TR 97/20 - Income tax: arm's length transfer pricing methodologies for international dealings

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Taxation Ruling
Income tax: arm's length transfer pricing methodologies for international dealings

other Rulings on this topic

IT 2350; TR 94/14; TR 95/23

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*This Ruling, to the extent that it is capable of being a 'public ruling' in terms of Part IVAAA of the **Taxation Administration Act 1953**, is a public ruling for the purposes of that Part. Taxation Ruling TR 92/1 explains when a Ruling is a public ruling and how it is binding on the Commissioner.*

What this Ruling is about

1. This Ruling explains how the arm's length principle applies to international dealings between separate legal entities in the context of Division 13 of the *Income Tax Assessment Act 1936* ('the Act') and the Associated Enterprises Articles in Australia's comprehensive Double Tax Agreements ('DTAs'). These are collectively referred to as 'Australia's transfer pricing rules'. Applying the arm's length principle leads to a calculation of the taxable income that might reasonably be expected to be derived if the parties were dealing at arm's length with one another.

2. It does not deal with profit allocations among separate branches or permanent establishments of the same enterprise. These will be the subject of a separate Ruling.

3. The Ruling explains the links between the concepts of the arm's length principle and of comparability and the methods that can be used to establish the arm's length outcome. This Ruling sets out:

(1) the methodologies acceptable to the Australian Taxation Office ('ATO');

(2) when they are considered appropriate; and

(3) the ATO's views on the concepts involved and the definitional issues that arise in applying them.

4. The principles contained in this Ruling are applicable to all nature of dealings, including dealings involving intangibles, intra-group services and cost contribution arrangements.

5. This Ruling examines in more detail than Taxation Ruling TR 94/14 ('TR 94/14') the methodologies that are available to apply the arm's length principle under Australia's transfer pricing rules.

6. The organisation of this Ruling follows the *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* released by the Organisation for Economic Co-operation and Development in 1995 ('1995 OECD Report'); Chapters I to III are covered by this Ruling.

7. This Ruling generally accepts the principles in the 1995 OECD Report. Differences in emphasis or extensions of OECD principles adopted by the ATO are clearly indicated in the Ruling. Further Rulings may be issued dealing with the application of the principles in this Ruling to specific kinds of dealings, such as those dealt with in other Chapters of the 1995 OECD Report.

Date of effect

8. This Ruling applies to years commencing both before and after its date of issue. However, the Ruling does not apply to taxpayers to the extent that it conflicts with the terms of a settlement of a dispute agreed to before the date of issue of the Ruling (paragraphs 21 and 22 of Taxation Ruling TR 92/20).

Detailed contents list

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Ruling and explanations

CHAPTER 1 THE ARM'S LENGTH PRINCIPLE

A. Fundamental approaches

1.1. It needs to be recognised at the outset that the application of the principles set out in this Ruling requires judgment. Issues cannot be resolved by the rigid and mechanical application of standardised or predetermined rules. Approaches need to be tailored to the facts and circumstances of the case under examination. Transfer pricing is not a precise science and applying the concepts requires some flexibility to produce a result that reflects the underlying purpose of the statutory provisions. The nature of the subject does not allow for marginal adjustments and the focus of any examination - whether by a taxpayer, its advisers or the ATO - should be on identifying whether there are any material discrepancies from the arm's length outcome (**paragraph 2.3**). At the end of the day, the outcome of any analysis must make business sense in the context of the particular case. There may be gaps in information and data for both taxpayers and the ATO that need to be acknowledged in making judgments. The effort required of a taxpayer varies depending on the importance of the transfer pricing issue and what a reasonable business person might be expected to do in similar circumstances.

1.2. In most situations, the proper selection and application of the transfer pricing methodologies discussed in this Ruling are best addressed in a structured way. It is usually necessary to:

(1) identify the nature and extent of the cross border dealings with associated enterprises and to also understand the taxpayer's business in the context of the markets and industry in which it operates; and

(2) consider the availability and reliability of information which can be used to establish comparability in accordance with arm's length principles.

1.3. The selection and application of the most appropriate methodology can then proceed with sufficient information to make decisions that reflect an arm's length outcome.

1.4. Australia's transfer pricing rules have a broad scope in recognition of the fact that dealings between associated enterprises involve many different types of property and services including tangible goods, the licensing of intangibles and financial and management services.

B. Arm's length principle as the statutory test

1.5. The arm's length principle is contained in the Associated Enterprises Articles in each of Australia's DTAs. A typical example is Article 9 of the Australia Vietnam DTA, which requires the comparison of the 'conditions that exist in [the] commercial [and] financial relations' between associated enterprises, with the conditions that might be expected to operate between independent parties dealing wholly independently with each other.

1.6. Division 13 of the Act incorporates the arm's length principle in paragraphs 136AA(3)(c) and (d) and subsections 136AD(1) to (4) through the concept of the 'arms length consideration' against which the Division requires the 'international agreement' to be evaluated. This Division is analysed in TR 94/14.

1.7. The statutory objective of Australia's transfer pricing rules is to counter the underpayment (for whatever reason) of Australian tax by allowing the amount subject to Australian income tax or withholding tax to be calculated on the basis of what truly independent parties acting independently would probably have done in the taxpayer's circumstances (see also TR 94/14, paragraphs 10, 13 and 154 to 157).

1.8. Australia's transfer pricing rules do not prescribe any particular methodology or preference for the order in which methodologies might be applied to arrive at an arm's length outcome. The statutory objective should be interpreted as allowing the greatest possible scope to use methodologies appropriate in the circumstances, given the myriad of different and possibly unique cases that may arise. This is particularly so given that Australia's transfer pricing rules allow the ATO to approximate the relevant arm's length consideration or profit allocation if there is an insufficiency of information (subsection 136AD(4) and, e.g., Australia Vietnam DTA - paragraph (2) of Article 9). However, this approximation still reflects arm's length principles.

1.9. Accordingly, the use of a novel methodology does not mean that the method is invalid, so long as it is applied consistently, so far as practicable, with the statutory objective (*Case N69* (1962) 13 TBRD 270 at 279; 11 CTBR (NS) *Case 63* at 274). The statutory objective is the benchmark against which the choice and application of methodologies are to be judged.

1.10. There are some differences in scope between Division 13 and the Associated Enterprises Article of Australia's DTAs which will be the subject of a further Ruling. In relation to the issues covered by this Ruling, it is considered that the same principles apply generally to both provisions; this is why they are collectively referred to as Australia's transfer pricing rules.

1.11. The expression 'associated enterprises' used in the Ruling refers to enterprises directly or indirectly connected through management,

control or shareholding. It includes enterprises to which the Associated Enterprises Articles of Australia's DTAs may apply (and to which Division 13 may also apply) and other enterprises whose dealings may be adjusted under Division 13 (i.e., independent enterprises that do not deal at arm's length with one another as discussed in paragraphs 50 to 53 of TR 94/14).

1.12. In this Ruling, 'controlled transactions' are transactions or arrangements between associated enterprises and 'uncontrolled transactions' are transactions or arrangements between independent enterprises that are dealing wholly independently with each other.

C. Maintaining international consensus: OECD guidelines are used in applying methodologies

1.13. When applying Division 13 and the Associated Enterprises Articles of Australia's DTAs, the ATO follows as closely as practicable the OECD guidelines on transfer pricing methodologies for the application of the Associated Enterprises Article of the OECD Model, being the considered view of many tax administrations with extensive experience on transfer pricing.

1.14. While it does not override the terms of Australia's transfer pricing rules, the 1995 OECD Report is seen as an important and influential document that reflects unanimous agreement amongst the tax administrations of the member countries - an agreement that was achieved after an extensive process of consultation with industry and tax practitioners in member countries.

D. Special considerations in Australia

1.15. Where the information available is inadequate to determine the income to be attributed to an enterprise on an arm's length basis, Australia's transfer pricing rules allow the Commissioner to invoke subsection 136AD(4). Having regard to the clear policy expressed in Division 13 that the arm's length principle be used as guiding principle (including the fact that subsection 136 AD(4) enables the deeming of the amount of the arm's length consideration, which is then used in the application of subsection 136 AD(1), (2) or (3) as appropriate), subsection 136 AD(4) must be applied in a way that achieves the closest practicable estimate of an arm's length result (see also TR 94/14, paragraphs 82, 83 and 338 to 340).

1.16. This principle is also explicit in all of Australia's DTAs (e.g., the Australia Vietnam DTA, paragraph (2) of Article 9). When subsection 136AD(4) is applied in conjunction with a DTA, it must be applied, so far as practicable on the basis of the available information, in a manner consistent with the principles of the relevant Associated

Enterprises Article. Australia's position is expressed in a reservation to the OECD Model Tax Convention : see paragraph 18 of the Commentary on Article 9.

1.17. It follows that any methodology used to make an estimate of the arm's length consideration under these powers in Australia's transfer pricing rules must be capable of reasonably approximating the amount that would arise if the dealings had been truly independent and must be applied in a manner consistent with that goal.

1.18. It also follows that these powers allow the use of methodologies that rely on indirect measures of comparability with arm's length dealings, since they apply only where it is not possible or practicable to determine the arm's length consideration on the information available.

1.19. Indeed, the definition of arm's length consideration in paragraphs 136AA(3)(c) and (d) arguably leaves open the availability of indirect approaches under subsections 136AD(1) to 136AD(3) and DTAs (although a view to the contrary has been expressed).

1.20. Out of abundant caution, any adjustments based on indirect methodologies (i.e., where the only evidence of what might reasonably be expected if the dealings had been truly independent arises from the indirect approach) should be based on subsection 136AD(4) as an alternative ground if subsections 136AD(1) to 136AD(3) have been invoked. This is so whether or not the ATO is also seeking to rely on the Associated Enterprises Article in one of Australia's DTAs.

1.21. The indirect approaches that may be used depend on the facts and circumstances of each case but could include:

(1) income and expense allocation on the basis of a formula;

(2) an analysis of return on assets;

(3) a mixture of methods;

(4) some form of profit comparison other than the profit split and transactional net margin method described later in this Ruling; or

(5) a margin calculated as a certain percentage of the resale price or a relevant cost base.

1.22. While the use of these approaches may be subject to even greater uncertainty than the traditional methods (e.g., a return on assets approach can introduce very complex asset valuation issues), there is a need to find an answer for all transfer pricing problems (**paragraphs 2.25, 3.88 and 3.89**).

1.23. Because of these special provisions in Australia's transfer pricing rules, it is possible in Australia to go beyond the guidelines in the 1995 OECD Report in resolving transfer pricing issues using indirect methods. However, any extensions, elaborations and different emphases in this Ruling are not viewed as being contrary to the 1995 OECD Report. This is so because the fundamental principle of the guidelines and the statutory objective of the Australian rules are the same, namely, what truly independent parties acting independently would probably have done in the taxpayer's circumstances.

1.24. The data available in Australia for assessing comparability is much more limited than that in larger overseas countries, especially the United States of America. This situation explains the position taken in Australia's transfer pricing rules. It means that indirect measures to assist in achieving results that accord as closely as possible with arm's length outcomes may need to be used more often in Australia.

CHAPTER 2: GUIDANCE FOR APPLYING THE ARM'S LENGTH PRINCIPLE

A. The approach to comparability

2.1. Conceptually, the arm's length principle requires a calculation of the taxable income that might reasonably be expected if the parties were dealing at arm's length with one another. It does this by contrasting the choices made and the outcomes achieved by the taxpayer with those that would have resulted from the interaction of the forces of supply and demand in a comparable open market, or from negotiating among comparable independent parties in more complex settings. In effect, this uses the open market results or the behaviour of the independent parties dealing at arm's length with each other as a benchmark.

2.2. The concept of comparability is therefore central to the application of the arm's length principle. The nature of this comparison with arm's length activity means that absolute precision and certainty is very difficult to achieve. The transfer pricing methodologies that have been developed to establish an arm's length result are intended to provide a basis for testing the related party choices and outcomes against arm's length benchmarks.

2.3. The preferred arm's length methodologies are based on the concept of comparing the prices or margins achieved by associated enterprises in their dealings to those achieved by independent enterprises for the same or similar dealings. As there are many matters that may influence prices or margins, there is a need to closely examine the dealings being compared and circumstances of the parties involved. To be comparable means that none of the differences (if

any) between the situations being compared could materially affect the condition being examined in the methodology (e.g., price or margin), or that reasonably accurate adjustments can be made to eliminate the effect of any such differences (1995 OECD Report, paragraph 1.15). The materiality depends on a full examination of facts and circumstances of each case and reflects the reality that there is likely to be some element of uncertainty inherent in the judgments that have to be made. However, the minor differences would not affect materiality.

2.4. Implicit in the arm's length principle is the notion that independent parties who are dealing at arm's length would each compare the options realistically available to them, and seek to maximise the overall value of their respective entities from the economic resources available to or obtainable by them (1995 OECD Report, paragraph 1.16; TR 94/14, paragraph 66).

2.5. Choosing between the options that are available is important, because in most applications of the arm's length principle the question is: what would have happened if the ownership link had been severed and the enterprise was motivated by its own economic interest? This approach involves a consideration of what a reasonable, independent business person might reasonably be expected to agree to in the same or similar circumstances.

2.6. Applying the arm's length test to dealings between associated enterprises against the benchmark of what an independent party dealing independently would do to protect its own economic interest requires a consideration of three related ways of looking at the dealings and the relevant circumstances. A model for doing this would be to look at these matters from three related perspectives: an 'external' view, a 'process' view, and a 'performance' view. They provide a model for dealing with transfer pricing issues and are justified by the terms of Australia's transfer pricing rules.

2.7. The basis for the 'external view' is found in the requirement to compare the 'conditions that exist in [the] commercial [and] financial relations' between associated enterprises with the conditions that might be expected to operate between independent parties dealing wholly independently with each other. Similarly, in Division 13, the notions of 'arm's length consideration' and 'arm's length dealings' require a comparison of what would have been done if the taxpayer had operated as an independent party.

2.8. The basis for the 'process view' is to be found in the requirement in Division 13 to consider whether the parties were dealing at arm's length with each other and the similar focus in the Associated Enterprises Articles on the conditions that operate in the parties' dealings with each other compared to what independent enterprises

operating wholly independently would have done. It is reasonable to expect that independent enterprises operating wholly independently would have adopted such a process.

2.9. The basis for the 'performance view' is to be found in the DTAs concern with the profit 'which might have been expected to have accrued ... if the conditions operative between the enterprises had been those which might have been expected to have operated between independent enterprises dealing wholly independently with each other', and in the Division 13 focus on the need for an 'arm's length consideration'.

2.10. In order to establish the arm's length consideration between associated enterprises, it would be relevant to consider (along with all other relevant circumstances):

(1) the prices paid, margins achieved, income splits agreed to, or consideration given, in comparable arm's length dealings under comparable circumstances;

(2) the nature of the bargaining that took place between the relevant parties; and

(3) the profit (more generally, economic performance) outcomes achieved or agreed to.

2.11. The evidence of what might reasonably be expected in the taxpayer's circumstances if the taxpayer's dealings had been truly independent could come from:

(1) reference to comparable dealings in comparable circumstances that have been transacted on an arm's length basis:

(a) by the taxpayer with independent parties (generally referred to as 'internal comparables'); and/or

(b) between independent parties ('external independent party comparables');

(2) an examination of the context and conduct of bargaining between the relevant parties, in terms of the consideration that passed between them as a consequence of their dealings and the overall manner and effect of what the parties did (paragraphs 284 to 288 of TR 94/14);

(3) measures of the economic performance expected and/or achieved by the relevant parties, both overall and specifically related to the dealings under consideration, and including (but not limited to) performance indicators such as net margin, return on sales, return on costs, return on assets, net present value measures, internal rates of

return, economic value added, and shareholder value added; and

(4) other information such as that between associated enterprises that assists in determining what an independent enterprise operating in its own economic interest on a 'stand alone' basis might reasonably have been expected to do if the relevant dealings had been between other independent enterprises, or had occurred on a truly independent basis.

2.12. These categories are not mutually exclusive, and a conclusion as to the arm's length nature of the dealings should be formed on a careful weighing up of such information as is available from all these different categories.

2.13. Determining the reliability of dealings that are being examined as possible **internal comparables** involves testing them against the categories of information set out in **paragraph 2.11**.

2.14. Some dealings between taxpayers and independent enterprises may not be accepted as reliable comparables because they are not made in the ordinary course of business. An example would be a relatively insignificant sale made at the price charged to associated enterprises in order to create an internal comparable to justify the pricing to associated enterprises, but which, by open market standards required by the arm's length principle, was concessional to the independent enterprise.

2.15. While internal comparables are generally an appropriate benchmark, it is not always sufficient to merely identify transactions on similar terms with independent parties. To be a reliable benchmark for dealings with associated enterprises, transactions or arrangements with independent parties also have to be undertaken in comparable circumstances. They also have to make business sense in all the taxpayer's circumstances (including its gearing and financial position - **paragraph 3.27** and paragraph 1.37 of the 1995 OECD Report - its cost structure, business strategies and the then prevailing market and economic conditions), having regard to what the taxpayer obtained in return for the functions it performed, the assets it used, and the risks it assumed. This objective test is required for the purposes of determining what an independent party dealing at arm's length might be expected to have done in the circumstances.

2.16. To be reliable benchmarks, **external independent party dealings** also have to make business sense in the taxpayer's circumstances.

2.17. If an open market exists that sets prices (or more generally contractual terms), then this provides benchmarks (whether internal or

external) for a proposed transaction. It would not be expected that a seller would accept less or a buyer pay more than the open market price (bearing in mind that this could be a range of prices) or settle, for example, for less profit and/or greater risk than would have been available to an uncontrolled enterprise. It is clear that if an open market exists from which one or more comparables can be found, these comparables identify options open to the enterprise if the ownership had been severed and thus show how its dealings should be structured for tax purposes to accord with the arm's length principle. One option, however, might be not to enter into a transaction because it does not make commercial sense for the particular taxpayer.

2.18. Paragraph 1.70 of the 1955 OECD Report indicates that evidence from enterprises engaged in controlled transactions with associated enterprises may be useful in understanding the transaction under review or as a pointer to further investigation.

2.19. The use of this kind of information, which is referred to in **subparagraph 2.11(4)** in relation to dealings between associated enterprises, should be restricted to cases of last resort where:

(1) there is sufficient data available to demonstrate their reliability; and

(2) related party comparable data provides the most reliable **available** data upon which to determine or estimate an arm's length outcome, and an estimate is required under subsection 136AD(4).

2.20. It has been argued that it is inappropriate to use such data in any circumstance to determine an arm's length outcome. While the ATO agrees that such data should only be used in exceptional cases, as indicated above, the ATO disagrees with the view that it can never be used, particularly where there is no better reliable data reflecting proper arm's length outcome.

2.21. This data should be used with extreme care and should not be relied on except where:

(1) it is consistent with such other information as is available in relation to truly independent dealings in comparable circumstances;

(2) the processes adopted in settling the terms and conditions of the related party dealings clearly demonstrate the parties were negotiating on the basis of their real economic circumstances and their functions, assets and risks, and were properly motivated to maximise their individual economic interests; and

(3) the outcomes resulting from the processes are reasonable having regard to those circumstances and functions, assets and risks.

Intangibles

2.22. Intangible and intellectual property can present particular problems when examining comparability, usually because of the specialised nature of the property.

2.23. However, the general principles and guidelines in relation to tangible property concerning comparability and the selection of the most appropriate method is also applicable to intangible property.

2.24. Where there is insufficient comparable data for direct comparisons, this can lead to greater reliance being placed upon profit based or other indirect arm's length methods. This situation can arise due to:

(1) the unique character of the intangible - commonly, information is scarce on comparable property or dealings and difficult valuation questions arise;

(2) the need for highly valuable intangibles to stay generally within the control of the group of Multinational Enterprises ('MNEs') to maximise its profitability;

(3) the fact that certain intangibles can be protected only by keeping their attributes secret within the MNEs group; or

(4) the intangible being developed solely by the efforts of an enterprise and for its own purposes (e.g., some marketing intangibles).

Market indices

2.25. The availability, or lack thereof, of reliable market data is often critical to the selection and application of particular transfer pricing methods. Market indices may be one source of data, for example in metals, energy or money markets.

2.26. Generally, market indices can be indicative that arm's length principles are being followed. If there are specific facts or circumstances that would suggest otherwise (e.g., where a company is able to materially influence a particular market index, and related party transfer prices are set using this manipulated market index), there is a need for further investigation.

2.27. Comparability is the key issue in the application of most arm's length methods. This remains true with use of public indices. It is necessary to evaluate the dealings in terms of the important factors

against which comparability needs to be assessed. These factors are established on the facts of the case but the subsequent discussion on comparability is relevant. Adjustments may be required for material differences and the reliability of the comparable needs to be evaluated against the controlled transactions. On the basis of this evaluation a conclusion can be reached on the suitability or otherwise of the use of the index. It may not always be appropriate to rely on a market index in the particular circumstances of an enterprise. The use of data from market indices should have regard to the need for the analysis to produce outcomes that make business sense (**paragraphs 1.1, 2.16, 2.17, 3.2 and 3.3**).

B. Factors affecting comparability

2.28. In determining comparability in the context of establishing the arm's length character of dealings between associated enterprises, the OECD has identified a number of factors that must be considered (1995 OECD Report, Chapter I). These include:

(1) characteristics of the property or services;

(2) functions performed, assets or resources contributed, risks assumed by the parties involved;

(3) contractual terms, e.g., duration, rights, payment options;

(4) business strategies, such as market penetration, research and development commitments, market positioning, involvement in strategic alliances, commitment to distinctive competencies; and

(5) economic and market circumstances.

2.29. In complex dealings involving several distinctive markets and product/service combinations, it may be necessary to consider the analysis of functions, assets and risks separately for each significant product/market combination.

2.30. Similarly, if more than one strategy is in use, it may be necessary to consider the analysis of functions performed, assets used and risks assumed separately for each strategy. This reflects the possibility that functions performed, assets used and risks assumed by the parties to the dealings may vary in each major product/market setting and by choice of strategy.

2.31. The analysis specified in **subparagraph 2.28(2)** is commonly referred to as a 'functional analysis' (1995 OECD Report Glossary). A functional analysis assists in assessing the level of comparability present in controlled and uncontrolled dealings and in assessing the relative contributions of the parties to those dealings.

2.32. An analysis that also involves the other steps in **paragraph 2.28** is referred to as a 'comparability analysis' (1995 OECD Report Glossary), while the term 'economic analysis' is used to refer to the overall process of determining transfer prices.

2.33. The process of conducting these analyses, which tend to merge one into the other, will be discussed in a separate Ruling on the documentation and practical issues associated with setting and reviewing transfer pricing in international dealings.

Characteristics of property or services

2.34. Differences in the specific characteristics of property or services often account, at least in part, for differences in their value in the open market. Therefore, comparisons of these features may be useful in determining the comparability of controlled and uncontrolled transactions or activities. However, care must be taken to focus on those attributes or characteristics that are valued by customers, including the intangible benefits of design, brand name, and perceived quality.

Functional analysis: functions, assets, risks

2.35. In order to establish comparability, one of the important factors is an analysis of functions performed, assets used and risks assumed by the parties under examination.

2.36. However, a functional analysis is not a transfer pricing methodology in its own right. Rather, it is a tool that assists in the proper assessment of comparability, and it has equal application for an enterprise that is setting prices as to a revenue authority that is reviewing those prices.

2.37. Note that the 1995 OECD Report treats risk as part of functions, and, more importantly, notes that changes in risk can affect appropriate rewards (paragraphs 1.23 to 1.27 of the Report).

2.38. In straightforward cases (e.g., if the associated parties are dealing in commodities available on open markets), it may only be necessary to conduct a brief functional analysis. In more complex cases (e.g., if intangibles are involved), the analysis needs to be more thorough.

2.39. However, the compilation of lists of functions, assets and risks, in whatever detail, does not in itself indicate which of the functions are the most significant, or economically the most important to the value added by the business activities of the enterprise.

2.40. A critical part of the analysis is to ascertain which are the most economically important functions, assets and risks and how these might be reflected by a comparable price, margin or profit on the dealings. This is what a reasonable business person following good business practice could be expected to do.

2.41. If a method involving external benchmarking with independent enterprises is being used (such as comparable uncontrolled price and transactional net margin methods as discussed below), the functional analysis assists in determining the comparability of the dealings of the enterprise with uncontrolled dealings undertaken by the independent parties. It is essential to ensure that, if there are differences in the significance of the functions, assets and risks to each of the businesses, these differences are taken into account.

2.42. If a profit split is being used, the functional analysis enables the identification of routine functions that can be rewarded with a basic rate of return. The high value added functions, assets and risks contributed by the parties to the international dealings under review are also identified in the process, enabling their relative importance to the profit outcome to be compared and the relative weightings to be used as a basis to split the profit.

Contractual terms

2.43. In arm's length dealings, the contractual terms of a transaction generally define explicitly or implicitly how the responsibilities, risks and benefits are to be divided between the parties. When independent enterprises negotiate contracts or agreements the ultimate price/margin agreed is influenced by the terms and conditions of the proposed agreement. Examples of the terms and conditions that may influence the agreed price/margin include:

(1) credit and payment terms;

(2) volume, duration, product and service liabilities of the parties; and

(3) warranties and exchange risk;

and these matters need to be taken into account when making any comparison. By way of an example, the difference in contractual terms between payment by cash on delivery and payment in 90 days would need to be recognised.

Economic and market circumstances

2.44. Arm's length prices or margins may vary across different markets even for transactions involving the same property or services. Therefore, achieving comparability requires that:

(1) the markets in which the independent and associated enterprises operate are comparable; and

(2) differences either do not have a material effect on price, or if they do have a material effect, they are able to be appropriately adjusted.

Business strategies and efficiencies

2.45. Business strategies of an MNEs group are often formulated by one member of the group (usually the parent), sometimes after consultation with and input from group members, and then put in place by the relevant members. These strategies may involve:

(1) product and/or service innovation;

(2) degree of diversification;

(3) market level and location;

(4) market penetration or market share;

(5) product and/or service quality;

(6) pricing;

(7) distribution channel selection;

(8) marketing costs;

(9) stock levels; and

(10) general policies relating to such things as accommodation or staffing levels.

2.46. The test in a transfer pricing context is whether an independent enterprise in the taxpayer's circumstances might have been expected to have participated in these strategies and if so what reward it would have expected.

Market penetration

2.47. Market penetration strategies take many forms, but essentially all implement conditions whereby parties to the dealings temporarily agree to forgo some level of profits or incur losses to position themselves for more substantial profits in the future.

2.48. The term 'market penetration strategies' is also used in this Ruling to include market expansion strategies. In the ATO's

experience, the issue of market penetration strategies is one of the most important questions in the application of Australia's transfer pricing rules (TR 94/14, paragraphs 138 to 141 and 445 to 457).

2.49. If there are costs incurred or profits forgone by the taxpayer resulting from strategies or policies imposed by an associated enterprise, the question then to be answered is who benefits from these decisions and who should bear the cost of such a policy or strategy.

2.50. Independent parties would not be prepared to accept strategies or policies that would reduce their level of profit for the benefit of another enterprise. In arm's length dealings, any party accepting additional risks or functions would require an appropriate reward.

2.51. For example, to establish whether a market penetration or expansion strategy as between associated enterprises is consistent with the arm's length principle, it is necessary to establish whether independent enterprises dealing at arm's length in fact have, or might be expected to have, accepted the terms and conditions of the strategy in the same or similar market circumstances.

2.52. Before entering into these strategies, independent enterprises might often be expected to come to some prior agreement (on price or profit sharing) that would take into account any additional risks, costs or functions and resulting rewards or profits. Either separately or together, the parties might be expected to prepare a budget or plan (culminating in an agreement) that might set out, among other things, each party's obligations and rewards, expected costs and profits, and the duration of such a strategy or policy. However, there may be circumstances, which would need to be demonstrated in a particular case, where a company may take a more ad hoc approach to determining strategy.

2.53. Apart from factual issues of how arm's length parties might be expected to approach such a strategy in terms of pricing, allocation of costs, or division of profits, other factors that should be considered include:

(1) whether, in substance, a market penetration strategy is being pursued. For example, if price concessions are a key feature of the market penetration strategy, it is expected that such discounting be reflected in the price of products or services to the end user;

(2) whether a market penetration strategy is appropriate given the substance of the business relationship between the parties and the nature of the market. For example, a discounting strategy would not make commercial sense if the seller was in a strong market position to supply a

valuable product or service for which there is strong demand;

(3) whether the prices, margins or profits on the dealings reflect the respective contributions of the parties. For example, a supplier of goods or services may agree with a subsidiary that the responsibility (the functions and risks) of developing a market rest with the subsidiary. In that case, one would expect that the risks and rewards associated with implementing such a strategy would 'belong' to the subsidiary and the sole undertaking of those risks would ultimately be reflected in the correct allocation of profits that derive from that activity.

2.54. The nature and duration of a market penetration strategy, including timing, generally depend on such questions as the features of the market and the product or service that is the subject of the strategy and the extent and nature of the competition in the market. A feature of any such strategy, when implemented by parties dealing at arm's length, is an expectation based on a reasonable belief that, by reducing profits or incurring increased losses in the short term, there is a definable outcome of increased returns in the future aimed at recouping original costs associated with the strategy and, further, enhancing future profits.

2.55. The longer the strategy is pursued, the greater the expected additional profits need to be recouped from that investment, and the more difficult it is to establish that a market penetration strategy is in place. For example, the Federal Finance Court of Germany, Decision of 17 February 1993, concluded that start-up losses should not exceed three years in the normal case, and United States Reg 1.482-1(d)(4)(i)(B) refers to a period that is reasonable, taking into consideration the industry and product in question.

2.56. By way of an example, assume that an Australian distributor of a product manufactured by its foreign parent has not been returning a profit for many years. When subject to an ATO review of its dealings with associated enterprises, the taxpayer claims that it was pursuing a long term market penetration strategy. The distributor appears to bear all the costs and risks associated with the strategy without additional reward while the parent continues to derive high levels of profit in the dealings. Its position is not supported by any documentation prepared at the time of implementing the market penetration strategy. The ATO is highly unlikely to accept that the taxpayer is pursuing a valid market penetration strategy in such a case.

Global price lists

2.57. Global price lists specify the prices at which goods or services are sold globally to all purchasers at a particular level of the market. A global price list satisfies the arm's length principle only if the prices:

(1) have been reviewed using an appropriate arm's length methodology; and

(2) are applied only in comparable circumstances (e.g., where the markets are comparable and the buyers and sellers respectively are performing equivalent functions); and

(3) are applied to both controlled and uncontrolled dealings.

2.58. Because markets often vary by location, it is difficult for a global list to satisfy these conditions. Isolated sales to independent enterprises are not generally sufficient to establish the arm's length nature of a global price list (**paragraph 2.14**).

C. Establishing the reliability of the data

2.59. When possible comparables or other factors have been identified, it is then necessary to consider their reliability. Factors influencing reliability include:

(1) measurement error, arising from slight differences in definitions, accounting practice, timing, etc.;

(2) departures from 'perfect market' conditions, leading to some indeterminacy in economic outcomes, for example, situations where the market power of the participants plays an important role;

(3) unadjusted differences in the circumstances of the dealings involved; and

(4) differences in the methodologies used.

2.60. The most important factor influencing reliability lies in the way material differences in the circumstances surrounding the dealings are dealt with. Since different methodologies focus attention on differing sets of attributes, the questions raised by the handling of material differences and thus reliability vary between methodologies.

2.61. The reliability of raw and adjusted data affects the uses to which the data can be put, the choice of transfer pricing methodology that is to used, the development of arm's length ranges and the confidence that can be placed on the answers that are obtained.

2.62. In assessing reliability, the following questions need to be addressed:

(1) what are the economically significant attributes of the dealings that need to be considered in any comparison?

(2) is data available to allow the needed comparisons to be made?

(3) are there any material differences showing up in the attributes under consideration?

(4) if there are material differences is an adjustment for the differences possible in principle?

(5) since making an adjustment implies a link between the attributes being adjusted and price, margin or taxable income, can this link be quantified and is the relationship strong enough for the purpose in hand? (a statistical analysis would assist here, although small sample sizes may make such analysis difficult);

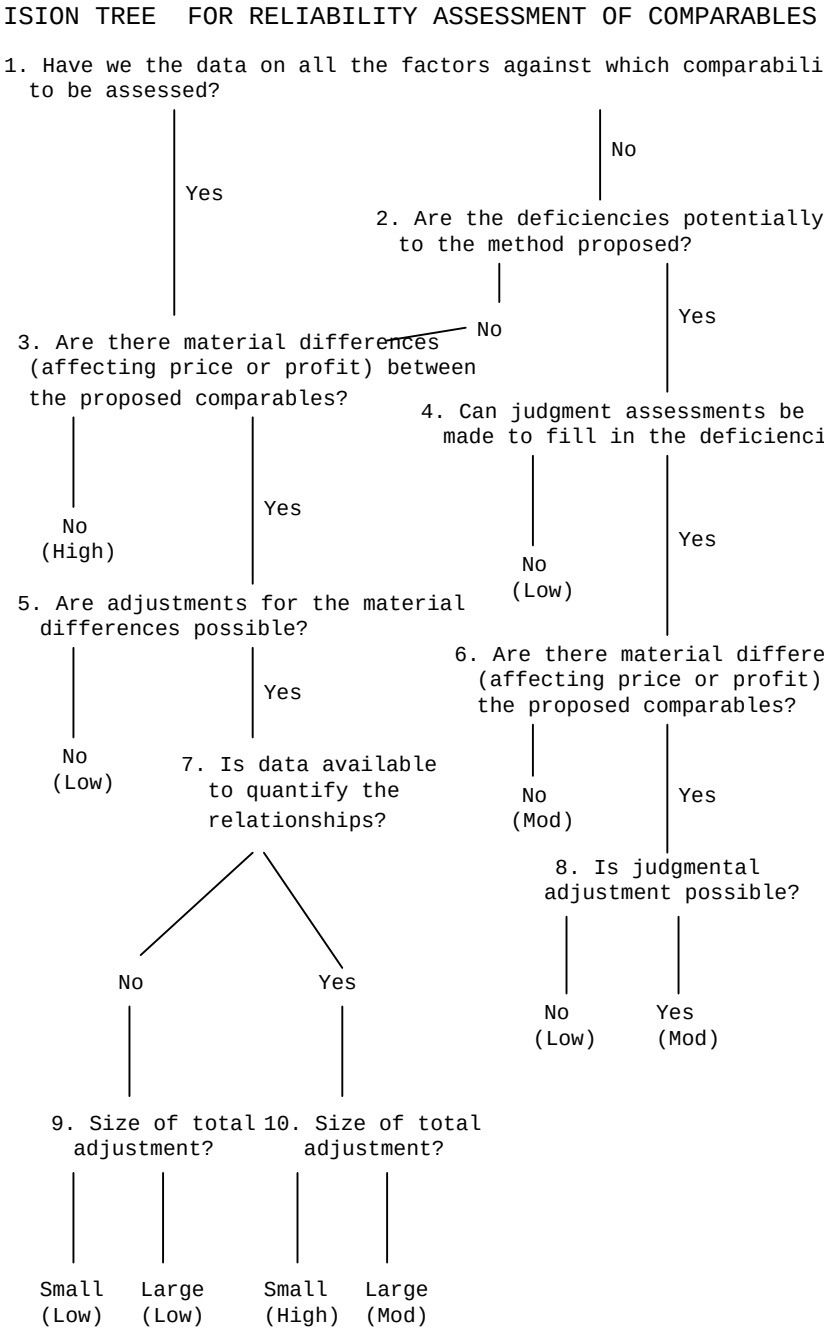
(6) how big in percentage terms is the resulting adjustment required for comparability purposes?

(7) if the data needed to answer any of the above questions is not available, can judgment be used?

2.63. The questions in **paragraph 2.62** and the possible responses are set out in the decision tree below, which assesses the reliability of data on potentially comparable dealings or potentially comparable enterprises, grouping the estimates into three broad categories of low, moderate and high reliability.

2.64. If judgment is significantly involved, reliability is at best moderate. If there are no material differences or the data is available to adjust for the differences found, reliability can be high.

2.65. The purpose of the decision tree is to focus attention on the need to examine the reliability of the results obtained from the use of the comparables. The higher the reliability the greater is the comfort that the use of the data will produce an arm's length outcome. However, there is a need for an outcome in transfer pricing cases and in the absence of more reliable data, data of low reliability sometimes has to be used to determine arm's length prices.



2.66. Practical examples of how this would operate are shown in the **Appendix** to this Ruling (**paragraphs A1 and A2)**.

Adjustments to data: differences in accounting treatment

2.67. Enterprises record their transactions in their books of account in a manner that suits their reporting needs and the statutory requirements of the country in which they operate. The majority of the methodologies rely upon costs and comparable margins, whether it be gross, net or some intermediate level. There is, therefore, a need to

ensure that any differences in accounting treatment between entities being compared are adjusted so that an accurate comparison of costs and margins can be made.

2.68. For example, some enterprises may include royalties paid or insurance and freight for purchased goods above the gross profit line while others may include them below the gross profit line.

2.69. While accepting that accounting standards vary between countries, the basic rule is that true comparability must be based on a consistent approach to the components of income and costs taken into account in comparing the taxpayer's performance with that of the independent enterprises considered as possible comparables.

2.70. If data is not available to determine the basis of accounting of any enterprise being considered as a comparable, then any comparability analysis should be at the net margin level or at a level that would include all relevant costs.

D. Recognition of the actual transactions undertaken

2.71. Any audit by the ATO starts with the actual transactions undertaken. When considering an agreement between associated enterprises, there is a need to have regard, not only to the terms of the agreement, but also to the actual conduct of the parties.

2.72. In applying Australia's transfer pricing rules, if the economic substance of a dealing differs from its form, regard must be given to the conduct of the parties in identifying the actual terms of the contract (1995 OECD Report, paragraphs 1.36 to 1.41; TR 94/14, paragraphs 45, 46, 262 and 263).

E. Evaluation of separate and combined transactions

2.73. Ideally, dealings between associated enterprises should be priced on a transaction by transaction basis. However, it is also recognised that if it is impractical to assess individual transactions (e.g., if such an approach would not address all the relevant aspects of the dealings between the parties that affect comparability), it may be more appropriate to consider a combination of transactions (TR 94/14, paragraphs 432 to 438).

2.74. Grouping may be appropriate in the following situations:

(1) *Transactions/components of transactions*

Dealings between associated enterprises in a particular product may involve separate transactions for the product, the intangibles associated with the product, technical

advice, management services and any other related matters.

In dealings with independent parties, these various aspects may be rolled into a package deal with all the associated costs being included in the transfer price of the product.

The various aspects may need to be considered together to account properly for the costs and to prevent double counting.

If the independent dealings being considered as possible comparables cannot be disaggregated, it would generally be appropriate to group all the relevant transactions between associated enterprises so comparability to the uncontrolled party package deal transaction can be properly determined.

Care is needed to identify the value of any component of the package that is subject to different domestic tax treatment, e.g., items subject to interest or royalty withholding tax.

(2) *Integrated operations*

If it is decided to route the transaction through an associated enterprise, it may be more appropriate to consider the dealing in its entirety rather than consider the component transactions on a separate basis. There could be practical difficulties in determining the true value added by any intermediate company if it is considered in isolation.

For example, a company may be licensing intangibles and supplying vital components to an associate as part of a highly integrated global manufacturing process (paragraph 1.42 of the 1995 OECD Report).

Further, it is necessary to consider incremental dealings that may have the effect of gradually eroding profitability. The most appropriate approach in such cases may be to apply the statutory test of whether independent enterprises would have entered into the package of transactions, rather than analysing each individual transaction separately.

If it cannot be demonstrated in a particular case that the intermediate company bears a real risk or performs a function adding economic value in the chain that has produced the value of the goods or services, it might be appropriate to attribute any profit element, claimed to be attributable to the activities of the intermediate company, elsewhere in the MNEs group. Independent enterprises

operating independently might not be expected to have allowed such a company to share in the profits from the dealing.

Alternatively, a group company resident in Australia may be a conduit for inbound and outbound dealings that appear properly priced when considered in isolation but the transactions in combination may have the net effect of reducing profits of the resident enterprise.

For example, the resident enterprise may obtain a lease of equipment from an associate, and agree to pay a stream of rental payments based on the value of the equipment calculated according to an acceptable method. The enterprise may on-lease the equipment to another associate and use another acceptable basis of valuation to calculate the payments it receives. The different basis of valuation may result in the Australian enterprise making a loss or suffering a timing disadvantage. These transactions should be grouped if independent parties operating independently might be expected to have grouped them in establishing prices and terms.

(3) *Product lines*

The business activities of MNEs may be based on a single product or service, a number of related products or services or a variety of products or services. When undertaking a profit analysis (gross, net or at some other level) the emphasis is more on the comparability of the functions performed, the assets utilised and the risks assumed in relation to the product rather than the product itself.

For example, assume that the business activities of a member of an MNEs group are the importing and wholesaling of toasters, electric kettles, blenders and the provision of services in the form of advice on appliance design. Although the MNEs management may have a number of separate product lines, it may be appropriate in analysing comparability to group the household electronic products together - the functions performed in relation to wholesaling these products and the assets utilised and the risks assumed in those activities are similar for each product line - but to treat appliance design services separately.

2.75. If dealings have been grouped, the allocation of the relevant operating, financial or other expenses needs to reflect that grouping. If it is not possible to allocate on a direct basis, a soundly-based

method of indirect allocation could be used that accords with accepted accounting principles and fits the particular circumstances (see discussion on cost allocations at **paragraph 3.35**).

2.76. For a composite transaction or a series of interconnected deals between associated enterprises, Australia's transfer pricing rules allow each component transaction or sub-transaction to be properly priced according to the arm's length principle.

2.77. In some cases, comparability can only be established by a further extension of the grouping approach. It may be necessary to aggregate the product or business lines so as to consider the matter in its proper business and economic context.

2.78. This situation may arise if, for any reason, there is insufficient data available on comparable dealings to undertake a comparability analysis on any other basis. Lack of reliable data on comparable dealings may be due to the complexity of the dealings or the relationships between the parties.

2.79. If the resulting dealings are unique, the only option available for making transactional comparisons may involve some divisional comparisons or aggregation of a range of dealings. In this regard, the special provisions in Australia's transfer pricing rules (**paragraphs 1.15 to 1.24**) permit the extension of the grouping approach beyond that contemplated in paragraphs 1.42 to 1.44 of the 1995 OECD Report.

2.80. Similarly, developments in relation to some sectors seem to indicate that in arm's length dealings, relationships may be more influential in international trade, and that transactions cannot be examined in isolation from those relationships. The special features of any relationships should be taken into account.

2.81. The complexity of those relationships is often dictated by the complexity of the deals being struck. While transactions suggest the possibility of markets or prices that may be of some help in benchmarking, a proper analysis of an arm's length relationship for the purpose of finding comparables may have regard to the exercise of skill and power in the bargaining context.

2.82. The availability and sharing of information, and the motivation and authority to operate as a separate profit centre, are key elements in analysing the arm's length nature of the dealings in cases where traditional transfer pricing methodologies are extremely difficult to apply.

F. Use of an arm's length range

2.83. In some cases, application of a methodology produces a single outcome (e.g., price, margin or profit) that is the most reliable measure of an arm's length outcome. In other cases, because transfer pricing is not an exact science, application of the most appropriate method(s) may produce more than one result. This may come about because:

(1) in using a single method, the arm's length principle only produces an approximation of conditions that may be established between independent enterprises and for this reason the comparables examined may lead to different results; or

(2) when using more than one method, differences in the nature of the methods and data relevant to applying each method may produce different results.

2.84. These data points may give rise to an arm's length range. There are a number of considerations to be taken into account when constructing an arm's length range. They include: -

(1) Comparable uncontrolled dealings need to be identified and selected on the basis of criteria required to undertake the method being applied.

(2) If material differences exist between the dealings by associated enterprises and the cases being considered as possible comparables, adjustments need to be made to reflect the differences in order to improve the reliability of the comparison with uncontrolled dealings. A comparability analysis is an important step in identifying material differences and may offer a basis for determining any necessary adjustment. If reasonably accurate adjustments cannot be made to eliminate material differences, then the case being considered as a possible comparable is not truly comparable and the comparison is of low reliability.

(3) The arm's length range is constructed using only comparable uncontrolled dealings that have, or have been adjusted to, a high level of reliability in comparison with the controlled dealings.

2.85. In order to be acceptable, a range has to be an arm's length range. If there is substantial divergence between data in the range, it may be that all the data in the range is not truly arm's length outcomes, or data points may not be representative of enterprises that are comparable with other enterprises in the range.

2.86. In such cases, the reliability of the data in respect of each possible comparable must be carefully assessed, any adjustments made for material differences in comparability and the methodology itself should be reviewed. It may be that material differences in functions, assets and risks in the dealings between the associated enterprises and the comparables in the range have not been correctly identified or accurately reflected.

2.87. In order to test the reliability of results, it may be helpful to apply another methodology. There would be more confidence in ranges that are established by the use of different methodologies if those ranges, when overlaid, reflect common results.

2.88. In some circumstances, only a limited number of comparable uncontrolled dealings may exist, or the reliability of those available may be so low that it may not be possible to construct an arm's length range.

2.89. However, it may be possible to approximate the arm's length range from a small sample of results or from results of low or moderate reliability using appropriate statistical procedures (**paragraphs 2.93 and 3.99**) such as weighting data points by their reliability. A range constructed in this way cannot be given the same status as a true arm's length range in the process of determining an arm's length outcome.

2.90. In the absence of comparable uncontrolled dealings, it may be possible to infer from other industry available information whether dealings between the associated enterprises achieve an arm's length outcome. However, it should be noted that data that does not achieve a high level of reliability cannot be used in constructing an arm's length range and, while it may be useful in terms of broad indications, cannot be given the same status in determining an arm's length outcome.

2.91. Nevertheless, the results or information referred to in **paragraph 2.89 or 2.90** do provide relevant information which, when combined with other information, may assist in determining an arm's length outcome in circumstances where there is no reliable data.

2.92. When using the traditional transaction methods, an outcome that falls within a properly constructed arm's length range should be regarded as being arm's length. However, if the dealing falls outside the arm's length range, which is comprised of data points with characteristics indistinguishable from one another, the consideration should be adjusted to the nearest point within the range. Where it is possible to distinguish between the points in a range on the basis of their relative comparability, it is a matter of judgment as to the point in the range to which the adjustment should be made. In this last case, the adjustment should reflect the point in the range that best accounts

for the facts and circumstances of the controlled transaction (paragraph 1.48 of the 1995 OECD Report).

2.93. When applying a method other than a traditional transaction methodology (such as a transactional net margin method) or making use of less reliable results, an approximation of an arm's length range may be obtained. The approximations used in applying these other methods, which rely on broader measures of comparability, can give extensive ranges, some points in which may not be sufficiently accurate to permit the general statement that any point in the range may be regarded as arm's length.

2.94. In these situations, the arm's length outcome that arises from the use of a method other than a traditional transaction methodology should reflect the point that best accounts for the facts and circumstances of the dealings between the associated enterprises. If such a point cannot be established, it is appropriate to consider using another method to assist in approximating an arm's length outcome.

2.95. In the use of ranges, Australia's transfer pricing rules permit the ATO to go beyond the methodologies in the 1995 OECD Report in order to obtain an answer in the most difficult cases (**paragraphs 1.23 and 3.90 to 3.93**).

G. Need for multiple year data to limit distortions

2.96. The purpose of using multiple year data is to ensure that the outcomes for the relevant year are not unduly influenced by abnormal factors. In attempting to determine an arm's length outcome for international dealings between associated enterprises, the results of any one year may be distorted by differences in economic or market conditions and the features and operations of the enterprise affecting the controlled or uncontrolled dealings. Participants in an industry may not be uniformly affected by business and product cycles, and therefore differences between dealings may reflect differences in circumstances, not the effects of non-arm's length dealings.

2.97. A valid conclusion as to what constitutes an arm's length outcome for a dealing usually requires examination of several years of dealings for both the controlled and uncontrolled parties. In this way, differences due to such factors as business or product cycles can be more effectively taken into account and comparability can more reliably be determined (1995 OECD Report, paragraphs 1.49 to 1.51). This is also important if there has been a substantial prior investment in the development of intangibles, or a prior sale of a relevant asset.

2.98. There is a need to establish an appropriate setting or starting point for identifying the economic alternatives a truly independent decision maker might normally be expected to consider and to identify

comparables if they exist. The number of years that need to be examined depend on the facts and circumstances of the case, but as a starting point the ATO usually considers the year under audit and the preceding four years. Taxpayers may wish to consider the current year and previous four years when setting their prices, subject to the particular facts of their case.

H. Losses

2.99. Independent enterprises can incur genuine losses for a variety of economic and business reasons. Some of the reasons why taxpayers dealing at arm's length may suffer losses include start-up losses, market penetration strategies (**paragraphs 2.47 to 2.56**), product liability, downturns in the business cycle, the emergence of more competition or new technologies in the market, or unfavourable economic conditions.

2.100. It is not, however, accepted that an independent enterprise would be prepared to sustain such losses on an indefinite basis without taking appropriate action to return the enterprise to profitability. To do otherwise would be contrary to fundamental business objectives of seeking to achieve an adequate return on the capital invested in the business within a reasonable period of time, taking into account the risks involved and the options open to management (1995 OECD Report, paragraph 1.54).

2.101. If an enterprise incurs sustained losses in relation to its dealings with associated enterprises, there are, *prima facie*, good grounds for questioning the arm's length nature of the associated enterprise dealings. This would be particularly so where the MNEs group, of which the taxpayer is a member, was as a whole profitable.

Losses on product lines

2.102. There may be situations where an enterprise carries an unprofitable product or line of products so as to have available a complete product range. This usually occurs where unprofitable items are auxiliary to the profitable items and there is sufficient profit available to provide an adequate return from the complete product range to reward the assets, functions and risks of the enterprise.

2.103. However, where the unprofitable product is a material part of the business of the enterprise, the matters included in the discussion on losses above need to be considered. Even though the enterprise as a whole may be profitable, there may not be a sufficient profit relative to what could reasonably be expected if the enterprise had been wholly independent and having regard to its contribution of assets, functions and risks. In these circumstances, it may be necessary to

properly group the transactions in assessing comparability (also TR 94/14, paragraphs 135 and 435).

I. The effect of government policies

2.104. Government policies or interventions are generally treated as conditions of the market in a particular country and they should be taken into account in evaluating the transfer price between associated enterprises (see OECD 1995 Report paragraphs 1.55 and 1.56).

2.105. The question to be addressed is who should bear the risk associated with the local market conditions, and (where applicable) how should the risk be shared between associated enterprises. In deciding these questions, any sharing of the risk should nevertheless produce an arm's length result for that market.

2.106. For example, if an arm's length distributor is confronted with local market conditions such as price controls, it might be expected to act to maintain its profit in line with its assets, functions and risks. If profit cannot be maintained at that level, the management might consider its options.

2.107. These options could include:

(1) cutting back on other expenses (e.g., by reducing its marketing expenses and promoting the product less aggressively);

(2) reducing the quantity of its purchases of the property or services;

(3) renegotiating the purchase price of the property or services from the supplier; or

(4) accepting the losses in the short term because there is a reasonable basis for expecting that the present value of future profits would more than offset short term losses.

Blocked payments

2.108. In some situations, a foreign group member is prohibited by the law of its country, or is in some other way prohibited, from paying an Australian enterprise for property or services. Whether an amount should be included in the assessable income of the Australian enterprise in these circumstances, where there has been no flow of funds (and possibly no charge made), depends on the facts and circumstances in each case. The type of restriction contemplated here is not simply a disallowance of a tax deduction for the payment in the foreign country.

2.109. It is often reasonable to expect that the property or services would not be provided free of charge if the parties were dealing wholly independently with each other in full knowledge of the restrictions on payment. The supplier may accept payment in the country blocking payments, or it could seek compensation by a back-to-back arrangement offshore. Provided the circumstances authorised the operation of either the relevant article of a DTA or subsection 136AD(2), the ATO would generally seek to impute an appropriate consideration to the Australian enterprise for any property or services that have been provided where no payment has been made.

2.110. The ATO does not accept the alternative view that the arm's length consideration in these situations is nil. Clearly, a benefit of some value has been provided by the Australian enterprise and the price for that benefit in arm's length dealings would not be zero. If the information needed to determine the arm's length price is not available in the recipient's market, the price given by the best available comparable in another comparable market not subject to the same constraints could be used.

2.111. There may be situations where an independent enterprise may be prepared to supply property or services to an enterprise in a country where payments are blocked in anticipation of developing a future profitable business relationship in that country. The evidence of such a business strategy, the time frame for expected lower returns and an analysis of expected future profits would need to be considered. Alternatively, evidence of other independent enterprises operating in this way would be necessary.

J. Set-offs

2.112. Intentional set-offs occur when one associated enterprise provides a benefit to another associated enterprise within the group that is deliberately balanced to some degree by different benefits received from that enterprise in return (1995 OECD Report Glossary).

2.113. The problem that arises, therefore, is how to determine whether dealings that involve an intentional set-off adhere to the arm's length principle. In all cases, it is necessary to seek an answer to the question of what, given the factual circumstances, might reasonably be expected to occur between independent enterprises dealing at arm's length in comparable circumstances.

2.114. The ATO would generally allow set-off arrangements if they are on terms and conditions that might be expected to be acceptable to independent enterprises in comparable circumstances dealing at arm’s length (1995 OECD Report, paragraphs 1.60 to 1.65).

2.115. Additional matters that would impact on the acceptance of set-off arrangements by the ATO include:

(1) ***Market practice***. Generally, arm's length parties might be expected to prefer to deal in terms of 'receipts and disbursements' for goods and services rather than contractual quid pro quos. So, although set-offs are known to occur especially in dealings with countries that have soft currencies, they do not normally appear to be a regular feature of trade in open market conditions by arm's length parties. If they become a common feature of international dealings between associated enterprises, the ATO and taxpayers may find their quantification difficult because of the lack of external benchmarks;

(2) ***Nexus***. Set-off arrangements are usually limited to a particular dealing or series of dealings as between two parties. As such, the set-off is directly related to the subject matter of the contract and does not usually involve other participants beyond the principal contracting parties, or subject matter not covered in the contract. Where there is a nexus, the contract participants in arm's length situations can more easily ascertain the impact that the set-off will have on their overall outcomes;

(3) ***Timing***. Outcomes flowing from a set-off arrangement should crystallise within a reasonable time of the arrangement being entered into, consistent with the expectation of arm's length parties dealing in comparable circumstances. Set-offs involving timing issues would need to be carefully examined to determine whether an independent party might be expected to accept the timing effect; and

(4) ***Equivalence***. There is an expectation that the benefits flowing from such arrangements are equivalent in value so as to give rise to mutually agreed outcomes from the perspective of the parties engaging in the set-off. If the effects of the set-off cannot be quantified, or there is a significant imbalance between the respective parties' outcomes as a result of entering into the arrangements, it is considered unlikely that the set-off would satisfy the arm's length principle.

2.116. Set-offs that have the effect of altering the characterisation of payments or receipts so as to alter the incidence of tax, or that effectively reduce the taxpayer's or the relevant MNEs group's overall Australian tax liability, are unlikely be regarded as at arm's length, if uncontrolled transactions would not have been structured in that way.

In addition, there may be a question in some cases as to whether Part IVA applies.

2.117. Even if enterprises are otherwise independent, the fact that they enter into two or more transactions with prices that in total reflect the market value of the property or services in question, but individually are not market values, may be sufficient to establish that the consideration is not arm's length and hence potentially subject to Division 13 (TR 94/14, paragraphs 284 to 392; *Collis v. FCT* (1996) 33 ATR 438; 96 ATC 4831). This principle applies equally to intentional set-offs between otherwise independent enterprises.

2.118. Where the ATO is proposing a transfer pricing adjustment, a taxpayer may seek to offset previously under-claimed deductions or over-reported income. Such unintentional over-reporting of taxable income in relation to transfer pricing dealings is only considered in the context of the Mutual Agreement Procedure under Australia's DTAs; this is because of the potential for no tax to be paid if the amount of the reduction is not brought to account and taxed in the other country (i.e., the ATO does not unilaterally grant requests on audit for adjustments in favour of the taxpayer; 1995 OECD Report, paragraph 1.64).

K. Use of customs valuations

2.119. Australia, in common with many member countries of the World Trade Organisation, uses the GATT Valuation Code as the basis for customs valuation of imported goods. There is similarity between the Australian customs methods of valuation and the arm's length standard in Australia's transfer pricing rules. Customs values are often indicative of an arm's length outcome, but the following substantive and procedural matters need to be taken into account.

2.120. Customs rules require that all imported goods be given an individual value, whereas aggregation approaches may be used under income tax rules (**paragraphs 2.73 to 2.82**). If profit methods, such as profit splits and the transactional net margin methods, are used under income tax rules, the transfer prices of particular goods need not be separately calculated.

2.121. Also, procedurally, the customs method starts with a presumption in favour of the price contained in the shipping documents and only allows for adjustments of prices within relatively short time periods after import. The onus is on the taxpayer for income tax purposes, and prices are often audited some years after the transaction occurred as no time limit is prescribed for initial adjustments under Australia's transfer pricing laws.

2.122. Therefore, conformity of transfer prices with customs values does not of itself prove that the standard in Australia's transfer pricing rules has been satisfied.

CHAPTER 3: ARM'S LENGTH METHODOLOGIES

A. What are the arm's length methodologies?

3.1. There are a number of internationally accepted methodologies that test compliance with the arm's length principle. These arm's length methodologies are divided into two groups:

(1) the traditional transaction methods ('traditional methods'), being:

(a) the comparable uncontrolled price (CUP) method;

(b) the resale price (RP) method; and

(c) the cost plus (CP) method; and

(2) the transactional profit methods, which include the profit split methods and transactional net margin methods ('profit methods').

Simply establishing the market terms and conditions may not be sufficient

3.2. The successful application of the arm's length methodologies (and in particular the traditional methods) establishes the consideration and contractual terms that prevail in the open market. It does not necessarily follow that it is always appropriate to adopt that consideration in the dealings between related enterprises. When dealing at arm's length, the parties generally have the option not to proceed with the dealings if the market prices do not satisfy their profit expectations or business strategies.

3.3. For example, if the prevailing market prices lead to unsatisfactory profit levels, then dealings may ultimately not be concluded or may be conducted in a different manner or on different terms. This indicates that arm's length dealings involve both the establishment of the market terms and conditions and an assessment of the implication of these dealings for the profits of the enterprise.

Sometimes a hybrid or more than one method is needed

3.4. In some cases, a hybrid method may be needed to properly address the blend of activities that are the subject of examination. In other cases, the application of more than one method may be needed to increase the accuracy of conclusions (e.g., by producing

overlapping ranges which enable comparable cases to be identified more closely).

B. Method selection

The most appropriate method

3.5. The ATO seeks to adopt the method that is the most appropriate or best suited to the circumstances of each particular case (TR 94/14, paragraphs 86, 343 and 344).

3.6. The choice of the most appropriate transfer pricing method or methods should be based on a practical weighing of the evidence having regard to:

(1) the nature of the activities being examined;

(2) the availability, coverage, and reliability of the data;

(3) the degree of comparability that exists between the controlled and uncontrolled dealings or between enterprises undertaking the dealings including all the circumstances in which the dealings took place; and

(4) the nature and extent of any assumptions.

3.7. The method must be capable of practical application and must produce an arm's length result that is a reasonable estimate of what would result if the dealings were undertaken on an arm's length basis.

3.8. Where an analysis of comparability has been undertaken using one of the traditional transaction methods and there is some uncertainty as to the reliability of the outcome, perhaps due to comparability factors and the quality of the data used, it would be appropriate to check the outcome by using some other basis.

3.9. One way this may be done is by comparing the result of the profits achieved by applying the selected method with the result achieved by a method that has regard to matters like expected rates of return, risk levels, profitability, hurdle rates or other statistical analyses that independent parties might be expected to use to evaluate potential transactions (1995 OECD Report, paragraph 1.15; see also **paragraphs 3.14 and 3.21**). However, it is acknowledged that this information might not always be available to taxpayers.

C. Traditional Methods

Comparable uncontrolled price (CUP) method

3.10. The CUP method compares 'the price for property or services transferred in a controlled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction in

comparable circumstances' (1995 OECD Report, paragraph 2.6; examples of the method appear in paragraphs 2.10 to 2.13; also TR 94/14, paragraphs 88 to 93 and 353 to 358).

3.11. Data to determine the CUP comparability factors may be examined in a functional analysis. This can produce four types of comparison of varying comparability and thus reliability. They are:

(1) the same property or services sold or acquired in the same circumstances (contract terms, volume, economic/market conditions). For example, the entity may be involved in arm's length dealings that can be directly compared to its dealings with associated enterprises for the same products or services. Such a comparison will generally be highly reliable provided that the matters covered by **paragraphs 2.10 to 2.17** are properly addressed;

(2) similar property or services in the same circumstances;

(3) the same property or services in similar circumstances;

(4) similar property or services in similar circumstances. This situation often results from a comparison of transactions undertaken between unrelated third parties.

The latter three may produce acceptable comparables provided adjustments are made for material differences (TR 94/14, paragraphs 89 to 93).

3.12. The CUP methodology could be used to arrive at an arm's length outcome for a wide range of dealings including a royalty rate for the use of intangible property, interest rate for funds supplied or acquired, or a fee for services acquired or provided, not just prices for the transfer of tangible goods.

3.13. However, there will be cases where the dealings between associated enterprises involve a variety of transactions (e.g., tangible and intangible property, management services, funding, etc.) and it is not possible to obtain CUPs for all the transactions. In those cases, the CUP method may be still suitable for some classes of dealings if it is supported by other methods that reliably evaluate those transactions where the terms and conditions are not able to be reliably determined by the CUP methodology.

3.14. While all comparability factors need to be taken into consideration, the most important are similarity of product, contract terms and economic/market conditions. For example, the prices of internationally traded mineral commodities often differ because of geographic differences in the markets, the terms of the contractual arrangements (such as volumes, discounts, interest free periods, and exchange rate exposure), the particular time period of the contracts, or differences in the physical/chemical features of the commodity and

the relative bargaining power and strategies of buyers and sellers. Business strategies like price competition and marketing intangibles like brand names can also impact on prices. If such differences are material, adjustment is needed; if such adjustments cannot be made, the reliability of the method is affected (**paragraphs 2.59 to 2.70**).

3.15. All OECD member countries recognise that the CUP method provides the most direct comparison, and encourage its use even if adjustments to the data are required to be made, provided that reliable adjustments can be made for material differences. In some cases, consideration may be given to applying a more flexible approach to enable the CUP method to be used and be supplemented as necessary by other appropriate methods. However, the reliability of the results needs to be considered and such an approach may not be acceptable if another method is more reliable in the circumstances (1995 OECD Report, paragraph 2.9).

3.16. Once an arm's length consideration has been determined, there is a need to monitor it over time to ensure that the CUP initially selected remains valid.

Difference between CUP and other traditional methods

3.17. The fundamental difference between the CUP method and other traditional methods is that the former compares the consideration for a comparable product or service in comparable circumstances, whereas the RP and CP methods (as described below) seek to establish the margin that the enterprise might be expected to achieve to reward it for functions undertaken, assets utilised and risks assumed.

3.18. In making comparisons for the purposes of the RP and CP methods, fewer adjustments are normally needed to account for product differences than under the CUP method, because minor product differences are less likely to have such a material effect on profit margins as they do on price. However, closer comparability of products produces a better result as significant differences in products or services are likely to be reflected in the functions performed (TR 94/14, paragraphs 94 to 96 and 360 to 362).

3.19. The application of the RP and CP methods is dependent on information about arm's length margins being available to either the taxpayer or the ATO. As there is no current requirement in Australia for companies to publicly disclose their gross margins, it may be difficult for taxpayers to obtain the information needed to apply either of these methods (see AASB 1034 but note that this may change should Draft Australian Accounting Standards ED80 be endorsed; IAS 2 paragraph 38).

Resale price (RP) method

3.20. The RP method is:

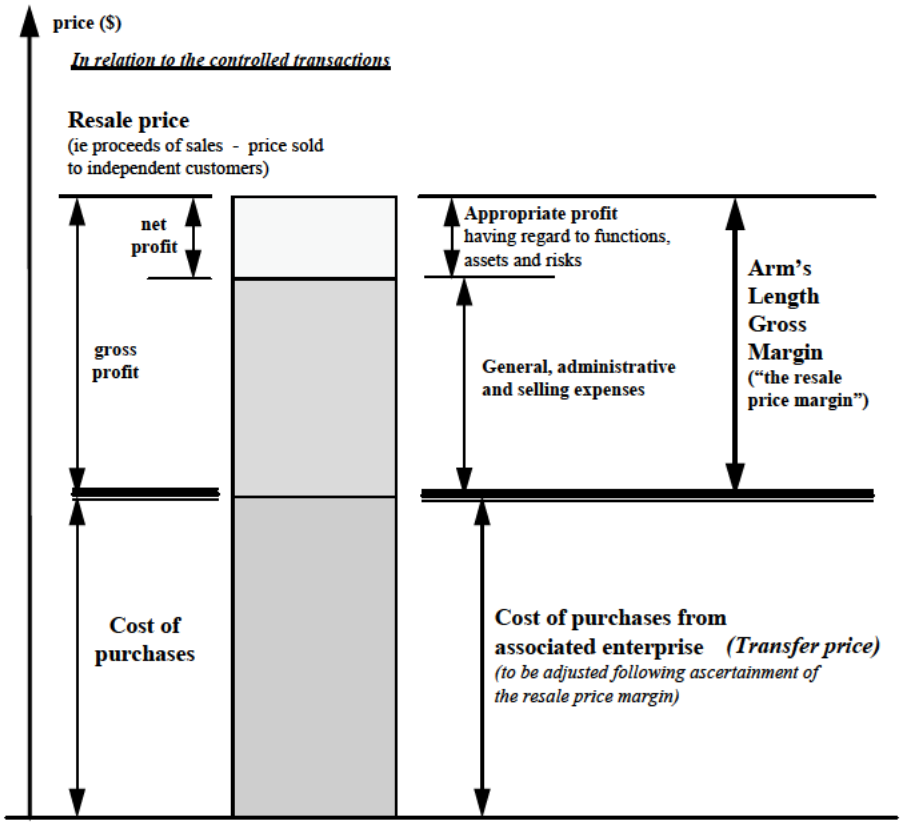
> 'A transfer pricing method based on the price at which a product that has been purchased from an associated enterprise is resold to an independent enterprise. The resale price is reduced by the resale price margin. What is left after subtracting the resale price margin can be regarded, after adjustment for other costs associated with the purchase of the product (e.g., customs duties), as an arm's length price of the original transfer of property between the associated enterprises' (1995 OECD Report Glossary).

3.21. The resale price margin is:

> 'A margin representing the amount out of which a reseller would seek to cover its selling and other operating expenses and, in the light of the functions performed (taking into account assets used and risks assumed), make an appropriate profit' (1995 OECD Report Glossary).

3.22. Examples of the method are found in the 1995 OECD Report at paragraphs 2.29 to 2.31 (also TR 94/14, paragraphs 94, 95 and 359 to 362). The RP method can be represented diagrammatically as follows.

Resale Price Method



Note: If, by way of associated enterprise dealings, amounts are included in selling, general and administration expenses, the arm's length value of these amounts needs to be determined prior to or in conjunction with the determination of the gross profit. If these dealings are extensive or complex, the resale price method may not be the most appropriate method.

3.23. The RP method requires the reseller to compare the functions (**paragraphs 2.28 to 2.31**) and the resulting gross margin obtained in its controlled dealings against either:

(1) the resale price margin that the same reseller earns on the same items purchased or sold in comparable uncontrolled dealings, e.g., the profit margin obtained by the taxpayer from a comparable purchase of goods (involving similar functions and risks) from an unrelated party which are resold to another unrelated party (also **paragraphs 2.10 to 2.17**); or

(2) the resale price margin earned by an independent enterprise in comparable uncontrolled dealings.

3.24. A methodology that adopts a margin calculated as a certain percentage of the resale price (for the purpose of determining the appropriate transfer price), is not a resale price methodology if the

percentage chosen is not benchmarked against comparable independent dealings.

3.25. The RP method is more reliable if the reseller on-sells within a short time. The more time that elapses, the greater the risks assumed in relation to changes in the market, in rates of exchange, in costs, etc., and this needs to be taken into account in any comparison (1995 OECD Report, paragraph 2.23).

Establishing the level at which the profit should be calculated

3.26. The appropriate margin is usually measured at the gross profit level. However, in some circumstances it may be more accurate to undertake the comparison at some other (intermediate) profit level, although such analysis would properly fall under a different method (e.g., transactional net margin method) where the analysis is at net profit level. The profit level at which to compare is determined by the availability of sufficient reliable data (also **paragraphs 2.67 to 2.70**). For example, financing expenses are often excluded from general, administrative and selling expenses on the basis that the funding of the business is not a material consideration in comparing products, outputs or functions, and that the financial expenses can in fact produce distortions.

3.27. Whenever the RP method is applied, it would be appropriate to check whether the resale price margin so determined is realistic having regard to the operating expenses of the taxpayer, measured against the benchmark of whether an independent party might reasonably be expected to have entered into the transactions. It would still be appropriate to consider whether the taxpayer is left with sufficient reward for its financial risks compared with what arm's length parties would expect in similar circumstances. For example, in some situations the financing expenses referred to in the example at **paragraph 3.26** may be so significant for the associated enterprise that to operate on a gross profit margin set without reference to these costs would not make commercial sense. This issue is relevant to all methodologies.

Calculating the RP margin

3.28. The appropriate RP margin would be expected to vary according to the amount of value added by the reseller. Many different situations can occur where the combination of functions, assets and risks add value to the product. This can be illustrated simply as follows:

(1) where the reseller performs minimal services as a forwarding agent or broker - here, the comparable profit

margin might be derived from an examination of commission or brokerage fees;

(2) where the reseller takes property in the goods, assumes the business risks, warehouses and distributes them to customers - here, the profit margin applicable to a principal would be relevant; or

(3) where the reseller not only carries out the functions and risks in (2) but also undertakes marketing, education and other activities, assumes warranty and other risks and employs intangible assets such as a developed distribution network - the additional functions undertaken, risks assumed and intangibles used should result in higher returns.

3.29. As a general rule, it is expected that the appropriate gross profit margin would increase with the increased assets, functions and risks. For example, if the taxpayer incurs a significant amount of marketing expenditure for the promotion of a trade mark that is owned by an associated enterprise and risks its own resources in these activities, the taxpayer would be entitled to a commensurately higher expected return than an agent.

3.30. Where the reseller has exclusive rights to resell the goods, the appropriate gross margin is influenced by such matters as:

(1) the size of the geographical market and the existence and relative competitiveness of possible substitute goods (i.e., do the goods sell themselves or is there a need to win or maintain market share?);

(2) the level of activity undertaken by the reseller (eg., the reseller may commit large resources to market the property or may realise a monopolistic turnover without much effort); and

(3) the risk associated with having the only source of supply and being tied to the other enterprise's product development cycles, etc..

Cost plus (CP) method

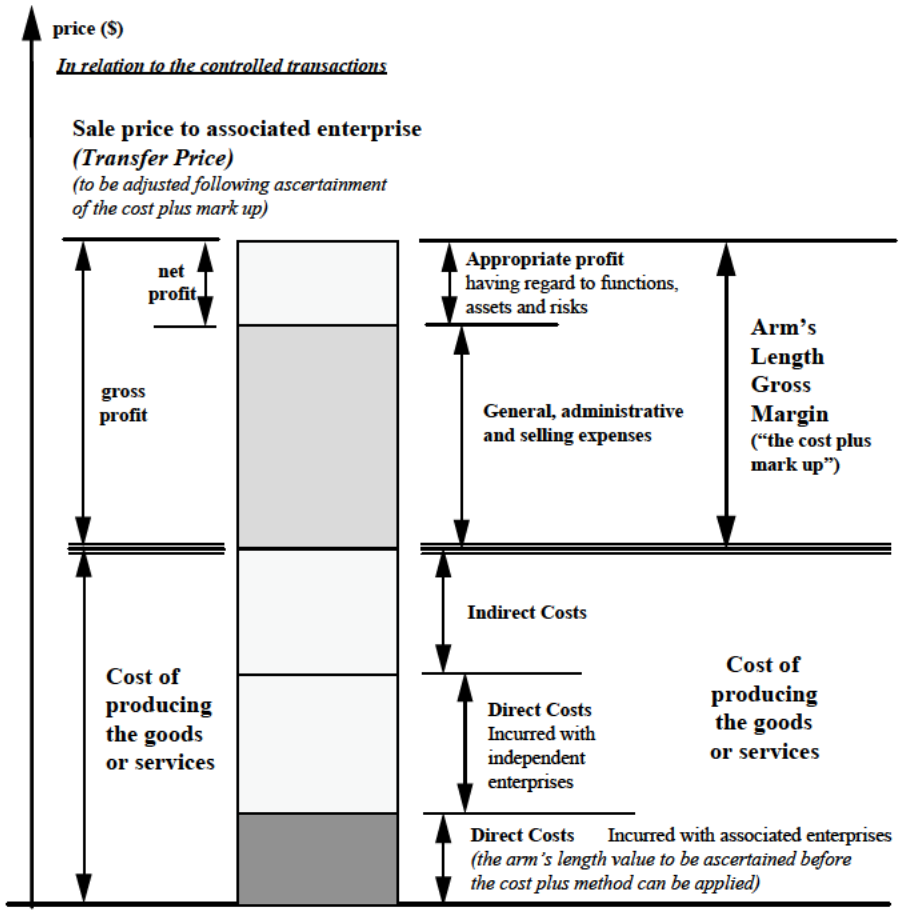
3.31. Paragraph 2.32 of the 1995 OECD Report states:

'The cost plus method begins with the costs incurred by the supplier of property (or services) in a controlled transaction for property transferred or services provided to a related purchaser. An appropriate cost plus mark up is then added to this cost, to make an appropriate profit in light of the functions performed and the market conditions. What is arrived at after adding the

cost plus mark up to the above costs may be regarded as an arm's length price of the original controlled transaction. This method probably is most useful if semi-finished goods are sold between related parties, related parties have concluded joint facility agreements or long-term buy-and-supply arrangements or if the controlled transaction is the provision of services.'

3.32. Examples of the method are found in the 1995 OECD Report at paragraphs 2.46 to 2.48 (also TR 94/14, paragraphs 97, 98 and 363 to 365). The CP method can be represented diagrammatically as follows.

Cost Plus Method



Note: If, by way of associated enterprise dealings, amounts are included in production costs or selling, general and administrative expenses, the arm's length value of those amounts needs to be determined prior to or in conjunction with the determination of the gross profit. If these dealings are extensive or complex the cost plus method may not be the most appropriate method.

3.33. While an enterprise must ultimately cover its costs to remain in business, there may at any given time be little relationship between cost and sale price (e.g., if competition forces the sale of goods that are approaching obsolescence at prices below cost or if a valuable discovery has been made with little research cost). It thus needs to be considered in each case whether CP is an appropriate methodology (1995 OECD Report, paragraph 2.36).

3.34. A methodology that applies a fixed percentage mark-up to a relevant cost base is not a cost plus methodology if that fixed percentage is not benchmarked against comparable independent dealings.

Which costs should be marked up

3.35. The costs, in general, that need to be established for the CP method are the direct and indirect costs of production of the relevant goods or services. The cost of trading stock for this purpose is calculated having regard to the principles that Australian income tax law generally applies (*Philip Morris Ltd v. FCT* 79 ATC 4352 and Taxation Ruling IT 2350 - note that direct cost referred to in paragraph 5 of that Ruling is no longer accepted for accounting purposes).

3.36. As historical costs for things such as materials, labour, depreciation, etc., may vary over a period, it may be appropriate to average these costs when determining the appropriate level of costs in the course of applying the CP method in relation to a limited period. Averaging may also be appropriate when determining costs across product groups or when applying the CP method in cases where dealings need to be grouped to properly assess comparability.

3.37. An example is where a taxpayer has to keep a smelter in production rather than incur significant expenditure in a shutdown, even though base metal prices have fallen significantly on world markets.

Indirect costs: acceptable basis for apportionment

3.38. Indirect costs should be allocated using sound cost accountancy principles (*BP Refinery (Kwinana) Ltd v. FCT* (1960) 8 AITR 113 at 117; 12 ATD 204 at 208). The allocation should fairly apportion the particular costs on the basis of the extent of the activity subject to the examination relative to the other purposes for which the costs were incurred.

3.39. The basis of allocation needs to make sense in the context of the particular case and should not produce significant distortions. Any

formula to allocate indirect costs must be consistently followed and there should not be any manipulation that produces an inappropriate loading of expenses. If different types of indirect costs are being allocated, it may be appropriate to use different allocation criteria.

Absorption costing

3.40. The aggregation of direct and indirect cost is also known as absorption costing. These calculations should generally be done on the basis of historical cost (1995 OECD Report, paragraph 2.42). As a general rule, the use of absorption costing is required if the cost plus method is used. The very limited exceptions occur if replacement cost and marginal cost result in a more accurate measure of the appropriate profit margin for which appropriate justification needs to be available (1995 OECD Report, paragraphs 2.42 and 2.44).

Marginal costing

3.41. Marginal costing is a method that applies only the variable production costs to the cost of a product. Marginal costing is often used by companies and MNEs groups for internal cost accounting purposes and for internal management control purposes.

3.42. However, its use for the purpose of setting transfer prices on international dealings between associated enterprises for tax purposes is acceptable only if pricing on the basis of marginal costs represents an arm's length outcome for the transfer of goods or services into the particular market (see the reference to marginal costing, 1995 OECD Report, paragraph 1.54).

3.43. As stated in **paragraph 3.40**, absorption costing is usually required when applying the cost plus method.

3.44. Representations have been made that marginal costing is an appropriate basis for setting transfer prices given that:

(1) Australian industry has a substantial degree of under-utilisation of plant facilities because of its relatively low population;

(2) overhead costs may not be fully absorbed against regular domestic sales; and

(3) a resulting surplus of overhead costs may impact on profits;

with the result that the impact of this cost surplus may be sought to be alleviated by a number of means, including competitively pricing goods into foreign markets by using a marginal cost plus basis for setting export prices.

3.45. The ATO accepts that on occasions pricing at marginal cost may occur if a taxpayer's manufacturing capacity is not being fully utilised. However, the mere existence of under-utilised capacity is not determinative in accepting marginal costing as an appropriate basis for setting transfer prices (1995 OECD Report, paragraph 2.44).

3.46. The overriding factor in determining whether a marginal costing pricing strategy represents an arm's length price is whether independent enterprises could be expected to set their transfer prices in a comparable manner. For example, regard could be had to any sales of the same or similar products in the foreign market by other taxpayers and their relevant price and volume.

3.47. It might reasonably be expected that, in an arm's length relationship, a marginal costing strategy would not be applied other than in relation to short term arrangements, and that the 'marginal production' is unlikely to represent a significant proportion of the taxpayer's overall production. An enterprise pricing at marginal cost and actually building new production facilities to manufacture the product (that is, incurring additional fixed costs not covered by the resultant sales) would not be accepted as pricing at arm's length.

Calculating the appropriate mark-up

3.48. The cost plus mark-up of the taxpayer in the dealings between associated enterprises should ideally be established by reference to the cost plus mark-up that the taxpayer earns in comparable uncontrolled dealings. If the taxpayer has no comparable uncontrolled dealings, the cost plus mark-up may be able to be determined on the basis of comparable dealings by independent enterprises that are operating wholly independently.

3.49. The appropriate mark-up should be measured at the gross profit level. However, in some circumstances, it may be more accurate to consider some intermediate profit level in order to make comparisons on a consistent basis (e.g., to adjust for accounting differences between the taxpayer and the company being considered as a comparable).

3.50. Distortions caused by different approaches to business financing between the taxpayer and a company being considered as a comparable would need to be removed (1995 OECD Report, paragraph 2.37).

3.51. As is suggested at **paragraph 3.27** in connection with the RP method, where the CP method is used it would be appropriate to check whether the outcome makes commercial sense in the circumstances of the case.

D. Profit methods

The need for profit methods

3.52. Global industries are based on highly sophisticated technology, involve valuable production, distribution or marketing intangibles and are generally vertically and horizontally integrated. The global networks in such industries are complex; they have their own unique structures and products that may have been supplied by a number of associated enterprises. In situations like this, it might not be possible or practicable to use traditional methods because:

(1) there is insufficient reliable data to analyse comparability so as to determine an arm's length outcome other than through a profit split or a profit comparison at the net profit level. For example, if selling, general and administrative costs that are treated as part of costs of goods sold for an independent enterprise cannot be identified so as to adjust the gross margin in a reliable application of cost plus, it may be necessary to examine net margins in the absence of more reliable comparisons;

(2) the product or service in question is unique or contains out-of-the-ordinary intangibles;

(3) while theoretically sound, the traditional methods may not be practicable because of the complexity of the business situation or the extent and diversity of the taxpayer's cross-border dealings with associated enterprises;

(4) in many cases, there is a variety of transactions (transfers of tangible and intangible goods and services) back and forth between the associated enterprises, some of which may involve overlaps, and there may be no comparables for the combination of transactions. In these cases, profit methods may be a more reliable way to set or review the transfer pricing used in the dealings between the associated enterprises, or to check findings made using traditional methods if there is doubt about the reliability of the data used or the outcome produced; or

(5) the net margins may be more tolerant to some functional differences between the controlled and uncontrolled transactions than gross profit margins. Differences in the functions performed between enterprises are often reflected in variations in operating expenses. Consequently, enterprises may have a wide range of gross profit margins but still earn broadly similar levels of net profits.

3.53. In these types of situations, it may be more appropriate to consider the use of profit methods (also TR 94/14, paragraph 99).

Descriptions of the types of profit methods

3.54. The type of profit method used depends on the facts and circumstances of each case. These profit methods include:

(1) the profit split method; and

(2) the transactional net margin method.

3.55. One of the main differences between the profit split and the transactional net margin methods is that the former is applied to all the relevant associated enterprises, whereas the latter is applied to only one of the associated enterprises. Such a one-sided analysis potentially can attribute to one member of an MNEs group a level of profit that implicitly leaves other members of the group with implausibly low or high profit levels. However, this is also a risk with the RP and CP methods, which are also one-sided analyses. Care needs to be taken to ensure that, so far as practicable, the result produced by the one-sided application of any method makes commercial sense in the circumstances of the case. Nevertheless, both one-sided and two-sided analyses are acceptable under Australia's transfer pricing rules.

3.56. A possible difficulty in attempting to undertake a profit split is obtaining the required information from foreign enterprises or tax administrations so that the combined profit can be determined.

3.57. When applying profit methods, as with other approaches, there can be a need in some situations for an aggregation of dealings in order to obtain a reliable answer. While it is possible to apply a profit method in respect of a single transaction, these methods are generally applied in respect of a group of transactions or on an aggregated basis.

3.58. It would generally be inappropriate, however, to apply a profit method on a 'whole of entity' basis unless a substantial part of the taxpayer's activities involved associates and, if a transactional net margin method is being used, the different types of controlled dealings can be compared on a consistent basis with a similar group of uncontrolled dealings by an independent enterprise operating wholly independently. A 'whole of entity basis' is a basis of analysis whereby the business operations of an entity are examined in their entirety rather than segmenting them into transactions or product, service or business lines.

Profit split methods

3.59. Profit split methods are transfer pricing methods that identify the combined profit to be split for the associated enterprises from a controlled transaction or controlled transactions, and then split those profits between the associated enterprises according to an economically valid basis that approximates the division of profits that would have been anticipated and reflected in an agreement made at arm's length between independent parties (1995 OECD Report Glossary).

3.60. The profit may be the total profit from the transactions or a residual profit intended to represent the profit that cannot readily be assigned to one of the parties, such as the profit arising from high value, sometimes unique, intangibles (1995 OECD Report, at paragraph 3.5).

3.61. The following factors need to be taken into account in undertaking a profit split:

(1) *Relevant dealings*

(a) There is a need to determine if the profit split is to be undertaken on a particular product line, an aggregation of products or a whole of entity basis;

(b) If the taxpayer has dealings with more than one associated enterprise, it is necessary to identify the parties in relation to those dealings and the profits of each so as to determine the profits to be split among them. For example, if an assembler was supplied parts by two related manufacturers from different tax jurisdictions any profit split would need to identify the contribution in each jurisdiction;

(2) *Consolidation of accounts*

So that the combined profit can be determined, the accounts of the parties need to be put on a common basis as to accounting practice and currency and then consolidated. Once the split has been determined the accounts can then be rewritten on a separate entity basis, taking account of the relevant requirements in the taxpayer's home jurisdiction.

Splitting profits using projected profits v actual profits

3.62. A basis for determining whether to apply the profit split to the projected or actual profits is as follows:

(1) *Projected profits*

If a taxpayer uses a profit split to establish (as opposed to 'review') transfer pricing for controlled transactions, this would necessarily be done on the basis of the projected profits because the actual profits would not be known at the time. This would produce a fractional allocation, which would then be applied as the actual profit was derived. However, if there are variances between projected and actual profits, arm's length parties might be expected to make appropriate adjustments when reviewing their profit split projections for future years (1995 OECD Report, paragraphs 3.11, 3.12 and 3.25).

(2) *Actual profits*

If prices have been set using a basis other than a profit split (as almost always is the case), any profit split evaluation should be undertaken on the actual profits achieved by the application of the other basis using the same information that was available at the time of the price setting, thus avoiding the use of hindsight (1995 OECD Report, paragraph 3.14). This does not, however, preclude taking into account unforeseen changes in circumstances if arm's length parties are reasonably expected to renegotiate (see **subparagraph 3.62(1)**).

Dividing the profits using a contribution analysis

3.63. A contribution analysis is:

'An analysis used in the profit split method under which the combined profits from controlled transactions are divided between the associated enterprises based upon the relative value of the functions performed (taking into account assets used and risks assumed) by each of the associated enterprises participating in those transactions, supplemented as much as possible by external market data that indicate how independent enterprises would have divided profits in similar circumstances' (1995 OECD Report Glossary).

3.64. In cases where the relative value of the contributions can be measured directly, it may not be necessary to estimate the actual market value of each participant's contributions (1995 OECD Report, paragraph 3.16). More often, however:

'It can be difficult to determine the relative value of the contribution that each of the related participants makes to the controlled transactions, and the approach will often depend on the facts and circumstances of each case. The determination might be made by comparing the nature and degree of each

> party's contribution of differing types (eg., provision of services, development expenses incurred, capital invested) and assigning a percentage based upon the relative comparison and external market data' (1995 OECD Report, paragraph 3.18).

Dividing the profits using a residual analysis

3.65. A residual analysis is:

> 'An analysis used in the profit split method which divides the combined profit from the controlled transactions under examination in two stages. In the first stage, each participant is allocated sufficient profit to provide it with a basic return appropriate for the type of transactions in which it is engaged. Ordinarily, this basic return would be determined by reference to the market returns achieved for similar types of transactions by independent entities. Thus, the basic return would generally not account for the return that would be generated by any unique and valuable assets possessed by the participants. In the second stage, any residual profit (or loss) remaining after the first stage division would be allocated among the parties based on an analysis of the facts and circumstances that might indicate how this residual would have been divided between independent enterprises' (1995 OECD Report Glossary).

3.66. A market return in the calculation of the basic return would have regard to the circumstances of the enterprise and the economic choices available to management. In some cases, it may be appropriate to calculate the basic return using the transactional net margin method. Indicators of the parties' contributions of intangible property and relative bargaining positions can be particularly useful in the second stage. At each stage, regard needs to be had to the relevant functions performed, assets contributed and risks assumed by each party. It is important, where a particular function, asset or risk is relevant to both stages, to apportion the relevant contribution between the two stages to avoid double counting.

3.67. If the total combined profit is more than the basic return, this is an indication that there are intangible assets or other factors like financial transactions, management strategies and efficiencies contributing to the combined profit. Conversely, if the combined profit is less than the basic return, this would indicate that these factors may be the source of the loss.

3.68. There is no one way of determining the basic return or a division of the residual profits. The following may serve as a guide in undertaking a residual profit split:

(1) one approach to a residual analysis would seek to replicate the outcome of bargaining between independent enterprises in an open market (1995 OECD Report, paragraph 3.21);

(2) in some cases, an analysis can be performed, perhaps as part of a residual profit split or as a method of splitting profits in its own right, by taking into account the discounted cash flow to the parties to the controlled transactions over the anticipated life of the business (1995 OECD Report, paragraph 3.22);

(3) if there is a close relationship between cost and the value generated, the development expenditures incurred to create the factors that gave rise to the residual may also provide an indication of the relative contributions of the enterprises, and may in some cases be an appropriate basis for allocating the residual;

(4) a systematic assessment of the relative values created by the factors that are not otherwise rewarded, e.g., in some cases, the residual profit may be attributable to either an intangible shared between the enterprises or there may be several intangibles contributed by separate enterprises. These cases may require a systematic assessment of the relative contributions of each enterprise to the factors that give rise to the residual profit and have not been rewarded in the basic return.

Other approaches to dividing the profits

3.69. One approach that should be used with caution is to split the combined profit so that each of the associated enterprises participating in the controlled transactions earns the same rate of return on the capital it employs in that transaction (1995 OECD Report, paragraph 3.24). This method creates particular difficulties if one or more parties is contributing high value services.

3.70. A more remote possibility is to determine the profit split based on the division of profits that actually results from comparable transactions among independent enterprises (1995 OECD Report, paragraph 3.25).

3.71. The ATO would not rule out any profit split approach that results in an answer that approximates an arm's length outcome. For example, it may be necessary to develop a methodology that is flexible enough to recognise the differing contributions by parties over economic and product life cycles (**paragraph E1 in the Appendix**). It may also be possible to use a formula to split profits. If possible,

the weightings used in the formula should be based on some form of external market data. The outcome sought should be directed to reflecting what independent enterprises would have done if they were confronted with the similar allocation problem in comparable circumstances. Differences in functions, assets and risks in different cases should be reflected in the allocation of profit.

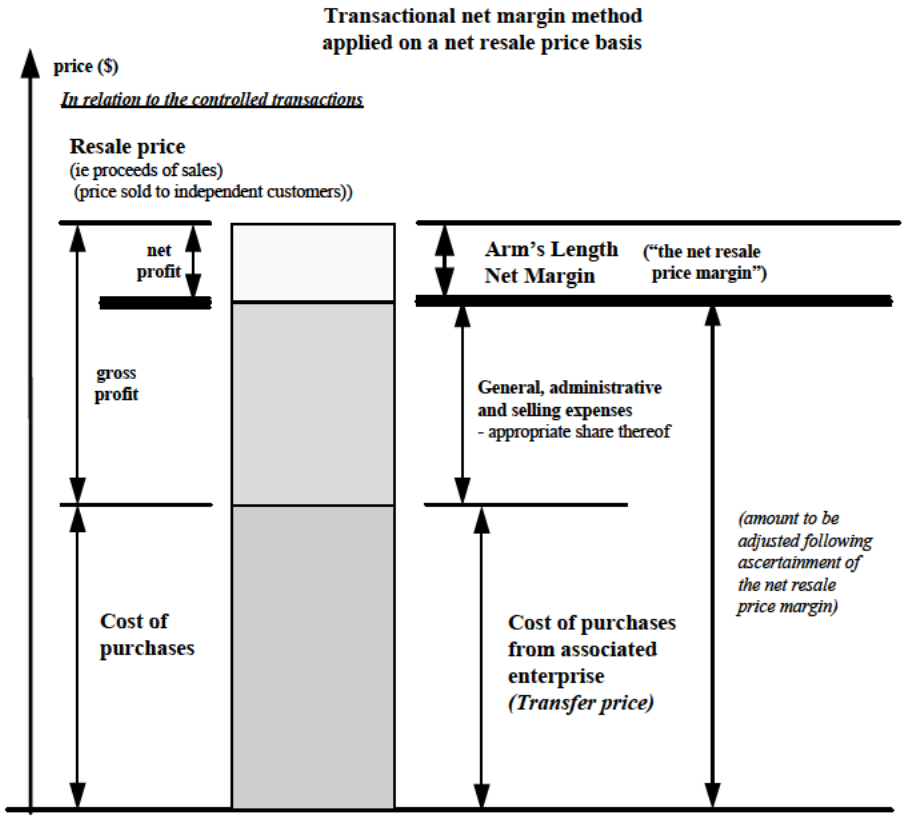
3.72. Practical examples for profit split, contribution analysis, residual analysis and flexible profit split methods are shown in the **Appendix** (**paragraphs B1 to E18**).

The transactional net margin method ('TNMM')

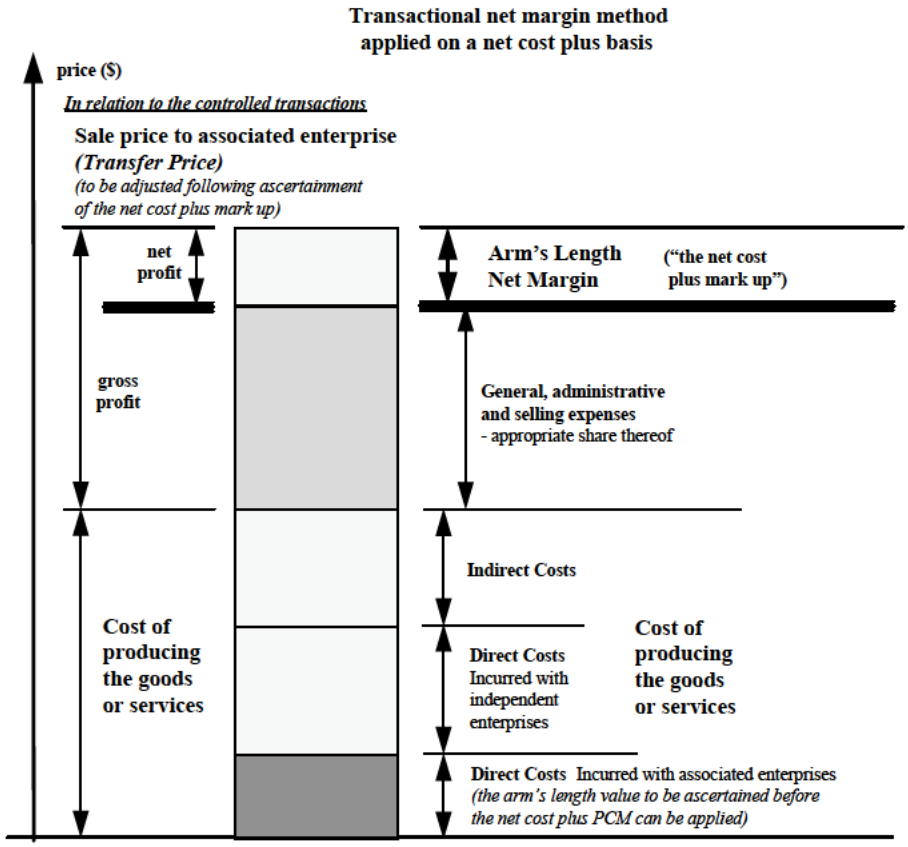
3.73. TNMM is a transfer pricing methodology based on comparisons at the net profit level between the taxpayer and independent parties dealing wholly independently in relation to a comparable transaction or dealings. Comparisons at the net profit level can be made on a single transaction or in relation to some aggregation of dealings between associated enterprises. The concept of TNMM is identical to that of 'transactional net margin method' used by the OECD (1995 OECD Report, Glossary, paragraph 3.26).

3.74. A profit comparison usually begins with an examination of the net margin relative to an appropriate base (e.g., costs, sales, assets). Sometimes it may be necessary to make the appropriate comparison above the net profit line prior to interest or royalty payments, for example. In many respects, TNMM is an extension of the RP and CP methods.

3.75. To illustrate the basic concepts of TNMMs, two diagrams (one applied on the net resale price basis and the other on the net cost plus basis), with supporting notes, are set out below.



Note: This method is used if there is insufficient reliable data, or the complexities of real life business put practical difficulties in the way of the application of traditional transaction methods.



Note: This method is used if there is insufficient reliable data or the complexities of real-life business puts practical difficulties in the way of the application of traditional transaction methods.

3.76. When applying TNMM, care is needed to have regard to the previously discussed requirements for the application of the RP and CP methods and the principles regarding comparability.

3.77. Data to apply TNMM and to determine the appropriate net margin is obtained from the comparability analysis of the taxpayer and the comparable enterprises. This method requires the comparison of the net margins obtained in its controlled dealings against either:

(1) the net margins of the taxpayer's uncontrolled dealings in comparable circumstances; or

(2) the net margins earned in comparable, uncontrolled dealings by an independent enterprise.

3.78. It is important to ensure that the profit comparison is confined to the net profit from cross-border dealings with associated enterprises. The OECD has termed TNMM the 'transactional net margin method' to emphasise the need to confine the analysis to the relevant dealings between the associated enterprises. However, this terminology by the OECD does not preclude the application of the TNMM on the basis of an aggregation of transactions if appropriate, though the reliability of

such an approach relative to the application of the CUP, RP and CP methods on a similar basis would need to be evaluated and the most reliable method used (1995 OECD Report, paragraph 3.50).

3.79. There are a number of measurements in the form of profitability ratios that could assist in applying the TNMM, some of which are discussed below. The relative usefulness of the various ratios depends on the facts of the case and the extent of reliable data being available for the taxpayer and any comparables. MNEs may adopt different policies to local comparable entities regarding such matters as shareholders' funds, dividend payments, asset purchase versus leasing, etc., that can restrict the use of some of the more acceptable ratio analysis.

3.80. In selecting appropriate ratios, care is needed that the selected ratios provide a reliable measurement of the taxpayer's profitability. The use of ratios may need to be tailored for the type of industry being analysed. For example, the rate of return on shareholders' funds is of greater importance if the taxpayer is operating in a capital intensive industry. It would often be appropriate to have regard to more than one ratio in any measurement of profitability. Ratios based on returns on assets could present problems when used in isolation, particularly if the enterprise under review provides or contributes high value services to an associated party.

3.81. When applying TNMM, the emphasis is on comparing profits of the taxpayer to comparables at or towards the net rather than the gross level. Accordingly, any ratio analysis should be directed at net profit or, depending on the facts and circumstances of the case, at some similar point. The following profit measurements may prove to be useful when undertaking a TNMM:

(1) ratio of net profit before tax (NPBT) to sales. This ratio is sometimes referred to as the net profit margin. It provides a bottom line analysis, and also includes management efficiencies that may need to be taken into account. If possible, the net profit should be the net operating profit to exclude non-operating income and expenses;

(2) ratio of net profit (before interest and tax) to sales. Such net profit is also referred to as earnings before interest and tax (EBIT). By using EBIT, operating profits can be compared without the direct effect of whether the business is funded by debt or equity, though the increased risk resulting from significant debt funding would have to be taken into account;

(3) ratio of gross profit to operating expenses. This ratio is sometimes referred to as the Berry Ratio and provides a quick test as to the profitability of the business as a ratio

of '1:1' is the break-even point. However, because Australian companies are not currently required to disclose operating expenses or gross margins (**paragraph 3.19**), it is not always possible for taxpayers to calculate this ratio for external comparables;

(4) ratio of NPBT to shareholders' funds. This indicates the return to shareholders on subscribed capital and retained earnings;

(5) ratio of EBIT to assets. This indicates the return on assets of the enterprise;

(6) ratio of NPBT or sales to number of employees. This provides some indication as to the efficiency of the business. On a comparison basis it may also indicate that functions are being performed by the controlled local entity for the benefit of an associated entity for which the local entity is receiving no or inadequate reward.

3.82. It is essential to be aware of the possible distorting effects of methods of business financing, business strategies and the relative efficiency of managers when doing NPBT to sales, EBIT and Berry ratios. For example, the EBIT ratio may not fully account for the increased risk in a highly geared enterprise for which an independent party would seek a higher earnings ratio. The application of these various ratios in appropriate cases might also indicate prima facie transfer pricing risks. However, further detailed analysis is needed to identify particular transfer pricing problems.

Application of TNMM

3.83. The application of the TNMM requires a careful analysis of the taxpayer's operating expenses. These expenses reflect the taxpayer's functions, assets and risks and provide an insight into the possible distorting effects of methods of business financing and management approaches in relation to the net profit.

3.84. Of course, care is also needed to ensure that expenses above the gross profit line, market and business factors are also properly considered (1995 OECD Report, paragraphs 3.35 and 3.36).

3.85. TNMM may assist in valuing the profit attributable to an intangible. If a profit comparison can be established with enterprises that do not possess valuable intangibles, it may be possible (in the absence of other factors) to infer how much of the return to the enterprise being examined is attributable to an intangible.

3.86. This may be useful in some situations involving the licensing of intellectual property. The method may also be useful as a check on

the accuracy of the results, if CUPs are used to establish the market consideration for the use of an intangible.

3.87. Care is needed if, for example, one of the associated enterprises owns a manufacturing intangible and the other has developed a marketing intangible. In this situation, the return to the intangibles would need to be allocated between the different intangible assets that are used. A profit split should also be considered in these cases. For examples of TNMM, see the 1995 OECD Report at paragraphs 3.46 to 3.48.

E. There is a need to find an answer for all transfer pricing problems

3.88. There will be cases where there may not be comparable dealings or sufficient data to apply traditional or profit methods. This may come about because of unique dealings, or the fact that the industry is so controlled and structured that there are either no comparable arm's length dealings or, for whatever reason, the data is not available to the ATO.

3.89. In such cases, some reasonable basis has to be used by the ATO in examining the dealings between associated enterprises to ensure that a sufficiently reliable approximation of an arm's length outcome is produced. Listed below are some further possible approaches.

Extension of the traditional and profit methods

3.90. If it is necessary to find an answer in such circumstances, the use of traditional methods (CUP, RP and CP) or the profit methods should be reconsidered on the basis of possibly broadening the comparability criteria to allow a comparison of the relevant dealings.

3.91. If this is the case, the appropriate arm's length comparison may be with enterprises in another industry segment or group of segments. However, to achieve an acceptable level of reliability, great care is needed to ensure that the industry segments or groups of segments being compared are sufficiently similar, especially in relation to functions performed and levels of profitability (1995 OECD Report, paragraph 3.34). If the comparability criteria have to be broadened, there is a need to consider the reliability of the result relative to those that would be obtained by applying other approaches.

3.92. If the extended application of the traditional and profit methods cannot provide an answer, it may be necessary to consider:

(1) a mixture of the above methods; or

(2) some other method or mixture of methods;

that is likely to lead to a result that is as consistent as practicable with the arm's length principle (TR 94/14, paragraph 100).

3.93. Taxpayers in such cases should give serious consideration to seeking an advanced pricing arrangement (APA) - see Taxation Ruling TR 95/23.

Internal rates of return may provide a suitable benchmark

3.94. Some enterprises establish criteria to evaluate the non-portfolio investment (where the taxpayer holds at least 10 % of the voting interest in a company), opportunities or strategic initiatives available to them. These criteria are then used, in particular, to evaluate the performance of the various business units; to assess future expansion opportunities (those that arise from internal search, and those that arise externally), and to consider the sale of units that are under performing or which no longer fit the purposes of the enterprise.

3.95. The criteria may include (but are not limited to) the following:

(1) payback period;

(2) rates of return on invested capital, equity, sales, etc.;

(3) net present value of a specified cash flow;

(4) strategic net present value - an option based approach;

(5) internal rate of return;

(6) shareholder value analysis; and

(7) economic value added.

3.96. If a discount rate is required, this may be the risk free rate, a weighted average cost of capital, or a risk adjusted rate, depending upon the purpose of the analysis. In each case, either industry practice or intra-company hurdle levels of performance may influence management attitudes to a proposed investment.

3.97. If external comparisons are not available, or if it is important to consider the internal viability of a specific deal, transaction, or profit flow, an evaluation of the choice represented by the offer (implied or actual) to the controlled enterprise involved in the transaction, deal or profit flow, using one or more of the criteria noted above, may assist in identifying the likely response of an arm's length participant.

3.98. The 1979 OECD Report '*Transfer Pricing and Multinational Enterprises*' which formed the starting point for the 1995 OECD Report discusses such other approaches (1979 OECD Report, paragraphs 70 to 74). While the use of such methods is significantly qualified in the 1979 OECD Report and the 1995 OECD Report does not canvass these other approaches, Australia's transfer pricing rules

do permit recourse to them in extremely difficult cases (**paragraph 1.23**).

3.99. One method that is an extension of the 1995 OECD Report is the use of statistical techniques to deal with the low reliability of data that can occur in transfer pricing cases. These techniques include the exclusion of outlying results, which may provide a solution in very extreme cases where more reliable data is unavailable. An example of these techniques is the use of the inter-quartile range in the United States.

F. Non-arm's length methodologies

Global formulary apportionment

3.100. Global formulary apportionment is a method that has sometimes been suggested as an alternative to the arm's length principle as a means of determining the proper allocation of profits across competing national tax jurisdictions. The method allocates the global profits of a multinational group calculated on a consolidated basis among the associated enterprises in different countries according to a predetermined formula (1995 OECD Report Glossary).

3.101. The OECD member countries, including Australia, do not consider global formulary apportionment to be an acceptable alternative to the arm's length principle for a number of reasons.

3.102. A principal reason is that global formulary apportionment can depart from the territorial connection that underpins the concept of source, and may also raise issues about the timing of derivation.

3.103. Equally important is the concern that predetermined formulas that are mechanically applied do not have regard to the facts, circumstances and merits of the particular case with the result that in many cases there is either over-taxation or under-taxation.

3.104. They also depend on a very high degree of international co-operation and co-ordination. The capacity for multinational groups to manipulate the formula and the inability of most formulas to capture the particular circumstances of individual enterprises, their risks, geographical differences and differences in company efficiencies are serious drawbacks with this method. Also, currency exchange rate movements and inconsistent accounting standards between countries could lead to inappropriate profit allocations.

3.105. Dispute over the acceptability and use of particular formulas that have different bases may mean that the expected benefits of no double taxation and lower compliance costs may not be realised.

3.106. In some cases, a formula developed by both tax authorities in co-operation with a specific enterprise after careful analysis of the

particular facts and circumstances, such as might be used in an APA, would be appropriate to determine a fair allocation of revenue to the countries involved. However, these formulas are not instances of global formulary apportionment because they have regard to the particular facts.

APPENDIX

A. Comparability examples

A1. AUSCO is the Australian subsidiary of a large overseas company FORCO and has licensed a well-known brand from FORCO for use on products sold in Australia. In considering the reliability of comparable licensing agreements, differences are found between the AUSCO agreement and the proposed comparables. These differences vary from comparable to comparable but include such attributes as: the market chosen (e.g., Japan compared with Australia); whether or not technical assistance is included and whether it is of importance; the duration of the license agreement; the product ranges included; and prior experience with and commitment to the brand. For some attributes, such as the inclusion of technical assistance, data is available to make an appropriate adjustment from comparisons of agreements with and without such assistance. For other attributes, such as the duration of the agreement, a valuation approach may suggest the adjustment needed. For yet other attributes, such as the market, it is difficult to obtain a quantitative base for an adjustment and judgment instead is needed. Depending on the attributes believed to make a material difference, the reliability of the comparables proposed could range from low to high.

A2. AUSCO is the Australian subsidiary of a large overseas company FORCO and distributes FORCO products in Australia through independent retailers to the household market, and directly, using AUSCO sales staff, to government and industry. Since in Australia gross margin data is not publicly available, AUSCO proposes a transactional net margin approach (**paragraphs 3.83 to 3.87**) using net margin data from several listed distribution companies. In considering the reliability of the proposed comparables, differences are found between the operations of AUSCO and those of the comparables. These differences vary from comparable to comparable but include assembly (AUSCO does assemble some of its products from components supplied by FORCO), the product range offered and the markets chosen, distribution channels used, stage of market development (AUSCO, unlike others, is not in a period of intensive investment in market development). Some of these attributes (e.g., assembly) may not be material; others, such as stage in market development, play a major role in influencing net margins, and some

adjustment is called for. This leads to a consideration of the link between the market development stage and level of investment and the resulting net margins. An industry-based study may provide evidence as to the nature of this link. Using this study, an adjustment is made that is assessed to be of moderate reliability. In this instance, the reliability of the proposed comparables might range from low to high.

B. Profit split example

B1. A and B are associated enterprises in two different jurisdictions, one in Australia and the other in a foreign jurisdiction. A manufactures goods and sells them to B, which re-sells (wholesales) them to independent enterprises. The combined profit from the dealings is $30 (being $10 manufacturer and $20 reseller).

PROFIT SPLIT METHOD

(A) Manufacturer		(B) Reseller	
Sales to Reseller	100	Sales to Customers	160
Less:		Less	
Direct materials		Purchases from the	
Labour and oncost	50	manufacturer (A)	100
Indirect costs	10	Indirect costs	10
Gross Profit	40	Gross Profit	50
		Selling and other costs	20
Administration		Administration and other	
and other costs	30	costs	10
Net Profit	10	Net Profit	20

B2. The split as originally disclosed is, therefore, 20/10 in favour to the reseller. However, if the product is 'yesterday's technology' and an arm's length party would have usually discontinued stocking the item, then the reseller's 2/3 share may not be sufficient. If the stock is unsaleable but the taxpayer has been required by its parent to buy the stock, the purchase price should be reduced to nil. If the stock can be sold at a much reduced price but only with considerable effort, the purchase price should be reduced to a level that would allow a reasonable return for the marketing and distribution effort and holding costs. Conversely, if the goods require a relatively small amount of marketing because of a high value intangible embedded in the product

that causes buyers to seek them out and demand exceeds supply, the manufacturer's 1/3 share may not be sufficient reward for its value added.

C. Contribution analysis example

C1. Using the data from the above example, the following illustrates the application of a profit split using a contribution analysis. The $30 combined profit on a contribution analysis would be split between A and B based on their contributions to the assets employed, functions undertaken and the risks assumed to achieve that combined profit. The value of their contributions would be determined, if possible, by external market data, i.e., from comparable uncontrolled enterprises performing comparable functions and operating wholly independently.

D. Residual analysis example

D1. FORCO manufactures goods that it sells to its associated enterprise, AUSCO, which re-sells the goods to independent parties. The total combined profit from the operations is $1,000, AUSCO is rewarded $150 for the marketing, distribution and other functions undertaken (based upon an analysis of typical returns for that type of business activity) while FORCO is rewarded $250 (based upon an analysis of returns for similar manufacturing functions).

D2. The remaining profit of $600 is then allocated on the basis of the contribution of each of the enterprises to the value of the intangible, say 10% (being $60) to AUSCO and, say, 90% (being $540) to FORCO.

Profits

	AUSCO		FORCO		Total Profits
Basic tangible assets, functions, risks	150		250		400
Intangibles	60	(10%)	540	(90%)	600
Total	210		790		1000

D3. While there is usually agreement on the use of this methodology when allocating profits, enterprises often fail to use the same logic if an overall loss has been incurred (subject to the considerations outlined in **paragraphs 2.99 to 2.111**).

D4. In the following example, where the total loss from operations is $500, AUSCO is still rewarded $150 for the marketing, distribution and other functions undertaken while FORCO is still rewarded $250 for the manufacturing function undertaken. The residual loss of $900 is then allocated on the basis of the contribution of each of the enterprises to the value of the intangible, say, 10% being $90 to AUSCO and, say, 90% being $810 to FORCO.

Losses

	AUSCO		FORCO		Total Loss
Basic tangible assets, functions, risks	150		250		400
Intangibles	-90	(10%)	-810	(90%)	-900
Total	60		-560		-500

D5. While this example is based on fixed contributions, market reality is such that a distributor's margin may change because of a range of factors including low levels of sales, promotion costs and discounts arising from competition (see flexible profit split below). The possibility, therefore, exists for lower than normal rates of return during lean years provided there are commensurately higher returns during good years.

E. Flexible profit split methodology

E1. The following example illustrates the theory behind the operation of a flexible profit split method. The reality of modern business is that companies, particularly in high technology industries, are affected by changing markets and this results in changing contributions of parties to the combined profit. As a consequence, patterns of profitability often vary from year to year. Arm's length parties, faced with the prospect of changing contributions of functions, assets and risks in their dealings, might be expected to seek to renegotiate the terms of any agreement to reflect those changes. Likewise, profit splits for related party dealings might be expected to change to reflect the differing contributions by the parties.

E2. An international agreement between related parties, which attempts to obtain an arm's length result through the use of a profit split, might be expected to require a regular review of the profit split to take into account changing market conditions (and changing

contributions of functions, assets and risks). However, it may be possible to construct a profit split mechanism, which is based on specific assumptions and parameters, to reflect changes in markets and patterns of profitability so that it automatically adjusts the profit split between the parties to reflect an arm's length result.

E3. This concept is best explained by an example and the following examines a flexible profit split based on a contribution analysis. However, it is equally possible to apply the concept to a residual profit split.

E4. The example considers the situation of a non-resident manufacturer of high technology equipment and its wholly owned Australian subsidiary, which imports and distributes its products. The example is viewed from the aspect of the Australian company, and looks to allocate that portion of the total combined profit that represents an arm's length return for the Australian operations. Combined profit for the multinational enterprise in this example is considered to be the profit arising from the commencement of the manufacturing process by the foreign manufacturer until the finished product is sold to an arm's length party by the Australian distributor.

E5. Profits within supply/distribution channels are not constant over time. The roles of supplier and distributor change, reflecting the current stage in evolution of the industry, the market strategies adopted and the impact of new technology. It is therefore necessary to establish indicators of the market environment that reflect the evolutionary stage of the market and the impact of innovative technology. These factors are instrumental in determining the relative contributions of the participants.

E6. Two factors capture the dynamics and uncertainty in contribution:

(1) the market growth rate, which is a direct reflection of the stage of industry evolution; and

(2) the combined gross margin, which is a concept related to trade margin, but in this instance is defined as the difference between production cost and distributor sale price. As competition intensifies, it can be expected that the combined gross margin will come under increasing pressure. Technological innovation that moves the enterprise to a new growth phase should widen combined margins and lift sales growth.

E7. These two variables then serve as indicators, reflecting the stage of industry evolution and intensity of competition. Both factors are important in determining the relative power and thus contribution of the distributor and the manufacturer in a distribution channel.

E8. A profit split model is contained in **Table 1** (at page 71). It identifies four scenarios that set out a pattern of high technology industry evolution. The next step is to determine the profit split for each scenario, and this depends on the functions undertaken, assets used and risks assumed by each party.

E9. A low profit split to the distributor would arise when risk and/or expertise and innovation are of little or no importance to the distributor, and the distributor had no significant interest in any intangible asset arising from the long term (but unrewarded) market development or other expenditure. This situation is reflected in Phase B of the profit split matrix.

E10. A high profit split to the distributor would be justified, if the distributor carried a wide range of commercial risks, and/or was responsible for a highly creative and successful innovation in marketing, and/or had contributed significantly over time to the development of relevant marketing intangibles. This situation is reflected in Phase D of the profit split matrix.

E11. Phases A and C of the profit split matrix represent situations between the above cases, where the contributions to total functions, assets and risks for the channel are more evenly divided between the manufacturer and distributor, and this results in a mid range profit split to the distributor.

E12. To implement the flexible profit split, it is necessary to determine benchmark rates for both combined margin and sales growth to ascertain parameters for the various phases. Actual profit split rates for each phase also need to be determined, and these should reflect contributions by each party to combined profits for each phase. It is then a matter of ascertaining from the results for any particular period which phase of the matrix is appropriate and the resulting profit split.

E13. It may be appropriate to add further variations in developing the matrix in order to identify more precisely an equilibrium point and to better reflect incremental changes in the marketplace. **Table 3** (at page 73) presents a more elaborate matrix than the simplified form that is used in **Table 2** (at page 72) as part of the example that follows.

Example

E14. FORCO is a non-resident manufacturer of high technology equipment. AUSCO is its wholly owned Australian subsidiary, which imports and distributes FORCO's products. In implementing a transfer pricing policy for the products, FORCO and AUSCO have determined that the only feasible method to ascertain an arm's length

result for their dealings is by using a profit split based on a contribution analysis.

E15. FORCO and AUSCO use the profit split matrix at **Table 1** to construct their own model, and determine that the parameters should reflect the following:

(1) combined gross margin of 30% of sales represents the norm and margins above 30% represent an increase in combined gross margin while margins below 30% represent a decrease in combined gross margin; and

(2) AUSCO normally achieves an annual increase in sales of 20% and increases above 20% represent high sales growth while increases below 20% represent low sales growth.

E16. FORCO and AUSCO also calculate that an arm's length result for each of the four phases is obtained for AUSCO by using the following profit split rates:

Phase A	33%
Phase B	25%
Phase C	33%
Phase D	50%.

E17. These rates are based on benchmark information the company was able to obtain and its experience and knowledge of conditions and practices in the industry. In the absence of third party benchmarks, the analysis becomes more subjective or theoretically based. The above parameters are then implemented into the model to create the flexible profit split matrix at **Table 2**.

E18. For the first year, a combined gross margin of 27% was achieved and AUSCO achieved sales growth of 23%. This placed AUSCO in Phase C of the matrix, resulting in a split of combined profits of 67% to FORCO and 33% to AUSCO. In the second year, a combined gross margin of 18% was achieved and AUSCO achieved sales growth of 14%. This placed AUSCO in Phase D of the matrix, resulting in a split of combined profits of 50% to FORCO and 50% to AUSCO.

E19. The model may continue to be used by FORCO and AUSCO, subject to any changes to the parameters used that are necessary achieve an arm’s length result.

TABLE 1 FLEXIBLE PROFIT SPLIT MATRIX

	Low Growth	High Growth
Increasing gross margin	**Phase A** Slow, steady acceptance of innovative technology. Mid-range profit split to distributor.	**Phase B** Rapid acceptance of innovative technology. Emphasis on simple order taking. Lower range profit split to distributor.
Decreasing gross margin	**Phase D** Technology less successful or rapidly matched; intense competition; careful segmentation essential in target marketing; heavy marketing emphasis; dominant distributor function. Higher range profit split to distributor.	**Phase C** Technology accepted widely but requires strong service support; emphasis on brand marketing; distributor plays essential role in value adding. Mid-range profit split to distributor.

TABLE 2 FLEXIBLE PROFIT SPLIT MATRIX FOR AUSCO

	Low Growth	High Growth
Increasing gross margin **Gross margin in excess of 30%**	**Phase A** Slow, steady acceptance of innovative technology. 33% profit split to AUSCO.	**Phase B** Rapid acceptance of innovative technology. Emphasis on simple order taking. 25% profit split to AUSCO.
Decreasing gross margin **Gross margin below 30%**	**Phase D** Technology less successful or rapidly matched; intense competition; careful segmentation essential in target marketing; heavy marketing emphasis; dominant distributor function. 50% profit split to AUSCO.	**Phase C** Technology accepted widely but requires strong service support; emphasis on brand marketing; distributor plays essential role in value adding. 33% profit split to AUSCO.

TABLE 3

	Low Growth Sales increase <10%	Normal Growth Sales increase 10% - 20%	High Growth Sales increase >20%
Increasing gross margin	**Phase A** Slow, steady acceptance of innovative technology.	**Transitional phase** Increasing acceptance of technology.	**Phase B** Rapid acceptance of innovative technology. Emphasis on simple order taking.
Gross margin in excess of 32%	33% profit split to AUSCO.	30% profit split to AUSCO.	25% profit split to AUSCO.
Normal gross margin	**Transitional phase** Introduction of new technology and phasing out of old.	**Equilibrium** Technology is accepted in the market and distributor undertakes normal level of marketing and support functions.	**Transitional phase** Market for the technology is maturing, service support role by distributor increasing but below normal levels.
Gross margin in the range 28% to 32%	40% profit split to AUSCO	33% profit split to AUSCO.	30% profit split to AUSCO.
Decreasing gross margin	**Phase D** Technology less successful or rapidly matched; intense competition; careful segmentation essential in target marketing; heavy marketing emphasis; dominant distributor function.	**Transitional phase** Increasing service support required with key value adding role by distributor, but normal gross margins achieved.	**Phase C** Technology accepted widely but requires strong service support; emphasis on brand marketing; distributor plays essential role in value adding.
Gross margin below 28%	50% profit split to AUSCO.	40% profit split to AUSCO.	33% profit split to AUSCO.

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legislative references
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case references
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