Print whole section

International transfer pricing – concepts and risk assessment

Learn the basic concepts of international transfer pricing and when a business may face a review or audit.

Last updated 17 November 2022

About Australia's transfer pricing rules

The arm's length principle and comparability

Simplifying transfer pricing record-keeping

International dealings schedule

Transfer pricing risk assessment

Inbound supply chain strategy

QC 17107

About Australia's transfer pricing rules

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Australia's transfer pricing rules seek to avoid the underpayment of tax in Australia.

The rules aim to make sure that businesses price their **related-party international dealings** in line with what is expected from independent parties in the same situation.

Pricing for international dealings between related parties should reflect the right return for the:

- activities carried out in Australia
- Australian assets used (whether sold, lent or licensed)
- risks assumed in carrying out these activities.

Pricing that does not comply 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 you enter with related parties to ensure that your business outcomes properly reflect economic activity in Australia.

For more information, see:

- The arm's length principle and comparability
- Simplifying transfer pricing record-keeping

QC 17107

The arm's length principle and comparability

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On this page

About the arm's length principle

Australia's double-tax agreements and domestic law require that pricing of goods and services and allocation of income and expenses between related parties comply with the arm's length principle.

The arm's length principle uses the behaviour of independent parties as a guide or benchmark to determine in international dealings between related parties:

- the pricing of goods and services
- how income and expenses are allocated.

It involves comparing what a business has done and what an independent party would have done in the same or similar circumstances. This principle is supported by all Organisation for Economic Co-operation and Development (OECD) countries.

Many factors may influence prices or margins, so you need to closely examine the dealings you're comparing and the circumstances of the parties involved. This comparison with arm's length activity means it is difficult to achieve absolute precision and certainty.

For dealings to be comparable:

- none of the differences between the situations should be material
- reasonably accurate adjustments can be made to eliminate the effect of any such differences.

The materiality of any differences depends on the facts and circumstances of each case and recognising that there's likely to be some uncertainty in the judgments that must be made.

Applying the arm's length principle

In assessing compliance with the arm’s length principle, you should exercise commercial judgment about the nature and extent of documentation appropriate to your circumstances. Both the ATO and the OECD state that businesses only need to reasonably assess whether their dealings with related parties comply with the arm’s length principle. They should not be expected to prepare or obtain documents beyond the minimum needed to do this.

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

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

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 to arrive at an arm's length outcome. You should seek to adopt the method that is best suited to the circumstances of each case.

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, considering their business strategy, economic and market

circumstances, and minimise the costs associated with acquiring property or services

- be adequately rewarded for any activities carried out.

For more information about the arm's length methodologies, see **Chapter 3** of Taxation Ruling **TR 97/20** *Income tax: arm's length transfer pricing methodologies for international dealings*.

Documentation requirements

You must keep documentation that can substantiate compliance with the arm's length principle.

Taxation Ruling **TR 2014/8** *Income tax: transfer pricing documentation and Subdivision 284-E* provides information on how to demonstrate that you have complied with the principle.

There are reasons why you must document compliance with the arm's length principle, namely to:

- reduce the risk of audit by us, and dispute with us
- help explain your position to us
- minimise penalties in the event of an audit adjustment, as any penalties will take into account the extent and quality of the documentation kept.

QC 17107

Simplifying transfer pricing record-keeping

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On this page

Impacts of applying a simplification option

We developed some simplified transfer pricing record-keeping options (simplification options) so eligible businesses can opt to minimise record-keeping and compliance costs. The following information should be read in conjunction with the Practical Compliance Guideline PCG 2017/2 *Simplified transfer pricing record-keeping options*.

The transfer pricing rules apply to you irrespective of whether you are eligible or choose to apply an option. We expect when you lodge your return you do so on the basis you have applied the transfer pricing rules to any relevant transaction or arrangement you have undertaken and you are satisfied the statutory test set out in subdivisions 815-B or 815-C of the *Income Tax Assessment Act 1997* (ITAA 1997) has been met.

Compliance assurance when applying a simplification option

If you are eligible for any option, we will generally not review the covered transactions or arrangements to which the options apply for transfer pricing purposes, beyond conducting a check to confirm your eligibility. This assurance applies for income years starting:

- on or after 29 June 2013 for the small taxpayers, distributors, intra-group services, and low-level inbound loans options
- on or after 1 July 2015 for the materiality, technical services and low-level outbound loans options
- on or after 1 July 2015 to the end of your 2019 income year for the management and administration services option.

This compliance assurance is specified in the guideline and within the Practice Statement Law Administration PS LA 2014/3 *Simplifying transfer pricing record keeping*.

If you have appropriately elected to apply any simplification options, then tax officers will not review the relevant cross border conditions between entities (CBCBEs) for transfer pricing purposes for the relevant covered transactions or arrangements, beyond conducting a check to confirm your eligibility.

However, you are still required to maintain the general record-keeping requirements under section 262A of the *Income Tax Assessment Act 1936*.

Applying simplification options for branches

If you are required to report at question 18 of the International Dealings Schedule (IDS), and have satisfied the relevant eligibility criteria, then you can elect to apply the appropriate simplification option.

Applying simplification options for trusts and partnerships

If you are a trust or partnership, and have satisfied the relevant eligibility criteria, then you can elect to apply the appropriate simplification option.

Transfer pricing documentation codes for the 2015 income year and onwards

If you are eligible, and have elected to apply a simplification option, you would include code 7 at the percentage of documentation label code at the relevant labels on the IDS. This confirms you have self-assessed your relevant transactions as complying with the transfer pricing rules and advised us that a simplification option has been applied to your record-keeping.

You can also make a disclosure of your election in your Country-by-Country (CBC) statements, if applicable. Refer to **Country-by-Country Reporting** for further information on how to make a disclosure of your election in your CBC statements.

Transfer pricing documentation codes for the 2014 year

For the 2014 year the simplification option code is not available. When completing the percentage of documentation label code at the relevant labels on the IDS you need to consider the application of the 2014 documentation codes. If you are contacted by the ATO and you have applied one of the simplification options, you will need to notify the compliance officer of your eligibility.

The codes available for the 2014 year relate specifically to whether you have prepared contemporaneous transfer pricing documentation. You will need to use one of the following codes to state to what extent you have documentation:

Percentage	Code
0%	1
1% to less than 25%	2
25% to less than 50%	3
50% to less than 75%	4
75% to less than 100%	5

100%	6

Applying a simplification option after lodging an income tax return and IDS

You may still have an opportunity to apply the options after lodging your IDS or CBC statements, as long as you meet the eligibility criteria for the options for the relevant income year.

Assessing your compliance with the transfer pricing rules

Applying a simplification option does not, of itself, meet the requirements of Subdivision 284-E of Schedule 1 to the *Taxation Administration Act 1953* (TAA) and Subdivisions 815-B or 815-C of ITAA 1997. Selecting an option does not limit or waive how the law operates, but demonstrates you have self-assessed your relevant transactions for compliance with the transfer pricing rules.

When you select an option, you do so on the basis you have done all you sensibly need to do in your circumstances to make sure your cross border dealings satisfy the arm's length principle as set out in Subdivisions 815-B or 815-C of the ITAA 1997.

Example: meeting the criteria

Victasubb is an Australian subsidiary of Nevadaplus, an American company from which it borrowed A$20 million. For the 2019 financial year, Victasubb had a taxable income of $8 million, no other related party dealings and there were no restructures. It is the only member of the Australian economic group and the interest charged on the loan was A$260,000 (1.3%). Therefore, it meets the first 4 eligibility criteria in the low-level inbound loans simplification option.

The remaining criterion to consider is whether Victasubb is compliant with the transfer pricing rules.

The loan and its interest rate are consistent with the group's third party debt and the overall level of debt does not have a significant impact upon its economic viability. Victasubb believes it has satisfied the arm's length principle and there is no transfer pricing benefit arising from the transaction.

Accordingly, Victasubb can elect to apply the low-level inbound loans option to its interest-bearing loan and interest paid to Nevadaplus.

Example: not meeting the criteria

If the facts were identical to the above, except interest charged on the loan was A$752,000 (3.76%) the first 4 eligibility criteria for the low-level inbound loans simplification option are still met. However, the additional interest amount of $492,000 occurred without material change in any relevant circumstances to the loan arrangement and only due to the option criteria.

Under this scenario, Victasubb can neither demonstrate it has satisfied the arm's length principle, nor that there is no transfer pricing benefit arising from the transaction.

Accordingly, Victasubb cannot elect to apply the low-level inbound loans option to this transaction.

Low value adding intra-group and technical services cost base

The cost base should be consistent with the transfer pricing rules, the arm's length principle and the 2010 OECD Transfer Pricing Guidelines or later OECD Transfer Pricing Guidelines incorporated into Division 815 of the ITAA 1997.

TR 1999/1 Income tax: international transfer pricing for intra-group services does not apply to the current transfer pricing rules.

Eligibility for other simplification options for small business taxpayers or distributors

All options have their own eligibility criteria which you would need to consider in isolation for determining if you can elect to apply the relevant option.

For example, a business with a turnover between $0 and $50 million may not be eligible for the small taxpayers' option, but still be eligible for the low value adding intra-group services or low-level loans option. A distributor with a turnover between $0 and $50 million may also be eligible for the materiality or technical services options.

Example: multiple options

Gustal Co is an Australian subsidiary of Britai, a United Kingdom company, from which it purchased goods, received management services and paid royalties. For the 2019 financial year, Gustal Co had a turnover of $18 million, total expenses of $14 million and was the only member of the Australian economic group. It had no restructures, no sustained losses and had a 4.7% mark-up on cost of services received .

During the year, Gustal Co paid $600,000 royalties, $3.5 million for goods, and $1 million for management services. Gustal Co is not eligible for the small taxpayers or materiality options due to payment of royalties being greater than $500,000. However, Gustal Co is eligible for the low value adding intra-group services option, as all eligibility criteria are satisfied, including that the fees paid for management services were less than $2 million.

Gustal Co believes it has satisfied the arm’s length principle and there are no transfer pricing benefits arising from the transactions.

Accordingly, Gustal Co can elect to apply the low value adding intra-group services option to its management services fees paid to Britai.

Specified countries list

For the 2014 to 2018 income years, the specified countries list for the purposes of the guideline is different to the specified countries list for the IDS.

For the 2019 income years onwards, the specified countries list in the guideline no longer applies.

Australian economic groups

The definition in paragraph 76 of the guideline states that for the purposes of the simplification options, an 'Australian economic group' consists of an entity together with all the entities it is required by the Australian accounting standards to include in consolidated financial statements.'

Australian Accounting Standard AASB 10 refers to an entity that controls one or more other entities and explains how to apply the principle of control in determining the group. The group must present a consolidated financial statement for:

- assets
- liabilities
- equity
- income
- expenses
- cash flows.

Note: Tax consolidation is not mentioned in paragraph 76 of the guideline. Accordingly, it follows that consolidation for tax purposes is not determinative of what is an 'Australian economic group' in this context.

Applying the term 'Australian economic group' when determining the turnover eligibility criterion

If the Australian accounting standards require entities to be included within a consolidated financial statement, then the revenue for the purposes of the simplification options is the amount that would be reported by that consolidated group of entities.

Example: meeting the criteria

3 companies have a combined turnover of $65 million and are part of the same MEC group for tax consolidation purposes. Keltali Co ($26 million turnover) and Richoil ($17 million turnover) prepare a consolidated financial statement in accordance with AASB 10. Victasubb ($22 million turnover) files an individual financial statement with ASIC as it does not need to be consolidated under AASB 10.

Accordingly, there are 2 Australian economic groups. The turnover to determine eligibility for either the small taxpayers or distributors options in these circumstances will be:

- $43 million for Keltali Co and Richoil
- $22 million for Victasubb.

International related-party dealings

For the purposes of applying the simplification options, the following references within the guideline relate to international related-party dealings:

- related-party dealings with entities in the specified countries
- related-party dealings involving royalties, licence fees or R&D
- specified service related-party dealings.

Determining total international related-party dealings for the materiality and technical services simplification options

The total international related-party dealings used in the development of the 2 options takes into account the following expense and revenue amounts (labels based on the 2018 IDS), but does not include the balance of any loans recognised in your accounting records:

- tangible property of a revenue nature (label 5)
- royalties or licence fees (labels 6a and 6b)
- rent or leasing (label 7)
- services (labels 8a to 8k)
- derivatives (label 9)
- financial dealings excluding loan balances (label 11 excluding 11a and 11b)
- other revenue dealings (label 12)
- branch operation dealings excluding loan balances
  - interest (labels 18aj and 18bj)

- internal trading stock transfers (label 18c)
- other dealings (label 18d).

The calculation differs from that used in determining the IDS lodgment threshold of A$2 million as it does not include loan balances. For the technical services option, you also need to consider the relevant dealings for all entities within its Australian economic group.

Satisfying the 'sustained losses' criterion

You cannot apply a simplification option if you have sustained losses. For the purposes of these options, a loss is calculated by subtracting the sum of the total expenses labels from the sum of the total income labels on your income tax return.

Example: 2018 income tax return

For a company, you would use label 6S total income and label 6Q total expenses.

For a partnership's total income, you would use the sum of the amounts at labels 5(C+D+B+E+F+G+H), 8(A+Z+B+R+F), 9F, 10Q, 11J, 12(K+L+M), 14O, 22 (M+X), and 23B. For a partnership's total expenses you would use the sum of the amounts at labels 5O, 8(S+T+G), 9(G+X+H), 16P, 17D, 18Q, and 23(B-V).

For a trust's total income, you would use the sum of the amounts at labels 5(C+D+B+E+F+G+H), 8(A+Z+B+R+F), 9F, 10Q, 11J, 12(K+L+M), 14O, 22 (M+X), and 23B. For a trust's total expenses you would use the sum of the amounts at labels 5O, 8(S+T+G), 9(G+X+H), 16(P+R), 17D, 18Q, and 23(B-V).

Documentation required to satisfy the eligibility criteria

If you want to rely on any of the simplification options, we expect you to self-assess your eligibility and keep contemporaneous documents that verify your eligibility. These do not need to be comprehensive, but they should simply and sensibly explain how and why you were eligible to apply any options.

Self-assessment without corroborating documents is not enough.

The profit-before-tax ratio denominator

The profit-before-tax ratio is based on the following formula:

(Total income - Total expenses) ÷ Total income

Total income and total expenses are as reported on your income tax return.

Calculating the weighted average for the profit-before-tax ratio criterion in the distributors simplification option

The profit-before-tax ratio is calculated for 3 consecutive years, including the year for which you are considering applying the distributors option. The 3 year's total income and 3 year's total expenses are added together and used to determine the 3 year profit before tax. That result is divided by 3 year's turnover to reach the weighted average profit-before-tax ratio.

Example: weighted average

Australco is the only member of an Australian economic group and reported the following amounts in its income tax returns:

Year ended 30 June	2016	2017	2018	3 year average
Total Income $	20,600,000	17,000,000	26,000,000	21,200,000
Total Expenses $	18,800,000	16,500,000	24,740,000	20,013,333

The calculation of profit-before-tax ratio for the 3 years is:

Profit Before Tax	$1,186,667
Turnover	$21,200,000
Profit Before Tax Ratio	5.5975%

Accordingly, for the 2018 year, the weighted average would be 5.60%.

Applying the small taxpayers, distributors, low value adding intra-group services, or technical services simplification options when you have financial transactions

The 4 options do not apply to international related-party financial transactions. However, this does not mean you are excluded from applying the options to other transactions that satisfy the eligibility criteria.

If you have international related-party loan transactions you need to consider the criteria within the low-level loans options, to determine if any inbound or outbound loan component could be eligible for simplified record-keeping.

For all other international related-party financial transactions, you would be expected to document your relevant related-party dealings contemporaneously and, more specifically, consider the requirements of Division 284-E of Schedule 1 to the TAA. Interpretive guidance can be found in Taxation Ruling **TR 2014/8** Income tax: transfer pricing documentation and Subdivision 284-E.

Entities in the financial sector applying the low value adding intra-group services simplification option

Entities within the financial sector may have services that are not financial in nature, for example management or administration services.

An entity in the financial sector that has satisfied the relevant eligibility criteria for low value adding intra-group services can elect to apply the simplification option to their non-financial services.

Satisfying the eligibility criteria for both services received and provided for low

value adding intra-group and technical services

Example: not meeting the criteria

Subco is the only Australian subsidiary of Gottlund, a Swedish company. It was paid $2.5 million (with a mark-up of 5.3%) for providing management and administration services to Gottlund and was charged $5 million (with a mark-up of 4.2%) by TestCo, a Finnish subsidiary of Gottlund, for services received to install a new IT system.

In the 2019 income year, Subco's turnover was $25 million and it had total expenses of $15 million. Subco had no other related-party dealings, did not undertake any restructures in 2019, and had no sustained losses.

The amount Subco was paid for services provided is less than 15% of its total revenue (being 12.5%). However, the amount Subco paid for services received is more than 15% of total expenses (being 33.3%). Therefore, Subco cannot elect to apply the low value adding intra-group services option to neither the management and administration services provided, nor the IT services received.

The ‘combined cross-border loan balance’

The 'combined cross-border loan balance' includes loans to and from independent third parties, as well as related parties.

Definition and currency of 'loan' for the inbound and outbound low-level loans simplification options

To be classified as a loan for the purposes of these options, the instrument must be a debt interest under Division 974 of the ITAA 1997.

The loan provided or received must be in AUD for both the low-level inbound and outbound loans options.

Interest rates for the low-level outbound loan simplification option

The interest rates published for the 2015 income year onwards in relation to the outbound loans option reflects the yield on AUD denominated debt issued by Australian BBB rated corporate issuers for a 5 year tenor (as sourced from Bloomberg Valuation Service's AUD Corporate yield curve for the BBB ratings band).

The rates are determined as the average observed yield on the AUD Corporate yield curve for the 2 weeks prior to the commencement of each income year on 1 July.

For the 2015 to 2018 income years, the relevant interest rates for each income year were not to be less than:

- 4.91% in the 2015 income year
- 4.37% in the 2016 income year
- 4.34% in the 2017 income year
- 3.79% in the 2018 income year.

Interest rates for the low-level inbound loans simplification option

2014 to 2018 income years

For the 2014 to 2018 income years, the interest rates for the inbound loans option must not be more than the Reserve Bank of Australia (RBA) indicator lending rate for 'small business; variable; residential-secured term'.

The applicable RBA indicator rate is a column in 'Indicator lending rates - F5', one of a series of interest rates published on the RBA website (search for 'Statistics', go to 'Economic and Financial Statistics/Interest Rates' and select the Excel spreadsheet). The rates were set monthly.

2019 income year onwards

For the 2019 income year onwards, the interest rate for the inbound loans option must not be more than the rate published in PCG 2017/2. This published rate has been determined using the same methodology as the outbound loans option.

For the 2023 income year, we note the interest rate of 5.65% is significantly higher compared to 1.83% in the 2022 income year. The interest rate published for the annual update to low-level inbound and

outbound loans is based on interest rates observed in the Australian market between independent borrowers and lenders. The increase in the interest rate is consistent with market movement within the financial markets and reflective of a tightening monetary policy environment.

Other considerations

For more information about how we undertake compliance action to cross-border conditions between entities (CBCBE), under the Subdivisions 815-B and 815-C of the *Income Tax Assessment Act 1997* where entities have applied simplification options in PCG 2017/2, see PS LA 2014/3.

QC 17107

International dealings schedule

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If your business is engaged in international dealings with related parties and has more than $2 million of related-party dealings, you are required to complete an international dealings schedule (IDS) and lodge it with your income tax return for that year.

The IDS imposes obligations to disclose information about related-party international dealings, including:

- the nature and amount of certain categories of transactions
- details of dealings of a financial nature
- receipts or payments of non-monetary consideration
- details of restructuring events
- 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
- details of disposals or acquisitions of any interest in a capital asset.

The IDS allows you to notify us if you are eligible and choosing to adopt any of the simplified transfer pricing record-keeping options.

The IDS may change from year to year, so make sure you check the schedule and accompanying instructions for the income year you are addressing. You will need to refer to Schedule 25A for relevant income years prior to 2011–12.

We will publish instructions each year to help businesses complete their IDS.

Take care when completing your IDS. We use the information provided to help identify businesses that may pose a transfer pricing risk. If you fail to complete an IDS where required, you may incur penalties or be prosecuted.

For more information about the application of Australia's transfer pricing provisions in Division 13 of Part III (Division 13) of the *Income Tax Assessment Act 1936* (ITAA 1936)[1] and the Associated Enterprises Article of Australia's tax treaties (treaty Article 9) of the *International Agreements Act 1953* (Agreements Act) to business restructuring arrangements, see Taxation Ruling **TR 2011/1** *Income tax: application of the transfer pricing provisions to business restructuring by multinational enterprises*.

QC 17107

Transfer pricing risk assessment

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Businesses with related-party international dealings may face:

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

We generally allocate resources to transfer pricing cases based on the perceived risk to revenue of businesses not complying with the arm's length principle.

The broader and more significant the scope of a business's international dealings with related parties, the more likely we are to do a client risk review.

Your business is at the greatest risk of a client risk review if it:

- has significant levels of international dealings with related parties
- pays less tax compared to industry standards
- has recently undertaken business restructures that materially affect its related-party international dealings.

For more information about procedures for taxpayers who enter into an advance pricing arrangement (APA), see the Practice Statement Law Administration **PS LA 2015/4** *Advance pricing arrangements*.

QC 17107

Inbound supply chain strategy

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> **On this page**
>
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On 15 December 2017 the **Tax and Corporate Australia** report was released. This report identified that there was a key compliance risk associated with the transfer pricing of inbound supply chain (ISC) arrangements, specifically the question of whether appropriate profit was being recognised in Australia.

The ISC strategy has been developed to help manage this risk.

About the ISC strategy

The ISC strategy manages the transfer pricing risk associated with supply chains into Australia. It will ensure we provide transparent and tailored client experiences.

The strategy focuses on the key industry sectors of life science, information and communication technology, and motor vehicles, as well as general distributors.

The strategy includes the:

- publication of a practical compliance guideline to outline our compliance approach to these arrangements to help you make informed decisions about your tax affairs
- consistent treatment of transfer pricing risks associated with inbound distribution arrangements through various compliance approaches, promoting fairness.

Practical compliance guideline

On 13 March 2019, we published the Practical Compliance Guideline PCG 2019/1 *Transfer pricing issues related to inbound distribution arrangements*.

This guideline applies to subsidiaries of multinationals with inbound distribution arrangements that purchase goods and digital products or services from related parties and on-sell to customers.

It includes schedules specific to the life science, information and communication technology, and motor vehicle industries; and a general schedule for other distributors.

The guideline outlines:

- arrangements to which the guideline applies
- our compliance approach
- how we risk-assess inbound distribution arrangements
- our risk assessment framework, and
- how to increase certainty through the advanced pricing arrangements (APA) program.

This guideline is limited to the transfer pricing risks associated with inbound distribution arrangements. It does not affect our compliance approach to other tax issues that might arise in connection with your inbound distribution arrangements.

For more information, see the Practical Compliance Guideline PCG 2019/1 and identify whether you have an arrangement that fits within the guideline.

- Use the guideline to self-assess the risk of your arrangement.
- If you have any questions about the strategy, email ISCStrategy@ato.gov.au

QC 17107

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We are committed to providing you with accurate, consistent and clear information to help you understand your rights and entitlements and meet your obligations.

If you follow our information and it turns out to be incorrect, or it is misleading and you make a mistake as a result, we will take that into account when determining what action, if any, we should take.

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