the nature of the expected benefits (subject to paragraphs 22 and 23, whether actually received or not) and the basis for the charge (this issue is discussed later in the Ruling).

Charging on a regional basis

49. Rather than charge every individual member of a group, a parent company or group service centre may choose to charge only one associated enterprise as the representative of all group members in a particular region (e.g., charge an associated enterprise resident in the USA for all associated enterprises in the Americas). The following paragraphs discuss the acceptability of this practice from an Australian tax perspective.

50. In the case of an Australian company charging other group members, it may be said that it does not matter, from the perspective of the Australian revenue, which foreign companies are charged by the Australian company nor is it necessary to determine the distribution of benefits among the foreign associated enterprises. Provided the total amount charged out is appropriate, the distribution of charges may not matter if each charge is based on the benefits expected to accrue to the relevant enterprises (e.g., for all companies in the Americas in the above example).

51. However, this practice could lead to other difficulties. There could be problems for the charged company being entitled to a deduction for the full amount (because the view may be taken that it does not get all the benefits for which it is being charged). This could in turn produce problems for both the Australian taxpayer and the Australian revenue if the amount chargeable to that company were reduced by the foreign tax authorities for their tax purposes. There could be relevant differences in the DTAs between Australia and the relevant countries in the region or there may be associated enterprises where a DTA wouldn't otherwise apply. These differences may affect source country taxing rights, foreign tax credits that could be claimed in respect of the charge, entitlements to deductions or the availability of correlative relief under a DTA.

52. Where an Australian company is being charged by a foreign associated enterprise for benefits provided to a number of regional associated enterprises, a deduction may not be allowable for service charges borne on behalf of the other members and they in turn may not be entitled to a deduction for amounts paid to the Australian company. We would accept the arrangement if the Australian company was adequately compensated by the other group members for charges paid on their behalf. Some of these concerns may not be as great where DTAs with other countries would be applicable, subject to the views of the other countries.

53. As a general rule, the practice of charging in this manner is acceptable for tax purposes where it is limited to same-country members. That is, a single arm's length charge by an Australian company on a foreign associated enterprise for services supplied to all its associated enterprises in the same country would be accepted. In the reverse situation, a single charge on one Australian group company for services provided to all Australian associated enterprises by a foreign associate would be acceptable (provided the total charge conformed with the arm's length principle when applied to all the relevant services) if the Australian company was adequately compensated by the other group members for charges paid on their behalf. The same-country limitation may be overcome in specific cases in consultation with the taxpayer and other relevant tax authorities.

Determining the amount of the charge

Methods of charging for services

54. If an MNE charges associated enterprises for services, it may charge individual group members directly for specific services or indirectly using an apportionment method, or by including an amount for the services in the price of other property. Whether an MNE uses either a direct or indirect method of charging for services, to conform with the arm's length principle the charge used for tax purposes should be the best possible approximation of the arm's length consideration for those services. See paragraphs 7.20 to 7.28 of the 1995, hindsight should not be OECD Report for a description of acceptable methods of charging.

55. Where an indirect method has to be used to calculate the benefits for individual group members from service activities, some way of allocating the total chargeable amount to the individual associated enterprises needs to be found. The basis of allocation must be practical enough to be administered yet sufficiently accurate to avoid arbitrary disparities between the benefits received and the amounts of intra-group charges. Taxpayers are not expected to use indicators for which data are not readily available. The main criterion

to be satisfied by whatever indicator or 'key' (for example, turnover or profits) is used as the basis of allocation of the charge for a particular service is that the chargeable amount is allocated in the same proportions as the expected benefits are estimated to be shared among the group members.

56. It is recognised by the ATO, however, that choosing an allocation method to estimate the shares of expected benefits is a matter of judgment. What is required of taxpayers is best endeavours be made to use an indicator that approximates the expected sharing of benefits in the particular circumstances faced at the time the service is provided. Certainly, hindsight should not be used to determine, after the event, the actual shares of benefits (if that can be done accurately) and then to adjust the charges to reflect the actual outcome.

57. Whether the allocation key is appropriate probably depends on the nature and usage of the service. Some keys may be suitable for more than one type of service and the total amounts to be allocated in respect of several services may be able to be allocated with the one key. Sometimes, a combination of indicators might be the best approach, for example, for a package of administrative services. It may be appropriate in some cases to use a single (combined) indicator for all services where that gives a reasonable estimate of the sharing of expected benefits of the services.

Methods for ascertaining an arm's length charge for services

58. Irrespective of whether a direct or indirect method of charging is used, internationally accepted arm's length methodologies may be used to determine the appropriate charge for services rendered within an MNE group. An advisable approach to selecting the most appropriate methodology is outlined in paragraphs 5.60 to 5.70 of TR 98/11. The specific characteristics of the services and the extent and reliability of reasonably available data on uncontrolled dealings will determine the most appropriate arm's length methodology (see paragraph 5.68 of TR 98/11 for a discussion in relation to an importer/distributor). The cost plus method may not be the most appropriate in all circumstances. For example, a profit method may be the most appropriate method where the expected value of the service to the recipient far exceeds the cost of providing the service or where services are part of highly integrated dealings between associated enterprises.

59. Paragraphs 2.6 to 2.12 of Taxation Ruling TR 97/20 discuss three related perspectives from which the dealings between associated enterprises may be viewed to test them against the arm's length principle, including whether the dealings result in a commercially realistic outcome. For conformity with the arm's length principle, the price to be used or the amount charged should be considered from the

perspective of both the service provider (is it sufficient?) and the service recipient (is it too much?). The application of the individual arm's length methodologies is discussed in Chapter 3 of TR 97/20 and in paragraphs 7.29 to 7.36 of the 1995 OECD Report. Step 3 of the four steps in TR 98/11 (see paragraphs 5.72 to 5.84) canvasses the role of a comparability analysis in applying the selected methodology and the need to establish the reliability of the answers it gives.

Comparable uncontrolled price method

60. Where the arm's length charge can be determined using a comparable uncontrolled price ('a CUP') based on a high level of comparability (see paragraphs 3.10 to 3.16 of TR 97/20), there is no need to calculate the costs of the service provider nor to determine whether a profit mark-up should be charged and if so how much. There is a possibility that the arm's length charge will not result in a profit for the provider but that amount must still be taken as the arm's length charge (see paragraph 7.33 of the 1995 OECD Report). The charge should not be increased simply to ensure a profit for the service provider. Similarly, where the arm's length price obtained using a CUP with a high degree of comparability results in a super profit for the provider, the price should not be lowered simply to reduce the profit to the service provider.

61. Too narrow a view of comparability, however, may lead to an inappropriate transfer price being selected as the arm's length consideration in the circumstances (see paragraphs 2.28 to 2.56 of TR 97/20). As is pointed out in paragraph 2.17 of TR 97/20, another option for the supplier or the purchaser of the services in these circumstances may be not to enter into the arrangement for the supply of the services if it does not make commercial sense for the parties involved. Paragraphs 445 to 449 of Taxation Ruling TR 94/14, 2.47 of TR 97/20 and 8.4 of TR 98/11 contain some explanation of 'start-up' or 'market penetration' situations which are also relevant to providing services.

Cost plus method

62. The cost plus method is often used to calculate an arm's length charge for services, particularly centralised service arrangements. The application of the cost plus method is discussed in detail at paragraphs 3.31 to 3.51 of TR 97/20. The ATO acknowledges many taxpayers may determine their charges for services by applying a fixed percentage mark-up to the cost of the service activities. However, only if that mark-up is obtained from reliable comparables will this method result in an arm's length price for the services. The use of a fixed percentage mark-up not obtained from an analysis of

comparable independent party dealings is not consistent with the arm's length principle. More is said about the appropriate mark-up in paragraphs 69 to 73.

63. In applying a cost plus methodology, a principal concern is to obtain a reliable estimate of the cost of providing the service. The charge should usually reflect all relevant costs, both direct and indirect. What is important for comparability is that there is consistency between the costs included in calculating the arm's length price for intra-group services and the costs used to calculate the arm's length mark-up charged in comparable independent dealings. For example, where good comparable data are available to enable the calculation of a mark-up on certain direct costs only, it would be appropriate to include only those direct costs in the calculation of the arm's length charge for the intra-group service. The ATO's views on marginal costing are set out at paragraphs 3.41 to 3.47 of TR 97/20.

64. Without being exhaustive or prescriptive, examples of indirect costs would include:

- light and power;
- rents, maintenance and repairs;
- rates and property taxes;
- insurance;
- telephone, facsimile and other telecommunications costs;
- postage and courier expenses;
- indirect labour costs, including (where relevant):
- leave payments (holiday, sick, long service, defence force reserves, jury duty, etc.);
- workers compensation;
- superannuation;
- payroll tax, other State taxes and FBT;
- depreciation on building, plant and equipment;
- entertainment expenses;
- contributions to other capital costs that are not depreciable; and
- costs of supporting units/departments (e.g., personnel, accounts, information technology, staff facilities

65. In summary, there are three broad steps that may be followed in determining the total costs of performing chargeable activities.

Step 1: *Ascertain which activities are chargeable and which aren't:*

- there would be few problems where individual activities can be identified (e.g., mainly specific benefit activities);
- some people's/units' activities may have to be apportioned between chargeable and non-chargeable activities on a reasonable basis (e.g., time).

Step 2: *Determine the direct costs of chargeable intra-group service activities:*

- the simplest cases will be where cost records are kept for particular activities;
- where all a person's/unit's activities are chargeable and costs are kept for the person/unit, the cost of the activities will be known;
- costs may have to be estimated (particularly labour costs) for some activities/some people or units;
- direct costs of other activities (including non-chargeable activities) should not be included.

Step 3: *Determine the indirect costs associated with the chargeable activities including the costs of supporting departments or units:*

- allocate individual indirect costs according to the nature of the costs (e.g., using time, floor space, plant and equipment used, or some other parameters other than total direct costs);

OR

- allocate all indirect costs according to total direct costs of chargeable service activities and other activities (there is a need to know total direct costs of all activities over which indirect costs are to be apportioned).

66. In many cases, the degree of analysis and recording needed to allocate costs among activities would involve an administrative burden disproportionate to the charge that could be levied. Accordingly, a survey of the time spent by staff on activities for the

benefit of other MNE group members (as distinct from non-chargeable activities) may in many cases constitute a reasonable basis for allocating all relevant costs associated with performing those activities. The information on which the allocation of costs is based should be updated when circumstances of the MNE group change substantially. There can be no categorical rules about how frequently that should occur.

67. The quality of the information obtained from such a survey is only as good as the methodology adopted and the questions asked. For example, a questionnaire requesting staff to estimate their time spent on chargeable activities over a substantial period, without previous records being kept, would not produce as reliable an estimate for the cost of a company's chargeable activities as where adequate records had been kept. Nevertheless, where records have not been kept such a questionnaire could be useful.

68. An estimate of the percentage of the total time of all staff spent on a relevant class of activities (e.g., non-chargeable activities), obtained in an appropriate manner, would be an acceptable basis for allocation of some indirect costs (e.g., property costs and power) and would be less burdensome than other more precise methods of allocating such costs. In appropriate cases, even an estimate of the proportion of staff principally involved in particular activities would be sufficient to allocate some costs to those activities.

Profit mark-ups

69. To achieve the correct profit allocations, the arm's length charge for services (including centralised services) determined by using the cost plus method would normally include a mark-up on the costs of performing the services. See paragraphs 3.48 to 3.50 of TR 97/20 for a discussion of some general issues to be considered in calculating the appropriate mark-up.

70. Where the service provider has special expertise that is made available to group members (e.g., engineering, legal or financial expertise), and the value of that expertise is not fully reflected in the cost of providing services, one might often find in comparable arm's length dealings a substantial mark-up being used. The size of the mark-up would depend on the expected value to the recipient of the high-value services. On the other hand, a parent company may be providing general administrative services to the group as a whole where it is difficult to determine the precise value to the recipients of the services. The nature of the services and the uncertainty as to the extent of the benefits for the recipients might suggest that a smaller mark-up than in the preceding example would be appropriate.

71. There may be cost savings to be made by a group in centralising some functions. When using the cost plus method to determine the arm's length price in this situation, the mark-up should not be increased to capture the benefit of the cost savings if it thereby becomes greater than the arm's length mark-up. If, however, a reliable CUP is available to determine the arm's length price, the service provider may well be able to retain the benefit of the cost savings and earn additional profits.

72. While the application of the cost plus methodology to services should be no different in principle to its application in determining the arm's length price for goods, it is recognised that it may be more difficult to obtain data on reliable comparables for services, particularly centralised services, than for goods or other property. If other accepted methods of determining the arm's length charge cannot be used, because of the lack of data or because they depend on even less comparable transactions, use could be made of the best available mark-up (i.e., that obtained from the best available comparable).

73. In cases where acceptable comparables for any of the arm's length methodologies cannot be found for the services supplied by a parent company, a fixed percentage mark-up might be used by the taxpayer or for the purposes of subsection 136AD(4). The percentage mark-up should be estimated to give a market return on the assets used, the functions performed and the risks assumed. Where this type of mark-up has to be used, it is imperative the costs of the service are correctly determined as discussed earlier. Paragraphs 3.88 to 3.99 of TR 97/20 describe some other approaches that might be taken where arm's length methodologies cannot be used. Alternatively, the taxpayer may be able to rely on either of the administrative practices discussed at paragraphs 75 to 102.

Apportionment charges

74. If an indirect-charge method requiring apportionment of the chargeable amount among members of a MNE group is being used, the arm's length principle requires that the amounts allocated to the respective members of the group should be in proportion to the individual members' benefits or expected benefits from the services. That is, the amount charged to the member would not be expected to exceed the value to it of the service, as is the case with direct charging. Of more practical importance, under arm's length dealing the amounts charged to the individual members would be in the same ratios as the expected benefits to the individual members. The possible methods of apportionment are discussed at paragraphs 55 to 57 above.

Administrative practices for services

75. Because of the difficulties frequently encountered in determining arm's length prices for intra-group services, other means are needed to apply the fair sharing of taxes concept which underlies the Associated Enterprises articles and Division 13. Additionally, Taxation Ruling TR 97/20 acknowledges it is often inappropriate to make small or marginal adjustments in transfer pricing cases. In order to reduce compliance costs, especially where they might otherwise be disproportionately large, and provide greater certainty, but still approximate arm's length pricing, the Commissioner will exercise the discretion in Division 13 and the Associated Enterprises articles not to make transfer pricing adjustments in the circumstances listed in paragraphs 78 to 86 below. The Commissioner will regard the use of the transfer prices specified below, in tax returns for the 1997-98 and later income years, as giving rise to a realistic outcome in these circumstances.

76. This approach is a practical response to the difficulties referred to in paragraph 7.37 of the 1995 OECD Report and is consistent with the practices of other revenue authorities. It has regard to the objective of reducing the need for mutual agreement procedures under DTAs, because of the costs involved in those procedures, but allows an adjustment to those prices where correlative relief is sought by a taxpayer under a DTA (see paragraph 100).

77. There are two separate instances in which the Commissioner will not seek to adjust transfer prices for services to strictly accord with arm's length prices where an adjustment might otherwise be authorised by the law (referred to in the rest of this Ruling as 'the administrative practices' or 'either administrative practice').

(a) ***Non-core services.*** This administrative practice relates to services supplied or acquired which are not integral to the profit-earning activities of the multinational group ('non-core' services). This practice recognises the practical difficulties faced in determining arm's length prices for such services and gives certainty to taxpayers while concentrating the application of the arm's length principle on the more significant related party dealings.

(b) ***De minimis cases.*** Where the costs of all intra-group services supplied or acquired are relatively small, the Commissioner will not adjust prices that are within a specified range. In the *de minimis* case, the adjustments that may be forgone are not considered to be material enough to warrant the extra compliance and/or administrative effort required to establish more precisely the arm's length price for the services.

Conditions for the application of the administrative practice in relation to non-core services

78. Non-core services refer to activities that are not integral to the profit-earning or economically significant activities of the group (see paragraphs 5.45 to 5.53 of Taxation Ruling TR 98/11). They include activities that are supportive of the group's main business and are generally routine but are not similar to activities by which the group derives its income. What constitutes non-core services depends on the facts of each case and may be identified as a result of Step 1 of the analysis described at paragraphs 39 to 47 above. For small and medium-sized businesses, the analysis needed to determine which are non-core services may be relatively straight forward.

79. In considering whether particular services are integral to the income earning activities of the group or not, factors that could emerge from the functional analysis as described in Chapter 5 of TR 98/11 and which might be taken into account are the amount of capital investment required for the services, the risks involved, the relative costs of the services, the time devoted to the services and the regularity of their supply, and whether they are directly or indirectly related to the income earning capabilities and activities of the group. Services whose value could reasonably be expected to substantially exceed the costs of their provision could not be categorised as non-core services because of the value they add to the group's business.

80. Non-core services may encompass administrative services, personnel services, management of remuneration schemes and other overhead activities. Assistance with production, buying, etc., and market analysis for a distributor or seller of goods or services would not generally be a non-core service. Nor would 'services' supplied by an importer/distributor, as discussed in paragraph 5.68 of TR 98/11, be non-core activities. Financial services may be non-core activities for enterprises other than banks and financial service companies. Where information technology is not part of a core business of a group, information technology services (e.g., in relation to accounting) would qualify as non-core services. Research and development activities are not to be included as non-core services.

Example 1

Services supplied by a special purpose subsidiary which is principally involved in providing centralised co-ordination and management services to group members may still qualify as non-core services because the services are, from the group's perspective, non-core services, even though their supply is the subsidiary's principal function.

Example 2

A parent company which supplies routine centralised management services to group members (non-core services) together with sales, marketing and technical assistance (core services) would need to distinguish between the different types of services supplied. The above-mentioned administrative practice in relation to non-core services would apply only in respect of the non-core services component.

81. To minimise the risk of substantial departures from arm's length pricing, taxpayers need to be able to demonstrate to the ATO that their non-core services fall within the principles in the preceding three paragraphs, especially in the less obvious cases. As a general rule, the greater the proportion of non-core services to total costs, the more care needs to be exercised in categorising activities as non-core services.

82 The administrative practice in relation to non-core services applies separately to non-core services either supplied to or acquired from foreign associated enterprises.

(i) The administrative practice may be used for non-core services acquired by Australian group companies (see paragraph 90) from foreign associated enterprises only where all of the following conditions are met:

(a) the amount charged for all non-core services supplied to Australian group companies by their foreign associated enterprises in a year is not more than 15 per cent of the total accounting expenses of the Australian group companies in the year; and

(b) the *transfer price* used by the Australian companies in their tax returns for these services is not more than the relevant costs incurred by the foreign associated enterprise(s) plus 7.5% of those costs, or the alternatives described in paragraph 83, but is not greater than the actual amount charged for the services; and

(c) adequate documentation is kept (see paragraph 88).

(ii) The administrative practice may be used for non-core services supplied by Australian group companies (see paragraph 90) to foreign associated enterprises only where all of the following conditions are met:

(a) the amount charged in a year by the Australian group companies for non-core services supplied to foreign associated enterprises is not more than 15 per cent of the total accounting revenues of the Australian group companies in the year; and

(b) the *transfer price* used by the Australian companies in their tax returns for these services is not less than the relevant costs incurred by the Australian companies plus 7.5% of those costs, or the alternatives described in paragraph 84, but is not less than the actual amount charged for the services; and

(c) adequate documentation is kept (see paragraph 88).

83. To accommodate the varying requirements of other jurisdictions and lessen the possibility of double taxation, taxpayers may use the following alternative prices for non-core services in the preparation of their tax returns, if relying on the Commissioner's application of the administrative practice. A transfer price of up to cost plus 10% of relevant costs would be accepted for non-core services supplied by associated enterprises resident in a particular foreign country where it is established by the taxpayer's group that it is the practice of that country to require that price for the services for its tax purposes and to accept such prices (or mark-ups) for similar services supplied by Australian companies to associated enterprises resident in that country (i.e., that the other country does or would be expected to accept symmetrical mark-ups for such services). Therefore, the Australian group may use different prices in respect of services acquired from associated enterprises in different countries, but none that exceed cost plus 10% of relevant costs.

84. Similarly, a transfer price not less than cost plus 5% of relevant costs but less than cost plus 7.5% of relevant costs would be accepted for non-core services supplied to associated enterprises resident in a particular foreign country where it is established by the taxpayer's group that it is the practice of that country to require, for its tax purposes, that the price for the services be no higher than the selected price and to accept such prices (or mark-ups) as an upper limit for similar services supplied by an associated enterprise in that country to Australian companies (i.e., that the other country does or would be expected to accept symmetrical mark-ups for such services). Again, the Australian company group might use different transfer prices for services supplied to associated enterprises in different countries, but none less than cost plus 5% of relevant costs.

85. All companies in the group must use the same mark-up on costs for services supplied to, or acquired from, associated enterprises in the same country, if they are relying on the administrative practice.

De minimis cases

86. As mentioned in paragraph 77, the Commissioner will apply a similar administrative practice in *de minimis* cases where the total direct and indirect costs of supplying services to Australian or foreign associated enterprises, as appropriate, is not more than $500,000 in a year. The practice applies to all intra-group services supplied or acquired where the relevant cost limit is not exceeded. Therefore, in some cases, it might be applicable to all intra-groups services both supplied and acquired. The transfer prices that must be used, and the conditions for their use, are the same as those specified in paragraphs 82 to 84. As for the practice in relation to non-core services, all taxpayers in a group must use the same mark-up, for incoming and outgoing services, in respect of each foreign jurisdiction, but the mark-up may vary from country to country, within the limits described above.

Example

An Australian subsidiary of a foreign based multinational group receives marketing and technical assistance from a foreign associate. No other services are acquired by any Australian member of the group from its foreign associated enterprises. The total direct and indirect costs of providing the services to the Australian subsidiary for the year are $200,000. As long as the amount actually charged for the services is not more than $215,000 (or $220,000 in the circumstances outlined in paragraph 83), the Commissioner would not require the taxpayer to establish an arm's length price for the services.

87. The following table summarises the main features of each of the administrative practices and the following paragraphs contain further rules regarding their application.

	Services acquired from foreign associated enterprises		**Services supplied to foreign associated enterprises**	
	Administrative practice for *non-core* services	Administrative practice in *de minimis* cases	Administrative practice for *non-core* services	Administrative practice in *de minimis* cases
Applies to all services?	No	Yes	No	Yes
Principal restrictions on the application of the administrative practices	The total amount charged for the services is not more than 15% of the total expenses of the Australian group companies Adequate documentation is maintained by the taxpayer	The total direct and indirect costs of providing the services is not more than $500,000 in the year Adequate documentation is maintained by the taxpayer	The total amount charged for the services is not more than 15% of the total revenues of the Australian group companies Adequate documentation is maintained by the taxpayer	The total direct and indirect costs of providing the services is not more than $500,000 in the year Adequate documentation is maintained by the taxpayer
Acceptable transfer prices	Not more than the lesser of: (a) the actual charge, and (b) the cost of providing the services plus a mark-up of 7.5%	Not more than the lesser of: (a) the actual charge, and (b) the cost of providing the services plus a mark-up of 7.5%	Not less than the greater of: (a) the actual charge, and (b) the cost of providing the services plus a mark-up of 7.5%	Not less than the greater of: (a) the actual charge, and (b) the cost of providing the services plus a mark-up of 7.5%
Alternative mark-ups in transfer prices for particular countries	Up to 10%, with additional documentation	Up to 10%, with additional documentation	Down to 5%, with additional documentation	Down to 5%, with additional documentation

Application

88. The first consideration is to establish that a service (i.e., a benefit) has actually been supplied (see paragraphs 17 to 23). To rely on these administrative practices, the taxpayer (whether a supplier or recipient of services) must maintain documentation to establish the nature and extent of services supplied/acquired and to address the issues (as far as is relevant) considered in calculating the relevant total costs as listed at paragraph 7.9 of TR 98/11. For example, the taxpayer may need to document its reasons for categorising particular services as non-core and its calculation of the ratio of non-core services to total revenues or expenses. As mentioned above, the extent of analysis and documentation needed will depend on the taxpayer's circumstances. If the taxpayer wishes to use a mark-up other than 7.5%, as indicated in paragraphs 83 and 84, documentation of other countries' practices to support that choice should be kept. Further, a record of the relevant group companies should be retained.

89. The administrative practices may be applied to any services covered by this Ruling (see paragraph 5), as is appropriate for each practice. In particular, they may apply to services (e.g., the supply of commercial knowledge or information) payment for which is a royalty in terms of subsection 6(1) or a DTA. Of course, the administrative practices cannot be used to determine royalties that are not payments for services as described in paragraph 5. Further, neither practice may be applied to financial transactions (e.g., loans, guarantees, foreign exchange trading and derivatives), the provision of insurance/reinsurance by a group member (e.g., a captive insurer) or the supply of equipment or other property for use/rent, even though these may be regarded as the provision of services as defined in Division 13. However, either practice may apply to the arrangement of external insurance or finance for the members of the group.

90. The cost limit for the *de minimis* administrative practice and the ratio of non-core services to total expenses or revenues for the non-core services administrative practice are to be applied separately to the flow of services in each direction between all members of an Australian company group and its foreign associated enterprises. The definition of a company group (of Australian resident companies only) that is used for this purpose is that in Division 1C of Part VI (company tax instalments). This concept of a company group is broader than that used for the transfer of tax losses between companies but narrower than a group of associated or related enterprises. According to this definition, two or more Australian companies with a common foreign parent, but at least one of which is not wholly owned by the foreign parent, would constitute a group of Australian companies.

91. The Commissioner is not bound to apply the administrative practice for *de minimis* cases where an Australian service supplier

fails to exercise reasonable care to ensure that all allocable expenditure is included in the total relevant costs of the intra-group services, for example, by omission of particular items of expenditure or by failing to return an amount of income for one or more services. Similarly, the Commissioner will not necessarily apply the administrative practice for *non-core services* where the taxpayer's group fails to exercise reasonable care in categorising intra-group services as non-core or in calculating the percentages of total revenues or expenses as described in paragraph 82. If such an error is made despite the taxpayer's group taking reasonable care in establishing it satisfies the conditions for the application of the administrative practices, the Commissioner would seek to correct the error and then apply the administrative practices if the conditions for their application are satisfied.

92. The Commissioner will not seek to deny the application of the administrative practices where there are only marginal departures from the conditions for their application. In the case of the *non-core services* administrative practice, the Commissioner would expect to see an appropriate functional analysis to support the taxpayer's categorisation of services and the continued application of the administrative practice.

93. Expenses that are paid by or reimbursed by another entity in the group for or on behalf of an Australian service supplier need to be included in calculating the total relevant costs where the expense would, if borne by the service provider, have been included in the cost of providing the services. This is the case irrespective of whether the payer is a domestic or foreign associate.

Example

An Australian subsidiary incurs total expenditure of $2 million of which $650,000 is allocable to sales and distribution services supplied to foreign associated enterprises. The company is reimbursed to the extent of $1 million by its foreign parent. The company's allocable direct and indirect costs of providing the services (before reimbursement) exceed the allowable limit of $500,000. The taxpayer does not qualify as a *de minimis* case in relation to services it supplies to its foreign associated enterprises.

Interaction with arm's length methodologies

94. The administrative practices may apply even if the arm's length consideration could be determined using one of the accepted methodologies. Where the $500,000 cost limit for services supplied in either direction is not exceeded, the practice in relation to *de minimis* cases would apply to all types of services provided between the related parties in that direction. That includes services for which it might be expected their value substantially exceeds the cost of providing them. If, for example, the cost limit is not exceeded for services supplied by the Australian company group to its foreign associated enterprises but there is a reliable CUP available for one or more of those services, the Commissioner will not make any adjustments if the prices returned by the Australian taxpayers for all those services are not less than cost plus the relevant mark-ups. The administrative practice in relation to non-core services will be applied in a similar manner.

95. Taxpayers may still establish the arm's length price for particular services where reliable, comparable data are available. They may wish to do this for instance in start-up situations where independent parties might be prepared in the short term to forego charging a mark-up on costs. Alternatively, a foreign parent may wish to or be required to charge a price in excess of cost plus 10% per cent (or the current upper limit for the mark-up) for a particular, high-value service. Where the Australian group may choose to rely on the administrative practices because the relevant percentage in paragraph 82 or the $500,000 cost limit in paragraph 86 is not exceeded, a decision to use arm's length prices for any of the relevant services (e.g., non-core services) means that the group must use arm's length prices for all similar services supplied or acquired by the Australian group. A choice to use arm's length prices in this situation would be indicated by the use of a price outside the ranges stipulated in paragraph 82 to 84 and/or by the use of an arm's length methodology to estimate prices.

96. The decision to rely on the administrative practices (or for the Commissioner to apply them) is to be made each year irrespective of whether they have been used in relation to the taxpayer's group in the past.

97. Questions willarise about the interaction of these practices with the application of arm's length methodologies to other dealings and the avoidance of double counting. The general principle to be used to resolve these questions is that of the all or nothing choice described in the preceding paragraph. In particular, if a MNE group uses a profit method at an aggregated level (e.g., the transaction net margin method) to reward several dealings with foreign associates, *including*

the supply or receipt of core and non-core services, then it cannot use either of the administrative practices.

98. As a further illustration, if an arm's length method is used to reward a *core* service acquired by the taxpayer, where there is a choice of using arm's length prices or relying on the *de minimis* administrative practice, that administrative practice cannot be relied upon for any services acquired or supplied by the taxpayer's group. Arm's length prices must be used by the taxpayer's group for all core services supplied or acquired by the group. It may still be possible to use the administrative practice for *non-core* services supplied or acquired by the group. Similarly, if an arm's length method is used to reward a *non-core* service acquired by the taxpayer, where there is a choice of using arm's length prices or relying on the *non-core services* administrative practice, the administrative practice cannot be relied upon for any *non-core* services acquired or supplied by the taxpayer's group.

99. Subject to paragraph 95, either practice may be able to be used to determine acceptable prices for services that are needed as inputs in the application of an arm's length methodology to other dealings (e.g., using the cost plus method to determine the arm's length price for goods supplied to an associated enterprise where repairs of relevant machinery by another associated enterprise is one of the relevant indirect costs). Also, where a basic return for services was sought as a step (that of determining the residual profit to be split) in applying a residual profit split methodology to determine arm's length prices for other dealings (not services), either practice could be used if the above conditions for its application were met. Clearly, those services for which an acceptable price has been determined in reliance on either practice would not be taken into account in the determination of how the residual profit should be split.

100. Where the taxpayer seeks correlative relief through a mutual agreement procedure under a DTA in response to an adjustment by another country, for its tax purposes, of a transfer price that has been accepted in Australia under either administrative practice, the grant of relief will be determined in the normal manner on a case-by-case basis. There would be no implications for the application of these practices to other services supplied or acquired by the taxpayer's group that are not covered by the mutual agreement procedure under the DTA. However, in the light of future experience with mutual agreement cases involving the administrative practices, the ATO may change the acceptable mark-ups that may be used by taxpayers in certain circumstances.

101. The ATO may, where the conditions in subsection 136AD(4) and/or the parallel conditions in DTAs are satisfied, deem the arm's length price for particular services to be the cost of supplying those

services plus the mark-ups able to be used for either administrative practice. In selecting the mark-up, the Commissioner would have regard to what the other country might accept in the circumstances, where a DTA is involved. The use of the specified mark-ups in such cases would be appropriate where to do so is consistent with the objective of using subsection 136AD(4) to arrive at the closest practicable estimate of the arm's length result.

102. These administrative practices will be reviewed in the light of data collected and experience with their use including in mutual agreement cases as mentioned in paragraph 100. If the mark-up is to be changed in the light of international practice or other relevant factors, the new value will be published by the Commissioner together with notice of its date of effect which will usually be the start of an income year.

Documentation

103. This Ruling addresses specific aspects of documentation as they relate to the provision or receipt of services. These comments complement the general discussion of documentation of transfer pricing in international dealings (including the reasons for keeping adequate records) in TR 98/11. While this Ruling applies to years prior to and after its issue, paragraph 2.13 of TR 98/11 should be followed when it comes to determining penalties to be applied following an adjustment to the transfer price used for services in a tax return, in the context of the modifications discussed in paragraph 7 of this Ruling. Where recipients of intra-group services do not have adequate documentation to substantiate deductions claimed in prior years, the ATO may request that some of the information and/or documents listed in paragraph 104 be obtained from associated enterprises.

104. Without attempting to be exhaustive or prescriptive, the following types of documentation will be of assistance in the case of the supply or acquisition of services between separate but related entities:

a) contracts or agreements for the provision of services between related parties, and appropriate variations to these contracts or agreements where conditions of the provision of services substantially alter. In this regard, to the extent that independent enterprises typically use written contracts to establish the nature and price of services to be rendered, even if they are rendered on a continuing basis, associated enterprises would be well advised to use similar contracts when they provide services to one another;

b) documents supporting the categorisation of activities and in particular the consideration and recognition of any non-chargeable activities. This may include reasons why each particular type of activity is considered to be correctly categorised as not chargeable or as a chargeable service. Any documents outlining the benefit expected to be conferred by an activity would also be of assistance;

c) documents supporting the selection of a charging method, for example direct or indirect methods of charging, including reasons why the selected method was considered to be the most appropriate for the particular case;

d) documents supporting the calculation of cost-based charges, for example, direct costs plus a reasonable proportion of indirect costs, and adequate records to permit verification of such costs;

e) documents supporting the mechanism used to determine the amounts to be apportioned among associated enterprises, for example, use of formulas, time surveys, etc. This may include detail of the application of this mechanism to the costs incurred in particular years and documentation supporting any review of the applicability of the chosen mechanism;

f) documents supporting the selection of keys for apportionment among several associated enterprises, including reasons why particular keys were considered the most appropriate in the circumstances of the case;

g) documents supporting the selection of a pricing methodology or methodologies and any documentation supporting the consideration and rejection of other methodologies;

h) where a cost plus methodology has been selected, documents outlining reasons for selection of a particular mark-up and reasons why a mark-up on costs may be inappropriate in the facts and circumstances of the case. This may include detail of any external benchmarking undertaken in arriving at the mark-up; and

i) documentation created in the undertaking of a functional analysis of the various group members providing and receiving services to establish the relationship between the relevant services and the members' activities and performance.

105. What documents are maintained will depend on the facts and circumstances of each case, including the complexity and importance of the issue. Taxpayers would be well advised to consider the nature, type and extent of the documentation that it is prudent to maintain having regard to the size of the dealings and the facts and circumstances of the case. Where the taxpayer is relying on the application of either of the administrative practices, the above requirements would need to be modified in the light of paragraph 88.

106. As a general rule, the ATO would suggest that the continued relevance and application of the documentation should be considered annually. It is suggested substantial new documentation would only need to be created where there has been an alteration of the taxpayer's circumstances which would have a significant impact on the continued application of the established pricing mechanism. Again, as a general rule the ATO would not anticipate that such significant alterations would occur on an annual basis.

Commissioner of Taxation

20 January 1999

Previous draft: TR 95/D29

Related Rulings/Determinations:

TR 94/14; TR 97/20; TR 98/11

Subject references:

- administrative practices
- apportionment methods
- arm's length consideration
- arm's length mark-up
- arm's length methodologies
- arm's length price
- arm's length principle
- associated enterprise article
- centralised services
- chargeable services
- comparable uncontrolled price (CUP) method
- contemporaneous documentation
- correlative relief
- cost contribution arrangements (CCAs)
- cost plus method
- direct costs
- direct-charge method
- documentation
- double taxation agreements (DTAs)
- functional analysis
- independent enterprise
- indirect costs
- indirect-charge method
- intra-group services
- management fees
- mark-ups
- multinational enterprise group (MNE group)
- mutual agreement procedures
- non-chargeable activities
- OECD
- profit mark-ups
- separate entities
- services
- shareholder activities
- specific benefit activities
- stewardship activities
- transfer pricing

Legislative references:

- ITAA1997 8-1
- ITAA1936 51(1)
- ITAA1936 79D
- ITAA1936 Pt. III Div 13
- ITAA1936 136AA(1)
- ITAA1936 136AD
- ITAA1936 136AD(2)
- ITAA1936 136AD(4)

Case references:

BP Refinery (Kwinana) Ltd v. FCT (1960) 12 ATD 204; [1961] ALR 52

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