International Transfer Pricing: The Australian Approach and Lessons for Canada

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PRÉCIS

En réaction aux nouveautés en matière de commerce international et à l'accent accru mis sur les questions de prix de transfert internationaux, le ministre des Finances du Canada a annoncé dans le budget de 1997 que le ministère des Finances procéderait à un examen des dispositions sur les prix de transfert contenues dans la Loi de l'impôt sur le revenu. Le 11 septembre 1997, le ministère des Finances a publié un avant-projet de loi sur les prix de transfert et Revenu Canada a publié la *Circulaire d'information* 87-2R révisée. Les dispositions législatives ont par la suite été modifiées et incluses dans le projet de loi C-28, adopté en première lecture le 10 décembre 1997. Les nouvelles règles visent à mettre à jour les pratiques du Canada en matière de prix de transfert internationaux. Plus particulièrement, elles visent à harmoniser les normes contenues dans la Loi de l'impôt sur le revenu et le principe de la pleine concurrence énoncé dans les directives sur les prix de transfert de l'OCDE. Les nouvelles règles contiennent également les exigences sur les documents ponctuels à l'égard des opérations transfrontalières conclues avec des personnes apparentées, facilitent l'administration de la loi par Revenu Canada et une pénalité y est prévue dans les cas où les prix de transfert ne sont pas conformes au principe de la pleine concurrence.

Les autorités fiscales australiennes ont aussi examiné et mis à jour leurs pratiques en matière de prix de transfert. Depuis 1992, le commissaire de l'impôt sur le revenu a publié trois décisions et sept projets de décisions directement reliés aux prix de transfert internationaux. Le choix et l'application de méthodes d'établissement des prix de transfert, les exigences sur les documents et les pénalités en cas de non-respect sont établis dans ces décisions. Le Taxation Office de l'Australie appuie l'utilisation d'ententes anticipées en matière de prix de transfert (EAPT) et il a élargi sa stratégie de vérification en exécutant des examens de l'évaluation du risque lié aux prix de transfert.

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Cet article contient un examen détaillé de la politique et des pratiques de l'Australie en matière de prix de transfert, qui traitent essentiellement des mêmes questions que celles visées par les nouvelles règles canadiennes. Cet examen constitue un cadre pour la comparaison des méthodes adoptées par les deux administrations. L'auteur conclut que, bien que ces méthodes diffèrent à certains aspects, elles procurent en fin de compte des résultats similaires. Une norme claire que doivent satisfaire les entreprises multinationales dans le cadre de l'établissement des prix de transfert est établie dans les deux régimes. Des vérifications et des pénalités en cas de non-respect y sont également prévues. De plus, l'utilisation de EAPT est prévue dans les deux régimes à titre de solution de rechange pour éviter les litiges sur les prix de transfert avec les autorités fiscales australiennes et canadiennes.

ABSTRACT

In response to developments in international trade and an increased focus on international transfer-pricing issues, Canada's minister of finance announced in the 1997 budget that the Department of Finance would undertake a review of the transfer-pricing provisions in the Income Tax Act. On September 11, 1997, the Department of Finance released draft transfer-pricing legislation and Revenue Canada released revised draft *Information Circular* 87-2R. The legislation was subsequently amended and included in Bill C-28, which received first reading on December 10, 1997. The new rules are intended to update Canada's international transfer-pricing practices. In particular, they attempt to harmonize the standards in the Income Tax Act with the arm's-length principle established in the OECD's transfer-pricing guidelines. The new rules also set out contemporaneous documentation requirements in respect of cross-border related-party transactions, facilitate administration of the law by Revenue Canada, and provide for a penalty where transfer prices do not comply with the arm's-length principle.

The Australian tax authorities have similarly reviewed and updated their transfer-pricing practices. Since 1992, the Australian commissioner of taxation has issued three rulings and seven draft rulings directly relating to international transfer pricing. These rulings outline the selection and application of transfer-pricing methodologies, documentation requirements, and penalties for non-compliance. The Australian Taxation Office supports the use of advance pricing agreements (APAs) and has expanded its audit strategy by conducting transfer-pricing risk assessment reviews.

This article presents a detailed review of Australia's transfer-pricing policy and practices, which address essentially the same concerns as those at which the new Canadian rules are directed. This review provides a framework for comparison of the approaches adopted in the two jurisdictions. The author concludes that although these approaches differ in some respects, ultimately they produce a similar result. Both regimes set a clear standard to be met by multinational enterprises in establishing

transfer prices. Both provide for audits and penalties in the event of non-compliance. And both offer the alternative of an APA as a means of avoiding transfer-pricing disputes with Australian and Canadian tax authorities.

INTRODUCTION

Increased cross-border transactions and expanding operations of multinational enterprises (MNEs) have raised concerns among major tax administrations about the potential loss of tax revenues through pricing arrangements for transactions between associated enterprises. In response to these concerns, the Organisation for Economic Co-operation and Development (OECD) has issued revised transfer-pricing guidelines[1] to replace those contained in its 1979 transfer-pricing report. The current guidelines represent a consensus among 25 OECD member countries on the preferred approach to international transfer-pricing issues.

The Canadian government has recognized the need for revision of its transfer-pricing regime, and in the February 1997 federal budget, the Department of Finance announced a review of the transfer-pricing provisions of the Income Tax Act.[2] A 1996 study on transfer pricing highlighted some of the financial implications of transfer-pricing arrangements for Canada.[3] It was noted that in 1993, $248 billion in cross-border related-party transactions was reported to Revenue Canada, $166 billion of which was generated by transactions between Canada and the United States.[4] In a country that in the same year raised less than $20 billion in corporate income tax, the potential impact on tax revenues of related-party transactions was significant.

The private sector also has recognized the significance of complying with transfer-pricing laws and administrative requirements. An independent survey conducted by Ernst & Young International in 1995[5] reported that 80 percent of MNEs in the eight countries surveyed[6] indicated that

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[1] Organisation for Economic Co-operation and Development, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD) (looseleaf) (herein referred to as "the OECD guidelines"). The OECD states in the preface at paragraph 1, "The role of multinational enterprises (MNEs) in world trade has increased dramatically over the last 20 years. This in part reflects the increased integration of national economies and technological progress, particularly in the area of communications. The growth of MNEs presents increasingly complex taxation issues for both tax administrations and the MNEs themselves since separate country rules for the taxation of MNEs cannot be viewed in isolation but must be addressed in a broad international context."

[2] Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the ITA").

[3] Robert Turner, *Study on Transfer Pricing*, Working Paper 96-10 prepared for the Technical Committee on Business Taxation (Ottawa: Department of Finance, December 1996).

[4] Ibid., at 1.

[5] Ernst & Young, *Transfer Pricing: Risk Reduction and Advance Pricing Agreements*, 1995.

[6] Australia and Canada were two of the countries included in the survey.

transfer pricing was the most important international tax issue facing them today, with over 50 percent indicating that it was the most important tax issue of any kind.

Australia's reform of its international transfer-pricing regime commenced in 1981 with amendments to the Income Tax Assessment Act 1936, as amended (herein referred to as "the ITAA"), resulting in the introduction of the present division 13 of part III of the ITAA. It was not until this decade, however, that the Australian Taxation Office (ATO) took an active interest in the operation of the transfer-pricing provisions. Since 1992, the ATO has issued three rulings[7] and seven draft rulings[8] directly relating to international transfer pricing. The three rulings are public rulings and consequently are binding on the commissioner of taxation;[9] the seven draft rulings are not binding.[10] The rulings and draft rulings outline the selection and application of transfer-pricing methodologies, documentation requirements, penalties for non-compliance, and procedures for negotiating advance pricing agreements (APAs). The ATO has also expanded its audit strategy by conducting transfer-pricing risk assessment reviews.

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[7] *Taxation Ruling* TR 92/11, "Application of the Division 13 Transfer Pricing Provisions to Loan Arrangements and Credit Balances," October 1, 1992; *Taxation Ruling* TR 94/14, "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," May 31, 1994; and *Taxation Ruling* TR 95/23, "Transfer Pricing—Procedures for Bilateral and Unilateral Advance Pricing Arrangements," June 22, 1995.

[8] *Taxation Ruling* TR 95/D11, "Division 13 and Permanent Establishments," April 20, 1995; *Taxation Ruling* TR 95/D22, "Using Arm's Length Pricing Methodologies in International Dealings Between Associated Enterprises," September 29, 1995; *Taxation Ruling* TR 95/D23, "International Transfer Pricing—Practical Issues Associated with Setting, Reviewing and Documenting Transfer Pricing—Application of Division 13 of Part III (International Profit Shifting) and Australia's Comprehensive Double Taxation Agreements," September 29, 1995; *Taxation Ruling* TR 95/D24, "International Transfer Pricing: Penalty Tax Guidelines," September 29, 1995; *Taxation Ruling* TR 95/D29, "Charging for Services and Expense Allocation," November 29, 1995; *Taxation Ruling* TR 95/D31, "Correlative Adjustment To Relieve Double Taxation Arising from an Adjustment by a Foreign Tax Administration," December 20, 1995; and *Taxation Ruling* TR 97/D5, "International Transfer Pricing: The Effects of Determinations Made Under Division 13 of Part III, Including Consequential Adjustments Under Section 136AF," June 4, 1997.

[9] Public rulings are the subject of part IVAAA of the Taxation Administration Act 1953, as amended (herein referred to as "the TAA"). The TAA provides that public rulings are binding on the commissioner. Public rulings have the force of law in relation to arrangements that were commenced after June 1992 and must be applied by the commissioner, the Administrative Appeals Tribunal, and the courts to give the taxpayer the benefit of the ruling. However, if the law, not taking into account the public ruling, is found to be more favourable to the taxpayer, the law will prevail. ITAA section 170BA(3) provides that if the amount of tax payable by a taxpayer under the ITAA is lower using the interpretation in a public ruling than that using the correct interpretation of the law (for example, where the two are subsequently found to differ), the interpretation in the public ruling must be applied.

[10] Public rulings are normally first issued in draft form. A draft ruling has no legal effect and is not binding on the commissioner or the taxpayer. The ATO does accept that a draft ruling may be used by a taxpayer to develop a reasonably arguable position in relation to penalty provisions (discussed subsequently in this article).

This article provides a detailed review of the Australian approach to transfer pricing, indicates how it differs from the Canadian approach, and considers what lessons may be learned from Australia's experience to assist in the implementation of Canada's new transfer-pricing rules. It will be seen that there are broad similarities between the two jurisdictions, both in the concerns that the respective tax authorities have tried to address and in the solutions they have adopted. These similarities are perhaps not surprising insofar as both countries have designed their transfer-pricing regime to be generally in accord with the OECD guidelines. Thus, both regimes are based on the arm's-length approach to transfer pricing, and both approve specific methods (along the lines endorsed by the OECD) that taxpayers may use to determine an arm's-length price for transfers within an MNE group. Both regimes also establish contemporaneous documentation requirements and provide for penalties for noncompliance with the rules. Both tax administrations have put in place audit processes to monitor compliance, and both have adopted APAs as a means of resolving transfer-pricing issues in advance and thereby avoiding costly audits, price adjustments, and penalties. Within these broadly similar approaches, there are, however, differences, which may be instructive to the tax administrations in both countries as they continue to develop and refine their solutions to transfer-pricing problems.

TRANSFER-PRICING LEGISLATION IN AUSTRALIA

As noted above, Australia's current transfer-pricing legislation is contained in division 13 of part III of the ITAA. Until that legislation was introduced in 1981, only one section of the ITAA dealt with transfer pricing—section 136, an original provision, without amendments, of the 1936 ITAA.[11]

Three conditions had to be satisfied before former section 136 applied.[12] First, a business must be carried on in Australia. Second, the business

[11] Section 136 was contained in former division 13, part III, of the ITAA. It was based on section 28 of the Income Tax Assessment Act 1922, as amended, which in turn was based on section 23 of the Income Tax Assessment Act 1915-1921, as amended, which in turn was based on section 31 of the Income (No. 2) Act 1915 (UK).

[12] Former section 136 provided:

Where any business carried on in Australia—

(a) is controlled principally by non-residents;

(b) is carried on by a company a majority of the shares in which is held by or on behalf of non-residents; or

(c) is carried on by a company which holds or on behalf of which other persons hold a majority of the shares in a non-resident company,

and it appears to the Commissioner that the business produces either no taxable income or less than the amount of taxable income which might be expected to arise from that business, the person carrying on the business in Australia shall, notwithstanding any other provision of this Act, be liable to pay income tax on a taxable income of such amount of the total receipts (whether cash or credit) of the business as the Commissioner determines.

must be controlled by non-residents. Third, it must appear to the commissioner that the business either produced no assessable income or produced less than the amount of assessable income that would be expected to arise from such a business.

The primary deficiency of former section 136 was exposed in the 1980 decision of the Full High Court[13] in *FCT v. Commonwealth Aluminium Corporation Limited*.[14] In that case, the High Court considered the meaning of section 136 and more specifically what was meant by the term "controlled principally."[15] The issue that had to be decided by the court was whether "control" meant de facto or de jure control. The majority of the court took a strictly literal approach, concluding that control meant de jure control.[16] While this decision clarified the scope and operation of

[13] An appeal by the commissioner against the Federal Court decision, 79 ATC 4202. The Federal Court overturned the assessments, and the commissioner sought their reinstatement by the High Court.

[14] 80 ATC 4371 (HC).

[15] During the years in question (1967-1971 inclusive), the taxpayer, a resident company that carried on a business in Australia of mining and selling bauxite, was wholly owned by Comalco Ltd., a company incorporated in Australia. In the years 1965-1969, the share capital in Comalco was 50 percent owned by Kaiser Aluminium and Chemical Corporation, a company incorporated in the United States, and 50 percent owned by Conzinc Riotinto Australia Ltd. (CRA), a company incorporated in Australia. In the years 1970-1971, the shareholdings of Kaiser and CRA in Comalco dropped to 45 percent each, and the remaining 10 percent were owned by the Australian and New Zealand general public. For the years in question, 80 to 85 percent of the shareholdings in CRA were held by CRA Holdings Pty Ltd., a company incorporated in Australia, and 15 to 20 percent were held by the Australian general public. However, 99.9 percent of the shareholdings in CRA Holdings Pty Ltd. were held by RTZ Aust Holdings, a company incorporated in the United Kingdom. In turn, RTZ Aust Holdings was wholly owned by Riotinto Zinc Corporation, also incorporated in the United Kingdom. The management of the taxpayer company was vested in the board of directors with no delegation of this power to a managing director or any other person. During the years in question, there was at least one non-resident director. The commissioner of taxation assessed the taxpayer for the years 1967-1971, arguing that the business of the taxpayer was controlled principally by non-residents of Australia. The sole issue to be decided by the High Court was whether the business of the taxpayer carried on in Australia was being controlled principally by non-residents within the meaning of ITAA section 136(a). The commissioner argued that Riotinto and Kaiser together had the capacity to control the business of the taxpayer through the control of general meetings of the shareholders. The taxpayer argued that it controlled its own business and, further, that even if non-residents had the capacity to control the business of the taxpayer, that control had not been exercised. The High Court, by a majority, held that the taxpayer company was not controlled principally by non-residents within the meaning of ITAA section 136(a).

[16] Stephen, Mason, and Wilson JJ, in a joint judgment, held that the business of the taxpayer was not principally controlled by non-residents and that the word "controlled" in ITAA section 136(a) referred to actual or de facto control, and not the capacity to control: supra footnote 14, at 4378-79. Their Lordships distinguished between control of a general meeting and control of a company's business, stating that it does not follow that the control of a general meeting results in the control of the business of the company. Barwick CJ, in a separate judgment, held that the only control of the taxpayer's business was by the taxpayer itself, and therefore the business was not controlled by non-residents. Murphy J,

(The footnote is continued on the next page.)

former section 136, it also revealed the deficiencies and limitations of its application. In particular, the judgment clearly reflected the view that a transfer-pricing provision based on a test of control rather than one of arm's-length price was not suitable.

In addition to the deficiencies exposed by the High Court, former section 136 had other shortcomings: the control test did not cover all situations that may be relevant to the kind of tax avoidance at which the section was directed; section 136 applied only to non-residents; it was limited to business income and consequently appeared to preclude other types of income not clearly linked to a business; it did not impute the derivation of income in a transaction that would produce income if it were one between independent parties; and its link with total receipts was restrictive.[17] In light of these limitations, it was clearly necessary to amend the legislation.

When the current division 13, part III of the ITAA was introduced,[18] former section 136 was repealed. The amended legislation discarded the previously ineffectual test of control along with the alternative shareholdings tests and replaced them with the arm's-length price test. The scope of amended present division 13 also extends to a broader spectrum of transactions by applying to both residents and non-residents, as well as applying to profit shifting between separate entities and profit shifting within the same entity. Further, the new provisions apply on a transactional basis rather relying on an examination of taxable income for the entire year.

The critical section of division 13, part III of the ITAA, in respect of international transfer-pricing arrangements,[19] is section 136AD headed "Arm's length consideration deemed to be received or given." This section sets out the following four conditions that must be satisfied before an arm's-length price can be substituted for the consideration actually paid or received:

1) there is a supply or acquisition of property under an international agreement;

2) the commissioner, having regard to any connection between any two or more of the parties to the agreement or to any other relevant

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[16] Continued . . .
dissenting, held that at all relevant times the taxpayer and the taxpayer's business was controlled by non-residents: ibid., at 4384. His Lordship stated that the taxpayer was part of a transnational operation and that the business of the taxpayer was controlled by non-resident transnational corporations: ibid., at 4385.

[17] *Australian Federal Tax Reporter* (North Ryde, NSW: CCH Australia) (looseleaf), paragraph 70-040.

[18] The present division 13 was introduced by Act No. 29 of 1982, section 19(1). Section 19(3) provides that the amendments apply in respect of income of the year of income in which May 28, 1981 occurred and all subsequent years.

[19] A parallel provision, ITAA section 136AE, addresses transfer pricing for single-entity transactions.

circumstances, is satisfied that two or more parties to the agreement were not dealing at arm's length;

3) the consideration paid or received by the taxpayer in respect of the acquisition or supply was greater or less than the arm's-length consideration in respect of the acquisition or supply, or no consideration was given; and

4) the commissioner determines that the section should apply in relation to the taxpayer.

The Arm's-Length Principle

The application of section 136AD relies in part on reference to the "arm's length consideration" for a supply or acquisition of property. The same concept is incorporated into Australia's double tax agreements (DTAs). Although the notion of arm's-length consideration is central to Australia's transfer-pricing policy, neither the ITAA nor the DTAs provide any guidance as to the acceptable methodologies for an arm's-length price for a particular transaction.

Australia, like Canada, has elected to adopt the arm's-length approach to transfer pricing rather than formulary apportionment. In this respect, both countries conform to the approach adopted in the OECD guidelines, which is based on the arm's-length principle set out in article 9 of the OECD's model tax convention.[20] Article 9 provides:

> When conditions are made or imposed between . . . two [associated] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

The OECD guidelines address the issue of how an arm's-length price is to be determined, and they clearly favour the use of "transaction-based" methods. The ATO's approach is generally in line with the OECD's recommendations. The methods that the commissioner considers acceptable for ascertaining an arm's-length consideration are set out in *Taxation Ruling* TR 94/14.[21] This ruling also offers a limited amount of guidance as to the factors that the commissioner will consider in the selection of a particular method.[22]

The methods stated to be acceptable are the comparable uncontrolled price (CUP), the resale price (RP), and the cost plus (CP) methods. The ruling recognizes that these methods may, having regard to commercial and economic realities, be inappropriate in some circumstances. In such

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20 Organisation for Economic Co-operation and Development, *Model Tax Convention on Income and on Capital* (Paris: OECD) (looseleaf).

21 TR 94/14, supra footnote 7, at paragraph 88.

22 Ibid., at paragraph 87.

cases, a combination of the above three methods or an alternative method may be used where it leads to a result that is consistent with the arm's-length principle.[23]

At the outset, the commissioner recognizes the ruling's limitations, three of which are significant. First, the ruling applies essentially to tangible property; principles relating to intangible property are discussed in broad terms only.[24] Second, it is concerned primarily with the application of division 13 of the ITAA, and not the DTAs. Third, it concentrates on transactions between separate legal entities and not transactions between different parts of the same legal entity.[25]

The greatest limitation of TR 94/14 is that while the commissioner identifies the various methods available in order to determine an arm's-length price, he does not provide a clear set of principles to assist the taxpayer in selecting and applying a particular method. As a result, while the ruling establishes the commissioner's position on various legal issues, such as definitions and methodologies, it does little in the way of providing practical guidance. It has thus failed to eliminate many of the uncertainties for MNEs that are subject to Australia's transfer-pricing regime.

Draft *Taxation Ruling* TR 95/D22[26] follows on from TR 94/14 and provides the practical guidance that TR 94/14 lacks. However, like TR 94/14, the draft ruling is limited to transactions between separate legal entities and consequently does not address transactions entered into between branch offices, divisions, and permanent establishments of a single entity.[27]

The draft ruling closely reflects many of the views expressed in the OECD guidelines, relying on most of the OECD's definitions and practical examples. The draft ruling also provides that the commissioner "will pay close attention to the OECD guidelines on transfer pricing methodologies and the operation of the Associated Enterprise Article of the OECD Model, being the considered view of many tax experts familiar with transfer pricing."[28]

The draft ruling reiterates and expands on many of the views expressed in TR 94/14. Again, the commissioner recognizes the need to adopt a practical and realistic approach when selecting an appropriate transfer-pricing method, stating:

> Having regard to the statutory objective of Australia's transfer pricing rules, the ATO takes the view that any transfer pricing methodology used to calculate an arm's length consideration in international dealings between associated enterprises must be applied in a way that will provide an arm's

[23] Ibid., at paragraph 100.

[24] Ibid., at paragraph 4.

[25] Ibid., at paragraph 6.

[26] TR 95/D22, supra footnote 8.

[27] Ibid., at paragraph 3.

[28] Ibid., at paragraph 14.

length outcome by closely reflecting commercial and economic reality and the economic contribution made by the enterprises in each jurisdiction.[29]

The most significant contribution of the draft ruling is to provide practical guidance to MNEs in selecting an appropriate transfer-pricing method for tax liability purposes. More particularly, the draft ruling recommends that, to ensure compliance with the transfer-pricing requirements of the ITAA, the taxpayer should employ a four-step approach.[30] First, the taxpayer needs to "understand the cross-border dealings between the associated enterprises in the context of the taxpayer's business." Second, the taxpayer selects the method or methods that are most appropriate to reflect commercial and/or economic reality. Third, the taxpayer applies the selected method or methods to dealings between the associated enterprises. Fourth, the taxpayer determines the arm's-length price and implements any necessary support process. To assist in the selection of an appropriate transfer-pricing method, the draft ruling identifies key factors that the taxpayer should take into account (as discussed below).

In arriving at an arm's-length price, the question being asked is "What would have happened if the ownership link had been severed and the enterprise [had been] motivated by its own economic interest?"[31] While, on its face, this question appears to be a simple one to answer, in very few scenarios is this the case. It is this difficulty in arriving at an arm's-length price that has led to the development of numerous transfer-pricing methodologies.

The various arm's-length methodologies, recognized both internationally and by the ATO, can be grouped into two basic categories: the traditional methods and the profit methods. The first category consists of the CUP, the RP, and the CP methods. The second category includes, but is not limited to, valuation procedures such as the profit split and the profit comparison methods.

While both the commissioner and the OECD have stated that the traditional methods are preferred over the profit methods,[32] application of the former depends on the availability of reliable comparable data.[33]

This requirement is the primary limiting factor associated with the traditional methods. The commissioner indicates that the word "comparable" means "the same as, similar to or analogous"[34] and elaborates on this definition as follows:

[29] Ibid., at paragraph 27.

[30] Ibid., at paragraph 186.

[31] Ibid., at paragraph 30.

[32] Ibid., at paragraph 79; and OECD guidelines, supra footnote 1, at paragraph 3.49.

[33] TR 95/D22, supra footnote 8, at paragraph 81; and OECD guidelines, supra footnote 1, at paragraph 3.5.

[34] TR 95/D22, supra footnote 8, at paragraph 89.

> To be comparable means that none of the differences (if any) between the situations being compared could materially affect the condition being examined in the methodology (e.g., price or margin), or that reasonably accurate adjustments can be made to eliminate the effect of any such differences.[35]

Where adequate highly comparable data are available, the preferred traditional method is the CUP method.[36] Where it is not possible to use the CUP method, the taxpayer should consider using the RP or CP method. Although the latter methods also depend on the availability of reliable data on comparable transactions, the commissioner recognizes that some of the problems associated with comparability in relation to the CUP method may not arise under the RP and CP methods. The reason is that minor product differences, while having a material effect on price, normally will not materially affect a profit margin.[37]

Where it is inappropriate to apply any of the three traditional methods to determine an arm's-length price, it will be necessary to consider an alternative. The commissioner acknowledges that a combination of the CUP, RP, and CP methods may be an acceptable alternative where no one method leads to a satisfactory arm's-length price. Alternatively, the profit split or profit comparison method may be used.[38] Although these methods are accepted alternatives, the commissioner supports the view of the OECD that they are methods of last resort.[39]

The commissioner also believes that it is essential to find an answer for all transfer-pricing problems, and where none of the methods mentioned above appear to be appropriate, their use should be reconsidered on the basis of either sufficiently broadening the comparability criterion or sufficiently relaxing the normal conditions imposed in applying the relevant methods.[40]

Despite the stated preference for the traditional methods, and the CUP method above all, the ultimate aim is to arrive at an arm's-length price that most closely reflects commercial and economic reality. When a taxpayer selects an arm's-length pricing methodology,

> [t]he choice of the most appropriate method should be based on a practical weighting of the evidence having regard to the nature of the activities being examined, the quality and reliability of the data and the nature and extent of any assumptions and the degree of comparability that exists between the controlled and uncontrolled dealings or between enterprises

[35] Ibid., at paragraph 38.

[36] Ibid., at paragraph 73.

[37] Ibid., at paragraph 91.

[38] These methods are suggested in TR 94/14, supra footnote 7, at paragraph 367.

[39] TR 95/D22, supra footnote 8, at paragraph 28; and OECD guidelines, supra footnote 1, at paragraph 3.50.

[40] TR 95/D22, supra footnote 8, at paragraph 173.

> undertaking the dealings where the difference would effect conditions in arm's length dealings being examined.[41]

It is recognized that the application of currently accepted methods, as well as others that may emerge, must remain flexible and receptive to developments that refine the determination of an approximate arm's-length price.[42] Further, the commissioner states:

> [I]t is essential to always be mindful of what is reasonable and to adopt practical, flexible approaches in the application of the methodologies so that they achieve the highest degrees of comparability that is feasible and to avoid disputes about theoretical aspects that may not produce practical solutions in a given case.[43]

The various accepted arm's-length methodologies are examined in turn below.

Comparable Uncontrolled Price Method

The comparable uncontrolled price method is defined in the OECD guidelines and in TR 95/D22 as

> [a] transfer pricing method that compares the price for property or services transferred in a controlled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances.[44]

In short, the CUP method determines an arm's-length price by reference to comparable transfers of property between unrelated parties in comparable markets.

As with all of the traditional methods, the primary limitation of the CUP method is the comparability requirement. The initial problem is to identify a comparable product. For example, if the property is highly specialized, there may be no truly comparable product in existence; if the property is unique, there will be no comparable product. In other cases, there may not be a comparable market—for example, where the property involved is work in progress. Problems with the CUP method will also arise where the property is an intangible or involves the provision of services, because issues such as quality will come into play. Even if a comparable product exists, it may not be possible to obtain a competitor's price list. If any of these scenarios applies, the CUP method will not be workable and an alternative will need to be considered.

The commissioner states that, in determining whether there is a comparable product, "[t]he most important comparability factors are similarity of product, contract terms and economic/market conditions."[45] Other factors

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[41] Ibid., at paragraph 80.

[42] Ibid., at paragraph 340.

[43] Ibid., at paragraph 344.

[44] Ibid., at paragraph 6; and OECD guidelines, supra footnote 1, at G-2.

[45] TR 95/D22, supra footnote 8, at paragraph 85.

such as business strategies and the relative bargaining power of the parties also may be taken into account.[46]

Even if there is not a directly comparable product, it may still be possible to use the CUP method. However, it will be necessary to adjust the price of the product used as a substitute for a comparable and thus to calculate an adjusted CUP. Inherent in this approach is the subjectivity of the valuation of differences, which, in turn, will affect the reliability of the adjusted CUP. Despite difficulties associated with any adjustments that may be necessary, the commissioner states that the CUP method should not be routinely dismissed where there are no readily available comparables.[47] If, however, differences cannot be measured and allowed for with any certainty, alternative methods should be considered.[48]

In view of the above limitations, the CUP method will be the obvious method of choice where an independent enterprise sells to unrelated parties a product identical to that sold by the taxpayer to a related party. In other situations, it may still be considered the most appropriate method if the resulting price most closely reflects commercial and economic reality.

Resale Price Method

The resale price method is defined in the OECD guidelines and in TR 95/D22 as

> [a] transfer pricing method based on the price at which a product that has been purchased from an associated enterprise is resold to an independent enterprise. The resale price is reduced by the resale price margin. What is left after subtracting the resale price margin can be regarded, after adjustment for other costs associated with the purchase of the product (e.g., customs duties), as an arm's length price of the original transfer of property between the associated enterprises.[49]

The arm's-length price under the RP method is determined by looking backward—that is, by deducting from the sale price of the goods, when sold to an arm's-length buyer, the taxpayer's costs and an appropriate profit margin.

The RP method can be expressed as the following equation:

Resale price to an independent enterprise − gross margin = Arm's-length price

As with the CUP method, the primary limitation of the RP method is the need for independent comparables. Calculating the gross margin by reference to a percentage of the resale price where that percentage has not been determined by reference to an independent comparable will not be acceptable except in extreme cases.[50]

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[46] Ibid., at paragraph 361.

[47] Ibid., at paragraph 86.

[48] Ibid.

[49] Ibid., at paragraph 6; and OECD guidelines, supra footnote 1, at G-6.

[50] TR 95/D22, supra footnote 8, at paragraphs 107 to 108.

In addition to the difficulty associated with the concept of comparability, the RP method entails the further problem of placing a value on the gross margin. This gross margin, usually measured at the gross profit level,[51] will vary according to the value added by the reseller.[52] This amount should reflect two components: the costs incurred by the reseller in relation to the particular property and an appropriate profit. Factors affecting the relevant margin will include the functions undertaken, assets employed, and risks assumed.[53]

The RP method will be most suitable where the reseller does little to enhance the value of the property and there are independent parties who undertake comparable transactions. Where the reseller further processes the goods or incorporates them into another product, thereby creating a new one, it will be more difficult to determine an arm's-length price. Likewise, where the reseller is the owner of intangible property that relates to the product and hence adds value, the RP method may not be suitable.[54]

Cost Plus Method

The cost plus method is defined in the OECD guidelines and TR 95/D22 as

> [a] transfer pricing method using the costs incurred by the supplier of property (or services) in a controlled transaction. An appropriate cost plus mark-up is added to this cost, to make an appropriate profit in light of the functions performed (taking into account assets used and risks assumed) and the market conditions. What is arrived at after adding the cost-plus mark-up to the above costs may be regarded as an arm's length price of the original controlled transaction.[55]

The CP method arrives at an arm's-length price by looking forward—that is, it determines an appropriate markup of profit to be added to the cost of the property to the supplier.

The CP method can be expressed as the following equation:

Cost of property to supplier + cost markup = Arm's-length price

The cost base to which the markup is added will consist of both the direct and indirect costs associated with the production of the property; that is, absorption costing[56] is used in determining the cost of the property to the supplier.[57] Indirect costs should be allocated on the basis of ordinary accounting principles since the ATO will apply those principles in evaluating the taxpayer's allocation.[58]

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[51] Ibid., at paragraph 103.

[52] Ibid., at paragraph 106.

[53] Ibid., at paragraph 102.

[54] Ibid., at paragraph 98.

[55] Ibid., at paragraph 6; and OECD guidelines, supra footnote 1, at G-3.

[56] For further information on absorption costing, see *Taxation Ruling* IT 2350, "Value of Trading Stock on Hand at End of Year: Cost Price: Absorption Cost," July 31, 1986.

[57] TR 95/D22, supra footnote 8, at paragraph 111.

[58] Ibid., at paragraph 115.

The appropriate profit markup, measured at gross profit level,[59] is usually determined by reference to the profit margin added by the supplier in independent transactions. Where the supplier does not engage in any independent transactions, it may be necessary to determine the cost plus markup by reference to comparable transactions of independent parties.[60] Calculating the profit markup by reference to a percentage of the cost price where that percentage has not been determined by reference to a comparable uncontrolled transaction will not be acceptable except in extreme cases.[61]

Profit Split Method

The profit split method is one of two non-traditional methodologies that may be used. It is defined in TR 95/D22 as

> [a] transfer pricing method that identifies the combined profit to be split for the associated enterprises from a controlled transaction (or controlled transactions that it is appropriate to aggregate under the principles set out in this Ruling) and then splits those profits between the associated enterprises according to an economically valid basis that approximates the division of profits that would have been anticipated and reflected in an agreement made at arm's length between independent parties.[62]

In short, the profit split method determines the combined profit and loss of the associated parties and then splits this amount between those parties in such a way as to reflect the profit split that would have been expected if the parties had been dealing at arm's length. A taxpayer may use this method to determine an appropriate split based either on projected profits or on actual profits, whichever approach best satisfies the transfer-pricing requirements of the ITAA.[63]

There are several problems associated with this method. The main difficulty will be determining the split of profits that would have occurred if the parties had been dealing at arm's length. The two most common approaches used to determine an appropriate profit split are contribution analysis and residual analysis.[64] Other approaches, such as return on capital[65] and profit split based on comparable transactions,[66] may be appropriate alternatives.

Contribution analysis operates in such a way as to divide the profits in question on the basis of the value of the functions performed by the respective parties. The value of the functions performed will be measured

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59 Ibid., at paragraph 123.

60 Ibid., at paragraph 122.

61 Ibid., at paragraphs 124 to 125.

62 Ibid., at paragraph 6. This definition differs from the definition contained in the OECD guidelines, supra footnote 1, at G-5.

63 TR 95/D22, supra footnote 8, at paragraph 141.

64 Ibid., at paragraph 142.

65 Ibid., at paragraph 147.

66 Ibid., at paragraph 148.

directly where possible or otherwise will be an estimation based on market data indicating the profit split between independent parties.[67]

Residual analysis is a two-stage process. First, an appropriate amount of profit is allocated to the respective parties which is equivalent to a basic amount determined in accordance with the market. Second, the residual amount is allocated to the respective parties according to the expected division between independent parties. At this second stage, an examination of intangible property and relative bargaining positions is undertaken. It should be noted that problems may arise where the first stage results in a loss to be allocated at the second stage.[68]

Apart from the difficulty of arriving at an equivalent arm's-length profit split, there are at least three other material difficulties associated with this method: first, determining the scope of the profit split (that is, whether it should apply to the whole business or only to a single product, service, or transaction); second, identifying the profits to be allocated to various transactions (for example, where there are several associated parties dealing with each other); and third, determining the appropriate accounting standards applicable to the consolidation of accounts.

Profit Comparison (Transactional Net Margin) Method

The other non-traditional methodology is the profit comparison method, defined in TR 95/D22 as

> [a] transfer pricing methodology based on comparisons at the net profit level, on a single transaction level or in relation to some aggregation of dealings between associated enterprises, between the taxpayer and independent parties dealing wholly independently in relation to a comparable transaction or dealings.[69]

The OECD guidelines refer to this method as the transactional net margin method.[70]

The profit comparison method determines an appropriate net profit margin relative to a specified base such as costs or sales. This is a variation on the cost plus method in the sense that that method considers an appropriate gross profit margin, whereas the profit comparison method involves a net profit margin. The markup will be determined by reference to transactions entered into with unrelated parties and the net profit margins of independent parties in the marketplace.

One of the problems associated with the CP method is the lack of independent industry data by which to determine the appropriate gross profit markup. The profit comparison method may overcome the unreliability and subjectivity associated with the CP method. The profit

[67] Ibid., at paragraph 143.

[68] Ibid., at paragraph 145.

[69] Ibid., at paragraph 6.

[70] See supra footnote 1, at G-7, for the definition of the transactional net margin method.

comparison method also may allow for greater accuracy when adjusting for differing functions undertaken by various enterprises.

The Reality

It is obvious that establishing an arm's-length price is difficult for both the taxpayer and the ATO. Entities within an MNE group will not be motivated by their own economic interest, but rather by the economic interest of the group as a whole. Consequently, independent market prices for transfers of property and services will not always be appropriate, for reasons that may be quite unrelated to tax liabilities. It is suggested that the arm's-length principle does not accord with the general purpose behind the establishment of an MNE. MNEs are created because the member entities can perform better as a group than they would as non-associated enterprises. The requirement to set an arm's-length (market value) price for intragroup transactions defeats the purpose of establishing an MNE.

Contemporaneous Documentation: Avoiding the Audit

The requirement for contemporaneous documentation is not found in division 13, part III of the ITAA. Rather, it is a product of a general statutory record-keeping provision, section 262A of the ITAA. The application of this provision in the context of international transfer pricing is considered in draft *Taxation Ruling* TR 95/D23.[71] This ruling is subsequent to and builds on several of the concepts outlined in TR 94/14.

TR 95/D23 is divided into two parts. Part 1 focuses on general concepts of substantiation and practical application, while part 2 focuses on specific areas of difficulty, for both the ATO and the taxpayer. It should be noted at the outset that this draft ruling generally relates to transactions between separate legal entities, and not transactions between different parts of a single entity.[72] Further, the draft ruling specifically deals with companies; however, the same principles will apply to individuals, partnerships, and trusts where they are dealing with separate legal entities.[73]

General Substantiation Requirements

There are several compelling reasons for maintaining contemporaneous documentation relating to price setting for international transactions between associated enterprises. The primary reason, of course, is the statutory requirement to do so. Section 262A of the ITAA requires a person carrying on a business to keep records that document and explain all transactions and other acts engaged in by the person that are relevant for any purpose

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[71] TR 95/D23, supra footnote 8. "Contemporaneous documentation" is defined in TR 95/D23, at paragraph 29, to mean "books, records, studies, analyses, conclusions and other written material, existing or brought into existence at the time the taxpayer was developing or implementing any arrangement, that might raise transfer pricing issues and which record the information relevant to transfer pricing decisions."

[72] In this regard TR 95/D11, supra footnote 8, should be consulted.

[73] TR 95/D23, supra footnote 8, at paragraph 5.

of the ITAA. TR 95/D23 considers the requirement contained in section 262A and the documentation that should be kept by a taxpayer to show compliance with the arm's-length principle in relation to international transactions with associated enterprises. It suggests that there is a greater onus on taxpayers who enter into such transactions than on independent enterprises dealing at arm's length.[74] The onus placed upon enterprises engaged in international dealings applies to both small and large businesses, although there will be a degree of flexibility with respect to the type and extent of documentation depending on the size of the business.

While section 262A and the accompanying penalty provisions in section 225 do not directly impose an obligation on the taxpayer to document the factors considered in determining an arm's-length price, the commissioner considers that these sections in effect impose an indirect requirement to do so.[75] Certainly, section 262A requires documentation of the process of setting and reviewing transfer prices.[76] In addition to the statutory requirement to keep records, regulation 15 of the Income Tax Regulations requires a taxpayer that has engaged in international transactions with an associated enterprise to file a schedule 25A form with its annual income tax return.

There are three further reasons for maintaining contemporaneous documentation. First, documentation may demonstrate that reasonable care was taken in determining a transfer price and thereby serve as a mitigating factor in the consideration of any penalty imposed in the event of a transfer-pricing adjustment. Conversely, a taxpayer may be considered negligent for the purposes of section 226H where there is a lack of contemporaneous documentation.[77] Second, in the event of a dispute with the ATO, the burden of proof rests with the taxpayer. In order to discharge the burden of proof under sections 14ZZK and 14ZZO of the Taxation Administration Act 1953—that is, to prove that the assessment was excessive or the taxation decision should have been made differently—the taxpayer will need to show not only that the assessment was made on the wrong basis, but also that corrections should be made to make it more nearly right.[78] Third, the existence of adequate documentation along with the production of that documentation to the ATO will reduce the likelihood of extensive inquiries and adjustments. The commissioner provides that

> [a] lack of sufficient and relevant contemporaneous documentation will, in the first instance, increase the risk of an ATO audit and, in the second instance, increase the risk of a transfer pricing adjustment and the risk of culpability penalties being imposed.[79]

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74 Ibid., at paragraph 15.

75 Ibid., at paragraph 18.

76 Ibid., at paragraph 19.

77 Ibid., at paragraph 24.

78 Ibid., at paragraph 25.

79 Ibid., at paragraph 27.

Where the ATO conducts a review of the transfer-pricing arrangements of a taxpayer, it will first undertake an appraisal of the processes and documentation to determine the risk to revenue. This examination may lead to an audit of the taxpayer, which, in turn, will result in a transfer-pricing adjustment if the ATO concludes that there is an understatement of tax.[80] The commissioner suggests a four-step process to be undertaken by the taxpayer in order to minimize the likelihood of an audit and a transfer-pricing adjustment.

First, the taxpayer needs to understand the cross-border dealings between associated enterprises in the context of the business. This step requires the taxpayer to adequately analyze and document a broad understanding of the relevant enterprise and the particular business it conducts. Primarily, a functional analysis of the enterprise will need to be undertaken and documented to satisfy the ATO.

The second step is the selection of the method or methods to be used in determining the arm's-length transfer price, and the third step is the application of the selected method or methods. The fourth and final step is the determination of the arm's-length consideration and a review of the process if factors change. The ATO considers that a review of the process is necessary where there is a significant change in the factors important to the conduct of the enterprise's business or there is a shift in the critical assumptions underlying the particular arm's-length pricing method adopted.[81] Any review will require further documentation in support of the changed circumstances and the resulting amendments to the arm's-length pricing method adopted by the taxpayer.

Once a taxpayer has established the appropriate transfer-pricing process for international transactions between associated enterprises, in order to minimize the risk of an audit by the ATO, it is necessary to ensure that this process is properly implemented. When undertaking its risk assessment analysis, the ATO will test the process established by the enterprise to determine whether it has been properly implemented.[82]

The documentation required by the ATO with respect to the selection and application of a particular arm's-length pricing method goes beyond that normally required to be kept in the ordinary course of business. The commissioner provides that the documentation required to support a correct selection and application of transfer-pricing methods falls into five broad categories:

(a) documents created by the taxpayer in the ordinary course of transacting its business;

(b) documentation created or obtained to support a study of the enterprise's significant business functions, business strategies, the assets utilized in pursuit of that business and the risks associated with the business activity;

[80] Ibid., at paragraph 32.

[81] Ibid., at paragraph 42.

[82] Ibid., at paragraph 44.

(c) documentation created or acquired to support an analysis of methodologies available in a particular case and their relative worth, the process of selection or rejection of one or more methodologies and the rationale for that selection or rejection;

(d) documentation created or acquired to support the application of the methodology to specific or generalized dealings as they occur and a reasonable sample checking of results; and

(e) documentation created or acquired in the course of any review of the taxpayer's process for setting transfer prices in relation to international dealings between associated enterprises.[83]

The kind of documentation required will vary according to the transfer-pricing method selected. The CUP method requires documentation showing the basis for comparison of the controlled transactions with transactions between independent parties. All features, physical and non-physical, that affect comparability must be recorded. The analysis of the functions being performed by the relevant parties also should be documented.[84]

As the RP method relies on functional comparability, in contrast to the CUP method, which relies on product comparability, it is necessary to adequately document the functional analysis undertaken along with the comparability analysis. Further, where any adjustments are made to the uncontrolled gross margin in order to improve comparability, where differences in accounting treatment are taken into account, or where it is not possible to find an independent enterprise dealing in comparable goods or services, these factors also should be adequately documented.[85]

The documentation required for the CP method is similar to that for the RP method, since both are based on functional analysis and comparability. As well as documentation pertaining to the functional analysis, there must be documentation of the components of the cost base along with any adjustments made to improve comparability.[86]

Where the profit split method is used, documentation will include the reason for choosing this method of last resort, the level at which the profit split is being undertaken, how the combined profit was calculated, whether the profit to be split is net or gross profit, the effect of differences in accounting treatment between jurisdictions, and a functional analysis.[87] Where the profit comparison method is used, documentation will include, again, the reason why this method was selected; identification of the aggregated method being applied and the process used to identify, analyze, and apply comparable uncontrolled data; and any adjustments made to those data to improve comparability.[88]

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[83] Ibid., at paragraph 47.

[84] Ibid., at paragraphs 49 to 50.

[85] Ibid., at paragraphs 52 to 55.

[86] Ibid., at paragraphs 57 to 59.

[87] Ibid., at paragraph 61.

[88] Ibid., at paragraph 64. The ruling lists a total of nine factors to be documented when using the profit comparison method.

Once the ATO has reviewed all of the documentation and taken into account all of the relevant circumstances, it will consider whether the outcome of the pricing process is commercially realistic.[89] If a taxpayer has losses or profits less than industry averages over several tax years, the ATO will investigate. The investigation will take into account market factors that may have contributed to this result. However, if losses are reported consistently over several years, the ATO will conduct a detailed analysis whether or not this pattern is consistent with the particular industry.[90]

The ATO's review of the taxpayer's international transfer-pricing process forms the basis for an assessment of the taxpayer's risk of exposure to a pricing adjustment under section 136AD of the ITAA. The ATO will then decide whether to proceed to a transfer-pricing audit. In undertaking an audit, the ATO has recourse to three sections of the ITAA, as well as the exchange-of-information articles in Australia's DTAs. All of these provisions may come into play where a simultaneous tax examination is conducted by the ATO and the tax authority of a relevant DTA partner.[91]

The first relevant statutory provision is section 263 of the ITAA, which allows the commissioner or an authorized officer with written authority, full and free access to all buildings, places, books, documents, and other papers of the taxpayer. Section 264 of the ITAA grants the commissioner power to require any person to furnish information upon request along with the handing over of any books, documents, or other papers in that person's possession. Where the commissioner requires information or documentation held offshore, he may serve an offshore information notice pursuant to section 264A, requesting the taxpayer to deliver up such information or documentation. An alternative method of obtaining offshore information is the use of the exchange-of-information articles in Australia's DTAs. However, the ATO will first request the information from the taxpayer using the relevant article as a secondary measure.[92]

When conducting a transfer-pricing audit, in addition to information obtained from the taxpayer, the ATO will require third-party information to determine the appropriate arm's-length consideration. The ATO does not consider itself restricted to publicly available information and may conduct third-party inquiries in the form of questionnaires regarding such factors as strategy, operational framework, and comparability. Where the ATO uses internal information, the taxpayer subject to the audit may not have access to these data; the information may be protected pursuant to the exclusions contained in the Freedom of Information Act 1982[93] and provisions of the Privacy Act 1988.[94] The ATO also contends that some

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[89] Ibid., at paragraph 65.

[90] Ibid., paragraphs 66 to 67.

[91] Ibid., at paragraph 75.

[92] Ibid., at paragraph 85.

[93] Sections 16, 38, and 43 of the Freedom of Information Act 1982, as amended.

[94] Part III of the Privacy Act 1988.

information may be subject to privilege on the grounds of public interest immunity. Further, in the event of a tribunal or court hearing, natural justice will override any other requirement of disclosure.[95]

Where an audit is undertaken and the ATO determines that there is a material difference—that is, one that is not minor or marginal—between the taxpayer's transfer price and the arm's-length price as determined by the ATO, an adjustment will be made to correct the misallocation of either income or expenses.[96]

Specific Issues of Substantiation

Part 2 of the draft ruling addresses certain aspects of international transfer pricing that may present difficulties to both the ATO and the taxpayer. Specifically, it sets out the commissioner's view on sustained losses, market penetration strategies, marginal costing, the use and relevance of global price lists, setoff arrangements, and safe harbours.

Sustained Losses

The commissioner recognizes that, for a variety of reasons, independent enterprises can sustain genuine losses; however, where an enterprise incurs sustained losses in relation to its dealings with an associated enterprise, the taxpayer will need to demonstrate that the same outcome would have occurred if the parties had been dealing at arm's length.[97] The onus of proving that the same losses would have occurred in an arm's-length situation lies with the taxpayer.[98] Further, any business strategy that resulted in such losses would need to be sufficiently documented, demonstrating that such a strategy would lead to increased profits in the future and that the strategy was one that would be adopted by an independent entity in similar circumstances.[99]

Market Penetration Strategies

Where a taxpayer wishes to undertake a market penetration strategy, again, the ATO will require substantiation of that strategy. Documentation must be maintained regarding both the target market[100] and the market strategy itself.[101] The taxpayer will need to demonstrate that the market penetration strategy between the associated enterprises is one that enterprises dealing at arm's length would have entered into. The commissioner's

95 TR 95/D23, supra footnote 8, at paragraphs 97 and 100.

96 Ibid., at paragraph 76.

97 Ibid., at paragraph 114.

98 Ibid., at paragraph 115.

99 Ibid., at paragraphs 116 to 117.

100 For a detailed list of the required contemporaneous documentation, see ibid., at paragraph 124.

101 For a detailed list of the required contemporaneous documentation, see ibid., at paragraph 125.

view is that the longer a market penetration strategy is in place, thereby reducing profits, the greater is the presumption that arm's-length parties would not have entered into such a strategy.[102]

Marginal Costing

The use of marginal costing as a basis for setting the transfer price of goods or services will be considered acceptable only where the taxpayer can demonstrate that the marginal cost represents the arm's-length price for the transfer. While no one factor will be determinative, the following factors will be taken into account in considering whether the marginal cost is an appropriate transfer price: whether the transfer is merely a short-term arrangement; whether the marginal production is not a significant part of the taxpayer's overall production; and whether there is underutilized capacity. Again, the use of marginal costing as the basis for establishing the transfer price should be supported by contemporaneous documentation, including the basis and rationale for implementing the strategy, the nature of the costs to be recovered, and the anticipated duration of the strategy.[103]

Global Pricing

Where an enterprise applies a global pricing policy—that is, particular goods or services are sold at a specific price to all purchasers of that good or service on a global basis, or there is consistent application of an internationally recognized transfer-pricing methodology to all such sales globally—the ATO will still undertake an analysis to consider whether the arm's-length principle has been adhered to. A global pricing policy may be applied either exclusively to associated enterprises or to both associated and arm's-length enterprises. Where the global pricing policy is applied exclusively within an MNE group, the ATO will undertake its normal review procedure. Even where the global pricing policy applies to both associated and arm's-length enterprises, the ATO will consider whether the two types of transaction are truly comparable; that is, documentation establishing functional comparability[104] will be required.[105]

Setoff Arrangements

As with monetary transactions, the ATO will accept a setoff arrangement between associated enterprises only where it is satisfied that the arrangement is on an arm's-length basis. The ATO will allow a setoff where all of the following conditions are satisfied:

> (a) the set-off arrangements are on terms and conditions that would be acceptable to independent enterprises dealing at arm's length;

[102] Ibid., at paragraph 122.

[103] Ibid., at paragraph 130.

[104] Functions, assets, and risks.

[105] TR 95/D23, supra footnote 8, at paragraphs 134 to 135.

> (b) they occur as an intentional, not coincidental, feature of international dealings between the associated enterprises;
>
> (c) there is a predetermined strategy which assesses and quantifies the outcomes for the respective parties to the dealings and identifies what the respective benefits and detriments to the individual parties to the transaction are . . . ;
>
> (d) the set-off arrangement and strategy are fully quantified, measured and tested against any arm's length outcome in comparable circumstances . . . ; and
>
> (e) taxpayers should disclose the existence of intentional set-offs built into dealings between associated enterprises by making adjustments to the relevant components of their taxable profits at the time of lodging a tax return and have the necessary documentation to demonstrate that the offsetting amounts are equal in value.[106]

Safe Harbours

There are very limited circumstances in which the commissioner will depart from the arm's-length pricing requirement for international transfers between associated enterprises. A safe harbour is not one of the permitted exceptions. The ruling defines the term "safe harbour" as applied in the transfer-pricing context to mean an administrative practice by a tax authority that accepts a process or outcome as automatically discharging a taxpayer's obligations to comply with the arm's-length principle.[107] The ruling goes on to state:

> The incompatibility of a safe harbour regime with the spirit of Australia's tax law taken together with the potential costs and risks associated with the implementation of a safe harbour regime, is sufficient basis for rejecting a safe harbour system and therefore the ATO does not favour the implementation of safe harbours.[108]

PENALTIES FOR NON-COMPLIANCE

The penalty provisions are contained in part VII of the ITAA. *Taxation Ruling* TR 95/D24[109] considers the application of these provisions where a taxpayer has failed to comply with the arm's-length principle when entering into international transactions with associated enterprises. The ruling will be relevant where the commissioner has applied division 13, part III of the ITAA or the relevant provision of a DTA to a taxpayer's assessment. The ruling is divided into two parts: part one deals with the penalty remission policy before the 1992-93 income years; part two deals with penalty guidelines for the 1992-93 and subsequent income years.

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[106] Ibid., at paragraph 138.

[107] Ibid., at paragraph 143.

[108] Ibid., at paragraph 148.

[109] TR 95/D24, supra footnote 8.

Penalty Remission Policy Before the 1992-93 Income Year

The penalty provisions contained in part VII of the ITAA, introduced by the Taxation Laws Amendment Act 1984, apply from December 14, 1984. Section 225, introduced at that time, replaced provisions[110] that formerly imposed an additional tax of 10 percent per annum on the transfer-pricing adjustment where division 13 of the ITAA or a relevant provision of a DTA had been applied. Before TR 95/D24 was issued, *Taxation Ruling* IT 2311[111] specifically dealt with the imposition and remission of penalties under section 225. IT 2311 also dealt with the former sections of the ITAA, indicating that the ATO would not generally remit the 10 percent penalty rate imposed by those sections. The present draft ruling provides that the ATO will maintain this position with respect to any penalties imposed under the former sections.[112]

Before the 1992 amendments, the ITAA provided for a penalty of 200 percent of the transfer-pricing adjustment where division 13 or a relevant provision of a DTA had been applied and it was concluded that a scheme had been entered into for the sole or dominant purpose of tax avoidance.[113] In circumstances where there was no tax-avoidance purpose, the penalty rate was reduced to 25 percent. As with the current position, the commissioner had the authority to remit all or part of the penalty.[114]

As a consequence of the introduction of section 170AA of the ITAA,[115] *Taxation Ruling* IT 2517, issued in February 1989, provided updated guidelines on the remission of penalties imposed under section 223 and former section 226(2). Section 170AA provides for the payment of interest where an amendment has been made to an assessment which increases a taxpayer's tax liability.[116] The ruling did not consider section 225; however, in practice, the concepts in IT 2517 were considered and applied in section 225 penalty cases, and this approach was subsequently recognized in *Taxation Ruling* TR 92/11.[117] The policy outlined in IT 2311 is modified to adopt the principles outlined in IT 2517 where the position is more advantageous to the taxpayer than a pure application of IT 2311. IT 2311 is further modified by the amendments of 1992, and any penalty imposed after July 1, 1992 with respect to a 1991-92 assessment will be no higher

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[110] ITAA sections 226(2B) to (2F).

[111] *Taxation Ruling* IT 2311, June 18, 1986.

[112] TR 95/D24, supra footnote 8, at paragraph 73.

[113] ITAA section 225.

[114] ITAA section 227(3). However, IT 2311, supra footnote 111, indicated that the ATO believed that the legislative intent was not for the power of remission to be generally exercised to reduce the statutory rates of penalties imposed under section 225.

[115] Taxation Laws Amendment Act 1986.

[116] ITAA section 170AA applies only to assessments relating to 1985-86 and subsequent income years.

[117] TR 95/D24, supra footnote 8, at paragraph 83; and TR 92/11, supra footnote 7, at paragraph 30.

than it would be under the self-assessment regime.[118] For the years before 1992-93, rulings IT 2311, as modified, and IT 2517 continue to apply.

Penalty Guidelines for 1992-93 and Subsequent Years

In 1992, a new system of penalties was introduced based on the requirement that taxpayers exercise reasonable care in carrying out their tax obligations.[119] The changes were the result of the introduction of the self-assessment regime requiring taxpayers to determine their own taxable income, which replaced the previous system of full and true disclosure to the commissioner, who, in turn, determined the assessment. The old penalty tax system no longer reflected the requirements of the self-assessment system. New standards were introduced aimed at achieving greater consistency and certainty in relation to penalties. Among these were the standards of "reasonable care" and "reasonably arguable position."

Under the new system, penalties are divided into two categories: those imposed under "scheme sections"[120] and those imposed under "shortfall sections."[121] Whenever a scheme section or a shortfall section is applied to the assessment of a taxpayer, penalties are payable. Where a transfer-pricing adjustment is made by the ATO under division 13, part III of the ITAA or the relevant provision of a DTA, section 225, a scheme provision, imposes additional tax in the form of penalties. Penalties may be imposed on a taxpayer for a number of reasons. First, where a taxpayer does not take reasonable care in the preparation of the return and throughout the year in respect of keeping records, and this conduct has an effect on the accuracy of the return and the amount of tax payable, the taxpayer may be subject to a penalty tax.[122] Second, where a multinational company has reason to believe or may reasonably be expected to know that transfer prices are not in accordance with the arm's-length principle, the ATO will consider that the company has failed to exercise reasonable care and again a penalty tax will be imposed.[123]

Section 225(1) will apply to a taxpayer where the "prescribed provisions" have been applied—that is, where the commissioner has exercised his power under the transfer-pricing provisions[124] of the ITAA. There are, however, preliminary considerations as to whether a penalty will be imposed. First, if the taxpayer has applied for a private ruling that has not yet been handed down, no penalty will apply.[125] (It should be noted,

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[118] TR 95/D24, supra footnote 8, at paragraph 17.

[119] Ibid., at paragraph 45.

[120] ITAA section 222A(1): "scheme section" means section 224, 225, or 226.

[121] Ibid.: "shortfall section" means section 226G, 226H, 226J, 226K, 226L, or 226M.

[122] TR 95/D24, supra footnote 8, at paragraph 21.

[123] Ibid., at paragraph 23.

[124] ITAA sections 136AD and 136AE.

[125] ITAA section 226A.

however, that private rulings are not normally issued in respect of transfer-pricing issues, and consequently, this provision will not normally be relevant.)[126] Second, where the taxpayer acted on the advice of an officer of the ATO or on the basis of a general administrative practice, no section 225 penalty will apply.[127]

Where it is concluded that a section 225 penalty applies and the assessment was made pursuant to division 13, part III of the ITAA, the basic penalty rate is determined under section 225(1). Where the adjustment is in respect of a scheme entered into for the sole or dominant purpose of avoiding tax, the penalty rate is 50 percent of the tax avoided; in other circumstances, the penalty rate is 25 percent. Section 225(2) applies where the assessment is made pursuant to the relevant provision of a DTA. The penalty applied by this section is that which would have been applied under section 225(1) if the DTA had been a "prescribed provision." In effect, the penalties are the same as those that would be applied if the assessment were made by virtue of a section 136AD or 136AE adjustment.

Once the basic penalty is determined, various factors are considered to ascertain whether the penalty should be increased or reduced. The existence of one of two possible factors will increase the penalty, while there are three possible factors that will result in a reduction of the penalty rate.

Where the taxpayer has prevented or hindered the ATO from becoming aware that a wrongful behaviour provision applies, the penalty rate will be increased by 20 percent.[128] A 20 percent increase in the penalty rate also will be imposed if the taxpayer was liable to pay additional tax under a wrongful behaviour provision in respect of an earlier year of income.[129]

The penalty rate will be reduced where the taxpayer has a reasonably arguable position (RAP).[130] If the taxpayer has a RAP, the penalty will be reduced to 25 percent where there was a sole or dominant purpose of tax avoidance and 10 percent in other circumstances. Where a taxpayer has relied on a well-reasoned construction of the relevant provision of the ITAA, even in the absence of any other authority, the ATO will conclude that there is a RAP. The ITAA provides the test for determining whether the taxpayer has a RAP, along with a non-exhaustive list of the authorities that may be taken into account and guidance as to the operation of the RAP test in cases where it is dependent on the ATO's exercising a discretion.[131] The draft ruling provides that "[t]he RAP test looks at whether it

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[126] *Taxation Ruling* TR 93/1, "Income Tax and Fringe Benefits Tax: Private Rulings," January 7, 1993, paragraph 10: "Private rulings cannot be given if they would require the Commissioner to forecast a value, whether market value, fair and reasonable value or some other value."

[127] ITAA section 226B.

[128] ITAA section 226C.

[129] Ibid.

[130] ITAA section 222C.

[131] Ibid.

is about as likely as not [that] the relevant provisions do not apply."[132] In order to satisfy the RAP test for the purposes of division 13, the taxpayer must demonstrate that the price used was "about as likely as not the 'arm's length price.' "[133]

The penalty rate may also be reduced where the taxpayer has made a voluntary disclosure. If the taxpayer makes a voluntary disclosure after notification of a tax audit, the amount of additional tax may be reduced by 20 percent.[134] Alternatively, if the taxpayer makes a voluntary disclosure before the notification of a tax audit, the amount of additional tax may be reduced by 80 percent.[135] The ATO will reduce the penalty tax in accordance with either of these provisions where

> • the disclosure is in writing and brings all the relevant facts and other information to the attention of the ATO that will allow the ATO to readily identify the transfer pricing matter, including the amount and nature of the relevant adjustment; and
>
> • the disclosure is such that it could reasonably be estimated to have saved the ATO a significant amount of staff time or resources in looking into the matter disclosed.[136]

Section 226F provides the commissioner with a discretion, for the purposes of these provisions, to determine that a taxpayer informed the ATO of the relevant facts and information before notification of an audit.

Section 227(3) also provides the commissioner with a discretion to remit the whole or part of a penalty tax otherwise payable by a taxpayer. The commissioner will reduce the penalty rate to one that best reflects the taxpayer's behaviour in the particular case.[137] While it is the view of the ATO that it is the legislative intent that there be consistency in relation to the imposition of penalties, and that the new legislative system does not contemplate a further reduction from the rates set by legislation,[138] remission will be granted to a taxpayer that has acted in good faith and with no fault, provided that the penalty was imposed under section 225 and that the taxpayer

• has genuinely made a reasonable good faith attempt to comply with the arm's-length principle and has not engaged in tax avoidance or evasion;

• has fully documented the process of selecting and applying an arm's-length method;

132 TR 95/D24, supra footnote 8, at paragraph 26.

133 Ibid., at paragraph 27.

134 ITAA section 226D.

135 ITAA section 226E.

136 TR 95/D24, supra footnote 8, at paragraph 32.

137 Ibid., at paragraph 29.

138 Ibid., at paragraph 66.

• has adopted, for tax return purposes, what the taxpayer considered—on reasonable grounds—to be the best approximation of the arm's-length outcome;

• can satisfy the ATO that there was no tax-avoidance intention or purpose;

• has a RAP;

• has fully cooperated with the ATO;

• is not also liable for a penalty under any shortfall section of part VII; and

• is not liable for the section 225 penalty because of the taxpayer's failure to make an adjustment in the tax return in accordance with the terms and conditions of any APA that the taxpayer has with the ATO.[139]

In addition to section 225 penalties, shortfall section penalties must be considered and applied when appropriate. The operation of shortfall penalty provisions is similar to that of section 225 penalties. Again, penalties may not be imposed if the taxpayer has applied for, but not yet received, a private ruling,[140] or if the taxpayer has followed the advice of the ATO or a general administrative practice.[141] Penalties will be increased if the taxpayer hinders the ATO.[142] They may be reduced if the taxpayer makes voluntary disclosure.[143] Section 227(3) will also apply to shortfall section penalties.[144]

Where a taxpayer fails to exercise reasonable care to comply with the ITAA or the regulations, the legislation imposes a penalty of 25 percent of the shortfall.[145] TR 95/D24 provides that

> [the] reasonable care test requires a taxpayer to exercise care that a reasonable ordinary person would be likely to have exercised in the circumstances of the taxpayer to fulfil the taxpayer's obligations under the ITAA and the regulations.[146]

A penalty of 25 percent also is imposed where a taxpayer adopts a particular position on a question of interpretation and that position is not a RAP.[147]

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[139] Ibid., at paragraph 179.

[140] ITAA section 226U.

[141] ITAA section 226V.

[142] ITAA section 226X.

[143] ITAA section 226Y or 226Z.

[144] For details on the shortfall section penalties, see *Taxation Ruling* TR 94/3, "Tax Shortfall Penalties: Calculation of a Tax Shortfall and Allocation of Additional Tax," January 6, 1994; *Taxation Ruling* TR 94/4, "Tax Shortfall Penalties: Reasonable Care, Recklessness and Intentional Disregard," January 6, 1994; *Taxation Ruling* TR 94/5, "Tax Shortfall Penalties: Reasonably Arguable," January 6, 1994; *Taxation Ruling* TR 94/6, "Tax Shortfall Penalties: Voluntary Disclosures," January 6, 1994; and *Taxation Ruling* TR 94/7, "Tax Shortfall Penalties: Guidelines for the Exercise of the Commissioner's Discretion To Remit Penalty Otherwise Attached," January 6, 1994.

[145] ITAA section 226G.

[146] TR 95/D24, supra footnote 8, at paragraph 107.

[147] ITAA section 226K.

It is possible that more than one section in part VII may apply. Where more than one shortfall section applies, section 226W provides that the taxpayer is liable to pay only the higher penalty. Where, however, a section 225 penalty applies as well as a shortfall penalty, there is no specific provision for a reduction in the rate of penalty. In these circumstances, it is necessary for the commissioner to exercise his discretion under section 227(3) to impose the most appropriate penalty, having regard to legislative intent.

In circumstances where a taxpayer requests an amended assessment on the basis that past practice does not accord with the arm's-length principle, any amendment under section 170(1) will not attract statutory penalties under section 225. If, however, a formal determination is required and the amendment is therefore pursuant to section 170(9B), a statutory penalty will be attached to the assessment.

In addition to any penalties payable under part VII, the self-assessment system also provides for the payment of interest on late payment and underpayment of tax.

A Unified Approach: Canada and Australia Agree

An equitable system of international taxation must provide for an appropriate distribution of the profits of MNEs among the jurisdictions concerned and, in doing so, avoid double taxation and prevent fiscal evasion. Because of the complexity of international business and the consequent difficulty of achieving these objectives, tax administrations must continually review and refine their tax policy, statutes, and administrative practice in the international taxation field. In the area of transfer pricing among MNEs, the OECD's study and issuance of guidelines, along with developments in other jurisdictions (notably the United States), have prompted an overhaul of Canada's transfer-pricing rules. Since the objectives of the recent Canadian review are in line with the issues that Australia has already addressed, either in legislative form or in a taxation ruling, it is useful to consider what lessons may be learned from the Australian approach to international transfer pricing.

The Canadian Review

As stated by the Department of Finance, the review of Canada's international transfer-pricing rules was intended to realize the following objectives:

> — to harmonize the standard contained in section 69 of the Act with the arm's length principle as defined in the revised OECD guidelines and ensure that, in selecting the most appropriate pricing method, all the various methods described in the OECD guidelines are available to taxpayers; and
>
> — to ensure the contemporaneous documentation by taxpayers of cross-border related-party transactions, so that taxpayers are in a position to provide Revenue Canada, on a timely basis, [with] the relevant information supporting the transfer prices used in the course of their related-party transactions. This will improve the ability of Revenue Canada to administer the

> law and make audits more efficient from a taxpayer perspective. Penalties commensurate with a transfer pricing adjustment would apply where these documentation requirements are not met or where the taxpayer did not act diligently in establishing transfer prices that are in conformity with the arm's length principle.[148]

On September 11, 1997, the finance minister and the revenue minister jointly released draft transfer-pricing legislation, which was subsequently amended and included in Bill C-28, tabled on December 10, 1997.[149] It has been suggested that the proposed provisions are consistent with Revenue Canada's intention to devote more resources to international transfer pricing and to make transfer-pricing audits more efficient for both taxpayers and Revenue Canada.[150]

The amendments propose the repeal of subsections 69(2) and (3) and their replacement with proposed section 247[151] in new part XVI.1. In line with the objectives of the review, proposed section 247 introduces legislation requiring compliance with the arm's-length standard, providing for a penalty where there is failure to comply, and specifying contemporaneous documentation requirements. The arm's-length requirement is set out in proposed subsection 247(2), which provides that amounts in respect of transactions between non-arm's-length parties may be adjusted as to quantum or nature where the terms or conditions of the transaction differ from those that would have been made between arm's-length parties, or where the transaction itself would not have been entered into by arm's-length parties and it may reasonably be considered that the transaction had no primary bona fide purpose other than to obtain a tax benefit.[152] Key terms

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[148] Canada, Department of Finance, 1997 Budget, Budget Papers, annex 6, Tax Measures: Supplementary Information and Notices of Ways and Means Motions, February 18, 1997, 18.

[149] Bill C-28, An Act To Amend the Income Tax Act, the Income Tax Application Rules, the Bankruptcy and Insolvency Act, the Canada Pension Plan, the Children's Special Allowances Act, the Companies' Creditors Arrangement Act, the Cultural Property Export and Import Act, the Customs Act, the Customs Tariff, the Employment Insurance Act, the Excise Tax Act, the Federal-Provincial Fiscal Arrangements Act, the Income Tax Conventions Interpretation Act, the Old Age Security Act, the Tax Court of Canada Act, the Tax Rebate Discounting Act, the Unemployment Insurance Act, the Western Grain Transition Payments Act and Certain Acts Related to the Income Tax Act, first reading December 10, 1997.

[150] Canada, Department of Finance, *Release*, no. 97-076, September 11, 1997; as noted by Finance Minister Herb Dhaliwal.

[151] Proposed subsection 247(2) of the Act will apply to taxation years beginning after 1997, while proposed subsections 247(3) and (4) will apply to adjustments made under subsection 247(2) for taxation years beginning after 1998.

[152] Proposed subsection 247(2) of the Act reads as follows:

> Where a taxpayer or a partnership and a non-resident person with whom the taxpayer or the partnership, or a member of the partnership, does not deal at arm's length (or a partnership of which the non-resident person is a member) are participants in a transaction or a series of transactions and

(The footnote is continued on the next page.)

for the purposes of section 247, such as "arm's length transfer price," are defined in proposed subsection 247(1). The penalty and documentation provisions are proposed subsections (3) and (4) respectively.

At the same time as the proposed legislative amendments were released, a draft revision of *Information Circular* 87-2 was issued.[153] Draft IC 87-2R reflects the proposed changes to the ITA and the recommendations set out in the OECD guidelines. Like the original information circular, the revised version endorses the arm's-length principle as the basic rule governing international transfer pricing. In the 1996 transfer-pricing study referred to earlier, it was recommended that the information circular be expanded to make it more comprehensive, and it was suggested that Australia's draft ruling TR 95/D22 could serve as a model for the revised circular.[154]

Lessons To Be Learned

Canada and Australia have adopted essentially the same taxation policy for international transfer pricing. The most obvious difference in their respective approaches to transfer pricing is one of timing. While Australia amended its legislation in 1981, it was not until 1997 that Canada introduced major statutory amendments in this area. In deferring such amendments, Canada has apparently gained the benefit of examining the approaches adopted by other jurisdictions. In addition, Canada has referred to the OECD guidelines in developing the new transfer-pricing rules,

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152 Continued . . .

(a) the terms or conditions made or imposed, in respect of the transaction or series, between any of the participants in the transaction or series differ from those that would have been made between persons dealing at arm's length, or

(b) the transaction or series

(i) would not have been entered into between persons dealing at arm's length, and

(ii) can reasonably be considered not to have been entered into primarily for *bona fide* purposes other than to obtain a tax benefit,

any amounts that, but for this section and section 245, would be determined for the purposes of this Act in respect of the taxpayer or the partnership for a taxation year or fiscal period shall be adjusted (in this section referred to as an "adjustment") to the quantum or nature of the amounts that would have been determined if,

(c) where only paragraph (a) applies, the terms and conditions made or imposed, in respect of the transaction or series, between the participants in the transaction or series had been those that would have been made between persons dealing at arm's length, or

(d) where paragraph (b) applies, the transaction or series entered into between the participants had been the transaction or series that would have been entered into between persons dealing at arm's length, under terms and conditions that would have been made between persons dealing at arm's length.

153 *Information Circular* 87-2, "International Transfer Pricing and Other International Transactions," February 27, 1987. The draft circular, IC 87-2R, of the same title, is dated September 11, 1997.

154 Supra footnote 3, at 18.

with the explicit intention of harmonizing the rules with the OECD's recommendations regarding the arm's-length approach and the methods that taxpayers may use to determine appropriate transfer prices.

Both Canada and Australia have adopted the arm's-length approach to transfer pricing rather than formulary apportionment. The formulary apportionment approach uses a predetermined formula (typically based on factors such as sales, payroll, and assets) to allocate the worldwide profits of an MNE group to entities in the various jurisdictions concerned. This approach has not been adopted by the OECD, or by Australia or Canada, for a number of compelling reasons:[155]

• it would be necessary to reach a global consensus on the design of the formulas and the definition of the group to which they applied;

• the formulas would be open to manipulation by taxpayers;

• formulas are arbitrary and may produce results that bear no relation to economic reality;

• the effect of exchange rate movements could produce chaotic results; and

• compliance costs would be high owing to the difficulty of assembling comparable data from many jurisdictions and the application of different accounting standards.

However, there are also problems associated with the arm's-length approach. For example, it has been argued that this approach necessitates the existence of a transaction in order to be applied.[156] Other difficulties associated with the application of the individual methods were highlighted earlier in this article.

While Australia has stated that taxpayers are to apply the arm's-length approach, it may be difficult in practice for them to do so; it may be discovered that, at least in part, formulary apportionment is being used. In essence, in very few cases will it be possible to refer to purely independent arm's-length data to determine transfer prices for international related-party transactions. The primary reason is the lack of independent comparable data, which necessitates a subjective adjustment in determining the arm's-length price. Canada also may experience problems in actually implementing the arm's-length principle.

There are three differences in the legislative framework to be noted. First, while Canada imposes statutory contemporaneous documentation requirements on taxpayers entering into international transactions with associated enterprises, the ATO has elected to apply the general statutory

[155] David G. Broadhurst, "The OECD Transfer-Pricing Report," International Tax Planning feature (1995), vol. 43, no. 1 *Canadian Tax Journal* 140-53, at 152-53.

[156] Brian J. Arnold and Thomas E. McDonnell, "Report on the Invitational Conference on Transfer Pricing: The Allocation of Income and Expense Among Countries" (1993), vol. 41, no. 5 *Canadian Tax Journal* 899-922, at 905.

provision of the ITAA, section 262A. Second, the application of the substantiation requirements also varies: the Canadian requirement is contained within the specific transfer-pricing provisions, while the ATO applies the general substantiation provisions of the ITAA. Third, while Canada has adopted a penalty of 10 percent of the difference between reported income and the arm's-length price, Australia imposes a penalty up to five times greater. The object of the taxpayer is, however, to avoid such a penalty; and the tax authorities would prefer to avoid costly audits. Accordingly, both jurisdictions provide for APAs (discussed below).

Aside from the above differences in the legislative framework, the results of the statutory rules in the two jurisdictions are essentially the same. It is in the area of administration that the most significant differences arise. Specifically, while Australia has issued detailed rulings, Canada has chosen instead to set out broad principles. The need for and the usefulness of detailed guidelines, particularly with respect to selection and use of the available methodologies, are the principal questions to be considered in comparing the Canadian and Australian approaches.

There are only two information circulars in Canada dealing specifically with international transfer pricing.[157] In contrast, the ATO has issued three final and seven draft taxation rulings directly relating to international transfer pricing. As taxpayers begin to comply with the new rules, Revenue Canada may find it necessary to publish additional, more detailed guidelines to facilitate the operation of the new system. Alternatively, it may be demonstrated over time that Australia has been unnecessarily detailed in its approach.

At present, it is not clear whether there is a need for the detail contained in the Australian taxation rulings. While it may be suggested that the ATO has gone too far in interpreting the rules for taxpayers, it also may be argued that such detail is necessary to ensure taxpayer compliance. Guidance is especially valuable where the taxpayer is considering entering into an APA.

Advance Pricing Agreements

APAs are becoming increasingly important in the regulation of international transfer pricing. For revenue authorities and taxpayers alike, APAs provide a means of avoiding transfer-pricing disputes and costly transfer-pricing audits. The OECD guidelines describe the concept of an APA as follows:

> An advance pricing arrangement ("APA") is an arrangement that determines, in advance of controlled transactions, an appropriate set of criteria (e.g. method, comparables and appropriate adjustments thereto, critical assumptions as to future events) for the determination of the transfer pricing for

[157] IC 87-2, to be replaced by IC 87-2R, supra footnote 153; and *Information Circular* 94-4, "International Transfer Pricing: Advance Pricing Agreements," December 30, 1994, paragraph 3.

> those transactions over a fixed period of time. An APA is formally initiated by a taxpayer and requires negotiations between the taxpayer, one or more associated enterprises, and one or more tax administrations. APAs are intended to supplement the traditional administrative, judicial, and treaty mechanisms for resolving transfer pricing issues.[158]

In short, an APA is an arrangement whereby the transfer-pricing methodology to be used by the taxpayer is agreed to in advance by the relevant tax authority or authorities. In Canada and Australia, an APA is designed to establish the transfer-pricing methodology or methodologies to be used in future international transactions, agreements, or arrangements between non-arm's-length taxpayers, and thereby to ensure that the arm's-length pricing requirement of the ITA or ITAA is met. The approved methodology will be used in any future apportionment or allocation of income, deductions, credits, or allowances reported to the tax authority or authorities with which the APA is negotiated.

An APA allows the taxpayer to resolve transfer-pricing issues in advance and thereby circumvent a possible audit and penalty for non-compliance. The Australian ruling TR 95/23 lists the following benefits of the APA process:[159]

• It may provide solutions in situations where there is no realistic alternative way of both avoiding double taxation and ensuring that all profits are correctly attributed and taxed.

• It provides certainty in the selection of an appropriate transfer-pricing methodology for the taxpayer and therefore enhances the predictability of the tax treatment of international transactions.

• It substantially reduces or eliminates the possibility of double taxation in the future.

• It limits costly and time-consuming examinations of major transfer-pricing issues that may arise as a result of a future transfer-pricing audit and lessens the possibility of protracted and expensive litigation.

• It places the taxpayer in a better position to predict costs and expenses, including tax liabilities.

While the ruling fails to provide a list of any possible disadvantages associated with an APA, the OECD guidelines do so. The disadvantages, for the taxpayer and/or tax authorities, are as follows:[160]

• Unilateral APAs may present problems for both tax administrations and taxpayers because other tax administrations may disagree with the conclusions.

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[158] OECD guidelines, supra footnote 1, at paragraph 4.124.

[159] TR 95/23, supra footnote 7, at paragraph 65. See also OECD guidelines, supra footnote 1, at paragraphs 4.143 to 4.147.

[160] OECD guidelines, supra footnote 1, at paragraphs 4.143 to 4.153.

• Where a unilateral APA is entered into, it is critical that the arm's-length principle be preserved since a foreign tax administration is not likely to allow a corresponding adjustment arising out of an APA that is inconsistent with the arm's-length principle.

• If an APA is based on an unreliable prediction of changing market conditions without incorporating adequate critical assumptions, the arm's-length price may not be adequately reflected.

• An APA program may place a strain on transfer-pricing audit resources.

• APAs may be applied across a group without sufficient regard to the conditions operating in specific markets.

• The APA program will interest taxpayers with a good voluntary compliance history and bypass those taxpayers that are the primary target of transfer-pricing audits.

As noted above, an APA will usually specify the transfer-pricing methodology to be used by the taxpayer. Occasionally, however, an APA may be used to fix a particular price or range of prices or to establish the tax treatment of a particular transaction, agreement, arrangement, or business activity.[161] In Australia, there is wide scope for application, since "[a]ny taxpayer with international transactions, agreements, arrangements, or interests, or contemplating investment in Australia may apply for an APA."[162]

An APA may be unilateral—that is, between the taxpayer and the domestic tax authority—or it may be bilateral—that is, between the taxpayer, the domestic tax authority, and a foreign tax authority. The Australian commissioner of taxation suggests that, where possible, an APA should be concluded bilaterally through the use of either the mutual agreement procedure article in Australia's DTAs or the executive power of the commonwealth conferred on the commissioner.[163] Australian bilateral APAs are limited to situations where Australia has a DTA with the foreign country concerned. Where the relevant parties enter into a unilateral or bilateral APA, the commissioner will provide written confirmation of the concluded agreement to the taxpayer.[164] The OECD guidelines suggest that in the event of a unilateral agreement, the competent authorities of other interested jurisdictions should be informed of the procedure as early as possible, so that they can consider a bilateral agreement under the mutual agreement procedure.[165]

Canada's procedure for implementing an APA is, in substance, similar to Australia's. *Information Circular* 94-4[166] provides guidance to Canadian taxpayers who wish to put in place an APA. As under the Australian

161 TR 95/23, supra footnote 7, at paragraph 48.

162 Ibid., at paragraph 62.

163 Ibid., at paragraph 12.

164 Ibid., at paragraphs 12 to 13.

165 OECD guidelines, supra footnote 1, at paragraph 4.130.

166 IC 94-4, supra footnote 157.

system, a taxpayer may elect to request a unilateral or bilateral APA, which will be consistent with the arm's-length principle and supported by reliable data. Compliance with section 69 of the ITA and with the principles established in IC 87-2 and the OECD guidelines will be necessary.

The APA process under IC 94-4 occurs in two stages. First, the taxpayer may request one or more pre-lodgement meetings to explore informally the suitability of an APA, to establish what documentation is required, to determine whether an expert is needed, and to outline the time process.[167] After this first step, the taxpayer may elect to withdraw from the process. The second step is the formal APA submission. At this stage, the taxpayer must provide a detailed explanation and analysis of the proposed transfer-pricing method, along with the facts and circumstances on which it is based and the reasons why that method is considered appropriate.[168] Again, in this sense, the two systems are similar.

A formal APA will not exempt a Canadian taxpayer from the audit process but rather will ensure that the transfer-pricing method is not reevaluated. An audit will be conducted to verify the accuracy of the representations in the APA and the annual reports. Further, the accuracy and consistency of the application of the transfer-pricing method, the related supporting data, and the continuing relevance and soundness of the critical assumptions will be tested.[169]

Canada's and Australia's policies on APAs are aligned. This congruity is evidenced by the fact that Revenue Canada and the ATO have reached an agreement on bilateral APAs whereby both tax authorities will agree on the transfer-pricing method to be used by a particular taxpayer.

EVOLUTION OF THE CANADIAN AND AUSTRALIAN TRANSFER-PRICING REGIMES

The effectiveness of any regime for the taxation of international business depends on its ability to achieve an appropriate distribution of profits between the relevant jurisdictions and, in doing so, to avoid double taxation and prevent fiscal evasion. Both Canada and Australia have developed policies and practices applicable to transfer pricing within MNEs which aim to attain these objectives. Their efforts have resulted in two systems that, while similar in substance, vary significantly in administrative approach.

Canada has elected to adopt a more general approach to its transfer-pricing legislation and administrative practices, choosing to set out broad principles rather than lengthy and detailed guidelines. The Canadian tax authorities may find it necessary, in the future, to publish additional and more detailed guidelines to facilitate the administration of the new system.

167 Ibid., at paragraph 15.

168 Ibid., at paragraph 20.

169 Ibid., at paragraph 30.

In this event, they may find it useful to look to Australia as an example of a regime that provides very specific guidelines.

Alternatively, it may be demonstrated over time that Australia has been unnecessarily detailed in its approach to transfer pricing. In contrast to the two information circulars published by Revenue Canada, the ATO has issued three final and seven draft taxation rulings directly related to international transfer pricing. Whether there is a need for such detail is yet to be determined. In the meantime, it will be necessary for both Canada and Australia to continue to evaluate and refine their transfer-pricing regimes to accommodate further changes in the arena of international commerce.