TR 95/D29 - Income tax: international transfer pricing: application of Division 13 of Part III and double taxation agreements - charging for services and expense allocation

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Taxation Ruling

TR 95/D29

Income tax: international transfer pricing: application of Division 13 of Part III and double taxation agreements - charging for services and expense allocation

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What this Ruling is about

Class of person/arrangement

1. This Ruling addresses the operation of Division 13 of Part III ('Division 13') of the *Income Tax Assessment Act 1936* ('the ITAA') and the Associated Enterprises Article of Australia's double taxation agreements ('DTAs') with respect to charging for services within a multinational enterprise ('MNE') and related expense allocation issues.

2. Specifically , this Ruling addresses:

(a) the circumstances in which section 136AD or the Associated Enterprises Article of a DTA will be applied resulting in an arm's length consideration being deemed in respect of the provision of services between separate legal entities; and

(b) the circumstances in which subsection 136AE(4) will be applied resulting in a deemed allocation of income and / or expenses within a single legal entity in respect of a provision of services between different parts of that entity.

3. The Ruling is designed to assist taxpayers to determine whether their prices for services or dealings with associated parties more generally in relation to services conform to the arm's length principle. 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 Guidelines'). That report updates the 1979 OECD report of the same name ('the 1979 OECD report on transfer pricing'). The latest OECD views on arm's length pricing for services are contained in a separate publication, *Discussion Draft on Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (Part II)* , released by the OECD in 1995 ('the 1995 Discussion Draft (Part II) of the OECD Guidelines'). This Ruling reflects how the principles in these OECD reports are considered to apply in the context of the relevant provisions of the Australian income tax law.

4. The Ruling is relevant to the provision of services in the form of work performed and to any of the other items or matters included in the definition of 'services' in subsection 136AA(1). Paragraphs 230 to 237 of Taxation Ruling TR 94/14 ('TR 94/14') discuss the various meanings of 'services'. Thus, in this Ruling, the term 'services' includes administrative, management, technical, financial, marketing, sales or distribution, research and development, and like services.

5. This Ruling addresses the operation of the provisions referred to in paragraph 1 above in relation to the provision of services both in dealings between separate legal entities in different countries that are members of a MNE consisting of a multinational group of companies or other entities (e.g.,a parent company and its subsidiaries), and also dealings between parts of a single legal entityMNE in different countries (e.g., head office, branch offices, divisions and permanent establishments of a single entity). The separate members of a multinational group will in this Ruling be referred to as 'associates'. Although this Ruling is stated in relation to dealings between associates who are necessarily related parties, the views expressed are, in general, equally applicable to non-arm's-length dealings between unrelated parties.

6. This Ruling also considers the application of subsection 51(1) of the ITAA to a charge levied for services received and to expenses incurred in rendering services.

7. It is not the purpose of this Ruling to deal with matters already explained in the other rulings on this topic listed on page one.

Date of Effect

8. 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 21-22 of Taxation Ruling TR 92/20).

Ruling

Services provided between separate entities

Provision of services or expense allocations?

9. In determining the appropriate taxation treatment of intra-group services, the first question to be answered is whether only the expenses of performing the activities need to be allocated to associates or whether an arm's length charge should be levied by the service provider. Considering domestic deduction provisions only, expenditure incurred by an Australian member of a corporate group which may benefit another member of the group is potentially either non-deductible or apportionable under subsection 51(1). Expenditure which is unequivocally incurred on behalf of a foreign associate would generally be non-deductible by the Australian taxpayer as being incurred for the production of income by another entity. Expenditure which is incurred partly for the purpose of gaining or producing Australian assessable income but which relates partly to income derived by foreign associates may be apportionable under subsection 51(1) because the purpose of the expenditure is partly to:

(i) derive income of another entity; and/or

(ii) derive dividends which will be exempt under section 23AJ.

Expenditure which is potentially apportionable might include: directors' fees, salaries of senior management, expenses relating to strategic, financial, legal and operational services, recruitment, training and public relations. Such expenditure is typically incurred for the benefit of a MNE as a whole and not just for the purpose of deriving assessable income of the Australian members of the group ***(paragraphs 77 to 79)*** .

10. There will be a limited number of situations where expenditure incurred by one entity either wholly or partially for the purpose of deriving the income of other members of the group may be fully deductible under subsection 51(1). For example, expenditure intended to render an associate more profitable where there is a real prospect of earning future assessable dividends may be fully deductible. On balance, expenditure incurred by an Australian resident or by an Australian permanent establishment ('PE') of a non-resident for the purpose of deriving income by a non-resident associate is not deductible under subsection 51(1) unless there is sufficient connection with the assessable income of the entity that has incurred the expenditure (**paragraph 81)** .

11. Where an Australian taxpayer charges foreign associates for services provided to them (e.g., a general management fee), the consideration would generally be included as assessable income under subsection 25(1) and the expenditure incurred in deriving that income would generally be fully deductible under subsection 51(1) except to the extent to which it is specifically precluded from deduction, for example, as being of a capital nature. In such a situation, Division 13 and/or the Associated Enterprises articles of relevant DTAs make it necessary to ascertain whether the management fee is an arm's length amount in relation to the services provided to all foreign associates. Where services are provided to foreign associates for no consideration, or for less than arm's length consideration, the ATO would seek to apply Division 13 and/or the Associated Enterprises articles of any relevant DTAs to impute an arm's length consideration for the services provided. Then the deductibility of the expenses incurred in providing the services would be determined **(paragraph 83)** .

12. Where an Australian company is charged for intra-group services, for example by its foreign parent, the deductibility of the charge would initially fall for consideration under subsection 51(1). However, if the charge is greater than an arm's length amount the extent of deductibility would need to be determined under Division 13 and/or the Associated Enterprises article of a DTA. If services are provided to an Australian taxpayer by a foreign associate and no charge is levied on the Australian company, no deduction is allowable under subsection 51(1) for expenditure incurred by the service provider **(paragraph 84)** .

13. Profit allocation between associated Australian and foreign entities to reflect the provision of intra-group services and the performance of head office functions should be determined in accordance with the arm's length principle rather than resolved solely under domestic deduction provisions of the ITAA. Similarly, the consideration paid or payable between non-associated parties for provision of services falls for consideration under Division 13 provided all its requirements are satisfied rather than being dealt with solely under the domestic deduction provisions **(paragraph 86)** .

The law on international transfer pricing

14. If services are provided between MNE members which are separate entities, both section 136AD and the Associated Enterprises Articles (where relevant) require a charge to be made, for taxation purposes, equivalent to an arm's length consideration for those services **(paragraphs 87 to 92)** .

Whether services have been provided and whether a charge should be levied

15. Whether a service has been or will be provided by the performance of an activityand whether a charge should be levied depends upon whether the relevant activity has conferred **,** or is expected to confer **,** a benefit on an associate. A benefit is something of economic or commercial value which an independent entity might reasonably expect to pay for, or to obtain valuable consideration for supplying **(paragraphs 94 and 95)** .

16. If it can be concluded or can be reasonably expected that an independent enterprise would either perform the activity itself or engage an unrelated party to do so, it follows that some benefit is conferred by the activity and a service is provided. For example, the development of a necessary training program for use by the group members is of benefit to them and would constitute the provision of a service. While independent enterprises may not themselves perform or have others perform the same range of activities as are performed in a MNE, that does not preclude a

determination that an independent recipient would value the activities sufficiently to be prepared to pay for them **(paragraph 96)** .

17. In cases where the associates clearly have no need for an activity and would not be willing to pay for it were they independent entities, it cannot be said that such an activity constitutes the provision of a service (i.e., a benefit) to the group members. The maintenance of the share register of the parent company, for example, is not a service performed for the benefit of the other group members **(paragraph 97)** .

18. A benefit is conferred if, when theactivities are performed, another party receives a benefit or is reasonably expected or anticipated to derive a benefit, even if this potential benefit is not realised in practice. There should be no adjustment for tax purposes of otherwise legitimate charges that have been paid simply because with hindsight it appears that the anticipated benefits were not received unless there is clear evidence that there was no intention that they ever would be received **(paragraphs 98 and 99)** .

Categorisation of activities

19. Activities that do not constitute the rendering of services to foreign associates for which a charge should be levied may be called **non-chargeable activities** . They include activities performed by one member of an MNE solely for its own benefit and activities conducted in its capacity as a shareholder of group companies ('shareholder activities') **(paragraph 101)** .

20. Shareholder activities are distinguishable from stewardship activities which refer to a broad range of activities undertaken by a parent company to enhance the value of the group. Where the parent company's involvement is limited to monitoring the performance of subsidiaries, preparation of consolidated statutory accounts and attendance at annual general meetings of subsidiaries, a charge by the parent company for these activities would not likely be warranted. On the other hand, a parent company that actively participates in the management and/or operations of subsidiaries, for example through centralised marketing and on-call services, would not be regarded as solely performing shareholder activities **(paragraphs 102 and 103)** .

21. Even though no charge should be levied by an Australian company on its foreign associates for non-chargeable activities performed by it, non-capital costs associated with those activities would be deductible under subsection 51(1) where they are necessarily incurred in carrying on its business **(paragraph 105)** .

22. Where the Australian entity is being charged for non-chargeable activities, the charge should be reduced to nil under subsection 51(1), a DTA or Division 13 (i.e., no deduction is allowed). If the Australian entity were the parent company and it was charging its foreign associates but it was providing them with little or no benefit, relief may be provided in Australia if another country reduced the deduction for the charge or disallowed it completely, in accordance with a DTA **(paragraph 106)** .

23. An associate should not be considered to receive an intra-group service simply because of incidental benefits derived from being part of an international group, such as a higher credit rating than it would obtain standing alone. However, where benefits arise from specific activities of the parent company such as the giving of a guarantee to obtain more favourable borrowing terms, a service would have been rendered. In general, passive association - which should not give rise to chargeable services - should be distinguished from active promotion of the group's attributes for which a charge would be appropriate. A worldwide advertising campaign by a MNE featuring local group members in different countries or readily associated with those local associates would constitute the provision of services and a charge on the individual group members would be justified **(paragraph 107)** .

24. Services performed to meet the specific needs of another member are called **specific benefit activities** and should always be charged for. If no charge is levied, or if a non-arm's-length amount is charged, an adjustment to impute an arm's length charge would normally be warranted. An activity performed by one company for the benefit of a particular associate that operates to incidentally

benefit other associates should be charged only to the recipient of the specific benefit **(paragraphs 108 to 110)** .

25. **Centralised activities** are the activities of a group member (usually the parent company) which benefit the MNE as a whole but aren't provided for the specific benefit of any individual member. In general, most centralised activities that are not solely for the benefit of the parent will provide a sufficiently non-incidental benefit to the other group members to justify charging for the services. Activities of the parent company that the associates would otherwise have to undertake themselves or have performed for them by third parties should be charged for **(paragraphs 111 to 113)** .

26. A particular type of centralised service is that available to the members of the group 'on-call' and for which a service charge like a retainer fee ought to be charged provided there is a reasonable expectation that the services will be required by the individual group members in the near term. The benefit conferred on a group member by the on-call arrangements should be considered at the time of entering into the arrangement, by looking at the extent to which the services have been used or might be expected to be used over a period of several years rather than solely for the year in which a charge is to be made, before determining the extent to which a service is being rendered **(paragraph 114)** .

Determining the extent of chargeable activities

27. Where there is a real connection between an Australian department's/unit's operations (or at least part thereof) and the business activities of a foreign associate, the associate would be expected to pay something for the work of the department or unit if it were an independent enterprise. It will be clear in some cases that the foreign associate, if it were an independent entity, would be prepared to pay for some activities or perform them itself because of need or the benefit expected from the activity. In this situation, a charge should be levied on the foreign associate **(paragraph 115)** .

Functional analysis

28. A functional analysis should be undertaken to determine the characteristics of the arrangements for the provision of intra-group services as a preliminary step to determining the arm's length price for those services. The same degree of analysis will not be required in all cases. The functional analysis could be performed by either an Australian or foreign member of the group. The analysis should detail what activities are performed for the benefit of other members of the group and which are not, and what other activities are considered to be directly or indirectly related to those activities **(paragraph 116)** .

Australian service provider

29. Non-chargeable activities should be identified in addition to arm's length dealings with unrelated parties. These activities would include activities undertaken for the benefit of the parent company or its Australian associates **(paragraph 119)** .

30. The activities of an Australian company are clearly chargeable if the Australian company is not prepared to undertake the activities for an unrelated party without charging it or if an independent recipient would usually pay to have the activities performed. Specific benefit activities are clearly chargeable. Some activities (those of supporting areas) that do not themselves provide sufficient benefit directly to other group associates to warrant a charge may need to be considered when determining the charge for activities that are chargeable **(paragraphs 115, 120 and 121)** .

31. Where chargeable and non-chargeable activities are carried out by the same people or departments it will be necessary to make a realistic assessment of how their activities should be categorised **(paragraph 123)** .

32. A company may accept the limitations of its existing cost system when determining the extent of activities performed for the benefit of its foreign associates. There will probably be a trade-off between the degree of aggregation of costs and the precision with which service activities can be identified and

costed. Taxpayers are not expected to pursue greater accuracy at all costs but to base their analysis on what would normally be required for cost accounting purposes in their particular circumstances **(paragraph 124)** .

33. Where a functional analysis undertaken by an Australian group member analyses relationships with foreign members of the group and is of use to them too, it is an activity that should be charged out to the relevant associates. However, it would not be appropriate to charge a foreign associate which had no need of such an analysis or which couldn't use one prepared in Australia. If an appropriate charge were in fact levied on an Australian subsidiary by its foreign parent for the conduct of a functional analysis that included the relationship with the Australian subsidiary and the details of which were available to the Australian subsidiary, that would be consistent with the arm's length principle **(paragraph 125)** .

Australian service recipient

34. An examination of all service charges by foreign associates needs to be undertaken by the Australian group company. The Australian company should ascertain what the charges are for and the nature of the benefits being received and have evidence of its preparedness to pay an independent party for such services. A charge would be acceptable where management of a foreign parent was involved in improving the efficiency of the Australian operations or in implementing a new management approach in the Australian subsidiaries. On the other hand, the Australian subsidiary would not be entitled to a deduction for a charge levied on it to cover the costs of a reorganisation of the parent's structure or activities unless real or anticipated benefits for the Australian subsidiary could be established **(paragraph 126)** .

Charging on a regional basis

35. As a general rule, an Australian company for example should charge each of its associates separately for the services which it provides to them. The ATO accepts, however, a single charge by an Australian company on a foreign associate for services provided to all its associates in the same country. In the reverse situation, a single charge on one Australian group member for services provided to all Australian members by a foreign associate would be acceptable subject to the company charged being reimbursed by the other Australian associates. The same-country limitation may be overcome in specific cases in consultation with the taxpayer and other relevant tax authorities **(paragraphs 127 to 131)** .

Blocked payments

36. Where independent enterprises dealing at arm's length would not have entered into an arrangement for the supply of services that exists within an MNE because the recipient is prohibited from paying for the services, the arm's length principle nevertheless requires that an arm's length amount of income be imputed to the service provider. The arm's length price in another comparable market not subject to the same constraints would be acceptable **(paragraphs 132 and 133)** .

Determining the amount of the charge

Methods of charging for services

37. An MNE 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, the charge used for tax purposes should be the best possible approximation of the arm's length consideration for those services. A method that may be practically applied and that facilitates the testing of the amount charged against the arm's length principle is to be preferred **(paragraphs 134 to 136)** .

38. Direct charging for services rendered to other MNE members would be expected if similar services are also rendered to independent parties **(paragraph 137)** .

39. For many centrally provided services which benefit a number of MNE members, the distribution of the benefits may have to be estimated using an apportionment approach because it is not practical or possible to determine a direct charge. Where an apportionment method is used, no single indicator or key (e.g., sales, turnover) is likely to be suitable for all services and the one chosen will vary depending on the nature of the service in question and the data available. However, there may not need to be a different key for each service, especially if the information needed to do so is not readily available. Sometimes, a combination of indicators or keys may be the best indicator of the distribution of benefits. The main criterion for the selection of an apportionment key, or keys, is that a reasonable effort is made to ensure that the chargeable amount is allocated in the same proportions as the expected benefits to individual group members **(paragraphs 138 to 140)** .

40. Where the charge for a service is included in the price of goods or intangibles, care needs to be taken to avoid charging twice for the services. Conformity with the arm's length principle would be determined by an examination of the price of the goods or intangibles recognising that ancillary services are also being provided. There may be situations where a single payment includes both a royalty component and a payment for services and should be dissected for withholding tax purposes **(paragraphs 141 and 142)** .

Methods of ascertaining an arm's length charge for services

41. Irrespective of whether a direct or indirect method of charging is used, the arm's length principle is to be applied to determine the appropriate amount to be charged for intra-group services. The appropriateness of the service charge should be considered from the perspective of both the service provider and the recipient **(paragraph 143)** .

42. For pricing intra-group services, the traditional arm's length methodologies (i.e., CUP, resale price and cost plus) are appropriate. In some circumstances (e.g., where services are combined with other intra-group dealings) a profit method might be the best method. The method to be used is that which is the most appropriate depending on the circumstances and the availability of data **(paragraphs 144 and 145)** .

43. A **CUP** is most likely to be used where there is a high degree of comparability between the intra-group service and a comparable service provided between independent parties, including where the associated party provides the same or similar services to an independent party in similar circumstances. A price obtained using a CUP should not be increased or decreased to deliver what might be thought to be a more reasonable profit for the service provider unless it is clear that independent parties would do so in similar circumstances **(paragraphs 146 and 147)** .

44. In applying the **cost plus method** , the arm's length charge for intra-group services should normally encompass all relevant direct and indirect costs. Direct costs are those identifiable with a particular service. While indirect costs cannot be identified as incurred for a particular activity, they are nevertheless related to the direct costs of an activity. In particular, the costs of supporting departments/units should be included where they are related to the direct costs of a service activity. There should be consistency between the costs included in the pricing of services provided to associates and comparable services provided between independent parties **(paragraphs 149 to 151)** .

45. Determination of the amount of direct and indirect costs related to intra-group services often requires an apportionment of the service provider's relevant costs. Any reasonable approach to this task that considers the relationship between the costs and the service activities will be acceptable **(paragraphs 152 and 153)** .

46. The arm's length charge would normally produce a profit for the service provider subject to whether an independent enterprise seeking the services would be prepared to pay the resulting charge in an open market situation. For example, where the value to the recipient of the service substantially exceeds the cost of providing the service, the arm's length price would invariably include a profit element. However, the profit imperative of a service provider does not justify a price for intra-

group services that exceeds the arm's length price or the value to the recipient of the services **(paragraphs 154 to 156)** .

47. The appropriate **mark-up on costs** is that which exists for similar services provided between independent parties dealing at arm's length in similar circumstances. Sometimes, it may be necessary to adjust the costs to which the mark-up is to be applied to ensure comparability. This wouldn't be done, however, where cost savings might be achieved by the service provider **(paragraphs 157 to 159)** .

48. The use of an arbitrary percentage mark-up not obtained from an analysis of comparable independent party dealings is not consistent with the arm's length cost plus method. Such an approach might be used, however, when arm's length methodologies cannot be satisfactorily applied provided the percentage mark-up is estimated to give a market return for the functions performed, the assets used and the risks assumed and the resulting price is not more than an independent party would be prepared to pay for the services **(paragraphs 160 and 161)** .

49. If the costs of a service provider are such that when an arm's length mark-up for the service (or an estimate of it) is applied to them the resulting price would exceed the maximum amount an independent party would be prepared to pay, the price should be reduced even if that means little profit or even a loss for the service provider. Deductibility of the costs of the activity would not be ruled out solely because they exceeded the arm's length price for the services. A significant disparity would prompt a thorough enquiry into whether the price is based on a true comparable **(paragraph 162)** .

50. As a general rule, the ATO does not accept that marginal cost pricing of intra-group services is consistent with the arm's length principle. This is especially so where it leads to different pricing of the same activities for different members of the group, or prices different to those charged to unrelated parties in the same foreign market, where the differences are not accounted for by differences in markets or other features of the dealings **(paragraph 164)** .

51. A profit mark-up is not appropriate where group members enter into a cost sharing arrangement for services which can be shown to be an arm's length arrangement. Such arrangements are, in the ATO's view, arm's length arrangements in limited circumstances only. They are not a means of avoiding the need to charge an arm's length price for intra-group services **(paragraph 165)** .

52. When apportioning a chargeable amount among a number of group members, the amounts charged to the individual members should be in the same ratios as the expected benefits to the individual members. The amount charged to an individual member should also not exceed the value to it of the service **(paragraph 166)** .

Cost contribution arrangements

53. MNE members may enter into an agreement for the joint production of goods, intangible property and/or services or for the joint acquisition of the same from an unrelated party. These are cost contribution arrangements ('CCAs'). For a CCA to be consistent with the arm's length principle, the contributors must be satisfied that they could obtain an acceptable rate of return within a time frame that has regard to their financial and business circumstances and the risks of the common venture. Where property or a product is being produced in a joint arrangement, it is accepted by the ATO that the parties performing the work (e.g., R&D) or making financial contributions may choose to defer their return over and above their costs in a manner consistent with independent parties dealing at arm's length. As a general rule, the ATO does not accept that an arrangement whereby centralised activities that are not pursued to produce or acquire property are paid for by cost contributions is an arm's length arrangement. Where there is a composite arrangement for the joint performance of R&D or the development of a product and the provision of ancillary or administrative services, there is a need to determine what the payments are for and to be able to substantiate an apportionment of the payments to their components. Each component would then be considered separately for conformity with the arm's length principle **(paragraphs 168 to 171)** .

54. Where some property or product is developed as a result of the arrangement, the joint-activity nature of an arm's length CCA requires that each participant acquires some economic ownership of that property. The interest in the property needn't be a share of legal ownership. A corollary to the acquisition of a degree of economic ownership of, or beneficial interest in, property that is developed, is the need for arrangements to deal with payments to be made when a participant enters or exits from an existing arrangement. In determining those payments, account should be taken of the risks of realising benefits from the existing arrangement **(paragraph 172)** .

55. In a CCA, costs are shared and these would encompass all direct and indirect costs. The manner in which capital costs would be included will depend on the arrangements for the ownership of the assets used in the performance of the joint activity. Any income that is to be shared among the members should be deducted from those costs before they are apportioned. The method of apportioning the total net cost would be determined in the same manner as where an apportionment method is being used to charge for intra-group services. It should be clear that there is not double charging for the activities performed. There should be no inclusion of the cost (direct or indirect) of joint activities in the charges for other transactions among the members (e.g., for goods or intangibles) **(paragraphs 173 to 176)** .

56. Other features an arm's length CCA would be expected to have are that the group participants have full access to the activities being jointly undertaken and are given details of how the calculation and allocation of costs are audited **(paragraph 177)** .

57. The payments made or received under an arm's length CCA for research and development will not generally be royalties. This does not extend, of course, to payments for existing know-how or information that may be part of an overall arrangement. Taxation Determination TD 95/44 would apply to determine deductibility under subsection 51(1) of payments made by an Australian company under a CCA for R&D **(paragraphs 178 and 179)** .

Services provided between parts of a single entity

Principles

58. Where a single entity carries on business in Australia and overseas, and services are provided between PEs, income or expenses of the entity that are connected with performance of the services must be allocated between those parts of the entity. The allocation is done under either subsection 136AE(4) or the Business Profits Article of a DTA. Under the single entity principle of Australian law, a deductible charge is not incurred nor is an assessable amount derived in respect of services provided between parts of the same entity. This part of the Ruling elaborates, so far as is relevant, on Taxation Ruling TR 95/D11 and is expressed only in terms of subsection 136AE(4) (but where applicable is relevant to subsections 136AE(5) and (6)) **(paragraphs 180 to 183)** .

59. Paragraph 136AE(4)(e) in conjunction with subsection 136AE(7) prescribe that consideration be given to all activities carried out by the entity wherever conducted. In doing so, regard must be had to the arm's length principle as one factor to be considered in determining the appropriateness of an allocation of an entity's income and/or expenses **(paragraph 187)** .

60. While subsection 136AE(4) does not specifically refer to the supply of services, activities performed by one part of an entity may represent the provision of services (i.e., benefits) to another part (or parts) of the entity and hence require an allocation of income or expenses between the parts **(paragraph 188)** .

61. If the services are sufficiently direct and significant to be regarded in some part as a source of income derived by the entity as a whole from a third party, some of the income should be attributed to the part of the entity performing the services. For example, where the activities conducted in Australia, or outside Australia by staff of the Australian head office or an Australian PE, warrant an attribution of some of the income of the entity to the Australian head office or PE, that amount of income would be deemed to have a source in Australia. Where income is attributed in this way, the expenses incurred in performing the services should be borne by the part of the entity performing the services. If the

services are not sufficiently direct or significant to require attribution of income, some of the expenditure incurred in performing the services should be allocated to other PEs (paragraphs 189 to 192).

Applications

62. A head office may undertake activities which are similar to those described as non-chargeable activities of separate entities but the concept of shareholder activities cannot apply to a single legal entity. The costs of centralised management activities should be borne proportionately between the head office and each PE unless the particular activity is unequivocally related solely to income derived in one country **(paragraphs 196 and 197)** .

63. Activities of a head office which are intended to provide specific benefits to a particular PE would warrant consideration as activities giving rise to an attribution of income to the head office. Centralised services may not generally be sufficiently direct or significant to the derivation of income to warrant income attribution but there may be instances where that is the case. In any particular situation, regard would have to be given to the factors listed in subsection 136AE(7) **(paragraphs 198 to 202)** .

Expense allocations

64. If an entity incurs expenditure through its head office in performing activities that provide a service to its PEs but an attribution of income to the head office is not warranted, some of the costs of performing the services may be deductible in calculating the profits of the PEs, whether the PEs have been charged for the service or not. If the service is performed solely for the benefit of a particular PE, the whole of the expenditure on the activity would be allocated to that PE. If the activity is performed for the benefit of the enterprise as a whole, the proportion of the expense attributed to a particular PE should reflect its expected share of the benefits from the activity **(paragraph 203)** .

65. Where services are provided between parts of the same entity, and this necessitates an allocation of costs, the amount charged for those services is not income of the service provider for tax purposes. Instead, its allowable deductions are reduced. The allowable deductions of the recipient PEs are increased by corresponding amounts **(paragraph 204)** .

66. An allocation of expenses among PEs will usually be unnecessary for Australian tax purposes if the expenses are not deductible in Australia. The expenses should be allocated to the PEs benefiting from the activities and not according to where the greatest tax benefit is obtainable **(paragraphs 205 and 206)** .

Methods of allocating income and expenses

67. The methods for calculating the expenses to be allocated among the entity's PEs and how they are to be allocated are the same as for separate entities calculating service charges using costs and apportioning the charge among group members. The appropriate indicator to use to apportion the expenses will vary with the activity and the data available **(paragraphs 207 and 208)** .

68. If the services are in some part regarded as a source of income derived by the entity, an arm's length charge determined in the traditional manner may be an appropriate amount of income to attribute to the part of the entity performing the service activities. That charge may be greater than the cost of the relevant activities but may not be greater than the amount of income being apportioned (**paragraph 209)** .

Documentation

69. As indicated in Taxation Rulings TR 94/14 and TR 95/D23, there are a number of reasons for a taxpayer to keep adequate records, including statutory obligation, impact on the imposition and level of penalties imposed, impact on discharge of a taxpayer's burden of proof in the event of disputation and commercial considerations. In general, it may be said that it is in the best interests of a taxpayer

to maintain sufficient contemporaneous documentation to support the fact that services are priced in accordance with the arm's length principle **(paragraphs 210 to 212)** .

70. Documentation of the following will be of assistance in the case of the supply or acquisition of services between separate but related entities:

arrangements for the provision of services within the group;
the categorisation of activities particularly any non-chargeable activities;
the selection of a charging method;
the calculation of cost-based charges;
the selection of cost allocation mechanisms;
the selection of apportionment keys;
the selection of a pricing methodology;
the ascertainment of an arm's length mark-up when using a cost plus methodology; and
the performance of a functional analysis **(paragraph 214)** .

71. All of the documentation mentioned above is not required to be kept for every case where services are provided or received by the members of a multinational enterprise. What documents are to be maintained will depend on the facts and circumstances of each case, and specifically having regard to the complexity and importance of the issue. Taxpayers should determine the nature, type and extent of the documentation they should keep based on principles of prudent business management **(paragraph 215)** .

72. In relation to cost contribution arrangements, it is expected that the terms of these arrangements will be set out as precisely as possible in a written contract concluded in advance of incurring the costs of the centralised activities. In addition, the parties must be able to demonstrate conformity with the agreement. Where alteration to the responsibilities and activities of group members would have a significant influence on their benefit positions, these changes must be taken into account in the written contract as soon as possible **(paragraphs 216 and 217)** .

Explanations

73. Corporate groups which operate internationally typically 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 in a number of ways. This Ruling considers the taxation implications of the provision of intra-group services, the approach to be adopted in relation to the general deduction provisions of the ITAA and the operation of the Associated Enterprises Articles of Australia's DTAs and Division 13.

74. With respect to the provision of services, Division 13 and the DTAs areintended to counter non-arm's-length transfer pricing or international misallocation of profits which involves either undercharging or overcharging for such services. In general terms, the practical effect of Division 13 and the Associated Enterprises and Business Profits Articles of Australia's double taxation agreements is that, for taxation purposes, cross border dealings involving the provision of services result in an allocation of related profits measured by reference to the internationally recognised arm's length principle. The application of the arm's length principle results in 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.

75. Some differences in taxation treatment are required between situations where services are provided between separate entities, and those where services are provided between different parts of a single entity. Nevertheless, effectively the same basic arm's length principle is applied in both situations. Paragraphs 76 to 126 below deal with services between separate legal entities and paragraphs 180 to 209 cover services provided within a single legal entity. Factors to be taken into account in determining the arm's length consideration for intra-group services are discussed in paragraphs 143 to 166.

Services provided between separate entities

Provision of services or expense allocations?

76. 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 which reflects the valueof the services provided. More specifically, the issue is whether the costs incurred by an Australian resident service provider or service recipient should be considered solely under domestic deduction provisions, which will principally be subsection 51(1), or whether consideration for provision of the services, determined in accordance with the arm's length principle, should be included in assessable income or allowed as a deduction.

Non-deductible and apportionable expenditure

77. Expenditure incurred by one member of a corporate group which may benefit another member of the group is potentially either non-deductible or apportionable under subsection 51(1). The subsection invites apportionment by authorising deductions only to the extentto which losses and outgoings are incurred in gaining or producing assessable income or are necessarily incurred in carrying on a business for that purpose.

78. Expenditure which is unequivocally incurred for or on behalf of a foreign associate would generally be non-deductible by the Australian taxpayer, because it is incurred for the production of income by another entity: *Hooker Rex Pty Ltd v. FCT* (1988) 19 ATR 1241 at 1253 and 1262; 88 ATC 4392 at 4411 (refer to paragraphs 194 and 195 of TR 94/14). Expenditure which is incurred partly for the purpose of gaining or producing Australian assessable income but which relates partly to income derived by foreign associates may be apportionable under subsection 51(1) because the purpose of the expenditure is partly to:

(i) derive income of another entity; and/or

(ii) derive dividends which will be exempt under section 23AJ (see paragraphs 197 and 198 of TR 94/14).

79. Directors' fees, salaries of senior management, as well as expenses relating to strategic, financial, legal and operational services, recruitment, training and public relations are all potentially apportionable where a corporate group conducts business outside Australia.

Expenditure otherwise deductible under subsection 51(1)

80. There is no authority in subsection 51(1) for non-allowance or apportionment of expenditure simply because the expenditure exceeds what might be considered to be a reasonable amount (see TR 94/14, paragraphs 200 and 201). If the expenditure is not commercially justifiable, it may be indicative that the expenditure, or part of the expenditure, is for a purpose other than gaining or producing assessable income (see paragraphs 189 to 193 of TR 94/14). It may be possible that a deduction for some of the expenditure may nevertheless not be allowable because of the operation of section 79D.

Situations where apportionment is not required

81. There will be a limited number of situations where expenditure incurred by one entity on behalf of, or for the benefit of, another member of the group may be fully deductible under subsection 51(1). For example, that may be the case if the expenditure was intended to render an associate more profitable and there is a real prospect of earning future dividends (other than dividends exempt under section 23AJ): *(FCT v. Total Holdings (Aust) Pty Ltd* 43 FLR 217; 24 ALR 401; 9 ATR 885; 79 ATC 4279). The full Federal Court decision in *EA Marr & Son Sales Ltd v. FCT* (1982) 13 ATR 656; 82 ATC 4654 may provide support for the view that expenditure is not apportionable where a taxpayer is in the

business of providing services to group members. The extent of the application of *Total Holdings* and *EA Marr & Son* is discussed in Taxation Ruling IT 2606 in so far as the principles relate to business conducted entirely within Australia. It is the ATO view that expenditure incurred by an Australian resident or by an Australian permanent establishment (PE) of a non-resident for the purpose of deriving income by a non-resident associate is not deductible under subsection 51(1) unless there is sufficient connection with the assessable income of the particular entity which has incurred the expenditure.

82. Where a deduction is allowable under a specific deduction provision, apportionment is not required under subsection 51(1) unless the provision itself provides for apportionment. For example, superannuation contributions which are deductible under section 82AAC are not apportionable under subsection 51(1).

Domestic deduction provisions and the arm's length principle

83. In order to fully consider the extent to which the expenditure incurred in providing services may be deductible under subsection 51(1), it may also be necessary to consider any consideration received or receivable as a result of providing the services. If no consideration is received or the consideration is less than an arm's length amount, then it is first necessary to determine the arm's length amount to be included as assessable income. The ATO would first seek to apply Division 13 and/or the Associated Enterprises articles of any relevant DTAs to impute an arm's length consideration for the services provided. Then the question of the deductibility of the expenditure can be considered.

84. 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 subsection 51(1). However, if the services are provided by a company in a country with which Australia has a DTA, the extent of the deduction allowable must also be determined under the Associated Enterprises Article of the DTA and possibly also under Division 13. Where the service provider is in a non-DTA country, the quantum of the deduction will potentially fall for consideration under Division 13. See paragraphs 187 to 203 of TR 94/14 for more explanation of the respective roles of section 51 and Division 13 in this case. If a 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).

85. The problem with viewing intra-group services solely from the perspective of domestic deduction provisions is that 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) 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 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.

86. Accordingly, the ATO considers that the issue of the allocation of profit between associated Australian and foreign entities 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 ITAA by apportioning expenses. Similarly, the consideration paid or payable between non-associated parties for provision of services falls for consideration under Division 13 provided all its requirements are satisfied rather than being dealt with solely under the domestic deduction provisions. This approach is consistent with the OECD commentary on the OECD Model Tax Convention on Income and Capital and the 1995 OECD Guidelines. The arm's length approach is recognised internationally and its adoption by taxpayers is less likely to lead to disputes between tax administrations in different countries and accordingly taxpayers are less likely to risk the incidence of double taxation.

The law on international transfer pricing

87. The basic concepts of the interpretation and application of section 136AD are dealt with in detail in TR 94/14. Briefly, section 136AD applies where:

(i) a taxpayer provides or receives property (including services) under or in connection with an international agreement;

(ii) the parties to the agreement are not dealing at arm's length with each other;

(iii) there is either no consideration or the consideration received or receivable is less or more than an arm's length consideration; and

(iv) the Commissioner determines that the relevant subsection should apply.

88. If all of the preceding conditions are satisfied, the arm's length consideration will be deemed to be the correct consideration for tax purposes. The arm's length consideration in respect of services is the amount which might reasonably be expected to have been paid or received if the services had been rendered between independent parties dealing at arm's length with each other in relation to the supply of the services.

89. Subsection 136AA(1) defines 'services' as including:

'any rights, benefits, privileges or facilities and, without limiting the generality of the foregoing, includes the rights, benefits, privileges or facilities that are, or are to be, provided, granted or conferred under-

(a) an agreement for or in relation to-

(i) the performance of work (including work of a professional nature);

(ii) the provision of, or the use or enjoyment of facilities for, amusement, entertainment, recreation or instruction;

(iii) the conferring of rights, benefits or privileges for which consideration is payable in the form of a royalty, tribute, levy or similar exaction; or

(iv) the carriage, storage or packaging of any property or the doing of any other act in relation to property;

(b) an agreement of insurance;

(c) an agreement between a banker and a customer of the banker entered into in the course of the carrying on by the banker of the business of banking; or

(d) an agreement for or in relation to the lending of moneys.'

90. The Associated Enterprises Articles of Australia's double taxation agreements adopt an approach consistent with Division 13 by authorising an adjustment to the profits of one of the related entities of the two contracting States if they do not deal at arm's length with each other. Where an adjustment is made to the profits of a taxpayer by an adjustment to the charge for intra-group services, relief from double taxation may be sought under the Mutual Agreement Procedures Articles (for example, Article 24 of the double tax convention between Australia and the United States ('the USA Agreement')).

91. Section 136AD may apply where entities are not formally associated yet their dealings are not at arm's length. Unlike Division 13, the Associated Enterprises Articles only apply where the entities are 'associated'; that is, where there is participation in the management, control or capital by the same persons or enterprises. Article 9 of the USA Agreement, for example, provides that it may apply 'where:

(a) an enterprise of one of the Contracting States participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State; or

(b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of one of the Contracting States and an enterprise of the other Contracting State...'

92. Accordingly, if services are provided between MNE members which are separate entities, both section 136AD and the Associated Enterprises Articles (where relevant) require a charge to be made, for taxation purposes, equivalent to an arm's length consideration for those services. The Associated Enterprises Articles have precedence over Division 13 in the case of any inconsistency (subsection 4(2) of the *International Tax Agreements Act 1953*) unless in the circumstances the particular DTA gives precedence to Australian domestic law (for example, Article 9(3) of the USA Agreement).

Whether services have been provided and whether a charge should be levied

93. Examining intra-group service arrangements for conformity with the arm's length principle should be an integral part of intra-group dealings of an MNE and any audit of those dealings. In determining whether services are being or have been provided within an MNE on a basis which reflects arm's length dealings, there are two main tasks to be completed:

(a) identification of chargeable services(paragraphs 94 to 126); and

(b) determination of the arm's length consideration for chargeable services (paragraphs 143 to 166).

94. The determination of whether a service has been or will be provided by the performance of an activityand whether a charge should be levied depends upon whether the relevant activity has conferred **,** or is expected to confer **,** a benefit on another member. Any group member could be the service provider (e.g., a subsidiary could undertake work for the benefit of its parent) but for convenience this Ruling refers only to the parent company as the service provider, unless otherwise specified.

95. In general terms, 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. A benefit is something of economic or commercial value which an independent entity might reasonably expect to pay for, or to obtain consideration for supplying. See paragraphs 230 to 237 of TR 94/14 for a more complete explanation. The benefit must be reasonably capable of being identified and valued, and hence must be sufficiently direct and substantial so that the benefit is sufficiently comparable to that which an independent entity would be prepared to pay for. Sometimes, this condition may be satisfied only by considering a number of activities taken together.

96. If it can be concluded or can be reasonably expected that an independent enterprise would either perform the activity itself or engage an unrelated party to do so, it follows that some benefit is conferred by the service for which a comparable independent enterprise would be prepared to pay. 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 a training program). Clearly, this is a matter of observation of the behaviour of unrelated enterprises or of the recipient in its dealing with unrelated parties. It may well be the case that independent enterprises do not themselves perform or engage others to perform the same range of activities as are found 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.

97. In cases where the group members clearly have no need for an activity and would not be willing to pay for it were they independent entities, it cannot be said that such an activity constitutes the provision of a service (i.e., a benefit) to the 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 very indirectly). Care needs to be taken in deciding whether a member of a MNE group has no need for a particular activity. For example, it may be difficult to identify all of the individual benefits which may be provided by the central co-ordination and control functions typically undertaken by a parent company. It may be necessary to examine broad groups of activities and the benefits derived or to be derived over several years. Central co-ordination and control activities are discussed at paragraph 111 below.

98. A difficulty arises if activities are performed with the expectation of conferring a benefit which does not actually accrue in practice or not to the extent anticipated. For example, a parent company may undertake work on a marketing strategy for a product to be sold by a number of MNE 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. A benefit is conferred if, when theactivities are performed, another party is reasonably expected or anticipated to derive a benefit, even if this potential benefit is not realised in practice. 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 that the benefits may not be fully realised. In a comparable situation, a related party should be required to pay for the work performed.

99. 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 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 (subject to fraudulent behaviour). Similarly, 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

100. For the purpose of determining the extent of activities of a servicing nature within an MNE, it is convenient to separately identify:

(a) non-chargeable activities;

(b) specific benefit activities; and

(c) centralised activities which are general enough to be excluded from category (b).

There can be considerable practical difficulties in placing actual activities into one or other of the categories. It is critical for arriving at the arm's length profit allocation to be able to distinguish non-chargeable activities from chargeable activities whether they fall within category (b) or (c).

(a) *non-chargeable activities*

101. Activities that do not constitute the rendering of services to foreign associates for which a charge should be levied may be called non-chargeable activities. Included are those functions undertaken by one member of an MNE exclusively for its own benefit. For example, a parent company may undertake a range of activities which 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, on behalf of the parent company.

102. 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. Stewardship activities may confer a variety of benefits on group members for which it may be appropriate to charge for the services provided. The terms 'shareholder activities' and 'stewardship activities' are sometimes used interchangeably in the literature. The 1995 Discussion Draft (Part II) of the OECD Guidelines distinguishes 'shareholder activities' from 'stewardship activities', as does this Ruling.

103. Activities conducted in the capacity as a shareholder, as distinguishable 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 parent company. 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 which provides sufficient benefit to the subsidiaries to warrant a charge by the parent company. On the other hand, a parent company which 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.

104. Without being prescriptive or exhaustive, examples of shareholder activities and other activities that are not chargeable to foreign associates are:

- meetings of the parent company's shareholders;
- the issuing of shares or optionsin the parent company and maintaining its share register;
- activities to satisfy statutory reporting requirements of the parent company, including the consolidation of group reports and results **,** and the preparation of the group annual report;
- an audit of the parent company;
- raising funds for the acquisition of new group members by the parent but not the provision of assistance to a subsidiary to acquire a new business or shares in another company; and
- approval of (but not development of) capital expenditure proposals of group members.

105. Even though no charge should be levied by an Australian company on its foreign associates for non-chargeable activities performed by it, non-capital costs associated with those activities would be deductible under subsection 51(1) where they are necessarily incurred in carrying on its business.

106. If, however, a charge has been levied by the parent company for any of these activities and it is clear that no chargeable activities are being performed, an adjustment under a DTA or Division 13 may be necessary. Where the Australian entity is being charged for non-chargeable activities, the charge should be reduced to nil under subsection 51(1), a DTA or Division 13 (i.e., no deduction is allowed). Care needs to be taken where the parent 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 arbitrarily reduce what might be an arm's length charge for the services that are being provided. If the Australian entity were the parent company and it was charging its foreign associates but it was providing them with little or no benefit, relief may be provided in Australia if another country reduced the deduction for the charge or disallowed it completely, in accordance with a DTA. That relief would

probably take the form of reducing the taxable income of the Australian parent. Further guidance on the provision and obtaining of relief under DTAs will be provided in a later ruling.

107. An associate should not be considered to receive an intra-group service simply because of incidental benefits derived from being part of an international group, such as a higher credit rating than it would obtain standing alone. However, where benefits arise from specific activities of the parent company such as the giving of a guarantee to obtain more favourable borrowing terms, a service would have been rendered. In general, passive association - which should not give rise to chargeable services - should be distinguished from active promotion of the group's attributes that positively enhances the profit-making potential of particular members of the group and for which a charge would be appropriate. A worldwide advertising campaign by a MNE featuring local group members in different countries or readily associated with those local associates would constitute the provision of services and a charge on the individual group members would be justified.

(b)

specific benefit activities

108. Services performed to meet the specific needs of an associate are referred to as specific benefit activities and are clearly chargeable. Ordinarily, an independent enterprise in comparable circumstances would have satisfied the identified need either by performing the activity in-house or by having the activity performed for it by a third party. Some examples would 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;
- the parent undertakes investment analysis for particular subsidiaries;
- the performance of certain accounting functions such as compliance with tax laws;
- the provision of guarantees for borrowings by particular group members; and
- training for employees of a particular associate.

109. Specific benefit activities confer a benefit by, for example, performing work for the associate or arranging a line of credit and for which a charge should always be levied. If no charge is levied, or if a non-arm's-length amount is charged, an adjustment to impute an arm's length charge would normally be warranted, under either a DTA or Division 13. If the Australian company were providing the service, an arm's length amount would normally be imputed in Australia as income. If the benefit were being bestowed on the Australian company by a foreign associate, 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, relief from possible double taxation may be available under a DTA for the Australian company.

110. There may be cases where an activity performed by the parent company for its own benefit or for the benefit of a particular associate incidentally provides benefits to other group members. Examples could be the taking of a decision to reorganise the group, to acquire new members or to terminate a division. These activities will be a service to the member of the group which is subject to the reorganisation as they would be expected to positively assist its profit making capacity. An independent party would be expected to pay for such assistance. However, if the re-organisation produces benefits for other group members, for example by some incidental increases in efficiency, the benefits ordinarily would not be sufficient to constitute the rendering of a service to the other associates. Such incidental benefits would generally be too indirect or remote for an independent party to be prepared to pay for them.

(c)

centralised services

111. Parent companies, and regional headquarters companies typically undertake activities which are intended to benefit the group 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 which are centralised in a particular MNE, and the extent of benefits conferred on members of the group, will 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 services are central co-ordination and control activities such as supervision of cash flows, management of foreign exchange and interest rate exposures, co-ordination of group finances, production and distribution.

112. In general, most centralised activities that are not solely for the benefit of the parent will provide a sufficiently non-incidental benefit to the other associates to justify charging for the services. The extent of the benefit to individual members will affect the amount of an arm's length charge for the service. A charge would clearly be justified where the activity of the parent company 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. Consideration would need to be given to whether the service is effectively being charged for in the price of other transactions (e.g., loans) between the group members.

113. Some examples of centralised activities might be:

- 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;
- personnel services such as recruitment and training;
- research and development and administration of intangibles;
- administration of a share and option scheme for executives, including executives of subsidiaries;
- 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;
- operation of employee share plans;
- analysis of markets for inputs and outputs; 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 that is determinative but whether benefits are provided to other group members.

114. A particular type of centralised service is that available to the members of the group 'on-call' (e.g., legal/technical advice) and for which a service charge like a retainer fee ought to be charged provided there is a reasonable expectation that the individual associate will want to use the services in the near term. It is reasonable to expect, based on observation of market behaviour, an independent enterprise in comparable circumstances to incur 'standby' charges to ensure the availability of the services when the need for them arises. It is unlikely that an independent enterprise would incur standby charges where the potential need for the service was remote, where the advantage of having services on-call was negligible, or where the on-call services could be obtained promptly and readily form other sources without the need for standby arrangements. The benefit (expected to be) conferred on a group member by the on-call arrangements should be considered, perhaps by looking at the extent to which the services (are expected to be used) have been used over a period of several years rather than solely for the year in which a charge is to be made, before determining whether a service (is being) has been rendered and if so the extent of the service.

Determining the extent of chargeable activities

115. What degree of connection with the foreign associates is necessary to bring an Australian department's/unit's activities within the realm of chargeable services? There should be a real connection between the department's/unit's operations (or at least part thereof) and the business activities of a foreign associate. In these cases, the associate would be expected to pay something for the work of the department or unit if it were an independent enterprise. It will be clear in some cases that the foreign associate, if it were an independent entity, would be prepared to pay for some activities or perform them itself because of need or the cost/benefit calculus of the activity. Where there is doubt, the Australian company might ask itself whether it would undertake the activity for its own benefit or whether it would do so for an unrelated party for no charge. If the answer to both these questions is no, a charge should be levied on one or more foreign associates.

Functional analysis

116. Determination of the activities of a particular company which should be charged to group members should be seen as part of undertaking a functional analysis of an MNE. As well as identifying the functions undertaken by the various group members, the assets, skills and expertise used in undertaking activities and the sharing of risks should be established by the analysis. The extent of the analysis will depend 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 services. The same degree of analysis will not be required in all cases. 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 should be all that is necessary. On the other hand, a more thorough functional analysis would be required where services are closely related with a number of intra-group dealings and might suggest that the dealings need to be examined on an aggregated basis. The analysis could be performed at either end of the relationship (i.e., either in Australia or by a foreign parent). The analysis should 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. Detailed guidance on undertaking a functional analysis is provided in Draft Taxation Ruling TR 95/D22 on methodologies.

117. The following suggestions are directed particularly at how the functional analysis (or that part of it dealing with service arrangements) may be used to identify and categorise the various activities undertaken by a company which provides a range of services to group members. Comments are also made on what is necessary from a service recipient's perspective.

118. First, it is necessary to broadly identify the various functions of the parent company and the functions of group members. The first step in the process of categorisation is to identify those members of the group which provide intra-group services.

Australian service provider

119. Where the functional analysis confirms that the Australian company is the service provider, those activities which are unquestionably non-chargeable activities should be identified in the first instance. Such activities would include shareholder activities (see paragraphs 101 to 103 above) and other functions performed solely for the benefit of the parent company and its Australian resident associates. Activities that relate exclusively to arm's length dealings with unrelated parties would also not be chargeable to group members.

120. The next step is to identify those activities conducted by the parent company which clearly confer a benefit on associates (see paragraphs 108 to 114 above). These types of activities will generally be those described in this Ruling as specific benefit activities but may also include centralised services.

121. 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 need to be recognised as being connected with the activities that are providing benefits to other group members and should be considered as an indirect cost when determining the charge for service activities (see paragraph 151 below).

122. The analysis will probably result in a number of residual activities which mayprovide benefits to individual subsidiaries and to the group as a whole but which may not necessarily be identified with any particular subsidiaries. These activities might be referred to as 'potentially chargeable' activities . Examples would generally include the functions of senior management including the Board of Directors, and the activities of administrative and service personnel.

123. The nature of each activity or function of each department/unit which has been classified as potentially chargeable should then be more thoroughly analysed. The activities should be classified as eitherchargeable or non-chargeable activities on the basis of the criteria outlined at paragraphs 101 to 114 above. Where chargeable and non-chargeable activities are carried out by the same people or departments, it will be necessary to make a realistic assessment of how their activities should be categorised.

124. 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 and the need for detailed cost data. The answer to this question probably involves a trade-off between aggregation of costs (because in practice the cost of activities will often form the basis of the charges) and precision. The more disaggregated the cost system is, the more finely tuned the analysis could be - but probably the greater would be the proportion of any relevant area's costs that are chargeable. If costs are only available on a very broad divisional or departmental basis, the activities of more divisions, etc may have to be considered, but smaller proportions of their costs may be included in the calculation of charges. Taxpayers are not expected to pursue greater accuracy at all costs but to base their analysis on what would normally be required for cost accounting purposes in their particular circumstances (Kitto J in *BP Refinery (Kwinana) Ltd v. FC of T* 12 ATD 204 at 208).

125. Who pays for a functional analysis, whether it is a shareholder activity or not, is an interesting question in itself. In as much as it analyses relationships with foreign members of the group and is of use to them too, it is an activity that should be charged out to the relevant associates. However, it would not be appropriate to charge a foreign associate which had no need of such an analysis or which couldn't use one prepared in Australia. It would be consistent with the arm's length principle if an appropriate charge were in fact levied on an Australian subsidiary by its foreign parent which has conducted a functional analysis which included the relationship with the Australian subsidiary and the details of which were available to the Australian subsidiary.

Australian service recipient

126. Where the functional analysis reveals that the Australian company is the recipient of services, an examination of all charges by foreign associates needs to be undertaken by the Australian group company. Fundamentally, it should have evidence of its willingness, or that of other parties dealing with independent entities, to pay an independent entity for the claimed services (evidence of its need for the service and of the benefits or cost savings that will result). For example, being provided with

necessary legal services saves the Australian company having to get them elsewhere or paying a retainer fee for on-call 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 expectancy of needing such services). The Australian company should ascertain what the charges are for ('management services' is not sufficient), the nature of the benefits being received and the basis for the charge (this issue is discussed later in the Ruling). A charge would be acceptable where management of a foreign parent was involved in improving the efficiency of the Australian operations or in implementing a new management approach in the Australian subsidiaries. On the other hand, the Australian subsidiary would not be entitled to a deduction for a charge levied on it to cover the costs of a reorganisation of the parent's structure or activities unless real or anticipated benefits for the Australian subsidiary could be established.

Charging on a regional basis

127. Rather than charge every individual member of a group, a parent company or group service centre may choose to charge only one associate as the representative of all group members in a particular region (e.g., a US company for all companies in the Americas). The following paragraphs discuss the acceptability of this practice from a tax perspective.

128. While this practice may make sense for the group, it may give rise to unintended tax consequences. It needs to be analysed both from the perspective of an Australian company charging other group members and from the reverse perspective.

129. In the former case, 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 associates. 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 members (e.g., for all companies in the Americas in the above example). However, there could be problems for the charged company (e.g., the US company in the above example) 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 the US company were reduced by the US tax authorities. There could be relevant DTA differences (e.g., between US and Canada) or there may be associates where a DTA wouldn't otherwise apply (e.g., Panamanian). These differences may affect source country taxing rights, foreign tax credits that could be claimed in respect of the charge or entitlements to deductions. When applied on a worldwide basis, the Australian company would need to ensure, for example, that the sales of all associates in the Americas are compared with those of associates in other regions, to avoid manipulation.

130. When looked at from the other side of an Australian company being charged for benefits provided to a number of regional subsidiaries, there could be significant implications for Australia. Where the Australian company is charged on behalf of non-Australian group members, 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 reimbursed by the other group members in the same year 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.

131. To avoid disputes with other taxing authorities, as a general rule, the practice of charging in this manner will be acceptable for tax purposes where it is limited to same-country members. That is, a single charge by an Australian company on a foreign associate for services provided to all its associates 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 associates by a foreign associate would be acceptable subject to the above requirement of reimbursement. The same-country limitation may be overcome in specific cases in consultation with the taxpayer and other relevant tax authorities.

Blocked payments

132. If a group member is prohibited by the law of its country, or is in some other way prohibited from paying the service provider for services received or which may be received, it would reasonably be expected that there would be no services provided to that company if the parties had been dealing wholly independently with each other. Whether an amount of imputed income should be included in the assessable income of an Australian service provider in these circumstances, where there has been no payment (and possibly no charge made), will depend on the facts and circumstances in each case. The arm's length principle does not require actual payment; the amount of consideration determined under either the Associated Enterprises Article or under section 136AD is for taxation purposes only, to adjust a taxpayer's accounts, if necessary, to reflect the situation which would have occurred had the parties been dealing wholly independently with each other. Provided the circumstances in any given situation authorised the operation of either the relevant article of a DTA or subsection 136AD(2), the ATO would generally seek to impute an appropriate amount of consideration to the Australian service provider.

133. The ATO does not accept that the arm's length consideration in these situations is nil, because clearly a benefit of some value has been provided and the price for that benefit in arm's length dealings would not be zero. Not including anything in the profits of the service provider for the supply of the benefit leads to a misallocation of profits. If the information needed to determine the arm's length price is not available in the market of the service recipient, the price given by the best available comparable in another comparable market not subject to the same constraints could be used.

Determining the amount of the charge

Methods of charging for services

134. MNEs use various methods of charging group members for services provided to associated enterprises by parent companies or group service centres. According to the 1995 Discussion Draft (Part II) of the OECD Guidelines, the most common methods are:

(a) charging individual group members directly for specific services (the direct-charge method); or

(b) indirect-charge methods:

(i) apportionment of an amount based on the cost of providing the services; or

(ii) inclusion of an amount for services in prices for other property transfers.

Cost contribution arrangements (sometimes called cost sharing or cost funding) are entered into by some MNEs in order to fund jointly acquired services or centralised activities. The joint acquisition of benefits in these arrangements distinguishes them from the case of one member providing services to one or more other members of a group. Cost contribution arrangements are discussed further at paragraphs 167 to 179 below.

135. In practice, companies use one or more of the above methods of charging or hybrids of the methods as described by the OECD. Whatever method is used, it is necessary for the purposes of Division 13 and the Associated Enterprises Articles of DTAs that the resultant intra-group charges conform with the arm's length principle.

136. The direct-charge method best facilitates the testing of the amount charged against the arm's length principle by allowing for clear identification of the service performed and the basis for the charge. Conversely, indirect charging tends to obscure the relationship between the relevant services, the value of the services to the recipient and the charge made. Accordingly, the ATO and other revenue authorities encourage taxpayers to use a direct-charge method wherever possible and practical.

(a)

Direct-charge method

137. Direct charging is particularly appropriate for services performed by an MNE member specifically for another MNE member (see paragraphs 108 to 110 above). Direct charging for services rendered to other MNE members would be expected if similar services are also rendered to independent parties. Sometimes, a market price for the service will be available and at other times a price based on the costs of the service provider will be calculated to estimate the arm's length price of the service.

(b)

Indirect-charge methods

138. Experience shows that a direct-charge method may be unsuitable for certain types of services, particularly centralised services (see paragraphs 111 to 114 above). Consequently, it has been necessary to develop indirect methods of charging for services. Where it is clear that real benefits have accrued to several other group companies but the benefits cannot be quantified except on an estimated basis, an indirect-charge method is appropriate. An indirect-charge method may be appropriate where a complete recording and analysis of the relevant activities to show the benefits received by individual associates will impose a disproportionate administrative burden upon an MNE. Accordingly, for many centrally provided services which benefit a number of MNE members, the costs of providing the services may have to be determined for several activities taken together and the distribution of the benefits may have to be estimated using an apportionment approach.

139. 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 associates 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. The main criterion to be satisfied by whatever indicator or 'key' (for example, turnover or profits) is used as the basis of allocation is that the chargeable amount is allocated in the same proportions as the expected benefits to individual group members. No single key will achieve this in all cases. Desirably, the appropriate key would be different for the various types of services provided by the group service centre. For example, if the service being charged is the administration of an employee share scheme, the appropriate indicator or key to use to apportion the chargeable amount would seem to be the proportion of employees eligible to participate in the scheme employed by each group member. A charge for helping to improve the movement of goods within the group might be allocated by reference to each company's share of the total volume of goods transported by the group during the year.

140. 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 but the same combination of indicators will probably not be appropriate in all cases (i.e., a single formula probably should not be applied in all cases).

141. In some cases, an extra mark-up may be included in the price of products sold or licensed to group members, to charge for technical assistance or marketing advice. Alternatively, an amount may be added to costs in applying a cost plus method to determine the arm's length price of the goods or the intangibles, to reflect the cost of the ancillary services. Where either of these approaches is adopted for the pricing of services, care needs to be taken to avoid charging twice for the services. Conformity with the arm's length principle would be determined by an examination of the package of dealings and the arm's length price of the goods or intangibles in these circumstances would have to take into account the fact that ancillary services are also being provided. This may require a dissection of the price into its service and other components.

142. Where services are packaged with goods or intangibles in this way and a package price is charged, it may be necessary to also dissect the payment where the tax treatment of the different components is different. For example, there may be situations where a single payment includes a royalty component as well as payments for services. In these situations, the payment should be

dissected into the respective components for withholding tax purposes (Taxation Ruling IT 2660 provides guidance on distinguishing between royalties and payments for services).

Methods for ascertaining an arm's length charge for services

143. Irrespective of whether adirect or indirect method of charging is used, the appropriate amount to be charged for services rendered within an MNE is to be determined in accordance with the arm's length principle. Thus, the amount charged must be consistent with what comparable independent enterprises charge or would reasonably be expected to charge in similar circumstances. The consideration should be considered from the perspective of both the service provider (is it sufficient?) and the service recipient (is it too much?) for conformity with the arm's length principle.

144. Methodologies for ascertaining an arm's length consideration are as stated at paragraphs 86 to 100 of Taxation Ruling TR 94/14 and expanded on in Draft Taxation Ruling TR 95/D22 on methodologies. Traditional transfer pricing methods, namely the comparable uncontrolled price method (CUP), the resale price method and the cost plus method would normally be appropriate. In situations where these methods are unable to be used or do not result in a sufficient degree of comparability, we also accept that some profit methods may be used to approximate the arm's length consideration.

145. The CUP and cost plus methods are more commonly used than other methods for determining the arm's length price of intra-group services. The resale price method may be a more suitable method in some cases (e.g., where services provided within a MNE are on-sold to independent parties). A profit method may be appropriate where, for example, the 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 associates.

Comparable uncontrolled price method

146. A CUP method is likely to be used where there is a high degree of comparability between the intra-group service being provided and a comparable service provided between independent parties. A CUP method is also likely to be used where the associated party provides the same or similar services to an independent party in comparable circumstances or the recipient purchases similar services from an independent party. For example, surveying or engineering services may be provided to an associate for which a comparable market price is readily available. The CUP method may be suitable for the pricing of on-call services and other centralised activities but the degree of comparability needs to be carefully assessed because of the combination of services made available in the group situation.

147. Where the arm's length charge can be determined using a CUP based on a high level of comparability, 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. The charge can't be increased simply to raise the profit for the service provider. This situation, however, would not be likely to continue for a long time in an arm's length situation. Paragraphs 445 to 449 of TR 94/14 contain some explanation of 'start-up' or 'market penetration' situations which are also relevant to providing services. 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. Where the quality of the data used to obtain the CUP is of insufficient comparability, an alternative method of determining an arm's length charge for the services may have to be used.

Cost plus method

148. If a suitable CUP cannot be found, the cost plus method is generally best suited to calculating an arm's length charge for services. If a cost plus methodology is to be used, the questions of what expenses should be covered by the service charge and whether a profit element should be included in the service charge need to be addressed.

149. In applying the cost plus method, the charge should usually reflect all relevant costs, both direct and indirect. Indirect costs should be included because in an arm's length situation the supplier of services would normally seek to recoup both direct and indirect costs as well as derive a profit and the recipient would normally be prepared to pay on that basis. Only in exceptional circumstances would a failure to include indirect costs be accepted as arm's length pricing (see paragraphs 169 to 173 of the draft ruling on methodologies, TR 95/D22). What is important is that there is consistency between the costs that are 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. More is said about the appropriate profit mark-up in paragraphs 154 to 165 below.

150. Direct costs are those identifiable with a particular service and include the cost of labour, transport, materials and supplies used directly in performing the services. Direct costs may be easy to identify and quantify for some particular services but may have to be estimated in other cases.

151. Indirect costs are those that cannot be identified as incurred for a particular activity but are still related to the direct costs. Without being exhaustive or prescriptive, examples of indirect costs would include:

- light and power;
- rents, maintenance and repairs;
- rates and property taxes;
- insurance;
- telephone, telex, facsimile and other telecommunications costs;
- postage and courier expenses;
- indirect labour costs, including:
- 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;
- interest and other financial expenses (not otherwise recouped);
- contributions to other capital costs that are not depreciable; and
- costs of supporting units/departments (e.g., personnel, accounts, information technology, staff facilities).

152. This Ruling is suggesting that there are three broad steps involved in determining the total costs of performing chargeable activities.

Step 1: Ascertain which activities are chargeable and which aren t:

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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 (need to know total direct costs of all activities over which indirect costs are to be apportioned).

153. In many cases the degree of analysis and recording needed to allocate costs 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 members may in many cases constitute a reasonable basis for allocating all relevant costs associated with performing those activities. The quality of the information obtained from such a survey will only be as good as the methodology adopted and the questions asked. For example, a questionnaire requesting staff to estimate their time spent on various activities for the previous twelve months without previous records being kept would be unlikely to establish an accurate basis for the cost of a company's activities. 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 overhead 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

154. Activities of benefit to particular associates contribute to their profit earning potential even if only indirectly. Even centralised services are usually undertaken with a view to improving the group's profitability. The fair sharing of taxes on those profits requires a determination of where those profits of the group should be reported. To achieve the correct profit allocations, in general, the application of the arm's length principle requires that a charge for services provided between separate entities within an MNE not only recovers the costs incurred in providing the services, but also produces a profit (e.g., normally included in the 'plus' component of the cost plus method) for the service provider. This would apply whether the cost plus method is being used to calculate a direct charge or whether an apportionment method is being used. The requirement is consistent with what an independent party would ordinarily do in an arm's length dealing, subject to whether an independent enterprise seeking the services would be prepared to pay the resulting charge in an open market situation.

155. Where the value to the recipient of the service substantially exceeds the cost of providing the service, the arm's length price determined using the cost plus method would invariably include a profit element. This situation would arise, for example, where an Australian company possesses all the technical knowledge and expertise for fulfilment of a contract which is entered into by an overseas group company and an independent party. The profits from performance of the contract would be earned entirely by the foreign associate unless the charge to it for services provided by the Australian company is sufficient to cover the latter's costs and return an appropriate profit.

156. Another case where a profit element would normally be called for is where a special purpose company's principal function is to provide services to the members of a MNE group. In such a situation, the special purpose company would have no profit earning capacity other than from the activities conducted for the benefit of the other members of the group. However, this profit imperative does not justify a price for services that exceeds the arm's length price or the value to the recipient of the services.

157. The appropriate amount of the profit mark-up is determined by a comparable profit mark-up on costs for similar services, either individually or in combination, provided between independent parties. In some cases, the arm's length mark-up may be obtainable from comparable service transactions between the group service provider and unrelated parties in similar market situations. The arm's length mark-up depends on such factors as the economic value added by the activities, the functions performed by both the provider and the recipient, the assets and skills used, the risks assumed, and market conditions in which the parties operate. Where the service provider has special expertise which is made available to group members (e.g., engineering, legal or financial expertise), the charge for any services using that expertise should incorporate a market rate of return for such expertise, provided other factors are comparable with the arm's length situation.

158. The extent of the actual mark-up on the service provider's costs will depend partly on the comparability of the costs of the service provider with the costs of the parties from which the arm's length mark-up is obtained. In some cases, it may be necessary to adjust the relevant costs (as opposed to the mark-up rate) in applying the cost plus method to make the respective transactions comparable. 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 (see Draft Taxation Ruling TR 95/D22 on methodologies).

159. There may be cost savings to be made by a group in centralising the provision of some services. When using the cost plus method to determine the arm's length price in this situation, the service provider should not increase its mark-up to capture the benefit of the cost savings if the mark-up thereby becomes greater than the arm's length mark-up. If, however, a 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.

160. Admittedly, it may be very difficult to find good comparables that are providing similar or comparable services to unrelated parties and to find out the profit mark-up on costs (if any) charged by them. If other 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, the taxpayer or the auditor must use the best available mark-up (i.e., that obtained from the best available comparable).

161. 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 cost plus method. In cases where acceptable comparables cannot be found for the combination of centralised services supplied by a parent company in a MNE, such an approach 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 (see paragraphs 188 to 190 of the draft ruling on methodologies).

162. In some circumstances it is possible that the mark-up may be very small or nil, or even negative, depending on the market circumstances. For example, the costs of a service provider may be such that when the arm's length mark-up is applied the resulting price exceeds the maximum amount an independent recipient of the services would be prepared to pay in similar circumstances (because the

cost-plus price exceeds the value to the recipient of the services and the opportunity cost to it of performing the activity itself). This situation might arise particularly where the service is incidental to the service provider's principal activities and the service is provided for the convenience of the group. In this situation, the price should be reduced to the maximum payable in the open market. The service provider may, nevertheless, agree to perform the services to complement its range of service activities. The reservations expressed in paragraph 147 above also apply in this case. In such a situation it would be necessary to examine the cost structure used for determining the intra-group charge. Deductibility of the costs of the activity would not be ruled out because they exceeded the arm's length price for the services. Nevertheless, if there was a significant disparity between costs and the arm's length price, a more detailed examination of the intra-group arrangements and the comparables would be warranted to ensure that the price is based on a true comparable.

163. A parent company which occasionally pays expenses incurred by subsidiaries and then re-charges the relevant subsidiaries would not generally be expected to charge anything other than the actual payments made on behalf of the group members. The charge represents a reimbursement of expenses rather than a charge for services because the parent company is not adding value in undertaking this activity. Where, however, the usual practice is for the payment of expenses to be coordinated and paid by a service company on behalf of several group members, it may be appropriate to include a service charge which is sufficient to cover the administrative costs of the service company and incorporate an arm's length mark-up for the agency function.

164. An issue which may arise is what a particular associate, e.g., a new group member, should be charged for services which involve little or no additional activity, or incurring of additional expenditure, by the service provider. It may be argued that a charge is justifiable only in respect of the additional activities and/or expenditure incurred in providing the additional services. This is a misunderstanding of the arm's length principle. While an independent party dealing at arm's length with another may be prepared to provide a service at a price which is sufficient to cover marginal costs, in the short term, it would be the exception rather than the rule. The arm's length principle requires consideration of the extent of the benefits actually conferred on the recipient of the service and not just the costs of the service provider. As a general rule, the ATO does not accept that marginal cost pricing of intra-group services is consistent with the arm's length principle. This would be especially so where it leads to different pricing of the same activities for different members of the group (even to the extent of some not being charged at all), or prices different to those charged to unrelated parties in the same foreign market, where the differences are not accounted for by differences in markets or other features of the dealings. The general approach to marginal cost pricing is further discussed at paragraphs 384 to 393 of the draft ruling on practical issues associated with setting, reviewing and documenting transfer pricing (TR 95/D23).

165. A profit mark -up is not appropriate in situations where MNE members enter into an arrangement for the joint sharing of costs in proportion to the expected benefits to be derived. Such arrangements, which are known as 'cost sharing', are generally acceptable to the ATO and other revenue authorities in limited circumstances. However, they cannot simply be used by taxpayers to avoid complying with the requirements of the arm's length principle, including the need for an appropriate element of profit in charges made for intra-group services. Cost sharing arrangements are discussed in paragraphs 167 to 179 below.

Apportionment charges

166. If an indirect-charge method requiring apportionment of the chargeable amount is being used, the arm's length principle requires that the amounts allocated to the 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 should not exceed the value to it of the service, as is the case with direct charging. Of more practical importance, the amounts charged to the individual members should be in the same ratios as the expected benefits to the individual members. That is, if a member is expected to reap about one fifth of the expected benefits from a centralised service activity (e.g., interest exposure management) it should pay about one fifth of the total amount charged by the parent company for the management services. The possible methods of apportionment are discussed at paragraphs 139 to 140 above.

Cost contribution arrangements

167. Cost contribution arrangements (CCAs) are recognised in the 1979 and 1984 OECD reports on transfer pricing as a method of charging for intra-group services. The 1979 report gives them a slightly different meaning in relation to research and development ('R&D') activity. The description of cost sharing in that context is an arrangement 'under which members of the group agree to share the actual costs and the risks of R&D undertaken for the benefit or expected benefit of each of them. In such cases, each participant would bear its fair share of the costs and risks and would in return be entitled to its fair share of any useable results of the R&D' (paragraph 103 of the 1979 OECD report on transfer pricing). While both reports leave open the possibility that such an arrangement could involve a sharing of costs without any mark-up, the general rule adopted in both is that a profit mark-up is more consistent with the arm's length principle in most circumstances.

168. The concept of a CCA in the 1995 Discussion Draft (Part II) of the OECD Guidelines is more akin to that used in the 1979 report in relation to R&D but is more far-reaching. A CCA is seen as one where members of an MNE group act in concert to jointly produce or provide goods, intangible property, and/or services, or to jointly acquire goods, intangible property or services from a third party. This concept of a CCA is more akin to a joint venture or a partnership and is distinguished from methods of charging for intra-group services. Another distinguishing feature of such an arrangement, according to the 1995 Discussion Draft (Part II) of the OECD Guidelines, is that in all cases the members share costs and no profit margin is involved. While a CCA may encompass R&D, the idea is not limited to R&D activities. It should be borne in mind that these views on CCAs are not yet included in the final 1995 OECD Guidelines.

169. For a CCA to be consistent with the arm's length principle, the contributors must be satisfied that they could obtain an acceptable rate of return within a time frame that has regard to their financial and business circumstances. In deciding whether the prospective return is sufficient, the participants will have regard to the risks of the proposed common venture, the time frame in which returns are expected and the level and nature of their contributions. Normally, where the provision of services is involved this rule requires that the service provider charges something more than its costs of providing the services. Where property or a product is being produced in a joint arrangement, those performing the work (e.g., R&D) or making financial contributions may choose to defer their return over and above their costs. The deferred return would be expected to be realised in the form of future benefits from the exploitation of the property being produced or acquired. Where there is no prospect of, or mechanism for, earning that profit margin, as with services that are consumed immediately, an arm's length provider of services would expect its full remuneration, on a current basis, for the activities performed, the assets used and the risks assumed.

170. As a general rule, therefore, the ATO does not accept that an arrangement whereby centralised activities that are not pursued to produce or acquire property are paid for by cost contributions is an arm's length arrangement. The mere labelling of a service arrangement as a CCA and the sharing of costs does not make the arrangement one that is consistent with the arm's length principle. Generally, a charge incorporating a mark-up on costs and calculated on an apportionment basis would be appropriate, as discussed earlier in this Ruling.

171. Where there is a composite arrangement for the joint performance of R&D or the development of a product and the provision of ancillary or administrative services, there is a need to determine what the payments are for and to be able to substantiate an apportionment of the payments to their components. Each component could then be considered separately for conformity with the arm's length principle.

172. Where some property or product is developed as a result of the arrangement, the joint-activity nature of an arm's length CCA requires that each participant acquires some economic ownership of that property. This would be the case, for example, with R&D activity, the development of an advertising program or the collation and analysis of market information. The interest in the property needn't be and usually isn't a share of legal ownership. The legal ownership may often remain with one of the participants, usually the parent company. A corollary to the acquisition of a degree of economic ownership of, or beneficial interest in, property that is developed, is the need for arrangements to deal with payments to be made when a participant enters or exits from an existing

arrangement. Part of the benefit sought to be obtained from the arrangement is the right to a share of the fruits from exploitation of the R&D results (if any) or of the property being produced. Parties dealing at arm's length would expect to pay for such a share of expected future benefits and to get some payment for forgoing it, account being taken of the risks of realising the benefits.

173. In a CCA that is arm's length, only costs are shared and these would encompass all direct and indirect costs of production and an appropriate allocation of other general and administrative expenses (i.e., absorption costing). Capital costs should be included. Where the terms of the CCA allow the operator to retain ownership of the asset giving rise to the expenditure, an annual charge (e.g., depreciation or rental charge) based on the usage of the asset would be appropriate. If, however, the asset used in the performance of the joint activity is to be owned jointly by the participants, capital expenditures would be charged out as they arise (along with revenue expenditure) and would retain that character in the books of the participants.

174. Any income that is to be shared among the members should be deducted from those costs before they are apportioned. For example, the income from the licensing to a third party of an accounting system used in the performance of a joint activity should be shared among the participants in the CCA and deducted from the costs of the joint activity before they are apportioned. Such income would be set off against the costs to be shared in the year in which the income is derived. This shared income needs to be distinguished from any which may be part of the benefit to be gained by an individual participant from the exploitation of the product of the R&D activity, etc.

175. The method of apportioning the total net cost in an arm's length manner would be determined in the same manner as where an apportionment method is being used to charge for intra-group services (see paragraphs 139 and 140 above). The principle to be applied is that costs should be allocated in the same proportions as the expected benefits from the joint activity. Some indicator (e.g., sales) or combination of indicators, using either actual data or expectations depending on availability and quality, will normally have to be used to estimate the expected distribution of benefits for participants.

176. As with the pricing of services generally, it should be clear that there is not double charging for the activities performed. There should be no inclusion of the cost (direct or indirect) of joint activities in the charges for other transactions among the members (e.g., for goods or intangibles). Particularly in relation to an Australian group member making cost contributions in a CCA and also purchasing other property or services from other participants in the CCA, the MNE must be able to establish that there is no double charging.

177. Other features an arm's length CCA would be expected to have are that the group participants have full access to the activities being jointly undertaken and are given details of how the calculation and allocation of costs are audited. Documentation and evidentiary requirements of a CCA are dealt with in the section on Documentation.

178. Questions frequently asked about CCAs concerned with R&D are whether the payments made or received under the agreement are royalties and whether payments made are deductible. There are two barriers to the payments being royalties according to the definitions in double taxation agreements or in subsection 6(1). First, a distinction has to be made between payments for services performed, even where they involve the supply of information or advice, and payments for the supply of know-how which are royalties. The criteria for making that distinction are spelt out in Taxation Ruling IT 2660: Income Tax: Definition of Royalties. The major consideration is whether there is the supply of existing information or know-how for use by the buyer or whether that know-how is applied by the supplier to provide to the buyer some further information, design or advice. Where there is a genuine CCA that meets all the requirements spelt out in this Ruling, the payments are not for the supply of existing information or know-how. They are for the joint acquisition of that information or the joint undertaking of a task. This does not extend, of course, to payments for the supply of existing information or know-how that may be part of an overall arrangement. In a particular case, however, that know-how may be the result of earlier work which was jointly undertaken and funded and therefore paid for by the participants. Secondly, the payments are a share of the cost of joint activity and their nature depends on the nature of the individual elements of that total cost. Only if a particular cost element is a royalty paid to a non-participant would any part of the CCA payment be a royalty.

Clearly, a careful examination of the facts is needed to determine whether the payments are royalties or not.

179. The ATO's views on whether research and development expenditure is deductible under subsection 51(1) are given in Taxation Determination TD 95/44. That Determination would apply to payments made by an Australian company under a CCA for R&D. Taxpayers should determine whether the payments have the requisite connection with the income producing activities of an existing business and whether they are of a revenue or capital nature.

Services provided between parts of a single entity

Principles

180. Where services are provided within a single legal entity (e.g., a non-resident company with an Australian permanent establishment (PE)), section 136AD cannot apply because there cannot be an 'international agreement' between separate parts of the same legal entity. Nor do the Associated Enterprises articles of DTAs apply to the single entity situation. Where a misallocation of profits occurs between different parts of a single entity, section 136AE and/or the Business Profits article of any applicable DTA may authorise the reallocation of income and expenses between the Australian and foreign operations.

181. Draft Taxation Ruling TR 95/D11 on the application of Division 13 to single entities ('TR 95/D11') deals with the basic concepts underlying subsections 136AE(4), (5) and (6) and the circumstances in which the subsections will be applied. The purpose of this part of this Ruling is to elaborate on the matters discussed in TR 95/D11 in so far as they relate specifically to allocation of income and expenses arising from activities in the nature of services within single entities. As in TR 95/D11, this Ruling is expressed only in terms of subsection 136AE(4) which, subject to any difference in the wording of subsections (5) and (6), is equally applicable to the latter subsections.

182. Australian law incorporates a single entity approach to dealings between a PE and another part of the same entity, such as its head office (HO) or another PE. As a single legal entity cannot transact with itself or make a profit out of transactions between its parts, it follows that no deductible charge can be incurred, and no assessable amount can be derived, in respect of services provided between a branch and a head office or another branch. There must, therefore, be some differences from the manner which is appropriate to separate entities in the way the provision of services provided within a single entity is analysed and how charging for services is approached.

183. Notwithstanding this legal position, charges between parts of a single entity may be recognised and recorded in its accounts, for commercial and accounting purposes. The presence or absence of an internal charge for accounting purposes, or the amount of the charge, is not determinative of the appropriate allocation of income and expenditure for tax purposes. Nevertheless, separate accounts that an entity keeps for its PE will invariably be the starting point for determining what is an appropriate allocation of income and expenses to the PE.

Income Tax Assessment Act 1936

184. Subsection 136AE(4) provides that where:

'(a) a taxpayer ... is a resident and carries on a business in a country other than Australia at or through a permanent establishment of the taxpayer in that other country or is a non-resident and carries on business in Australia at or through a permanent establishment of the taxpayer in Australia;

(b)
a question arises whether, and if so, as to the extent to which -

(i)
any income derived by the taxpayer is derived from sources in Australia or sources out of Australia; or

(ii)

any expenditure incurred by the taxpayer is incurred in deriving income from sources in Australia or sources out of Australia;

(c) none of the preceding provisions of this section applies in relation to the determination of that question;

(d) that question, if determined on the basis of the return lodged by the taxpayer, would have a tax result more favourable to the taxpayer than the result that would occur if that question was determined in accordance with this subsection; and

(e) in the opinion of the Commissioner, the derivation of the income or the incurring of the expenditure is attributable, in whole or in part, to activities carried on by the taxpayer at or through the permanent establishment;

the income or expenditure shall be deemed, for all purposes of this Act, to have been derived or to have been incurred in deriving income, as the case may be, from such source, or from such sources and in such proportions, as the Commissioner determines.'

185. Subsection 136AE(4) provides for determining the source of income or the extent to which expenditure is incurred in deriving income from a particular source, where that income or expenditure is in some part attributable to activities carried on through a PE. In a practical sense the result achieved may be conveniently expressed in terms of allocating income or expenditure to a PE to correctly determine the profits of the PE. It is on this basis that this abbreviated way of expressing the function performed under subsection 136AE(4) is used in this Ruling.

186. In applying subsection 136AE(4), subsection 136AE(7) requires that regard be had to:

'(a) the nature and extent of any relevant business carried on by the taxpayer and the place or places at which the business is carried on;

(b) if any relevant business carried on by the taxpayer is carried on at or through a permanent establishment - the circumstances that would have, or might reasonably be expected to have, existed if the permanent establishment were a distinct and separate entity dealing at arm's length with the taxpayer and other persons; and

(c) such other matters as the Commissioner considers relevant.'

187. Paragraph 136AE(4)(e) in conjunction with subsection 136AE(7) prescribe that consideration be given to all activities carried out by the entity wherever conducted. In doing so, regard must be had to the arm's length principle as one factor to be considered in determining the appropriateness of an allocation of an entity's income and/or expenses. The operation of subsections 136AE(4) and (7) is explained in more detail in Draft Taxation Ruling TR 95/D11.

The meaning of services in relation to single legal entities

188. Subsection 136AE(4) does not specifically refer to the supply or acquisition of property (which includes services) as in the case of section 136AD. Nevertheless, the meanings of services and benefit as discussed in relation to separate entities will generally be equally applicable to those activities conducted within a single entity which are incidental and relevant to the derivation of income or lead to a reduction of expenditure within one or more other parts of a single entity. The principles at paragraphs 94 to 99 may be used to determine whether activities performed by one part of an entity represent the provision of services for another part, and hence require an allocation of either income or expenses between those parts.

Allocation of income and expenditure in relation to intra-entity services

189. Subsection 136AE(4) authorises the allocation of actual income derived and actual expenses incurred by a taxpayer. Accordingly, where an internal charge has been levied for services provided within a single entity (e.g., engineering assistance provided by a head office to a PE), the charge cannot in itself result in the creation of income or expenditure. However, if the activities in respect of which the charge is levied are sufficiently direct and significant to be regarded as the source, or part of the source, of income which is derived by the entity from dealings with other parties then an appropriate part of the externally generated income will be properly attributed to that part of the entity which carried out the activities. That is, if the service activity is being performed by an Australian head office or PE, the amount of income which is attributable to the Australian operations may be deemed to have an Australian source even though under general law principles the income may have its source, or predominant source, outside Australia. (Paragraphs 180 to 189 of TR 95/D11 provide further explanation of source principles under general law and subsection 136AE(4).)

190. Accordingly, where activities are conducted, and expenditure is incurred, by one part of the entity which is related to income produced in another part of the same entity, subsection 136AE(4) requires an enquiry beyond the mere allocation of expenditure. The enquiry must examine the nature and extent of the activities themselves in order to determine:

(a) the extent of expenditure which is incidental and relevant to the income derived both in and out of Australia which should be allocated to the relevant part or parts of the entity; and

(b) the nature and extent of activities conducted in each location and the respective contributions made to the derivation of income by the entity as a whole.

191. Where the activities conducted in Australia, or outside Australia by staff of the Australian head office or an Australian PE, are sufficiently direct and significant to be regarded as the source, or part of the source, of income which is derived from dealings with other parties then it will be necessary to allocate the relevant income between the respective parts of the entity. Where income is attributable to Australia, the expenditure incurred in gaining that income should be borne by the Australian PE. That is, there is no requirement for expenses to be allocated to another PE. The circumstances where activities would be sufficiently direct and significant to warrant attribution of income are discussed further in paragraphs 200 to 202 below.

192. Where the activities conducted at or through a PE in Australia are incidental and relevant to income derived from a foreign source, but not sufficiently direct or significant to require attribution of income, it will be necessary to allocate the appropriate proportion of the relevant expenditure to the foreign PE or PEs.

Double tax agreements

193. The Business Profits Articles of Australia's double taxation agreements (DTAs) govern the attribution of profits where a single entity is a resident of Australia or a treaty partner country and conducts business in the other country at or through a PE. For example, Article 7 of the DTA with the USA states:

'(1) The business profits of an enterprise of one of the Contracting States shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the business profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment.

'(2) Subject to the provisions of paragraph (3), where an enterprise of one of the Contracting States carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the business profits which it might be expected to make if it were a distinct and independent enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly

independently with the enterprise of which it is a permanent establishment or with other enterprises with which it deals.

'(3) In the determination of the business profits of a permanent establishment, there shall be allowed as deductions expenses which are reasonably connected with the profits (including executive and general administrative expenses) and which would be deductible if the permanent establishment were an independent entity which paid those expenses, whether incurred in the Contracting State in which the permanent establishment is situated or elsewhere.'

194. The interpretation and application of the Business Profits Articles will be the subject of a later ruling. For this reason, this section of this Ruling applies where a DTA does not apply.

Applications

195. With regard to those activities which might be regarded as services (or benefits) provided within a single legal entity, there are broadly three types of activities which need to be distinguished:

(i) activities which are performed solely for the purpose of deriving income in one country (e.g., activities conducted by an Australian head office which relate solely to gaining or producing Australian assessable income);

(ii) activities conducted by one part of the entity(e.g., a head office), which are incidental and relevant to the income derived by another PE but which cannot be regarded as being sufficiently direct and significant to be the source of the entity's income;

(iii) those activities conducted by one PE which are sufficiently direct and significant to the income produced by another PE to warrant attribution of income under subsection 136AE(4).

Activities undertaken solely for the purpose of deriving income in one country

196. Activities which are undertaken solely for the purpose of deriving income in one country are similar to those described as non-chargeable activities conducted by separate legal entities (see paragraph 101 above). However, the existence of a single legal entity requires some modification to those principles.

197. The concept of shareholder activities which applies to separate legal entities (paragraphs 101 to 103 above) cannot be extended to the single entity situation. A head office, for example, does not act in the capacityof a shareholder in other parts of that entity. Centralised management activities are part of the general management activity of the entity as a whole. The costs should be borne proportionately between the head office and each PE unless the particular activity is unequivocally related solely to derivation of income in one country.

Activities which are incidental and relevant to the business of another PE

198. Activities which are incidental and relevant to the business of another PE will include:

(i) activities undertaken for or on behalf of another PE; and

(ii) activities which are conducted for the benefit of the entity as a whole but which cannot be readily identified as relating to income from any particular source.

199. Expenditure incurred in relation to these types of activities should be charged at cost (both direct and indirect) to the relevant parts of the entity. Examples of expenditure centrally incurred for the benefit of the entity as a whole would typically include:

directors' fees;
executive salaries and expenses of providing fringe benefits;
office overheads such as rent, electricity, telephone rental;
the cost of indirect activities such as corporate services and personnel departments which relate, in part, to services provided by staff more directly involved in providing intra-company services.

Activities which require attribution of income

200. Whether a particular activity constitutes a sufficiently material and contributing factor to the income earned by a particular PE will depend on the facts and circumstances of each case. Activities which are intended to provide specific benefits to a particular PE (e.g., those conducted by a head office for a PE), would potentially fall for consideration as activities giving rise to the income derived by that PE. For example, if a head office developed and implemented an advertising campaign on behalf of a particular PE, it would be appropriate to attribute some part of the income, or future income, of the PE to the HO. An arm's length provider of similar services would be expected to seek to recover all costs as well as earn a profit and so the attribution of an amount of the entity's income greater than the cost of providing the services might be appropriate. In such a situation, the timing of income attribution needs to be considered; refer to paragraphs 286 to 290 of TR 95/D11.

201. Centralised administrative services would not generally be sufficiently direct nor significant, viz-a-viz other factors giving rise to production of income of the recipient PE, to warrant an amount of income being attributed to the PE conducting administrative activities. However, there may be instances where particular centralised services are sufficiently direct and significant to the income derived by one or more other PEs. For example, legal and/or financial services provided by a head office may form a significant component of the total activities of the entity in deriving income from the sale of financial products or services by a PE to independent parties to warrant part of the income earned by the PE being attributed to the head office.

202. In any particular factual situation regard would have to be given to each of the factors listed in subsection 136AE(7) (see paragraph 186). If, for example, a PE merely acted as an intermediary or agent for the head office then the income arising from services on-sold to independent customers should be apportioned having regard to respective contributions of the head office and the PE.

Expense allocations

203. If an entity incurs expenditure, through its head office for example, in performing activities that provide a service to a PE, and the activities are not considered in some part to be a source of income derived by the entity through the PE (e.g., the cost of planning activities), then part of or the whole of that expenditure is allocated to the PE. The costs of performing the services may be deductible in calculating the profits of the PE, whether the PE has been charged by the HO for the service or not. If, for instance, an overseas head office of an MNE provides services to an Australian PE, then the expenditure incurred in providing the services is allocated to the PE, and a deduction under subsection 51(1) may be allowable in calculating the entity's Australian taxable income derived through the PE. This is subject to the amount of the expenditure that is allocated to the PE being appropriate in terms of subsection 136AE(4) and to the other requirements of the Australian deduction provisions. If the service is performed solely for the benefit of the PE, the whole of the expenditure on the activity would be allocated to the PE. If the activity is performed for the benefit of the enterprise as a whole, the proportion of the expense attributed to a particular PE should reflect its expected share of the benefits from the activity.

204. Where services are provided between parts of the same entity, and this necessitates an allocation of costs, the amount charged for those services is not income of the service provider for tax purposes. That is, the assessable income of the PE providing the service is not increased by any internal charge. Instead, its otherwise allowable deductions are reduced by the amount allocated to other PEs and the allowable deductions of the service recipient are increased by the same amount. This is different from the treatment where the activities warrant an attribution of income to the service provider (see paragraph 200 above).

205. An issue that needs to be considered is whether only deductible expenses should be allocated to PEs when an allocation of expenses is called for. In the single entity situation, the task will usually be one of properly allocating actual expenses. If those expenses are not deductible, the question of their allocation will usually be irrelevant for Australian tax purposes. This result can be contrasted with the situation where specific intra group services are provided between separate entities. In the separate entity situation, the relevant task is that of determining the arm's length price for services rendered regardless of the deductibility of the expenses incurred in performing those services. The issue of deductibility of those expenses for the service provider to a separate entity is in that sense a secondary issue. However, in the case of a single entity, it may still be necessary that the expenses are properly allocated amongst the entity's PEs because the expenses may be deductible for foreign tax purposes.

206. While the MNE may be concerned to ensure that all its expenses are deductible somewhere, if expenses that are properly attributable to foreign PEs are not deductible in some or all foreign countries (but are deductible in Australia), that doesn't mean that they should be allocated to an Australian PE to ensure deductibility. The reverse is also true. The expenses should be allocated to the PEs benefiting from the activities and not according to where the greatest tax benefit is obtainable.

Methods of allocating income and expenses

207. Where the provision of services to a PE requires an allocation of expenses, the total cost of undertaking the service activities is to be allocated to the PE or head office. The costs to be taken into account should include both direct and indirect costs of performing the activities as discussed in relation to services provided between separate legal entities (see paragraphs 149 to 151 above).

208. As to the methods which may be used to allocate that expenditure among a number of PEs in the case of centralised services, the principles outlined in paragraphs 139 and 140 above could be applied. The appropriate indicator to use to apportion the expenses will vary with the activity and the data available. Some expenses might best be allocated proportionately to each PE, including other PEs in the same country as the service provider. For example, it may be appropriate to take account of the assets in each PE, the number of employees, the relative amounts of certain types of income or of certain other expenses, or some combination of more than one of these (or other possible candidates).

209. Despite the lack of recognition in law of an internal charge which exceeds the cost of the relevant activities to the provider of an intra-company service, such a charge may nonetheless be an appropriate and practical means of attributing income to that part of the entity which conducted activities giving rise to income derived from external dealings. For this purpose, the transfer pricing methodologies discussed in paragraphs 144 to 166 above may be one method of determining the notional income which would have been earned had the PE been a separate entity dealing at arm's length with the entity of which it is a part and with other persons. The charge would be determined in the same way as for separate entities, subject to its not being greater than the amount of income derived by the entity as a whole. The interaction between the arm's length charge and the income being apportioned is explained in paragraphs 243 to 246 of TR 95/D11. A practical outcome of this is that where an Australian entity is providing these services to both foreign subsidiaries and PEs (e.g., a bank) it may determine the charge in the same way.

Documentation

210. The Commissioner has noted in Taxation Ruling TR 94/14 that the tax law imposes an obligation on taxpayers to lodge correct and accurate income tax returns. In this regard, it is noted at paragraph 101 of TR 94/14 that:

'Taxpayers need to keep sufficient contemporaneous records to enable this evaluation to be done in the course of preparing their tax returns. It is not accepted that taxpayers need not address the question of whether their pricing policies comply with the arm's length principle until they are subject to audit by the ATO.'

211. 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 in Draft Ruling TR 95/D23: Practical Issues Associated With Setting, Reviewing and Documenting Transfer Pricing.

212. It is considered that the statements in TR 94/14 are equally applicable to the provision of services between related parties as they are to pricing of transfers of goods among associated enterprises. In addition to any statutory requirements, it is considered to be in the best interests of a taxpayer to maintain sufficient contemporaneous documentation to support the fact that services are priced in accordance with the arm's length principle. The existence and availability of such documentation should reduce the risk of disputation, will assist the taxpayer to discharge the burden of proof in the event that disputation does occur, and will impact on the level of any penalties imposed in the event that an ATO adjustment is required to the international transfer prices between associated enterprises. More detail on the reasons for keeping documentation may be found in paragraphs 22 to 63 of TR 95/D23. It is also noted in TR 94/14 at paragraph 372:

' 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.'

213. This approach is supported in the 1995 OECD Guidelines, where it is stated at paragraph 5.14:

'Taxpayers should recognise that notwithstanding limitations on documentation requirements, a tax administration will have to make a determination of arm's length 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.'

214. 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 and, where relevant, between PEs of a single entity:

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 continual basis, associated enterprises would be well advised to use similar contracts when they provide services to one another. Similar written evidence of the service activities performed by the head office or permanent establishments of a single entity would be expected;

b) documents supporting the categorisation of activities and in particular the consideration and recognition of any non-chargeable activities. This should include reasons why each particular type of activity is considered to be correctly categorised as not chargeable. Any documents outlining the relationship between an activity and the benefit expected to be conferred by the 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 or expenses to be allocated among PEs, 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 associates or PEs, for example, use of formulas, time surveys,

etc. This should include detail of the application of this mechanism to the costs incurred in particular years and documentation supporting the regular review of the applicability of the chosen mechanism;

f) documents supporting the selection of keys for apportionment among several associates or PEs, 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 would be of assistance. This should 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.

215. It should be noted that the ATO is not saying that each of the types of documentation mentioned above is required to be kept for every case where services are provided or received by the members of a multinational enterprise. What documents are to be maintained will depend on the facts and circumstances of each case, and specifically having regard to the complexity and importance of the issue. Taxpayers should determine the nature, type and extent of the documentation they should keep based on principles of prudent business management (refer to paragraph 5.4 of the 1995 OECD Guidelines).

216. Specifically in relation to cost contribution arrangements, it is expected that the terms of these arrangements will be set out as precisely as possible in a written contract concluded in advance of incurring the costs of the centralised activities. In addition, the parties to the arrangement should be able to demonstrate that the centralised activities they are paying for are provided in conformity with the agreement and have been or will be carried out in practice over several years.

217. The costs of the relevant activities should be determined on the basis of generally accepted accounting principles. It would also be expected that, where alteration to the responsibilities and activities of group members would have a significant influence on their benefit positions, these changes will be taken into account in the written contract as soon as possible.

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219. If you wish to comment on this Draft Taxation Ruling, please send your comments by **29 March 1996** to:

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Commissioner of Taxation

29 November 1995

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