



Submission No 105

**Review of Australia's Relationship with the
Countries of Africa**

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Organisation: Australian Uranium Association –
Answers to Questions on Notice

ANSWERS TO QUESTIONS FROM MR PHILLIP RUDDOCK

Beginning at page FADT 50, Mr Ruddock asked the Association a number of questions about 'transfer pricing'.

Transfer pricing refers to prices paid for goods or services under transactions **between related parties**. It is regulated by a comprehensive international network of taxation treaties and agreements. Transfer pricing as a routine business transaction between related parties is neither illegal nor unethical.

Transfer pricing is not exclusively a practice that could occur in mining or in uranium mining; it could arise in many multinational corporate settings. For example, the motor vehicle industry or the processed foods industry – both of which are dominated by large multinational companies manufacturing components or ingredients in plants located all around the world - have to transfer those components and ingredients between plants and markets.

Because much corporate revenue could be subject to taxation in transactions of this kind, most countries have mechanisms for identifying, examining, and approving or amending transfer pricing arrangements within their own taxation regimes. I have attached an ATO publication that describes some of the complexities involved.

The issue of transfer pricing is also dealt with in a number of documents and guidelines established by international organisations including *OECD Transfer Pricing Guidelines for Multinational Enterprises & Tax Administration – 2010* and *The OECD Guidelines for Multinational Enterprises*, which establishes principles for multinational investment.

Principle X covers taxation as follows:

It is important that enterprises contribute to the public finances of host countries by making timely payment of their tax liabilities. In particular, enterprises should comply with the tax laws and regulations in all countries in which they operate and should exert every effort to act in accordance with both the letter and spirit of those laws and regulations. This would include such measures as providing to the relevant authorities the information necessary for the correct determination of taxes to be assessed in connection with their operations and conforming transfer pricing practices to the arm's length principle.

Australian resource industry sustainable development principles, most notably the Minerals Council of Australia's *Enduring Value*, deal with the issue. Principle 1 in *Enduring Value* provides as follows

Implement and maintain ethical business practices and sound systems of corporate governance.

- *Develop and implement company statements of ethical business principles and practices that management is committed to enforcing.*
- *Implement policies and practices that seek to prevent bribery and corruption.*
- *Comply with or exceed the requirements of host country laws and regulations.*
- *Work with governments, industry and other stakeholders to achieve appropriate and effective public policy, laws, regulations and procedures that facilitate the mining, minerals and metals sector's contribution to sustainable development within national sustainable development strategies.*

The AUA's *Code of Practice* endorses and adopts *Enduring Value* as a foundation.

Transfer pricing may, however, be taken to imply the sale of goods or services produced in a particular country to a related party of the seller in a different country at prices significantly different to 'arms length'.ⁱ Examples of such behaviour include incorrect declaration of value or inflation of processing, transport, delivery costs etc. Where that occurs, one of the countries affected by the transaction concerned may be deprived of revenue due to it under its domestic taxation arrangements.

This is not 'transfer pricing' but, rather, is the fraudulent selling of goods and services at non-market values.

Such behaviours, which are rooted in corruption and illegality, are liable to detection under the laws of the host country or the recipient country.

The *Extractive Industries Transparency Initiative* also seeks to combat this behaviour.

Such behaviours are difficult to conceal in markets where there are published commodity prices. For example, in regard to copper, whose price is published every trading day on the LME, it would be a relatively straightforward matter to assess if a copper producer was under-reporting revenue. A similar situation applies in the case of uranium where there are weekly spot and term market indices which would give a good indication of whether product is being under-priced.

In summary:

- 'Transfer pricing' is a generic issue common to most multinational businesses and refers to *related party transactions*. It is neither illegal nor unethical and is not a significant cause of revenue deprivation because of the oversight of tax authorities under international treaties
- Corrupt pricing practices are illegal and there are laws in place to deal with them
- Members of the Australian Uranium Association undertake not to engage in such practices as a result of their commitment to the Association's Code of Practice, which applies to the operations of AUA members anywhere in the world.

ⁱ The arm's length principle uses the behaviour of independent parties as a guide or benchmark to determine how income and expenses are allocated in international dealings between related parties. It involves comparing what a business has done and what a truly independent party would have done in the same or similar circumstances. The internationally accepted arm's length methodologies are based on comparing the outcomes of related party dealings with the same or similar dealings of independent parties. The concept of comparability is central to the arm's length principle.

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INTERNATIONAL DEALINGS

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INTERNATIONAL TRANSFER PRICING

INTRODUCTION TO CONCEPTS AND RISK ASSESSMENT



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MORE INFORMATION

If you need more information about international transfer pricing, you can:

- visit our website at **www.ato.gov.au**
- phone **13 28 66**, or
- write to us at GPO Box 9990 in your capital city.

If you do not speak English well and want to talk to a tax officer, phone the Translating and Interpreting Service on **13 14 50** for help with your call.

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**.

OUR COMMITMENT TO YOU

The information in this publication is current at April 2005.

In the taxpayers' charter we commit to giving you information and advice you can rely on. If you try to follow the information contained in our written general advice and publications, and in doing so you make an honest mistake, you won't be subject to a penalty. However, as well as the underpaid tax, we may ask you to pay a general interest charge.

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You are protected under GST law if you have acted on any GST information in this publication. If you have relied on GST advice in this Tax Office publication and that advice has later changed, you will not have to pay any extra GST for the period up to the date of the change. Similarly, you will not have to pay any penalties or interest.

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**

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ABOUT THIS OVERVIEW

This overview 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: applying the arm's length principle*
- *International transfer pricing: advance pricing arrangements*
- *International transfer pricing: a simplified approach to documentation and risk assessment for small to medium businesses, and*
- *International transfer pricing: attributing profits to a dependent agent permanent establishment.*

This overview explains the basic concepts underlying international transfer pricing and when a business may face a transfer pricing review or audit. We recommend that you read this overview before reading the other guides.

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

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

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

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

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

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**¹ according to what truly independent parties acting independently would reasonably be expected to have done in the same situation.

Pricing for international dealings between related parties should reflect a fair return for the activities carried out in Australia, the Australian assets used (whether sold, lent or licensed), and the risks assumed in carrying out these activities.

Pricing that is not in accordance with Australia's transfer pricing rules is often referred to as 'international profit shifting'.

You should carefully consider the terms and conditions of any international dealings with related parties to ensure your business properly allocates income and expenses between Australia and other countries for tax purposes.

Methods of setting prices and reviewing the outcome of international transactions with related parties are recognised internationally using the **arm's length principle**, and Australia has adopted these in taxation rulings to help businesses understand what is expected of them.²

THE ARM'S LENGTH PRINCIPLE AND COMPARABILITY

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

The internationally accepted arm's length methodologies are based on comparing the outcomes of related party dealings with the same or similar dealings of independent parties. The concept of comparability is central to the arm's length principle.

As many factors may influence prices or margins, you need to closely examine the dealings you are comparing and the circumstances of the parties involved. The nature of this comparison with arm's length activity means that it is very difficult to achieve absolute precision and certainty. To be comparable means that none of the differences (if any) between

the situations being compared are material, or that reasonably accurate adjustments can be made to eliminate the effect of any such differences. The materiality depends on fully examining the facts and circumstances of each case and reflecting the reality that there is likely to be some element of uncertainty inherent in the judgments that have to be made.

ARM'S LENGTH METHODOLOGIES

There are several internationally accepted methodologies that your business can use to comply with the arm's length principle. Australia's transfer pricing rules do not prescribe any particular methodology or preference for the order in which you apply methodologies to arrive at an arm's length outcome. We seek to adopt the method that is the most appropriate or best suited to the circumstances of each particular case.

The appropriate arm's length consideration should reflect the realities of operating in a commercial or financial environment. That is, whatever method you use should give a commercially realistic outcome. It is generally expected that a reasonable business person would seek to:

- maximise the price received for supplying property or services, taking into account their business strategy, economic and market circumstances (see paragraphs 2.44 to 2.56 of TR 97/20)
- minimise the cost associated with acquiring property or services, and
- be adequately rewarded for any activities carried out.

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

DOCUMENTATION REQUIREMENTS

There are sound practical reasons why you should adequately document compliance with the arm's length principle, namely:

- to reduce the risk of audit by, and dispute with, the Tax Office, and
- to help explain your position to the Tax Office.

From a commercial perspective, the improved corporate knowledge gained from examining functions, assets and risks can provide an insight into the things that really add value to your business.

Both the Tax Office and the OECD have stated that businesses should not be expected to prepare or obtain documents beyond the minimum needed to enable a reasonable assessment to be made of whether their related party dealings comply with the arm's length principle.

A major problem we have encountered is that businesses with related party international dealings have little or no documentation to explain how they set and reviewed prices for these dealings in accordance with the arm's length principle.

¹ **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.

² TR 98/11 – documentation and practical issues associated with setting and reviewing transfer pricing in international dealings.

TR 97/20 – arm's length transfer pricing methodologies for international dealings.

TR 94/14 – basic concepts in applying Division 13.

Where a business has inadequate or incomplete information, Australia's transfer pricing rules allow the Commissioner to deem an amount as the arm's length consideration.

In assessing compliance with the arm's length principle, you should exercise commercial judgment about the nature and extent of documentation appropriate to your particular circumstances. We expect the level of contemporaneous documentation you need to create or obtain to explain a dealing to increase according to the significance and the complexity of the dealings to your entity's overall business (in terms of the size of the dealings and their proportion to total dealings).

➤ See paragraph 2.2 in chapter 2 of TR 98/11 for some examples of documentation that we consider beneficial.

The information needed in the process may be within the knowledge of a limited number of key personnel not confined to the tax or accounting areas of your business. Much of it may already be recorded in a variety of documents prepared in the ordinary course of your business (for example, marketing reports and analyses). If so, you can just collate and index the existing material rather than doing further research and creating additional documentation. Once this has been done, in future years you would generally only have to do a review to account for any significant changes.

Documentation is contemporaneous if it exists or is brought into existence at the time you develop or implement any arrangement that might raise transfer pricing issues or review these arrangements when preparing tax returns. Examples of contemporaneous documents are books, records, feasibility studies, budgets, plans and projections, analyses, conclusions and other written material.

Such documentation does not mean documents that merely evidence your business's related party international dealings, but documents that illustrate the processes you used to select and apply arm's length methodologies.

We may consider various documentation, such as a review undertaken by a business after lodging a tax return. However, if such a review was in progress when we commence our review, we reserve the right to proceed with our own enquiries and risk ranking.

Schedule 25A

Businesses that engage in international dealings with related parties during an income year are required to complete a Schedule 25A and lodge it with their income tax return. There are a number of questions in Schedule 25A relating to the level of documentation held by a business about selecting and applying an arm's length methodology.

The current Schedule 25A imposes obligations to disclose information about related party international dealings, including:

- the nature and amount of certain categories of transactions
- details of interest-free loans
- receipts or payments of non-monetary consideration
- details of arm's length methodologies used
- the level of documentation held to support the selection and application of the most appropriate arm's length methodologies, and
- details of disposals of any interest in a capital asset.

Guidelines on when you may be required to lodge a Schedule 25A are provided in TR IT 2514. We also publish instructions each year to help businesses complete a Schedule 25A.

Take care when completing a Schedule 25A as we use the information provided to help identify businesses that may be a transfer pricing risk. If you fail to complete the Schedule 25A where required, you may incur penalties or be prosecuted.

Documentation for small businesses and those with low levels of international dealings

While there is a degree of flexibility in the nature and extent of documentation that small businesses must create or obtain, they may still need to create some supporting documentation beyond that created in the ordinary course of business. This is an exercise in commercial judgment, whereby small businesses need to balance the risk associated with doing nothing and the potential outcomes of that decision with the cost of doing something that may satisfy these concerns.

➤ For more information about the documentation expected for small businesses and entities with low levels of international dealings, see chapter 6 of TR 98/11 and *International transfer pricing: a simplified approach to documentation and risk assessment for small to medium businesses* (NAT 12032).

Businesses with related party international dealings may face the risk of:

- a transfer pricing review, and
- a subsequent transfer pricing audit, with possible pricing adjustments and penalties.

We generally allocate resources on transfer pricing cases according to the perceived risk to revenue of businesses not complying with the arm's length principle. The more significant and broader the scope of a business's international dealings with related parties, the more likely we are to do a transfer pricing review. Businesses with significant levels of dealings who are consistently returning losses are at the greatest risk of a transfer pricing review.

TRANSFER PRICING REVIEW

A transfer pricing review looks at:

- the nature and extent of a business's international dealings with related parties
- the quality of the process established by the business to show compliance with the arm's length principle for tax purposes, and
- the quality of the business's documentation of those dealings and the outcomes of the dealings.

As part of a transfer pricing review, we assess the quality of a business's processes and documentation, and the commercial realism of the outcomes of its dealings. We then decide whether to proceed to a transfer pricing audit. We advise the business of the outcomes of the review and give them a risk ranking as shown in the graph on page 7.

As the circumstances of individual businesses may vary over time, we may review their risk ranking in light of their current circumstances.

Quality of processes and documentation

The quality of a business's processes and documentation can generally be assessed as falling into broad categories, ranging from low, which will increase the likelihood of an audit, to high, which will decrease the likelihood of an audit.

To decrease the possibility of an audit, you should have processes that allocate income and expenses in accordance with the arm's length principle. We have suggested a four-step approach to establishing and maintaining such processes.

➤ See chapter 5 of TR 98/11 and *International transfer pricing: applying the arm's length principle* (NAT 2726) for more information.

The five levels of quality of process and documentation for international dealings with related parties are shown in the following table.

LEVELS OF QUALITY OF PROCESSES AND DOCUMENTATION FOR INTERNATIONAL DEALINGS WITH RELATED PARTIES

1 Low quality	2 Low to medium quality	3 Medium quality	4 Medium to high quality	5 High quality
No analysis of functions, assets, risks, market conditions and business strategies	No analysis of functions, assets, risks, market conditions and business strategies	Inadequate analysis of functions, assets, risks, market conditions and business strategies	Sound analysis of functions, assets, risks, market conditions and business strategies	Sound analysis of functions, assets, risks, market conditions and business strategies
No documentation or processes to enable a check on selection of methodologies	Insufficient documentation or processes to enable a check on selection of methodologies	Selection of method supported with some contemporaneous documentation	Selection of method fully supported with contemporaneous documentation	Selection of method fully supported with contemporaneous documentation
No comparables used No documentation or processes to enable a check on application of methodologies	No comparables used No documentation or processes to enable a check on application of methodologies	Broad inexact comparables used or comparability based on data from external related party comparables Application of method supported with some contemporaneous documentation	Comparability based on limited data from independent dealings Reliability assessed Application of method fully supported with contemporaneous documentation	Comparability based on adequate data from independent dealings Reliability taken into account in choice of comparables Application of method fully supported with contemporaneous documentation
No effort to implement and review arm's length transfer pricing policies	Limited effort to implement and review arm's length transfer pricing policies	Limited effort to implement and review arm's length transfer pricing policies	Genuine effort to implement and review arm's length transfer pricing policies	Genuine effort to implement and review arm's length transfer pricing policies

The characteristics of the five quality levels shown in the table are indicative only. We recognise that a business may fall into one of the higher quality levels even though they have not satisfied every characteristic of each step.

Situations outside the transfer pricing review process

Where we find that a business has deliberately structured its international dealings with related parties to avoid Australian tax, we would probably proceed straight to a transfer pricing audit.

Factors that lead us to such a conclusion include:

- the use of tax havens where little or no economic value is added, for example, re-invoicing
- the use of back-to-back arrangements to conceal the full extent of the consideration given, and
- complex and circular arrangements with little or no business purpose.

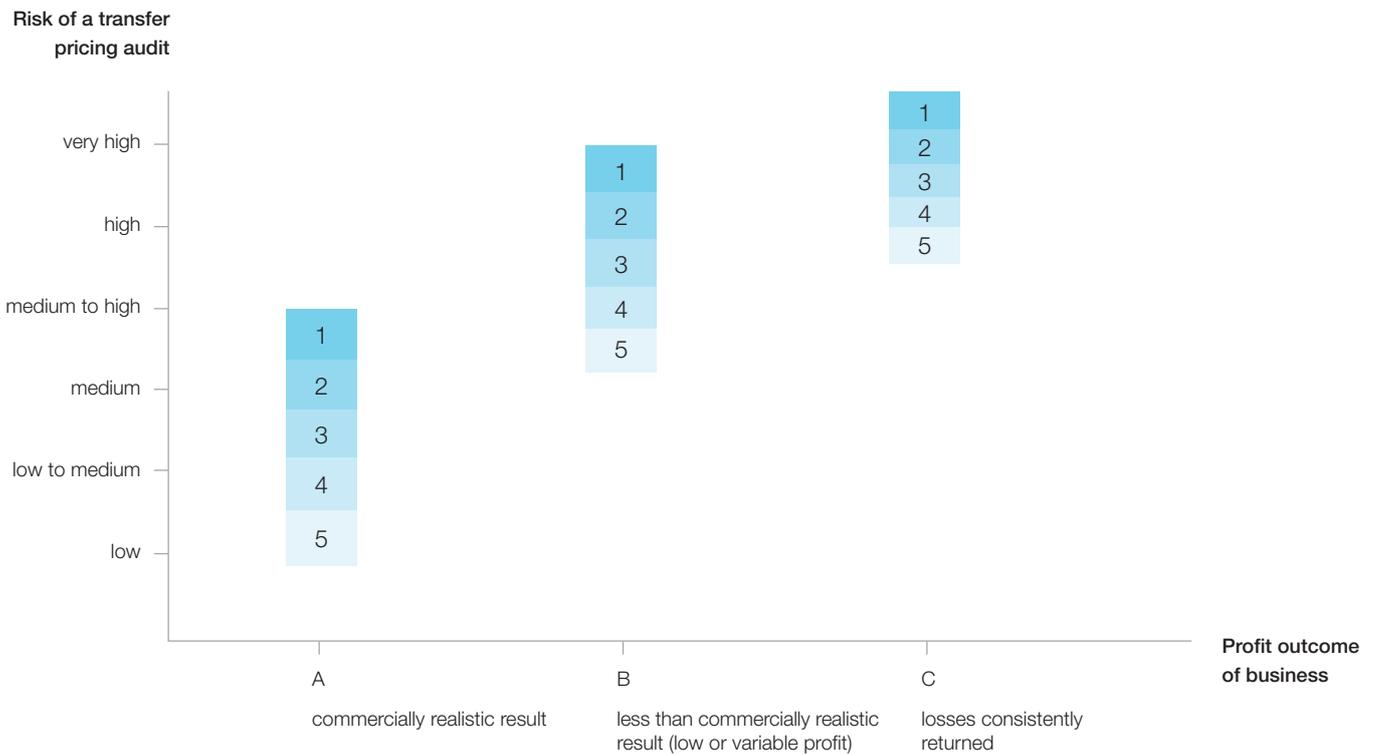
Where we have an advance pricing arrangement with a business and the critical assumptions specified in the arrangement are met, we would take no further action in relation to transactions covered by the arrangement. We would, however, check to ensure that the terms of the arrangement are being adhered to.

TRANSFER PRICING RISK RATING

The following graph shows how we assess the risk to a business of a transfer pricing audit. We look at two factors:

- the quality of the business’s processes and documentation, and
- the commercial realism of their outcomes.

As can be seen from the graph, a business that consistently returns losses and has a low quality of process and documentation is at the highest risk of a transfer pricing audit. Conversely, a business that has commercially realistic outcomes and has a high quality of process and documentation is at the lowest risk.



Where

- 1 = Low quality of processes and documentation
- 2 = Low to medium quality of processes and documentation
- 3 = Medium quality of processes and documentation
- 4 = Medium to high quality of processes and documentation
- 5 = High quality of processes and documentation

TRANSFER PRICING AUDIT

If we decide to do a transfer pricing audit as a result of a transfer pricing review, the risk of a transfer pricing adjustment and penalties becomes highly likely. Before making any transfer pricing adjustment, we generally issue position papers and allow a business the opportunity to comment before making any adjustment. However, any resulting adjustment is subject to the normal review and appeal processes.

We acknowledge that there is a need for judgment in applying Australia's transfer pricing rules and would propose an adjustment only if our view is materially different from that of the business.

In all cases we adhere as closely as possible to international standards and seek to determine cases according to those principles.

 See paragraph 4.39 of TR 98/11 for more information.

SUMMARY OF TRANSFER PRICING REVIEW AND AUDIT PROCESS

The flowchart on the next page summarises our likely approach to reviewing and auditing a business's international dealings with related parties to decide whether it is complying with the arm's length principle. Individual circumstances may require a modification or departure from the process illustrated.

