

BUSINESS

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BUSINESSES WITH
INTERNATIONAL DEALINGS

AUDIENCE

OVERVIEW

FORMAT

NAT 2725-04.2005

PRODUCT ID



Australian Government

Australian Taxation Office

INTERNATIONAL TRANSFER PRICING

INTRODUCTION TO CONCEPTS AND RISK ASSESSMENT



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PUBLISHED BY

Australian Taxation Office
Canberra
April 2005

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ABOUT THIS OVERVIEW

This overview 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: applying the arm's length principle*
- *International transfer pricing: advance pricing arrangements*
- *International transfer pricing: a simplified approach to documentation and risk assessment for small to medium businesses, and*
- *International transfer pricing: attributing profits to a dependent agent permanent establishment.*

This overview explains the basic concepts underlying international transfer pricing and when a business may face a transfer pricing review or audit. We recommend that you read this overview before reading the other guides.

When we refer to 'you' in this overview we are referring to you as a business with international dealings.

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

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

- 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

The purpose of Australia's transfer pricing rules is to counter the underpayment of Australian tax by requiring businesses to price **related party international dealings**¹ according to what truly independent parties acting independently would reasonably be expected to have done in the same situation.

Pricing for international dealings between related parties should reflect a fair return for the activities carried out in Australia, the Australian assets used (whether sold, lent or licensed), and the risks assumed in carrying out these activities.

Pricing that is not in accordance with Australia's transfer pricing rules is often referred to as 'international profit shifting'.

You should carefully consider the terms and conditions of any international dealings with related parties to ensure your business properly allocates income and expenses between Australia and other countries for tax purposes.

Methods of setting prices and reviewing the outcome of international transactions with related parties are recognised internationally using the **arm's length principle**, and Australia has adopted these in taxation rulings to help businesses understand what is expected of them.²

THE ARM'S LENGTH PRINCIPLE AND COMPARABILITY

The arm's length principle uses the behaviour of independent parties as a guide or benchmark to determine how income and expenses are allocated in international dealings between related parties. It involves comparing what a business has done and what a truly independent party would have done in the same or similar circumstances.

The internationally accepted arm's length methodologies are based on comparing the outcomes of related party dealings with the same or similar dealings of independent parties. The concept of comparability is central to the arm's length principle.

As many factors may influence prices or margins, you need to closely examine the dealings you are comparing and the circumstances of the parties involved. The nature of this comparison with arm's length activity means that it is very difficult to achieve absolute precision and certainty. To be comparable means that none of the differences (if any) between

the situations being compared are material, or that reasonably accurate adjustments can be made to eliminate the effect of any such differences. The materiality depends on fully examining the facts and circumstances of each case and reflecting the reality that there is likely to be some element of uncertainty inherent in the judgments that have to be made.

ARM'S LENGTH METHODOLOGIES

There are several internationally accepted methodologies that your business can use to comply with the arm's length principle. Australia's transfer pricing rules do not prescribe any particular methodology or preference for the order in which you apply methodologies to arrive at an arm's length outcome. We seek to adopt the method that is the most appropriate or best suited to the circumstances of each particular case.

The appropriate arm's length consideration should reflect the realities of operating in a commercial or financial environment. That is, whatever method you use should give a commercially realistic outcome. It is generally expected that a reasonable business person would seek to:

- maximise the price received for supplying property or services, taking into account their business strategy, economic and market circumstances (see paragraphs 2.44 to 2.56 of TR 97/20)
- minimise the cost associated with acquiring property or services, and
- be adequately rewarded for any activities carried out.

➔ See chapter 3 of TR 97/20 for more information about the arm's length methodologies.

DOCUMENTATION REQUIREMENTS

There are sound practical reasons why you should adequately document compliance with the arm's length principle, namely:

- to reduce the risk of audit by, and dispute with, the Tax Office, and
- to help explain your position to the Tax Office.

From a commercial perspective, the improved corporate knowledge gained from examining functions, assets and risks can provide an insight into the things that really add value to your business.

Both the Tax Office and the OECD have stated that businesses should not be expected to prepare or obtain documents beyond the minimum needed to enable a reasonable assessment to be made of whether their related party dealings comply with the arm's length principle.

A major problem we have encountered is that businesses with related party international dealings have little or no documentation to explain how they set and reviewed prices for these dealings in accordance with the arm's length principle.

¹ **Related party international dealings** cover sale, purchase, finance or asset transactions to or from an Australian taxpayer and an overseas company or other overseas business entity or non-Australian resident person who is related to the taxpayer by common ownership or family ties. The dealings cover goods, services and intangibles.

² TR 98/11 – documentation and practical issues associated with setting and reviewing transfer pricing in international dealings.

TR 97/20 – arm's length transfer pricing methodologies for international dealings.

TR 94/14 – basic concepts in applying Division 13.

Where a business has inadequate or incomplete information, Australia's transfer pricing rules allow the Commissioner to deem an amount as the arm's length consideration.

In assessing compliance with the arm's length principle, you should exercise commercial judgment about the nature and extent of documentation appropriate to your particular circumstances. We expect the level of contemporaneous documentation you need to create or obtain to explain a dealing to increase according to the significance and the complexity of the dealings to your entity's overall business (in terms of the size of the dealings and their proportion to total dealings).

➤ See paragraph 2.2 in chapter 2 of TR 98/11 for some examples of documentation that we consider beneficial.

The information needed in the process may be within the knowledge of a limited number of key personnel not confined to the tax or accounting areas of your business. Much of it may already be recorded in a variety of documents prepared in the ordinary course of your business (for example, marketing reports and analyses). If so, you can just collate and index the existing material rather than doing further research and creating additional documentation. Once this has been done, in future years you would generally only have to do a review to account for any significant changes.

Documentation is contemporaneous if it exists or is brought into existence at the time you develop or implement any arrangement that might raise transfer pricing issues or review these arrangements when preparing tax returns. Examples of contemporaneous documents are books, records, feasibility studies, budgets, plans and projections, analyses, conclusions and other written material.

Such documentation does not mean documents that merely evidence your business's related party international dealings, but documents that illustrate the processes you used to select and apply arm's length methodologies.

We may consider various documentation, such as a review undertaken by a business after lodging a tax return. However, if such a review was in progress when we commence our review, we reserve the right to proceed with our own enquiries and risk ranking.

Schedule 25A

Businesses that engage in international dealings with related parties during an income year are required to complete a Schedule 25A and lodge it with their income tax return. There are a number of questions in Schedule 25A relating to the level of documentation held by a business about selecting and applying an arm's length methodology.

The current Schedule 25A imposes obligations to disclose information about related party international dealings, including:

- the nature and amount of certain categories of transactions
- details of interest-free loans
- receipts or payments of non-monetary consideration
- details of arm's length methodologies used
- the level of documentation held to support the selection and application of the most appropriate arm's length methodologies, and
- details of disposals of any interest in a capital asset.

Guidelines on when you may be required to lodge a Schedule 25A are provided in TR IT 2514. We also publish instructions each year to help businesses complete a Schedule 25A.

Take care when completing a Schedule 25A as we use the information provided to help identify businesses that may be a transfer pricing risk. If you fail to complete the Schedule 25A where required, you may incur penalties or be prosecuted.

Documentation for small businesses and those with low levels of international dealings

While there is a degree of flexibility in the nature and extent of documentation that small businesses must create or obtain, they may still need to create some supporting documentation beyond that created in the ordinary course of business. This is an exercise in commercial judgment, whereby small businesses need to balance the risk associated with doing nothing and the potential outcomes of that decision with the cost of doing something that may satisfy these concerns.

➤ For more information about the documentation expected for small businesses and entities with low levels of international dealings, see chapter 6 of TR 98/11 and *International transfer pricing: a simplified approach to documentation and risk assessment for small to medium businesses* (NAT 12032).

Businesses with related party international dealings may face the risk of:

- a transfer pricing review, and
- a subsequent transfer pricing audit, with possible pricing adjustments and penalties.

We generally allocate resources on transfer pricing cases according to the perceived risk to revenue of businesses not complying with the arm's length principle. The more significant and broader the scope of a business's international dealings with related parties, the more likely we are to do a transfer pricing review. Businesses with significant levels of dealings who are consistently returning losses are at the greatest risk of a transfer pricing review.

TRANSFER PRICING REVIEW

A transfer pricing review looks at:

- the nature and extent of a business's international dealings with related parties
- the quality of the process established by the business to show compliance with the arm's length principle for tax purposes, and
- the quality of the business's documentation of those dealings and the outcomes of the dealings.

As part of a transfer pricing review, we assess the quality of a business's processes and documentation, and the commercial realism of the outcomes of its dealings. We then decide whether to proceed to a transfer pricing audit. We advise the business of the outcomes of the review and give them a risk ranking as shown in the graph on page 7.

As the circumstances of individual businesses may vary over time, we may review their risk ranking in light of their current circumstances.

Quality of processes and documentation

The quality of a business's processes and documentation can generally be assessed as falling into broad categories, ranging from low, which will increase the likelihood of an audit, to high, which will decrease the likelihood of an audit.

To decrease the possibility of an audit, you should have processes that allocate income and expenses in accordance with the arm's length principle. We have suggested a four-step approach to establishing and maintaining such processes.

➤ See chapter 5 of TR 98/11 and *International transfer pricing: applying the arm's length principle* (NAT 2726) for more information.

The five levels of quality of process and documentation for international dealings with related parties are shown in the following table.

LEVELS OF QUALITY OF PROCESSES AND DOCUMENTATION FOR INTERNATIONAL DEALINGS WITH RELATED PARTIES

1	2	3	4	5
Low quality	Low to medium quality	Medium quality	Medium to high quality	High quality
No analysis of functions, assets, risks, market conditions and business strategies	No analysis of functions, assets, risks, market conditions and business strategies	Inadequate analysis of functions, assets, risks, market conditions and business strategies	Sound analysis of functions, assets, risks, market conditions and business strategies	Sound analysis of functions, assets, risks, market conditions and business strategies
No documentation or processes to enable a check on selection of methodologies	Insufficient documentation or processes to enable a check on selection of methodologies	Selection of method supported with some contemporaneous documentation	Selection of method fully supported with contemporaneous documentation	Selection of method fully supported with contemporaneous documentation
No comparables used No documentation or processes to enable a check on application of methodologies	No comparables used No documentation or processes to enable a check on application of methodologies	Broad inexact comparables used or comparability based on data from external related party comparables Application of method supported with some contemporaneous documentation	Comparability based on limited data from independent dealings Reliability assessed Application of method fully supported with contemporaneous documentation	Comparability based on adequate data from independent dealings Reliability taken into account in choice of comparables Application of method fully supported with contemporaneous documentation
No effort to implement and review arm's length transfer pricing policies	Limited effort to implement and review arm's length transfer pricing policies	Limited effort to implement and review arm's length transfer pricing policies	Genuine effort to implement and review arm's length transfer pricing policies	Genuine effort to implement and review arm's length transfer pricing policies

The characteristics of the five quality levels shown in the table are indicative only. We recognise that a business may fall into one of the higher quality levels even though they have not satisfied every characteristic of each step.

Situations outside the transfer pricing review process

Where we find that a business has deliberately structured its international dealings with related parties to avoid Australian tax, we would probably proceed straight to a transfer pricing audit.

Factors that lead us to such a conclusion include:

- the use of tax havens where little or no economic value is added, for example, re-invoicing
- the use of back-to-back arrangements to conceal the full extent of the consideration given, and
- complex and circular arrangements with little or no business purpose.

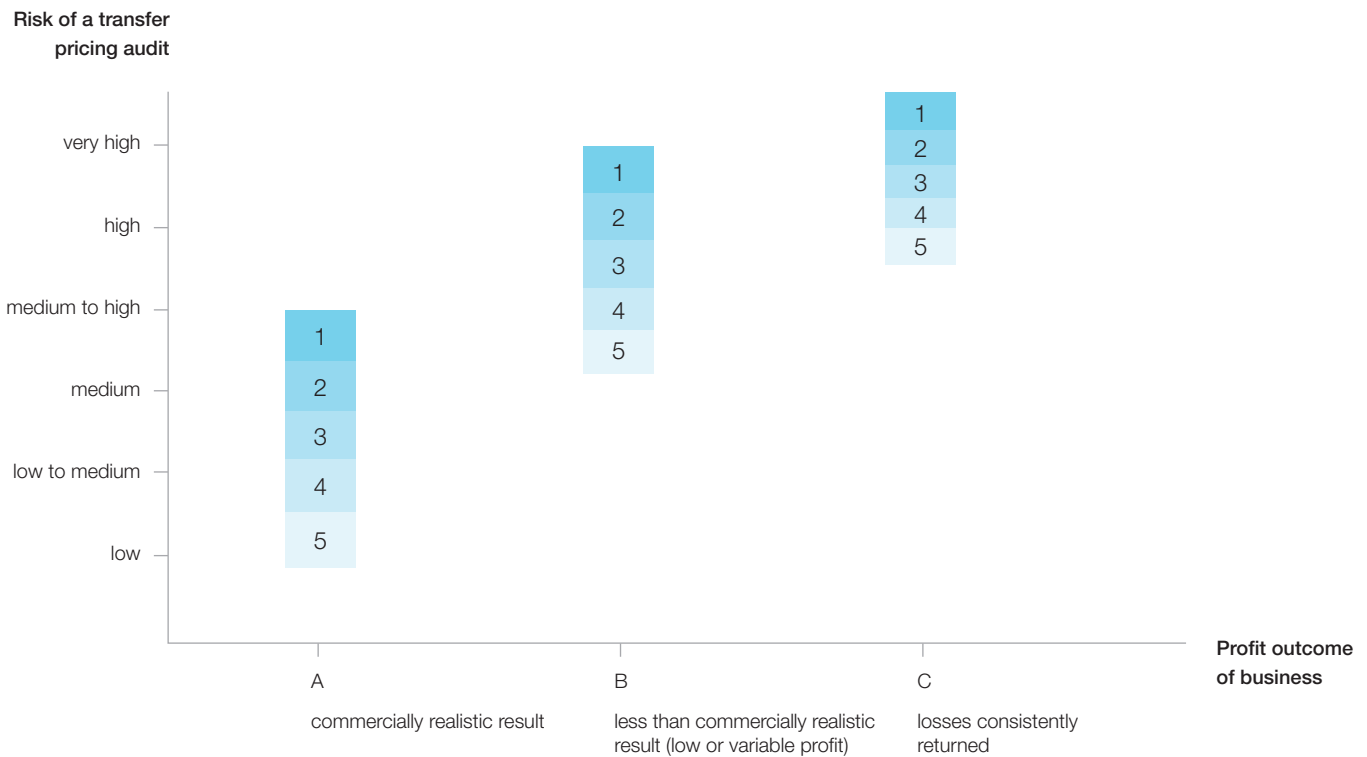
Where we have an advance pricing arrangement with a business and the critical assumptions specified in the arrangement are met, we would take no further action in relation to transactions covered by the arrangement. We would, however, check to ensure that the terms of the arrangement are being adhered to.

TRANSFER PRICING RISK RATING

The following graph shows how we assess the risk to a business of a transfer pricing audit. We look at two factors:

- the quality of the business’s processes and documentation, and
- the commercial realism of their outcomes.

As can be seen from the graph, a business that consistently returns losses and has a low quality of process and documentation is at the highest risk of a transfer pricing audit. Conversely, a business that has commercially realistic outcomes and has a high quality of process and documentation is at the lowest risk.



Where

- 1 = Low quality of processes and documentation
- 2 = Low to medium quality of processes and documentation
- 3 = Medium quality of processes and documentation
- 4 = Medium to high quality of processes and documentation
- 5 = High quality of processes and documentation

TRANSFER PRICING AUDIT

If we decide to do a transfer pricing audit as a result of a transfer pricing review, the risk of a transfer pricing adjustment and penalties becomes highly likely. Before making any transfer pricing adjustment, we generally issue position papers and allow a business the opportunity to comment before making any adjustment. However, any resulting adjustment is subject to the normal review and appeal processes.

We acknowledge that there is a need for judgment in applying Australia's transfer pricing rules and would propose an adjustment only if our view is materially different from that of the business.

In all cases we adhere as closely as possible to international standards and seek to determine cases according to those principles.

 See paragraph 4.39 of TR 98/11 for more information.

SUMMARY OF TRANSFER PRICING REVIEW AND AUDIT PROCESS

The flowchart on the next page summarises our likely approach to reviewing and auditing a business's international dealings with related parties to decide whether it is complying with the arm's length principle. Individual circumstances may require a modification or departure from the process illustrated.

