

**BUSINESS**

SEGMENT

SMALL TO MEDIUM  
BUSINESSES

AUDIENCE

GUIDE

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**Australian Taxation Office**

## INTERNATIONAL TRANSFER PRICING

A simplified  
approach to  
documentation and  
risk assessment  
for small to medium  
businesses



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

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If you have a hearing or speech impairment and have access to appropriate TTY or modem equipment, phone **13 36 77**. If you do not have access to TTY or modem equipment, phone the Speech to Speech Relay Service on **1300 555 727**.

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If you feel this publication does not fully cover your circumstances, please seek help from the Tax Office or a professional adviser. Since we regularly revise our publications to take account of any changes to the law, you should make sure this edition is the latest. The easiest way to do this is by checking for a more recent version on our website at **[www.ato.gov.au](http://www.ato.gov.au)**

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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: applying the arm's length principle*
- *International transfer pricing: advance pricing arrangements, and*
- *International transfer pricing: attributing profits to a dependent agent permanent establishment.*

This guide explains our transfer pricing risk review process for small to medium businesses under the simplified approach to compliance outlined in chapter 6 of Taxation Ruling TR 98/11.

When we refer to 'you' in this guide we are referring to you as a small to medium-sized business.

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

- TR 92/11 – *Income tax: treatment of interest free, low interest and excessive interest loans*
- 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 99/1 – *Income tax: international transfer pricing for intra-group services*
- TR 2000/16 – *Income tax: international transfer pricing – transfer pricing and profit reallocation adjustments, relief from double taxation and the mutual agreement procedure*
- TR 2000/16A – *Addendum income tax: international transfer pricing – transfer pricing and profit reallocation adjustments, relief from double taxation and the mutual agreement procedure*
- TR 2001/11 – *Income tax: international transfer pricing – operation of Australia's permanent establishment attribution rules*
- TR 2004/1 – *Income tax: international transfer pricing – cost contribution arrangements.*

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

The Tax Office carries out transfer pricing reviews as part of broader risk reviews of businesses under our compliance program.

To minimise costs for small to medium businesses, we have developed a simplified approach to the transfer pricing review process for these businesses. This simplified approach is outlined in chapter 6 of Taxation Ruling TR 98/11.

The simplified approach applies to businesses with an annual turnover of less than \$100 million *unless they are*:

- part of a multinational group that is listed on any stock exchange, or
- part of a private group with any international subsidiary or other offshore related party that has the resources to deal with global transfer pricing issues.

❗ Businesses not covered by the simplified approach are expected to fully comply with TR 98/11 and associated transfer pricing rulings.

For small to medium businesses this guide explains:

- the transfer pricing risk review process and how we select businesses for review
- the simplified transfer pricing documentation we advise businesses to maintain, as set out in TR 98/11
- the simplified four-step process for setting related party pricing under an acceptable arm's length method and reviewing or testing the outcome by doing a benchmarking study
- how we score the commercial reality of a business's profit and the quality of their transfer pricing records from C1 to A4 to determine whether a watching brief, tax audit or other follow-up action is necessary, and
- the outcomes of a transfer pricing review or audit.

❗ This guide deals with income tax issues. However, your related party transactions may also be subject to goods and services tax (GST). If so, you need to take into account any GST implications when considering your position and any action you may take. You may also need to consider customs duties.

### WHY WE DO TRANSFER PRICING REVIEWS

The purpose of Australia's transfer pricing rules is to counter the underpayment of Australian tax by requiring businesses to price **related party international dealings**<sup>1</sup> according to what truly independent parties would reasonably be expected to have done in the same situation. In this guide we refer to international dealings as cross-border transactions.

Prices should reflect a fair return for activities carried out by or for an Australian business based on what is done, what assets are used, and who bears the risks in carrying out the activities.

Methods of setting prices and reviewing the outcome of cross-border transactions are recognised internationally, and Australia has adopted these in tax rulings to help businesses understand what is expected of them.<sup>2</sup>

### HOW WE SELECT BUSINESSES FOR REVIEW

Small and medium businesses must complete and lodge a Schedule 25A with their annual income tax return if the total value of related party cross-border transactions is more than A\$1 million.

Under self-assessment, you are required to disclose the value of certain transactions and answer questions about whether you have priced and tested the transactions.

Depending on how you do business, your bottom-line profitability and how you answer Schedule 25A, your business may face:

- a transfer pricing review, and
- if scored as high risk as a result of the review, a transfer pricing tax audit and subsequent adjustments and penalties.

Our field audit teams conduct a risk review process covering all areas of tax risk, with transfer pricing issues a part of this wider review process. If transfer pricing is judged to be an area of concern for a business, TR 98/11 requires us to conduct a transfer pricing review as a prelude to any audit action. This process is mandatory, regardless of the size of a business.

In selecting businesses for transfer pricing review, we consider factors such as the number and value of related party cross-border transactions and the performance of the business over time (that is, whether the business makes commercial profits or consistent losses or low profits).

Businesses with significant cross-border transactions and year-on-year Australian losses, or consistent low, non-commercial profits, are at the greatest risk of a review and possible follow-on audit.

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

<sup>2</sup> TR 98/11 – documentation and practical issues associated with setting and reviewing transfer pricing in cross-border transactions.  
TR 97/20 – arm's length transfer pricing methodologies for cross-border transactions.  
TR 94/14 – basic concepts in applying Division 13.

### WHAT IS THE ARM'S LENGTH PRINCIPLE?

In simple terms, the arm's length principle means using the transactional or profit results of independent parties as a guide or benchmark in allocating income or expenses in cross-border transactions with related parties.<sup>3</sup>

It requires understanding what you have done in your business and whether or not your actions compare with what independent parties have done, or would have done, in the same or a similar situation.

The process requires judgment calls by:

- your business, in how you set prices and terms of trade with related parties, and how you document this policy to support your position, and
- the Tax Office, in reviewing the quality of your documentation file.

The arm's length principle is covered in more detail in the section 'How to apply the arm's length principle'.

### WHAT TO EXPECT FROM A REVIEW

A transfer pricing review involves the Tax Office reviewing transfer pricing documentation and interviewing a business (through desk and fieldwork). The aim is to assess the quality of processes and documentation on hand and the commercial realism of the outcomes of the business's dealings with related parties. In doing so we use our economists and data from public databases that can be accessed by the business and its adviser.

In assessing the quality of a business's processes and documentation, we recognise that, under paragraph 6.1 of TR 98/11, small to medium businesses do not have to create documents beyond the minimum necessary to arrive at an arm's length outcome in the context of their business.

We then assess (or 'score') the quality of the business's processes, records and commercial outcome arising from related party cross-border transactions. Scoring is covered in more detail in the section 'How we score risk'.

Where a transfer pricing review shows that there is a risk to revenue associated with a business's related party cross-border transactions, the business may face an audit.

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<sup>3</sup> Australia's domestic tax law (Division 13 of the Income Tax Assessment Act) and international treaties Australia has entered into with other countries to avoid double taxation of international transactions require related party cross-border transactions to be priced under the arm's length principle. This is supported by the OECD *Guidelines on transfer pricing*. Division 13 refers to the need for all cross-border transactions to be priced under the arm's length principle, regardless of whether they are with related parties.

The Tax Office view on the extent to which you should prepare documentation is set out in TR 98/11. Generally, we expect significantly less transfer pricing documentation for a small to medium business than for a large business, with the extent of documentation increasing as the significance and complexity of transactions increase. For example, we would expect a business with \$48 million in related party cross-border transactions to have more extensive documentation than a business with \$8 million in such transactions.

Chapter 6 of TR 98/11 states that small businesses with relatively low levels of cross-border transactions ‘need not create documents beyond the minimum necessary to arrive at arm’s length outcomes in the context of their business’ (paragraph 6.1 of TR 98/11). The ruling goes on to state that ‘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 Tax Office’.

As a guide, paragraph 6.5 sets out issues that managers may consider to help them judge what documentation they should prepare to be satisfied that the arm’s length principle has been applied. These issues are broadly stated in the following questions managers are asked to consider:

- 1 Is the cross-border dealing with a related party significant in terms of its dollar value compared to the overall turnover of your business?
- 2 Is the cross-border dealing unusual, or one-off, and not part of similar dealings that can as a group be priced and tested to show that the arm’s length principle has been applied?
- 3 Would the answer to 1 or 2 above lead the Tax Office to question the basis of pricing or its outcome against your profit outcome?

If you answer ‘yes’ to any of these questions, you need to take some action that is reasonably balanced against the cost of complying.

### HOW TO PREPARE A DOCUMENTATION FILE

Transfer pricing documentation is not just about recording and filing invoices; it involves creating a record outside your everyday business record keeping that shows how you have dealt with cross-border transactions. It requires:

- writing down how your business works – this is known as a functional analysis
- writing down how your business has set prices in cross-border transactions with related parties, that is, putting a name to the method and why it was used. Remember that global price lists of related parties may not be an acceptable justification under the arm’s length principle (see paragraphs 2.57 to 2.58 of TR 97/20), and
- justifying that the price used was an arm’s length price (that is, what independent parties would be comfortable with) by:
  - comparing the price charged to the related party with prices charged to non-related parties (this is known as the comparable uncontrolled price method), or
  - comparing your profit outcome (gross profit and/or net profit before interest and tax) with other companies in your industry. This may be as simple as comparing your profit outcome to public data on our website or, if your profitability is not similar, doing a more complex review with your adviser.

You also need to record how often you review these issues.

Under the simplified approach, we expect your business to prepare a documentation file to address what is expected in a functional analysis and provide evidence of how you set cross-border pricing. We expect you to undertake at least a basic benchmarking study to broadly show that the outcome of the business reflects arm’s length pricing.

You may have a very good knowledge of your market and pricing and have budgets and other management tools to help run your business. Or you may deal with independent parties in the market as well as related parties and thus be aware of prices that reflect the arm’s length principle that may, with some adjustment, be comparable with related party pricing.

Information such as this can be a primary support for your actions and may form part of the required documentation if organised into a file that can be given to our field staff in a transfer pricing review.

On the other hand, you may find it difficult to gather external information on prices or margins to support your actions because your business may differ from other companies in your industry; or you may have a unique business operating in Australia. It may also be difficult to get publicly available data on bottom-line profits for similar companies that are not controlled by related parties to compare your net profit outcome. But this is not an excuse for doing nothing.

The alternative is to gather this data from commercial databases and tailor it to a documentation report for your business. You need to weigh the cost of gathering this data internally or using an external service provider against the likelihood of a transfer pricing review and subsequent tax audit adjustments.

We encourage businesses to keep the most valuable transfer pricing documentation, referred to in the rulings as **contemporaneous documentation**.<sup>4</sup> This is the documentation that existed at or before the time of preparing your tax return for a given year, and is used to set or review the outcome of your related party cross-border transaction pricing. As stated earlier, in addition to documents created in the ordinary course of your business, we expect to see some documentation specifically created to show how you applied the arm's length principle.

In all cases selected for a transfer pricing review, we undertake our own benchmark review to gauge what outcome we think a business should reflect in its taxable income relative to the industry it is engaged in.

Under the simplified approach, during a transfer pricing review we may discuss the use of benchmarking with you and your adviser to help you understand what is expected in testing the arm's length outcome of prices used in your cross-border transactions.

For example, we may discuss how your low profit outcome (gross profit and/or net profit before interest and tax) compares to higher, comparable broad Australian Bureau of Statistics (ABS) data profit outcomes. We may also ask you to explain how your related party dealings have influenced this comparison and/or how market and other environmental issues are relevant (for example, business cycle or market competition or foreign exchange risks). This process also helps you understand what action you need to take in future years.

Pricing and benchmarking studies are discussed in the next section.

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<sup>4</sup> **Contemporaneous documentation** is a self-contained report (with evidence attachments) that describes:

- your business
- the environment in which you work
- the method you have used to set or review related party pricing (including discussion of why acceptable methods were rejected for each type of transaction), and
- a comparable study that uses publicly available accounting data to indicate a price or range of prices or profit that proves your business was at arm's length in its dealings with related parties. This would include analysing comparables (independent company accounting data) that were accepted and rejected in the study and why the selected data is comparable and reflects arm's length results when applied to your business.

# 04

## HOW TO APPLY THE ARM'S LENGTH PRINCIPLE

In a transfer pricing review, we need to understand the business process undertaken between you and your overseas related entities. We also need to understand what efforts your business has made to ensure the price set or accepted by your business reflects what arm's length parties would have agreed to in similar circumstances.

Here is what we suggest you do to ensure that the way you set and test transfer prices reflects an arm's length result, in accordance with chapter 6 of TR 98/11.

### SELECT AN ARM'S LENGTH METHOD AND TEST IT

In chapter 5 of TR 98/11 we recommend that small to medium businesses use a four-step process to demonstrate compliance with the arm's length principle, as shown in the left-hand column of the table on page 10. The right-hand column sets out a more simplified approach in the spirit of chapter 6.

❗ This approach is not appropriate for businesses that are part of large multinational groups or large private company groups with the resources to fully follow the processes outlined in paragraph 5.16 of TR 98/11. See the attachment on page 15 for what is expected of businesses generally.

For many businesses with relatively simple and/or low value cross-border transactions with related parties, the extent of data collection and analysis and therefore the contents of the documentation file may be minimal.

### PUT A NAME TO THE METHOD USED

Some small to medium businesses may find it burdensome to put a name to the method used to set the price (step 2) or test the price (step 3). TR 97/20 lists various internationally accepted methods that are considered arm's length, while the instructions to Schedule 25A describe other methods that may or may not be considered arm's length.

The decision tree on page 11 may help you describe the method you used and how you tested it.

### SIMPLIFIED APPROACH TO DOING A BENCHMARKING STUDY

The cost of doing the benchmarking analysis required by step 3 and placing it in the documentation file before lodging your company's annual tax return may also be a material cost burden for small to medium businesses.

Therefore, as a manager of a small to medium business, you may assess the risk of any subsequent Tax Office adjustment as low and rely only on your company's internal procedures and records to comply with steps 1 and 2 and not proceed with step 3.

If you do so, we accept that you may leave the answer to question 4b in part A of Schedule 25A as code 1. While profitable businesses would be unlikely to be prejudiced by taking this approach, loss businesses run higher risks if no action is taken.

For example, we would expect businesses with related party cross-border transactions that are using documented business plans to have the resources to undertake a basic benchmarking study using Tax Office/ABS publicly available information.

⊖ Not preparing a benchmarking study and placing it in the documentation file may trigger a 'working together' process. Under this process, we present to a business a benchmarking study based on ABS data, and ask the business to explain why its profit outcome is below the benchmarking information.

The profit outcome benchmark is a risk indicator we use to assess whether the pricing of related party transactions has been used to achieve a low tax position in Australia. The explanation for a low tax position may therefore not relate to related party transactions but to bad product sales, management issues, foreign exchange exposure or other business cycle pressures on the business.

Accordingly, the benchmark study handed to a business in the simplified approach may not be the only benchmark pointing to the pricing that should be adopted to show that the business has applied the arm's length principle to related party cross-border transactions. If we are not satisfied with other explanations, the business may need to undertake a more detailed benchmarking study as discussed in TR 98/11 and TR 97/20, or seek additional time from us to comply within the spirit of the simplified approach.


### COMPLETING SCHEDULE 25A

If your business has minimal documentation evidencing the four-step process and pricing methods, refer to the instructions to Schedule 25A for which code to use when answering questions 4 and 5 in part A of the schedule.

Use of code 1 (0%) will not automatically lead to a transfer pricing risk review if your level of profitability is within industry norms for the income year.

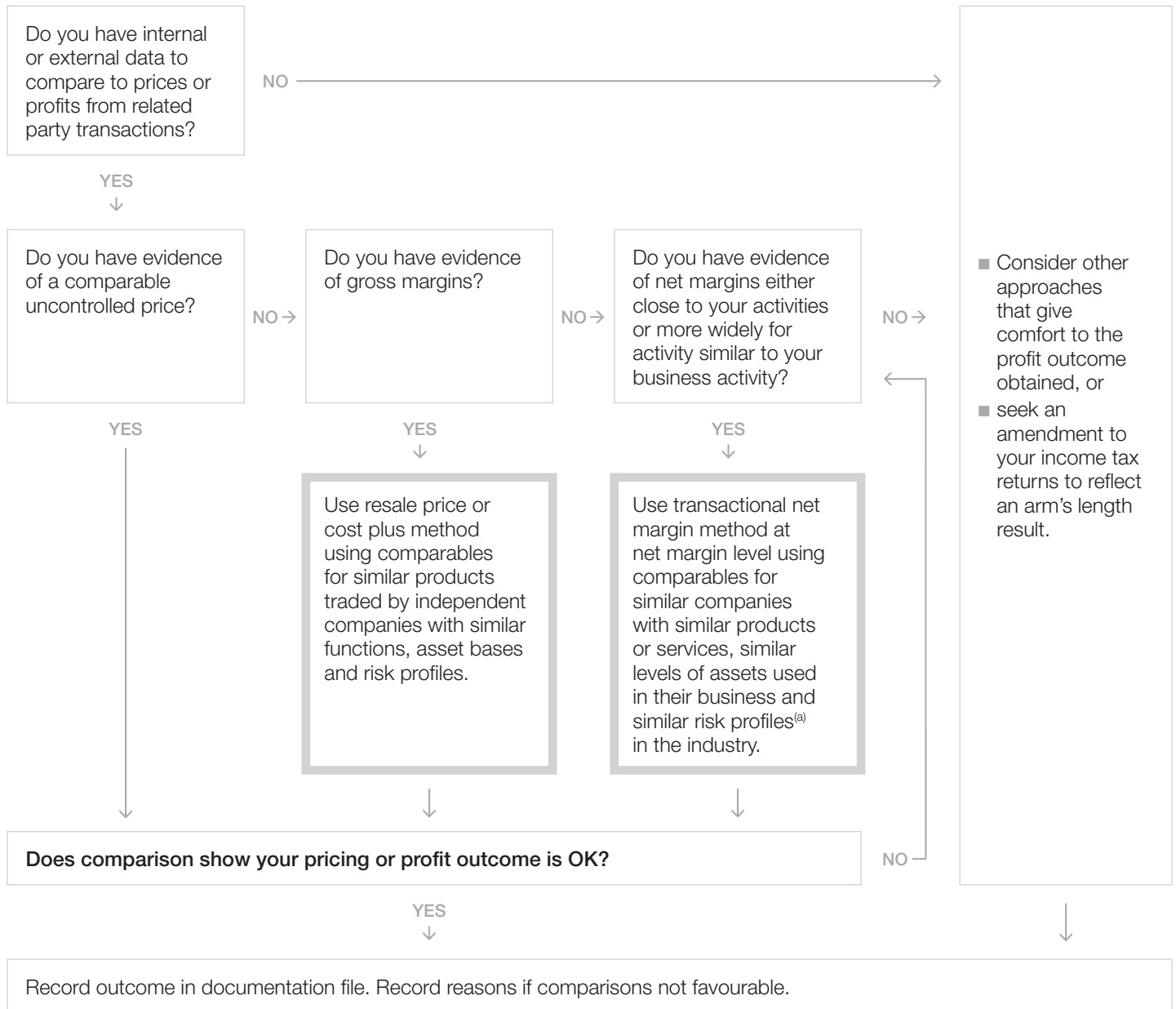
For practical purposes, steps 1 and 2 are joined in question 4a in part A and many businesses should be able to achieve a level of documentation file more than code 1.

Take care in answering question 5. If you are unsure of what is expected, refer to the instructions to Schedule 25A.

 Schedule 25A may change after this guide is published, so make sure you check the schedule and accompanying instructions for the income year you are addressing.

The four steps for testing international transfer prices (as described in TR 98/11)	Simplified approach for small to medium businesses (as outlined in chapter 6 of TR 98/11)
<p><b>Step 1</b></p> <p>Accurately characterise the international dealings between the associated enterprises in the context of your business and document that characterisation.</p>	<ul style="list-style-type: none"> <li>■ Know (and record in a documentation file) what business you are carrying on and how cross-border transactions with related parties fit into your everyday business and how industry and/or economic conditions affect your business. Identify any major business strategy you are conducting, such as a market penetration strategy.</li> </ul> <p>This information is usually put together in a functional analysis report.</p>
<p><b>Step 2</b></p> <p>Select the most appropriate transfer pricing methodology or methodologies and document your choice.</p>	<ul style="list-style-type: none"> <li>■ Add to the documentation file, records such as price lists, budgets, correspondence, working papers and agreements with related parties that reflect how you set and recorded prices.</li> <li>■ What you actually call the pricing method you use is not important, but you must have some basis to show how you set prices and that it reflected the arm's length prices used, for example, by competitors. Identify whether your competitors are part of a controlled group as their prices may be influenced by their transfer pricing policy and may not be a reliable comparison.</li> <li>■ You may, for example, know that cost plus mark up is normal in your industry and be able to use this industry 'plus' percentage to set your prices and/or test your position. You need to make sure the industry 'plus' is based on arm's length dealings and not controlled party dealings.</li> <li>■ You may also have charged a related party the same or similar price you charged a third party for the same or similar goods or services. This method is generally referred to as the comparable uncontrolled price method.</li> <li>■ You may also have set your related party prices based on a business plan that used sale prices from or to related parties that result in a planned gross profit sufficient to cover administration and selling costs and return you a fair net profit. Your documentation file should explain how this was calculated. You need to test whether the fair net profit reflects an arm's length result.</li> </ul>
<p><b>Step 3</b></p> <p>Apply the most appropriate method, determine the arm's length outcome and document the process.</p>	<ul style="list-style-type: none"> <li>■ Add to the documentation file what action you have taken to test that the price you have set and recorded reflects an arm's length outcome, for example, doing a benchmarking study.</li> <li>■ This may be a general comparison of your company's profit result with Tax Office or ABS data for the type of business you carry on; or a more detailed study conducted by an outside adviser using profit level indicators that are acceptable arm's length methods.</li> </ul>
<p><b>Step 4</b></p> <p>Implement support processes and a review process to ensure adjustment for material changes. Document these processes.</p>	<ul style="list-style-type: none"> <li>■ Review the transaction pricing and benchmarking study if there are any changes to the nature of the transaction, the parties to the transaction, or economic conditions, and record the outcome in your documentation file.</li> </ul>

**DECISION TREE FOR PUTTING A NAME TO THE METHOD USED**



<sup>(a)</sup> Internal evidence may support the arm's length nature of pricing used with related parties but profit comparisons may either strengthen or weaken the case if your profit outcome falls outside the comparable profit range. Reasons for this situation may not be related only to transfer pricing.

TR 98/11 introduced five levels for scoring the quality of processes and documentation for cross-border transactions with related parties. We have used these five levels in all risk reviews since 1998.

Chapter 6 recognises that many small to medium businesses do not have the in-house resources or cannot afford to engage external advisers to prepare the medium to high quality documentation expected of large businesses. We nonetheless encourage small to medium businesses to aspire to a medium to high quality of documentation, while recognising that in most cases they would not be required to have the same amount of documentation as large businesses.

Accordingly, in a transfer pricing review of a small to medium business, the **quality** of process and documentation applied to related party cross-border transactions will generally fall into one of the following three levels set out in chapter 4 of TR 98/11:

- low (score = 1) – which will increase the likelihood of an audit unless the business and its adviser cooperate under the simplified approach outlined in chapter 6, by working with us to provide an acceptable level of documentation and explain profitability
- medium (score = 3) – which will also allow a business and its advisers to work with us to provide an acceptable level of documentation and explain profitability, and
- medium to high (score = 4) – which will generally be seen as acceptable, requiring little interaction with us and decreasing the likelihood of an audit. It recognises the limitations of finding reliable comparables in the Australian market (the high quality level 5 is rarely obtained in practice).

The major factors used in scoring these three most common levels for small to medium businesses are summarised in the following table.

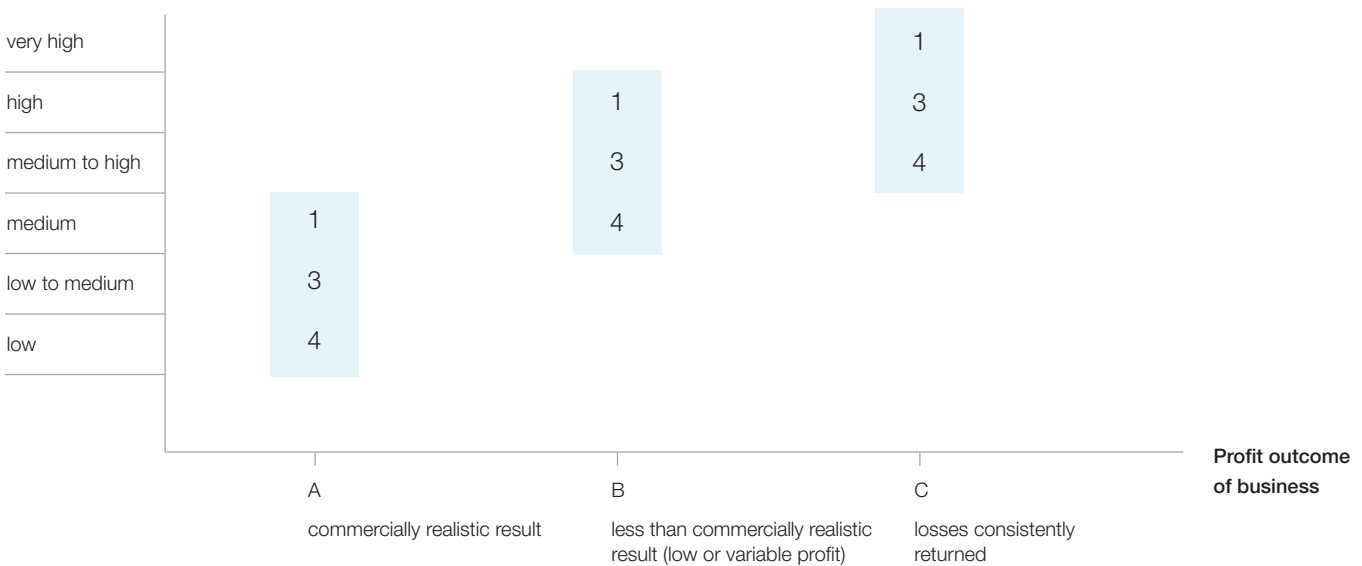
Score 1 Low quality	Score 3 Medium quality	Score 4 Medium to high quality
No analysis to describe the functions, assets and risks of the business, the markets in which it operates, and business strategies used by management to gain a commercial return.	Inadequate analysis to describe the functions, assets and risks of the business, the markets in which it operates, and business strategies used by management to gain a commercial return.	Sound analysis to describe the functions, assets and risks of the business, the markets in which it operates, and business strategies used by management to gain a commercial return.
No or insufficient documentation or processes to enable a check on selection of pricing method used.	Selection of method supported by some contemporaneous documentation. <sup>5</sup>	Selection of method fully supported by contemporaneous documentation.
No comparables used.	Broad inexact comparables used <i>or</i> comparables based on data from external related party comparables (for example, data used by an overseas related party to justify the pricing).	Comparables based on limited to adequate data from independent dealings and reliability taken into account in choice of comparables.
No documentation to allow a check on application of pricing method used.	Application of pricing method supported by some contemporaneous documentation.	Application of pricing method fully supported by contemporaneous documentation.

<sup>5</sup> See TR 97/20 for an explanation of the selection and use of the main acceptable methods: comparable uncontrolled price, cost plus, resale price, transactional net margin method and profit split. Other methods that are sometimes used are described in the instructions to Schedule 25A, which we publish each year.

## THE SCORE GRAPH

After calculating the quality of documentation score, we assess the risk of a transfer pricing audit as shown in the following graph.

### Risk of a transfer pricing audit



As a guide, in a transfer pricing record review of a small to medium business using the simplified approach, we would score the business as follows:

- A score of **C1** would show a very high risk, indicating that a Tax Office audit is possible. To avert an audit, we would encourage the business to prepare and maintain a documentation file to at least the '3' quality level, and examine its profit position relative to ABS benchmarking information and limited analysis. If we commence an audit, we may offer the business an opportunity to enter into an advance pricing arrangement.
- A score of **B3** would indicate a medium to high risk of an audit. If a business has related party cross-border transactions that present as medium to high risk in our risk review process, we would provide the business with ABS benchmarking information and limited analysis. Subject to a cooperative discussion, we may place the business on a watching brief to review their progress in demonstrating compliance with the arm's length principle. An audit may result in future years if little progress is made.
- A score of **A4** would suggest that the business has made a big effort to manage its related party cross-border transactions on an arm's length basis, indicating to us that no audit action was required on transfer pricing issues.

If we decide to audit a business following a transfer pricing review, the business is likely to face tax adjustments and penalties. Any adjustment is subject to normal Tax Office and legal review and appeal processes. It may also be subject to discussions with another revenue administration involved under the mutual agreement procedure of the relevant double tax agreement.

Our usual practice is to issue a position paper and give the business an opportunity to comment before we assess any adjustments and resulting tax and penalties.

The following flow chart shows how we conduct transfer pricing reviews and audits and other follow-up action specifically for small to medium businesses.

By working with a business we endeavour to help the business (and its tax adviser) understand the minimum steps needed to comply with the arm's length principle. We may provide benchmarking information applicable to the business that indicates the outcome expected of a business trading at arm's length with all parties it deals with.

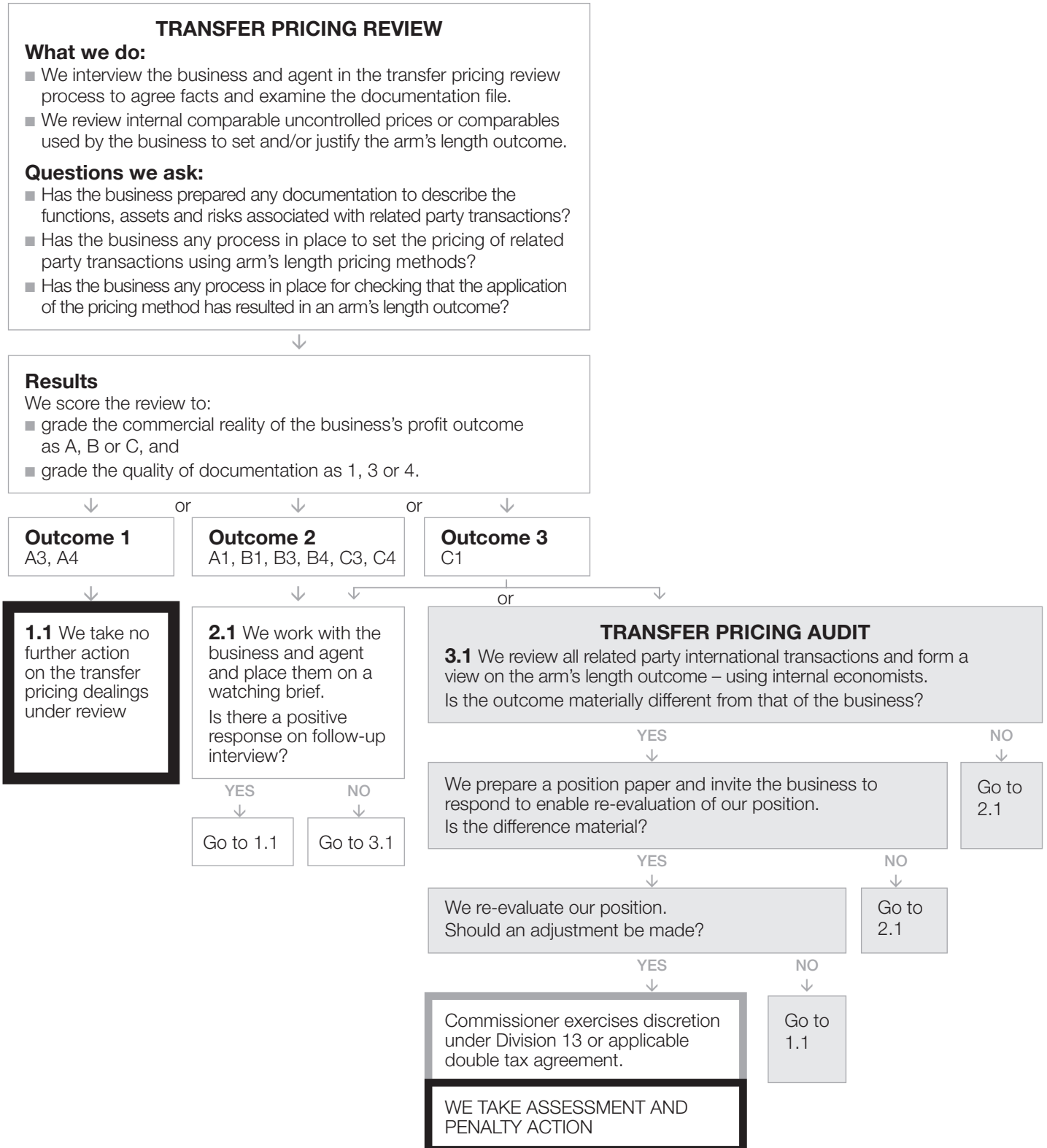
The aim is to improve the documentation held by the business and encourage commercially realistic outcomes from related party dealings. We may therefore give the business time before the review is finished to explain why it has performed below industry standards and how it will address the issue, both commercially and in documenting the arm's length nature of dealings with related parties.

### **IS AN AUDIT STILL POSSIBLE IF RISK IS LOW?**

The transfer pricing review process focuses only on cross-border transactions and how the parties deal with each other to demonstrate arm's length outcomes. So although the risk of a transfer pricing audit may be low, we may still audit a business if a broader review indicates that other tax-related issues demonstrate a risk to revenue.

We recognise that low profit performance by a business is not necessarily the result of transfer pricing action. However, the following may precipitate an audit:

- the use of tax havens, for example, where a business is in a re-invoicing arrangement
- the use of back-to-back transactions to mask the true consideration involved in a transaction, or
- the use of triangular or circular structures to shield related party dealings.



# ATTACHMENT: FOUR-STEP PROCESS FOR BUSINESSES GENERALLY

The following four-step process is expected of businesses generally. It is taken from TR 98/11.

Data collection/organisation	Action/evaluation
<p><b>Step 1. Accurately characterise the international dealings between the associated enterprises in the context of the taxpayer's business and document that characterisation.</b></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 may require an understanding of the context of the dealings including:</p> <ul style="list-style-type: none"> <li>■ organisation, decision processes and systems, and incentive structures</li> <li>■ the conditions affecting the industry, the nature of the competition experienced, economic and regulatory factors</li> <li>■ the business objectives, strategies adopted, and financial performance</li> <li>■ intellectual assets used, their contribution, ownership and reward</li> <li>■ the economically important activities undertaken by each of the associated enterprises, resources used and risks assumed in each.</li> </ul>	<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><b>Step 2. Select the most appropriate transfer pricing methodology or methodologies and document the choice.</b></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><b>Step 3. Apply the most appropriate method, determine the arm's length outcome and document the process.</b></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"> <li>■ adjust the data to account for material differences in comparability</li> <li>■ group or aggregate data</li> <li>■ extend the analysis over a number of years</li> </ul> <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 on 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"> <li>■ assumptions and judgments made</li> <li>■ how data points or ranges were interpreted, or</li> <li>■ how results from different methods were used.</li> </ul>
<p><b>Step 4. Implement support processes. Install review process to ensure adjustment for material changes and document these processes.</b></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>

