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**Australian Taxation Office**

## INTERNATIONAL TRANSFER PRICING

# Attributing profits to a dependent agent permanent establishment



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## ABOUT THIS GUIDE

This guide is part of a suite of publications about international transfer pricing produced by the Tax Office.

The other publications in the suite are:

- *International transfer pricing: introduction to concepts and risk assessment* (NAT 2725) (we recommend that you read this overview before reading the other guides)
- *International transfer pricing: advance pricing arrangements* (NAT 2748)
- *International transfer pricing: applying the arm's length principle* (NAT 2726), and
- *International transfer pricing: a simplified approach to documentation and risk assessment for small to medium businesses.* (NAT 12032)

This guide explains how to apply Australia's permanent establishment (PE) attribution rules<sup>1</sup> to a PE that arises for a taxpayer through the activities of a third party. Such a PE is commonly known, and is referred to in this guide, as a **dependent agent PE**.

The guide includes:

- a summary of the principles and approaches we use to attribute profits to dependent agent PEs, and
- examples illustrating how these principles and approaches are applied to sales agency and toll manufacturing patterns.

Threshold issues of whether a dependent agent PE exists in particular circumstances are not addressed in the guide.

The guide does not replace, alter or affect in any way the Tax Office interpretation of the relevant law as discussed in the various taxation rulings.

### **I** GLOSSARY OF TERMS

**FAR** – Functions, assets and risks

**PE** – Permanent establishment

**ForCo** – The taxpayer non-resident enterprise

**SubCo** – An enterprise associated with ForCo which is a resident of the host jurisdiction and whose actions give rise to a dependent agent PE of ForCo

**ForCo(HO)** – Parts of ForCo other than the dependent agent PE

**CUP** – Comparable uncontrolled price

**TNMM** – Transactional net margin method

**EBIT** – Earnings before interest and tax

**RandD** – Research and development

**LBI** – Large Business and International business line

**➤** The following Tax Office taxation rulings are relevant to the issues discussed in this guide:

- TR 92/11 – *Income tax: application of the Division 13 transfer pricing provisions to loan arrangements and credit balances*
- TR 94/14 – *Income tax: application of Division 13 of Part III (international profit shifting) – some basic concepts underlying the operation of Division 13 and some circumstances in which section 136AD will be applied*
- TR 95/23 – *Income tax: transfer pricing – procedures for bilateral and unilateral advance pricing arrangements*
- TR 97/20 – *Income tax: arm's length transfer pricing methodologies for international dealings*
- TR 98/11 – *Income tax: documentation and practical issues associated with setting and reviewing transfer pricing in international dealings*
- TR 98/16 – *Income tax: international transfer pricing – penalty tax guidelines*
- TR 1999/1 – *Income tax: international transfer pricing for intra-group services*
- TR 2000/16 – *Income tax: international transfer pricing – transfer pricing and profit reallocation adjustments, relief from double taxation and the Mutual Agreement Procedure*
- TR 2000/16A – *Addendum income tax: international transfer pricing – transfer pricing and profit reallocation adjustments, relief from double taxation and the Mutual Agreement Procedure*
- TR 2001/11 – *Income tax: international transfer pricing – operation of Australia's permanent establishment attribution rules*
- TR 2004/1 – *Income tax: international transfer pricing – cost contribution arrangements.*

These rulings are available on our website at **[www.ato.gov.au](http://www.ato.gov.au)**

<sup>1</sup> These rules are contained in subsections 136AE(4) to (7) of Division 13 of Part III of the *Income Tax Assessment Act 1936* and the Business Profits Article in Australia's double tax agreements.

Both the *Income Tax Assessment Act 1936* (ITAA 1936) and Australia's double tax agreements include in the definition of **permanent establishment** (PE) specific situations that give rise to a dependent agent PE. For example, an agent with power to contract is treated as a PE of the taxpayer enterprise in certain situations.<sup>2</sup> Another instance is where one person processes goods on behalf of another.<sup>3</sup> In addressing these situations, the guide focuses on a dependent agent PE arising for a taxpayer enterprise through the activities of an associated enterprise, where both are members of the same multinational enterprise.

Taxation Ruling TR 2001/11 sets out our views on how these rules operate. Paragraphs 5.37 to 5.42 of the ruling discuss in general terms the application of the rules to dependent agent PEs. The purpose of this guide is to expand on that discussion and provide practical guidance on our approach to applying the rules to the most common types of dependent agent PEs.

❗ For convenience, in this guide we refer to the taxpayer non-resident enterprise as 'ForCo', and to the associated enterprise that is a resident of the host jurisdiction and whose activities give rise to the dependent agent PE of ForCo as 'SubCo'. Parts of ForCo other than its dependent agent PE are referred to as ForCo(HO).

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<sup>2</sup> See paragraph (a) of the definition in subsection 6(1) of the ITAA 1936 and, for example, paragraph 5(a) of Article 5 of the Vietnamese Double Tax Agreement.

<sup>3</sup> See paragraph (d) of the definition in subsection 6(1) of the ITAA 1936 and, for example, paragraph 5(c) of Article 5 of the Vietnamese Double Tax Agreement.

## THE TWO-STEP PROCESS

Taxation Ruling TR 2001/11 states our view that Australia's PE attribution rules use a two-step process to apply an arm's length separate enterprise principle in attributing profits to a PE:

- Step 1: Undertake a **functional analysis**, which attributes to the PE the functions performed, assets used and risks assumed (FAR) by the enterprise in respect of the business it carries on through the PE.
- Step 2: Undertake a **comparability analysis**, which determines an arm's length return for the FAR attributed to the PE.

This process applies to all PEs, including dependent agent PEs.

In performing this process, it is critical to properly distinguish between two different taxpayer enterprises with different FAR and, invariably, different taxable profits, that is:

- ForCo, through its dependent agent PE, and
- SubCo, through its agency activities.

The FAR of the dependent agent PE are the FAR of ForCo, not SubCo, in respect of the agency activity. The dependent agent PE is attributed profit of ForCo, not SubCo, arising from the agency activity. Thus the profit attributable to ForCo's dependent agent PE is not merely an arm's length profit for the agent entity, SubCo. Rather, it is an arm's length profit for the FAR of ForCo in respect of the agency activity performed by SubCo on behalf of ForCo.

The taxable profit of the dependent agent PE is calculated by taking some part of ForCo's income from the activity performed by the agent and deducting the expenses (including the service fee paid to SubCo) ForCo incurs in deriving that income. Accordingly, while an arm's length service fee paid by ForCo to SubCo may be an arm's length reward for the agent's FAR, it does not follow that it also constitutes the arm's length reward for the dependent agent PE's FAR.

## Step 1: Undertake a functional analysis – attributing FAR to the PE

The functional analysis for a dependent agent PE takes into account any functions performed by the agent on behalf of the enterprise, and any assets used and risks assumed by the enterprise through the agent.

The functional analysis aims to determine the extent to which ForCo's business is carried on through the dependent agent PE, by examining which FAR of ForCo in respect of that business are attributable to the PE. For instance, where SubCo acts as a sales agent on behalf of ForCo, the functional analysis focuses on determining what FAR of ForCo in respect of its business of selling goods, and how much of its selling profit, are attributable to its dependent agent PE. Similarly, where SubCo acts as a toll manufacturer on behalf of ForCo, the functional analysis focuses on determining what FAR of ForCo in respect of its business of manufacturing goods, and how much of its manufacturing profit, are attributable to its dependent agent PE.

The functions attributable to the dependent agent PE are those performed by SubCo on behalf of ForCo, including those compensated by the service fee SubCo receives from ForCo. Where these functions give rise to the assumption of risks by ForCo as principal, the risks are attributable to the dependent agent PE of ForCo.

Where SubCo, acting on behalf of ForCo, employs third parties to perform functions, these functions are attributable to the dependent agent PE just as if the agent had itself performed the functions. Where these functions give rise to the assumption of risks by the principal (ForCo), the risks are attributable to the dependent agent PE.

The assets attributable to the dependent agent PE are those assets of ForCo that are used in the functions performed by SubCo on behalf of ForCo. For instance, where SubCo is performing sales agency activity and is responsible for warehousing and managing a stock of product inventory owned by ForCo to fill customer orders, the inventory is attributable to the dependent agent PE. Importantly, only assets of ForCo, not SubCo, can be attributed to ForCo's dependent agent PE.

Attributing an asset to a PE that is using the asset does not of itself result in the PE being attributed all of the profit derived from use of the asset.

Where an asset of ForCo is used by its dependent agent PE, it is necessary in attributing profit to the PE to attribute the functions performed and risks assumed by ForCo in respect of creating or acquiring and maintaining that asset. These functions and risks must be rewarded as part of Step 2 of the process of attributing profit to the PE. They may, depending on the particular circumstances, be attributable to the PE or to some other part of ForCo. For example, where SubCo is performing tolling activity, and the functions and risks involved in RandD that creates product intangibles owned by ForCo that are used in the tolling activity are attributable to a part of ForCo other than the dependent agent PE, that part must be rewarded for these functions and risks in attributing profit to the PE.

As part of the functional analysis, it is important to assess the relative economic significance of the various functions, assets and risks relevant to the business activity involving the dependent agent PE. It is particularly important to determine the functions that involve assuming and managing the most significant risks of that business. The extent to which the dependent agent PE performs those functions (that is, the extent to which SubCo undertakes those functions on behalf of ForCo) will largely determine the amount of profit as a reward for FAR, attributable to the PE.

### **Step 2: Undertake a comparability analysis – rewarding FAR of the PE**

An arm's length reward for the FAR of a PE is determined by following the guidelines for applying arm's length pricing methods in associated enterprise cases.<sup>4</sup> Thus an economic model of the PE is used to select the most appropriate analogous separate enterprise characterisation (for example, distributor, agent or service provider). The most appropriate arm's length pricing method (comparable uncontrolled price, cost plus, resale price, profit split or transactional net margin method – TNMM) is then applied to determine an arm's length compensation for the PE based on that characterisation. This requires a comparability analysis using the most reliable available data on arm's length comparables.

In using an arm's length pricing method to attribute profit to a dependent agent PE, it is important to recognise the differences in FAR, and hence profit, between the PE and SubCo. While SubCo is rewarded for its FAR as a service provider, the PE is rewarded for the FAR of ForCo as entrepreneur or principal in respect of the agency activity of SubCo. Thus in a sales agency case, for instance, uncontrolled comparables data about market rates of commission for sales agents, while relevant to determining an arm's length compensation for SubCo, is not directly relevant to determining an arm's length attribution of profit to the dependent agent PE.

However, in applying certain arm's length pricing methods to determine an arm's length profit for the dependent agent PE of ForCo, it is essential to use an arm's length compensation for SubCo. The service fee paid to SubCo is an expense of ForCo that is attributable to its dependent agent PE. Therefore, if, for instance, a cost plus or TNMM method is to be used reliably to determine an arm's length profit for the PE by benchmarking a gross or net mark-up on its costs, then the amount of those costs, including the service fee to SubCo, must demonstrably be arm's length.

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<sup>4</sup> See paragraphs 4.40 to 4.42 of TR 2001/11.

For a number of reasons, the method most likely to give the best estimate of an arm's length profit for the dependent agent PE in a particular case will depend on the outcome of the functional analysis and the comparables and taxpayer data available for the comparability analysis because:

- in many cases it may be difficult to obtain uncontrolled data that enables direct benchmarking of an arm's length return for the FAR of the dependent agent PE
- the functional and risk profile of the dependent agent PE may commonly not be similar to that of any available uncontrolled comparables. For instance, if the dependent agent PE arises under a sales agency arrangement, the PE typically will not have FAR comparable to either a full-risk buy-sell distributor or to a selling agent, and
- it may also be difficult to make reasonably accurate comparability adjustments so that these potential comparables could be used to reliably estimate an arm's length compensation for the dependent agent PE.

This may commonly mean that a comparable uncontrolled price (CUP), resale price, cost plus or TNMM is not the most appropriate method, and that it is necessary to resort to an indirect method (a profit split) to estimate an arm's length result for the PE. Nevertheless, the possible application of a traditional transaction method (CUP, resale price or cost plus) should be considered in the particular circumstances before resorting to the use of a transactional profit method.

### Using a resale price method

A possible approach to determining the profit of a dependent agent PE arising under a sales agency arrangement is to characterise the dependent agent PE as a reseller of the goods and use a resale price method. This would attribute profit as if there were a sale by ForCo to the dependent agent PE and a resale by the PE to the customer.

The gross profit attributed to the PE would thus be the difference between the customer price and an arm's length transfer price between ForCo and the PE. An arm's length gross resale margin would be benchmarked using comparables with FAR similar to the dependent agent PE. The resulting transfer price would therefore exclude from the amount attributed to the dependent agent PE any costs and profit attributable to activities of ForCo related to the goods sold, other than those attributed to the PE (for example, any purchasing, manufacturing and/or selling activities undertaken by other parts of ForCo – ForCo (HO)).

### Using a cost plus method

A cost plus method might be used to determine the profit attributable to a dependent agent PE by benchmarking a mark-up on the cost of the agent's services. The extent of the mark-up would depend on the particular circumstances. This means that the level of profit attributable to the dependent agent PE is that which ForCo, as an independent party, would expect to make over and above its costs (including service fee payments to the agent) related to the activity performed by SubCo on behalf of ForCo.

### Using a TNMM

Alternately, it might in some cases be more appropriate to use TNMM by benchmarking a net margin on resale price or a net margin on cost. This would depend on the availability of comparables data or concerns about the lack of data on comparables needed to reliably apply the resale price or cost plus method.

### Using a profit split method

A profit split method might be applied by determining ForCo's profit from its business operations involving the agency activity and splitting this between the dependent agent PE and ForCo(HO). The split would be based on the relative value of the contributions of the dependent agent PE and ForCo(HO) to generating that profit, as determined in the functional analysis (step 1). To the extent possible, contributions would be valued using external market data.

In practice, it may be difficult to reliably determine ForCo's actual profit from its business operations involving the agency activity, as this is likely to require apportioning of revenues and expenses between those operations and ForCo's other operations. For instance, ForCo may have profits from both manufacture and sale of products, where the agency activity only relates to the latter.

In addition, ForCo's relevant profit must reflect an arm's length amount. This means that where it includes transactions with associates (for example, SubCo), it is necessary to establish that the profit outcome of those transactions is arm's length.

It may also be difficult to reliably value contributions where it is not possible to obtain external market data to benchmark the contribution of FAR of the dependent agent PE or ForCo(HO). In such circumstances, it may be necessary to use some type of allocation key (for example, costs, assets or headcount) or to subjectively judge the relative value of the contributions in generating the profit from the activity performed by SubCo on behalf of ForCo.

Where these difficulties prevent a reliable application of a profit split method in the usual way, possible alternative profit split approaches may be considered. Any such approach should ideally use available comparables data to the fullest extent possible to achieve the most reliable estimate of an arm's length profit for the dependent agent PE.

Bearing this in mind, the available comparables data may enable the benchmarking of a combined result for ForCo and SubCo in respect of their contributions to generating the profit of the business involving the agency activity, which can then be split to produce a reliable estimate of an arm's length profit for ForCo's dependent agent PE.

For instance, it may be possible using available comparables data to benchmark an arm's length combined result for SubCo and the dependent agent PE, and then deduct a benchmarked arm's length return for SubCo to estimate an arm's length return for the dependent agent PE. Alternatively, the benchmarked combined result might be split between SubCo and the PE using an appropriate allocation key (for example, return on costs or return on assets).

For example, where a dependent agent PE arises under a sales agency arrangement, and the PE and SubCo together have FAR comparable to a full-risk buy-sell distributor, uncontrolled distributors could be used to benchmark an arm's length combined result for SubCo and the dependent agent PE. Deducting an arm's length compensation for SubCo, benchmarked using sales agent comparables, for example, might produce a reliable estimate of an arm's length compensation for the dependent agent PE.

Similarly, where a dependent agent PE arises under a toll manufacturing arrangement, one approach might be to use full-risk manufacturer comparables to benchmark a combined result for SubCo and the dependent agent PE, and then deduct a benchmarked result for SubCo using toll manufacturer comparables to get an arm's length result for the dependent agent PE.

Alternatively, a combined result for SubCo and the PE might be benchmarked using contract manufacturer comparables rather than full-risk manufacturer comparables, if SubCo and the PE are together considered to have FAR comparable to a contract manufacturer. However, given that a contract manufacturer commonly holds inventory and that this largely explains the difference between its return and that for a toll manufacturer, it is unlikely that this alternative approach could reliably be used if inventory ownership and risk are not attributable to the PE, or if FAR other than related to inventory are likely to account for significant profit attributable to the PE.

The above approach would be reliable only if SubCo and the dependent agent PE were together considered to have similar FAR to the selected comparables. Where significant FAR of the selected comparables are attributable to ForCo(HO), this approach cannot be used without adjustment or modification. This could be achieved in two ways.

- The results of the comparables could be adjusted to account for a return for the FAR attributable to ForCo(HO) and the adjusted results then used to benchmark a return for SubCo and the dependent agent PE.
- The unadjusted results of the comparables might be used to benchmark the combined result for SubCo and the dependent agent PE *and* ForCo(HO), not merely SubCo and the dependent agent PE. For example, if this approach were adopted in respect of a toll manufacturing arrangement, the steps would be:
  - 1 benchmark an arm's length combined result for ForCo(HO) + dependent agent PE + SubCo using either full-risk or contract manufacturer comparables (as appropriate)
  - 2 benchmark an arm's length result for SubCo alone, using toll manufacturer comparables
  - 3 deduct the result of (2) from (1), to arrive at an arm's length result for ForCo(HO + dependent agent PE), and
  - 4 use the most reliable possible basis to split the result of (3) to give an arm's length result for the dependent agent PE alone.

Under this approach, the arm's length return for the combined FAR of ForCo(HO) and the dependent agent PE (that is, the result at (3) above) is effectively used as a proxy for ForCo's actual profit from its manufacturing operations involving the agency activity, thus overcoming any practical problems in reliably determining this. This resulting 'residual profit' must be split in some way between ForCo(HO) and the dependent agent PE. This requires a similar valuing of relative contributions, with the same associated difficulties as in using a traditional profit split approach (see 'Using a profit split method' section above).

Examples 1 and 2 illustrate our approach to attributing profit to a dependent agent PE arising from a sales agency arrangement. Examples 3 and 4 illustrate our approach in a toll manufacturing arrangement.

We have intentionally limited our discussion to highly simplified fact patterns and analyses so that the approach can be more easily explained and understood. We recognise that, in practice, most situations may be significantly more complex and difficult to deal with, although this should not alter the principles underlying the attribution process.

### **EXAMPLE 1: SALES AGENCY ARRANGEMENT**

#### **Facts**

ForCo sells computer products to independent customers in Country A through its selling agent SubCo. ForCo manufactures the products outside Country A. All activity related to selling the products in Country A is performed by a sales force employed by SubCo. ForCo has no presence in or connection with Country A other than through SubCo. The agency agreement between ForCo and SubCo provides that SubCo acts for the account and at the risk of ForCo in performing marketing, sales and distribution activities in Country A for the products. In return, ForCo pays SubCo a commission for its agency services, calculated as a percentage of sales revenue.

The agency agreement, consistent with the relevant facts established by Tax Office enquiries, evidences the following significant functions and risks.

- Product ordering – SubCo is responsible for processing customer purchase orders on behalf of ForCo.
- Marketing/advertising – SubCo determines marketing strategy and advertising content for selling the products in Country A. ForCo reimburses SubCo for all expenses it incurs in placing local advertising for the products.
- Warehousing/inventory management – SubCo is responsible for warehousing and managing a stock of the products to fill customer orders as a service to ForCo.
- Delivery/shipping – SubCo is responsible for arranging delivery of the products to customers.
- After-sales support – SubCo is responsible for technical services related to installation and use of the products.
- Stock ownership (inventory risk) – title in the products passes directly from ForCo to customers, so that ownership and risk remain with ForCo until sale to the customer.
- Property, plant and equipment – SubCo owns or leases all property, plant and equipment used for distributing ForCo's products.
- Receivables ownership (credit risk) – all amounts due from customers are for the account and at the risk of ForCo. SubCo is responsible for debt management and collections.
- Product liability and warranty risk – ForCo as manufacturer has sole liability for product defects and customer warranty claims, agreeing to indemnify SubCo for any losses or damages.
- Foreign exchange risk – ForCo bears any losses resulting from conversion of sales proceeds into a currency other than that in which SubCo collects those proceeds from customers.

In the relevant income year, the following amounts are received and expended in connection with the sale of the products in Country A.

- ForCo derives \$100 million sales income.
- ForCo manufactures the products at a total cost of \$60 million.
- ForCo incurs costs of \$30 million related to sale of the products:
  - (a) \$15 million commission paid to SubCo
  - (b) \$12 million advertising costs reimbursed to SubCo
  - (c) \$2 million bad debt losses, and
  - (d) \$1 million stock losses (damage caused during warehousing of goods by SubCo).
- SubCo incurs operating expenses of \$13 million for its agency activities (other than costs reimbursed by ForCo, as above):
  - (e) \$6 million for sales/marketing, including costs of sales force
  - (f) \$2 million for warehousing and inventory management services provided to ForCo
  - (g) \$2 million paid to third-party freight forwarder employed by SubCo for delivery
  - (h) \$2 million for after-sales support, including costs of technical services related to installation and use of products sold, and
  - (i) \$1 million for debt collection and receivables management.

### Step 1: Undertake a functional analysis

Applying the views discussed above in 'Step 1: Undertake a functional analysis – attributing FAR to the PE', the following tables summarise how we would attribute the significant FAR between ForCo(HO), SubCo and ForCo's dependent agent PE.

To clarify the process, it is performed in two stages.

- Table 1 summarises how FAR are allocated between the principal and agent entities (that is, ForCo and SubCo, ignoring the dependent agent PE).
- Table 2 takes the table 1 allocations a step further by adding the dependent agent PE of ForCo.
- As the agency arrangement relates only to product distribution and marketing, FAR attributable to ForCo as product manufacturer are excluded from the tables.

**TABLE 1**

FAR	ForCo	SubCo
<b>Functions</b>		
Product ordering		X
Marketing – sales force		X
Marketing/advertising strategy		X
Warehousing/inventory management		X
Delivery/shipping		X
Debt management and collections		X
After-sales support		X
<b>Assets</b>		
Inventory	X	
Property, plant and equipment (distribution)		X
Receivables	X	
<b>Risks</b>		
Inventory risk	X	
Credit risk	X	
Foreign exchange risk	X	

TABLE 2

FAR	ForCo (HO)	SubCo	ForCo (PE)
<b>Functions</b>			
Product ordering		X	X
Marketing – sales force		X	X
Marketing/advertising strategy		X	X
Warehousing/inventory management		X	X
Delivery/shipping		X	X
Debt management and collections		X	X
After-sales support		X	X
<b>Assets</b>			
Inventory			X
Property, plant and equipment (distribution)		X	
Receivables			X
<b>Risks</b>			
Inventory risk			X
Credit risk			X
Foreign exchange risk			X

Table 3 shows how we would attribute the various selling cost items listed in the facts above.

TABLE 3

Cost item	ForCo (HO)	SubCo	ForCo (PE)
		\$m	\$m
(a) Commission			15
(b) Advertising			12
(c) Bad debts			2
(d) Stock losses			1
(e) Sales/marketing		6	
(f) Warehousing/inventory mgmt		2	
(g) Delivery		2	
(h) After-sales support		2	
(i) Debt collection/management		1	

**Step 2: Undertake a comparability analysis**

For this part of the attribution process, the facts about the availability of uncontrolled comparables data are as follows:

- There are no internal comparables, with SubCo acting exclusively as agent for ForCo.
- There are no external comparables to directly benchmark an arm's length compensation or margin for the particular combination of FAR of the dependent agent PE.
- There are external comparables (that is, independent selling agents in Country A) to establish that \$15 million is an arm's length amount of commission for SubCo's dependent agent services.
- Data for independent full-risk marketers or distributors of computer products in Country A, with similar FAR to the FAR of SubCo and the dependent agent PE combined, shows a 3% return on sales at the EBIT level.

Given the outcome of the functional analysis and the available comparables data, it is unlikely that an arm's length pricing method can reliably be used to directly benchmark the compensation of the dependent agent PE. This suggests the need to resort to a profit split method. If ForCo's operating profit for the sales operations involving SubCo can reliably be determined, then the functional analysis indicates that the whole of that profit is properly attributable to the dependent agent PE, as there is no contribution of ForCo(HO) to such profit. As discussed above in 'Using a profit split method', it may be difficult to reliably determine this profit.

If it is not possible to reliably use another method, we suggest that an alternative might be the type of profit split approach discussed above.

Using this approach, the relevant calculations are:

- combined arm's length EBIT of dependent agent PE and SubCo is 3% of \$100 million (\$3 million)
- arm's length EBIT of SubCo, based on arm's length commission of \$15 million and operating expenses of \$13 million, is \$2 million (that is, 2% of \$100 million), and
- therefore, arm's length EBIT of dependent agent PE is 1% of \$100 million (that is, \$1 million).

Given the above outcome, if this case involved a conversion of SubCo from a full-risk marketer or distributor into a selling agent (for example, as part of a supply chain restructuring), this would not have caused any change in the overall profit on which the multinational enterprise is subject to tax in Country A. The conversion would have reduced the taxable profit of SubCo, but created a taxable profit in the PE of ForCo corresponding to that reduction. This result would seem justified in this case, as the lack of FAR attributable to ForCo(HO) would indicate that the conversion has not been accompanied by any changes 'on the ground' in Country A.

## EXAMPLE 2: SALES AGENCY ARRANGEMENT

The facts provided in this example are designed to show the effect that different contractual arrangements between ForCo and SubCo can have on the profit of the dependent agent PE.

### Facts

The facts in example 1 are the same for this example. The agency agreement, consistent with the relevant facts established by Tax Office enquiries, evidences the following significant functions and risks

- Product ordering – SubCo is responsible for processing customer purchase orders for approval by ForCo.
- Marketing/advertising – ForCo determines marketing strategy and advertising content for sale of the products in Country A. ForCo reimburses SubCo for all expenses it incurs in placing local advertising for the products.
- Warehousing/inventory management and delivery – ForCo is responsible for warehousing and managing a stock of the products to fill customer orders and for arranging delivery to customers.
- After-sales support – ForCo is responsible for technical services related to installation and use of the products.
- Stock ownership (inventory risk) – title in the products passes directly from ForCo to customers, so that ownership and risk remain with ForCo until sale to the customer.
- Property, plant and equipment – ForCo owns or leases all property, plant and equipment used for distributing its products.
- Receivables ownership (credit risk) – all amounts due from customers are for the account and at the risk of ForCo. ForCo is responsible for debt management and collections.
- Product liability and warranty risk – ForCo as manufacturer has sole liability for product defects and customer warranty claims, agreeing to indemnify SubCo for any losses or damages.
- Foreign exchange risk – ForCo bears any losses resulting from conversion of sales proceeds into a currency other than that in which it collects those proceeds from customers.

In the relevant income year, the following amounts are received and expended in connection with sale of the products in Country A.

- ForCo derives \$100 million in sales income.
- ForCo manufactures the products at a total cost of \$60 million.
- ForCo incurs costs of \$28.5 million related to sale of the products:
  - (a) \$6.5 million commission paid to SubCo
  - (b) \$12 million advertising costs reimbursed to SubCo
  - (c) \$2 million bad debt losses (ForCo handles all debt management and collections from a centralised location)
  - (d) \$1 million stock losses (damage caused during warehousing of goods by SubCo)
  - (e) \$4 million paid to third-party freight forwarder employed by ForCo for warehousing, inventory management and delivery
  - (f) \$2 million paid to third-party contractor employed by ForCo for technical servicing of products, and
  - (g) \$1 million costs of debt collection and receivables management.
- SubCo incurs operating expenses of \$6 million for its agency activities for sales/marketing, including costs of sales force.

**Step 1: Undertake a functional analysis**

Applying the views discussed above in 'Step 1: Undertake a functional analysis – attributing FAR to the PE', the following tables summarise how we would attribute the significant FAR between ForCo(HO), SubCo and ForCo's dependent agent PE.

To clarify the process, it is performed in two stages:

- Table 4 summarises how FAR are allocated between ForCo and SubCo, ignoring the dependent agent PE.
- Table 5 takes the table 4 allocations a step further by adding the dependent agent PE of ForCo.

**TABLE 4**

FAR	ForCo	SubCo
<b>Functions</b>		
Product ordering		X
Marketing – sales force		X
Marketing/advertising strategy	X	
Warehousing/inventory management	X	
Delivery/shipping	X	
Debt management and collections	X	
After-sales support	X	
<b>Assets</b>		
Inventory	X	
Property, plant and equipment (distribution)	X	
Receivables	X	
<b>Risks</b>		
Inventory risk	X	
Credit risk	X	
Foreign exchange risk	X	

**TABLE 5**

FAR	ForCo (HO)	SubCo	ForCo (PE)
<b>Functions</b>			
Product ordering		X	X
Marketing – sales force		X	X
Marketing/advertising strategy	X		
Warehousing/inventory management	X		
Delivery/shipping	X		
Debt management and collections	X		
After-sales support	X		
<b>Assets</b>			
Inventory	X		
Property, plant and equipment (distribution)	X		
Receivables	X		
<b>Risks</b>			
Inventory risk	X		
Credit risk	X		
Foreign exchange risk	X		

Table 6 shows how we would attribute the various selling cost items listed in the facts above.

**TABLE 6**

Cost item	ForCo (HO)	SubCo	ForCo (PE)
	\$m	\$m	\$m
(a) Commission			6.5
(b) Advertising	12		
(c) Bad debts	2		
(d) Stock losses	1		
(e) Warehousing/inventory management/delivery	4		
(f) Technical support	2		
(g) Debt collection/ management	1		
(h) Sales/marketing		6	

### Step 2: Undertake a comparability analysis

The facts about the availability of uncontrolled comparables data are the same as in step 2 in example 1, except that the combined FAR of SubCo and the dependent agent PE in example 2 are not similar to independent full-risk marketers or distributors.

Given the outcome of the functional analysis, and the available comparables data, the method most likely to give the best estimate of an arm's length profit for the dependent agent PE may be a form of cost plus method, as discussed above in 'Using a cost plus method'. The functional and risk profile of the dependent agent PE is little different to that of the agent, SubCo. Accordingly, the most reliable method is simply to mark up ForCo's costs of the agency activities.

The method used in example 1 would not be the most appropriate here. The dependent agent PE and agent together do not have a functional profile comparable to that of a full buy-sell distributor. Given the number and size of the comparability adjustments that would be needed to obtain an appropriate result for the dependent agent PE by starting with distributor results, it would not seem possible to make sufficiently accurate adjustments to reliably use this method.

It might be possible to estimate an appropriate mark-up on cost for the dependent agent PE using the same comparables data that determined an arm's length commission for the agent. This might be so if, for instance, a TNMM were used to benchmark the commission (see 'Using a TNMM' above). Say, in this case, the \$6.5 million commission was benchmarked applying a TNMM using data for independent limited-risk service providers, giving a return on cost result of 8%. Using this same method and data, an arm's length profit for the dependent agent PE would be estimated as 8% of \$6.5 million, or approximately \$500,000.

### EXAMPLE 3: TOLL MANUFACTURING ARRANGEMENT

#### Facts

ForCo sells computer products manufactured for it in Country A by its toll manufacturer SubCo. All activity related to manufacturing the products in Country A is performed by SubCo. The agreement between ForCo and SubCo provides that SubCo acts on behalf of ForCo in performing manufacturing activities in Country A in respect of the products. In return, ForCo pays SubCo a processing fee for its agency services.

The toll manufacturing agreement, consistent with the relevant facts established by Tax Office enquiries, evidences the following significant functions and risks:

- Raw materials purchasing – ForCo has master agreements with materials suppliers that specify terms, including quantities and pricing. ForCo negotiates these contracts and pays for all materials supplied under them. SubCo requisitions materials under these contracts as and when needed to meet its production schedules.
- Production scheduling – ForCo provides SubCo with a demand plan, detailing its requirements as to quantities and timing of product to be delivered. SubCo uses this plan to determine its daily production schedule.
- Manufacturing – SubCo performs the processing function on behalf of ForCo.
- Quality control – ForCo is responsible for providing SubCo with the intangibles, designs and specifications needed to manufacture the product. Quality control standards are set by the multinational enterprise on a global basis, with ForCo requiring that SubCo's production conform to these standards. ForCo has the right to dictate the production processes to be used by SubCo, such as making plant inspections. SubCo performs quality assurance testing to ensure that its production conforms to the required standards.
- Warehousing – finished goods are held by SubCo awaiting delivery/shipping by ForCo.
- Inventory ownership and risk – SubCo has no ownership interest or risk in raw materials, work-in-process or finished goods inventories.
- Intangibles ownership – all intangible property rights for the products being manufactured (for example, patented designs, processes, know-how, brand names, trademarks and logos) belong to ForCo. (Trade intangibles are internally created through RandD performed by ForCo outside Country A).
- Property, plant and equipment – SubCo owns or leases all property, plant and equipment used for manufacturing ForCo's products.
- Product liability and warranty risk – ForCo has sole liability for product defects and customer warranty claims, agreeing to indemnify SubCo for any losses or damages.
- Foreign exchange risk – ForCo bears any foreign exchange risk in respect of amounts payable for raw materials.

In the relevant income year, the following amounts are received and expended in connection with the products manufactured in Country A:

- ForCo derives \$100 million in sales income.
- ForCo sells the products at a total distribution and marketing cost of \$30 million.
- ForCo incurs costs of \$59 million related to manufacture of the products:
  - (a) \$14 million processing fee paid to SubCo
  - (b) \$10 million allocation of RandD costs for developing product intangibles
  - (c) \$30 million for purchases of raw materials
  - (d) \$3 million product liability and warranty claims costs
  - (e) \$1 million to operate raw materials purchasing and production scheduling departments, and
  - (f) \$1 million stock losses (damage caused during warehousing of components and finished products by SubCo).
- SubCo incurs operating expenses of \$13 million for its toll manufacturing activities.

### Step 1: Undertake a functional analysis

Applying the views discussed above in 'Step 1: Undertake a functional analysis – attributing FAR to the PE', the following tables summarise how we would attribute the significant FAR between ForCo(HO), SubCo and ForCo's dependent agent PE.

To clarify the process, it is performed in two stages:

- Table 7 summarises how FAR are allocated between the principal and agent entities (that is, ForCo and SubCo, ignoring the dependent agent PE).
- Table 8 takes the table 7 allocations a step further by adding the dependent agent PE of ForCo.
- As the toll manufacturing arrangement relates only to product manufacture, FAR attributable to ForCo in relation to product distribution and marketing are excluded from the tables.

**TABLE 7**

FAR	ForCo	SubCo
<b>Functions</b>		
Raw materials purchasing	X	
RandD	X	
Manufacturing		X
Production scheduling	X	
Quality control	X	
Warehousing		X
<b>Assets</b>		
Inventory	X	
Property, plant and equipment (manufacturing)		X
Intangibles	X	
<b>Risks</b>		
Inventory risk	X	
Product liability and warranty risk	X	
Foreign exchange risk	X	

**TABLE 8**

FAR	ForCo (HO)	SubCo	ForCo (PE)
<b>Functions</b>			
Raw materials purchasing	X		
RandD	X		
Manufacturing		X	X
Production scheduling	X		
Quality control	X		
Warehousing		X	X
<b>Assets</b>			
Inventory			X
Property, plant and equipment (manufacturing)		X	
Intangibles			X
<b>Risks</b>			
Inventory risk			X
Product liability and warranty risk			X
Foreign exchange risk	X		

Table 9 shows how we would attribute the various manufacturing cost items listed in the facts above.

**TABLE 9**

Cost item	ForCo (HO)	SubCo	ForCo (PE)
	\$m	\$m	\$m
(a) Processing fee			14
(b) RandD	10		
(c) Raw materials			30
(d) Product liability/warranty	1		3
(e) Purchasing and production scheduling departments			
(f) Stock losses			1
(g) Manufacturing		13	

### Step 2: Undertake a comparability analysis

For this part of the attribution process, the facts about the availability of relevant data for ForCo, SubCo and uncontrolled comparables are as follows:

- There are no internal comparables, with SubCo acting exclusively on behalf of ForCo and other affiliates.
- There are no external comparables to directly benchmark an arm's length compensation or margin for the particular combination of FAR of the dependent agent PE.
- There are external comparables (that is, independent toll manufacturers in Country A) to establish that \$14 million is an arm's length fee for SubCo's processing services.
- Data for independent contract manufacturers of computer products in Country A, with similar FAR to the FAR of SubCo and the dependent agent PE combined, shows a 10% net return on costs.
- ForCo's operating profit for the manufacturing operations involving SubCo cannot reliably be determined.

Given the outcome of the functional analysis and the available data for the comparability analysis, it is not possible to reliably use an arm's length pricing method to directly benchmark the compensation of the dependent agent PE. This suggests the need to resort to a profit split method. Given that it is not possible to apply this method using ForCo's actual operating profit results, an alternative might be the type of profit split approach discussed above in 'Using a profit split method'. Using this approach, the relevant calculations are:

- combined arm's length net return on costs of ForCo's dependent agent PE and SubCo is approximately \$5 million (that is, 10% of consolidated costs of \$48 million)
- arm's length profit of SubCo is \$1 million, based on arm's length processing fee of \$14 million and operating expenses of \$13 million, and
- therefore, arm's length profit of ForCo's dependent agent PE is \$4 million (that is, \$5 million less \$1 million).

#### **EXAMPLE 4: TOLL MANUFACTURING ARRANGEMENT**

The facts are designed to show the effect that different contractual arrangements between ForCo and SubCo can have on the profit of the dependent agent PE.

##### **Facts**

The facts in this example are the same as for example 3. The toll manufacturing agreement, consistent with the relevant facts established by Tax Office enquiries, evidences the following significant functions and risks.

- Raw materials purchasing – SubCo has agreements with materials suppliers that specify terms, including quantities and pricing. SubCo negotiates these contracts and pays for all materials supplied under them. These costs are reimbursed by ForCo.
  - Production scheduling – SubCo uses the multinational enterprise's intranet systems to ascertain the required quantities and timing of product to be delivered. SubCo uses this to determine its daily production schedule.
  - Manufacturing – SubCo performs the processing function on behalf of ForCo.
  - Quality control – quality control standards are set by the multinational enterprise on a global basis, with SubCo responsible for ensuring that its production conforms to these standards.
  - Warehousing – finished goods are held by SubCo awaiting delivery/shipping by ForCo.
  - Inventory ownership and risk – SubCo has no ownership interest or risk in raw materials, work-in-process or finished goods inventories.
  - Intangibles ownership – all intangible property rights for the products being manufactured (for example, patented designs, processes, know-how, brand names, trademarks and logos) belong to ForCo. (ForCo licenses the product intangibles for use by SubCo.)
  - Property, plant and equipment – SubCo owns or leases all property, plant and equipment used for manufacturing ForCo's products.
  - Product liability and warranty risk – ForCo has sole liability for product defects and customer warranty claims, agreeing to indemnify SubCo for any losses or damages.
  - Foreign exchange risk – ForCo bears any foreign exchange risk in respect of amounts payable for raw materials.
- In the relevant income year, the following amounts are received and expended in connection with the products manufactured in Country A:
- ForCo derives \$100 million in sales income.
  - ForCo sells the products at a total distribution and marketing cost of \$30 million.
  - ForCo incurs costs of \$59 million related to manufacture of the products:
    - (a) \$15 million processing fee paid to SubCo
    - (b) \$10 million royalties paid for licensing of product intangibles
    - (c) \$30 million raw materials purchase costs reimbursed to SubCo
    - (d) \$3 million product liability and warranty claims costs, and
    - (e) \$1 million stock losses (damage caused during warehousing of components and finished products by SubCo).
  - SubCo incurs operating expenses of \$14 million for its toll manufacturing activities, (other than costs reimbursed by ForCo, as above), including \$1 million for its purchasing and production scheduling departments.

### Step 1: Undertake a functional analysis

Applying the views discussed above in ‘Step 1: Undertake a functional analysis – attributing FAR to the PE’, the following tables summarise how we would attribute the significant FAR between ForCo(HO), SubCo and ForCo’s dependent agent PE.

To clarify the process, it is performed in two stages.

- Table 10 summarises how FAR are allocated between the principal and agent entities (that is, ForCo and SubCo, ignoring the dependent agent PE).
- Table 11 takes the table 10 allocations a step further by adding the dependent agent PE of ForCo.

**TABLE 10**

FAR	ForCo	SubCo
<b>Functions</b>		
Raw materials purchasing		X
Manufacturing		X
Production scheduling		X
Quality control		X
Warehousing		X
<b>Assets</b>		
Inventory	X	
Property, plant and equipment (manufacturing)		X
Intangibles	X	
<b>Risks</b>		
Inventory risk	X	
Product liability and warranty risk	X	
Foreign exchange risk	X	

**TABLE 11**

FAR	ForCo (HO)	SubCo	ForCo (PE)
<b>Functions</b>			
Raw materials purchasing		X	X
Manufacturing		X	X
Production scheduling		X	X
Quality control		X	X
Warehousing		X	X
<b>Assets</b>			
Inventory			X
Property, plant and equipment (manufacturing)		X	
Intangibles			X
<b>Risks</b>			
Inventory risk			X
Product liability and warranty risk			X
Foreign exchange risk			X

Table 12 shows how we would attribute the various manufacturing cost items listed in the facts above.

**TABLE 12**

Cost item	ForCo (HO)	SubCo	ForCo (PE)
	\$m	\$m	\$m
(a) Processing fee			15
(b) Royalties			10
(c) Raw materials			30
(d) Product liability/ warranty		3	
(e) Purchasing and production scheduling departments	1		
(f) Stock losses			1
(g) Manufacturing		13	

### Step 2: Undertake a comparability analysis

The facts about the availability of relevant data for ForCo, SubCo and uncontrolled comparables are as follows:

- There are no internal comparables, with SubCo acting exclusively on behalf of ForCo and other affiliates.
- There are no external comparables to directly benchmark an arm's length compensation or margin for the particular combination of FAR of the dependent agent PE.
- There are external comparables (that is, independent toll manufacturers in Country A) to establish that \$15 million is an arm's length fee for SubCo's processing services.
- Data for independent full-risk manufacturers of computer products in Country A, with similar FAR to the FAR of SubCo and the dependent agent PE combined, shows a 10% return on assets.
- Relevant assets of SubCo are valued at \$20 million and of ForCo at \$50 million, of which 100% is attributable to the dependent agent PE.

Given the outcome of the functional analysis and the available data for the comparability analysis, the method most likely to give the best estimate of an arm's length profit for the dependent agent PE may be a similar type of profit split approach to that used in example 3. Using this approach, the relevant calculations are:

- combined arm's length Return on Assets of dependent agent PE and SubCo is \$7 million (that is, 10% of combined assets of \$70 million)
- arm's length profit of SubCo is \$1 million, based on arm's length processing fee of \$15 million and operating expenses of \$14 million, and
- therefore, arm's length profit of dependent agent PE is \$6 million (that is, \$7 million less \$1 million).

Given the above outcome, if this case involved a conversion of SubCo from a full-risk manufacturer into a toll manufacturer (for example, as part of a supply chain restructuring), this would not have caused any change in the overall profit on which the multinational enterprise is subject to tax in Country A.

The conversion would have reduced the taxable profit of SubCo, but created a taxable profit in the PE of ForCo corresponding to that reduction. This result would seem justified in this case, as the lack of FAR attributable to ForCo(HO) would indicate that the conversion has not been accompanied by any changes 'on the ground' in Country A.



