13.

Australia

Introduction

Australia's transfer pricing legislation was introduced with effect from 27 May 1981. Since this time, the Australian Taxation Office (ATO) has issued a series of major rulings and publications providing guidance in applying the legislation. The Australian Government commenced a review of Australia's transfer pricing legislation in 2011. The first stage of changes was enacted in September 2012, and further changes are expected to be introduced shortly.

The ATO is vigilant in policing taxpayers' compliance with Australia's transfer pricing rules and continues to work closely with tax authorities in other jurisdictions and international bodies (such as the Organisation for Economic Co-operation and Development [OECD]) to reduce double taxation, resolve transfer pricing disputes and share information. The views of the ATO are largely consistent with the views expressed by the OECD.

Statutory rules

Division 13 – Transfer pricing legislation

Division 13 of Part III of the Income Tax Assessment Act 1936 (ITAA 1936) (SS136AA to 136AF) contains Australia's domestic law dealing with transfer pricing. It is an anti-avoidance division aimed at countering international profit-shifting techniques. The division operates only at the discretion of the Commissioner of Taxation (the Commissioner) and only to increase the tax liability of a taxpayer.

Section 136AD deals with circumstances in which a taxpayer has 'supplied' or 'acquired' 'property' (all of these terms are widely defined in Section 136AA[1]) under an 'international agreement', as defined in Section 136AC. Section 136AD does not require that the parties to an international agreement be related. Section 136AD contains four subsections:

- Supplies of property for less than arm's-length consideration.
- Supplies of property for no consideration.
- Acquisition of property for excessive consideration.
- Determination of the arm's-length consideration in circumstances in which it is neither possible nor practicable to ascertain.

Section 136AE addresses international dealings between different parts of the same entity (e.g. dealings between a permanent establishment [branch office] and its head office, or between two permanent establishments of the same entity). The Commissioner is authorised to reallocate income and expenditure between the parties and thereby determine the source of income and the allocation of related expenses.

The ITAA does not impose a time limit for the Commissioner to make transfer pricing adjustments. Therefore, adjustments are technically possible commencing from 27 May 1981, being the date of effect of Division 13; although this would be highly unlikely in practice.

Double-tax agreements

The domestic legislation is supplemented by the provisions in Australia's double-tax agreements (DTAs), which appear as schedules to the Income Tax (International Agreements) Act 1953. The DTAs contain specific provisions which deal with profit-shifting arrangements, namely the Associated Enterprises and Business Profits Articles. These Articles are broadly similar to Division 13 in that they are based on the arm's-length principle. In the event that Division 13 and the DTA are inconsistent, the provisions of the DTA will prevail.

The ATO holds the view that the Associated Enterprises and Business Profits Articles of Australia's DTAs provide the Commissioner a separate power to make transfer pricing assessments independently of Division 13. While obiter dicta comments in the recent SNF case provide some support for this position, it remains untested as to whether the relevant Articles of Australia's DTAs provide a separate power to assess. However, with the recent introduction of retrospective legislation that inserts language consistent with the Associated Enterprises article within Australia's domestic legislation (Subdivision 815-A; *see below*), and the likely introduction of similar language in new prospective transfer pricing legislation, this particular debate may well become redundant in the context of transfer pricing assessments within Australia.

Subdivision 815-A

Subdivision 815-A of the Income Tax Assessment Act 1997 (ITAA 1997) was enacted in September 2012 with retrospective application to income years beginning on or after 1 July 2004. Subdivision 815-A applies to dealings between Australian taxpayers and related parties in countries with which Australia has a DTA in place. Subdivision 815-A was introduced to remove doubt over whether the Commissioner can make transfer pricing assessments based on the Associated Enterprises and Business Profits Articles of Australia's DTAs (*see above*), by introducing 'treaty-equivalent' transfer pricing rules into the domestic legislation. Subdivision 815-A applies to dealings between Australian resident taxpayers and related parties in DTA countries and to Australian permanent establishments of foreign residents of DTA countries.

The Commissioner can make a determination under Subdivision 815-A when an Australian taxpayer has received a 'transfer pricing benefit' in relation to dealings with a related party in a DTA country. A 'transfer pricing benefit' is defined by reference to the relevant Associated Enterprises or Business Profits DTA Article. These Articles typically refer to the profits that have accrued to the parties, so a 'transfer pricing benefit' for the purposes of Subdivision 815-A will arise where the Australian taxpayer's actual profits are less than the profits it would have accrued if it had been dealing wholly independently with its related party. The Commissioner must have regard to relevant OECD guidance (including the Transfer Pricing Guidelines and Model Tax Convention) when assessing whether a transfer pricing benefit has arisen.

Subdivision 815-A also contains specific rules on the interaction of Australia's transfer pricing and thin capitalisation rules, which give legislative effect to the position taken by the Commissioner in a Taxation Ruling issued on this topic (TR 2010/7; *see Thin capitalisation section below*).

Minerals Resource Rent Tax
The Australian Federal Government has introduced a profits-based tax on the economic rents from the extraction of coal and iron ore in Australia. A key component of the Minerals Resource Rent Tax (MRRT) requires the application of generally accepted transfer pricing principles, albeit in a domestic context, to identify the value of the mineral at the MRRT taxing point. The MRRT regime commenced from 1 July 2012.

Other regulations
Taxation rulings
In addition to the statutory rules referred to above, the ATO has issued various public rulings concerning transfer pricing. These both interpret the application of the statutory rules and provide guidance on other issues not specifically covered by statute.

The taxation rulings issued to date, of relevance to transfer pricing, include:

- Loan arrangements and credit balances – Taxation Ruling TR 92/11.
- Basic concepts underlying the operation of Division 13 – Taxation Ruling TR 94/14.
- Arm's-length transfer pricing methodologies – Taxation Ruling TR 97/20.
- Documentation and practical issues associated with setting and reviewing transfer pricing – Taxation Ruling TR 98/11.
- Penalty tax guidelines – Taxation Ruling TR 98/16.
- Intra-group services – Taxation Ruling TR 1999/1.
- Transfer pricing and profit reallocation adjustments, relief from double taxation and Mutual Agreement Procedure – Taxation Ruling TR 2000/16 and Taxation Ruling TR 2000/16A.
- Operation of Australia's permanent establishment attribution rules – Taxation Ruling TR 2001/11.
- Interpreting Australia's DTAs – TR 2001/13.
- Meaning of 'arm's length' for the purpose of dividend deeming provisions – Taxation Ruling TR 2002/2.
- Thin capitalisation, applying the arm's-length debt test – Taxation Ruling TR 2003/1.
- Cost contribution arrangements – Taxation Ruling TR 2004/1.
- Branch funding for multinational banks – Taxation Ruling TR 2005/11.
- Effects of determinations made under Division 13, including consequential adjustments – Taxation Ruling TR 2007/1 (replaces Taxation Ruling TR 1999/8).
- Interaction of the thin capitalisation provisions and the transfer pricing provisions – Taxation Ruling TR 2010/7.
- Application of the transfer pricing provisions to business restructuring – Taxation Ruling TR 2011/1.

Taxation determinations
In addition to taxation rulings, the ATO also releases taxation determinations. While also a type of public ruling, determinations are generally shorter than rulings and deal with one specific issue rather than a comprehensive analysis of the overall operation of taxation provisions. For example, Tax Determination TD 2008/20 provides specific guidance in relation to the interaction of Australia's transfer pricing and debt/equity provisions.

Final taxation determinations may be relied upon by taxpayers.

Law administration practice statements

The ATO provides instructions to ATO staff on the approaches to be taken in performing their duties. These instructions may outline, for example, procedures for identifying and resolving significant issues, and work practices to be followed in the practical application and administration of the tax laws.

The instructions, known as a Law Administration Practice Statement (LAPS), do not express a precedential ATO view. Taxpayers who rely on a LAPS will remain liable for any tax shortfall (but not interest and penalties) in the event the LAPS is incorrect and the taxpayer makes a mistake as a result.

The LAPS that are directly applicable to transfer pricing include:

- Making a determination under Division 13 and applying the relevant Articles of Australia's DTAs – PS LA 2003/5.
- The transfer pricing review panel – PS LA 2004/13.
- Transfer pricing review work – PS LA 2005/14.
- Treatment of non-resident captive insurance arrangements – PS LA 2007/8.
- ATO's Advance Pricing Arrangement program – PS LA 2011/1.

ATO transfer pricing publications

The ATO has issued a suite of publications about international transfer pricing. They include:

- *International transfer pricing: introduction to concepts and risk assessment.*
- *International transfer pricing: applying the arm's-length principle.*
- *International transfer pricing: a simplified approach to documentation and risk assessment for small to medium businesses.*
- *International transfer pricing: marketing intangibles.*
- *International transfer pricing: attributing profits to a dependent agent permanent establishment.*

The ATO has indicated that these guides do not replace, alter or affect in any way the ATO interpretation of the relevant law as discussed in the various taxation rulings; however, they do provide insights into the ATO view on various matters.

Other transfer pricing publications

Australia is a member of the OECD. The ATO generally has followed the OECD Guidelines in relation to transfer pricing, the principles of which are reflected in Australia's tax rulings, but is under no obligation to follow them when applying Division 13. The ATO must follow the OECD Guidelines when applying Subdivision 815-A, i.e. when considering arrangements between Australian taxpayers and international related parties located in treaty jurisdictions.

Australia is also a member of the Leeds Castle group, which superseded the Pacific Association of Tax Administrators (PATA) in 2006. While the PATA no longer exists, we understand that the ATO will continue to apply the principles in PATA publications which deal with bilateral transfer pricing issues with Canada, Japan and the United States.

Australia

Legal cases

There have been few cases relating to transfer pricing brought before an Australian court or tribunal. Most of these cases have involved an administrative law challenge to the Commissioner's processes in issuing transfer pricing-based assessments. Only two cases have involved the substantive operation of Australian transfer pricing rules.

The Australian transfer pricing cases include:

- San Remo Macaroni Company Pty Ltd v Commissioner of Taxation (1999) – allegations that the Commissioner had made transfer pricing assessments in bad faith.
- Daihatsu Australia Pty Ltd v Commissioner of Taxation (2001) – challenging transfer pricing adjustments on the basis that the Commissioner did not exercise his power on a bona fide basis.
- Syngenta Crop Protection Pty Ltd v Commissioner of Taxation (2005) – request for the Commissioner to provide details of the transfer pricing assessments.
- WR Carpenter Holdings Pty Ltd v Commissioner of Taxation (2008) – request for the Commissioner to provide particulars of matters taken into account in making transfer pricing determinations.
- Roche Products Pty Ltd v Commissioner of Taxation (2008) – an Administrative Appeals Tribunal (AAT) case, which represents the first transfer pricing case involving the application of Division 13.
- Commissioner of Taxation v SNF (Australia) Pty Ltd (2011) – the second substantive transfer pricing matter to face an Australian court or tribunal after the Roche case.

The recent cases are discussed in more detail below.

WR Carpenter Holdings Pty Ltd

In July 2007 the Full Court of the Federal Court of Australia upheld an earlier decision to deny the taxpayer the right to request particulars of how the ATO arrived at its transfer pricing determination. Affirming the precedent set in the case of Syngenta Crop Protection, the court found that Division 13 does not make the Commissioner's reasoning process in making a transfer pricing determination a relevant consideration. Therefore, the court declined to give the taxpayer an opportunity to view and challenge these reasons, removing a potential avenue by which the taxpayer could challenge the ATO's transfer pricing adjustment.

The taxpayer was granted leave to appeal to the High Court of Australia. In July 2008, the High Court of Australia unanimously dismissed the appeal.

Roche Products Pty Ltd

This case, handed down in July 2008, was the first Australian judgment on substantive transfer pricing issues. The case concerned the transfer price of goods acquired by Roche Products (an Australian company) from its Swiss parent. The AAT found that the transfer prices paid by the Australian taxpayer for ethical pharmaceutical products were excessive and made adjustments accordingly. No adjustments were made to the transfer prices of the other product lines.

In its judgment, the AAT made a number of comments that have potential implications for all Australian taxpayers with transfer pricing issues. They include:

- The operation of DTAs – Although the AAT was not required to decide on this issue, the AAT commented that there is a lot to be said for the proposition that Australia's DTAs do not give the ATO the ability to impose tax and that Division 13 must form the base that supports any assessment.
- Transfer pricing methodologies – Although the ruling acknowledges the difficulty in finding available comparable data, and uses a uniform gross margin to price the transfers of all pharmaceutical products, the AAT expressed a preference for transactional methods over profit methods, such as the profit-based TNMM.
- Loss-making companies – In noting the weaknesses of profit methods, the AAT pointed out their tendency to attribute any losses to incorrect transfer pricing. The AAT rejected this inference. The ruling accepted the taxpayer's commercial reasons for the losses, despite their occurring over a number of years, and did not order a transfer pricing adjustment.
- Division 13 test – The ruling clearly stated that the provisions of Division 13 require that arm's-length prices be determined for each separate year under consideration, rather than a multiple-year average.

In January 2009 the ATO released its Decision Impact Statement in relation to the case. The Statement expresses the ATO's view that the decision in Roche is confined 'to the facts of the case' and that 'all things considered [Roche] is seen as having limited significance for the administration of transfer pricing laws generally'. The ATO's message is that the status quo prevailed. As a result, taxpayers were not provided with any guidance by the ATO to that which was already in the public domain. However, in our view, aspects of the AAT decision should not be ignored by taxpayers.

SNF (Australia) Pty Ltd

A judgment in only the second substantive transfer pricing matter to face an Australian court or tribunal (after Roche) was handed down by the Federal Court of Australia in June 2010. The Federal Court found in favour of the taxpayer. The Commissioner subsequently appealed this decision in the Full Federal Court in 2011. The Full Federal Court upheld the original decision.

The proceedings concerned an Australian distributor (SNF Australia) purchasing from offshore related parties. For 13 years SNF Australia had no income tax liability and made trading losses in all years bar two. The Commissioner argued that an arm's-length purchaser would never agree to the prices paid, given the sustained period of losses. In a significant win for the taxpayer, the Federal Court and the Full Federal Court both held that SNF Australia had successfully discharged its burden to satisfy the court that the price paid to offshore related parties did not exceed the arm's-length price. SNF Australia did this through the application of a comparable uncontrolled price (CUP) method.

The transfer pricing issues emerging from SNF Australia's win in the Full Federal Court were similar to those addressed by the AAT in Roche. These issues include:

- The operation of DTAs – Although the operation of the DTAs was not at issue, obiter dicta comments in the June 2010 Federal Court decision suggest that Australia's DTAs may provide a standalone taxing power. These obiter dicta comments, however, have reduced precedential value to taxpayers as the Commissioner elected not to pursue the issue. Therefore, the question of whether or not the DTAs provide the Commissioner a legal basis for raising transfer pricing assessments independently of Division 13 remains untested; although this now appears

irrelevant (for post-2004 transactions) following the introduction of Subdivision 815-A.

- Transfer pricing methodologies (CUP method) – The courts found that the CUP method is the most appropriate methodology where direct transactional data is available, but noted that Division 13 does not require the same 'exactness' of comparability as suggested by the ATO. The Full Federal Court observed that the ATO's current approach was impractical and would set the bar 'at an unattainable height' for taxpayers to ever be able to apply the CUP method.
- Relevance of OECD Guidelines. The Full Federal Court found that the Commissioner did not provide sufficient evidence to establish that the OECD Guidelines were relevant for the interpretation of Division 13 or the DTAs. The Government has addressed this in Subdivision 815-A by explicitly requiring the OECD Guidelines to be taken into account when applying the treaty-equivalent transfer pricing rules. It is likely that the new prospective transfer pricing rules will include a similar requirement that will apply to all dealings subject to the transfer pricing rules.
- Loss-making companies – The judgment in SNF indicates that the existence of losses, even over a lengthy period, will not necessarily mean that the price paid for products is not arm's length.
- Division 13 test – According to the courts, the test under Division 13 is not to determine what consideration an arm's-length party 'in the position of the taxpayer' would have given for the products. Rather, the essential task is to determine the arm's-length consideration in respect of the acquisition of the goods. This meant that the financial position of the taxpayer (such as a history of sustained losses) was not relevant to the determination of an arm's-length price in this case. The ATO acknowledged in its Decision Impact Statement that a loss does not automatically mean that a transfer price was not arm's length, but it also indicated that there are some types of transactions where it is necessary to consider the taxpayer's circumstances to identify an arm's-length consideration (such as a loan).The ATO's Decision Impact Statement on the SNF case raised a possible alternative argument that the Commissioner could have put forward: that an arm's-length party in the taxpayer's position 'would have sought separate compensation' for representing the SNF group in the Australian market. In other words, the ATO believes it could have argued that SNF was implicitly providing a service to its parent company. Since there was no actual service transaction between the taxpayer and its parent company, this would have required the ATO to deem a new transaction to exist. It is questionable whether the ATO would be able to successfully 'reconstruct' transactions under Division 13, but it may take the view that Subdivision 815-A would support this approach due to comments in the OECD Guidelines that suggest reconstruction of transactions may be appropriate in exceptional circumstances. It is unlikely that a clear position on this will be known until a case is tested in the courts.

Burden of proof

The burden of proof to satisfy the ATO and the courts that transfer prices are arm's length lies with the taxpayer.

The weight of this burden has been affirmed by the judicial decisions in Syngenta and WR Carpenter Holdings. In these judgments, the court declined to allow taxpayers to examine and challenge the Commissioner's reasons underlying transfer pricing determinations on the grounds that this was not a relevant consideration to the case.

The court found that the provisions of Division 13 do not require the ATO to establish the validity of its transfer pricing assessments. Rather, the burden rests entirely on the taxpayer to establish that its prices were arm's length or that the Commissioner's assessments were excessive. The SNF appeal decision clarified that the taxpayer's burden does not require it to demonstrate a single arm's-length price; rather, the taxpayer is only required to demonstrate that (in the case of an acquisition from a related party) the prices paid did not exceed an arm's-length amount.

Tax audit procedures

Tax return

Australia has a self-assessment system. Taxpayers are responsible for correctly assessing and reporting their tax obligations. Taxpayers are expected to take reasonable care in preparing and documenting their income tax returns.

Every taxpayer that engages in international transactions with connected parties with an aggregate amount greater than Australian dollar (AUD) 2 million is required to submit an International Dealings Schedule (IDS) with their income tax return, detailing the nature and value of these transactions. For permanent establishments, the responses in the IDS should be provided on a notional basis that a permanent establishment is a separate but related entity. The ATO uses information from the IDS to assess a taxpayer's transfer pricing risk and select taxpayers for review.

The IDS became mandatory for all taxpayers in 2012 after a trial in 2010 and 2011 for certain financial services entities. The IDS has replaced the Schedule 25A and the Thin Capitalisation Schedule. The disclosures required in the transfer pricing section of the IDS (Section A) are significantly more detailed than the disclosures that were required in the Schedule 25A. Details must be provided regarding the nature and dollar value of transactions, the locations of counterparties, the extent to which each type of transaction is covered by transfer pricing documentation, details of any cross-border business restructures involving related parties, and various other questions.

In addition to the above schedules, the ATO has introduced a Reportable Tax Position (RTP) Schedule, which requires certain taxpayers to disclose information about reportable tax positions (i.e. uncertain or contestable positions) in an attachment to their income tax return. The RTP Schedule was introduced for certain large business taxpayers for 2012, and may be rolled out to other taxpayers in future years. Transfer pricing involves inherent uncertainty, which means that taxpayers with international related party transactions could potentially have reportable tax positions.

The public officer's duties in relation to the income tax return also apply in respect of the schedules to be lodged with the income tax return. The public officer is required to sign the declaration on the company's income tax return, certifying disclosures in the company income tax return and supporting schedules to be true and correct.

Recent ATO activity

The ATO releases an annual compliance program which sets out the tax compliance risks of most concern to the ATO and the ATO's mitigation strategies to address these risks. The 2012/13 compliance program continued to highlight transfer pricing as a key compliance risk for both large business (turnover of AUD 250 million or more) and small to medium enterprises (SMEs) (turnover of between AUD 2 million and AUD 250 million).

Australia

In June 2010 the ATO released a new edition of the Large Business and Tax Compliance booklet, previously released in 2006. The booklet contains essential information on the ATO's expectations around good corporate tax governance, sets out how the ATO identifies tax risk and details how large corporate taxpayers can work with the ATO to manage their tax risks. The ATO is also preparing a Compliance Booklet for SMEs. This was released in draft in March 2012.

Large business
The ATO's compliance activities for large businesses are focused on increasing the level of 'real time' information gathering and interactions with taxpayers. The ATO has developed a range of initiatives that it is using to achieve this objective, including Annual Compliance Arrangements (a voluntary arrangement between the taxpayer and ATO similar to a unilateral-APA [Advance Pricing Agreement] but covering a wider range of tax issues), Pre-lodgement Compliance Reviews, risk workshops, and the RTP Schedule. There is also a trend of increased information sharing with other tax authorities around the world.

Particular focus areas of the ATO's compliance activities for large businesses in 2012-13 include:

- Related party debt arrangements, particularly where taxpayers have relied upon asset revaluations to fall within the thin capitalisation safe harbour.
- Corporate restructures, including those involving complex or novel arrangements.
- Research and development claims.
- MRRT implementation reviews.

Understanding taxpayers' tax risk management and governance policies and procedures is also a key theme of the ATO's compliance activities in the large business segment.

Small to medium enterprises
The ATO's focus areas for SMEs in 2012-13 include:

- Ensuring that taxpayers are aware of their IDS lodgement obligations.
- Business losses.
- Dealings with low tax jurisdictions.
- Promotion of the 'simplified' APA product.

The audit procedure

Risk differentiation framework

The ATO uses a Risk Differentiation Framework (RDF) to assess tax risk and determine an appropriate risk management response. In using this framework, the ATO considers the likelihood of non-compliance (i.e. having a tax outcome that the ATO doesn't agree with) and the consequences of that non-compliance (e.g. in terms of dollars, precedent). If the likelihood and consequences of non-compliance are considered to be high, the ATO will target the taxpayer for a review or audit. Conversely, if the risk assessment by the ATO is determined to be low, the taxpayer will be monitored periodically.

A

Risk review

The ATO typically uses an approach known as a Client Risk Review (CRR) when undertaking a risk assessment of potential material tax issues, including transfer pricing. The ATO will examine information such as the taxpayer's IDS, compliance history, latest collections, news or media articles and other publicly available information. A CRR is a review of one or more historical income years for which a tax return has been lodged. As noted above, the ATO is increasingly conducting real time reviews of taxpayers to gather information prior to lodgement of the income tax return.

When transfer pricing is identified as a significant risk, the CRR may proceed to a formal Transfer Pricing Record Review (TPRR). As part of a TPRR, and in deciding whether to proceed beyond a TPRR to a transfer pricing audit, the ATO considers:

- the quality of a taxpayer's processes and documentation, and
- whether the taxpayer's results are commercially realistic.

The quality of a taxpayer's processes and documentation is generally assessed as falling into broad categories ranging from 'low quality' to 'high quality'. The taxpayer's financial results will be assessed as either 'commercially realistic', 'less than commercially realistic' or 'consistently returns losses'.

Taxpayers will receive a risk rating at the completion of the risk review. A higher risk rating does not necessarily mean that the company will be selected for audit, but with such a risk rating, the taxpayer is likely, at a minimum, to be placed on a watching brief.

Audit

An ATO audit is more comprehensive than a risk review. When a taxpayer is selected for audit, the audit process usually commences with the ATO requesting a meeting with the taxpayer. At this meeting the ATO will carry out an inspection of the taxpayer's premises and interview key operational personnel. The ATO's approach broadly follows the first three steps of the four- step process set out in Taxation Ruling TR 98/11 as follows:

- Step 1: Characterise the international dealings with related parties in the context of the taxpayer's business.
- Step 2: Select the most appropriate transfer pricing methodology.
- Step 3: Apply the most appropriate methodology and determine the arm's-length outcome.

At the completion of this process, the ATO would consider all information gathered (including a review of the taxpayer's transfer pricing documentation) and issue a position paper outlining its findings and proposed adjustments to taxable income over the review period.

While verbal communications between the ATO and the taxpayer generally will continue throughout the process, the taxpayer is offered an opportunity to respond in writing to the ATO's position paper, which would involve correcting any factual errors made by the ATO and, where available, to provide additional information and arguments to counter the ATO's position. After a review of the taxpayer's response, the ATO will issue its final position paper followed by determinations and notices of assessment or amended assessments giving effect to the determinations. The notices of

assessment or amended assessment will state when any tax, interest and penalties are 'due and payable'. Usually the due date for payment will be 21 days from the notice, but the Commissioner has the discretion to defer or bring forward the payment time. Any delay in paying the assessments incurs additional interest costs.

The provision of information and duty of the taxpayer to cooperate with the tax authorities

The record-keeping provisions of the ITAA do not require taxpayers to create specific records demonstrating that international related party dealings comply with the arm's-length principle. However, according to Taxation Ruling TR 98/11, taxpayers are well advised to prepare such documentation contemporaneously (the ATO considers documentation to be 'contemporaneous' if it is completed at or before the date of filing the income tax return for the relevant year).

There are four key reasons why taxpayers should create and maintain 'contemporaneous' documentation:

- There is a statutory requirement to retain documents. A taxpayer must retain documents that are relevant for the purposes of ascertaining the taxpayer's income and expenditure, etc., for at least five years (calculated from the date the records were prepared or obtained, or from the date the transactions or acts to which the records relate were completed, whichever is later).
- The burden of proof rests with the taxpayer in the event of an ATO dispute. Taxpayers will be better placed to discharge their burden of proof if contemporaneous documentation exists.
- It may be easier to demonstrate a reasonably arguable position if contemporaneous documentation exists. This is relevant to determining whether penalties should be remitted in the event of a transfer pricing adjustment.
- Contemporaneous documentation mitigates the risk of an ATO audit and helps the taxpayer communicate its position.

The Commissioner, or any duly authorised taxation officer, has the right of full and free access to all buildings, places, books, documents and other papers for the purposes of the ITAA. The Commissioner might also require any person to attend and give evidence or produce any documents or other evidence relating to a taxpayer's assessment. The provisions of the ITAA also empower the Commissioner to require a person to produce documents held outside Australia. Compliance with this latter requirement is not mandatory, but where a taxpayer fails to comply with such a requirement, the taxpayer may not rely on those documents in the event it wishes to challenge the Commissioner's assessment.

Revised assessments and the appeals procedure

Australia has a comprehensive objection and appeals procedure for disputing an amended assessment raised by the Commissioner. Under these provisions, the taxpayer may object to an amended assessment issued by the Commissioner to give effect to a Division 13 determination. A taxpayer who is dissatisfied with such an assessment has the later of four years from the date of the original assessment (which is shortly after filing the relevant income tax return) or 60 days from receiving the notice of amended assessment to lodge an objection in writing, setting out the grounds relied upon in support of the claim.

In practice, most transfer pricing audits are not completed until more than four years after the original assessment, i.e. the date at which the taxpayer lodges its tax return under a self assessment regime, so in most cases taxpayers are required to object within 60 days of receiving an amended assessment. The Commissioner is required to consider the objection and may either allow it in full, or in part, or disallow it. The Commissioner is then required to give notice to the taxpayer of the decision on the objection. A taxpayer dissatisfied with such a decision may either refer it to the AAT for review or refer the matter to the Federal Court of Australia.

Where the notice of assessment includes additional tax for incorrect returns, it is generally prudent to remit the matter to the AAT, which has the discretion to reconsider the level of additional tax imposed and may substitute its own decision for that of the Commissioner. In contrast, on appeal to the Federal Court, that court can only decide whether the Commissioner has made an error in law in imposing the additional tax. If no error of law has occurred, then the penalties will remain unadjusted. Decisions of the AAT may be appealed to the Federal Court, but only on a question of law.

Additional tax and penalties

Penalties for 1992/93 onwards

Penalty rates applying to transfer pricing adjustments are outlined in Taxation Ruling TR 98/16.

The penalties generally range from 10% of the additional tax where the taxpayer has documented a reasonably arguable position and had no purpose of avoiding Australian tax, to 50% where there was an intention to avoid Australian tax and a reasonably arguable position had not been documented. Broadly speaking, a position will be considered ‘reasonably arguable’ if it is ‘about as likely as not’ to be correct. In order to demonstrate that a position is reasonably arguable, the taxpayer must retain documentation to support arm’s-length pricing.

The ATO has the discretion to remit penalties in full if special circumstances exist.

Penalties may be increased by 20% where:

- a taxpayer takes steps to prevent or hinder the ATO from discovering that a transfer pricing provision should be applied. It is noteworthy that unreasonable time delays in responding to ATO enquiries or failure to notify the ATO of errors within a reasonable time could amount to ‘hindrance’
- a taxpayer has been penalised under a scheme section in a prior year of income.

Penalties may be reduced:

- by 20% if the taxpayer makes a voluntary disclosure to the ATO after it has been informed of an impending audit
- by 80% if the taxpayer makes a voluntary disclosure to the ATO before it has been informed of an impending audit.

In addition to penalties, the taxpayer is liable to pay a shortfall interest charge (SIC) on the value of any increase in the tax assessment arising from an ATO adjustment. The SIC annual rate was 6.66% for the quarter July-September 2012.

Penalties for 1991/92 and prior years
Prior to the introduction of the self-assessment regime there was a two-tier structure for penalties – 200% for schemes designed to avoid tax and 25% per annum in other cases. Where voluntary disclosures are made, the penalty may be restricted to 10% per annum, subject to a maximum of 50% of the tax avoided in any year.

Resources available to the tax authorities
The ATO's new Jurisdictional Income Practice deals with transfer pricing, thin capitalisation, withholding tax and other international tax issues. The move to combine transfer pricing with other international tax issues within a single team recognises that the examination of these issues is often interrelated and of key importance to the ATO's ongoing compliance initiatives.

In addition to the above, there are various specialist teams within the ATO that deal with transfer pricing. For example, the Transfer Pricing Operations Group oversees the implementation of strategies to manage transfer pricing risks and is responsible for allocating and overseeing active compliance case work, identifying transfer pricing risks, selecting cases for active compliance and capability development initiatives. The Economist Practice provides economic advice on transaction/business characterisation, transfer pricing methods and benchmarking.

On occasion, normally in the most complex cases, the ATO seeks advice from external economists.

Use and availability of comparable information
Availability of comparable information
Public companies and large private companies must lodge financial statements with the Australian Securities and Investments Commission (ASIC). This information is publicly available. However, despite the information being lodged with ASIC, reliable comparable data is difficult to locate in the Australian market.

Databases are available (for example IBISWorld, Company 360, OSIRIS) to identify organisations on an industry and activity basis; however, the particularly small Australian market makes identification of reliable comparables difficult. In addition, some Australian entities are exempt from lodging full financial statements with ASIC, and many Australian companies are members of multinational groups and consequently themselves are engaged in controlled transactions such that reliable comparisons often cannot be made.

Given the limitations of Australian data, the ATO (and taxpayers) may turn to overseas markets to identify comparables. It is also of note that the ATO has a strong preference for use of public companies (over private companies) in comparability analyses; however this is yet to be tested in court.

Australian Bureau of Statistics data
In conducting TPRRs, the ATO sometimes uses publicly available data from the Australian Bureau of Statistics (ABS) in order to form an opinion on the commercial realism of a taxpayer's financial performance, relative to the performance of a market segment as a whole. The ATO's use of ABS data is limited to this situation and not used in comparability analyses because the data includes details of companies engaged in

controlled transactions, and the categories may be wide enough to include companies that might be functionally dissimilar.

Use of controlled data
A contentious aspect of Taxation Ruling TR 97/20 is the ATO's intention to use controlled data in circumstances for which there is insufficient publicly available information on which to base a comparison. In practice, the ATO's use of controlled data has softened and where possible it endeavours to work with methodologies put forward by the taxpayer and publicly available information.

Anticipated developments in law and practice
Division 13
After the Commissioner suffered an adverse decision in the SNF appeal in the Full Federal Court, the Government initiated a review and rewrite of the Australian transfer pricing rules. The first stage of changes involved the introduction of Subdivision 815-A (with retrospective effect) to dealings between Australian taxpayers and related parties in treaty countries. The second stage of changes will involve a comprehensive rewrite of Division 13 which will apply prospectively to all non-arm's-length international dealings regardless of the location of the counterparty.

The new transfer pricing rules are expected to include the following features:

- Similar to the existing Division 13, the rules are expected to apply to non-arm's-length dealings even in situations where the parties are not related by common ownership or control.
- The OECD Guidelines are likely to be given formal recognition. This would confirm that all methods recognised by the OECD (including profit based methods) are able to be applied.
- Documentation is likely to become mandatory (possibly subject to certain thresholds).
- A statute of limitations on transfer pricing adjustments is expected to be introduced.
- The discretionary power held by the Commissioner under s136AD(4) is expected to be removed; although it is likely that some form of discretionary power will continue to exist which will allow the Commissioner to deem an arm's-length outcome and/or reconstruct transactions in certain circumstances.

Risk transactions or industries
It is possible that the ATO may review all types of international dealings, situations or industries in the context of a transfer pricing review. Each year the ATO releases a compliance program which sets out the tax compliance risks of most concern to the ATO and the ATO's strategies to address these risks. The ATO annually adjusts its compliance program to address new and emerging transfer pricing issues.

Limitation of double taxation and competent authority proceedings
In the event that a transfer pricing audit results in an adjustment, a taxpayer may suffer double taxation. There are, however, mechanisms available to taxpayers which may be able to limit the double taxation.

Resident taxpayers
An Australian taxpayer may obtain relief from double taxation; however, the mechanism available depends on whether or not there is a DTA.

Where there is a DTA
A resident taxpayer may present his case to the Australian competent authority. The Mutual Agreement Procedure (MAP) Article in each of Australia's DTAs enables competent authorities of the relevant countries to meet and consult with each other with a view to seeking to resolve potential double-taxation issues. The MAP does not compel an agreement to be reached and does not relieve the Australian taxpayers from penalties or interest charged by the ATO. Taxation Ruling TR 2000/16 and TR 2000/16A outline the procedures for seeking relief from double tax.

Where there is no DTA
If a foreign tax authority makes a transfer pricing adjustment and Australia does not have a DTA with that country, there is generally no mechanism to obtain relief from double taxation. However, the resident taxpayer may pursue domestic relief through the Australian appeals process.

Non-resident taxpayers
A non-resident party to certain transactions may be able to obtain relief from double taxation under Australia's domestic legislation.

Division 13 allows for consequential adjustments to be made to the income or deductions of the non-resident party to a transaction, where a transfer pricing adjustment has been made in relation to that non-resident taxpayer. For example, where withholding tax has been paid on interest, the provision prevents double taxation by allowing the withholding tax to be recalculated based on the adjusted interest (i.e. as revised for the transfer pricing agreement). Taxation Ruling TR 2007/1 explains the effects on taxpayers of a determination made under the provisions of Division 13, including consequential adjustments.

Advance pricing arrangements
A formal APA process is available in Australia. APAs represent an agreement between a taxpayer and the tax authority to establish the transfer pricing methodology to be used in ensuring arm's-length transfer prices are achieved for tax purposes. The APA programme is well-established within the ATO, with more than 150 APAs completed or renewed since its inception.

In March 2011, the ATO released detailed guidance on Australia's APA program. The guidance is contained in Law Administration Practice Statement PS LA 2011/1 (replaces Taxation Ruling TR 95/23, which has now been withdrawn).

PS LA 2011/1 outlines a number of major initiatives, including:

- The development of a differentiated framework for simplified, standard and complex APAs.
- Improved ATO procedures and processes, including the introduction of an ATO Case Leader role, and the implementation of a more detailed project management framework for all APAs.
- The establishment of a circuit breaker mechanism in some cases.

- Alternative risk assessment products.

Differentiated framework
PS LA 2011/1 outlines a differentiated APA program, with three different types of APAs: simplified, standard and complex.

The simplified APA product aims to be a shorter, less costly and less time-consuming process, and as such, it is designed for low-value, low-risk dealings. It is available only for unilateral APAs. The standard APA product can be undertaken on a unilateral or bilateral APA, and may also include collateral issues – that is, taxation issues unrelated to transfer pricing. The complex APA product is suitable for high-risk, complex international related party dealings with limited comparables and a significant amount of tax at stake. It is available on a unilateral or bilateral basis.

ATO procedures and processes
PS LA 2011/1 outlines a more rigorous framework in relation to project management procedures, and to both the ATO's and taxpayers' obligations with respect of the process. For example, the introduction of an APA case leader role aims to ensure a single point of responsibility within the ATO, with accountability for delivery, including meeting agreed timing milestones and facilitating the resolution of technical issues.

The LAPS also outlines the reporting requirements for the taxpayer. Specifically, an Annual Compliance Report is required and must include information and computations necessary to the transfer pricing methodology, and information pertaining to the specific related party dealings covered in the APA. The ATO may request further information, and may cancel the APA where records are not in order.

Circuit breaker/review mechanism
Importantly, the LAPS introduces a 'circuit breaker' option which can be requested by the taxpayer. This process allows the taxpayer to seek an internal review when the ATO does not accept the APA, cannot reach an agreement with the taxpayer, withdraws the APA, or where there is a 'standstill' in proceedings.

Alternative risk assessment tools
There are products available to both SME and large business taxpayers who require a level of assurance as to the ATO view of their international related party dealings without the cost and time associated with undertaking an APA. These products include the ATO Risk Assessment Product (for taxpayers wishing to obtain some degree of assurance from the ATO as to its views on the arm's-length nature of their dealings based on their transfer pricing documentation) and the Self Assessment Risk Product (for taxpayers to evaluate their own transfer pricing risk).

Liaison with customs authorities
The Australian Customs and Border Protection Service (Customs) and the ATO have an agreement to share information relating to transfer pricing issues. This arrangement includes reciprocal exchange rights to their systems, particularly with respect to product and company pricing data.

In July 2009, Customs released a Practice Statement that addressed the impact of transfer pricing arrangements on the Customs value of imported goods. Companies importing into Australia from related parties should always review any customs

implications of their transfer pricing adjustments, particularly with respect to overpaid or underpaid duties. This applies to all transfer pricing adjustments, whether they are self-assessed adjustments, adjustments resulting from an audit or compensating adjustments arising under an audit adjustment.

OECD issues

Australia is an OECD member and has a representative on the OECD Transfer Pricing Task Force. The ATO is an active participant in OECD working parties for emerging areas of transfer pricing.

The ATO generally has followed the OECD Guidelines in relation to transfer pricing, the principles of which are reflected in Australia's tax rulings, but is under no obligation to follow them.

Joint investigations

Australia is supporting the OECD and others in various initiatives to promote greater transparency in the tax field. For example, the OECD is looking at improving and expanding exchange-of-information activities between tax authorities under a multilateral framework known as the Global Forum on Transparency and Exchange of Information for Tax Purposes. The Joint International Tax Shelter Information Centre is another example where several countries (including Australia) work together to promote tax compliance through the exchange of information on complex cross-border cases.

Australia has a number of taxation information exchange agreements with non-OECD offshore financial centre jurisdictions (most of which are tax havens) in order to improve transparency and information exchange.

In addition, the OECD's Forum on Tax Administration is promoting joint cross-jurisdictional audits as a way to enforce tax compliance across multinational corporations (MNCs). Transfer pricing audits have traditionally been challenging for MNCs given the breadth and depth of the revenue authorities' enquiries and the time and resources taken up in managing the audit. It is likely that joint audits will present new challenges for MNCs, given the need to manage two or more tax authorities examining both sides of a transaction simultaneously.

Thin capitalisation

Substantial changes to Australia's thin capitalisation regime became effective in 2001. The legislation is lengthy and complex.

The legislation has introduced a 'safe harbour' debt amount. An alternative test is the 'arm's-length' debt amount, which potentially can increase the permissible interest deduction. Taxation Ruling TR 2003/1 deals with the application of the arm's-length debt test in the thin capitalisation regime.

Taxation Ruling TR 2010/7 provides guidance on the interaction of Australia's thin capitalisation provisions (Division 820 of the ITAA 1997) and the transfer pricing provisions. The ruling confirms the ATO's view that Division 13 applies independently of Division 820 in determining the allowable deduction for a taxpayer's related party debt. The transfer pricing provisions are to be applied first to determine an arm's-length interest rate. The arm's-length rate is then applied to the actual amount of the

loan. The ruling provides four examples to demonstrate possible scenarios involving the interaction of Division 13 and Division 820 to a taxpayer's related party debt.

The ruling also sets out the ATO's approach for determining an arm's-length consideration on inbound related party loans under Australia's transfer pricing rules. The Commissioner confirms that his views on transfer pricing methods in relation to related party debt arrangements are contained in Taxation Ruling TR 92/11 and Taxation Ruling TR 97/20. However, a number of important observations are made in TR 2010/7. Firstly, the ruling confirms the ATO's view that in setting an interest rate on a related party loan, it must 'produce an outcome that makes commercial sense" for both the borrower and the lender in all of the circumstances. Secondly, the ruling confirms the ATO's view that it is important to take into account parental affiliation in determining the credit standing of the borrower.

The position taken by the Commissioner in TR 2010/7 has been given legislative effect for loan arrangements with related parties in DTA countries under Subdivision 815-A.

Management services and other services

Taxation Ruling TR 1999/1 sets out the ATO's position on whether prices for services, or dealings between associated enterprises in relation to the provision of services, conform to the arm's-length principle.

According to the ruling, whether a service has been, or will be, provided by the performance of an activity, and whether a charge should be levied depends upon whether the activity has conferred, or is expected to confer, a benefit to a related party.

The ruling introduces administrative practices or a safe harbour, which allow for a 7.5% mark-up on 'non-core' services provided or received where service revenue/ expenses are not more than 15% of the Australian group's total revenue/expenses. A mark-up of between 5% and 10% may be permitted if the services are provided to, or received from, another country that requires a different mark-up. Taxpayers relying on the administrative concession must apply a consistent mark-up for the relevant services globally. Examples of 'non-core' services include administration and human resource matters, but specifically exclude technical and marketing services.

The ruling also allows for smaller companies that receive or provide services worth not more than AUD 500,000 per annum, to apply the administrative practices to all services (i.e. core and non-core). The adoption of a safe harbour mark-up does not remove the requirement for taxpayers to document their intragroup services transactions. The safe harbour mark-up will only remove the necessity for taxpayers to include benchmarking analysis of their intragroup services mark-ups within their documentation.

Marketing and other intangibles

The ATO's position on the application of Australia's transfer pricing rules to marketing services provided by an Australian enterprise that uses trademarks and names it does not own is outlined in an ATO publication titled International transfer pricing: Marketing intangibles. This publication is intended to be consistent with previous ATO rulings and with the OECD Guidelines.

In determining whether an arrangement for the provision of marketing services is consistent with the arm's-length principle, the ATO considers the following issues relevant:

- The nature of the contractual arrangements.
- The extent to which the activities are expected to benefit the trade name owner and/or the marketer.
- Whether the level of marketing activities performed by the marketer exceeds that of comparable independent enterprises.
- Whether the marketer is properly compensated by a normal return on its activities or should receive an additional return on the trade name.

The ATO is likely to challenge an arrangement in which a distributor pays a royalty yet receives no rights to use a trade name other than to distribute a branded product. Furthermore, if the ATO perceives that a distributor is performing a greater level of marketing than comparable independent distributors, it will expect the taxpayer to earn a higher level of profit than that of a 'routine' distributor.

In addition to marketing intangibles, the ATO also focuses on transfers of intellectual property (IP) to international related parties.

R&D tax incentive program

The research and development (R&D) tax incentive provides a tax offset for eligible R&D activities and is targeted toward R&D that benefits Australia. Specifically, the new R&D tax program, which came into effect from 1 July 2011, provides a 40% non-refundable tax credit for eligible R&D activities conducted in Australia, regardless of where the resulting IP is held. The 40% tax credit equates to a cash benefit of 10 cents in the dollar of eligible R&D expenditure. Additional benefits will be available to small companies with group turnover of less than AUD 20 million. Companies undertaking R&D activities in Australia should consider their R&D tax position to ensure they take advantage of all R&D tax benefits.