

TR 98/11 - Income tax: documentation and practical issues associated with setting and reviewing transfer pricing in international dealings

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Taxation Ruling

Income tax: documentation and practical issues associated with setting and reviewing transfer pricing in international dealings

Other Rulings on this topic

IT 2514; TR 92/11;
TR 94/14; TR 95/23;
TR 96/7; TR 97/20

*This Ruling, to the extent that it is capable of being a 'public ruling' in terms of Part IVA of the **Taxation Administration Act 1953**, is a public ruling for the purposes of that Part. Taxation Ruling TR 92/1 and TR 97/16 together explain when a Ruling is a public ruling and how it is binding on the Commissioner.*

What this Ruling is about

1. This Ruling sets out the ATO's views on documentation and other practical issues that are relevant in setting and reviewing transfer pricing in international dealings. The Ruling covers the following specific issues:

- (1) the reasons for keeping documentation showing that international dealings are reported on an arm's length basis for tax purposes;
- (2) the advantages of having contemporaneous documentation;
- (3) identifying and discussing the risk of transfer pricing audits and adjustments;
- (4) developing and documenting the four steps for testing the arm's length nature of international transfer prices;
- (5) documentation relevant to the application of particular pricing methodologies;
- (6) documentation issues for small businesses or entities with low levels of international dealings;
- (7) documentation issues for certain business strategies;
- (8) access to information by the ATO and taxpayers; and
- (9) use of industry information and publicly available sources of data.

2. This Ruling should be read having regard to the principles in Taxation Ruling TR 97/20 (*Income Tax: using arm's length transfer pricing methodologies in international dealings*). In general, while

that Ruling addresses the principles of transfer pricing methodologies, this Ruling discusses how these principles can be applied by ATO staff and taxpayers.

3. This Ruling examines in more detail than Taxation Ruling TR 94/14 (*Income tax: Application of Division 13 of Part III (International Profit Shifting)*) the nature and type of documentation that is relevant to supporting a contention that the consideration in relation to international dealings with associated enterprises complies with the arm's length principle (see paragraph 5 of Taxation Ruling TR 96/7).

4. This Ruling focuses primarily on dealings between separate legal entities. However, the views expressed are also relevant to support a contention that the allocation of income and expenses between the different parts of the same legal entity (e.g., between a permanent establishment and its head office or between two permanent establishments of the same enterprise) have been undertaken on a basis that is consistent with the arm's length principle.

5. Although the Ruling deals mainly with companies, the same principles apply where individuals, partnerships and trusts engage in dealings with associated enterprises. The expression 'associated enterprises', as used in the Ruling, includes both:

- enterprises directly or indirectly connected through management, control or shareholding 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 who do not deal at arm's length with one another as discussed in paragraphs 50 to 53 of TR 94/14).

6. It is not the intention of this Ruling to lay down any conditions which restrict the exercise of any discretion. Each case must be decided on its merits.

Definitions

7. The terms 'associated enterprises' or 'associated enterprise dealings' can be used interchangeably with the expression 'related party' or 'related party dealings' which appear in other ATO rulings and schedules.

8. Similarly, the expressions 'dealings' and 'international dealings' have been selected to encompass all of the conditions that operate

between associated enterprises in their commercial or financial relations across national borders.

9. The terms 'comparable uncontrolled transactions' or 'comparable uncontrolled dealings' used in this Ruling may include dealings between associated enterprises as discussed in subparagraph 2.11(4) of TR 97/20 where the circumstances outlined in paragraphs 2.19 to 2.21 of that Ruling are met.

10. The term 'multinational enterprise group' or 'MNE group' used in this Ruling refers to a group of associated companies with business established in two or more countries. The term 'multinational enterprise' or 'MNE' refers to a company that is part of an MNE group.

Date of effect

11. This Ruling applies to years commencing both before and after its date of issue (but see paragraph 2.13 of the Ruling in relation to penalty considerations). However, the Ruling does not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 21 and 22 of TR 92/20).

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Ruling and explanations

Chapter 1: Introduction

1.1 Australia's transfer pricing rules centre around Division 13 of the *Income Tax Assessment Act 1936* ('the ITAA') and the Business Profits and Associated Enterprises Articles of Australia's DTAs that adopt the arm's length principle as the basis for determining whether Australia has been denied its fair share of tax (paragraphs 154 to 168 of TR 94/14 and paragraphs 1.5 to 1.10 of TR 97/20).

1.2 TR 97/20 discusses in detail the issues that arise in relation to comparability and application of the various methodologies which are

acceptable to the ATO for the purpose of showing conformity with the arm's length principle. As indicated in Chapter 1 of TR 97/20, the application of principles set out in that Ruling requires judgment. This Ruling focuses, among other things, on the nature of documentation that will be relevant in the selection and application of transfer pricing methodologies. The nature and type of documentation that is relevant varies with the methodology employed (refer to paragraph 108 of TR 94/14).

1.3 While the record-keeping provisions of the ITAA (as discussed in Chapter 2) do not place an express obligation on taxpayers to create specific records demonstrating that their international dealings with associated enterprises comply with the arm's length principle for tax purposes, taxpayers are well advised to do so in order to demonstrate to the ATO that this has been the case. This Ruling, therefore, aims to provide taxpayers with guidance as to what they need to do if they are to demonstrate to the ATO that they have complied with the arm's length principle.

1.4 In reviewing transfer pricing, regard should be had not only to relevant documentation but also to the conduct of the associated enterprises. In this respect, regard should be had to the discussion at paragraphs 45, 46 and 261 to 263 of TR 94/14 on 'Evidence of a course of conduct'.

1.5 The ATO will follow as closely as practicable the OECD publication '*Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*', 1995, OECD ('the 1995 OECD Report') (see paragraphs 1.13 and 1.14 of TR 97/20). Both the ATO and the OECD have stated that taxpayers should not be expected to have prepared or obtained documents beyond the minimum needed to enable a reasonable assessment to be made of whether their dealings with associated enterprises comply with the arm's length principle (paragraphs 102 and 373 of TR 94/14; paragraph 5.7 of the 1995 OECD Report). References to documentation in this Ruling therefore are not meant to be prescriptive or to indicate standardised or predetermined requirements that are to be applied in a rigid and mechanical manner. These references are meant to be prompts and not an exhaustive check list of documentation needed in each and every case.

1.6 In assessing compliance with the arm's length principle, taxpayers need to exercise commercial judgment about the nature and extent of documentation appropriate to their particular circumstances. Paragraph 5.4 of the 1995 OECD Report states:

"The taxpayer's process of considering whether transfer pricing is appropriate for tax purposes should be determined in accordance with the same prudent business management principles that would govern the process of evaluating a business decision of a similar

level of complexity and importance. It would be expected that the application of these principles will require the taxpayer to prepare or refer to written materials that could serve as documentation of the efforts undertaken to comply with the arm's length principle, including the information on which the transfer pricing was based, the factors taken into account, and the method selected.'

1.7 Paragraph 5.14 of the 1995 OECD Report highlights the advantages to taxpayers that result from good record-keeping practices, and recognises the practical reality that tax administrations have obligations to ensure compliance by taxpayers within their jurisdiction with the arm's length principle. It states that:

'Taxpayers should recognize that notwithstanding limitations on documentation requirements, a tax administration will have to make a determination of arm's length transfer pricing even if the information available is incomplete. As a result, the taxpayer must take into consideration that adequate record-keeping practices and the voluntary production of documents can improve the persuasiveness of its approach to transfer pricing. This will be true whether the case is relatively straightforward or complex, but the greater the complexity and unusualness of the case, the more significance will attach to documentation.'

1.8 The criteria for assessing the levels of documentation needed affect small business taxpayers as well as large business taxpayers. Although the extent and form of documentation needed will vary, it can be said that, in general, all taxpayers dealing with associated enterprises may need to create or obtain some supporting documentation in addition to that created by the taxpayer in the ordinary course of business (see paragraph 3.2). (See also paragraphs 102 and 373 of TR 94/14 and paragraphs 5.6 and 5.7 of the 1995 OECD Report.)

1.9 In applying principles of prudent business management, the expectation that contemporaneous documentation would be created or obtained to explain the basis of a dealing increases according to the significance of the dealings to the entity's overall business (in terms of quantum and/or proportionality) and the complexity of the dealing. The legislation does not require a taxpayer to go beyond what is reasonable in terms of documentation. What is reasonable is determined on the basis of what a reasonable business person in the taxpayer's circumstances would do, having regard to the complexity and importance of the transfer pricing issues that arise in the taxpayer's case.

1.10 The introduction of *de minimus* rules for documentation which would obviate the need for small business taxpayers to keep any explanatory material at all, could erode the value of what is recognised as an internationally accepted principle. A degree of flexibility in the type and extent of documentation to be created or obtained by small business taxpayers exists based on principles of

prudent business management (see paragraph 5.4 of the 1995 OECD Report and Chapter 6 of this Ruling).

Chapter 2: Reasons for keeping documentation

Introduction

2.1 There are four related reasons why taxpayers should create and keep contemporaneous documentation recording the application of the arm's length principle in setting the prices or the terms of their international dealings with associated enterprises for tax purposes:

- (1) statutory requirements to keep records (paragraphs 2.4 to 2.8);
- (2) relevance to penalty considerations (paragraphs 2.9 to 2.14);
- (3) the burden of proof which rests with taxpayers in the event of dispute (paragraphs 2.15 to 2.17); and
- (4) practical advantages in reducing the risk of tax audits and adjustments and in communicating your position to the ATO (paragraphs 2.18 and 2.19).

2.2 Without attempting to be exhaustive or prescriptive, some of the documentation and records which have been relied on by taxpayers and to which the ATO has given weight include:

- (1) budgets, business plans and financial projections;
- (2) pricing policies, documents relating to product profitability, relevant market information and profit contributions of each party;
- (3) documents establishing the reasons for entering into significant international dealings with associated enterprises;
- (4) documents establishing the reasons for the taxpayer's selection of a particular pricing methodology or methodologies;
- (5) where other methodologies have been considered and rejected, details of these other methodologies, including reasons for their rejection. Ideally, these documents should be created contemporaneously with the decision-making;
- (6) documentation establishing the structure and nature of the company and the MNE group to which it belongs;

- (7) documentation establishing the taxpayer's sales and operating results and the nature of its dealings with associated enterprises;
- (8) documentation setting out the taxpayer's business strategies and the reasons for their adoption;
- (9) documents evidencing the negotiating positions taken by taxpayers in relation to their international dealings with associated enterprises and the basis for those negotiating positions; and
- (10) documents created at the time of preparing the relevant tax return and taken into account in determining arm's length consideration for tax purposes.

(See also paragraph 2.11 of TR 97/20.)

2.3 The ATO is not suggesting that all the types of documentation mentioned in this Ruling need to be created or obtained in all cases.

Statutory requirements to keep records

2.4 Section 262A of the ITAA imposes obligations on taxpayers to retain records created in the process of setting transfer prices and calculating the appropriate amounts to be reported in the taxpayer's return. These records need to be in writing in the English language or so as to enable the records to be readily accessible and convertible into writing in the English language. The ATO's view on the effect of section 262A has been discussed at paragraphs 368 and 369 of TR 94/14. See also TR 96/7.

2.5 For example, in determining the amount of costs and gross margin for the purpose of applying the cost plus method, section 262A requires documenting the calculation of costs (paragraph 262A(2)(b)). Where a taxpayer calculates the gross margin, section 262A requires that the relevant documentation created in making this calculation be retained. In determining the combined profit and the basis for the profit split for the purposes of applying a profit split method section 262A requires the retention of relevant documentation created or collected in calculating the combined profit to be split. Where a taxpayer has documented the basis for the profit split, this documentation should be retained. Similarly, section 262A requires that relevant documentation created or obtained in calculating the net income for the purpose of applying a transactional net margin method must be retained.

2.6 Subsection 262A(2) requires taxpayers, when allocating indirect costs between controlled transactions and other transactions entered into by the taxpayer for the purpose of applying an arm's

length methodology, to retain documents explaining the allocation basis used.

Taxpayers having international dealings with associated enterprises must provide certain information with their income tax returns

2.7 A taxpayer that has engaged in international transactions with an associated enterprise during a year of income is required to complete a Schedule 25A pursuant to Regulation 15 of the Income Tax Regulations and lodge it with its income tax return. Failure to complete the Schedule 25A where this is required may attract penalties or prosecution action. Guidelines on when taxpayers may be required to lodge a Schedule 25A are provided in Taxation Ruling IT 2514. As the Schedule 25A forms part of the tax return, the Regulations require that it be signed by the person making the return (the Public Officer in the case of a company) that the particulars shown therein are true and correct.

2.8 The current Schedule 25A imposes obligations on taxpayers to:

- disclose whether they have used arm's length methodologies;
- say what those methods are; and
- disclose the extent to which they have documentation to show that they have selected and applied the most appropriate arm's length methodologies in relation to their international dealings with associated enterprises.

Relevance to penalty considerations

2.9 If Division 13 or a corresponding provision of a DTA has been applied and the result is an increase in the amount of tax assessed to a taxpayer, a statutory penalty is imposed pursuant to section 225 of the ITAA. The ATO's interpretation of Parliament's intention in introducing the section 225 penalty was publicly stated by the then Second Commissioner, Trevor Boucher, in his address to the 1983 Taxation Conference of the Australian Mining Industry Council:

'If I can put our reading of the Parliament's intention another way, it is that the penalty provisions represent a signal that firms ought to be steering clear of transfer pricing practices or, at least, from reliance on them in presentation of their annual tax returns.

... The legislation is saying in effect that returns ought to be prepared and lodged on a basis that responds to the call for pricing to be on an arm's length basis.'

2.10 The existence of adequate contemporaneous documentation is an indicator that the efforts of a taxpayer are such that penalties should be remitted in the event of a transfer pricing adjustment.

2.11 Taxpayers who have in good faith followed the four steps outlined in Chapter 5 of this Ruling in the preparation of their returns and kept sufficient and relevant contemporaneous documentation to show compliance with the arm's length principle will not be subject to penalties under section 225. This approach would also be taken where taxpayers undertake a similar review before they lodge their tax return and make any necessary adjustments.

2.12 Adequate documentation in this area is an integral aspect of a risk management approach. From the taxpayer's point of view, it is much easier to convince the ATO that they have a reasonably arguable position if they maintain contemporaneous documentation.

2.13 While this Ruling has application to years before its date of issue (see paragraph 11) it is acknowledged that understanding of the transfer pricing rules and their application has significantly developed in recent years. In considering issues of penalty under section 225 and remission of such penalties under subsection 227(3), the guidance on the application of the transfer pricing rules that was reasonably available at the time that the dealings were undertaken or relevant tax returns prepared must be taken into account.

2.14 The imposition and remission of penalties under section 225 of the ITAA as a result of a transfer pricing adjustment having been made are the subject of a further Ruling.

The burden of proof rests with taxpayers in the event of dispute

2.15 See sections 14ZZK and 14ZZO of the *Taxation Administration Act 1953* ('the TAA'). The taxpayer has the burden of proving that a disputed assessment is excessive. However, this does not remove from the ATO the need to ensure that any transfer pricing adjustments made are soundly based in law (see paragraphs 371 and 378 to 385 of TR 94/14 and paragraph 4.16 of the 1995 OECD Report.)

2.16 In discharging its onus of proof, a taxpayer must not only show that the assessment is wrong, but must also positively establish what correction should be made in order to make it right or more nearly right (see *Trautwein v. FC of T* (1936) 56 CLR 63; *FC of T v. Dalco* (1990) 168 CLR 614; 90 ATC 4088; (1990) 20 ATR 1370; *FC of T v. Australia and New Zealand Savings Bank Limited* (1994) 181 CLR 466; (1994) 29 ATR 11; 94 ATC 4844; *Allard v. FC of T* 92 ATC 4897; (1992) 24 ATR 493).

2.17 In the event of a dispute, taxpayers will therefore be better placed to discharge their burden of proof where they have developed and implemented arm's length transfer pricing policies at the time of setting and reviewing their transfer prices and have fully and contemporaneously documented these policies.

Practical advantages in reducing the risk of tax audits and adjustments and in communicating your position to the ATO

2.18 The Commissioner has a statutory obligation to ensure compliance with the transfer pricing rules and to form a view as to whether an adjustment should be made to a taxpayer's taxable income. Where the ATO is confronted with inadequate or incomplete information, each of Australia's DTAs includes a mechanism which enables the Commissioner to deem an amount as the arm's length consideration (see paragraph 1.15 of TR 97/20).

2.19 There are also sound practical reasons why taxpayers should document compliance with the arm's length principle. The keeping of such documentation mitigates the risk of audit by and dispute with the ATO and assists in improving the communication of a taxpayer's position to the ATO (see Chapter 4).

Chapter 3: Contemporaneous documentation

The advantages of contemporaneous documentation

3.1 Documentation is contemporaneous if it is existing or brought into existence at the time the taxpayer is developing or implementing any arrangement that might raise transfer pricing issues, or reviewing these arrangements prior to or at the time of the preparation of tax returns, and which records information relevant to transfer pricing decisions. The documentation may be in the form of books, records, studies, budgets, plans and projections, analyses, conclusions and other material which records the information. It may be in electronic or written form.

3.2 A distinction must be made between documentation created or obtained by a taxpayer as part of its ordinary business operations and used by it to set the prices of its international dealings with associated enterprises (e.g., invoices, orders, etc.) and documentation created or obtained by the taxpayer which, when considered with the records kept in the ordinary course of business, establishes whether such prices comply with the arm's length principle. The former does not generally represent contemporaneous documentation in the sense used

in the previous paragraph because such documentation does not produce evidence relevant to whether the pricing of the international dealings with associated enterprises are arm's length.

3.3 The accurate recording of events on a contemporaneous basis provides the best evidence. This can happen prior to or at the time of undertaking the dealings up to the time of preparing the relevant tax return. One factor which may influence the timing of creation or obtaining of contemporaneous documentation is the choice of transfer pricing methodology.

3.4 When bringing documents into existence at the time of preparing tax returns, taxpayers can obtain a reasonable level of confidence that:

- their transfer prices comply with the arm's length principle; and
- they are perceived as being lower risk cases (see paragraphs 4.6 to 4.27);

if they carry out the following steps:

- (1) review their international dealings with associated enterprises taking account of the relevant available data and the guidance provided in this Ruling; and
- (2) adjust (where necessary) for tax purposes the dealings with associated enterprises to accord with the arm's length principle and lodge their tax returns on that basis; and
- (3) properly document this process (see also paragraphs 108 and 382 of TR 94/14).

3.5 The ATO is aware that a variety of reviews have been undertaken by taxpayers following the lodgment of tax returns with the aim of providing information about whether their transfer prices are arm's length or not, notwithstanding the absence of contemporaneous documentation and the lack of existence of appropriate processes. It is the ATO view that the best way to reduce the risk of ATO intervention is for the taxpayer to create or obtain contemporaneous documentation which seeks to establish the arm's length nature of international dealings with associated enterprises. This is a logical consequence of truly independent dealing, where arm's length enterprises consider their options and likely outcomes prior to or at the time of the dealing, not after lodgment of the tax return.

3.6 After-the-event justifications of transfer prices can raise the issue of hindsight, are time consuming, can be less precise, and often

are more expensive way of attempting to satisfy the Commissioner that the process and outcomes accord with the arm's length principle. It is more difficult for companies to convince the ATO that the dealings were on an arm's length basis where after-the-event analyses are relied upon, than would be the case where the taxpayer has documented the relevant analysis and application of a transfer pricing method contemporaneously (paragraphs 105 and 376 of TR 94/14).

3.7 Notwithstanding the provision to the ATO of any such reviews or the fact that these may be in course at the time the ATO commences its own review, the ATO reserves the right to proceed with its own enquiries and risk ranking in accordance with the general principles outlined in this Ruling (see *Guidelines for the Conduct of Taxpayers and Taxation Auditors Involved in Complex Audits*, 17 July 1991 (Addendum issued on 18 November 1992) ('the Code of Conduct Guidelines')).

3.8 Where any such reviews are concluded at the time of the ATO commencing its transfer pricing review, they may be taken into account as part of the ATO's examination. In order to facilitate the ATO's consideration of the taxpayer's post-lodgment analysis, taxpayers are well advised to have all materials comprising the analysis, including the comparability analysis and the basis for selection or rejection of transfer pricing methodologies, available upon request by the ATO.

Chapter 4: The risk of transfer pricing audits and adjustments

Introduction

4.1 ATO resources on transfer pricing cases are generally allocated on the basis of the perceived risk to the revenue of taxpayer non-compliance with the arm's length principle. The more important and the broader the scope of the dealings, the more likely it is that a taxpayer will be the subject of a transfer pricing review.

4.2 This Chapter examines two broad types of transfer pricing risk for taxpayers with international dealings with associated enterprises:

- the risk of a transfer pricing audit which may follow a transfer pricing review (paragraph 4.6); and
- the risk of a transfer pricing adjustment and the imposition of penalties if the ATO undertakes a transfer pricing audit (paragraph 4.31).

4.3 Taxpayers should consider the level of certainty they wish to achieve, having regard to the impact of international dealings with associated enterprises on their overall business and other relevant factors. This assessment determines the level of risk to which the taxpayer is exposed.

4.4 The first stage in the ATO's process of obtaining an indication of the level of compliance with the arm's length principle - and hence whether to refine the investigation by proceeding to the next stage, being a transfer pricing review - is an initial screening process that considers a range of factors, having regard to particular facts and circumstances of each case.

4.5 Taxpayers with significant levels of international dealings with associated enterprises who are consistently returning losses (see paragraphs 2.96 to 2.98 of TR 97/20) are at the highest risk of an ATO transfer pricing review.

The risk of a transfer pricing audit

4.6 The diagram at paragraph 4.25 titled 'Flowchart Illustrating Process' shows how the ATO is likely to approach a review of a taxpayer's international dealings with associated enterprises to reach a view about whether there has been compliance with the arm's length principle. The flowchart is divided into stages involving the initial process review leading to risk assessment and an escalation of this review to a transfer pricing audit. This flowchart is provided as a general indication of what steps the ATO takes. However, individual circumstances of international dealings may also require a modification or departure from the process illustrated.

4.7 The ATO conducts a transfer pricing review by analysing the nature and extent of a taxpayer's international dealings with associated enterprises, the process established by the taxpayer to show compliance with the arm's length principle for tax purposes, the documentation retained by the taxpayer in relation to those dealings and the outcomes of those dealings. In deciding whether to proceed beyond a transfer pricing review to a transfer pricing audit of some or all of a taxpayer's international dealings with associated enterprises, the ATO considers:

- (1) the quality of a taxpayer's processes;
- (2) the extent of relevant and adequate contemporaneous documentation; and
- (3) whether the outcome of the international dealings with associated enterprises provides a commercially realistic result for the Australian taxpayer (see paragraph 2.11(3) of TR 97/20).

4.8 The quality of a taxpayer's processes and documentation in applying the arm's length principle to its international dealings with associated enterprises can be generally assessed as falling into broad categories ranging from 'low quality' to 'high quality'.

4.9 Other situations fall outside an analysis of the quality of processes and documentation and, as such, are not included in the review process. For example, where evidence is found that a taxpayer has deliberately structured its international dealings with associated enterprises so as to avoid Australian tax, it is highly probable that the ATO will proceed straight to an audit of the taxpayer's pricing outcomes. Factors that will lead the ATO to such a conclusion include:

- (1) the use of tax havens where little or no economic value is added, e.g., re-invoicing;
- (2) the use of back-to-back arrangements to conceal the full extent of consideration given; and
- (3) complex and circular arrangements with little or no business purpose.

4.10 Where an Advance Pricing Arrangement ('APA') has been concluded with a taxpayer and the critical assumptions specified in the APA are met (see TR 95/23), the ATO will, apart from some checking to ensure that the terms of the APA have been implemented as originally agreed, take no further action in relation to the transactions covered by the APA.

4.11 To increase the likelihood of falling into one of the higher quality categories, a taxpayer is well advised to establish and adhere to processes which follow the guidance provided in this Chapter and Chapter 5, including assessment of the outcomes of the dealings to determine whether the results are commercially realistic in the context of the overall conditions impacting on the market and the taxpayer's own circumstances. The steps that taxpayers can take in this regard are more fully addressed in the discussion in the next Chapter on 'the four steps'.

4.12 As individual taxpayer circumstances may vary over time, the ATO may review a taxpayer's risk ranking in the light of current circumstances.

Low quality processes lead to higher risk

4.13 Low quality cases are those where there is no process in place or documentation to check the selection and application of transfer pricing methodologies for tax purposes. In these cases the consideration for the dealings usually has been set without regard to

the interests of the Australian party. It is not possible for the ATO to test the transfer price-setting processes of taxpayers in such cases and a detailed transfer pricing audit is likely to be needed to assess their contribution to the profits of the MNE group and to ensure that these are properly reflected in their tax returns or reported income.

Low to medium quality processes

4.14 In some cases there may be some contemporaneous documentation but no analysis of functions, assets, risks, market conditions or business strategies. The ATO is generally unable to test the transfer price setting processes of taxpayers in such cases. The processes and documentation would be classified as low to medium quality by the ATO. These taxpayers need to analyse their contribution to the profit of the MNE group and ensure that this is properly reflected on an arm's length basis in their tax returns (see paragraphs 1.52 and 1.53 of the 1995 OECD Report).

Medium quality processes

4.15 The medium quality category includes taxpayers undertaking only rudimentary arm's length analyses when setting pricing policies or determining the terms and conditions of international dealings with associated enterprises. There may be evidence of some limited efforts to develop and implement transfer pricing setting policies for tax purposes, although these would not be sufficiently developed or properly implemented having regard to the complexity and importance of the particular transfer pricing issues in the case. In these cases, there is an inadequate analysis of functions, assets, risks, market conditions and business strategies and no external benchmarking.

4.16 Taxpayers may have relied on data that is broadly comparable although they have not sought to refine it to their circumstances or not used it in conjunction with an adequate comparability analysis. There may be some contemporaneous documentation but it provides only limited scope for the ATO to test the taxpayer's transfer price setting processes. These taxpayers should nonetheless refine their analyses and processes and review their tax returns to reduce further their risk of a transfer pricing audit. However, where high value dealings are involved, this lack of precision in the taxpayer's comparability analysis could present a high risk to the revenue.

4.17 A ranking no higher than medium quality applies where the taxpayer has recourse to information from dealings between associated enterprises of the type discussed in sub-paragraph 2.11(4) of TR 97/20 in the development of their functional and comparability

analyses and transfer pricing methodologies. The medium quality category applies only where:

- (1) the taxpayer would otherwise fall into a higher quality category apart from the use of this type of information; and
- (2) the requirements of paragraphs 2.19 and 2.21 of TR 97/20 have been met.

Where these requirements have not been met, the taxpayer falls into a lower quality category. The ATO does not consider that a ranking higher than medium quality applies where a taxpayer uses related party comparables.

Medium-high quality processes

4.18 Medium-high quality cases are those where taxpayers carefully undertake arm's length pricing analyses (and appropriate future monitoring) using available data about independent enterprises or third party international dealings (having regard to comparability), but may be confronted with limitations on data availability which are beyond the control of the MNE group.

4.19 These taxpayers have undertaken a sound analysis of functions, assets, risks, market conditions and business strategies that are fully supported by contemporaneous documentation and have relied on this information in preparing their tax returns. The ATO is able to carry out full testing of the taxpayer's process and analyses. While the value of the dealings, combined with the limitations on the data, may present a high risk to the revenue, these taxpayers will be regarded as having used their best endeavours and would not generally be subject to penalty tax under section 225 in the event of a transfer pricing adjustment.

High quality processes lead to lower risk

4.20 High quality cases are those where taxpayers:

- (1) consider their international dealings with associated enterprises carefully;
- (2) undertake arm's length pricing analyses (and appropriate future monitoring) using sufficient reliable data about independent enterprises or third party international dealings (having regard to comparability) - including undertaking a sound analysis of functions, assets, risks, market conditions and business strategies;

- (3) establish and implement a process which the ATO can readily test;
- (4) support the analysis and processes with contemporaneous documentation;
- (5) engage in real bargaining or otherwise achieve an arm's length outcome; and
- (6) prepare their tax returns on the basis of their analysis.

4.21 Like the preceding category, these taxpayers will be regarded as having used their best endeavours and would not generally be subject to penalty tax under section 225 in the event of a transfer pricing adjustment. An example of a high quality case is where a taxpayer also has extensive dealings with independent enterprises in open market conditions and its dealings with associated enterprises are of a similar kind and on similar terms and conditions. Another example is a transaction with an associated enterprise which is narrowly confined, e.g., a loan to an offshore associate, where the consideration has been set by reference to a market rate of interest and the loan has terms and conditions which are found in the open market for comparable loans. These cases are high quality, subject to the above steps being satisfied.

4.22 The above examples should not be taken to imply that a multi-divisional enterprise with a range of complex dealings with associated enterprises cannot be capable of falling into the high quality level.

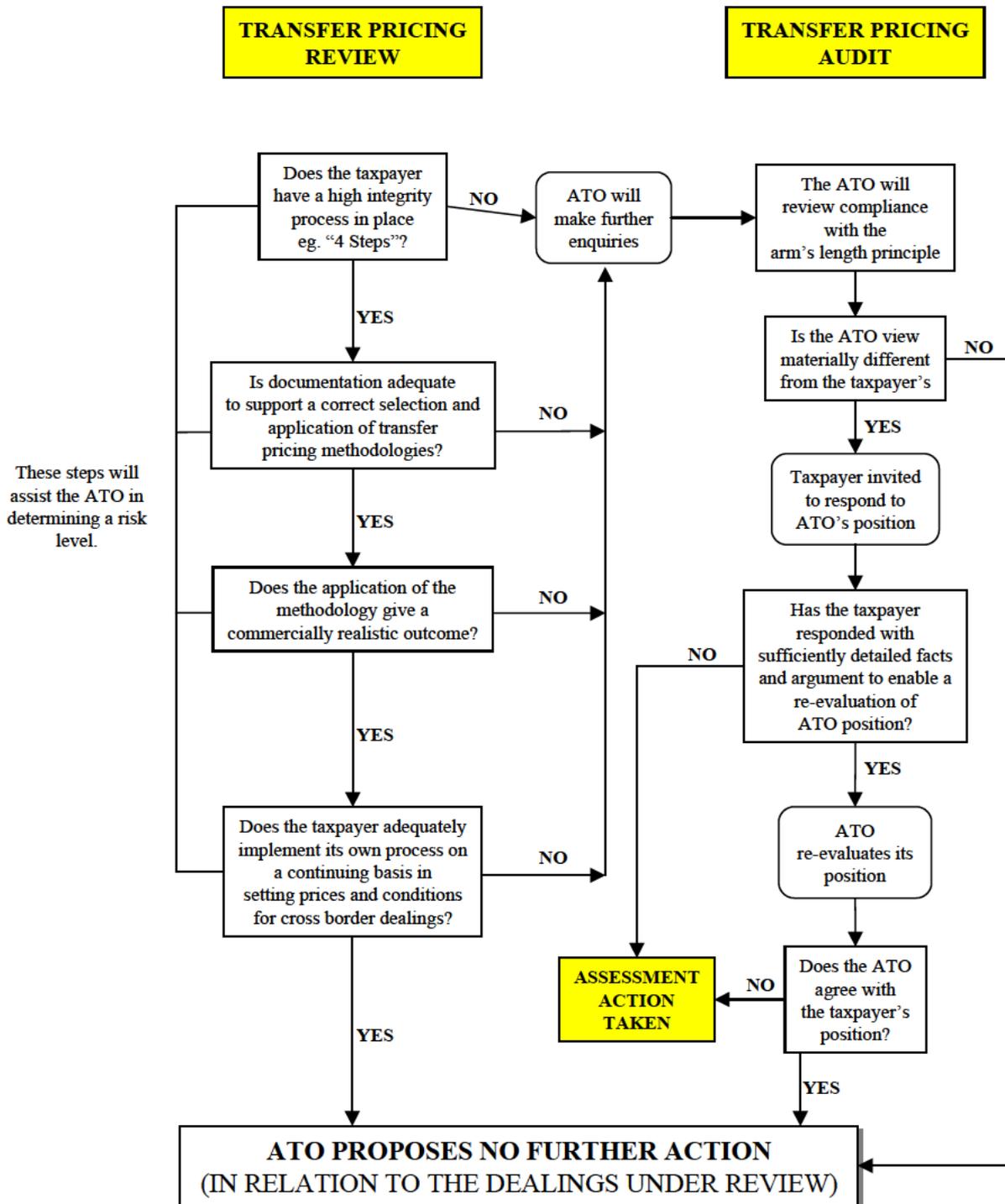
Diagrams of ATO processes in assessing risk

4.23 The above comments on levels of quality of processes and documentation in respect of a taxpayer's international dealings with associated enterprises are illustrated in the table titled 'Levels Of Quality Of Processes And Documentation For International Dealings With Associated Enterprises' at paragraph 4.26. The main elements contributing to a taxpayer's level of quality ranking are represented in the boxes and can be used by taxpayers and ATO staff as a practical guide to determining the level of quality of a taxpayer's processes and documentation. The characteristics of particular quality levels shown in the boxes are only indicative.

4.24 The ATO recognises that a taxpayer may still fall into one of the higher quality levels even though it has not satisfied every characteristic of each step shown in the table.

4.25 The following diagram illustrates how the ATO is likely to approach a review of a taxpayer's international dealings to reach a view about compliance with the arm's length principle.

FLOWCHART ILLUSTRATING PROCESS



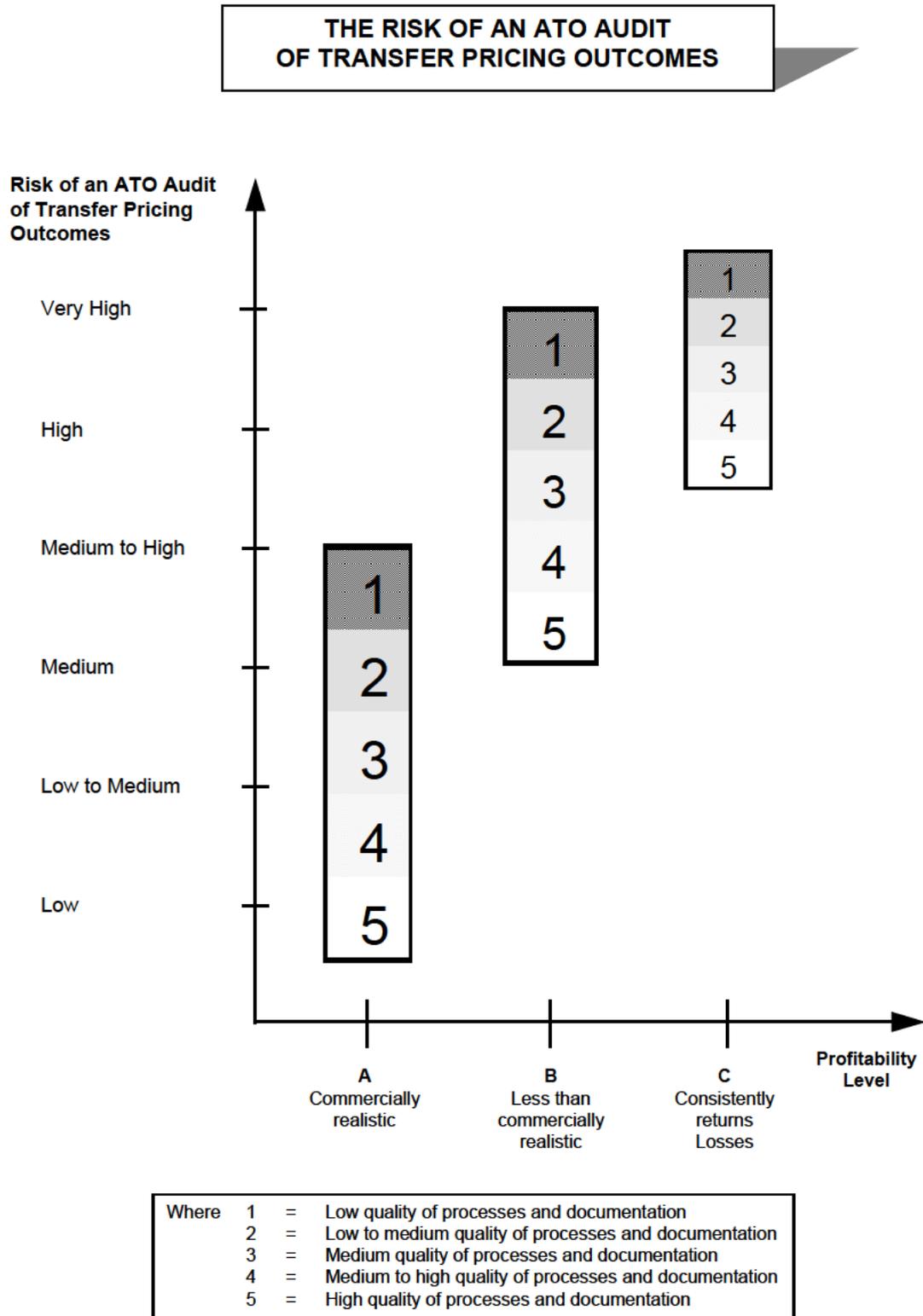
4.26 The following table illustrates the levels of quality of processes and documentation for international dealings with associated enterprises.

LEVELS OF QUALITY OF PROCESSES AND DOCUMENTATION FOR INTERNATIONAL DEALINGS WITH ASSOCIATED ENTERPRISES

1	2	3	4	5	
LOW QUALITY	LOW TO MEDIUM QUALITY	MEDIUM QUALITY	MEDIUM-HIGH QUALITY	HIGH QUALITY	LINK TO THE 4 STEPS (SEE CHAPTER 5)
No analysis of functions, assets, risks, market conditions & business strategies	No analysis of functions, assets, risks, market conditions & business strategies	Inadequate analysis of functions, assets, risks, market conditions & business strategies	Sound analysis of functions, assets risks, market conditions & business strategies	Sound analysis of functions, assets risks, market conditions & business strategies	See Step 1
No taxpayer documentation or processes to enable a check on selection of methodologies	Insufficient taxpayer documentation or processes to enable a check on selection of methodologies	Selection of method supported with some contemporaneous documentation	Selection of method fully supported with contemporaneous documentation	Selection of method fully supported with contemporaneous documentation	See Step 2 (See question on selection of most appropriate method in Schedule 25A)
No comparables used No taxpayer documentation or processes to enable a check on application of methodologies	No comparables used No taxpayer documentation or processes to enable a check on application of methodologies	Broad inexact comparables used OR comparability based on data from external related party comparables (see paragraph 4.17) Application of method supported with some contemporaneous documentation	Comparability based on limited data from independent dealings Reliability assessed Application of method fully supported with contemporaneous documentation	Comparability based on adequate data from independent dealings Reliability taken into account in choice of comparable Application of method fully supported with contemporaneous documentation	See Step 3 (See question on application of most appropriate method in Schedule 25A)
No effort to implement and review arm's length transfer pricing policies	Limited effort to implement and review arm's length transfer pricing policies	Limited effort to implement and review arm's length transfer pricing policies	Genuine effort to implement and review arm's length transfer pricing policies	Genuine effort to implement and review arm's length transfer pricing policies	See Step 4

Illustration of the risk of a transfer pricing audit

4.27 The interaction of quality level and commercial realism of the outcomes in determining the risk of a transfer pricing audit is illustrated in the following chart.



The ATO may proceed to a transfer pricing audit notwithstanding inadequate information available to a taxpayer or cases where a taxpayer has implemented its own processes

4.28 Representations have been made to the ATO that, in the reality of business life, there are many situations where comparable pricing information is inadequate or unavailable. It is accepted that availability of information may impose a constraint on a taxpayer in selecting and applying an appropriate arm's length pricing methodology in some circumstances. However, there is still a need to ensure an appropriate return to the Australian taxpayer having regard to the functions it performs, the assets it uses and the risks that it bears, the Australian economic and market conditions, and the need to find an answer for all transfer pricing problems (see paragraphs 3.88 to 3.99 of TR 97/20). It is the ATO view that taxpayers greatly increase the chance of achieving an arm's length outcome and significantly reduce the risk of a transfer pricing audit by the ATO, if they make full use of available information (including analysis of the respective contributions of each of the associated enterprises to the profit generated by the MNE group from the dealings between the associated enterprises) and adequately document that analysis. Also, the higher the standard of taxpayers' processes, the more likely it is that they can demonstrate that they have a reasonably arguable position for the purpose of section 225 and that their efforts warrant the exercise of the remission discretion under subsection 227(3).

4.29 Representations have also been made that where a taxpayer has implemented steps to consider application of the arm's length principle and documented that analysis, and the methodology applied is reasonably likely to provide an arm's length result, then the ATO should voluntarily restrict itself from proceeding to an audit of the taxpayer's pricing outcomes in any situation. This is not accepted as a universal rule. While it would generally be the case, the ATO reserves the right to review cases in these circumstances. The application of the arm's length principle is an objective test requiring consideration of the outcomes of the associated enterprise dealings, not just the process adopted (see paragraphs 54 and 289 of TR 94/14).

4.30 Notwithstanding submissions to the contrary, the application of the arm's length principle as an objective test cannot depend on whether the taxpayer has access to sufficient information. Voluntarily restricting reviews is likely to have serious implications in Australian markets where oligopolies are not uncommon. Even in an extreme case, the clear legislative policy is that there is still a need to find an answer (see subsection 136AD(4)). The underlying legislative policy is to ensure an arm's length result (see also paragraphs 12 and 154 of TR 94/14). The policy would be defeated if corrective action could not be taken in circumstances where taxpayers may have had limited

access to adequate relevant information. While most taxpayers can be expected to use best endeavours, administrative practice also needs to guard against any self limitation in this regard, recognising that methods such as profit splits and those covered in paragraphs 3.90 to 3.99 of TR 97/20 are available.

The risk of a transfer pricing adjustment

4.31 Where the ATO commences a transfer pricing audit, the risk of a transfer pricing adjustment and the imposition of penalties become real possibilities. The following discussion builds upon the discussion in paragraphs 103, 104, 374 and 375 of TR 94/14 and outlines in broad terms the nature and type of enquiries that the ATO may make in reviewing compliance with the arm's length principle.

How the ATO reviews compliance with the arm's length principle

4.32 For the purpose of reviewing a taxpayer's compliance with the arm's length principle, the ATO will follow the four steps discussed in Chapter 5. The procedures and processes described are not meant to be prescriptive and would be tailored to ensure that the process is appropriate to the complexity and importance of the transfer pricing issues in the case and to ensure that the cost to all parties is not disproportionately high relative to the revenue risk.

4.33 It can be expected that the ATO would acquire a good knowledge of the business of the enterprise to assist in taking a realistic view of the issues involved. The enquiries may need to cover industry and economic cycles and a number of relevant businesses and years. They may include:

- (1) examining the worldwide operations, strategies and structure of the MNE group to which the taxpayer belongs to establish the roles played by the taxpayer and the associated enterprise(s);
- (2) examining the market structure and dynamics, the enterprise's strategic direction, financial position, marketing strategies, pricing documentation, assets employed and risks borne and examining the documentation for specific international transactions, where necessary. This also includes an examination of all arrangements with associated enterprises and the interrelationship of those arrangements. Performance reports may also be examined to isolate any products or services that warrant particular attention;

- (3) examining budgets, business plans and financial projections;
- (4) interviewing a selection of the taxpayer's staff to establish the skills base and to understand the functions performed and the decision making processes adopted. Staff interviewed normally include relevant operational, managerial, finance and accounting staff;
- (5) reviewing the taxpayer's pricing processes; and
- (6) ascertaining in broad terms any comparable uncontrolled dealings, the assets employed and risks borne by any comparable uncontrolled enterprises. This would normally be refined as part of a comparability analysis.

4.34 However, the demand for this information depends on the ATO's progress through the four steps. Requests for information should be framed having regard to the specific information needs of the case.

4.35 Every effort should be made to ensure that necessary information is collected only once, subject to the need to verify information or amplify explanations from time to time and subject to cases where it may be more convenient to the taxpayer to provide information that overlaps.

4.36 The ATO will make reasonable attempts to obtain the necessary data through informal approaches. However, in some cases, the ATO may have to take more formal steps to obtain sufficient relevant information within a reasonable time. Such formal steps could include action under:

- (1) section 263 of the ITAA;
- (2) section 264 of the ITAA;
- (3) the Exchange of Information Articles of Australia's DTAs; or
- (4) section 264A of the ITAA (offshore information notices).

Further discussion is included in Chapter 9.

4.37 In selecting the most appropriate arm's length methodology the ATO may also consult with external experts, including economists, market and industry experts, accountants, lawyers and other relevant experts (refer to Appendix 7 of the *Access and Information Gathering Manual - Guidelines for Obtaining Assistance from External Advisors* ('the Access Manual')).

4.38 Where a transfer pricing audit is commenced, while our analysis will begin with the method that the taxpayer has adopted for showing that its international dealings with associated enterprises comply with the arm's length principle (see paragraph 4.9 of the 1995 OECD Report), we will develop our own analysis of the international dealings with associated enterprises.

What happens when the ATO view differs from the taxpayer's?

4.39 If, after following the previous steps, the ATO forms the considered view that there is a material difference between the results of its analysis and the results achieved by the taxpayer, an adjustment or series of adjustments will be proposed to the taxpayer. In the absence of a need for urgency this will be in the form of a position paper. A 'material difference' in this context is one which is outside an arm's length range (see paragraphs 2.83 to 2.95 of TR 97/20) and which is significant in dollar or precedent terms (see also paragraph 1.68 of the 1995 OECD Report). It is not used in the sense of an external auditor for the purposes of the *Corporations Law* forming a view on whether financial information is properly stated in all material respects (see also paragraphs 117 and 394 of TR 94/14).

4.40 Representations have been made to us that where a taxpayer has selected and applied a methodology for the purpose of setting or reviewing the terms or prices of its international dealings with associated enterprises, the ATO should be precluded from adopting some other methodology as part of a transfer pricing audit of a taxpayer. This view is not accepted (paragraphs 87 and 344 of TR 94/14 and paragraph 4.9 of the 1995 OECD Report). Neither the ATO nor the taxpayer is precluded from using any appropriate methodology to test or verify the outcome of international dealings with associated enterprises.

4.41 Representations have also been made that there should be no scope for the ATO to dispute the price set by the taxpayer where the taxpayer has implemented a process under which the taxpayer has a reasonable expectation that the resultant price will be an arm's length price, and that such a reasonable expectation will arise if the taxpayer's process for setting a transfer price is 'about as likely as not' to establish an arm's length price. It is suggested that this interpretation flows from the definition of 'arm's length consideration' in paragraphs 136AA(3)(c) and (d) of the ITAA and is broadly consistent with each of the Associated Enterprises Articles under Australia's DTAs. This view is also not accepted by the ATO because the test is an objective one (see paragraphs 71 and 320 of TR 94/14 and paragraph 2.15 of TR 97/20).

4.42 What is necessary is that there must be real and substantial grounds for considering that arm's length parties would enter into a transaction at the price under consideration. It is not necessary for it to be shown that on the balance of probabilities a particular price would have been chosen, although in some cases, the evidence will allow a high degree of confidence as to what arm's length parties would have done.

4.43 Hence, the expressions 'might reasonably be expected' in paragraphs 136AA(3)(c) and (d) of the ITAA and 'might be expected' in the Associated Enterprise Articles of Australia's DTAs provide some latitude in application and recognise that the determination of arm's length consideration or arm's length profit may involve an element of judgment. In appropriate circumstances, these expressions allow for the possibility of a range of arm's length outcomes and for the application of commercially realistic business strategies in determining the arm's length consideration or profit (see paragraphs 2.83 to 2.95 of TR 97/20). However, these expressions do not reduce the application of the arm's length principle to a question of probability in relation to whether the taxpayer's processes (see paragraphs 73, 74, 322 and 323 of TR 94/14), judged from the taxpayer's viewpoint, produce an arm's length outcome on an objective basis. Other processes may have a higher probability of producing the right result. The most appropriate method should be preferred (see paragraphs 86, 87 and 343 to 367 of TR 94/14 and paragraphs 3.5 to 3.7 of TR 97/20).

Chapter 5: Developing and documenting four steps for testing the arm's length nature of international transfer prices

The practical application of the arm's length principle - the four steps

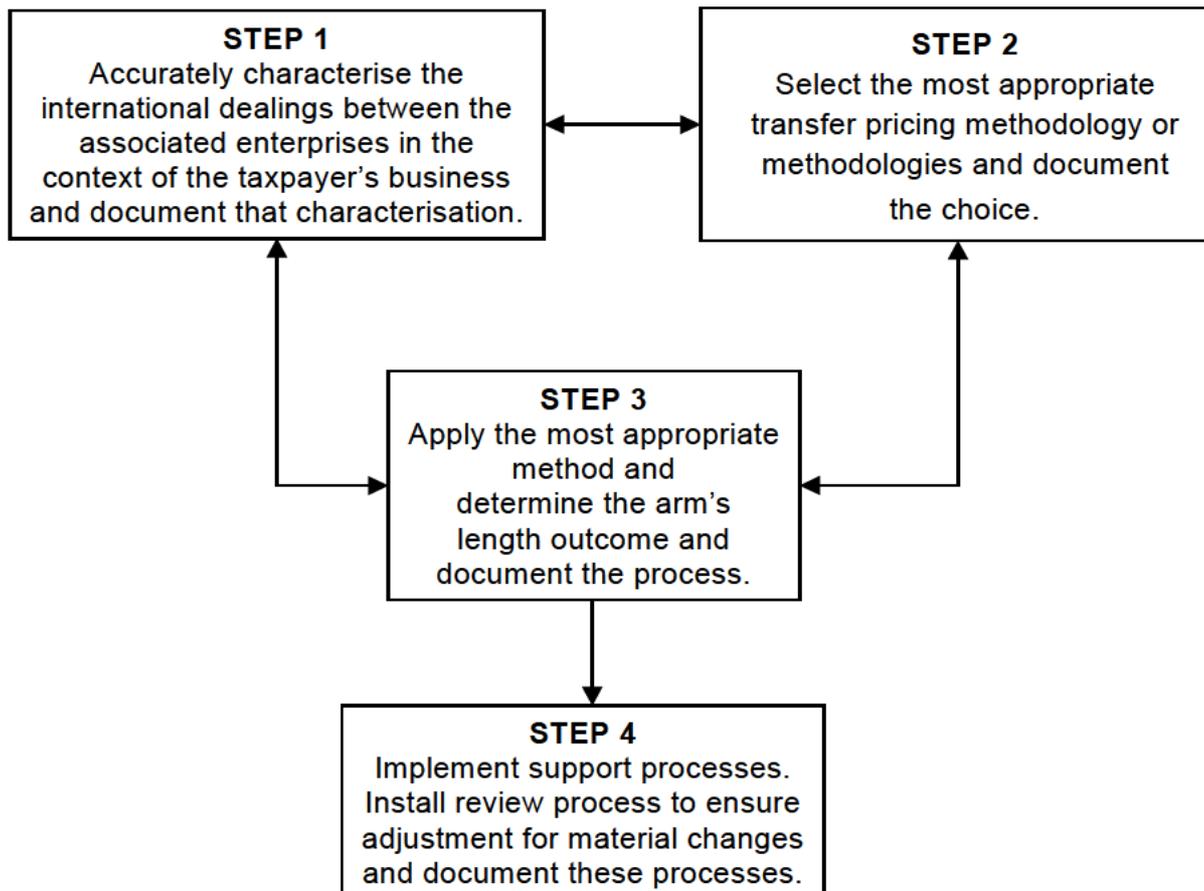
5.1 Implicit in the arm's length principle is the notion that independent parties who are dealing at arm's length would each compare the options realistically available to them, and seek to maximise the overall value of their respective entities from the economic resources available to or obtainable by them. Choosing between the available options 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 and commercial interest? (paragraphs 2.1 to 2.5 of TR 97/20).

5.2 The following four steps provide a useful basis for setting or reviewing transfer pricing for international dealings between associated enterprises:

- Step 1: Accurately characterise the international dealings between the associated enterprises in the context of the taxpayer's business and document that characterisation.
- Step 2: Select the most appropriate transfer pricing methodology or methodologies and document the choice.
- Step 3: Apply the most appropriate method, determine the arm's length outcome and document the process.
- Step 4: Ensure documentation is complete and implement support processes. Install review process to ensure adjustment for material changes.

5.3 The interaction among the four steps is shown in the following diagram. It may be seen that the process is not a linear one and it is expected that there will be movement particularly between the first three steps until the most appropriate method is selected and applied and an arm's length outcome determined.

**TESTING INTERNATIONAL TRANSFER PRICES
THE FOUR STEPS**



5.4 Taxpayers are well advised also to implement and adequately document a process that supports the selected method(s) with a review mechanism to ensure an appropriate adjustment if material changes occur. Although other approaches may achieve reliable results, taxpayers who properly develop, implement and document the four steps as outlined are less likely to find themselves exposed to transfer pricing adjustments (see also paragraphs 107 and 381 of TR 94/14) and will not be subject to penalties under section 225 in respect of these adjustments (see paragraph 2.11). Where taxpayers adopt an alternative process, they need to ensure it produces outcomes consistent with the arm's length principle and are well advised to document that process.

5.5 The information needed in the process described in this Chapter may be within the knowledge of a limited number of key

personnel not confined to the tax or accounting areas of the business. Much of it may already be recorded in a variety of documents prepared in the ordinary course of business (e.g., marketing reports and analyses). In these cases, the task may be simplified by collating and indexing existing material rather than undertaking further research and creating additional documentation. In fact, material prepared by the enterprise for its business or reporting purposes can be persuasive in explaining how an arm's length consideration can be achieved from the usual conduct of the enterprise's business or be explained by material produced during the course of conducting its business (see paragraph 6.7 in relation to small business taxpayers). Some relevant documentation may also be in the possession of associated enterprises and time and cost may be saved through collating and indexing this material.

5.6 Taxpayers may wish to adopt this four step approach in several situations. First, it could be used at the time they are contemplating or entering the arrangements with associated enterprises. Secondly, where other approaches for arriving at a consideration are used for management purposes, these may need to be reviewed at the time tax returns are being prepared and adjusted, if necessary, to the arm's length consideration for tax purposes. Finally, taxpayers may wish to satisfy themselves, or be asked by the ATO to demonstrate, that the commercial practices or other approaches used in the international dealings between associated enterprises achieve an outcome consistent with the arm's length principle. It makes good business sense to document properly the process undertaken to determine or review transfer prices.

5.7 In suggesting these four steps, the following points need to be made:

- (1) the four steps and the data collection and analysis outlined in this Chapter are neither mandatory nor prescriptive and, importantly, need to be tailored to the facts of the case;
- (2) the approach outlined below assumes that the international dealings are fairly extensive and necessitate a thorough analysis. For many small business taxpayers that have relatively simple and/or low value international dealings with associated enterprises, the extent of data collection and analysis may be minimal (see Chapter 6 of this Ruling); and
- (3) proper application by the taxpayer of the four steps to the facts and circumstances of the case should normally be sufficient to establish the arm's length consideration.

5.8 A useful guide to the types of issues and facts that might be taken into account is included in the Appendix to Auditing Standard AUS 304, *Knowledge of the Business*, prepared by the Auditing Standards Board of the Australian Accounting Research Foundation. An extract from this Auditing Standard is reproduced as an Appendix to this Ruling.

5.9 Auditing Standard AUS 304 was not created for the purposes of resolving practical problems surrounding arm's length methods. Its purpose is to illustrate the knowledge that an auditor needs to conduct an effective audit of financial reports. However, it also provides a useful guide to any person seeking to understand the business of an enterprise and the factors that determine its competitive advantage.

Is a detailed analysis required in every case?

5.10 A detailed analysis is not required in every case and the level of detail required varies, subject to the size of the business and the complexities involved. If you are a small business taxpayer please see Chapter 6 of this Ruling for discussion on the documentation issues in your case.

5.11 One situation of low complexity where a detailed analysis is not required is where dealings between associated enterprises are narrowly confined, e.g., a loan made to an offshore associated enterprise. In such a case, where it is accepted that independent enterprises would have entered into a loan arrangement (see TR 92/11), market data about interest rates could be used to determine an appropriate arm's length interest rate. The dealings still require some level of demonstrable analysis and documentation to establish that the market rates used are truly comparable to the conditions affecting the associated enterprise dealings, e.g., risk, currency, duration and other loan terms. If relevant, any adjustments for such differences should be quantified and documented but a detailed comparability analysis (see paragraph 2.32 of TR 97/20) is not required.

5.12 The level of complexity in completing a comparability or Step 1 analysis increases where, for example, a taxpayer performs manufacturing functions as well as distribution functions and has a mix of related and unrelated inbound and outbound international dealings. In this more complex example, the scope and detail in the comparability analysis increase with the need to identify business strategies as well as significant economic functions, assets and risks as a basis for selecting an appropriate methodology and benchmarks against which to assess the associated enterprise dealings.

5.13 The following two examples demonstrate how different approaches are necessary in determining the arm's length outcome,

depending on the degrees of complexity of the relevant businesses and the availability (or absence) of data on comparability.

5.14 Example: Company 1 is an Australian company which has two markets of similar size and characteristics in the USA. It sells its finished goods to a subsidiary in San Francisco and significant quantities of the same goods to an unrelated distributor in Los Angeles on the same terms and conditions. The arm's length distributor performs essentially the same functions as the subsidiary. There are no other features that might affect comparability. Establishing the arm's length consideration in this situation should be relatively simple because there are arm's length sales of an identical product under the same terms and conditions in comparable circumstances. In this case, it is suggested that a limited form of comparability analysis is needed to ensure that the internal comparable was truly comparable in all material respects.

5.15 Example: Company 2 has an exclusive agreement to import and distribute finished goods obtained from associated enterprises. The company also manufactures finished goods which incorporate components supplied by an associated enterprise, and it exports some of its own manufactured components and finished goods exclusively to other associated enterprises. In this case, analyses and data collection are generally necessary for each of those business lines to establish the arm's length outcomes. Depending upon the availability of reliable data on comparable dealings, one result may be the application of different methodologies to each of the business lines to determine the arm's length consideration.

A chart showing the detail of the four steps for setting international transfer prices

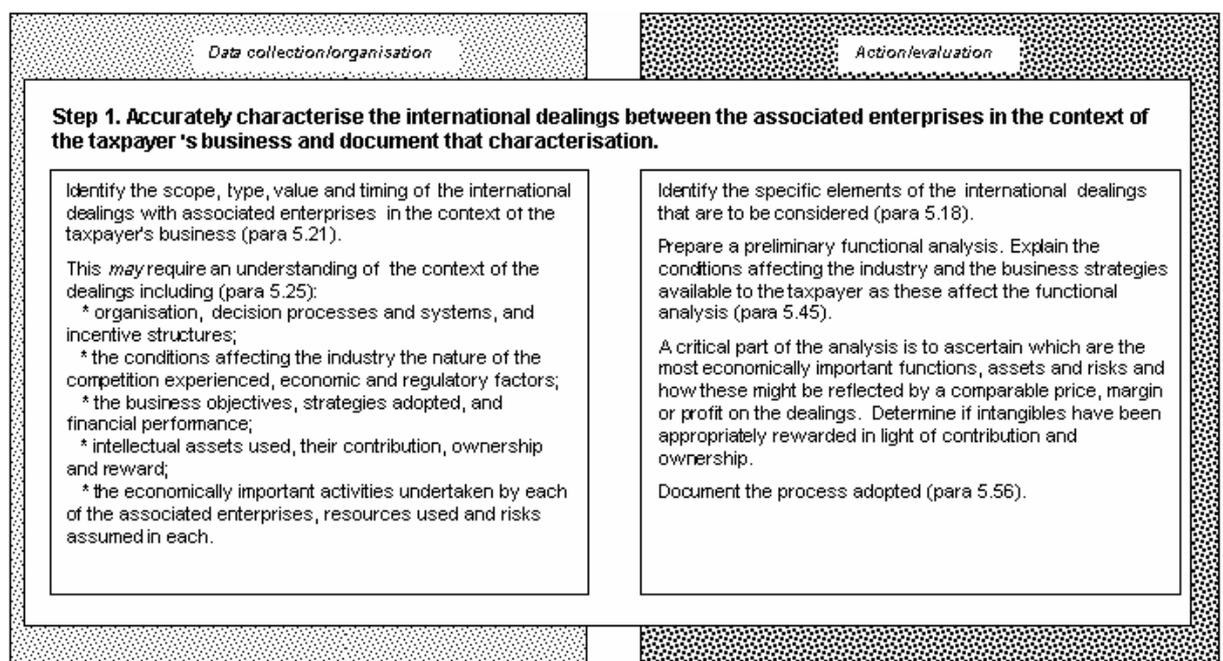
5.16 The following chart illustrates the detail included in each of the four steps (but see paragraph 5.7).

TR 98/11

Data collection/organisation	Action/evaluation
<p>Step 1. Accurately characterise the international dealings between the associated enterprises in the context of the taxpayer's business and document that characterisation.</p>	
<p>Identify the scope, type, value and timing of the international dealings with associated enterprises in the context of the taxpayer's business.</p> <p>This <i>may</i> require an understanding of the context of the dealings including:</p> <ul style="list-style-type: none"> * organisation, decision processes and systems, and incentive structures; * the conditions affecting the industry the nature of the competition experienced, economic and regulatory factors; * the business objectives, strategies adopted, and financial performance; * intellectual assets used, their contribution, ownership and reward; * the economically important activities undertaken by each of the associated enterprises, resources used and risks assumed in each. 	<p>Identify the specific elements of the international dealings that are to be considered.</p> <p>Prepare a preliminary functional analysis. Explain the conditions affecting the industry and the business strategies available to the taxpayer as these affect the functional analysis.</p> <p>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. Determine if intangibles have been appropriately rewarded in light of contribution and ownership.</p> <p>Document the process adopted.</p>
<p>Step 2. Select the most appropriate transfer pricing methodology or methodologies and document the choice.</p>	
<p>Identify the available data that may establish an arm's length consideration for each of the dealings and for the dealings taken in their entirety.</p>	<p>Determine the most appropriate methodology or methodologies based on the facts and circumstances of the particular case.</p> <p>Document the choice of methodologies.</p>
<p>Step 3. Apply the most appropriate method, determine the arm's length outcome and document the process.</p>	
<p>Refine, examine and organise the data on comparable dealings or comparable enterprises to enable comparability to be properly assessed.</p> <p>To improve comparability it may be necessary to:</p> <ul style="list-style-type: none"> * adjust the data to account for material differences in comparability, * group or aggregate data, * extend the analysis over a number of years. <p>Data points or a range of results may emerge.</p>	<p>If necessary broaden and refine the preliminary functional analysis. Prepare a comparability analysis.</p> <p>Establish the level of reliability which can be placed in the answers derived from application of the selected method and the conclusions which are drawn.</p> <p>It may be necessary to apply several methods.</p> <p>Decide on the arm's length outcome.</p> <p>Document practical considerations such as:</p> <ul style="list-style-type: none"> * assumptions and judgments made; * how data points or ranges were interpreted; or * how results from different methods were used.
<p>Step 4. Implement support processes. Install review process to ensure adjustment for material changes and document these processes.</p>	
<p>Monitor international dealings and their economic context to identify any material changes as they occur.</p> <p>Collect data relevant to evaluating the impact of these changes on the arm's length consideration.</p>	<p>If the data used to establish the outcome changes then the process and the choice of methodology should be reviewed.</p> <p>Put a system in place to support ongoing application of the chosen method in future years.</p> <p>Establish a review mechanism to ensure that if material changes occur the comparability analysis or methodology are adjusted as appropriate.</p>

5.17 In discussing the four steps, the contents of each box relevant to a particular step is considered, in the order in which they are likely to arise.

Step 1: Accurately characterise the international dealings between the associated enterprises in the context of the taxpayer's business and document that characterisation



5.18 An accurate picture of the enterprise and the activities that create profits should emerge. Within Step 1 the most important aspects are:

- (1) the identification of the scope, type, value and timing of international dealings with associated enterprises in the context of the taxpayer's business; and
- (2) the preparation of the preliminary functional analysis, a critical part of which 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.

5.19 Taken together, these points should enable the international dealings to be characterised accurately. This information is important because it enables reliable comparables to be selected that truly reflect the dealings being conducted between the associated enterprises. The ATO has found that the nature of the international dealings of many enterprises are such that there are significant functional and other differences between enterprises classified within similar industry codes. In these cases, a more insightful explanation of the nature of the business activities of the enterprise and how these affect the form of the international dealings is desirable.

5.20 The taxpayer needs to understand the nature and extent of the dealings with associated enterprises in the context of the Australian taxpayer's business, the strategies adopted by the MNE group, and the economic and market circumstances in which the taxpayer is operating. In determining whether the dealings are consistent with the arm's length principle it is important to understand:

- (1) what the international dealings with associated enterprises are;
- (2) which enterprises are party to what dealings;
- (3) how and when the dealings were negotiated;
- (4) the purpose or object of the dealings;
- (5) the property or services involved;
- (6) the contractual terms and timing of the dealings;
- (7) what the taxpayer contributes and obtains from its participation in them; and
- (8) their significance to the taxpayer's overall business activities and those of the multinational group.

Above all, it is important at the end of this first step to understand clearly the economic role filled by the taxpayer within the MNE group. This may range, for example, from that of a decentralised, largely autonomous business to that of a closely controlled service provider to the group.

Identify the scope, type, value and timing of international dealings in the context of the taxpayer's business

5.21 Taxpayers are well advised to document the scope, type, timing and value of their international dealings with associated enterprises. *Scope* refers to the range of business activities or range of business lines of the enterprise. The key characteristics of these activities or business lines need to be identified. *Type* refers to the categories set out in Question 2 of the 1997 Schedule 25A in sufficient detail to identify the

components of the dealings. *Value* refers to the dollar amounts of purchases, expenditure or sales revenue in each category, and *timing* refers to the date and/or frequency of the dealings. In many cases, more detailed information may be needed to thoroughly identify the property or services involved, the nature of the dealings, and the costs and benefits to the enterprise. For example, it is important to separate domestic and international dealings and the shares of costs allocated to each.

5.22 The dealings may include sales or transfers of goods and services, fees and charges, royalties, cost contribution arrangements, and agreements (explicit or implicit) that limit the ability of management to take action that might otherwise benefit the taxpayer's enterprise if it were acting independently in its own best interests. The terms of any agreements not evidenced by a written contract could be established from the business records and the conduct of the parties. This should include details of any set-off arrangements agreed between the parties (see paragraphs 2.112 to 2.118 of TR 97/20). Where the actual dealings differ from the contracted terms, it is important to determine the reasons why the original agreement was varied and whether the changes favour one or both parties (see paragraphs 45, 46 and 261 to 263 of TR 94/14).

5.23 Taxpayers are well advised to identify the parties involved in the dealings between the associated enterprises and establish their relationship with the taxpayer. The relationships thus identified may include formal ownership (parent-subsidiary relationship), joint venture, franchise or similar links, strategic alliances, cost contribution arrangements, common or cross shareholding, as well as informal agreements or co-operative ventures (see paragraph 1.11 of TR 97/20). When reviewing transfer prices, knowledge of how the dealings are conducted and the internal controls surrounding them can assist in gauging the likelihood that past dealings have been conducted in accordance with the arm's length principle.

5.24 These enquiries may also reveal the extent and nature of the plans, performance reports, statistics, etc., produced by the taxpayer. It may also be appropriate to examine a range of other material such as strategy documents or marketing plans, forecasts, costings, bids, capital expenditure requests and budgets, as well as documents lodged with corporate regulatory authorities in Australia and overseas. This helps develop an understanding of the business and the context in which the dealings are conducted.

Organisation, decision processes and systems, and incentive structures

5.25 Within particular enterprises in the MNE group it may be necessary to consider in detail the organisational structure, decision

making systems and processes, and how management performance is rewarded. It may also be necessary to review the capital structure of the MNE group and of the Australian enterprise, looking, for example, at the balance and sources of debt and equity funding (see paragraph 3.27 of TR 97/20). Examining these aspects can give an insight into the nature and purpose of the dealings between the taxpayer and other companies within the MNE group and may indicate non-arm's length features of the relationships.

5.26 It makes good business sense to have the following documents readily available:

- (1) documents outlining the organisation structure of the taxpayer and the structure of the corporate group both in Australia and worldwide;
- (2) documents outlining the company's internal procedures and controls which are in place to ensure that arm's length consideration is consistently determined and applied to its international dealings with associated enterprises. These would include manuals and written instructions drawn up by the company in the ordinary course of carrying on its business;
- (3) information from a range of key managerial and supervisory staff to assist in obtaining an accurate perspective of the functions, assets, risks and operational aspects of the business. This applies particularly where the enterprise is experiencing a regular turnover of key staff who might otherwise be able to explain the context and choice of strategy, especially where the enterprise adopts strategies that have a measurable effect on the arm's length outcome (e.g., particular pricing strategies) or where those strategies have not previously been documented; and
- (4) mission statements, corporate plans and divisional business plans, reports proposing and recommending strategies and relevant records of meetings of Boards of Directors or corporate management groups where recommendations for the implementation of these strategies, policies or objectives were considered and approved.

5.27 Multinational enterprises may conduct their domestic business along divisional lines. These business segments or divisions may operate as individual business centres within the enterprise and may produce separate budgets and reports outlining net contribution to profit. In understanding the organisation and business of the multinational it is important to document how the various business

segments or divisions interact, what their individual business plans are, and what their respective contribution to profit is. It is also important to document the nature and extent of dealings that occur between each divisional line and the associated enterprise.

5.28 Further, it is likely to assist in the preparation of a functional analysis if each business segment documents its key functions, assets utilised and risks assumed in furtherance of its individual objectives within the larger enterprise, as discussed at paragraph 315(a) to (c) of TR 94/14. The information needs identified in the following discussion may have to be undertaken separately for one or more of the divisions or business segments of the multinational enterprise. Combining or aggregating business segments or divisions that differ significantly in any of these factors should be avoided, if at all possible.

The conditions affecting the industry, the nature of the competition experienced, economic and regulatory factors

5.29 It is also important to document over an appropriate period of time:

- (1) the nature of the industry and the markets within which the enterprise (or its separate divisions) conducts its business, including factors such as industry development, technology, location, resource needs and innovation, market size and growth, changes in customer groups and patterns of buying, and changing channel structure;
- (2) the structure, intensity and dynamics of competition experienced, including an identification of competitors, an assessment of the economic power of suppliers and customers, the possibility of new entrants, and the potential threat of substitutes; and
- (3) any broader economic, regulatory and other factors affecting the taxpayer's business, e.g., relevant shifts in the regional and Australian economy, in international trade relations, exchange rates, and government policies (see paragraphs 2.104 to 2.107 of TR 97/20).

The business objectives, strategies adopted, and financial performance

5.30 An evaluation of the strategies of the taxpayer and the MNE group is also generally necessary and this should be documented as part of the four steps. Information on the business strategies can assist in establishing the selection of methodologies and may be very important when addressing questions associated with comparability. In considering these issues, the underlying question is whether an

independent enterprise in the taxpayer's circumstances might have been expected to have initiated or participated in these strategies or policies or accepted these objectives, and if so, what reward would have been expected (see paragraphs 3.2 and 3.3 of TR 97/20).

5.31 Examples of strategies which may be influenced by the interests of the MNE group are set out in paragraph 2.45 of TR 97/20. These include market penetration or expansion (see also paragraphs 2.47 to 2.56 of TR 97/20), product and/or service innovation, market level and location, inventory levels and obsolescence or warranty issues, distribution channel selection and management, pricing, advertising and promotion. Also relevant are strategic choices concerning capital structure, market positioning and the development of core competencies, introduction of new technologies, participation in strategic alliances and economic webs, diversification and/or integration, the development of a distinctive corporate culture, corporate image and status, knowledge management and information systems, staffing levels and salary or incentive structures.

5.32 Strategies such as these may need to be examined in order to understand the business context in which the enterprise operates. Account should also be taken of the possible existence of relevant policies, such as the provision of cross-subsidies to parts of the business, as well as any broader corporate objectives such as those concerning sales, share, growth and profitability.

5.33 For example, a subsidiary may have undertaken market development activities at its own expense and risk, and enhanced the value of an associate's brand name which previously had no value in that market. Senior management of the subsidiary may subsequently agree to the payment of a royalty or management fee to the foreign associate. The payment of the royalty or management fee may significantly erode the profitability of the subsidiary. In evaluating whether the associated enterprise dealings conform with the arm's length principle, it is relevant to examine the decision making process of senior management or the board of directors in arriving at the decision to agree to pay these fees and also incur market development expenses. It may be expected that the ATO will consider evidence as to whether the parties considered other options realistically available to the enterprise. In this regard, it may be reasonable in some situations to conclude that an arm's length party would want its contribution to market development expenditure taken into account in the calculation of any royalty (see paragraph 6.38 of the 1995 OECD Report), for example by way of a reduced price for trading stock purchased from the owner of the brand name, and the consideration should be set accordingly.

5.34 An initial assessment as to whether the economic outcomes achieved by the Australian entities are consistent with an arm's length

involvement is important. However, information on financial performance may be particularly important at a **later** stage if the methodology requires comparisons of the enterprise's performance over the relevant years or with other enterprises. The key ratios and statistics may vary depending upon the nature of the business being conducted. Usually, an application of methods requires a comparison of the level of enterprise profit arising from dealings between associated enterprises with that achieved in its arm's length dealings or with the level of profit achieved by an uncontrolled enterprise (see paragraph 2.9 of TR 97/20 for a discussion of the 'performance view' of dealings between associated enterprises).

5.35 This comparison usually turns on suitable accounting ratios or measures (see subparagraph 2.11(3) and paragraph 3.81 of TR 97/20). These ratios or measures may include:

- (1) ratio of gross profit to operating expenses;
- (2) ratio of operating profit to sales;
- (3) ratio of working capital to sales;
- (4) ratio of sales to fixed assets;
- (5) ratio of sales to inventories;
- (6) return on capital employed;
- (7) return on shareholders funds; and
- (8) economic value added (EVA), i.e., profitability relative to the firm's cost of capital.

5.36 The most appropriate ratio or ratios need to be established on the facts available. Consideration should also be given to trends which may affect the ratio/s selected.

5.37 Trends would include general factors affecting the performance of an enterprise on a macro level, such as economic conditions as well as any significant features of the particular market or market segment within which an enterprise operates. Relevant trends at the enterprise level may include trends in gearing, dividend rate, non-performing assets and stock levels, as well as in other key financial ratios.

5.38 When considering trends as part of the four steps, account should be taken of those elements or factors which have a quantifiable impact on an enterprise's profit performance over time, or could reasonably have had an impact on pricing policy at the relevant time. Projected trends and potential profit outcomes may be crucial in situations, such as APAs, and in those circumstances where taxpayers set the consideration on their dealings by reference to a profit split.

Intellectual assets used, their contribution, ownership and reward

5.39 The intellectual assets used in a taxpayer's business, and the way in which they are used, should be identified. These assets include:

- (1) internal, trade or manufacturing intangibles (see paragraph 6.3 of the 1995 OECD Report) - for example, patents, procedures, designs, databases, trade secrets, research and development, software, customer lists, information systems;
- (2) external or marketing intangibles - for example, brands, trademarks, licenses, franchises, contractual rights, customer and supplier relationships (see paragraph 6.4 of the 1995 OECD Report); and
- (3) human capital or competencies - for example, knowledge held by managers, engineers, production workers, functional specialists.

5.40 Where significant intellectual assets are found, the legal owner or owners of the asset should be identified. It may also be important to identify the parties who have contributed to the economic development of the asset (including the use of cost contribution arrangements) and thus to its current value, the extent of their contribution, and whether they have been appropriately rewarded. While careful analysis and, ultimately, judgment is still needed to determine an appropriate reward for the use of each of these assets, a better decision is likely to be made once the nature of the intellectual assets, including intangibles and their role in the profit making processes of the associated enterprises, are properly understood. It is also important to identify the expected benefit from the application of the intellectual assets. In the case of intangible property, this should be considered from the perspective of both the transferor and transferee of the property. From the transferee's perspective, the value and usefulness of the intangible property should be carefully considered (see paragraph 6.14 of the 1995 OECD Report.)

5.41 For example, an enterprise may be the legal owner of a trade mark and name which it legally protects. It may attribute a high value to these marks for which it seeks a direct reward. Under licence, subsidiaries in different countries may separately produce, market and support goods bearing this name and mark. Taxpayers are well advised to identify each party's contribution to any manufacturing and/or marketing intangibles. A shared economic ownership of the intangibles derived from the relative contribution of the parties could result. This could influence the selection of a transfer pricing method or the manner by which comparability is assessed against independent dealings.

5.42 As another example, a patented production process may be useful, but it may represent a minor advance or be fairly simple to design around the patented aspects in order to achieve a similar

outcome. This type of intangible does not add significant value and should not receive the same level of relative reward as a breakthrough patent that produces a sustainable competitive advantage.

5.43 One of the major assets which may need to be considered is a taxpayer's human resources, in particular its skilled and experienced staff. The type of staff and their duties and skills may also be a reliable guide to the nature and type of the activities that the taxpayer undertakes. Documentation which may be relevant here includes details of the experience, educational qualifications, remuneration, performance evaluation and duties of key operational staff. This would include performance agreements and statements of performance indicators for key staff. It would make good business sense to retain any written statements provided by key staff and used by the company in determining the functions, assets and risks of the enterprise as part of the functional analysis. It is recommended that documentation created in the course of dealing with arm's length parties, such as documentation created by the enterprise in tendering for work, including curriculum vitae of key staff members and areas of particular expertise, also be retained. The extent of such analysis depends on the facts and circumstances of the case. Enquiries by ATO staff should be limited to the minimum necessary, having regard to the specific information needs of the case (see paragraph 4.34).

5.44 The purpose of this analysis is to identify the human resource asset and, from the information obtained, draw some conclusions as to the importance of the skilled and experienced staff to the enterprise's activities. This analysis may be particularly relevant in cases where profit split is the methodology adopted. This analysis may be used by enterprises in service industries and those enterprises whose business activities primarily consist of the provision of services to associated enterprises, where the skill and experience of the human resources is the major asset exploited for profit.

Identify the economically important activities and prepare a preliminary functional analysis

5.45 The information that has been collected on the taxpayer's international dealings with associated enterprises may be used to provide an analysis of:

- (1) the economically significant activities or functions undertaken by each of the associated enterprises (including their nature and frequency);
- (2) the risks each of the parties assumes; and

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- (3) the assets (both tangible and intangible) used or to be used by each of the parties and the nature and extent of that use or intended use.

This is referred to as a functional analysis and is, to some extent, necessary regardless of the methodology that is ultimately selected (see paragraphs 1.20 to 1.27 of the 1995 OECD Report and paragraphs 2.35 to 2.42 of TR 97/20).

5.46 The purpose of this analysis is to gain as clear an insight as possible into what the enterprise does, the origin and use of information, where it generates costs and value, and how this might differ from other similar enterprises. At its broadest level, such an analysis results in the identification of the role of the enterprise in the chain of economically relevant activities linking basic inputs (raw materials, etc.) to end-use customers.

5.47 At **Step 1** of the four steps, it is expected that a preliminary functional analysis will identify for each party to the dealings:

- (1) the functions or activities undertaken and their economic significance;
- (2) the tangible and intangible assets (including human capital) contributed overall, and where appropriate, by function; and
- (3) the risks borne (see paragraphs 1.20 to 1.27 of the 1995 OECD Report and paragraphs 2.35 to 2.42 of TR 97/20).

For each of the main business activities of the enterprise it is recommended that a summary listing of the significant functions, assets and risks be compiled. The functional analysis may then be extended and developed in **Step 3** depending upon the methodology that is selected in **Step 2**. At that stage, it is possible that the type of analysis that has been undertaken on some or all of the dealings between associated enterprises may be repeated using the available information on uncontrolled dealings. This allows comparisons to be drawn between the two different types of dealings.

5.48 Often, it will be prudent to identify specific activities within broad groupings. For a manufacturing enterprise these might include inbound logistics, operations, outbound logistics, marketing and service, procurement, research and development, human resource management and corporate infrastructure. Within each of these groupings there are specific functions such as inspection, component fabrication, assembly, order processing, stock holding, advertising, sales promotion, spare parts systems, materials procurement, process design, market research, staff selection and training, accounting and finance, credit and collection and corporate planning. For a financial services firm, the groupings might include the different services offered

(transaction services, credit services, investment and international services), the operations needed to provide these services (clearing operations, asset management, debt recovery, portfolio management, trading, offshore services), as well as management information systems, finance, legal and human resource management. As before, each of these might be further subdivided into specific functions or activities.

5.49 Some direct questions of the following type may be helpful in identifying the economically important activities:

- (1) what is the nature of your business?
- (2) how does this enterprise add value?
- (3) what is affecting the performance of this enterprise?
- (4) are there any unique factors in your success?
- (5) what examples are there of cases where the strategies/success factors did/did not work? and
- (6) what assistance do you receive and what transfers have been made to and from the enterprise?

5.50 The compilation of lists of functions, assets and risks, however detailed, does not in itself indicate which of the functions are the most significant, or economically the most important, to the value added created by the business activities of the enterprise. 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 in terms of an arm's length price, margin or profit, or consideration in respect of the dealings. For example, this may include functions that:

- (1) represent a significant proportion of operating costs;
- (2) are subject to a distinctive set of cost drivers;
- (3) may be performed by competitors in different ways; or
- (4) may be important in differentiating one competitor from another.

Cost drivers might include scale, scope, past experience, process technology, complexity, work force skills and participation, quality management, capacity utilisation, layout efficiencies, product or process design, and exploitation of supplier or customer linkages.

5.51 It is not necessary to value separately each function, taking assets and risks into account. The purpose of the examination is to identify and to take into account any comparison with other enterprises, the economically significant functions performed, assets contributed and risks assumed. Adjustments are to be made, where possible, for any material differences and to understand the qualitative nature of the functions, assets and risks. This enables a comparison to be made with

other enterprises that have similar functions, assets and risks so that the key operations in the value chain can be weighted against each other.

5.52 A functional analysis can be performed with varying levels of detail and can serve a variety of purposes. The analysis may be applied on a product or divisional basis for individual or aggregated transactions, or it could be applied up to a corporate group basis. The scope of the analysis will be determined by the nature, value and complexity of the matters covered by the international dealings and the nature of the taxpayer's business activities.

5.53 Care needs to be taken to identify and compensate for those decisions which may transfer risks between the associated enterprises. The following example shows how an obsolescence risk can be transferred from the parent to the subsidiary.

Example: The market for the product is characterised by significant changes in product technology which results in the build up of excess stock of products embodying outdated technology in the inventories of the parent enterprise. The product has become less competitive in all of the MNE group's retail markets. Associated distributors of these products are directed by the parent to take part of this excess inventory at the usual inter-company price and on the same payment terms. Because of the need to offer discounts in order to sell the stock, the dealings erode the subsidiary's profitability. In an arm's length situation, the distributor may choose not to purchase the product, or may attempt to negotiate changes in the terms of the purchases including volumes, price, rebates, etc., in order to protect its own profitability.

The functional analysis and its use in selecting comparables

5.54 In terms of the preliminary functional analysis, it is prudent to continue the analysis to the point where the nature of the business activities of the enterprise is accurately established, where the economic significance of the international dealings (and of each of the component elements) can be clearly identified, and where the economic contribution of each party to the dealings is clearly apparent. The analysis of function, assets and risks would be useful in:

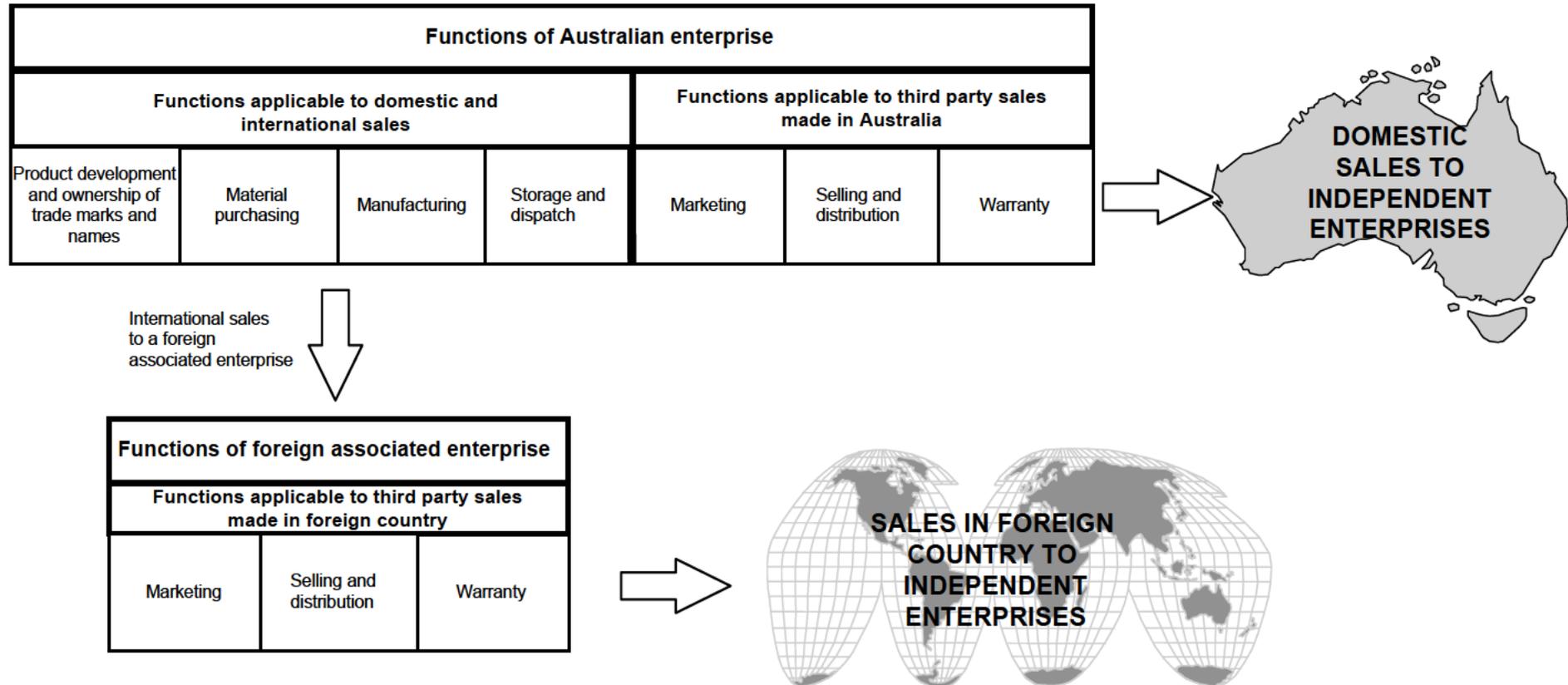
- (1) determining the availability of comparables in relation to prices or functions;
- (2) assessing the degree of comparability with the functions, assets and risks in respect of the taxpayer's uncontrolled transactions or with those undertaken by other enterprises being considered as possible comparables; and

- (3) assessing the relative weighting of the functions, assets and risks of each of the associated enterprises that are a party to the international dealings in cases where an apportionment methodology, such as a profit split, is needed.

5.55 Following is a diagrammatic representation of a simplistic functional analysis illustrating how a preliminary analysis can assist in the selection of an appropriate methodology. Details of risks assumed, assets utilised and sources of comparable data have not been shown to help clarity.

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This diagrammatic representation of a simplistic functional analysis illustrates how a preliminary analysis can assist in the selection of an appropriate methodology. Details of risks assumed, assets utilised and sources of comparable data have not been shown to help clarity.



What does this simplified analysis highlight?

- Third party sales are made in two different markets and are not comparable. Their use in calculating the transfer price between the associated enterprises is limited because, compared to the intercompany sales, the sales to independent enterprises occur at a different level in the market.
- The primary functions needing to be rewarded by arm's length gross margins in any application of the cost plus or resale price methods have been identified. Refinement and development of the preliminary analysis may assist with evaluating any comparables depending upon the availability of data.
- The functions of both associated enterprises have been broadly identified.

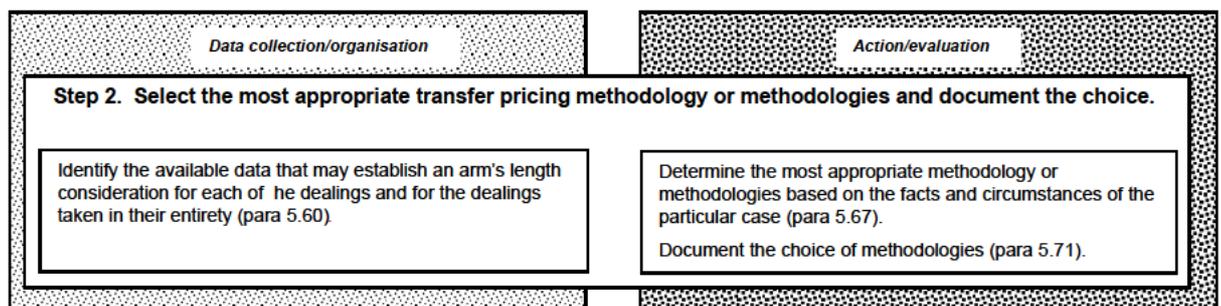
Documenting Step 1

5.56 Taxpayers are well advised to identify those parts of the above commentary on **Step 1** relevant to the facts and circumstances of their case and document these. It is strongly suggested that all documentation created or obtained in completing the analysis comprising **Step 1** should be retained, at least until a new analysis is completed, and preferably for as long as possible after this to detail how business strategies and the major functions, assets and risks of the enterprise change over time. It makes good business sense to retain documentation that evidences a change in the business circumstances of a taxpayer so that the evolution of the business, and business relationships can be traced. This may mean retention beyond the statutory period, where such changes extend over a number of years and represent a major shift in the position of the enterprise.

5.57 It is appreciated that the costs of completing a **Step 1** analysis may be significant, particularly where complex issues are involved. It is not, therefore, expected that a new analysis should be carried out within a prescribed time frame, but we do recommend an ongoing process of review. A new analysis is only useful where there is a material change in any of the elements that make up the **Step 1** analysis which have a significant impact on the taxpayer's business. In this regard, refer to the discussion on **Step 4** at paragraphs 5.90 to 5.100.

5.58 As stated at paragraph 5.52, the **Step 1** analysis may be performed with varying levels of detail and it would be desirable that there be documentation of the reasons why the particular level of the analysis was conducted at, for example, a product or divisional level, a whole of enterprise level or a corporate group level.

Step 2: Select the most appropriate transfer pricing methodology or methodologies and document the choice



5.59 **Step 2** primarily includes the compilation and assessment of data to be used and the selection of a methodology for establishing acceptable standards of comparability or in determining the appropriate allocation of profits or income between the associated enterprises.

Identify the available data that may establish an arm's length consideration for each of the dealings and for the dealings taken in their entirety

5.60 In this step it is important to ascertain the extent and reliability of the uncontrolled data that is available (see paragraphs 2.59 to 2.66 of TR 97/20). The nature of the available data, and especially the amount and reliability of detail on the factors entering into a comparability analysis, are very important issues in the selection and application of a methodology. The data that might be sought will vary from case to case. It could mean investigating the availability of open market prices and terms for comparable transactions in particular types of commodities. However, in other cases it may mean enquiring into the availability of information about the gross or net profit margins or business risks of enterprises that may have comparable functions. See paragraphs 2.1 to 2.21 of TR 97/20.

5.61 Different transfer pricing methodologies also require that different basic data be created or obtained for their successful application. Some information, such as data on potential internal comparable uncontrolled prices, is more readily available to a taxpayer than other types of relevant information. Another type of information which may be more readily available is data from an offshore parent company identifying the channel profit on transactions that the Australian subsidiary participates in. Insights into the nature of the data that is necessary to apply particular transfer pricing methodologies may be found in Chapter 7 and in Chapter 3 of TR 97/20.

5.62 The information collected in the first step should identify whether the taxpayer's case raises transfer pricing issues and, if so, identify the dealing or dealings that are of concern. However, to assess the arm's length return for the dealing or dealings of interest, other data may need to be collected.

5.63 For example, the additional data to be collected may be important in evaluating the role of intangible assets used in the business (refer also to paragraphs 2.22 to 2.24 of TR 97/20). To illustrate, the distribution/reseller network utilised by a controlled importer may be essential in creating and realising the value from a particular product. If the particular methodology being considered necessitates an evaluation of the proper return on such intangible

assets, then specific data concerning development costs, economic ownership, and the importance or value of the reseller network may be relevant.

5.64 Where comparability is difficult to assess or can only be approximated, it may be important to consider wider issues surrounding the dealings. This may include examining and documenting the circumstances surrounding the decision to enter into the dealings or, in some cases, how the property was dealt with in subsequent dealings.

5.65 In this regard, the right to exploit property protected by copyright may be assigned to a related foreign enterprise. If there are subsequent reassignments to other associated enterprises in third countries (perhaps in a treaty shopping arrangement) prior to ultimate licensing to a third party, it may be relevant to examine these subsequent dealings in the course of establishing an arm's length consideration that has regard to the value of the intangible. This may include an examination of the consideration that each received, the functions they performed, the risks they undertook and the assets they employed.

5.66 The collection of further data should be done on a selective basis to provide further insight into the important value adding activities of the enterprise and to get a good sense of their relative importance to the taxpayer's income earning activities. This facilitates comparisons with arm's length parties and evaluation of the appropriateness of profit splits. It is again important to assess the reliability of the data and to ensure that it is sufficient to allow the practical application of the methodology selected.

Determine the most appropriate methodology or methodologies based on the facts and circumstances of the particular case

5.67 Deciding on the most appropriate methodology depends firstly on the specific nature of the dealings and then on the extent and reliability of the data available or reasonably accessible (see paragraphs 3.6 and 3.7 of TR 97/20). It is not normally sufficient to operate on broad classifications of businesses (e.g., distributors). Not all businesses can be simply categorised. Within broad groupings, unique or critical attributes and strategies can significantly alter the characterisation of the business and therefore affect the selection of comparables. This may also affect the choice of methodology and therefore the selection of comparables.

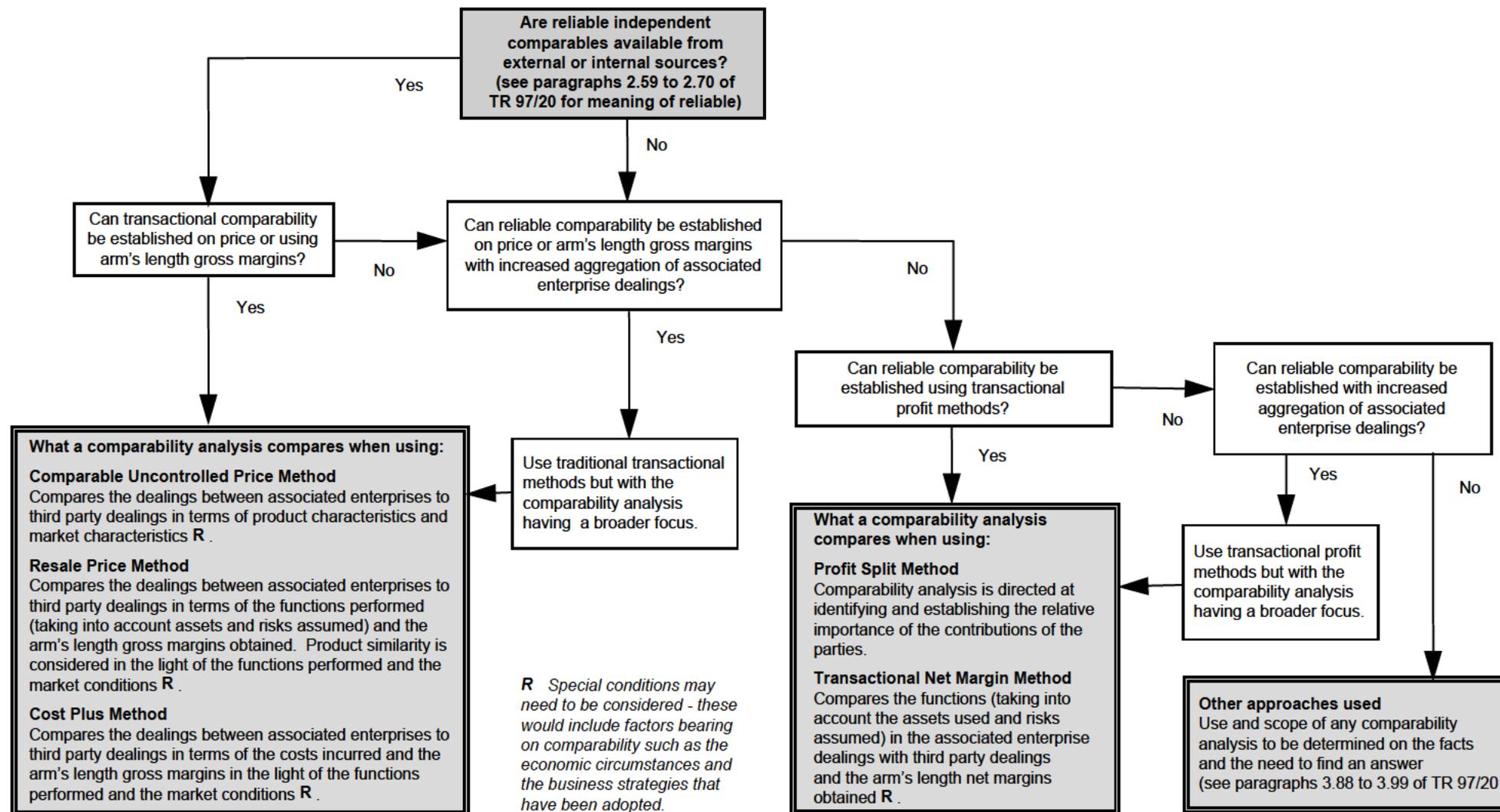
5.68 **Example:** An enterprise imports, distributes and markets the products of an associated enterprise. It also extensively services its dealer network, conducts market research and intelligence functions for the associate, presents the product to the market

according to the instructions of the parent and may employ senior staff from the associate in key positions to ensure consistency with the overall group policies. Sometimes, it may implement particular strategies and incur significant expenses in pursuing group policies. In considering what might comprise a suitable comparable in the context of the selection of a methodology, it may be appropriate to categorise the true nature of the enterprise's dealings as those of a service provider to its associate. As a result, it may need to be considered whether the better approach is to establish a return on costs through some form of aggregated return on cost ratio regarding the taxpayer as a service provider rather than as a wholesaler.

5.69 In some circumstances, it may be possible to apply a particular method to only part of the relevant dealings of a taxpayer. Sometimes, because of different activities performed, an enterprise can have a mix of methods successfully applied to its dealings (paragraph 3.4 of TR 97/20, paragraphs 100 and 367 of TR 94/14 and paragraph 1.69 of the 1995 OECD Report).

5.70 The following chart broadly outlines the comparability issues to be considered for the purpose of selecting the most appropriate methodology(ies).

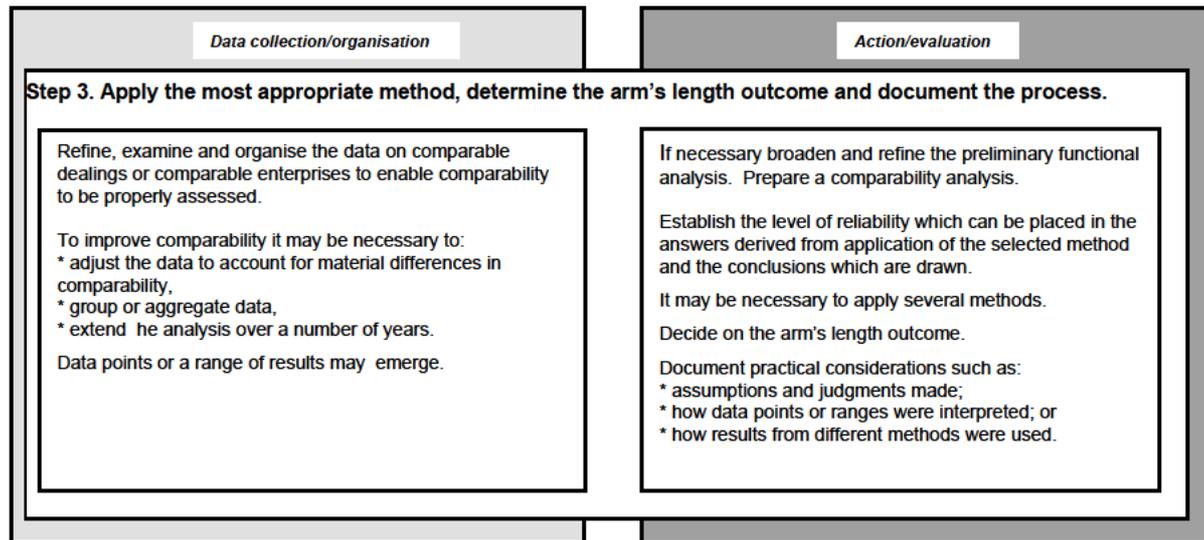
Availability of reliable comparables affects the choice of the most appropriate methodology and the resultant comparability analysis is used differently with each method.



Documenting the choice of methodology

5.71 Taxpayers are well advised to document the process used in selecting the methodology, including reasons why the particular methodology was selected. While a taxpayer is not required to consider exhaustively and eliminate methodologies, it may be prudent for a taxpayer, who of its own volition considered a number of methodologies, to document its reasons for discarding some of those methodologies.

Step 3: Apply the most appropriate method, determine the arm's length outcome and document the process



Refine, examine and organise the data on comparable dealings or comparable enterprises to enable comparability to be properly assessed

5.72 Under **Step 3** the functional analysis begun in **Step 1** is reviewed with the specific needs of the chosen methodology or methodologies in mind. The factors to be considered are outlined in Chapter 3 of TR 97/20 for each of the methodologies. The analysis makes use of the data collected in the earlier steps, which may need to be supplemented where a detailed comparability analysis is to be completed in the context of the chosen methodology or methodologies.

5.73 Some of this data may involve projections of profit splits or outcomes from dealings. The data would be gathered and organised in such a way as to demonstrate how the projections are consistent with what an arm's length party might obtain. With regard to the extension

of the functional analysis in this step, data on profit projections would be relevant and it is desirable to retain this and other documentation supporting or supplementing the functional analysis or recording ratios of financial performance.

If necessary broaden and refine the preliminary functional analysis

5.74 One situation in which a refinement of the preliminary functional analysis would be advisable is where data needed to establish comparability is missing but potentially available. If this is the case, it is important to revisit **Steps 1** and **2** to gather the necessary data to apply the methodology. Taxpayers are also well advised to refine the preliminary functional analysis in the light of any relevant information on the functions, assets and risks of the enterprise obtained in **Step 2**. A taxpayer is well advised, in this step, to refine and apply relevant financial ratios or measures, the information in relation to which has been collected in **Step 1** (see paragraphs 5.34 to 5.38).

Prepare a comparability analysis

5.75 Structuring the available data in the form of a comparability analysis of the type outlined in paragraph 2.32 of TR 97/20, addressing the issues set out in paragraph 2.28 of that Ruling, enables the selected methodology to be applied properly.

Improving Comparability

Introduction

5.76 Some of the data may need to be refined or adjusted to improve comparability. This may be particularly important in those cases where the enterprise is engaged in strategies (special conditions) which ought to be taken into account in determining the arm's length consideration. Some of the data may be incomplete, and some of the data may be irrelevant to determining an arm's length outcome. It is possible that further, more detailed, data may need to be collected at this stage to supplement the comparability analysis. In practice, there may be gaps in the available data which necessitate further enquiries of the type already conducted.

5.77 In some cases, the selected methodology may prove incapable of practical implementation. In these cases, the selected methodology and its reliability may need to be reconsidered against other methods that could achieve greater reliability.

Adjust the data to account for material differences in comparability

5.78 Factors affecting comparability, and which may require adjustment for material differences, are comprehensively discussed in Chapter 2 of TR 97/20 (for example, paragraphs 2.67 to 2.70 on adjustments for differences in accounting treatment). An example is different levels of accounts payable between the enterprise and the potential comparable.

Group or aggregate data

5.79 Refer to paragraphs 2.73 to 2.82 of TR 97/20.

Extend the analysis over a number of years

5.80 Refer to paragraphs 2.96 to 2.98 of TR 97/20 for a discussion of this issue.

Establish the level of reliability which can be placed in the answers derived from application of the selected method

5.81 Refer to paragraphs 2.59 to 2.66 of TR 97/20 for discussion on establishing the reliability of data and, in particular, to the decision tree at paragraph 2.65 of that Ruling.

Data points or a range of results may emerge

5.82 Refer to the discussion on range in paragraphs 2.83 to 2.95 of TR 97/20.

It may be necessary to apply several methods to obtain a reliable result

5.83 Refer to paragraph 2.87 of TR 97/20.

Decide on the arm's length outcome

5.84 It is relevant to demonstrate how the methodology used actually produces an arm's length outcome for the dealings between the associates. That is, it is necessary to show how the data has been used in the application of the selected methodology to determine the arm's length result. When this step is completed, there should be sufficient documentation and reasoning to explain how the outcome is consistent with what arm's length parties would have achieved.

Documenting Step 3

5.85 The above commentary on **Step 3** raises a number of key issues, including the refinement of the functional analysis, preparation of a comparability analysis and steps taken to improve comparability which a taxpayer may be well advised to document. For a commentary on the types of documentation which may be relevant to particular arm's length pricing methods, see Chapter 7 of this Ruling.

5.86 Documentation outlining the application of the company's comparability study to the determination of the pricing outcome is also relevant in this step, which is the conclusion of the processes of analysis and documentation outlined in earlier steps. Little additional documentation should need to be created in this stage.

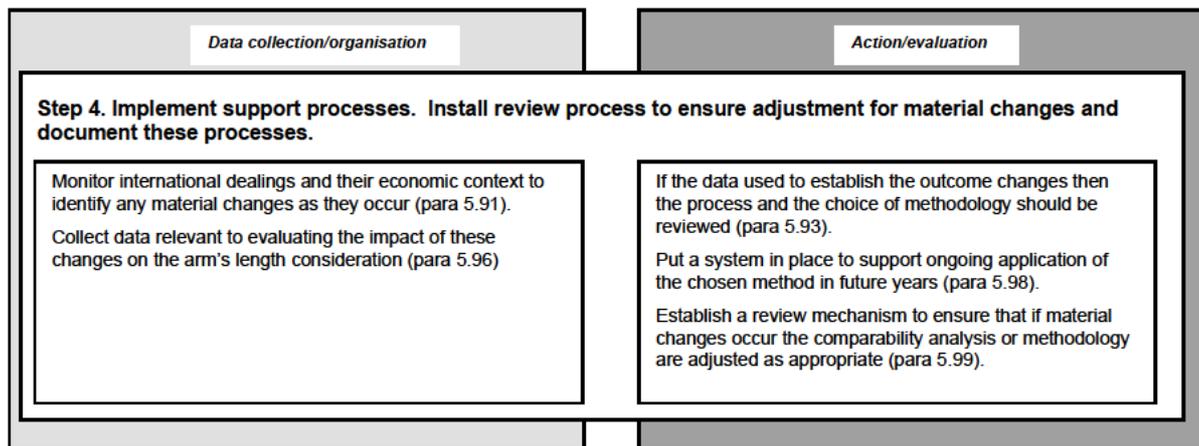
5.87 It will be of great assistance to have documentation outlining the performance reports generated by the enterprise which may be used to verify on an on-going basis the arm's length outcome of the pricing system between the associated enterprises. These reports may be used to conduct test checking of the pricing processes.

5.88 Taxpayers are well advised, at this stage, to record considerations taken into account in moving from the comparability analysis and application of the transfer pricing method to the determination of an arm's length outcome. This includes any assumptions made in interpreting data and applying the method, judgments made in the determination of the arm's length outcome, interpretation of data points or ranges to arrive at an outcome, and the use and interpretation of results where more than one methodology is used.

5.89 Proper implementation by a taxpayer of its process for the setting of its transfer prices with associated enterprises for tax purposes would require the taxpayer to:

- (1) undertake an appropriate process that seeks to arrive at an arm's length outcome, having regard to the principles outlined in this and other related Rulings;
- (2) rely on the outcomes generated by application of its process for the purposes of lodging a correct tax return;
- (3) apply its process to all its associated enterprise dealings;
- (4) undertake reviews of its process when these are needed and making appropriate changes as necessary to its process; and
- (5) preferably document the process that is being implemented.

Step 4: Implement support processes. Install review process to ensure adjustment for material changes and document these processes



5.90 Where a methodology is being used on a continuing basis, the choice of methodology and the data used to establish the consideration need to remain valid. The methodology and the data can become outdated and unreliable if there are material changes in the business or its business environment, or if the data available to apply the methodology change. For example, data on comparable dealings may cease to be available or better sources of data may be found.

Monitor international dealings and their economic context to identify material change as it occurs

5.91 **Step 4** involves an ongoing monitoring by the taxpayer of its process for setting arm's length transfer pricing. It is highly recommended that taxpayers document the steps taken to monitor the continuing relevance of any process for setting arm's length transfer pricing. Where this monitoring indicates that a change in the process may be required, it may be prudent to document the factors that lead to this conclusion, as well as the review of the process itself and any adjustments to the parameters of the process that arise as a result of the review.

5.92 The types of questions that may need to be addressed and documented as part of any such review include the following:

- (1) **What has changed?** For example, new competition in an existing market or entry into a new market, development of new products or know-how, new business strategies, impact of economic conditions on a specific market or business segment, change in the

incidence of risk, or internal changes such as changes in the capital structure, management or ownership changes;

- (2) **What impact do these changes have on the business, its expected outcomes, pricing policies, selection of methodology, and the application of that methodology?** Market share analysis, profit forecasts, revised mission statements, business plans, statements of objectives and other strategic documentation would assist in establishing the significance of changed circumstances to an enterprise's overall business. Any documentation created when pricing methodologies are reconsidered is of particular importance; and
- (3) **Does this change also affect other enterprises which form the basis for arm's length comparisons?** In such cases, if changes have a material effect on arm's length comparables it will be necessary to reconsider the appropriate pricing methodology or its application. It is prudent to adequately document any process of reconsideration.

If the data used to establish the outcome changes then the process and the choice of methodology should be reviewed

5.93 Representations have been made that if a taxpayer has selected a methodology which appears to be appropriate and suited to the circumstances of a particular segment of the taxpayer's business, then the process of selection and application of such a method need not be continuously reviewed by the taxpayer in relation to future transactions. It has been further suggested that if a taxpayer selects and applies a methodology and maintains business in line with that methodology, then it need not reconsider its pricing policy in relation to future transactions. These representations are not accepted. Business does not operate in a static environment, nor does the arm's length principle operate without having regard to the possibility of changed circumstances (see paragraph 5.3 of the 1995 OECD Report).

5.94 In carrying on business, independent enterprises generally display some degree of flexibility in their business strategies by seizing opportunities available in the markets in which they operate or by establishing additional markets. Adapting to a changing business environment on a global scale could see business enterprises developing new products, exploiting skills or resources and developing new markets. This process may create new assets or cause an enterprise to undergo major structural changes and could lead to a

revision in its expectations of outcomes in accordance with these changes.

5.95 **Example:** A subsidiary of a foreign MNE group may initially be established in Australia as the sole distributor of the products of the MNE group. The Australian subsidiary may, at the time of its establishment, undertake no manufacturing activities and act simply as a wholesaler or retailer of the products of the MNE group. In such a case, the taxpayer's process for setting its transfer prices may suggest that the most appropriate method is a resale price method using gross margins, benchmarked against those obtained from entities undertaking comparable wholesaling or retailing functions. Some years later, the nature of the Australian subsidiary's business may have materially changed as a result of it undertaking manufacturing activities in Australia which add significant economic value to the products of the MNE group, or having embarked upon a strategy of exporting its products to the Asia/Pacific region, in addition to continuing to act as a wholesaler or retailer of the products of the MNE group. As the nature of the taxpayer's business has materially changed, it would not necessarily be the case that a resale price method would continue to be the most appropriate method to use for future dealings.

Collect data relevant to evaluating the impact of these changes on the arm's length consideration

5.96 A number of documentation issues arise. For example, situations may arise in respect of the price charged for the supply of minerals or metals in a long term supply contract, the royalty rate charged to an associated enterprise for the right to use valuable intangible property, or the costs allocated to an associated enterprise for the provision of services to it by other members of an MNE group.

5.97 Where taxpayers are involved in revisions or renegotiations of existing international dealings with associated enterprises, it is desirable that information about the following factors be readily available:

- (1) the terms of the new agreement;
- (2) the changed circumstances which have led to the need for the revision or renegotiation;
- (3) the analysis undertaken to support the revised transfer price or terms of the arrangement including adequate detail of external benchmarking undertaken and the pricing methodology used; and
- (4) the basis upon which it is considered that the revision or renegotiation is consistent with what arm's length

parties would have done in the same or similar circumstances (i.e., that it would be usual for arm's length parties to revise or renegotiate the terms of a comparable arrangement and that the approach adopted is consistent with what an arm's length party would have done, in the taxpayer's circumstances). Refer also to paragraph 5.27 of the OECD Report.

Put a system in place to support the ongoing application of the methodology

5.98 It is strongly recommended that taxpayers put in place a process to apply the chosen method to the facts and circumstances in future years. Taxpayers are well advised to include a documentation stage as part of this process, with the amount and type of documentation generated depending largely on the method applied.

Establish a review mechanism to ensure that if material changes occur adjustments are made

5.99 There can be no prescription for how often a review by a taxpayer of its process should be undertaken, or what changes in circumstances would make a review of a taxpayer's process necessary. As a general rule, where there has been a significant impact on factors important to the conduct of an enterprise's business, or any shift in the critical assumptions which form the basis for the selection and application of a methodology, a detailed review of process may be required and, if necessary, **Steps 1 to 4** should be repeated, having regard to the changed facts and circumstances.

5.100 In implementing the four steps and documenting this process, a taxpayer applying the process in a detailed manner satisfies most, if not all, of the documentation requirements for an APA (see TR 95/23). Taxpayers completing the four steps in these circumstances, while they are likely to fall into a high or medium-high quality level, may wish to consider seeking an APA at this point to provide certainty for their transfer pricing outcomes.

Chapter 6: Documentation issues for small business taxpayers and entities with low levels of international dealings

6.1 Small business taxpayers and taxpayers with relatively low levels of international dealings with associated enterprises (in this

Ruling collectively referred to as 'small business taxpayers') need not create documents beyond the minimum necessary to arrive at arm's length outcomes in the context of their business (see paragraph 1.5). However, this usually involves the creation of some documentation, in addition to that which would otherwise be created in the ordinary course of business (see paragraph 1.8). The circumstances in which a taxpayer does not require at least some level of analysis of external data upon which to base any comparison of its international dealings with associated enterprises may be very limited in the Australian context. Even in cases where reliable internal benchmarks (see paragraphs 2.13 to 2.15 of TR 97/20) exist, a less detailed functional analysis combined with an assessment of any external data available about price and/or performance, provides a greater degree of certainty and a reduced risk of adjustment by the ATO.

6.2 The various possible situations arising in business do not lend themselves to a code of practice or formal process being spelt out for small business taxpayers. The wide range of situations give rise to different judgments about what to do, or not do, with no consistent line of reasoning emerging. Small business taxpayers need to exercise good commercial judgment in determining the level of documentation they think appropriate for their international dealings with associated enterprises.

6.3 For example, a small business which has turnover of \$10 million and international dealings with associated enterprises of \$500,000 may not deem it prudent business management to undertake extensive analysis and documentation of its transfer pricing practices to demonstrate compliance with the arm's length principle. This is an exercise of commercial judgment made by a manager having regard to the particular circumstances of the taxpayer's business, the complexity of the dealings and the risk of an ATO review.

6.4 On the other hand, if the particular example above involves a dealing that is narrowly focused and can be benchmarked against arm's length outcomes by reference to readily available data, then a prudent manager, at little cost and with little effort, could document the process used and the comparison with arm's length outcomes.

6.5 In order to assist small business taxpayers, the ATO suggests managers consider the following issues to assist in determining the nature and extent of documentation required in order to satisfy themselves that international dealings with associated enterprises accord with arm's length outcomes:

- (1) Is the dealing significant, in terms of quantum or proportionality, to the overall business turnover?
- (2) Are there any features of the dealing(s) that make them unusual, one-off or distinguishable from international

dealings with associated enterprises that had been assessed against the arm's length principle? and

- (3) Would the features in (1) and (2), or other features of the dealings, lead the ATO to question their basis or outcomes?

6.6 If the answer to any of (1) to (3) above is 'yes', then the small business taxpayer manager would want to consider what further work might be done to satisfy themselves and the ATO of the arm's length nature of the dealings. This is an exercise in commercial judgment, balancing the risk associated with doing nothing and the potential outcomes of that decision (e.g., non-compliance with the law and ATO intervention) with the cost of doing something, perhaps only a bare minimum, that may satisfy these concerns.

6.7 Having done this cost/benefit analysis, the prudent small business taxpayer manager may then ask more questions about the nature of documentation available. These questions would include:

- (1) Are the documents prepared in the ordinary course of business sufficient to demonstrate compliance with the arm's length principle?

Many small business taxpayers often prepare the same type of documentation as large multinational enterprises operating in Australia. The corporate regulatory framework and the general law, together with routine management reporting requirements, may already provide elaborate documentation to assist in establishing the business rationale for many of the relevant dealings. (See paragraph 5.5.)

- (2) Are there any broadly comparable dealings with associated enterprises in common with arm's length parties, in similar circumstances and during the same period?

The prudent small business taxpayer manager should then have regard to the discussion in TR 97/20 concerning the various internationally accepted transfer pricing methodologies. This present Ruling deals with documentation issues associated with the various methodologies in Chapter 7. Other material that could provide guidance is the treatment of the four steps (Chapter 5 of this Ruling), appropriately modified to suit the circumstances of the small business taxpayer, taking into account the risk of ATO intervention and the quantum / proportionality issues raised above. The four steps are flexible enough to accommodate the full range of business types and business sizes.

- (3) Is there any broadly indicative open market data that could be used to support the business outcomes as being commensurate with those that arm's length parties would anticipate? (See Chapter 10 of this Ruling and paragraphs 2.25 to 2.27 of TR 97/20.)

6.8 Having asked these and other basic questions, the small business taxpayer manager would assemble the data that the answers to these questions would yield, together with any explanatory/additional information, and make a commercial judgment about the result and the availability, coverage and reliability of the data that supports it. In many cases this will suffice. In other cases, the manager may need to go further in applying the four steps, and again have to balance cost versus benefit.

6.9 Broad indicators of price, margin or profit performance may provide taxpayers with a degree of comfort about whether their outcomes satisfy the arm's length principle.

Chapter 7: Documentation relevant to the selection and application of particular pricing methodologies

Introduction

7.1 The following section deals with specific documentation issues that emerge from an application of the methodologies described in TR 97/20. The suggestions on information and documentation outlined in this Chapter reflect the ATO's expectation of what a taxpayer would be well advised to provide for each of the various methods in order to demonstrate that the methods have been applied consistently with the arm's length principle.

7.2 In addition to documentation issues arising from the application of specific methodologies discussed below, it is also important for taxpayers to document the process involved in the selection of particular methodologies. Documentation that establishes consideration of more than one methodology or the rejection of a particular methodology assists the taxpayer in demonstrating to the ATO the integrity of the process undertaken and the suitability of the selected methodology having regard to the taxpayer's facts and circumstances.

7.3 Only general guidelines can be given on the type of documentation that would be relevant when selecting or applying specific transfer pricing methodologies. It is not possible, or desirable, to provide a formulated checklist outlining documentation

requirements for any particular methodology because of the enormous range of possible situations encountered in practice.

Documentation relevant to applying a comparable uncontrolled price methodology

7.4 The comparable uncontrolled price ('CUP') method is discussed in paragraphs 353 to 358 of TR 94/14, paragraphs 3.10 to 3.19 of TR 97/20 and paragraphs 2.6 to 2.13 of the 1995 OECD Report. A CUP methodology seeks to compare prices used in comparable uncontrolled transactions with the price used in the controlled transaction. Such a comparison may involve consideration of a number of factors which are discussed in TR 97/20 at paragraphs 2.28 to 2.58. Documentation evidencing the issues considered in undertaking such a comparison would assist the taxpayer to demonstrate to the ATO that the price paid or received for the uncontrolled dealing is an appropriate benchmark for the purposes of the arm's length principle. This may include documentation relating to the following issues:

- (1) the physical identity of the property or services being compared. In the case of complex, high value property or services, this could include establishing technical differences in the specifications of the benchmark property or services and the impact of these differences on the operation and effectiveness of the product in an end-use situation;
- (2) differences in the quality of the property or services being compared. This could extend to identifying any differences in the raw materials used and the manufacturing processes and their impact on quality;
- (3) any valuable trade or marketing intangibles associated with the property or services being compared and their impact on price. If such property or services is being used as a comparable taxpayers would be well advised to identify and quantify the impact of any valuable intangibles associated with the sale of the property or services;
- (4) whether any services are supplied in relation to the product. There may be training, after sales service or warranty arrangements that differ between the two situations being compared. These should be analysed and quantified and each step adequately documented;
- (5) conditions other than differences in the property or service that may impact on comparability. These could

- include business strategies (e.g., marginal costing or market penetration), contract terms and conditions, volumes, differences in markets and other features of the dealings or enterprises being compared;
- (6) the quantification of differences identified and, where those differences have a material effect on price, details of the adjustments made to the price to make it a reliable comparable;
 - (7) processes undertaken to determine the reliability of any internal comparables used as a benchmark (see paragraphs 2.13 to 2.15 of TR 97/20);
 - (8) an analysis of the reliability of comparable data being used (see paragraphs 2.59 to 2.66 of TR 97/20);
 - (9) any analysis undertaken which demonstrates that there is no CUP or that one uncontrolled situation is a more reliable CUP than another;
 - (10) reasons for arriving at the number of comparables selected; and
 - (11) the development and application of any pre-determined pricing policy rather than developing CUPs for individual transactions. Such an approach may be appropriate where, for example, a taxpayer deals in large numbers of differentiated products or services and it is not practical or cost effective to conduct a CUP analysis on a transaction-by-transaction basis.

Documentation relevant to applying a resale price methodology

7.5 The resale price method ('RP method') is explained in paragraphs 359 to 362 of TR 94/14, paragraphs 3.20 to 3.30 of TR 97/20 and paragraphs 2.14 to 2.31 of the 1995 OECD Report. These discussions explain that the resale price method focuses on functional comparability rather than on product comparability. Documentation evidencing the comparison of functions performed by the enterprise and the comparable parties (either internal or external comparison) therefore assists the taxpayer in demonstrating to the ATO that the resale price margin being relied upon is an appropriate benchmark for the purposes of the arm's length principle. This may include documentation relating to the following analyses and issues:

- (1) the functional analysis of the enterprise including the process undertaken to ensure that there is functional comparability and, where material differences occur, the quantification and adjustment of those differences;

- (2) comparison of the gross margin achieved by the enterprise from associated enterprise dealings with gross margins from uncontrolled dealings and any adjustments made to improve comparability;
- (3) reasons for arriving at the number of comparables selected;
- (4) an analysis of the reliability of comparable data being used (see paragraphs 2.59 to 2.66 of TR 97/20);
- (5) reconciliation of differences in accounting treatment which have an effect on the gross profit (or other profit level) to be used as the basis of comparison between the taxpayer and any potential benchmarks;
- (6) where it is not possible, in applying the RP method, to find independent enterprises performing comparable functions in a comparable market, the process undertaken in broadening the comparability analysis;
- (7) where the taxpayer has been limited by the extent of information available and has relied on a broad analysis to determine comparability, identification of the limitations or knowledge gaps associated with the analysis and how the judgments made allow for this;
- (8) an analysis of any other factors which need to be taken into account when determining comparability eg contractual terms, geographic market, market penetration strategies, stock levels, marketing, finance and other operating expenses; and
- (9) checks undertaken by the taxpayer to determine whether the use of the resale price methodology has resulted in an outcome which is consistent with the arm's length principle.

This list is indicative of factors that may impact on the accuracy of the comparisons made, both internal and external. Taxpayers need to consider their own particular circumstances and focus on issues to improve the reliability of the application of the RP method to the dealings being examined.

7.6 In cases where a taxpayer has used a margin calculated as a certain percentage of the resale price without benchmarking the margin against comparable independent dealings (see paragraph 3.24 of TR 97/20), that is, in extreme cases where no other approach is reasonably open, the taxpayer is well advised to document:

- (1) the rationale for the selection of this methodology including reasons for its use in preference to arm's length methodologies; and
- (2) how the fixed percentage has been calculated to produce a result that fairly reflects the functions performed, assets employed and risks undertaken.

Documentation relevant to applying a cost plus methodology

7.7 The cost plus methodology ('CP method') is explained at paragraphs 363 to 365 of TR 94/14, paragraphs 3.31 to 3.51 of TR 97/20 and paragraphs 2.32 to 2.48 of the 1995 OECD Report. The CP method also focuses on functional comparability and so, as with RP method, the adequate documentation of the analysis of functions, assets and risks of the enterprise and the comparable parties is of prime importance. Documentation of the enterprise's costs is also relevant in determining the appropriate cost base for the application of the CP method.

Documenting the determination of costs when using the cost plus method

7.8 Determination of the costs referable to the controlled transactions (to which the arm's length gross margin is applied) may, in most cases, present few documentation difficulties for taxpayers as the relevant costs are generally able to be equated to the calculation of cost of goods sold used for the trading stock provisions of the ITAA, or deductible cost for service providers. The documentation is, in most cases, created in the ordinary course of business.

7.9 In order to satisfy the ATO that costs referable to international dealings between associated enterprises have been determined on an appropriate basis, it is useful to document all issues considered in the calculation of the cost base including:

- (1) costs which have been included in the cost base (generally, absorption costing should be used (see paragraph 3.40 of TR 97/20));
- (2) the method of allocation of costs between associated enterprise and independent enterprise dealings within the same business stream or production line;
- (3) the basis of allocation or apportionment of all indirect costs included in the cost base (see paragraphs 3.38 and 3.39 of TR 97/20);

- (4) where marginal costing has been used, analyses or evaluations which support the use of marginal costing in determining an arm's length outcome; and
- (5) the determination of the arm's length value of any purchases of materials from associated enterprises which are used in the manufacturing process.

Documenting the choice of an arm's length gross margin for the cost plus method

7.10 The arm's length gross margin is intended to cover an appropriate portion of expenses incurred below the line including general, administrative and selling expenses, and to allow an appropriate profit to be earned having regard to the functions undertaken, assets employed and risks borne by the manufacturing entity / service provider. Documentation evidencing the comparison of functions performed by the enterprise and the comparable parties (either internal or external comparison) therefore assists the taxpayer in demonstrating to the ATO that the margin being relied upon is an appropriate benchmark for the purposes of the arm's length principle. This would include documentation of the same type as outlined at paragraph 6.5 of this Ruling in relation to the RP method.

7.11 In extreme cases where no other approach is reasonably open - for example, where a taxpayer has used a margin calculated as a fixed percentage mark-up to a relevant cost base and where the percentage chosen is not benchmarked against comparable independent dealings (see paragraph 3.34 of TR 97/20) - the taxpayer is well advised to document the same factors as outlined at paragraph 7.6 in relation to the RP method.

Documentation relevant to applying a profit split methodology

7.12 The nature of profit split methods and their application are discussed in TR 97/20 at paragraphs 3.59 to 3.72. The documentation issues relevant to the application of this methodology depend on the type of profit split undertaken and whether the profit split is conducted:

- with a narrow focus, that is, at the transactional level;
- on a wider scale, involving limited aggregation of dealings; or
- on a total aggregation of all international dealings with associated enterprises.

7.13 In applying a profit split it is useful for taxpayers to document a number of issues including:

- (1) reasons why the taxpayer is applying a profit method instead of a traditional transactional method;
- (2) the level at which the profit split is being undertaken, for example, on a transactional or an aggregated dealings basis, and the rationale for undertaking the split at a particular level;
- (3) how the combined profit was calculated, including the basis used to allocate the indirect costs and the relevant general administrative and selling expenses of each of the associated enterprises;
- (4) whether the profit to be split is net or gross profit;
- (5) the identification and reconciliation of the effects on the calculation of the profits attributable to differences in accounting treatment of profit between jurisdictions, or to the effects of currency. The calculation of the profit to be split also needs to be standardised as between the taxing jurisdictions involved;
- (6) the functional analysis undertaken in respect of all parties to the dealings, including the identification of significant economic contributions to the combined profit;
- (7) the basis for any allocations of values to functions which contribute to the profit to be split;
- (8) an analysis of the reliability of any comparable data being used (see paragraphs 2.59 to 2.66 of TR 97/20);
- (9) where profits are split using contribution analysis (or as part of the first stage of a residual profit split), supplementation of the analysis with external market data that indicates how independent enterprises would have divided the profits in similar circumstances. Comparability of the external benchmark having regard to the functions undertaken, assets employed and risks assumed is also an important factor in undertaking this type of analysis. Material differences between the situations being compared should be quantified and adjusted to eliminate these differences;
- (10) where a residual profit split is being applied, the basis used to determine the allocation of values under the second stage of the analysis and details of external benchmarking applied to supplement this allocation.

Here again, comparability of external benchmarks used, having regard to the functions undertaken, assets employed and risks assumed, is an important factor in undertaking this type of analysis. Material differences between the situations being compared should be quantified and adjustments made to eliminate their effect;

- (11) in the case where the combined profit to be split is a projected profit, the basis used for such projection, details of its estimation and the critical assumptions on which it is based. An analysis of past profit experience on comparable dealings and how this experience may impact on future profit projections would be relevant here. Details of how the parties deal with changes in critical assumptions and variations from the projection would also be relevant; and
- (12) where there are variances between projected and actual profits, details of appropriate adjustments made to profit split projections for future years commensurate with what arm's length parties would do in the same or similar circumstances.

Documentation relevant to applying a transactional net margin methodology ('TNMM')

7.14 The TNMM is discussed at paragraphs 3.73 to 3.87 of TR 97/20 and in paragraphs 3.26 to 3.48 of the 1995 OECD Report.

7.15 The TNMM is similar to the resale price and cost plus methodologies in that it focuses on a comparison of functions, assets and risks of the enterprise and the comparable parties. Documentation issues associated with this method are therefore largely centred around the functional analysis of the enterprise and the comparability analysis.

7.16 In applying a TNMM it is useful for taxpayers to document all issues relevant to the application of the methodology including:

- (1) reasons why the taxpayer is applying a profit method instead of a traditional transactional method;
- (2) the process used to confine the comparison to the taxpayer's international dealings with associated enterprises;
- (3) reasons for the selection of a particular net profit margin, including factors considered in determining that a particular profit margin is the most appropriate

- one having regard to the comparability analysis of the taxpayer and the comparable enterprises;
- (4) the process used to identify, analyse and benchmark against comparable uncontrolled data, any adjustments made to the uncontrolled data to improve comparability and any assumptions made in comparing the taxpayer's result with those of comparables;
 - (5) an analysis of the reliability of comparable data being used (see paragraphs 2.59 to 2.66 of TR 97/20);
 - (6) where profitability ratios have been used in applying the TNMM, reasons why the particular ratios used were selected and why other ratios were discarded.
Taxpayers are well advised to consider providing similar documentation where additional ratios are used as, effectively, supporting methodologies to check the reasonableness of the outcomes of a primary measure;
 - (7) reasons for arriving at the number of comparables selected;
 - (8) ensuring that appropriate accounting and measurement consistency exists in relation to the application of the selected ratio for the taxpayer and any comparable independent enterprises. For example, a divisional application of TNMM will usually be preferred over a whole of enterprise approach;
 - (9) any multi-year data of both the taxpayer and any comparable independent enterprise(s) used in the analysis (see paragraphs 2.96 to 2.98 of TR 97/20). Ordinarily, multi-year data for both the taxpayer under examination and the comparable independent enterprises should be used for the purposes of applying TNMM (see paragraphs 1.49 to 1.51 and 3.44 of the 1995 OECD Report);
 - (10) in cases where the application of TNMM has resulted in the creation of a range of outcomes, taxpayers should record details of all points in the range and the taxpayer's process for identifying the most appropriate outcome in the range. The treatment of ranges of outcomes and arm's length ranges is discussed at paragraphs 2.83 to 2.95 of TR 97/20;
 - (11) how the relevant amount for costs was ascertained in cases where TNMM is used on a net cost plus basis; and

- (12) calculations and supporting reasoning used to apportion indirect costs in relation to the controlled transactions in cases where TNMM is applied on a net cost plus basis (refer to discussion in TR 97/20 on 'Acceptable bases for apportionment of indirect costs' at paragraphs 3.38 and 3.39).

Chapter 8: Documentation issues for certain business strategies

Introduction

8.1 This Chapter discusses a number of business strategies requiring special justification and supporting documentation from taxpayers if they are to be accepted by the ATO.

Sustained losses

8.2 It is expected that where a business strategy either intentionally or otherwise has led to the incurring of sustained losses, the taxpayer is able to show that the objective of the business strategy at the time it was entered into was to lead to increased profits within a time period that might be reasonably expected of a comparable independent enterprise. It is also prudent to demonstrate that adjustments have been made to the business strategy that might reasonably have been expected to have been made by comparable independent enterprises when the anticipated profits under the business strategy did not eventuate (paragraph 2.100 of TR 97/20). This could involve an analysis of the business strategy including such factors as anticipated period of implementation and expected time frame for a return to profitability.

8.3 Analysis in support of a contention that the business strategy implemented is consistent with the arm's length principle is desirable and might include comparative studies showing:

- (1) the period in which comparable independent enterprises would have been prepared to endure losses;
- (2) the prices at which independent enterprises dealing at arm's length would have been prepared to sell in the same or similar circumstances; and
- (3) the prices at which independent enterprises dealing at arm's length would have been prepared to buy in the same or similar circumstances.

Market penetration

8.4 Documentation that might reasonably be expected to have been created in relation to a market penetration strategy depends on the facts and circumstances in each case. However, information about the target market and about the strategy itself generally assists the credibility of a taxpayer's claim that it was pursuing a market penetration strategy (see also paragraphs 138 to 141 and 445 to 457 of TR 94/14, paragraphs 2.47 to 2.56 of TR 97/20 and paragraphs 1.32 to 1.35 of the 1995 OECD Report).

8.5 Information about the target market includes:

- (1) the market sought to be penetrated;
- (2) the level of penetration sought as a percentage of any existing market;
- (3) expected demand for the product or service in this market before, during and after implementation of the strategy;
- (4) niche opportunities within that market;
- (5) information about competitors in that market including their respective market shares, and information about their products; and
- (6) any plans to counter competitors responses to the strategy.

8.6 The market may be affected by government policies, subsidies and regulations which could affect the nature of the product or service sought to be delivered into that market and its associated costs of production. Taxpayers are well advised to address and document any such policy and its effects on profitability and pricing.

8.7 Information about the market penetration strategy includes:

- (1) an outline of the strategy and its aims including a detailed sales plan;
- (2) identification and quantification of the anticipated costs associated with the strategy for the parties involved, how such costs are to be shared and the means of effecting that sharing between the parties;
- (3) a statement of the reasons for variances where actual sales and costs deviate from plan;
- (4) an outline of the intended duration of the strategy;
- (5) specification of the benefits sought to be obtained by the parties to the strategy;

- (6) identification of the anticipated time it will take to realise the benefits or profits for the respective parties to the strategy; and
- (7) provision of a cost/benefit analysis and cash flow projection clearly indicating the intention for all parties to the strategy to derive increased profit within a reasonable time from the commencement of the market penetration strategy.

8.8 In addition to factual information about the market being targeted and details of the plan and its method of implementation, independent benchmarking assists taxpayers to establish the arm's length nature of the conditions which are a feature of the strategy itself. Taxpayers are well advised to document any such comparability studies, either prior to the formulation of the strategy or, at the latest, prior to implementation.

8.9 Where set-off arrangements are included as part of the market penetration strategy, the documentation created should meet the pre-conditions specified at paragraphs 8.16 and 8.17 of this Ruling.

Marginal costing

8.10 Marginal costing is discussed at paragraphs 3.41 to 3.47 of TR 97/20. While recognising that sound commercial reasons may require the temporary adoption of a marginal costing business strategy, the ATO considers that arm's length parties would give due consideration to its implementation. Such consideration may include a plan evidenced by documentation which outlines the basis and rationale for implementing the strategy (including the factors outlined at paragraph 2.44 of the 1995 OECD Report), the nature of the costs to be recovered and the anticipated duration of the strategy (including reasons for any extensions or deviations from the planned time frame).

8.11 Where marginal costing is used in conjunction with other business strategies, such as market penetration, taxpayers are well advised to retain the same types of documents as outlined in paragraphs 8.4 to 8.9 of this Ruling.

Global pricing

8.12 Global pricing is discussed at paragraphs 2.57 and 2.58 of TR 97/20. Claims that a global pricing policy satisfies the arm's length principle are supported where a taxpayer produces documentation showing:

- (1) an analysis of whether the profit expectation for the Australian taxpayer is commensurate with the

expectations of parties dealing at arm's length operating under similar conditions and having similar functions, assets and risks;

- (2) an analysis of the markets the MNE group operates in and whether such terms as the global price, the terms surrounding the supply of goods or services into those markets, and the functional performance of the independent and associated enterprises in each of those markets are comparable; and
- (3) that the global pricing policy is applied to both controlled and uncontrolled dealings.

8.13 Where a global price list is implemented exclusively intra-group, it does not satisfy paragraph 2.57 of TR 97/20 and taxpayers are well advised to implement and document a process showing that their pricing satisfies the arm's length principle.

8.14 A global price list is not indicative of an arm's length price and the procedure the ATO adopts to review a taxpayer's processes is the same whether a global price list exists or not. The initial focus of any ATO examinations is on these processes and whether the outcomes afforded to the respective parties are commercially realistic and broadly indicative of comparable independent dealings.

8.15 Where a global pricing policy is used for both intra-group dealings and also applied to independent enterprises dealing at arm's length, such a strategy may be broadly indicative of an arm's length price for the goods or services where comparable independent enterprise sales are made into Australia (see paragraphs 2.13 to 2.15 of TR 97/20). In such cases, documentation evidencing that the conditions affecting both associated and independent enterprises are truly comparable would be helpful. For example, the volume of sales, market conditions, any special conditions affecting the relationship and the contractual terms imposed.

Set-off arrangements

8.16 TR 97/20 at paragraphs 2.112 to 2.118 defines and outlines the nature of set-off arrangements. That Ruling highlights that acceptance by the ATO of set-offs as between associated enterprises is dependent on whether such arrangements are on terms and conditions that would be acceptable to independent enterprises dealing at arm's length.

8.17 The credibility of claims by taxpayers for a set-off is assisted if there is contemporaneous documentation supporting such claims. The following information might be useful:

- (1) documentation which outlines the predetermined strategy, assesses and quantifies the outcomes for the respective parties to the dealings and identifies the respective benefits and detriments to the individual parties to the transaction (refer paragraph 5.20 of the 1995 OECD Report);
- (2) documentation which fully quantifies the set-off arrangement and strategy and tests it against any arm's length outcomes in comparable circumstances. Taxpayers are also well advised to document the methodology used in this process.

Chapter 9: Access to information

Introduction

9.1 This Chapter discusses collection, use of, and access to third party data in the context of a transfer pricing review or audit. In this Ruling, the term 'third party data' refers to information, documentation and all forms of records obtained or sought to be obtained by the ATO from parties other than the specific taxpayer under transfer pricing review or audit. The Chapter addresses a number of issues related to the ATO's powers to access information and documentation and taxpayers' right of access to information collected by the ATO. General access and information gathering principles are discussed more fully in the ATO's published guidelines.

9.2 It needs to be recognised that the Commissioner has to obtain relevant factual information to perform the statutory obligation of ensuring there is compliance with the arm's length principle. The voluntary production of documents by taxpayers facilitates examination and resolution of transfer pricing issues (see paragraphs 5.28 and 5.29 of the 1995 OECD Report) because it avoids undue delays and unnecessary costs. It would be prudent business management for taxpayers to ensure that all the associated enterprise documentation necessary to support their transfer pricing policies is readily available.

The ATO ordinarily limits the information required from taxpayers at the time of lodgment of tax returns

9.3 In most cases the ATO seeks documentation only at the time of a transfer pricing review or audit. Consistent with the principles of self-assessment and the 1995 OECD Report (paragraph 5.15), the ATO ordinarily limits the information required from taxpayers at the time of lodgment of tax returns to the minimum necessary to facilitate

identification of taxpayers who ought to be the subject of further examination (e.g., Schedule 25A and see Chapter 4).

Access to documentation held by an associated enterprise

9.4 There is an obligation to make relevant records available to the ATO within a reasonable time when requested. Where the taxpayer has been tardy or unco-operative in providing all the relevant information from Australian and/or overseas sources, formal requests should be made.

9.5 While the document storage process should be subject to the taxpayer's discretion, the ATO's expectation that documentation kept outside Australia by a taxpayer will be made available to the ATO in a timely manner is consistent with the approach in paragraph 5.5 of the 1995 OECD Report and with section 262A.

9.6 The ATO accepts the view in paragraph 5.10 of the 1995 OECD Report that a taxpayer cannot be required to produce information which is not in the taxpayer's possession or under its control, although regard should be had to sections 262A and 264A.

9.7 Examples of situations where the issue of a section 264A notice should be considered are set out in paragraphs 111 to 113 and 387 to 389 of TR 94/14. When invoking section 264A, ATO officers should only request information that is relevant to the transactions under examination and where they have a reasonable expectation that such information exists (*FH Faulding & Co Ltd v. FC of T* 94 ATC 4867; (1994) 29 ATR 475).

Exchange of Information

9.8 Each of Australia's DTAs incorporates an Exchange of Information ('EoI') Article which provides for the exchange of information between the treaty partners for purposes consistent with the purpose of the DTA. In the context of a transfer pricing review or audit, the ATO may seek information from a treaty partner under EoI where this facilitates the process of reviewing a taxpayer's compliance with the arm's length principle. The use of EoI Articles contained in Australia's DTAs is not necessarily a 'last resort' approach.

9.9 Information obtained under the provisions of Australia's DTAs is generally secret and will be released only to the extent that such release is permitted under the terms of the specific treaty and by law. This position is supported by the judgment of Wilcox J of the Federal Court of Australia in *Nestle Australia v. Federal Commissioner of Taxation* (1986) 67 ALR 128 at 134; and the New Zealand Court of

Appeal decision in *C of IR v. E R Squibb & Sons (NZ) Ltd* (1992) 14 NZTC 9146 at 9156; (1992) 17 TRNZ 97 at 105.

Legal professional privilege and access to professional accounting advisors' papers

9.10 The ATO's general right of access to documents is subject to the common law doctrine of legal professional privilege (refer to *Access to Lawyers Premises* guidelines, Chapter 8.6 of the *Access and Information Gathering Manual* ('the Access Manual')).

9.11 The ATO has also issued guidelines governing access to certain accountants' papers (*Access to Professional Accounting Advisors' Papers* (in this Chapter referred to as 'the Guidelines', see Chapter 8.7 of the *Access Manual*). They apply only to documents prepared by external professional accounting advisors who are independent of the taxpayer and grant, to certain categories of advice papers and opinions, a similar level of protection as is accorded to legal advice.

9.12 In the context of a transfer pricing review, the ATO's objective is to assess the taxpayer's level of risk. All documents which indicate that a taxpayer has addressed the question of whether their transfer pricing policies comply with the arm's length principle, including documents prepared in connection with the analysis, selection, application and review of a methodology, therefore assist the ATO in assigning a level of risk to a taxpayer. Accordingly, where particular documents might fall into categories which afford them some form of restricted access, it may still be in the taxpayer's interest to facilitate an ATO initial review by providing timely access to such documents as these will assist in demonstrating whether their transfer pricing is appropriate for tax purposes.

9.13 Where access to such documents is denied in reliance upon the Guidelines, the ATO will need to satisfy itself that the Guidelines are being properly applied. Where this is the case, the ATO will consider the facts and circumstances of the case and assess the taxpayer's level of risk based upon the documentation available for the initial review. The practical implication of withholding such documents may be that the taxpayer's processes and procedures cannot be properly evaluated and, therefore, result in the ATO assigning a higher level of risk to the taxpayer than would otherwise be the case.

9.14 Where the ATO undertakes a more detailed examination (e.g., a transfer pricing audit), documents which are relevant in ascertaining arm's length outcomes are equally relevant at this stage. It is again in the taxpayer's interest to provide the documents as early as possible. Where informal approaches are unlikely to produce the necessary

information within a reasonable time, consideration should be given to using formal approaches.

Collection, use of and access to third party data by the ATO

Introduction

9.15 Testing compliance with the arm's length principle requires access to, and analysis of, third party data for the purposes of identifying comparable independent enterprises and for benchmarking. The purpose of such enquiries is the acquisition of documentation and information having a direct bearing on the discharge of the Commissioner's statutory obligation to establish what is the arm's length outcome in a particular case. The legislative authority for the ATO making third party enquiries is found in the Commissioner's general powers of access in sections 263 and 264 of the ITAA and under the EoI Articles of Australia's DTAs.

9.16 Subject to the specific procedural requirements imposed by the law, the ATO seeks, as much as possible, to utilise data already available to it through taxpayer information and/or publicly available sources. When it is considered that external enquiries are necessary to test properly international dealings between associated enterprises, or to clarify and expand upon internal data used as independent benchmarks, such enquiries will be made. The ATO also seeks to avoid unnecessary duplication of enquiries.

9.17 The ATO ordinarily needs to access third party data in cases where it is necessary to go further than an examination of a taxpayer's documented processes.

9.18 The ATO may conduct third party enquiries through written questionnaires, surveys and interviews, or any combination of these. The enquiries are aimed at establishing the characteristics of the third party's business, its strategies, operational framework and the risks peculiar to its business for the purpose of identifying comparables and achieving as high a level of comparability as possible with the controlled dealings of the taxpayer under review. Questionnaires and surveys will be used by the ATO in appropriate cases, having regard to the relative size of the entities and/or the complexity of the issues involved.

Use of non-publicly available data by the ATO

9.19 The ATO possesses a range of information which can provide various performance indicators across a range of industries. This data includes information extracted from tax returns and other enquiries and databases. It also includes information obtained from publicly

available databases. In some cases, the data available may be modified to provide a broad based analysis of outcomes across industries or, alternatively, it can be more highly focused, taking in specific groups or even individual taxpayers.

9.20 Broad industry data, including average figures and financial ratios, may act as a pointer to what an arm's length dealing might be. Alternatively, in the absence of more detailed data about comparable arm's length dealings, broad industry data could form the basis of a determination by the Commissioner under subsection 136AD(4) of the ITAA to deem an arm's length amount (see *Gamini Bus Co Ltd v Commissioner of Income Tax Colombo* [1952] AC 571 at 578 - 581). As stated in paragraphs 82, 83, 338 and 339 of TR 94/14, any such determination would have to be supported by sufficient relevant information to demonstrate that an informed and reasonable decision has been reached in the circumstances of the case.

9.21 Representations have been made that the ATO should be restricted to using only publicly available data reasonably available to a taxpayer at the time of an international dealing with an associated enterprise in determining the arm's length consideration or profit. It is the ATO view that, by enacting the arm's length principle into the law, Parliament intended the ATO to use data about comparable independent transactions in the benchmarking process.

9.22 The statutory objective, consistent with the incorporation of the arm's length principle into our law, is to achieve the closest practicable degree of comparability with independent dealings. This outcome cannot be achieved where the ATO voluntarily restricts itself to particular sources of data. The public policy intention of ensuring that Australia receives its fair share of tax must also be considered. The ATO agrees with the following remarks of Richardson J in *C of IR v. E R Squibb & Sons (NZ) Ltd* (1992) 17 TRNZ 97 at 109; (1992) 14 NZTC 9146 at 9159 and considers that they are equally applicable in an Australian context:

'In discharging the obligation to see that every taxpayer is assessed to tax the Commissioner cannot always and simply rely on the taxpayer's returns. The Commissioner must often have regard to any other sources of information including data derived from the records of other taxpayers and other information obtained from other taxpayers or third parties.'

In view of the above considerations, the ATO rejects the suggestion that it should be limited to publicly available third party data.

9.23 In utilising third party data, however, the ATO recognises that:

- (1) third party data requires close scrutiny to ensure comparability;

- (2) taxpayers are not always in a position to obtain sufficient competitor's information, particularly in relation to pricing data;
- (3) the information may not have been available to taxpayers at the time the transfer price was established. Taxpayers do not have the benefit of hindsight (although periodic reviews can and should be undertaken);
- (4) the secrecy provisions in the ITAA may prevent the ATO from disclosing third party data to taxpayers; and
- (5) fairness requires that the ATO position paper (see paragraph 4.39) gives the taxpayer sufficient detail of the grounds for proposed adjustments.

In what circumstances will the ATO limit its access to third party data?

9.24 For the purpose of a transfer pricing review, the ATO will generally restrict its need to access information to broad third party data and to documentation created or obtained by the taxpayer in support of the process it has adopted to ensure compliance with the arm's length principle. Broad third party data includes data available from both public sources and any sources internal to the ATO, including related party data, but excludes the high level comparability analysis necessary if a full review of the taxpayer's transfer pricing policies and outcomes was necessary.

9.25 For example, where a taxpayer's processes and documentation are likely to result in it being in a 'high quality' or 'medium-high quality' category in the ATO's ranking of quality levels (see paragraph 4.26), and the process gives rise to a commercially realistic outcome (see paragraph 2.11(3) of TR 97/20), we generally would not need to access high level detailed third party data at the initial review stage, but would limit our enquiries to broad third party data and to documentation created or obtained by the taxpayer in support of its process.

Taxpayer access to third party data

Introduction

9.26 All information obtained by the ATO, either internally or from third parties, which relates to the taxation affairs of taxpayers, is protected by:

- (1) section 16 of the ITAA (subject to certain specified exceptions and to the performance of any duty as an officer);
- (2) exclusions to the *Freedom of Information Act 1982* ('the FOI Act'); and
- (3) in some cases, by the provisions of the *Privacy Act 1988*.

Subsection 16(2) of the ITAA contains the general prohibition against divulging information about taxpayers' affairs obtained during the course of ATO enquiries. Other subsections of the provision allow for limited release of such information in a variety of circumstances. This includes release of information to a court (subsection 16(3)) or to the Administrative Appeals Tribunal ('AAT') (paragraph 16(4)(c)).

9.27 As part of the audit process and prior to the raising of assessments, the ATO has introduced review processes which are designed to assist taxpayers to understand, within the limits of the law, the case that is being prepared by the ATO and to afford taxpayers the fullest opportunity to present evidence and argument in support of their position. However, the ATO's internal review processes are not avenues for taxpayers to seek to circumvent legislative provisions designed to protect the privacy of other taxpayers' information or to access commercially sensitive information relating to other taxpayers which might be held by the ATO.

9.28 A taxpayer's right to know the case it has to answer does not override other considerations, including privacy and confidentiality, that should be afforded to commercially sensitive third party data or the requirements of procedural fairness where the interests of third parties may be affected (*Kioa and Ors v. West and Anor* (1985) 159 CLR 550, per Mason J at 584). See also *Nestle Australia v. Federal Commissioner of Taxation* 86 ATC 4499 at 4504; (1986) 67 ALR 128 at 134 (which related to an application for judicial review under the *Administrative Decisions (Judicial Review) Act 1977*); *C of IR v. E R Squibb & Sons (NZ) Ltd* at 14 NZTC 9146 at 9159; 17 TRNZ 97 at 109 per Richardson J; and *Alfred Crompton Amusement Machines Ltd v. Commissioners of Customs and Excise (No 2)* [1974] AC 405 at 433-4; [1973] 2 All ER 1169 at 1184-5. Subject to these constraints, the ATO will explain its position and give taxpayers the opportunity to put their position.

Release under the Freedom of Information Act

9.29 Section 38 of the FOI Act provides that a right of access to a document is not granted if disclosure of the document or information contained in the document is prohibited under a provision of an

enactment and either (i) that provision is specified in Schedule 3 of the FOI Act, or (ii) section 38 is expressly stated to apply to the document or information by a provision of that enactment or any other enactment. Subsection 16(2) of the ITAA is listed in Schedule 3 of the FOI Act with the result that information about the affairs of other taxpayers is exempt for the purpose of the FOI Act.

9.30 Prior to the amendment of section 38 in 1991, the Full Federal Court had affirmed that the section prevented disclosure of the affairs of another taxpayer where section 16 of the ITAA specifically prohibited the release of such information: *FC of T v. Swiss Aluminium Australia Limited and Ors (No 2)* 86 ATC 4364; (1986) 17 ATR 645 (per Bowen CJ at ATC 4368, ATR 648). See also *In re Mann and FC of T* 87 ATC 2010; (1987) 18 ATR 3671.

9.31 Information obtained by the ATO under the EoI provisions of Australia's DTAs is also exempt for the purposes of section 38 of the FOI Act: *Association of Mouth and Foot Painting Artists Pty Ltd v. FC of T* 87 ATC 2020 at 2028 - 2030; (1987) 18 ATR 3800 at 3810-3812.

Release as part of AAT or court proceedings

9.32 In its decision in *Mobil Oil Australia Proprietary Limited v. Commissioner of Taxation* (1963) 113 CLR 475, the majority of the High Court agreed that nothing in section 16 precluded an officer, with the authority of the Commissioner, from communicating any information to a Board of Review (Dixon CJ, McTiernan and Taylor JJ).

9.33 In his judgment, Kitto J reflected on the problems arising in cases such as those involving the former Division 13 where the conflicting interests of various parties to the proceedings may arise. This could include conflict of interest between those parties who provide information to the Commissioner, in good faith, in order for the Commissioner to properly exercise his statutory obligations and the interests of taxpayers who have the right to know the case against them. The problems inherent in ensuring that procedural fairness is accorded to all parties are highlighted in the following passage from his judgment at 501-502:

It is generally true, as the Court observed in *Sutton v. Commissioner of Taxation* (1959) 100 CLR 518, at p. 524 that natural justice requires that the taxpayer shall know the course that is taken and what is placed before the Board; **but the Court was not there deciding as a matter of law that the Board is bound to disclose to the taxpayer every scrap of material that it takes into consideration.** A decision that the Board is so bound in a case under s. 136 would involve two steps, first that the nature of the Board's function in such a case is (to use a convenient though

inexact expression) quasi judicial, and secondly that the general proposition stated in *Sutton's Case* (1959) 100 CLR 518 is absolute, or at least applies without qualification to such a case. Unless both steps are to be taken, the Board has an unfettered discretion as to what it will and what it will not disclose to the taxpayer; and while its sense of fairness will no doubt lead it to make what disclosure it considers can reasonably be made it will have to decide in relation to particular pieces or classes of evidence, as a matter of purely discretionary judgment, whether and to what extent considerations of fairness *to other people* and the readily understandable and highly important policy which is reflected in s. 16 should deter it from doing all that natural justice might otherwise suggest.' (emphasis added).

9.34 This balancing of interests is still relevant today and is apparent in the mechanisms found in the *Administrative Appeals Tribunal Act 1975* ('AAT Act').

9.35 The Commissioner's approach to the release of third party data in Court and AAT proceedings is governed by public policy considerations underlying the ITAA and by considerations of procedural fairness. In general terms, this approach is supported by Kitto J's judgment in the *Mobil* case. This question was also considered, in the specific context of the exclusions to the prohibition found in section 16, in *Consolidated Press Holding Limited v. FC of T & Anor* 95 ATC 4231; (1995) 30 ATR 390. In this case Lockhart J said at ATC at 4239; ATR at 399:

'In the long run the duty of the Commissioner to accord procedural fairness to the applicants is directly referable to the proper administration of the Act because it is not conducive to the confidence of taxpayers if highly sensitive and important information about their finances and affairs may be revealed to persons or bodies outside the ATO ...'

9.36 The ATO therefore acknowledges that procedural fairness extends to the providers of information to the ATO as well as to taxpayers affected by the use of such information (see paragraph 9.28).

9.37 In respect of claims for public interest immunity in proceedings before the AAT, subsection 36D(6) precludes the operation of any rules of law relating to the public interest (subject to section 36 and 36B which relate to certificates from the Commonwealth and State Attorneys-General respectively). Subsection 36D(6) was considered by the AAT in *Re Queensland Nickel Management Pty Ltd and Great Barrier Reef Marine Park Authority and Others* (1991) 25 ALD 160 and in *Re Ajka Pty Ltd and Australian Fisheries Management Authority* (1995) 39 ALD 445. These cases confirm the exclusion of the common law rule of public interest immunity in the absence of a certificate under sections 36 or 36B.

9.38 In appropriate cases the ATO may seek to obtain a certificate from the Commonwealth Attorney-General under section 36, for example, where information has been obtained by the ATO under an EoI Article of a DTA. Where a certificate is obtained but the Attorney-General places no reliance upon paragraphs (a) or (b) of subsection 36(1), the decision whether third party data, if any, should be released to the taxpayer and, if so, what form such release will take, is a matter for the AAT to decide. This decision is subject to a right of appeal to the Federal Court under section 44 of the AAT Act.

9.39 In respect of claims for public interest immunity in proceedings before the courts, a claim by a third party for the non-release of its commercially sensitive information will not determine the matter, as the authorities establish that a claim for public interest immunity involves a weighing or balancing process by the courts: *Sankey v. Whitlam and Ors* (1978) 142 CLR 1. In any proceedings on such matters, the ATO will argue that third party data should not be released to taxpayers or their representatives.

Chapter 10: Industry information and publicly available sources of data

Introduction

10.1 The arm's length principle, as embodied into our domestic laws, requires a reasoned comparison of what independent enterprises dealing at arm's length in the same or similar circumstances may have achieved. Publicly available databases may not, on their own, give 'the correct answer' in terms of arm's length consideration or profit relevant to a taxpayer's associated enterprise dealings (see paragraphs 2.25 to 2.27 of TR 97/20). Many databases provide both aggregated and disaggregated information which, although being generally indicative of trends in a particular industry segment, lack the element of focused comparability on which the arm's length principle is based. This is a strict standard, yet the ATO recognises that it may not be possible for taxpayers to achieve absolute precision, based on the individual circumstances of the case (see also paragraph 1.16 of the 1995 OECD Report). The many differences affecting taxpayers means that adjustments may need to be made by taxpayers to establish comparability with their particular circumstances taxpayers would be well advised to adequately document any adjustments so made.

10.2 Consideration has been given to the relative merits of the ATO maintaining a database and publishing pricing and profit data as a means of enabling taxpayers to comply with their statutory obligations. However, it is felt that the concerns raised, particularly in relation to the historic nature of data available and secrecy and

confidentiality concerns, preclude the ATO from providing such a database, excepting those reports which are currently presented to Parliament and consequently published for public information (TAXSTATS).

10.3 Public databases may be a useful means of checking the validity of information where a taxpayer has comparable uncontrolled dealings which could be used as a benchmark for its controlled dealings, or where a taxpayer has specific information about uncontrolled competitors' prices or outcomes which enable a more focused and direct comparison to be made. The ATO does not consider it appropriate to endorse any particular database.

10.4 It has been suggested that the ATO should formulate a checklist, as part of this Ruling, setting out the minimum amount of public data that a taxpayer must take into account in identifying comparables. The question of how much data is required to minimise the risk of a transfer pricing audit or adjustment by the ATO may only be answered by the exercise of commercial judgment which has regard to principles of prudent business management in relation to the facts and circumstances of each case (see paragraph 1.6 of this Ruling).

10.5 Taxpayers are well advised to have regard to the significance of international dealings to their overall business and the level of certainty they require in determining the extent to which public databases are used as the sole basis for comparability. (See Chapter 6 in relation to small business taxpayers.)

Qualifications to the use of public databases

10.6 To obtain a better level of comparability, it may be more appropriate to access information which gives disaggregated results, or prices, based on various business segments or product lines within various industry classifications. A feature of both aggregated and disaggregated databases is that they contain data about dealings between associated enterprises. This may limit the usefulness of any comparisons based on this data, especially where a particular industry segment is dominated by multinational enterprises which essentially deal intra-group, without significant levels of independent dealings. It would only be appropriate to use such databases where any dealings from enterprises engaged in controlled transactions with associated enterprises satisfied the qualifications referred to in paragraphs 2.19 to 2.21 of TR 97/20.

10.7 Many of the public databases provide profit information and other financial ratios such as return on assets and other performance indicators. Other databases provide discrete information on commodities and manufactured goods. It may be useful to secure

information about both comparable prices and profits within a market segment, and, if possible, focusing enquiries to known competitors. This would enable a 'top'-(price)-down and a 'bottom'-(profit outcome)-up approach using discrete sources of information to assess outcomes.

10.8 A further source of data is published market information. Generally, information about commodities and financial services, such as market indices, can indicate that arm's length principles are being followed and may be used in conjunction with more specifically targeted data sources described above (see paragraphs 2.25 to 2.27 of TR 97/20). The approaches described above may provide several levels of comparison with external databases.

10.9 Often, market indices provide no more than a useful starting point to arm's length consideration, which may be, for example, at a discount to or premium on the market index price. Where this is the case, taxpayers are well advised to document the calculation of the amount of premium or discount applied and reasons for applying such a premium or discount.

10.10 International trade in tangible goods is well documented by various customs authorities around the world. Much data is gathered on price and volume, globally, and some publicly available databases offer access to this information with data recovery based on the specific needs of individual enquirers. However, dealings in services and intangibles are not well documented and taxpayers may find very limited pricing data in this area. This may affect the level at which the comparisons can be made, limiting taxpayers to measures of profit performance (see paragraph 2.24 of TR 97/20).

10.11 Any analysis based on offshore information needs to take into account the differences in geographic, economic and market conditions, etc., operating offshore and other factors which may affect reliability of the data. That is, offshore data must apply the same standard of comparability that is expected in the Australian context.

Appendix

Appendix to Auditing Standard AUS 304 Knowledge of the Entity - Matters to Consider

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Knowledge of the Entity - Matters to Consider

This list covers a broad range of matters applicable to many engagements; however, not all matters will be relevant to every engagement and the listing is not necessarily complete.

General economic factors

- (a) general level of economic activity, for example recession and growth;*
- (b) interest rates and availability of financing;*
- (c) inflation, currency revaluation;*
- (d) government policies:*
 - (i) monetary;*
 - (ii) fiscal;*
 - (iii) taxation - corporate and other;*
 - (iv) financial incentives, for example government aid programs;*
- and*
- (v) tariffs, trade restrictions; and*
- (e) foreign currency rates and controls.*

The industry - important conditions affecting the entity

- (a) the market and competition*
- (b) cyclical or seasonal activity;*
- (c) changes in product technology;*
- (d) business risk, for example high technology, high fashion and ease of entry for competition;*
- (e) declining or expanding operations;*
- (f) adverse conditions, for example declining demand, excess capacity and serious price competition;*
- (g) key ratios and operating statistics;*
- (h) specific accounting practices and problems;*
- (i) environmental requirements and problems;*
- (j) regulatory framework;*
- (k) energy supply and cost; and*

- (l) *specific or unique practices, for example relating to labour contracts, financing methods and accounting methods.*

The entity

Management and ownership - important characteristics

- (a) *corporate structure - private, public, government (including any recent or planned changes);*
- (b) *beneficial owners and related parties, for example, local, foreign, business reputation and experience;*
- (c) *dominance by one individual;*
- (d) *capital structure (including any recent or planned changes);*
- (e) *organisational structure;*
- (f) *management objectives, philosophy, strategic plans;*
- (g) *acquisitions, mergers or disposals of business activities (planned or recently executed);*
- (h) *source and methods of financing (current, historical);*
- (i) *governing body:*
 - (i) *composition;*
 - (ii) *business reputation and experience of individuals;*
 - (iii) *independence from and control over operating management;*
 - (iv) *frequency of meetings;*
 - (v) *existence of audit committee and scope of its activities;*
 - (vi) *existence of policy on corporate conduct; and*
 - (vii) *changes in professional advisers, for example, outside legal counsel;*
- (j) *operating management:*
 - (i) *experience and reputation;*
 - (ii) *turnover;*
 - (iii) *key financial personnel and their status in the organisation;*
 - (iv) *staffing of accounting department;*

- (v) *incentive or bonus plans as part of remuneration, for example, based on profit;*
- (vi) *uses of forecasts and budgets;*
- (vii) *pressures on management, for example, overextended, dominance by one individual, support for share price and unreasonable deadlines for announcing results; and*
- (viii) *quality of management information systems;*
- (k) *Internal audit function (existence, quality);*
- (l) *Attitude to internal control structure.*

The entity's business - products, markets, suppliers, expenses, operations

- (a) *nature of business(es), for example, manufacturer, wholesaler, financial services and import/export;*
- (b) *location of production facilities, warehouses, offices;*
- (c) *employment, for example, by location, supply, wage levels, union contracts, superannuation commitments and government regulation;*
- (d) *products or services and markets, for example, major customers and contracts, terms of payment, profit margins, market share, competitors, exports, pricing policies, reputation of products, warranties, trends, marketing strategy and objectives and manufacturing processes;*
- (e) *important suppliers of goods and services, for example long-term contracts, stability of supply, terms of payment, imports and methods of delivery such as 'just in time';*
- (f) *inventories, for example, locations and quantities;*
- (g) *franchises, licences, patents;*
- (h) *important expense categories;*
- (i) *research and development;*
- (j) *foreign currency assets, liabilities and transactions - by currency, hedging;*
- (k) *legislation and regulation that significantly affect the entity, for example, environmental;*
- (l) *use of information technology and plans to change; and*

- (m) *debt structure, including covenants and restrictions.*

Financial performance - factors concerning the entity's financial condition and profitability

- (a) *key ratios and operating statistics; and*
- (b) *trends.*

Reporting environment - external influences which affect management in the preparation of the financial report

- (a) *legislation;*
- (b) *regulatory environment and requirements;*
- (c) *taxation;*
- (d) *measurement and disclosure issues peculiar to the entity;*
- (e) *audit reporting requirements;*
- (f) *users of the financial report.*

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