

# ***PS LA 2005/14 - Transfer Pricing Review Work***

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**PS LA 2005/14**

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**FOI status: may be released**

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*This Practice Statement is issued under the authority of the Commissioner and must be read in conjunction with Law Administration Practice Statement PS LA 1998/1. It must be followed by Tax officers unless doing so creates unintended consequences. Where this occurs officers must follow their Business Line's escalation process.*

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**SUBJECT: Transfer Pricing Review Work**

**PURPOSE: To provide guidance to staff on:**

- The review products used for assessing transfer pricing risks, and
- The transfer pricing review process which embodies a transfer pricing record review and a commercial realism assessment

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## BACKGROUND

1. The process outlined in this practice statement has evolved out of the *Transfer Pricing Record Review and Improvement Project – Large Business* (sometimes referred to as the '207 project'). The aim of this project was to ensure that taxpayers were following Taxation Rulings TR 97/20 and TR 98/11.<sup>1</sup>
2. Since the conclusion of this project, transfer pricing work has been integrated into business as usual risk assessment and audit work. It has also been integrated into project work focused on specific transfer pricing risk issues and rulings.
3. Supporting the integration to business as usual, the Transfer Pricing Practice was created within International Strategy & Operations (ISO)<sup>2</sup> to provide strategic leadership and assurance over transfer pricing work corporately. The

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<sup>1</sup>Taxation Ruling TR 97/20 entitled 'Income tax: arm's length transfer pricing methodologies for international dealings' and Taxation Ruling TR 98/11 entitled 'Income tax: documentation and practical issues associated with setting and reviewing transfer pricing in international dealings'.

<sup>2</sup>International Strategy and Operations is part of the Large Business & International (LB&I) business line. Its objective is to shape international strategic direction and management together with associated compliance strategies and to provide the ATO with the assurance that the international tax system is being managed efficiently and effectively.

Transfer Pricing Practice chairs an operationally focused forum (the Transfer Pricing Operations Group) which oversees the patterns that may arise from the outcomes of transfer pricing review actions.

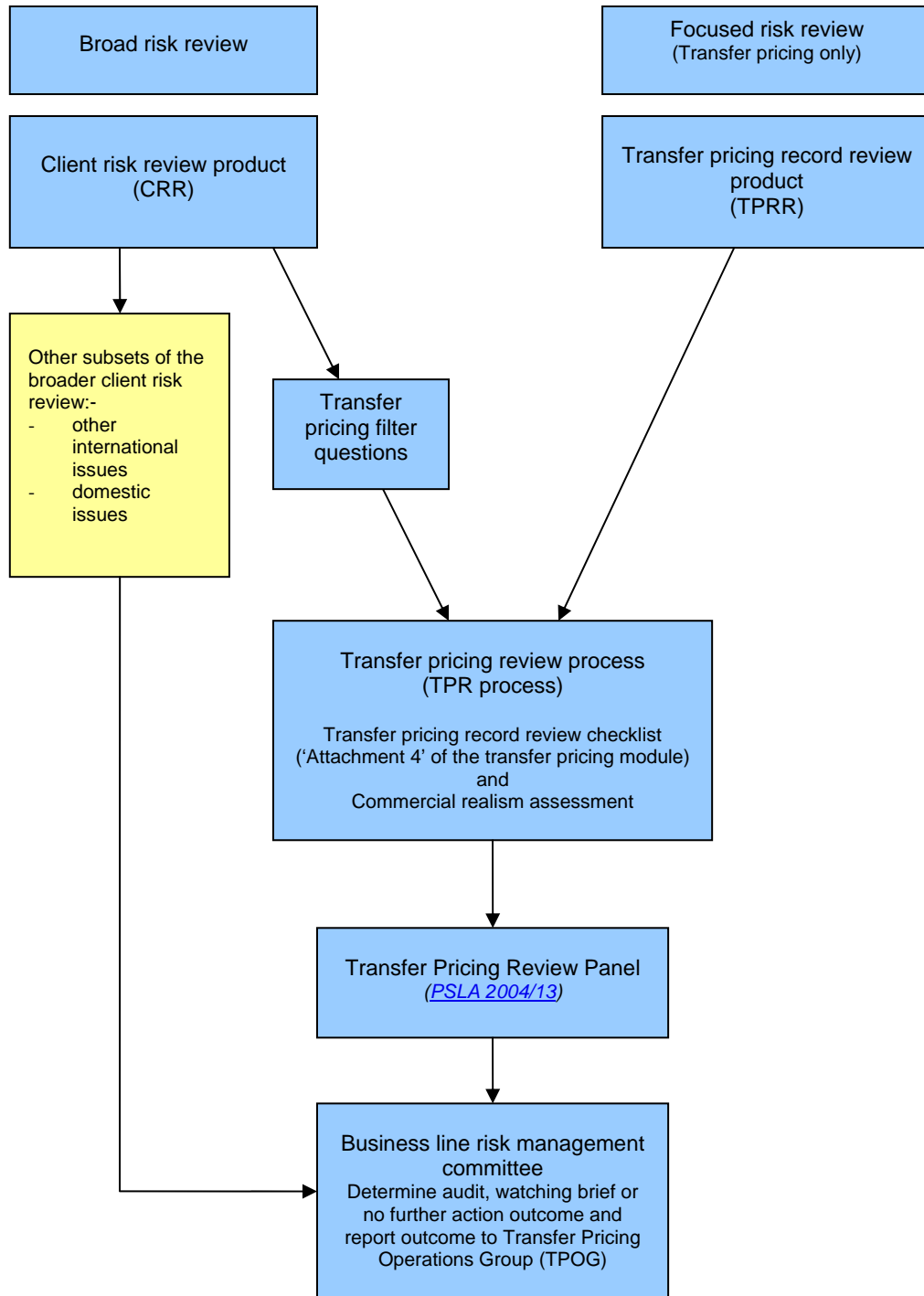
4. The Transfer Pricing Practice and the Transfer Pricing Operations Group both report to the Transfer Pricing Steering Committee, a transfer pricing leadership forum, responsible for the delivery of transfer pricing work in relation to the Compliance program.
5. The Assistant Commissioner of Transfer Pricing Practice is responsible, through the Transfer Pricing Steering Committee for transfer pricing matters – including the Compliance program.
6. Transfer pricing review work is required to be in alignment with the following published documents:
  - *Compliance program 2005-06*, and later versions that may be published (NAT 7769-08.2005)
  - *Co-operative compliance - working with large business in the new tax system* (NAT 22630)
  - *Law Administration Practice Statement PS LA 2004/13 – Transfer Pricing Review Panel*
  - *Law Administration Practice Statement PS LA 2006/9 – Referral of Work to International Strategy and Operations*
  - *International Transfer Pricing; Introduction to concepts and risk assessment* (NAT 02725-4.2005)
  - *International Transfer Pricing; Applying the arm's length principle* (NAT 02726-04.2005)
  - *International Transfer Pricing; Advanced pricing arrangements* (NAT 02748-04.2005)
  - *International Transfer Pricing; A simplified approach to documentation and risk assessment for small to medium businesses* (NAT 12032-03.2005)
  - *International Transfer Pricing; Attributing Profits to a Dependent Agent Permanent Establishment* (NAT 14314-09.2005)
  - *International Transfer Pricing; Marketing Intangibles* (NAT 14586-11.2005)

## **STATEMENT**

7. This practice statement sets out the procedures officers must follow when undertaking a transfer pricing review process within a client risk review or a transfer pricing record review product. A transfer pricing review process is mandated by [Taxation Ruling TR 98/11](#) and is conducted at a risk assessment level, before a transfer pricing audit is commenced. A fast track to a transfer pricing audit in certain circumstances is also set out in the ruling (see paragraph 4.9 of TR 98/11).

8. A transfer pricing review involves (see paragraph 4.7 of TR 98/11) an assessment of the:
  - quality of processes and the extent of relevant and adequate contemporaneous documentation maintained by a taxpayer (using the transfer pricing record review checklist), and
  - commercial realism of the dealings with the international related party/parties. This is usually done by comparing an appropriate profit level indicator of the taxpayer to broad industry benchmarks applicable to the taxpayer's activities. (This will indicate if transfer pricing as applied by the taxpayer broadly reflects a commercially realistic outcome after taking into account other commercial explanations of business performance.)
9. The following review products are used in the ATO for assessing transfer pricing risk depending on whether that risk is considered broadly with other potential risks or narrowly as a perceived risk :
  - Client risk review – the broad risk review to assess international and domestic risk in specific business entities or consolidated groups. (If a material transfer pricing risk is identified, this work can proceed into a transfer pricing review process.)
  - Transfer pricing record review – a focused risk review used to address a perceived transfer pricing risk in specific business entities or consolidated groups, or to undertake specific issue project work. (This work will always follow a transfer pricing review process.)
10. The transfer pricing review process is conducted by a case officer with assistance from the Economist Practice in all cases. The Economist Practice provides both the commercial realism assessment and a review of the taxpayer's benchmarking study (if any) – refer to paragraph 16.
11. The case officer is responsible for the engagement of the Economist Practice. The case officer may also seek assistance from ISO – Complex Assistance and Technical Support Team where the complexity of the case merits such assistance. Guidelines for referral to Complex Assistance and Technical Support Team can be found in [PS LA 2006/9](#). If assistance is required the case officer should refer the issue to either the relevant Complex Assistance and Technical Support Team manager or team leader ([Contact List](#) - link available internally only).

Diagram 1: High level view of the transfer pricing risk review process



### Transfer pricing review process

12. As indicated in diagram 1, the transfer pricing review process is the foundation for undertaking both the transfer pricing section of a client risk review and a transfer pricing record review. The process is summarised in the following paragraphs – see paragraph 26 for the location of a more detailed explanation of the process.

13. The review by the ATO of documentation prepared by the taxpayer, and the realism of its commercial outcome after taking into account international related party dealings is the basis of the transfer pricing review process.
14. 'Documentation', for the purpose of transfer pricing rulings, is a recommended form of record keeping to record in report format the processes taken by the taxpayer to evidence the application of the arm's length principle to its international related party dealings. These dealings may be subject to adjustment under Division 13 of the *Income Tax Assessment Act 1936* (or via an applicable double tax treaty) to reflect the arm's length principle if the ATO does not agree that the outcome of the dealings reflects arm's length consideration.
15. The maintenance of documentation by a taxpayer is not mandatory but recommended under TR 98/11. The ruling describes record keeping that details the taxpayer's functional analysis of its functions, assets and risks. It also describes the process for selecting and applying an appropriate methodology for setting and checking, under the arm's length principle, international related party pricing of trading goods, services, intangibles, capital goods and financing transactions. Chapter 5 of TR 98/11 discusses and encourages the use of the 4 step process. Documentation which broadly covers the spirit of the 4 step process is acceptable in certain circumstances, for example the 'simplified approach' for certain small to medium businesses.<sup>3</sup>
16. The taxpayer's documentation would normally contain a benchmarking study to show that pricing of the taxpayer's international related party dealings is comparable to outcomes obtained by independent entities dealing at arm's length with each other. A review of this benchmarking study is performed by the Economist Practice. The Economist Practice, in consultation with business line segments, appoints an Economist Practice officer to the transfer pricing review case team.
17. The focus of the transfer pricing review process is not only on the form of the documentation but also on the substance, in terms of its relevance to the taxpayer's related party dealings and business activities.

#### ***Actions required in the transfer pricing review process***

18. The review of documentation in the transfer pricing review process involves scoring the adequacy of the taxpayer's description of actions the taxpayer has taken under each of the 4 steps, leading to an overall indicative score for the quality of the documentation. The scoring of each step on a 1 to 5 scale (1 = low quality, 5 = high quality) is assisted by a scoring reference template contained in TR 98/11. The 'simplified approach' for certain small to medium businesses uses a modification of this system.
19. The TR 98/11 transfer pricing review process is performed by case officers via a transfer pricing record review checklist. This checklist is located as [Attachment 4](#) (link available internally only) to the transfer pricing module on the ISO website. The checklist addresses the key elements of coverage of the 4 step process and requires case officers to assess the adequacy of the documentation of the taxpayer's processes under the 4 step approach.

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<sup>3</sup> TAX OFFICE guide: 'International Transfer Pricing: A simplified approach to documentation and risk assessment for small to medium businesses' (Nat 12032-03.2005).

20. The commercial realism assessment is performed by the Economist Practice in conjunction with business line segments. The outcome of this broad assessment is an ABC rating [A = commercially realistic outcomes, B = less than commercially realistic outcomes, C = consistently returns losses].
21. TR 98/11 contains a scoring graph for the 1 to 5 documentation review and ABC commercial realism assessment that plots in a broad way the risk of a ATO transfer pricing audit. This risk is ranked in 6 steps from low risk of audit to very high risk of audit. This graph is indicative only and does not prescribe that an audit will in fact occur, but does give the ATO view on the potential to move to a transfer pricing audit.
22. The transfer pricing review process performed by the case officer is quality assured by ISO by a mandatory Transfer Pricing Review Panel. The Transfer Pricing Review Panel will confirm scores for quality of taxpayer documentation, commercial realism of outcomes and risk of a transfer pricing audit. The chair of the Transfer Pricing Review Panel is a Transfer Pricing Practice EL2 (or Complex Assistance and Technical Support Team or segment delegate) who, in collaboration with the segment and Chief Economist of Economist Practice, nominates the panel representatives from Economist Practice, Complex Assistance and Technical Support Team and the segment depending on the complexity of the review case. The role and work practice of the Transfer Pricing Review Panel is set out in Law Administration Practice Statement [PS LA 2004/13](#).
23. The decision to move to a transfer pricing audit rests with risk management committees. These committees will take into account the agreed score from the Transfer Pricing Review Panel, the economic significance of the transfer pricing risk and other taxation risk areas, and resources available to undertake an audit. Any such decision, however, will need to be consistent with the integrity of the process set out in TR 98/11 for assessing transfer pricing risk. It would not, for example, be appropriate for a decision to be made to take no follow-up action whatsoever where the taxpayer has been assessed as high or very high risk of a transfer pricing audit from the transfer pricing review process.
24. Regardless of the review product utilised, the transfer pricing review process requires the case officer to communicate the risk of audit outcome to the taxpayer. The completed transfer pricing record review checklist is presented to the taxpayer at the end of a client risk review or transfer pricing record review with a covering letter detailing action proposed (generally: no action, watching brief or audit).

### **Location of material to assist case officers**

25. The international risk review guides available at the [ISO web page](#) (link available internally only) contain a transfer pricing module that embodies all material required to assist case officers to make a risk assessment. It also contains guidance notes on the transfer pricing review process to be used in both the client risk review and transfer pricing record review products. ISO - Complex Assistance and Technical Support Team managers and team leaders are available to provide assistance with these guides and the processes involved ([Contact List](#) - link available internally only).

## **Transfer pricing review using the client risk review product**

26. This section explains how the client risk review product is used to:
  - identify whether or not a transfer pricing risk is significant; and if so
  - undertake a transfer pricing review process.
27. The client risk review product is used by the case officer to determine both domestic and international risks. The product is used for a broad risk assessment that will normally review a range of risks, including transfer pricing.
28. The case officer performs an initial transfer pricing review using filter questions set out in the [transfer pricing risk review guide](#) (link available internally only). This guide forms part of the international risk review guides available at the [ISO web page](#) (link available internally only). The transfer pricing risk review guide is designed to assist officers to determine whether or not international related party dealings are material. This guide also assists case officers (where a material risk is identified) to proceed to a more detailed review of taxpayer documentation and commercial realism as required by TR 98/11.
29. Where it has been ascertained that a taxpayer has no cross border related party dealings or such dealings are rated immaterial from the use of the filter questions, there is no need for further action and the review focus is confined to domestic issues or other international dealings.
30. If a transfer pricing risk is identified as material from the use of the filter questions, the taxpayer should be informed in writing that a transfer pricing review process will be undertaken. This process involves completion of the transfer pricing record review checklist and the commercial realism assessment. The outcome will be quality assured by a Transfer Pricing Review Panel. The role of the Transfer Pricing Review Panel is explained in PS LA 2004/13. Business lines may develop their own specific questions to accompany but not replace the use of the transfer pricing record review checklist.

## **Transfer pricing review using transfer pricing record review product**

31. This section explains how the transfer pricing record review product is used to undertake a transfer pricing review process.
32. Case selection to identify potential high risk transfer pricing taxpayers is a business line responsibility (utilising the Economist Practice risk engine and other intelligence). The business line determines which cases will move to a transfer pricing record review, but must have regard to advice from specialist areas including Economist Practice, Transfer Pricing Practice and Complex Assistance and Technical Support Team.

33. Where only transfer pricing risks are seen, the transfer pricing record review product is selected and the transfer pricing review process is followed. This involves completion of the transfer pricing record review checklist and the commercial realism assessment. The outcome will be quality assured by a Transfer Pricing Review Panel. The role of the Transfer Pricing Review Panel is explained in PS LA 2004/13. Business lines may develop their own specific questions to accompany but not replace the use of the transfer pricing record review checklist.

### **Compliance program generated specific issue transfer pricing reviews (project cases)**

34. The [Compliance program](#) identifies key international transfer pricing compliance focus areas. Transfer Pricing Practice, in cooperation with the business lines undertakes a project based activity that embodies transfer pricing specific focus issues referred to in the Compliance program.
35. These focus areas may change from year to year.
36. The project cases are selected with assistance from the Economist Practice risk engine analysis and business line intelligence. They are overseen by the Transfer Pricing Operations Group, with case work performed by appropriate case officers.
37. Checklists based on the transfer pricing record review checklist have been developed to assist field staff in completing a review of documentation and internal taxpayer processes specific to the area of inquiry. Business lines may develop their own specific questions to accompany but not replace the use of these checklists.

### **Conclusion**

38. Regardless of the form of selection of taxpayer cases for a transfer pricing review it is mandatory that procedures detailed in this practice statement are followed. The transfer pricing review process embodying completion of a transfer pricing record review checklist and commercial realism assessment is the only process that generates a risk ranking score as described in TR 98/11.

### Amendment history

<b>Date of amendment</b>	<b>Part</b>	<b>Comment</b>
21 November 2011	Contact details	Updated
9 November 2010	Contact details & general style update	Updated & reference to Tax Office changed to ATO
14 May 2007	Paragraph 5  Paragraph 6 General	edit to remove reference to International Steering Committee Insert additional publications Change references to PS LA 2005/1 to PS LA 2006/9, change references to Client Engagement and Strategic Intelligence to Complex Assistance and Technical Support Team

Subject references	<ul style="list-style-type: none"> <li>Transfer pricing</li> <li>Transfer Pricing Review Panel (TPRP)</li> <li>Transfer Pricing Record Review product</li> <li>Transfer Pricing risk</li> <li>Transfer Pricing Review</li> <li>Transfer Pricing Practice (TPP)</li> <li>Risk Review Products</li> <li>Transfer Pricing Operations Group (TPOG)</li> <li>Transfer Pricing Steering Committee (TPSC)</li> <li>International Steering Committee (ISC)</li> <li>Client Risk Review product (CRR)</li> <li>Specific Issue Transfer Pricing Review</li> <li>Transfer Pricing Review process (TPR process)</li> <li>Commercial realism</li> <li>Economist Practice</li> <li>Complex Assistance and Technical Support Team</li> <li>International Strategy and Operations (ISO))</li> </ul>
Legislative references	Part III Division 13 <i>Income Tax Assessment Act 1936</i>
Related public rulings	<ul style="list-style-type: none"> <li>TR 98/11</li> <li>TR 97/20</li> </ul>
Related practice statements	<ul style="list-style-type: none"> <li>PS LA 2004/13</li> <li>PS LA 2006/9</li> </ul>
Case references	
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