

BUSINESS

SEGMENT

BUSINESSES WITH
INTERNATIONAL DEALINGS

AUDIENCE

GUIDE

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INTERNATIONAL TRANSFER PRICING

Applying the arm's length principle



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- phone **13 28 66**, or
- write to us at GPO Box 9990 in your capital city.

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ABOUT THIS GUIDE

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

The other publications in the suite are:

- *International transfer pricing: introduction to concepts and risk assessment* (we recommend that you read this overview before reading the other guides)
- *International transfer pricing: advance pricing arrangements*
- *International transfer pricing: a simplified approach to documentation and risk assessment for small to medium businesses*, and
- *International transfer pricing: attributing profits to a dependent agent permanent establishment*.

This guide explains how businesses can apply the arm's length principle in their international dealings with related parties.

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

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

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

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

These rulings are available on our website at www.ato.gov.au

You should carefully consider the terms and conditions of any international dealings with related parties to ensure that you properly allocate income and expenses between Australia and other countries when preparing your tax return. Australia's double tax agreements and domestic law require income and expenses to be allocated according to the arm's length principle for tax purposes. This principle is supported by all OECD countries.

International transfer pricing: introduction to concepts and risk assessment (NAT 2725) discusses the arm's length principle and comparability, the levels of quality of processes and documentation, and the risk of a transfer pricing audit and adjustment. This guide builds on these concepts and suggests a process for addressing the issues raised.

We generally allocate resources to transfer pricing cases according to the perceived risk to revenue of a business not complying with the arm's length principle in relation to international dealings with related parties.

Businesses risk a transfer pricing audit if they do not have proper processes to determine arm's length prices and cannot demonstrate to us the methods they have used to determine their prices. They also risk a transfer pricing adjustment and penalties as a consequence of any audit.

Businesses should therefore consider the level of certainty they wish to achieve, having regard to the impact of international dealings with related parties on their overall business. This assessment will determine the level of risk to which a business is exposed.

THE ARM'S LENGTH PRINCIPLE

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

ASSISTANCE IN APPLYING THE ARM'S LENGTH PRINCIPLE

This guide outlines four steps that may help you implement a process for setting and reviewing the pricing used in your international dealings with related parties. The four steps link the arm's length principle, questions of comparability and the transfer pricing methodologies into a process that:

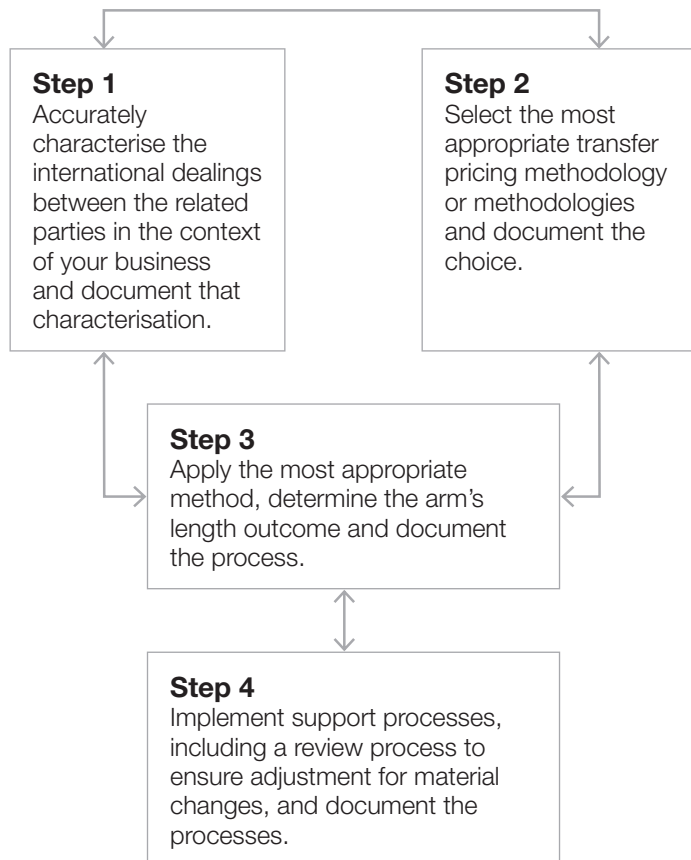
- considers the particular facts and circumstances of your business, and
- helps to collect, analyse and document the results.

The process is not prescriptive and you do not have to follow this approach. It is explained in more detail in chapter 5 of TR 98/11.

As the diagram on the next page shows, the four steps are not linear. 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.

Although other approaches may achieve reliable results, businesses that properly develop, implement and document the four steps as outlined in this guide are less likely to find themselves exposed to transfer pricing adjustments. Where businesses adopt an alternative process, they need to ensure it produces outcomes consistent with the arm's length principle. We advise them to document that process.

THE FOUR STEPS



In suggesting these four steps, we make the following points:

- 1 The four steps and the data collection and analysis discussed are neither mandatory nor prescriptive and, importantly, may need to be tailored to the facts of your case.
- 2 The approach outlined below assumes that your international dealings are fairly extensive and necessitate a thorough analysis. For many small businesses that have relatively simple and/or low-value international dealings with related parties, the extent of data collection and analysis may be minimal.
- 3 Properly applying the four steps to the facts and circumstances of your case should normally be sufficient to establish the arm's length consideration.
- 4 The information needed in the process may be within the knowledge of a limited number of key personnel not confined to the tax or accounting areas of your business. Much of it may already be recorded in a variety of documents you have prepared in the ordinary course of business (for example, marketing reports and analyses). If so, you can simplify the task by collating and indexing existing material rather than doing further research and creating additional documentation.

In assessing compliance with the arm's length principle, you need to exercise commercial judgment about the nature and extent of documentation appropriate to your particular circumstances. Both the Tax Office and the OECD have stated that businesses should not be expected to prepare or obtain documents beyond the minimum needed to reasonably assess whether their dealings with related parties comply with the arm's length principle.

STEP 1:**Accurately characterise the international dealings between the related parties in the context of your business and document that characterisation****Data collection/organisation**

Identify the scope, type, value and timing of the international dealings with related parties in the context of your business.

This *may* require understanding the context of the dealings, including:

- 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
- the intellectual assets used, their contribution, ownership and reward, and
- the economically important activities undertaken by each of the related parties, resources used and risks assumed by each.

Within step 1 the most important aspects are:

- identifying the scope, type, value and timing of international dealings with related parties in the context of your business, and
- preparing the preliminary functional analysis, a critical part of which is to ascertain the most economically important functions, assets and risks and how these might be reflected by a comparable price, margin or profit on the dealings.

Taken together, these points should enable you to accurately characterise your international dealings with related parties. This information is important because it enables you to select reliable comparables that truly reflect these dealings.

Identify the economically important activities and prepare a preliminary functional analysis

You can use the information collected about your business's international dealings with related parties to analyse:

- the economically significant activities or functions each of the related parties undertakes, including their nature and frequency
- the tangible and intangible assets used or to be used by each of the parties and the nature and extent of that use or intended use, and
- the risks assumed by each of the parties.

This is referred to as a functional analysis and, regardless of the methodology you ultimately select, is necessary to some extent.

Action/evaluation

Identify the specific elements of the international dealings that are to be considered.

Prepare a preliminary functional analysis. Explain the conditions affecting the industry and the business strategies available to you as these affect the functional analysis.

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.

Document the processes adopted.

Compiling lists of functions, assets and risks, however detailed, does not indicate which of the functions are the most significant, or economically the most important, to the value added by your business activities. A critical part of the analysis is therefore to ascertain 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.

Use the functional analysis to select comparables

The analysis of functions, assets and risks is useful in:

- determining the availability of comparables for prices or functions
- assessing the degree of comparability with the functions, assets and risks in respect of your uncontrolled transactions or with those undertaken by other enterprises being considered as possible comparables, and
- assessing the relative weighting of the functions, assets and risks of each of the related parties to the international dealings in cases where you use an apportionment methodology, such as a profit split.

Document step 1

We advise you to identify those matters relevant to the facts and circumstances of your case and document them. It is a good idea to retain all the documentation you created or obtained in completing the analysis for step 1, at least until you complete a new analysis, and preferably for as long as possible after this to detail how your business strategies and your major functions, assets and risks change over time.

STEP 2:**Select the most appropriate transfer pricing methodology or methodologies and document the choice****Data collection/organisation**

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.

Action/evaluation

Determine the most appropriate methodologies based on the facts and circumstances of your particular case.

Document your choice of methodologies.

Step 2 primarily involves compiling and assessing the data you will use and selecting a methodology for establishing acceptable standards of comparability or determining the appropriate allocation of profits or income between the related parties.

Select the most appropriate method

There are various internationally accepted methods for determining an appropriate arm's length consideration. We aim to adopt the method that is the most appropriate or best suited to the circumstances of each particular case. Your choice of the most appropriate transfer pricing method or methods should be based on a practical weighing of the evidence having regard to:

- the nature of the activities being examined
- the availability, coverage and reliability of the data
- the degree of comparability that exists between the controlled and uncontrolled dealings or between enterprises undertaking the dealings, including all the circumstances in which the dealings took place, and
- the nature and extent of any assumptions.

The method you choose must be able to be applied in practice and must produce an arm's length result that is a reasonable estimate of what would have resulted if the dealings had been undertaken on an arm's length basis.

Simply establishing the market terms and conditions may not be sufficient. When dealing at arm's length, parties generally have the option not to proceed with the dealings if the market prices do not satisfy their profit expectations or business strategies. For example, if the prevailing market prices lead to unsatisfactory profit levels, then dealings may ultimately not be concluded or may be conducted differently or on different terms.

The availability of reliable comparables affects the choice of the most appropriate methodology and the resultant comparability analysis is used differently with each method. The diagram on the next page broadly outlines the comparability issues you should consider when selecting the most appropriate methodologies.

What are the arm's length methodologies?

There are a number of internationally accepted methodologies that your business can use to comply with the arm's length principle.

These arm's length methodologies are divided into two groups:

- the traditional transaction methods (known as traditional methods), which include:
 - (a) the comparable uncontrolled price (CUP) method
 - (b) the resale price (RP) method, and
 - (c) the cost plus (CP) method
- the transactional profit methods (known as profit methods), which include the profit split methods and the transactional net margin method (TNMM).

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

There will be instances where there may not be comparable dealings or sufficient data to apply traditional or profit methods. For example, your business may have unique dealings, or your industry may be so controlled and structured that there are either no comparable arm's length dealings or the data is not available.

In such circumstances you still have to find an answer. You should reconsider using the traditional or profit methods by broadening the comparability criteria to allow the relevant dealings to be compared.

If you cannot find an answer by extending the application of the traditional or profit methods, you may have to consider a mixture of the above methods, or some other method or mixture of methods likely to lead to a result that is as consistent as practicable with the arm's length principle.

In the limited circumstances where there are no external comparables available, you may have to use internal benchmarks (for example, internal rates of return or 'hurdle' rates) to evaluate your available choices and the arm's length nature of the outcome of the relevant dealings.

Businesses that have difficulty in establishing a reliable approach should seriously consider seeking an advance pricing arrangement.

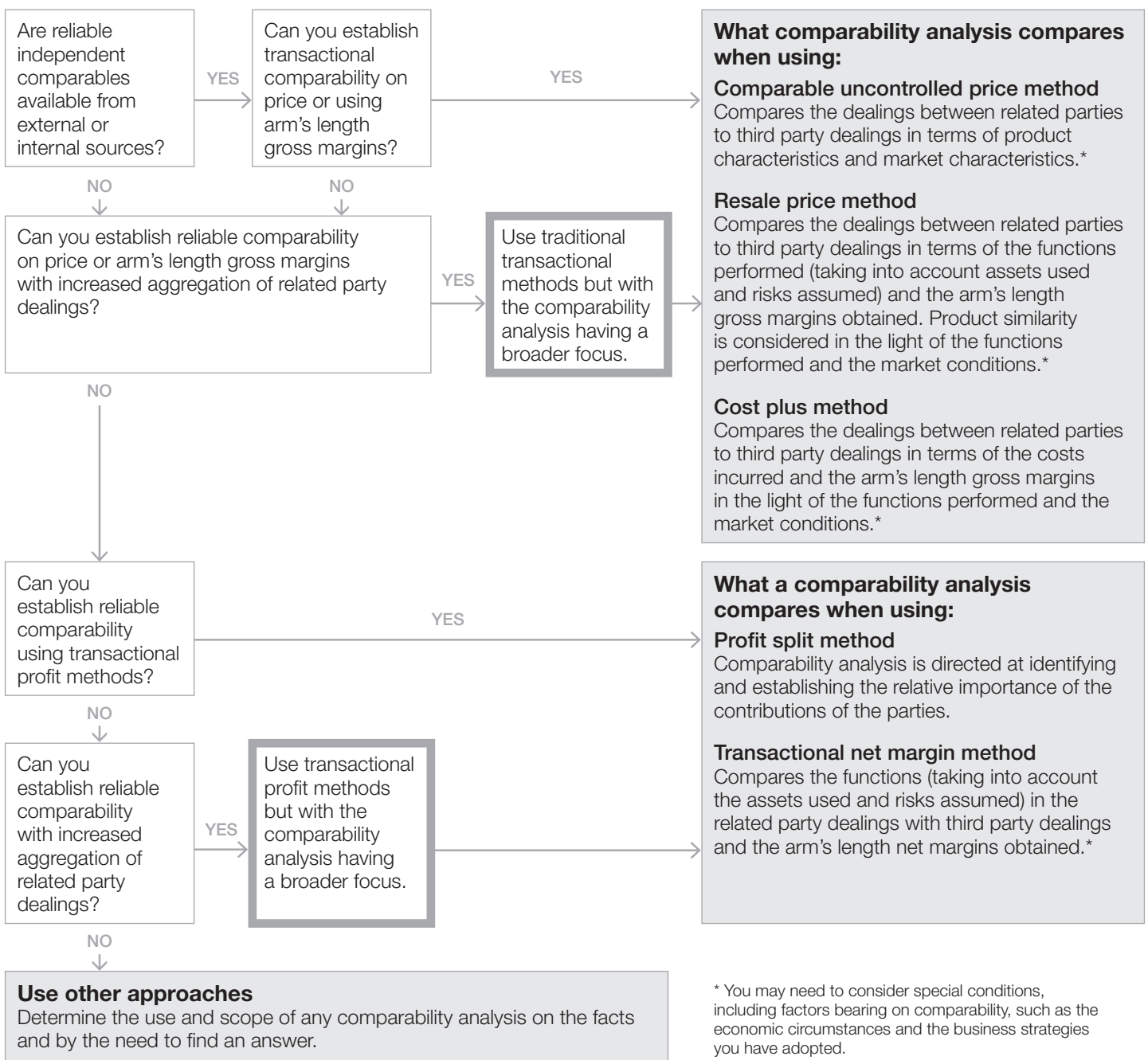
➤ For more information see *International transfer pricing: advance pricing arrangements* (NAT 2748).

Document step 2

We advise you to document the process you used in selecting your methodology, including why you selected the particular methodology. While you are not required to exhaustively

consider and eliminate methodologies using a form of hierarchy, we do expect you to document your process for considering and discarding other methodologies, including why you discarded those methodologies.

Comparability issues in methodology selection



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

| Data collection/organisation | Action/evaluation |
|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <p>Refine, examine and organise the data on comparable dealings or comparable enterprises so that you can properly assess comparability.</p> <p>To improve comparability you may have 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 appear.</p> | <p>If necessary, broaden and refine the preliminary functional analysis. Prepare a comparability analysis.</p> <p>Establish what level of reliability you can place in the answers derived from applying the selected method and the conclusions drawn.</p> <p>You may have 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"> ■ your assumptions and judgments ■ how you interpreted data points or ranges, and ■ how you used results from different methods. |

The aim of step 3 is to apply the methodology you selected in step 2 to determine the arm's length outcome. You may have to refine, examine and organise the data on comparable dealings or enterprises to be able to properly assess comparability.

Structuring the available data in the form of a comparability analysis, while addressing the factors affecting comparability, will allow you to properly apply the selected methodology. The most important factor influencing reliability is the way you deal with material differences in the circumstances surrounding the dealings. Since different methodologies focus attention on differing sets of attributes, the questions raised by the handling of material differences, and thus reliability, vary between methodologies.

For these reasons, it is important to assess the reliability of the data.

Establish what reliability you can place on the answers derived from applying the selected method

The decision tree on the next page assesses the reliability of data on potentially comparable dealings or enterprises, and groups the estimates into three broad categories of low, moderate and high reliability.

The decision tree helps you focus on the need to examine the reliability of the results obtained from using the comparables. Higher reliability gives greater comfort that the data will produce an arm's length outcome. However, there is a need for an outcome in all transfer pricing cases and, in the absence of more reliable data, data of low reliability sometimes has to be used to determine the arm's length consideration.

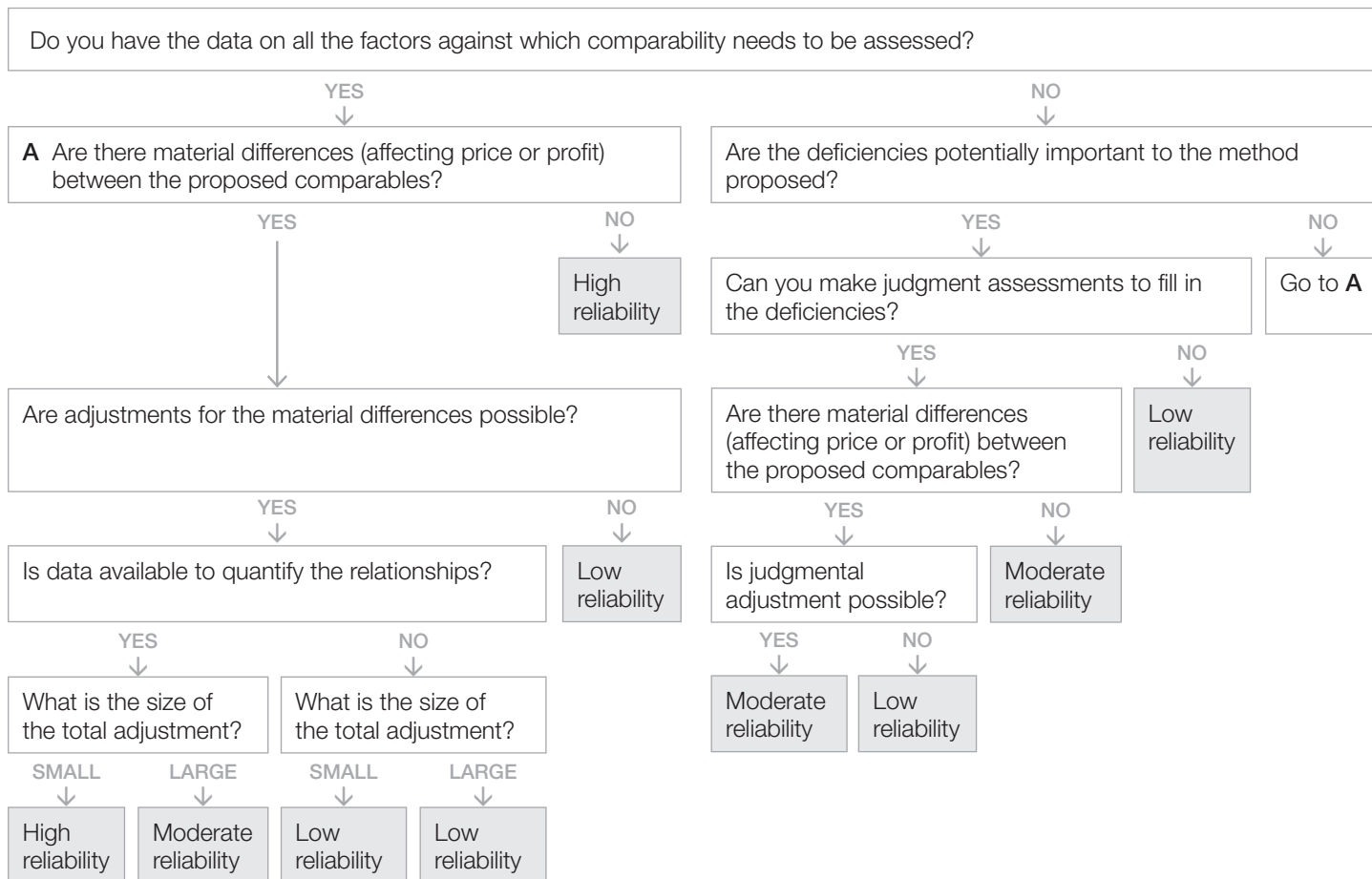
Decide on the arm's length outcome

It is advisable to show how you have used the data in applying the selected methodology to determine the arm's length result. After completing this step, you should have sufficient documentation and reasoning to explain how the outcome is consistent with what an independent party would have achieved.

Document step 3

Documentation outlining how you applied your comparability study to determine the pricing outcome is relevant in this step, which concludes the analysis and documentation process outlined in earlier steps. You should not need to create much additional documentation in this stage.

DECISION TREE FOR ASSESSING RELIABILITY OF COMPARABLES



STEP 4:
Implement support processes, including a review process to ensure adjustment for material changes, and document the processes

| Data collection/organisation | Action/evaluation |
|-----------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------|
| Monitor international dealings and their economic context to identify any material changes as they occur. | If the data used to establish the outcome changes, you should review the process and your choice of methodology. |
| Collect data relevant to evaluating the impact of these changes on the arm's length consideration. | Set up a system to support ongoing application of the chosen method in future years. |
| | Establish a review mechanism to ensure that if material changes occur, you adjust the comparability analysis or methodology as appropriate. |

The fourth step involves monitoring your process for setting arm's length transfer pricing. We highly recommend that you document the steps you have taken to monitor the continuing relevance of the process.

Where your monitoring shows that a change in the process may be required, it is a good idea to document the factors leading to this conclusion, as well as the review of the process and any adjustments to the parameters of the process resulting from the review.

