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[Insert client name]

[Insert client position]

[Insert company name]

[Insert client address]

[Suburb state postcode]

Dear [insert client name],

**Re:** **Transfer pricing rules and documentation requirements**

The scope and complexity of Australia’s transfer pricing regime has increased considerably following the enactment of more stringent and robust domestic transfer pricing rules set out in Subdivisions 815-B to 815-E of the *Income Tax Assessment Act* 1997 (***ITAA 1997***).

This self-assessment regime also effectively requires a taxpayer to prepare and maintain transfer pricing documentation to demonstrate that the taxpayer’s cross-border transactions are at arm’s length in accordance with the transfer pricing legislation before the taxpayer lodges its income tax return for the year in which those transactions occur.

Whilst the legislation does not mandate the compilation of such, any failure to do so will prevent an entity from establishing that is has a reasonably arguable position in contesting any penalties later imposed on any tax shortfall (i.e. underpayment of tax) arising from a transfer pricing adjustment.

Recognising this considerable compliance burden the Australian Taxation Office (**ATO**) has also issued optional simplified transfer pricing documentation as an administrative concession to simplify transfer pricing record keeping rules imposed on certain smaller taxpayers.

However, even where these administrative concessions apply, taxpayers will still be required to complete an ‘International Dealings Schedule’ when completing their income tax return for the year ended 30 June 2021 where the aggregate amount of the transactions or dealings with international related parties (including the value of property transferred or the balance outstanding on any loans) is greater than $2 million.

Accordingly, in this letter, we provide an overview of the following:

1. Transfer Pricing Rules under Subdivisions 815-B to 815-E of the *ITAA 1997*
2. Simplified Transfer Pricing Documentation Requirements
3. 2021 International Dealings Schedule.

**Transfer Pricing Rules**

Subdivision 815-B of the *ITAA 1997* requires an Australian resident entity to calculate its aggregate Australian tax position on the basis that the actual conditions of its cross-border transactions be substituted with the arm’s length conditions that should have applied to such transactions where the Australian entity and the overseas entity were not acting at arm’s length.

In these circumstances, a transfer pricing benefit will arise for the Australian entity being either an increase in its taxable income or withholding tax on interest and royalties, or a decrease in its tax loss, net capital loss or tax offset depending on the nature of the particular adjustment.

Some of the key features of the transfer pricing rules under Subdivision 815-B are as follows:

* the operation of the transfer pricing rules has traditionally been limited to related party international transactions. However, Subdivision 815-B applies to all cross-border transactions entered into by Australian entities including those with unrelated parties
* Subdivision 815-B applies to cross-border transactions with overseas entities located in a jurisdiction in respect of which Australia has a double tax treaty and with entities in non-treaty countries
* the cross-border test is widely defined but will be usually met where the resident entity is operating in Australia and the non-resident entity operates offshore in its country of jurisdiction and not through a permanent establishment operating in Australia
* it is necessary to first determine the actual conditions between the Australian entity and the overseas entity in connection with their commercial or financial relations. Such conditions include, amongst others, the price paid for goods and services, the terms of any agreement and the division of profits amongst the Australian and overseas entity
* these actual conditions must then be compared to the arm’s length conditions that would have applied to the cross-border transaction being conditions that might be expected to operate between independent entities dealing wholly independently with one another in comparable circumstances
* in determining such arm’s length conditions, a taxpayer must use the most appropriate and reliable arm’s length pricing methodology available, for example, the comparable uncontrolled price method, resale price method, cost plus method, profit split method or transactional net margin method
* the ATO has issued detailed Taxation Rulings on the four step process taxpayers should follow in identifying and applying the most appropriate arm’s-length methodology as set out in Taxation Ruling TR 98/11 as well as guidance on the application of the above arm’s-length transfer pricing methodologies which is discussed in Taxation Ruling TR 97/20.

Crucially, the Commissioner of Taxation can reconstruct the actual conditions of a cross-border transaction in certain circumstances including, amongst others, where the legal form of a commercial transaction between parties is inconsistent with the commercial substance of the transaction. Further guidance on the application of this reconstruction provision in section 815-130 of the *ITAA 1997* is set out in Taxation Ruling TR 2014/6.

Subdivision 815-C of the *ITAA 1997* extends the application of the amended transfer pricing rules to the allocation of profits which are attributable to a permanent establishment, whilst Subdivision 815-D of the *ITAA 1997* ensures that the transfer pricing rules apply to the calculation of the net income of a trust or a partnership in the same way that they apply to the calculation of a company’s taxable income.

As discussed, taxpayers must also compile transfer pricing documentation of all its cross-border transactions for a year before the date the entity lodges its tax return in respect of the year in which those transactions occurred. Where such contemporaneous documentation is not prepared the entity will not be able to demonstrate that it has a reasonably arguable position should a transfer pricing adjustment penalty later be made by the ATO in relation to that tax year.

Such documentation must provide details of the actual and arm’s-length conditions of each cross-border transaction, the arm’s length methodology selected to determine those arm’s length conditions, the comparability factors used in identifying the arm’s-length conditions, and the application of the selected arm’s length methodology to the particular cross-border transaction.

Taxation Ruling TR 2014/8 further clarifies the records that must be kept in order for a taxpayer to develop a reasonably arguable position whilst the application of the penalty provisions is discussed in Practice Statement PSLA 2014/2.

It should be noted that Subdivision 815-E of the *ITAA 1997* also imposes specific and detailed reporting obligations on ‘country by country reporting entities’[[1]](#footnote-1). These obligations are typically referred to as Country by Country (CbC) reporting but may also, amongst other obligations, require the lodgement of General Purpose Financial Statements in addition to CbC reporting.

For these purposes an entity will be a significant global entity and potentially a ‘country by country reporting entity’ for the year ended 30 June 2021 ifit is a global parent entity whose annual global income for the 2021 year is $1 billion or more, or if the entity is a member of a group of consolidated entities for accounting purposes where the group’s global parent entity has an annual global income of $1 billion or more for the 2021 year or it is a member of a notional listed company group and one of the other group members is a global parent entity with an annual global income of $1 billion or more

Given the complexity of the CbC reporting regime, it is recommended that specialist advice be obtained by any Australian resident entity which is subject to its reporting requirements.

### Simplified transfer pricing documentation requirements

Practice Statement PSLA 2014/3 allows certain smaller taxpayers the option of meeting simplified transfer pricing documentation requirements. Where these simplified options are applied, eligible taxpayers will not be liable for a 25 per cent penalty if they do not have a reasonably arguable position because they do not have full transfer pricing documentation. However, such taxpayers are not relieved of their broader obligation to ensure that all their cross-border transactions are compliant with the transfer pricing rules.

Practical Compliance Guideline PCG 2017/2 provides that simplified transfer pricing record keeping options are available for:

* taxpayers whose international related party dealings (**IRPDs**) do not exceed 2.5 per cent of the total turnover of its Australian economic group for accounting purposes where the turnover of the Australian economic group does not exceed $100 million and where related party dealings involving royalties, licence fees or research and development arrangements do not exceed $500,000
* ‘small taxpayers’ which are part of an Australian economic group whose aggregated turnover is less than $50 million, where such entities are not distributors and do not have related party dealings involving royalties, licence fees or research and development arrangements totalling more than $500,000 or who engage in specified service related party dealings which are greater than 15 per cent of turnover
* distributors who are part of an Australian economic group whose aggregated turnover is less than $50 million and who do not have a profit-before-tax ratio of less than 3 per cent, do not have related party dealings involving royalties, licence fees or research and development arrangements totalling more than $500,000
* an Australian entity’s technical services (i.e. engineering, architecture and industrial design services) where the income and expenditure on services received or provided are not more than 50 per cent of the total IRPDs of its Australian economic group, and there is a mark-up on costs of 10 per cent or less for services received or 10 per cent or more for services provided
* taxpayers engaged in low value adding intra-group services where the combined value of the services provided and received are $2 million or less, or the total amount charged for services received does not exceed 15 per cent of the total expenses of the Australian economic group, or the total amount charged for services provided does not exceed 15 per cent of the total revenue of the Australian economic group, the low value adding intra-group services cannot be more than 25 per cent of the pre-intra-group services charges profit and the mark-up on the costs of the services provided is at least 5 per cent where the services are provided or do not exceed 5 per cent where services are received
* taxpayers who are part of an Australian economic group whose combined cross-border loan balance is $50 million or less at all times during the income year and where the interest rate charged on AUD dollar denominated inbound borrowings is not more than 1.79 per cent for the year ended 30 June 2021 or
* taxpayers who are part of an Australian economic group whose combined cross-border loan balance is $50 million or less at all times during the income year where the interest rate charged on AUD dollar denominated outbound borrowings is not less than 1.79 per cent for the year ended 30 June 2021.

Some of the options may be subject to additional eligibility conditions which must be met. For example, the options for small taxpayers, distributors, low-level inbound and outbound loans, technical services and intra-group services will not be available if the taxpayer has sustained tax losses for three consecutive years (including the current year) or has undergone a restructure in the current income year. Accordingly, reference should be made to Practical Compliance Guideline PCG 2017/2 to confirm that all conditions associated with the use of any selected transfer pricing record keeping option is fully satisfied.

The above simplified record keeping options do not apply to IRPDs of a capital nature (excluding the options for low-level inbound and outbound loans).

**International Dealings Schedule**

Where taxpayers undertake transactions or dealings with international related parties over the specified A$2 million threshold (including average loan balances) of total transactions, the taxpayer must disclose such transactions at Section A of the International Dealings Schedule (**IDS**).

Small business entities, being those entities whose aggregated turnover is less than $10 million, whose IRPDs do not exceed $5 million and 50% of the aggregated turnover for the 2021 income year, are not required to complete Section A.

‘IRPDs’ refer to commercial or financial dealings or relations between related parties including back-to-back arrangements. A relationship with an international party exists where either entity participates in the management, control or capital of the other entity, or simply conduct transactions that are not at arm’s length.

IRPDs include any type of transaction be it on revenue or capital account (including the provision of loans, the provision of services and the licence of intellectual property).

For each distinct transaction type, taxpayers are required to disclose the transfer pricing methodology applied and percentage of contemporaneous Australian transfer pricing documentation that is kept for each ‘type’ of IRPD.

It is important to note that, in the event of a business restructure (including transfers of functions, assets and risks), a narrative is also required and taxpayers will need to describe the restructure and specify whether a professional valuation study or transfer pricing analysis of the event has been performed.

If you are eligible to apply a simplified record-keeping option because you fall within one of the categories discussed above, then at the relevant labels on the IDS you would include Code 7 at the percentage of documentation label code. This confirms that you have assessed your situation as complying with the transfer pricing rules and advised the ATO that a simplification option has been applied to your record keeping.

It is strongly recommended that significant attention is given to the accuracy and nature of the disclosures made by the taxpayer in the preparation of the IDS.

In closing, we reiterate the transfer pricing rules operate on a self-assessment basis, and that public officers must turn their minds to the veracity of the pricing of their cross-border transactions before signing and lodging returns.

If you have further queries on any details contained within this letter or on any other matter, please do not hesitate to contact me on [insert telephone number].

Yours faithfully,

**[Insert partner name]**

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1. Changes were made to the CbC reporting provisions, including the introduction of a new category of ‘country by country reporting entities’. There are also some changes to the determination of a ‘significant global entity’. These changes apply for income years starting on or after 1 July 2020. [↑](#footnote-ref-1)