

Introduction

TRANSFER PRICING is a central ingredient to trade and commerce, to financing and accounting, and to law and economics. We have selected 15 countries in Asia and the Pacific where these transfer pricing components have grown in importance.

We have divided the *Asia-Pacific Transfer Pricing Handbook* into two parts: Part One: Country-by-Country Analysis and Part Two: Advanced Applications—complex transfer pricing issues.

PART ONE: COUNTRY-BY-COUNTRY ANALYSIS

For the convenience of the reader, we provide alphabetical country-by-country analysis. We examine these countries in the Asia-Pacific region:

Australia
China

Hong Kong
 India
 Indonesia
 Japan
 Korea
 Malaysia
 New Zealand
 Philippines
 Singapore
 Sri Lanka
 Taiwan
 Thailand
 Vietnam

PART TWO: ADVANCED APPLICATIONS

The *Asia-Pacific Transfer Pricing Handbook* then examines transfer pricing issues that take place across borders:

- Hong Kong and Singapore
- India and Hong Kong
- Australia, Canada, Japan, and the United States
- Singapore and the United States
- Japan and South Korea
- China and Taiwan
- Malaysia and Singapore
- Hong Kong and India

Multinational institutions play a major role in the transfer pricing context. These organizations include the Organisation for Economic Co-operation and Development (OECD) and the Association of Southeast Asian Nations (ASEAN), including ASEAN + three. At this time, the OECD has 34 members, only 4 of which are in the Asia-Pacific region: Australia, Japan, New Zealand, and South Korea. Nevertheless, the broader Asia-Pacific group of 15 countries, which are the subject of this analysis, follow OECD principles. Most of the nonmember countries are already on track to become OECD members.

Today the ASEAN pact, including ASEAN + three, have moved slowly in addressing transfer pricing issues. In part, the ASEAN pact and ASEAN + three are reticent because some members do not have their own transfer pricing regimes.

Each country stands on its own, despite the impact of the OECD. In particular, these six developments are notable:

1. Japan took the lead in profit split techniques, and the OECD follows these techniques.
2. China and Vietnam address control issues, which the OECD fails to address.

3. Singapore is applying important techniques for the treatment of services in the transfer pricing context.
4. Hong Kong has developed anti-tax haven techniques and put these rules with its transfer pricing guidelines.
5. India is far ahead in case law developments, leaving the United States behind.
6. Australia is far ahead in developing pre-audit techniques for midsize businesses.

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Australia's Risk Assessment Transfer Pricing Approach

THE AUSTRALIAN GOVERNMENT, through its Australian Tax Office (ATO), issued in March 2005 an international transfer pricing document entitled "A Simplified Approach to Documentation and Risk Assessment for Small to Medium Businesses." As tax practitioners working in the field of international transfer pricing, it is our position that the ATO's document is neither simplified nor designed for small and medium businesses. The ATO, in response to this comment, increased the small business threshold. Nevertheless, despite these shortcomings, this document provides multinational taxpayers with a worthwhile risk assessment approach toward transfer pricing issues.

The U.S. taxpayer is cautioned that the ATO transfer pricing review and audit process involves two essentially separate procedures:

1. The ATO pervasively applies the transfer pricing review process, evaluating the business and its transfer pricing activities as an intermediate audit-related step. Many companies can find themselves as being on the ATO's watch list, but few companies face transfer pricing audits.
2. The ATO rarely audits business for transfer pricing issues, which suggests that a company facing a transfer pricing audit likely can be subject to transfer pricing adjustments and penalties.

INTRODUCTORY ISSUES

The ATO's transfer pricing simplified approach applies to businesses with an annual turnover of less than A\$100 million, which the ATO defines as small to medium businesses. The threshold is based on total transactions, not just on international transactions. Thus, a business having domestic Australian sales of A\$5 million and international sales of A\$90 million would be within the confines of the small- to medium-businesses parameters. In contrast, a business having domestic sales of A\$100 million and international sales of A\$5 million would be outside the confines of those parameters. Earlier we suggested that the ATO would be well advised to base the small- to medium-businesses parameter on international transactions standing alone. However, the ATO increased the parameters in 2009, thus alleviating some of the objections that we previously had made.

The ATO overrides the A\$100 limitation for small to medium businesses in two respects:

1. The enterprise is part of a multinational group that is listed on any stock exchange. The term "any stock exchange" might possibly include stock exchanges outside Australia.
2. The enterprise is part of a private group with any international subsidiary or other offshore related party that "has the resources" to deal with global transfer pricing issues. The ATO provides no guidance to access the parameters that would constitute "having the resources."

The small- to medium-businesses guide seeks to explain:

- The transfer pricing review process
- The ATO's methodology in selecting businesses for review
- The "simplified" transfer pricing documentation that the ATO suggests businesses maintain
- A four-step process for setting up related party pricing and reviewing the transfer pricing outcome
- The mechanism under which the ATO scores the business reality of the business's profit and the quality of the company's transfer pricing records to determine the ATO's further response
- The outcomes of the transfer pricing review or audit

TRANSFER PRICING REVIEWS

The ATO views the prices in the transfer pricing mechanism as reflecting a fair return for activities carried out by or for an Australian business based on:

- What is done
- What assets are used
- Who bears the risk in carrying out the activities

ATO's aim is to assess the quality of the processes and documentation on hand and with the commercial realism of the outcomes of the business's dealing with related parties. In this regard, the ATO uses economists and data from public databases that the business and its tax advisor can access. Small to medium businesses do not have to create documents beyond the minimum necessary to arrive at an arm's length outcome in the context of their business.

The ATO applies a scoring process to the business, evaluating:

- The quality of the business's processes
- The quality of the business's records
- Commercial outcome arising from related party cross-border transactions

After the ATO undertakes the scoring process, it evaluates whether a transfer pricing review shows that there is a risk to the revenue associated with a business's related cross-border transactions. The business may face an ATO audit if the risk occurs.



DOCUMENTATION REQUIREMENTS

The ATO expects significantly less transfer pricing documentation for a small to medium business than for a large business. The extent of the documentation the ATO requires increases as the significance and complexity of the transactions increase. For example, the ATO would expect a business having AS\$48 million in related party cross-border transactions to have more extensive documentation than a business having AS\$8 million in related party cross-border transactions.

Small businesses having relatively low levels of cross-border transactions need not create documents beyond the minimum necessary to arrive at arm's length outcomes in the context of their business. A less detailed functional analysis, coupled with an assessment of any external data available about price and/or performance, provides a greater degree of certainty and a reduced risk of tax adjustments.

Business managers might want to consider the next issues regarding the documentation that would satisfy the requirement that the taxpayer has applied the arm's length principle:

- Is the cross-border transaction that deals with a related party significant in terms of dollar value compared with the turnover of the business?
- Is the cross-border dealing unusual, and not part of similar activities, enabling a group to be priced and tested to show that the taxpayer has generally taken these factors into account?
- Should the ATO question the basis of the taxpayer's pricing against the profitability of the business?

The ATO suggests that if the taxpayer were to respond affirmatively to one or more of the preceding inquiries, the taxpayer should take some action that is

“reasonably balanced” against the cost of complying. The “reasonable balance” criterion is far from universal, but Singapore also uses such a reasonable balance approach.

PREPARATION OF THE DOCUMENTATION FILE

The ATO uses the term “transfer pricing documentation” in a broad manner. Thus, transfer pricing documentation includes more than transaction data and requires the taxpayer to undertake much of the transfer pricing analysis a priori, even before seeking to undertake a transfer pricing analysis per se.

Transfer pricing documentation is more than recording and filing invoices. Transfer pricing documentation involves creating records outside the everyday business record keeping that shows how the business deals with cross-border transactions. Transfer pricing documentation requires:

- Writing down and describing how the business operates—in other words, functional analysis.
- Writing down and describing how the business sets its prices in cross-border transactions with related parties. The business should name the transfer pricing methods it uses and explain why it selected that method. Justifying its transfer pricing approach using global lists of related parties might not be sufficient for the business merely to justify its transfer pricing approach.
- Justifying that the transfer price used was an arm’s length price, a price that independent parties would find appropriate. The taxpayer should undertake one of two approaches to determine comparability:
 - Compare the price charged to the related party with the price charged to unrelated parties (the comparable uncontrolled price method), or
 - Compare its profit outcome based on gross profit or on net profit before interest and tax with other companies in its industry. This comparison might be as simple as comparing the profit outcome to public data on the ATO’s Web site or undertaking a more complex review if the business’s profitability is not similar.
- The taxpayer should prepare a documentation file that would include the functional analysis and include evidence of how the taxpayer determines cross-border pricing. The ATO expects the taxpayer to undertake at least a basic benchmarking study to show broadly that the outcome of the business reflects arm’s length pricing.
- The taxpayer can take advantage of its knowledge of its market and pricing, and can take budgets and management tools into account.
- The taxpayer can take advantage of making both independent and affiliated party sales.

The ATO recognizes that the taxpayer might find it difficult to gather external information on prices or margins to support the business's actions. This difficulty can occur because of the following:

- The business might differ from other companies in its industry, or
- The business might have a unique business operating in Australia

The ATO also recognizes that it might be difficult for the taxpayer to obtain publicly available data as to bottom-line profits for similar companies that are not controlled by related parties to compare net profit outcome. The ATO warns, though, that the presence of these adverse situations is not an excuse for doing nothing.

At its option, the taxpayer can obtain data from commercial databases and tailor these data to the company's documentation report. The taxpayer should weigh the cost of obtaining these data internally or using an external service provider against the likelihood of a transfer pricing review and subsequent tax audit adjustments.

The ATO encourages businesses to keep the most valuable transfer pricing documentation, which the ATO refers to as contemporaneous documentation. The ATO, then, does not specifically require the taxpayer to undertake contemporaneous documentation. It defines "contemporaneous documentation" as the documentation that existed at or before the time of preparing the business's tax return for the given year. The taxpayer is to use contemporaneous documentation to set or review the outcome of the company's related party cross-border transaction pricing. The ATO expects the taxpayer to prepare some documentation specifically created to show the business applied the arm's length principle.

According to the ATO, contemporaneous documentation is a self-contained report with evidence attachments that describe:

- The business itself.
- The environment in which the business operates.
- The method the business uses to set or review related party pricing, including a discussion of why the businesses rejected acceptable methods for each type of transaction.
- A comparability study that uses publicly available accounting data to indicate a range of prices or profit that demonstrates or proves that the business was at arm's length in its dealing with unrelated parties. This comparability study should include the analysis of comparables (i.e., independent company data) that were accepted or rejected in the study and specify why the selected data are comparable and reflect arm's length results when applied to the business.

The ATO will select certain cases for a transfer pricing review. In all such cases that it selects, the ATO will undertake its own benchmark review to gauge what outcome it thinks the business should reflect in its taxable income relative to the industry it is engaged in. If the taxpayer is subject to the simplified transfer pricing approach, during the transfer pricing review, the ATO may discuss the use of benchmarking

with the business and its advisors to let them know what to expect in testing the arm's length outcome of the prices the business uses in its cross-border transactions.

The ATO provides an example of the pre-review process. Thus, in this example, the ATO might discuss how the business's low profit outcome, based on gross profit or net profit before interest and tax, compares with higher comparably broad Australian Bureau of Statistics data profit outcomes. The ATO might also ask the business to explain how its related party dealings have influenced this comparison and/or how market and other environmental issues are relevant. Such factors include business cycles, market competition, and foreign exchange risks. This pre-review process is designed to help businesses understand what action they need to take in future years.

APPLYING THE ARM'S LENGTH PRINCIPLE

The first step in applying the arm's length principle is to select an arm's length method and test it. The ATO recommends that small to medium businesses use a four-step process to demonstrate compliance with the arm's length principle. This four-step process is not appropriate for businesses that are part of large multinational groups that can avail themselves of more resources.

Some businesses might have relatively simple cross-border transactions with related parties. Other businesses might have low-value cross-border transactions with related parties. In these two situations, the ATO states that the extent of the data collection and analysis and the contents of the documentation might be minimal.

The ATO asks small to medium businesses to put a name to the transfer pricing method it uses, although the ATO acknowledges that some businesses of this size may find doing so or testing the price burdensome. The instructions to Schedule 25A describe transfer pricing methods that might or might not be considered arm's length.

SIMPLIFIED APPROACH TO DOING A BENCHMARKING STUDY

The ATO recognizes that the cost of doing the benchmarking analysis and placing it in the documentation file before lodging the company's annual tax return may be a material cost burden for small to medium businesses. As a result of incurring this burden, the management of the small to medium business incurs the risk of any subsequent Tax Office adjustment as being low, and proceeds to rely on the company's internal procedures and records only. A profitable business is unlikely to be prejudiced by this approach, but loss businesses run higher risks if no action is taken.

The ATO expects that businesses having related cross-border transactions that are using documented business plans to, in fact, have documented these business plans. The ATO expects businesses to have the resources to undertake a basic benchmarking study, doing so by using Tax Office publicly available information. The small to medium business might not prepare a benchmarking study or might not place the

- Price lists
- Budgets
- Correspondence
- Working papers
- Agreements with related parties

According to the ATO, what the business actually calls the pricing method it uses is not important. Nevertheless, the business must have some basis to show how it sets prices. The business should reflect the price it uses and that the price reflects arm's length prices used, for example, by its competitors. The business is to identify whether its competitors are part of a controlled group, as their prices may be influenced by their transfer pricing policy; in such cases, prices might not provide a reliable comparison. Note that this consideration impacts antitrust considerations and that the U.S. tax authorities typically avoid this comparison issue.

The business might know, for example, that cost plus markup is normal in its industry, and it might be able to use this industry "plus" percentage to set its prices and test its position. The business needs to make sure that the industry "plus" is based on arm's length dealings and not on controlled party dealings. The business might have charged a related party the same or similar price as it charged a third party for same or similar goods or services. The ATO calls this method the comparable uncontrolled price method. The United States calls this method the comparable uncontrolled price method using an in-house comparable.

The business might have set its related party prices based on a business plan that used sale prices from or to related parties that result in a planned gross profit that is sufficient to cover administration and selling costs, returning to the business a fair net profit. Such a business should prepare its documentation file to explain how it calculated that profit. The business needs to test whether the "fair net profit" reflects an arm's length result.

Step 3. The business applies the most appropriate transfer pricing method, determines the arm's length outcome, and documents the process. The business should add to the documentation file the actions it has taken to test that the price it has set and recorded reflects an arm's length outcome. For example, the business should reflect in its documentation file whether it undertook a benchmarking study. This study might be a general comparison of the business's profit result with the Tax Office for the type of business the company carries on. The business should reflect in its documentation file a more detailed study conducted by an outside advisor using profit level indicators that are acceptable arm's length methods.

Step 4. The business implements support processes and review processes to ensure adjustment for material changes and to document these processes. The business should review the transaction pricing and the benchmarking study if there are any changes to:

- The nature of the transaction
- The parties to the transaction
- Economic conditions

The business should record the outcome of these changes in its documentation file.

DECISION TREE

The beginning point for the decision tree is to ascertain whether the business has internal or external data to compare prices or profits from related party transactions. The ATO views internal data and external data in the same manner. If the response to the inquiry is negative, the ATO would have the business consider other approaches that give comfort to the profit outcome the business obtained or the business can seek an amendment to its income tax returns to reflect an arm's length result.

If the business does have internal data or external data to compare prices or profits from related party transactions, the next question is whether it has evidence of a comparable uncontrolled price. If the response to the comparable uncontrolled price inquiry is affirmative, the final step is to ascertain whether the comparison shows that the business's pricing and profits are acceptable.

A separate method applies if the business does have internal data or external data to compare prices or profits from related party transactions but no evidence of a comparable uncontrolled price. When the business has no evidence of a comparable uncontrolled price, the next question becomes whether it has evidence of gross margins. If the business does have evidence of gross margins, it is to use the resale price method or the cost method using comparables using similar products traded by independent companies having similar functions, asset bases, and risk profiles. If the business does not have evidence of gross margins, it is to apply the transactional net margin method at the net margin level, using comparables for similar companies with similar products or services, similar levels of assets used in their businesses, and similar risk profiles in the industry.

Internal evidence might support the arm's length nature of the pricing the business uses with related parties. Nevertheless, profit comparisons might either strengthen or weaken the case if the profit outcome of the business falls outside the comparable profit range. The ATO points out that the reasons for this situation may not relate only to transfer pricing.

HOW THE ATO SCORES RISK

The ATO originally introduced five risk levels for scoring the quality of the transfer pricing processes and for documentation of cross-border transactions with related parties. Three of these five risk levels survive for small to medium businesses. The ATO recognizes that many small to medium businesses do not have the in-house resources or cannot afford to engage external advisors to prepare the medium- to high-quality documentation expected of large businesses. The ATO nonetheless encourages small to medium businesses to aspire to a medium to high quality of documentation. At the same time, the ATO recognizes that in most cases, the business would not be required

to provide the same amount of documentation as would be required of large businesses. Accordingly, in developing a transfer pricing review, the quality of the processes and documentation applied to related party cross-border transactions generally falls into one of these three levels:

- **Low score, score 1.** This score increases the likelihood of an audit. However, the business and its advisor can cooperate by using the simplified approach if the business works with the ATO to provide an acceptable level of documentation and explain the level of profitability.
- **Medium score, score 3.** This approach also allows the business and its advisors to work with the ATO to provide an acceptable level of documentation and explain the level of profitability.
- **Medium to high score, score 4.** The ATO generally accepts this approach. It requires little interaction with the ATO and provides a decreasing level of audit. This score recognizes the limitations of obtaining comparables in the Australian market. The high-quality level, level 5, is rarely obtained in practice.

SCORING THE THREE LEVELS

The ATO uses a scoring system to evaluate the taxpayer's activities. The ATO then uses this analysis to ascertain its response to the taxpayer.

Score 1 Low Quality

- The business provides no analysis to describe the functions, assets, and risks of the business, the markets in which it operates, and the business strategies that business management uses to gain a commercial return.
- The business provides no documentation or insufficient documentation or processes to enable a check on the selection of its pricing method.
- The business does not provide comparables.
- The business provides no documentation to allow a check on the application of the pricing methods the business uses.

Score 3 Medium Quality

- The business provides inadequate analysis to describe the functions, assets, and risks of the business; the markets in which the business operates; and the business strategies that business management uses to gain a commercial return.
- The business provides a selection of the transfer pricing method it uses, supported by some contemporaneous documentation.
- The business uses broad inexact comparables or comparables based on data from external related comparables. For example, the business uses data used by an overseas related party to justify the pricing.

- The business provides an application of the pricing method, supported by some contemporaneous documentation.

Score 4 Medium to High Quality

- The business provides sound analysis to describe the functions, assets, and risks of the business; the markets in which it operates; and the business strategies that business management uses to gain a commercial return.
- The business provides a selection of the transfer pricing method it uses, supported by some contemporaneous documentation.
- The business uses comparables that are based on, and limited to, adequate data from independent dealings. This reliability is taken into account in the choice of comparables.
- The business provides an application of the pricing method, fully supported by contemporaneous documentation.

SCORE GRAPH

The ATO provides a score graph to measure the risk of a transfer pricing audit. The ATO scores the risk of a transfer pricing audit as being very high, high, medium to high, medium, low to medium, or low. Then the ATO categorizes the profit outcome of the business as being within one of three categories:

- A. A commercially realistic result
- B. A less than commercially realistic result
- C. Consistently provides losses

The ATO then seeks to categorize both the quality of the documentation and the audit risk in this manner:

1. Regarding profit outcome A, the ATO categorizes scores in this manner:
 - The commercially realistic result as applicable to the medium-risk score of 1, low quality
 - The commercially realistic result as applicable to the low- to medium-risk score of 3, medium quality
 - The commercially realistic result as applicable to the low-risk score of 4, medium to high quality
2. Regarding profit outcome B, the ATO categorizes scores in this manner:
 - The less than commercially realistic result as applicable to the high-risk score of 1, low quality
 - The less than commercially realistic result as applicable to the medium- to high-risk score of 3, medium quality
 - The less than commercially realistic result as applicable to the medium-risk score of 4, medium to high quality

3. Regarding profit outcome C, the ATO categorizes scores in this manner:

- The losses consistently returned result as applicable to the very-high-risk score of 1, low quality
- The losses consistently returned result as applicable to the high-risk score of 3, medium quantity
- The losses consistently returned result as applicable to the medium- to high-risk score of 4, medium to high quality

The ATO provides examples of its scoring system:

- A score of C1 shows the business had a high risk, indicating that a Tax Office audit is possible. To avert an audit, the ATO would encourage the business to prepare and maintain a documentation file to at least the 3 quality level. The ATO would also encourage the business to examine its profit position relative to available statistical data for benchmarking purposes. The ATO would offer the business an opportunity to enter into an advance pricing agreement if the ATO commences an audit.
- A score of B3 would indicate that the taxpayer has medium to high risk of an audit. The ATO would provide the business with statistical data benchmarking information if the business has related party cross-border transactions that present medium to high risk in the ATO risk review process. The ATO might undertake "a cooperative discussion" with the business. The ATO might place the business on a watch list to review the business's progress in demonstrating compliance with the arm's length principle. The audit may result if the business makes little progress in future years.
- A score of A4 would suggest that the business has made a big effort to manage its related party cross-border transactions on an arm's length basis. The results would indicate to the ATO that it would require no audit action as to its transfer pricing issues.

OUTCOME OF TRANSFER PRICING REVIEW OR AUDIT

The ATO might decide to audit a business after a transfer pricing review. If the ATO decides to undertake such an audit, the business is likely to face tax adjustments and penalties. Any such adjustment is subject to normal Tax Office review and legal review and appeal processes. The adjustments might also be subject to discussions with another revenue administration involved in the mutual agreement procedure of the relevant double tax agreement. The ATO, as part of the audit process, normally will issue a position paper and give the business an opportunity to comment before the ATO assesses any adjustments and enforces any resulting tax and penalties.

The ATO has issued a flow chart that shows how it conducts transfer pricing reviews and transfer pricing audits and how it undertakes other follow-up action specifically for small to medium businesses. The ATO will work with a business and its

HOW THE AUSTRALIAN TRANSFER PRICING AUDIT PROCEDURE WORKS

The ATO reviews all of the business's related party transactions during a transfer pricing audit. Then, using internal economists, the ATO forms a view of the business's arm's length outcome. The ATO then questions whether the outcome of the transfer pricing audit is materially different from that of the business.

If the transfer pricing results are not materially different from that of the business itself, the ATO then works with the business and its agents to put the company on a watch list. If the transfer pricing results are different from that of the business itself, the ATO prepares a position paper and invites the business to respond to reevaluate the ATO's position if the difference is material. The ATO can reevaluate its position, working with the business and its agents, and putting them on a watch list or exonerating the business. If the ATO determines that it should make an adjustment, the Commissioner can rely on a double tax agreement, if applicable, and the ATO can take assessment and penalty action.

AUSTRALIA'S FOUR-STEP PROCESS FOR BUSINESSES

Australia applies a four-step process for businesses:

1. Accurately characterize business dealings between associated enterprises in the context of the taxpayer's business, and document that characterization.
2. Select the most appropriate transfer pricing methodology or methodologies, and document that choice.
3. Apply the most appropriate transfer pricing method, determine the arm's length outcome, and document that process.
4. Implement support processes, including the installation of the review process to ensure adjustment for material changes, and document these processes.

Step 1 involves the determination of the next points, which would accurately characterize the business dealings:

- The business is to identify the scope, type, value, and timing of its international transactions with associated enterprises in the context of the taxpayer's business. This identification may require an understanding of the context of the business's dealings, including:
 - Organization, decision processes and systems, and incentive structures
 - The conditions affecting the industry, the nature of competition the business experienced, and economic and regulatory factors
 - Business objectives, strategies the business adopts, and financial performance
 - Intellectual assets the business uses, their contribution, ownership, and reward

- The economically important activities undertaken by each of the associated enterprises, the recourses the business uses, and the risks that the business assumed in each case
- The business is to identify the specific elements of the international dealings that it is to consider.
- The business is to prepare a preliminary functional analysis.
- The business is to explain the conditions affecting the industry and the business strategies available to the taxpayer as these conditions affect functional analysis.
- A critical part of this functional analysis is to ascertain which of these functions are the most economically important functions, assets, and risks, and how these functions, assets, and risks might be reflected by a comparable price, margin, or profit on the dealings.
- The business is to determine if it appropriately rewards intangibles in light of contribution and ownership.
- The business is to document the process it adopts.

Step 2 involves the determination of these points, which should accurately select the most appropriate transfer pricing methodology or methodologies:

- The business would identify the available data that might establish an arm's length consideration for each of its dealings and for the dealings taken into account in their entirety.
- The business would determine the most appropriate methodology or methodologies, based on the facts and circumstances of the particular case.
- The business is to document its choice of methodologies.

Step 3 involves the determination of the next points, which would accurately apply the most appropriate transfer pricing methodology or methodologies:

- The business should refine, examine, and organize data pertaining to comparable dealings, or comparable enterprises, for each of the business's dealings for the purpose of enabling the business to properly assess comparability. To improve comparability, it is necessary for the business to:
 - Adjust the data to account for material differences in comparability
 - Group or aggregate data
 - Extend its analysis over a number of years
- The business should develop data points and ascertain whether a range of results appears.
- It might be necessary to broaden and refine the business's functional analysis.
- The business should undertake a comparability analysis.
- The business should establish a level of reliability that it can place on the answers that it derives from the application of selected methods and its consequences.
- The business may need to apply several transfer pricing methods.
- The business is to decide on the arm's length outcome.

- The business is to document practical transfer pricing considerations, such as:
 - Assumptions and judgments the business makes
 - The interpretation of data points or ranges
 - How the business uses results from different methods

Step 4 involves the determination of these points, which would accurately implement support processes:

- The business should monitor international dealings and their economic content to identify any material changes as they occur.
- The business should collect data relevant to evaluating the impact of these changes based on an arm's length consideration.
- The business should review the process and the choice of methodology if the data that the business uses establish the outcome of the change.
- The business should put a system in place to support the ongoing application of the chosen method in future years.
- The business should establish a review mechanism to ensure that, if material changes occur, the comparability analysis or its methodology is adjusted as appropriate.

Profit Attribution for a Dependent Agent's Permanent Establishment in Australia

THE AUSTRALIAN Tax Office (ATO) issued a guide in September 2005 that explains how Australia's permanent establishment (PE) attribution rules apply to a PE activity that arises through the activities of a third party (i.e., through a dependent agency PE). As a general matter, dependency agency status has come to the fore in transfer pricing issues as India and other countries seek to take a more stringent approach in applying PE status. Much of the ATO's guidance titled "Attributing Profits to a Dependent Agent Permanent Establishment" is relevant inside and outside Australia.

Other countries in the region, including New Zealand and Thailand in particular, tend to rely on Australia transfer pricing developments. The ATO published this guidance in September 2005. We analyze these provisions here because the Organisation for Economic Co-operation and Development (OECD) addressed the same dependent agency PE profit attribution issues, and these OECD issues impacted the PE approach in 2010.

PERMANENT ESTABLISHMENT CONCEPTS IN AUSTRALIA

Australia generally provides PE rules in sections 136AE(4) through (7) of Division 13 of Part III of the Income Tax Assessment Act of 1936 (ITAA). The Business Profits Article in Australia's double tax agreements determines PE status. Both the ITAA and the double tax agreements determine dependent agency PE status. Consider these two examples:

1. Australia treats an agency that has the power to contract on behalf of the principal as a PE in certain circumstances.¹
2. Australia treats a party that possesses goods on behalf of another as a PE.²

Australia's guide to a dependent agency PE arises from a taxpayer enterprise that takes place through the activities of associated enterprises. The guide applies when both parties are members of the same multinational enterprise.³ Australia's guide, for the most part, presupposes that a foreign party has an Australian activity that might or might not be a PE.

PROFIT ATTRIBUTION CONCEPTS IN AUSTRALIA

The ATO applies a two-step process in determining profit attribution to a PE, with both facets applying transfer pricing principles:

1. **Undertake a functional analysis.** This functional analysis attributes to the PE the functions performed within the PE, the assets used in the PE, and the risks that take place within the PE. The taxpayer is to determine its functions, assets, and risks as to the business that the taxpayer carries on through its PE.
2. **Undertake a comparability analysis.** Under this comparability analysis, the taxpayer is to determine an arm's length return for its functions, assets, and risks.

Australia, then, requires the taxpayer in a PE situation to undertake a full-blown transfer pricing analysis, including its functions, assets, and risks, and then undertake a comparability study. This two-step process applies to all PEs in Australia, including all dependent agent PEs.

THE ATO'S OPERATIONAL APPROACH

The Australian approach delineates two types of taxpayer enterprises, as these enterprises have different functions, assets, and risks, and the inevitable ensuing taxable profits:

1. The taxpayer's nonresident enterprise, or ForCo. ForCo earns taxable profits through its dependent agency PE.

business of selling goods and how much of its selling profit are attributable to its dependent agent PE.

Manufacturing Example

SubCo acts as contract manufacturer (described as a toll manufacturer) on behalf of ForCo. The functional analysis in this instance determines the extent to which ForCo's functions, assets, and risks apply to its business of manufacturing goods and to the magnitude of its manufacturing profits that are attributable to its dependent agent PE.

The ATO provisions delineate the nature of the functions that are attributable to dependent agent PE. The functions so attributable are those performed by SubCo on behalf of ForCo. These amounts include those activities compensated by the service fee that SubCo receives from ForCo. These functions might give rise to assumption of risks by ForCo as principal. If ForCo does in fact assume these risks, the risks are attributable to the dependent agent PE of ForCo.

SubCo, while acting on behalf of ForCo, might employ third parties to perform specified functions. In that event, these functions are attributable to the dependent agent PE just as if the agent itself had performed the functions. These functions might give rise to assumption of risks by ForCo as principal. In that event, the risks that ForCo assumes are attributable to the dependent agent PE.

The ATO provides guidance in determining the assets attributable to the dependent agent PE. The ForCo assets that are attributable to the dependent agent PE are assets used in the functions performed by SubCo on behalf of ForCo. Consider the next sales agency example.

SubCo is performing sales agency activity on behalf of ForCo. SubCo is responsible for warehousing and managing a stock of product inventory owned by ForCo, doing so for the purpose of filling customer orders. Such inventory is attributable to the dependent agent PE. According to the ATO, only the assets of ForCo, not the assets of SubCo, can be attributed to ForCo's dependent agent PE.

The ATO provides that the taxpayer can attribute the asset to a PE that is using the asset. The attribution of an asset to a PE that is using the asset does not, in and of itself, result in the PE attributing all of the profit derived from the use of the asset.

ForCo's dependent agent PE can use ForCo's assets. When that situation happens, it is necessary that ForCo attribute profits to the PE. ForCo is to attribute profits to the dependent agent PE based on functions performed and risks assumed by ForCo in creating, acquiring, or maintaining that asset. Step 2 in this analysis provides the basis for which the taxpayer is to award functions and risks to the PE in attributing profits. The taxpayer might, depending on its particular circumstances, attribute profits to the PE or to another ForCo activity. Consider this manufacturing activity example.

SubCo performs contract manufacture (tolling) activities on behalf of ForCo. The functions and risks involved in research and design create ForCo's product intangibles. ForCo uses these product intangibles in the contract manufacture activity. Those product intangibles are outside of the dependent agent activity. ForCo is to reward that portion attributable to these functions and risks in attributing profit to the PE.

According to the ATO, functional analysis assesses the relative economic significance of various functions (i.e., the assets are risks that are relevant to the business activity involving the dependent agent PE). The ATO recognizes that it is particularly important for the taxpayer to determine the functions that involve assuming and managing the significant risks of that business. The extent to which the dependent agent PE performs these functions is equivalent to the extent to which SubCo undertakes these functions on behalf of ForCo. The extent of the above-mentioned activities determines the amount of profit as a reward for functions, assets, and risks attributable to the PE.

COMPARATIVE ANALYSIS FOR THE PERMANENT ESTABLISHMENT

According to the ATO, the taxpayer is to determine a PE for its functions, assets, and risks by following the guidelines for arm's length pricing in associated enterprise cases.⁴

- The taxpayer, in applying the ATO's approach, is to use an economic model of the PE to select the most appropriate "separate enterprise characterization," such as that of a distributor, agent, or service provider.
- The taxpayer is then to apply the "most appropriate" arm's length pricing method (i.e., comparable uncontrolled price, cost plus, resale price, profit split, or transactional net margin method [TNMM]) to determine the arm's length compensation for the PE based on that characterization.
- This process requires the taxpayer to apply a comparability analysis, using the most reliable available data as to arm's length comparables.

The ATO recognizes that it is important for the taxpayer to recognize the differences in functions, assets, and risks, and hence profits, between the PE and SubCo in using an arm's length pricing method to attribute profit to a dependent agent PE.

SubCo: The ATO presupposes that SubCo is rewarded for its functions, assets, and risks as being a service provider.

ForCo: The PE is rewarded for its functions, assets, and risks of ForCo as being an entrepreneur or principal in regard to SubCo agency activity.

Data that concern uncontrolled comparables as to market rates of commission for sales agents are relevant to determining an arm's length commission for SubCo. However, data concerning uncontrolled comparables as to market rates of commission for sales agents are not directly relevant to determining an arm's length attribution of profit to a dependent agent PE.

The ATO recognizes that it is essential for the taxpayer to use an arm's length compensation for SubCo in applying certain arm's length pricing methods to determine the arm's length profit for ForCo's dependent agent PE. The ATO views the arm's length compensation as a service fee. ForCo's service fee to SubCo is ForCo's expense that is attributable to its dependent agent PE.

The ATO recognizes that the cost plus method or the TNMM might be a reliable method to determine an arm's length profit for the PE. Such a taxpayer is to benchmark a gross markup on costs or a net markup on costs. In that event, the amount of these costs, including the service fee to SubCo, must demonstrably be arm's length.

The ATO believes that the transfer pricing method that most likely will give the taxpayer the best estimate of an arm's length profit for the dependent agent PE in a particular case will depend on these inputs:

- The outcome of the functional analysis
- The comparables available
- Taxpayer data available for the comparability analysis

The ATO reasons that an arm's length profit for the dependent agent PE provides the best estimate for transfer pricing purposes for three reasons:

1. In many cases, the taxpayer might find it difficult to obtain uncontrolled data that enable the taxpayer to directly benchmark an arm's length return for the functions, assets, and risks of the dependent agent PE.
2. Each dependent agent PE is unique. The function and risk profile of the dependent agent PE commonly is not similar to the function and risk profile of any available uncontrolled comparables. This example illustrates the uniqueness of the dependent agent PE: The sales agency arrangement creates a dependent agent PE. In this situation, the dependent agent PE typically will not have functions, assets, or risks that are comparable to either a full-risk buy-sell distributor or to a selling agent.
3. It might also be difficult for the taxpayer to make reasonably accurate comparability adjustments that would have permitted the taxpayer to use potential comparables to reliably estimate an arm's length compensation for the dependent agent PE.

Having determined that an arm's length profit for the dependent agent PE typically provides the best estimate for transfer pricing purposes, the ATO suggests that the comparable uncontrolled price (CUP), resale price, cost plus method, or TNMM is

not the most appropriate method. In that situation, it is necessary for the taxpayer to resort to an indirect transfer pricing method, such as a profit split method, to estimate the arm's length result for the PE. Nevertheless, the ATO suggests that the taxpayer consider the application of a traditional transfer pricing method (CUP, resale, or cost plus) before resorting to the use of a transactional profit method.

APPLICATION OF THE RESALE PRICE METHOD

The ATO suggests that one possible approach in determining the profit of a dependent agent PE in the sales agency arrangement process is to characterize the dependent agency PE as reseller of the goods. The taxpayer would then apply a resale price method to the transaction. This allocation process would allocate the profit as if:

- ForCo sold the goods to a dependent agent PE.
- The dependent agent PE resold the goods to the customer.

The ATO explains the three-step profit attribution process:

1. Ascertain the price to ultimate customer.
2. Determine the arm's length transfer price between ForCo and the PE.
3. The difference between the amounts specified in step 1 and step 2 is gross profit attributable to the PE.

The taxpayer would then benchmark an arm's length gross sales margin using comparables having functions, assets, and risks that are similar to those of the dependent agent PE. The resulting transfer price would therefore exclude, from the amount attributed to the dependent agent PE, any costs and profit attributable to the ForCo activities related to the costs of goods sold, other than costs attributable to the PE. Such excluded costs include purchasing, manufacturing, and/or selling activities undertaken by other parts of ForCo—ForCo(HO).

APPLICATION OF THE COST PLUS METHOD

The taxpayer might be able to use a cost plus method to determine the profit that is attributable to dependent agent PE. The ATO's approach is to benchmark a markup on the cost of the agent's services. The extent of the markup, then, would depend on the taxpayer's particular circumstances.

Under the application of the cost plus method, the level of profit that is attributable to the dependent agent PE is the level of profit that ForCo, as an independent party, would expect to make. Such amount is over and above its costs related to the activity that SubCo performs on behalf of ForCo. Such amounts, then, include service fee payments to the agent.

USING A TRANSACTIONAL NET MARGIN METHOD

In some cases, it might be more appropriate for the taxpayer to use the TNMM in attributing profits to a dependent agent PE. The taxpayer, then, uses the TNMM by benchmarking a net margin based on resale price; alternatively, the taxpayer can use the TNMM by benchmarking a net margin based on cost. The selection of the TNMM would depend on the availability of comparables data. The taxpayer's concern should be the lack of data regarding comparables needed to reliably apply the resale price method or the cost plus method.

USING A PROFIT SPLIT METHOD

In some cases, it might be more appropriate for the taxpayer to use a profit split method in attributing profits to a dependent agent PE. The taxpayer can apply a profit split method by:

- Determining ForCo's profit from its business operations involving the agency activity
- Splitting ForCo's profit between the dependent agent PE and ForCo(HO)

The taxpayer, in undertaking the profit split method, would split the profit based on the relative value of the contributions of dependent agency PE, on one hand, and the contributions of ForCo(HO), on the other hand. The taxpayer would take into account these profit contributions for this profit split purpose as determined by the functional analysis, step 1 in attributing profits to a dependent agent PE.

The ATO then significantly adds to the complexity of the profit split process, mandating that the taxpayer value these contributions using external market data to the extent possible. In reality, the taxpayer is likely to find that the external data do not exist, or, if the external data do exist, the taxpayer will have to make an extraordinary level of external data assumptions to assess profitability. Notwithstanding its external data profit split requirement, the ATO recognizes that the taxpayer may have difficulty in reliably determining ForCo's actual profit from its business operations involving the same activity. This profit analysis is likely to require the taxpayer to apportion revenues and expenses between those operations and from ForCo's other operations. For example, ForCo might have profits from both manufacturing and the sale of products, but the agency activity relates only to the sales activities.

The ATO specifies that ForCo's relevant profit must reflect an arm's length amount. This arm's length standard means that when ForCo includes transactions with its associates, such as with SubCo, ForCo must establish that its profit outcome with these transactions is an arm's length amount.

The ATO recognizes that it may be difficult for the taxpayer to reliably value contributions when it is not possible for the taxpayer to obtain external market data to

TOLL MANUFACTURERS

The ATO addresses profit split method analysis in the context of toll manufacturing (contract manufacturing). One approach might be for the taxpayer undertaking the profit split to attribute profits to a dependent agent PE using a two-step process:

1. The taxpayer uses full-risk manufacturing comparables to benchmark a combined result for SubCo and the dependent agent PE.
2. Having benchmarked a combined result for SubCo and the dependent agent PE, the taxpayer then deducts a benchmarked result for SubCo, using toll manufacturer comparables, to get an arm's length result for the dependent agent PE.

The ATO then elucidates an alternative profit split approach in the contract manufacturer situation. Under this alternative approach, the taxpayer can determine a combined result for SubCo and the PE by benchmarking using contract manufacturer comparables rather than full-risk manufacturer comparables. The taxpayer can apply the contract manufacturer comparables if SubCo and the PE are together considered to have functions, assets, and risk comparable to those of a contract manufacturer.

However, the ATO limits the use of the comparable contract manufacturer approach. The ATO points out that a contract manufacturer commonly holds inventory and that the inventory-owning relationship largely explains the difference between the return of the contract manufacturer and the toll manufacturer. The ATO concludes that the alternative contract manufacturer is unlikely to be used if the inventory and risk are not attributable to the PE. The ATO similarly concludes that functions, assets, and risks other than related to inventory are likely to account for significant profit attributable to the PE.

According to the ATO, the taxpayer can use the comparable contract manufacturer approach as a reliable measure only if SubCo and the dependent agent PE were together considered to have similar functions, assets, and risks to selected comparables. The taxpayer is unable to use the comparable contract manufacturer approach without adjustment or modification where significant functions, assets, and risks are attributable to ForCo(HO).

The ATO suggests two ways in which the taxpayer can modify or adjust the contract manufacturer analysis:

1. The taxpayer can adjust the results of the comparables to account for a return for the functions, assets, and risks attributable to ForCo(HO) and the adjusted results that the taxpayer used to benchmark a return for SubCo and the dependent agent PE.
2. The taxpayer can use unadjusted results of the comparables to benchmark the combined result for SubCo and the dependent agent PE and ForCo(HO). The data under review are more than SubCo and the independent agent PE.

The ATO provides an example under which the taxpayer applies and modifies the contract manufacture situation to benchmark the combined result for SubCo and the dependent agent PE and ForCo(HO). The taxpayer would apply the next four steps, assuming it were to adopt the combined approach as to toll manufacturing arrangement:

1. The taxpayer would benchmark an arm's length combined result for ForCo(HO) plus dependent agent PE plus SubCo. The taxpayer, in arriving at this benchmark, would use either full-risk manufacturer comparables or contract manufacturer comparables, as appropriate.
2. The taxpayer would benchmark an arm's length result for SubCo standing alone. The taxpayer, in making this analysis for SubCo, would use toll manufacturer comparables.
3. The taxpayer would deduct the results from step 2 from the results in step 1. The purpose of this subtraction is to arrive at an arm's length result for ForCo (both the HO segment and the dependent agent PE segment).
4. The taxpayer would use the "most reliable basis" to split the results of step 3. The goal of this profit split is to give an arm's length result for the dependent agent PE standing alone.

The ATO further explains the purpose of ascertaining the arm's length return for the combined functions, assets, and risks of ForCo(HO) and the dependent agent PE, the results of step 3: The taxpayer uses the arm's length return for the combined functions, assets, and risks of ForCo(HO) and the dependent agent PE as a proxy for ForCo's actual profit from its manufacturing operations involving the agency activity. Thus, the taxpayer overcomes any practical problems in this determination.

In essence, the taxpayer applies a residual profit analysis. The taxpayer must split this residual profit in some way between ForCo(HO) and the dependent agent PE. This residual profit analysis requires the taxpayer to value relative contributions and presents the same difficulties a traditional profit split approach.

FOUR EXAMPLES

The ATO provides four examples under which the taxpayer undertakes (1) a function analysis and then (2) a comparability analysis in the process of attributing profits to a dependent agent PE. Examples 1 and 2 illustrate the ATO's approach to attributing profit to a dependent agent PE arising from a sales agency arrangement. Examples 3 and 4 illustrate the ATO's approach in a toll manufacturing situation.

The ATO examples are, by design, intentionally limited to highly simplified fact patterns and analysis so that the reader can more readily understand the approach taken. The ATO recognizes that most situations may be significantly more complex and difficult to deal with in practice. This complexity should not alter the principles that underlie the attribution process.

Adding to this analysis, the dependent agent PE of ForCo causes the dependent agent PE of ForCo to assume functions that in part were ascribed to SubCo in Table 2. These functions are: product ordering, marketing; sales force, marketing; advertising strategy, warehousing; inventory management, delivery; shipping, debt management, and collections; and after-sales support. The categorization of assets and risks remains the same, notwithstanding the fact that the data then reflect the dependent agent of ForCo.

Table 3 allocates the functions between SubCo and ForCo PE. ForCo PE is charged with the costs of the commission, advertising, bad debts, and stock losses. SubCo is charged with sales and marketing, delivery, after-market support, and debt collection and management.

After the taxpayer and/or the ATO analyze the functions, assets, and risks, the taxpayer and/or the ATO is to undertake a comparability analysis as step 2 of the process of attributing profits to a dependent agent PE.

Example 1: Sales Agency Arrangement, Step 2 Comparability Analysis

The ATO requires the taxpayer to undertake a comparability analysis:

1. Seek internal (in-house) comparables. In Example 1, there are no internal comparables because SubCo acts exclusively as an agent for ForCo.
2. Seek external comparables, to directly benchmark an arm's length compensation or margin for the dependent agent PE for its particular functions, assets, and risks. Here such external comparable as a whole does not exist.
3. Seek a comparable for SubCo's dependent agency services standing alone. This comparable is said to exist in Example 1. Under the hypothetical, independent selling agents in Country A establish that the \$15 million commission amount is an arm's length amount for SubCo's independent agency services.

Now we turn to the risk analysis impacting the full-risk marketers and distributors of computer products in Country A, determined on a combined basis. The hypothetical data as to these comparables reflects companies with similar functions, assets, and risks compared with SubCo and the dependent agent PE, determined on a combined basis. The data reflects a 3 percent return on sales (\$100,000,000) at the earnings before interest and taxes (EBIT) level, or return on sales of \$3 million. Later we need to divide the division of income between SubCo and the dependent agent PE.

The first step in the process is to ascertain whether the taxpayer has a direct benchmark to determine the compensation of the dependent agent PE. Based on the data that the taxpayer obtains—data that are typical in attributing profits to a dependent agent PE—and given the outcome of the functional analysis and the available comparable data, it is unlikely that the taxpayer can use an arm's length pricing method as a direct benchmark regarding compensation of the dependent agent PE.

After the taxpayer determines that it has no direct benchmark regarding compensation of the dependent agent PE, the ATO suggests that the taxpayer apply the profit split method.

The ATO would have the taxpayer apply an arm's length pricing method if the taxpayer could reliably use this method to directly benchmark the compensation of the dependent agent PE. However, the ATO also recognizes that the taxpayer is unlikely to apply such an arm's length pricing method to benchmark the compensation of the dependent agent PE, given the outcome of the functional analysis and the available comparables data. The ATO suggests, then, that given the lack of a taxpayer's ability to apply such an arm's length pricing method to benchmark the compensation of the dependent agent PE, the taxpayer should then resort to a profit split transfer pricing method.

ForCo might be able to determine its operating margin on a reliable basis for its sales operations that involve SubCo. In the event that ForCo in fact can do so, the functional analysis would then indicate that the whole of that profit is properly attributable to the dependent agent PE. In the event that ForCo can determine its operating margin on a reliable basis for its sales operations that involve SubCo, the functional analysis would then indicate that there is no contribution for ForCo(HO) for such profit. The taxpayer is likely to find that it may be difficult to apply this profit under the profit split method.

The ATO suggests that, after the taxpayer cannot successfully apply the profit split method, it might not be possible for the taxpayer to select another transfer pricing method. In the event that the taxpayer cannot select another transfer pricing method, the ATO suggests that the taxpayer apply a formulary approach to the EBIT amount. Returning to the basic Example 1 situation, the data for independent full-risk marketers of computer products in Country A having similar functions, assets, and risks of SubCo and the dependent agent PE, on a combined basis of 3 percent return on sales at the EBIT level, ForCo derives \$100 million in sales income.

The combined arm's length EBIT amount as to dependent agent PE and SubCo is 3 percent of \$100 million, or \$3 million. SubCo has an arm's length commission of \$15 million and incurs operating expenses of \$13 million (sales and marketing of \$6 million; warehousing and inventory management of \$2 million; delivery of \$2 million; after-sales support of \$2 million; and data collection and management of \$1 million), leaving SubCo with a net profit of \$2 million of the \$100 million. The final step to determine the EBIT of the dependent agent PE is to subtract the arm's length EBIT of SubCo (\$2 million) from the combined arm's length EBIT of the dependent agent PE and SubCo (\$3 million), which leaves \$1 million for the arm's length EBIT of the dependent agent PE.

The situation could have involved a conversion of SubCo from a full-risk marketer or distributor into a selling agent. This conversion could take place as part of a supply chain restructuring, for example. Such a restructuring would not have caused any change in the overall profit on which the multinational enterprise is subject to tax in Country A. The conversion of SubCo from a full-risk marketer or distributor into a selling agent would reduce the taxable profit of SubCo. However, the conversion of SubCo from a full-risk marketer or distributor into a selling agent would create a taxable profit in the PE of ForCo corresponding to that reduction as to SubCo. The ATO suggests that

the taxpayer could justify the conversion of the profit from SubCo to the profit of the PE of ForCo because the lack of functions, assets, and risks attributable to ForCo(HO) would indicate that SubCo's conversion was not accompanied by any changes on the ground in Country A.

Example 2: Sales Agency Arrangement

Example 2 shows the effect that different contractual arrangements between ForCo and SubCo would have on the profit of the dependent agent PE. The underlying facts in Example 2 are the same as in Example 1. The taxpayer receives and expends these amounts in connection with the products in Country A:

ForCo derives sales income of \$100 million in sales income and manufactures the products at a cost of \$60 million.

ForCo incurs costs of \$28.5 million related to sale of products, including these specific expenditures:

Commission of \$6.5 million paid to SubCo

Advertising costs of \$12 million paid to SubCo

Bad debt losses of \$2 million for ForCo's handling of all debt management and collections from a central location

Inventory stock losses of \$1 million in damages caused by the warehousing of the goods by SubCo

Payments of \$4 million made to a third-party freight forwarder that ForCo employs for inventory management and delivery

Payment of \$2 million paid to a third-party contractor that ForCo employs for technical services of products

Debt collection and receivables management of \$1 million

In addition to the preceding revenues, costs, and expenses for ForCo, SubCo incurs operating expenses of \$6 million. These agency activities are for sales and marketing, including the costs of SubCo's sales force.

Step 1 is to undertake a functional analysis in attributing the functions, assets, and risks to the PE. Based on the preceding set of facts, the ATO would attribute the significant functions, assets, and risks to ForCo(HO), to SubCo, and to ForCo's dependent agent PE. The ATO would employ two steps to attribute the significant functions, assets, and risks to ForCo(HO), to SubCo, and to ForCo's dependent agent PE. The first step in the attribution process would be to allocate the functions, assets, and risks between ForCo and SubCo, ignoring the dependent agent PE at this step in the analysis. The second step in the attribution process would be to allocate the functions, assets, and risks between ForCo and SubCo by adding ForCo's dependent agent PE.

The first step in the analytical process reveals that, as to functions, the product ordering function and the marketing sales force function are attributable to SubCo

while the marketing advertising strategy, the warehouse inventory management function, the delivery shipping function, the debt management and collection function, and the after-sales support services function are attributable to ForCo. All of the assets are attributed to ForCo: inventory; property, plant, and equipment for distribution; and receivables. All of the risks are attributed to ForCo: inventory risk, credit risk, and foreign exchange risk.

The second step in the analytical process causes a partial shifting of the product ordering function and the shifting of the marketing sales force function from SubCo to ForCo PE. The remaining functions, assets, and risks that were attributable to ForCo in the first instance are now attributable to ForCo(HO).

The third step in the analytical process is to quantify the cost items among ForCo(HO), SubCo, and ForCo PE. Based on the set of facts, the \$6.5 million inter-company commission from ForCo(PE) to SubCo is attributable to ForCo(HO); SubCo's \$6 million for sales and marketing is attributable to SubCo. The other costs of \$2.2 million are attributable to ForCo(HO): advertising of \$1.2 million, bad debts of \$2 million, inventory stock losses of \$1 million, warehousing inventory management delivery services of \$4 million, technical support services of \$2 million, and debt collection and management services of \$1 million.

Example 2: Comparability Analysis

The next step in Example 2 is to undertake a comparability analysis. The facts as to the comparability analysis in this instance pertain to the availability of uncontrolled comparables, which are generally the same as in Example 1. However, in this instance the combined functions, assets, and risks of SubCo and the dependent agent PE are not similar to those of independent full-risk managers or distributors.

Under the facts and circumstances of Example 2, the transfer pricing method most likely to provide the best estimate of the arm's length profit of the dependent agent PE may be a form of the cost plus method, given the outcome of the functional analysis and the available comparable data. The ATO points out that the functional and risk profile of the independent agent PE is little different from that of the agent, SubCo. Accordingly, and under those circumstances, the most reliable method is to mark up ForCo's costs of the agency activities.

Example 1 used the profit split method, based on EBIT activity. Example 2 is a situation in which the profit split method would not be the most appropriate transfer pricing method. The dependent agent PE and agent together do not have the functional profile that is comparable to a full buy-sell distributor. The ATO concluded that it does not seem possible for the taxpayer to make sufficiently accurate adjustments to reliably use the profit split method. The ATO reached this conclusion given the number and size of the comparability adjustments that the taxpayer would have to make to obtain an appropriate result for the dependent agent PE, beginning with distributor results.

The ATO acknowledges that it might be possible for the taxpayer to estimate an appropriate markup on cost for the dependent agent PE. The taxpayer could achieve

this result by using the same comparables data that determined an arm's length commission for the agent. The taxpayer could apply this comparable result if the taxpayer used a TNMM to benchmark the commission.

The ATO provides an example of the "comparable result" technique. Assume, in this instance, the taxpayer benchmarked the \$6.5 million commission fee by applying a TNMM for limited-risk service providers. Then assume that the rate of return on cost was 8 percent. Under this method and data, the arm's length profit for the dependent agent PE would be 8 percent. The arm's length profit for the dependent agent PE would be 8 percent of \$6.5 million, or approximately \$500,000.

Example 3: Toll Manufacturing Arrangement

Toll manufacturer SubCo manufactures computer products in Country A for ForCo. ForCo then sells the computer products in Country A. SubCo performs all the activity related to manufacturing the products in Country A. There is a contract or toll agreement between ForCo and SubCo. The agreement between ForCo and SubCo provides that SubCo acts of behalf of ForCo in performing the manufacturing activities of these products in Country A. In return for SubCo acting on behalf of ForCo in performing the manufacturing activities in Country A, ForCo pays SubCo a processing fee, which the ATO describes as SubCo's agency services.

Example 3: Facts

The ATO visualizes that the production process itself contains more than 15 separate production functions. This delineation is important, as the ATO process necessitates a more extensive involvement than to the tax authorities in other taxing jurisdictions. The next step, then, in attributing profits to a dependent agent PE is to examine the following significant functions and risks pertaining to the toll manufacturing agreement, based on these facts:

- ForCo has master agreements with materials suppliers. These master agreements specify the terms of the material supplier agreements, including quantities and pricing.
- ForCo negotiates these materials supplier contracts.
- ForCo pays for material that materials suppliers supplied under the agreements.
- SubCo requisitions the materials supplied under these materials supplier contracts, ordering these materials when needed to meet its production schedules.
- ForCo provides SubCo with a demand plan regarding product scheduling. This demand plan details ForCo's requirements as to the quantities and timing of the products to be delivered to SubCo.
- SubCo uses its demand plan to determine its daily production schedule.
- SubCo performs the manufacturing processing function on behalf of ForCo.
- ForCo is responsible for providing SubCo with the intangibles, designs, and specifications needed to manufacture the product.

Example 3: Functions

The next step in the analysis is to ascertain the functions, assets, and risks to ForCo(HO), SubCo, and ForCo's dependent agent PE. The taxpayer (and the ATO) apply this analysis in two steps:

1. The taxpayer (and the ATO) ignore the presence of the dependent agent PE and allocate amounts between the principal and agent entities, ForCo and SubCo.
2. The taxpayer (and the ATO) add to the allocations the dependent agent PE of ForCo.

This analysis excludes the analysis of the functions, assets, and risks relating to product distribution and marketing because the toll manufacturing arrangement relates only to product manufacture.

We look at ForCo and SubCo standing alone as to functions, assets, and risks. ForCo undertook the functions pertaining to raw materials purchasing, R&D, production scheduling, and quality control. SubCo undertook the manufacturing and warehousing functions. As to the assets, ForCo had the inventory and the intangibles. SubCo had the property, plant, and equipment pertaining to manufacturing. As to the risks, ForCo had all risks, including inventory risks, product liability and warranty risks, and foreign exchange risks.

ForCo originally had all risks, including inventory risks, product liability and warranty risks, and foreign exchange risks. After the division of the risks between ForCo(HO) and ForCo(PE), ForCo(HO) has the foreign exchange risk; ForCo(PE) has the inventory risk and the product liability and warranty risks.

After dividing up ForCo's assets between ForCo(HO) and ForCo(PE), ForCo(PE) has the inventory and the intangibles. SubCo has the property, plant, and equipment for manufacturing.

Dividing up ForCo's functions between ForCo(HO) and ForCo(PE), SubCo has the manufacturing functions and the warehousing functions, but ForCo also has the same functions. ForCo(HO) has these functions: raw material purchasing, R&D, production scheduling, and quality control.

The ATO attributed the cost items in this way:

- To ForCo(PE): the \$14 million processing fee paid to SubCo; the ATO attributed none of this processing amount to ForCo(HO).
- To ForCo(HO): the \$10 million R&D expense; the ATO attributed none of the R&D expense to ForCo(PE).
- To ForCo(PE): the \$30 million raw material expenditure; the ATO attributed none of the raw material expenditure to ForCo(HO).
- To ForCo(PE): the \$3 million product liability and warranty claims costs; the ATO attributed no product and liability and warranty costs to ForCo(HO).
- To ForCo(HO): \$1 million in purchasing and production scheduling department costs; the ATO attributed no purchasing and production scheduling

department costs to ForCo(PE). The ATO's own schedule (Table 8) erroneously reflects the purchasing and production scheduling department costs as being part of the product liability and warranty claims cost.

- To ForCo(PE): \$1 million inventory stock loss cost; the ATO attributed none of the inventory stock loss cost to ForCo(HO).
- To SubCo: the entire \$13 million manufacturing cost

Step 2 in Example 3 provides for a comparability analysis as to ForCo and SubCo. Here there are no internal comparables as SubCo acts exclusively on behalf of ForCo. There are no external comparables that would benchmark an arm's length compensation or margin regarding the functions, assets, and risks of the dependent agent PE. There is, however, an external comparable, independent toll manufacturers in Country A, to establish the \$14 million arm's length fee for SubCo's processing services. There are sufficient data for independent contract manufacturers of computer products in Country A. These data establish that SubCo and the dependent agent PE combined, as to functions, assets, and risks, have a 10 percent net return on costs. However, it is not possible to reliably determine ForCo's operating profit for the manufacturing operations involving SubCo.

The ATO concludes that it is possible to reliably use an arm's length pricing method to directly benchmark the compensation to the dependent agent PE, given the outcome of the functional analysis and the available data for the comparability analysis. This result suggests a need on the part of the taxpayer and the ATO to resort to a profit split transfer pricing method. However, it is not possible for the taxpayer and the ATO to apply the profit split method using ForCo's actual operating profit results. The ATO suggests that the taxpayer apply a transfer pricing profit split alternative.

Under the ATO alternative transfer pricing method, the taxpayer would determine the combined arm's length return of costs, taking into account ForCo's dependent agent PE and SubCo. This amount is approximately \$5 million, 10 percent of \$48 million in consolidated costs. Then the taxpayer would subtract the arm's length profit for SubCo, the processing fee of \$14 million less the operating expenses of \$13 million, a net amount of \$1 million. The net amount and arm's length profit of ForCo's dependent agent PE is \$4 million—the \$5 million for ForCo's dependent agent PE and SubCo on a combined basis less the \$1 million amount for SubCo.

Example 4: Toll Manufacturing Arrangement

Example 4 illustrates that different contractual arrangements between ForCo and SubCo impact the profit of the dependent agent PE. The facts in Example 4 are the same as in Example 3 except:

- While ForCo had complete control of the raw material purchasing function in Example 3, in Example 4, SubCo has agreements with materials suppliers. These agreements specify terms, including quantities and pricing. SubCo negotiates these raw material purchasing functions and pays for all material supplied under

these contracts. However, ForCo reimburses SubCo for these raw material purchasing costs.

- While ForCo had provided SubCo with a demand plan for production scheduling in Example 3, in Example 4, SubCo uses the international enterprise's intranet systems to ascertain the required quantities and product to be delivered and to determine its production schedule.
- The manufacturing functions are identical in Example 3 and Example 4. SubCo performs the processing function on behalf of ForCo.
- Example 3 had provided that the multinational enterprise set quality control standards on a global basis, with ForCo requiring that SubCo's production conform to these global basis quality standards. In contrast, Example 4 provides that, although the multinational enterprise sets global quality control standards, SubCo has the responsibility to ensure that its production conforms to these standards.
- The warehousing functions are identical in Example 3 and Example 4. SubCo holds the finished goods awaiting ForCo's delivery and shipment.
- In both Example 3 and Example 4, when it comes to inventory ownership and risk, SubCo has no ownership or risk in raw materials, in work-in-process, or in finished goods inventories.
- Example 3 and Example 4 provide that ForCo owns all intangible property rights for the products being manufactured. Such rights include patented designs, processes, know-how, brand names, trademarks, and logos. Example 3 provides that ForCo create trade intangibles internally through R&D outside of Country A. In contrast, in Example 4, ForCo licenses the product intangibles for SubCo's use.
- For both Example 3 and Example 4, SubCo owns or leases all property, plant, and equipment that it uses for manufacturing ForCo's products.
- For both Example 3 and Example 4, as to product liability and warranty risk, ForCo has sole liability for product defects and customer warranty claims. ForCo agrees to indemnify SubCo for any losses or damages.
- For both Example 3 and Example 4, ForCo bears any foreign exchange risk regarding amounts payable for raw materials.
- For both Example 3 and Example 4, ForCo derives \$100 million in sales income and incurs total distribution and marketing costs of \$30 million.
- For both Example 3 and Example 4, ForCo incurs costs of \$59 million related to the manufacture of the products, but the components of this \$59 million amount differ from each other. ForCo paid SubCo a \$14 million processing fee in Example 3 and \$15 million in Example 4.
- In Example 3, ForCo had a \$10 million R&D allocation for developing product intangibles; in Example 4, ForCo incurred \$10 million in royalties for licensing intangibles.
- In Example 3, ForCo paid \$30 million in intangibles for raw materials; in Example 4, ForCo paid \$30 million to reimburse SubCo for raw material costs.
- For both Example 3 and Example 4, ForCo incurred \$3 million in product liability and warranty costs and incurred \$1 million in inventory stock losses caused by SubCo's damage to components and finished products during warehousing.

Example 3 reflected a \$1 million expenditure to operate the raw material purchasing and production scheduling department. Example 4 had no comparable expenditure.

- In Example 3, SubCo incurred operating expenses of \$13 million for its toll manufacturing operations. In Example 4, SubCo incurred operating expenses of \$14 million for its toll manufacturing activities, other than costs reimbursed by ForCo as above. These amounts include the \$1 million for purchasing and production scheduling departments.

Example 4: Functional Analysis

The ATO attributes functions, assets, and risks to ForCo(HO), SubCo, and ForCo's dependent agent PE by first allocating functions, assets, and risks to the principal and agent activities, ForCo and SubCo, ignoring the functions, assets, and risks pertaining to the independent agent PE. Then the ATO attributes functions, assets, and risks to the independent agent PE.

Viewing functions, assets, and risks to ForCo and to SubCo, SubCo incurs all of the functions: raw material purchasing, manufacturing, production scheduling, quality control, and warehousing. As to assets, the inventory and intangibles belong to ForCo while the property, plant, and equipment for manufacturing belong to SubCo. All of the risks belong to ForCo: inventory risk, product liability and warranty risk, and foreign exchange risk.

Different results apply when we take into account the dependent agent PE. All functions are split between SubCo and ForCo: raw material purchasing, manufacturing, production scheduling, quality control, and warehousing. Regarding assets, the inventory and intangibles belong to ForCo(PE); the property, plant, and equipment for manufacturing belong to SubCo. All of the risks belong to ForCo(PE): inventory risk, product liability and warranty risk, and foreign exchange risk.

The ATO would attribute these cost items based on the facts specified in Example 4:

- \$15 million processing fee—ForCo(PE)
- \$10 million royalties—ForCo(PE)
- \$30 million raw materials—ForCo(PE)
- \$3 million product liability and warranty—SubCo
- \$1 million purchasing and promotion scheduling departments—ForCo(HO)
- \$1 million inventory stock losses—ForCo(PE)
- \$13 million manufacturing—SubCo

Example 4: Comparability Analysis

The ATO ascertained the next facts regarding ForCo, SubCo, and uncontrolled comparables. There are no internal comparables in this situation, as SubCo acted exclusively on behalf of ForCo and its other affiliates. There are no external comparables to benchmark an arm's length compensation or margin for particular combination of functions, assets, and risks of the dependent agent PE. Independent toll manufacturers

APA PROCESSING TIMES

The ATO moves rapidly compared with most other tax offices in formulating APAs. Thus, the ATO expects to complete an APA within 12 months after the taxpayer files the application. The ATO expects the taxpayer to cooperate with the ATO and to provide the ATO with timely, detailed, and accurate information. The completion of the APA process within 12 months depends on:

- Availability of information
- Amount of cooperation among the ATO, the taxpayer, and the foreign tax authority, assuming the APA is a bilateral APA
- The APA's available resources to undertake the APA process

Australian APAs completed in 2007–2008 took, on average, 11 months to process, determined from the inception or filing of the APA to the finalization of the APA. The processing time during the prior year, 2006–2007, was 13 months. The average time to complete the APA depends on whether the APA was unilateral or bilateral:

	Unilateral	Bilateral
2006–2007	8 months	17 months
2007–2008	8 months	16 months

The processing time to complete the APA in Australia is much less than the processing time in the United States. The disparity in processing times between countries applies to both unilateral APAs and bilateral APAs. The median processing times in Australia were similar to the average processing times.

In 2007–2008, on average, the taxpayer's renewal APA application took the same time to process as would a new APA application. In contrast, in 2006–2007, a renewal APA application took 30% less time than a new application took.

An APA application in 2007–2008 involving a small and midsize taxpayer took about 60% less time than a large taxpayer APA application took. In contrast, an APA application in 2006–2007 for a small and midsize taxpayer took about 45% less time than for a large taxpayer application.

The ATO permits a small to midsize taxpayer to enter into an APA application process when the ATO undertakes transfer pricing review and/or transfer pricing audit. Small and midsize APA applications were often prompted by the compliance activity on the part of the ATO. These small and midsize APA applications were usually unilateral. The ATO's knowledge of the business helped to improve processing times for these cases.

APA processing time for bilateral applications increased over the six years beginning in 2002–2003 from 13 to 23 months in 2004–2005 and then decreased to 16 months in 2007–2008. The processing time for unilateral applications ranged from 8 to 12 months. Australia had one multilateral APA application.

According to the ATO, unilateral APA applications are more common. It attributes this high percentage to:

- A unique joint venture arrangement in which bilateral APAs were not appropriate
- Small to midsize businesses, which could not justify the costs of submitting a bilateral APA application

UNILATERAL AND BILATERAL APAS

Australia completed bilateral APA applications with four countries in 2007–2008: Canada, Japan, New Zealand, and the United States. As tax practitioners conversant with developments in the area, we anticipate that Australia will soon be developing bilateral APA applications with Singapore.

The number of total APAs in Australia increased from 20 or fewer APAs per year in the pre-2000, 2000, and 2001 period to 38 in 2005, 27 in 2006, 31 in 2007, and 48 in 2008. Bilateral and multilateral APAs have never reached 20 of Australia's total APAs. In fact, there were just 4 bilateral and multilateral APAs in 2000. These data reflect program life, including renewals.

THE ATO'S APA WORK IN PROCESS

The ATO divides its APA work in process into these categories:

	At June 30, 2007	At June 30, 2008
Discussion stage	18	29
Pre-filing stage	3	20
Filed and in process	41	23
Includes bilateral APAs	18	23

APA ISSUES AND METHODS

The ATO categorizes APAs by type of activity during the 2007–2008 year:

Type of Dealing	Primary Activities	All Activities
Tangible Property	36	36
Intangible Property	3	5
Services	9	18
Total completed	48	

Several APAs cover more than one type of activity. For example, an APA might cover the selling of tangible property and the receiving of management services. The

ATO lists the primary activity first and totals all covered activities in the right-hand column. The broad categories encompass these activities:

- Sales and purchases of goods, made by marketers, distributors, and manufacturers
- Sales of commodities and sales of semicompleted goods
- Licensing of intellectual property
- Services, including financial services and research and development
- Management services and other support services

The APA process in Australia involves the selection of primary transfer pricing methods. As in previous years, taxpayers and the ATO primarily use the transactional net margin method (TNMM). Taxpayers in Australia have ready access to independent comparable data in Australia and elsewhere to show that their related party dealings achieve an arm's length outcome. The tested party might be in Australia or elsewhere, depending on the facts of the case. The taxpayer can also use the TNMM to establish routine returns in a residual profit split:

Primary Methods	
TNMM—Return on Assets	8
TNMM—Sales	24
TNMM—Costs/Berry	4
Method	
Profit Split	3
Comparable uncontrolled price	7
Cost Plus	2
Total	48

The taxpayer should note that Australia's primary methods do not include the resale method.

China Implements Transfer Pricing Procedures

THE CHINESE tax authorities have implemented transfer pricing regulations. These transfer pricing provisions came into force in January 1, 2008, but the tax authorities postponed the contemporaneous documentation requirements until December 31, 2009.

OVERVIEW

The tax practitioner should be aware of three specific facets of the Chinese transfer pricing regulations in particular:

1. The Chinese tax authorities cast "associated enterprises" in a broad net. As a result, the tax authorities in other countries might not view these associated parties, and relationships among these parties, as constituting control. Nevertheless, the Chinese tax authorities would treat these associated parties as constituting associated enterprises and therefore as constituting control. The reader should examine Article 9 in particular.