[Insert DD month YYYY]

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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 expects 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 or low risk 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 2023 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* (with a focus on Subdivision 815-B due to its wider application)
2. Simplified Transfer Pricing Documentation Requirements
3. 2023 International Dealings Schedule.

**Transfer Pricing Rules**

Broadly, 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 other words, the actual pricing of the cross border related party transaction can be substituted by what the ATO considers to be an arm’s length price.

The adjustment seeks to negate any transfer pricing benefit for the Australian entity. The adjustment could result in an increase in an entity’s 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:

* 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 determination of arm’s length conditions should be rendered consistently with the principles set out in the *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, as approved by the Council of the Organisation for Economic Cooperation and Development and last amended on 19 May 2017.

Crucially, the Commissioner of Taxation can reconstruct the commercial or financial relations in connection with which the actual conditions in certain circumstances including, amongst others, where the form of a relation between parties is inconsistent with the substance of the relation, or where there is strong evidence to suggest that the actual relation is not commercially realistic. 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.

With the March 2023 release of draft legislation on changes to the thin capitalisation rules (Division 820 of the *Income Tax Assessment Act 1997)*, taxpayers should consider the interaction between the thin capitalisation rules with the transfer pricing provisions. In particular, taxpayers may consider whether the reconstruction provisions under section 815-130 could apply to deem a different capital structure (i.e. quantum of debt) for affected taxpayers. This goes beyond the pricing of debt (note: the old thin capitalisation rules limit arm’s length pricing of debt determined under transfer pricing rules to be applied to actual debt issued).

Subdivision 815-C of the *ITAA 1997* extends the application of the modernised 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 are expected to compile transfer pricing documentation for their cross-border transactions for a year by the date of lodgement of the tax return in respect of the year in which those transactions occur. 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 income year.

Such documentation must provide details of the actual and arm’s length conditions of relevant 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 standard of documentation 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 PS LA 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-2). 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 2023 if:

* it is a global parent entity whose annual global income for the 2023 year is A$1 billion or more, or
* 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 A$1 billion or more for the 2023 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 A$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 may be subject to CbC reporting requirements.

### Simplified transfer pricing documentation requirements

Practice Statement PS LA 2014/3 allows certain smaller or low risk taxpayers to apply simplified transfer pricing documentation options. Where these simplified options are applied, eligible taxpayers will not be liable for a tax shortfall 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 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 generally 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, do not have related party dealings involving royalties, licence fees or research and development arrangements totalling more than $500,000 and do not 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, do not have a profit-before-tax ratio of less than 3 per cent and 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 from and expenditure on services provided or received 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, 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 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 5.65 per cent for the year ended 30 June 2023 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 5.65 per cent for the year ended 30 June 2023.

Some of the options may be subject to additional eligibility conditions which must be met. For example, the options for small taxpayers, materiality, 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 are fully satisfied.

For all the above simplified options, taxpayers are still required to assess their situation as complying with the transfer pricing rules while the level of assessment is expected to be lighter than a detailed assessment.

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 enter into IRPDs over the specified A$2 million threshold (including loan balances), the taxpayer must disclose the IRPD details 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 2023 income year[[2]](#endnote-2), are not required to complete the bulk of 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 conducts transactions in the context of not being wholly independently with one another.

IRPDs include any type of transaction be it on revenue or capital account between different persons or entities. IRPDs do not include dealings within own branch operations.

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 (typically involving 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 in 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 simplified 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.

**Transfer Pricing Risk Assessment**

The ATO has also released multiple Practical Compliance Guidelines (PCGs) which broadly facilitate the risk assessment of a taxpayer’s relevant international related party dealings from a transfer pricing perspective. The relevant PCGs include the following:

* PCG 2017/1: ATO compliance approach to transfer pricing issues related to centralised operating models involving procurement, marketing, sales and distribution functions
* PCG 2017/4: ATO compliance approach to taxation issues associated with cross-border related party financing arrangements and related transactions
* PCG 2019/1: Transfer pricing issues related to inbound distribution arrangements
* PCG 2020/1: Transfer pricing issues related to projects involving the use in Australian waters of non-resident owned mobile offshore drilling units – ATO compliance approach
* PCG 2020/7: ATO compliance approach to the arm’s length debt test
* PCG 2021/D4 – Intangibles Arrangements

If relevant, it is recommended that your international related party dealings be risk assessed against applicable PCGs and risk mitigation actions be taken if required.

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]**

1. Changes were made to the CbC reporting provisions, including the introduction of a new category being a ‘country-by-country reporting entity’ (as a subset of a ‘significant global entity’). These changes apply to income years starting on or after 1 July 2019. [↑](#footnote-ref-2)
2. As at the date of authoring this letter, the 2023 instructions had not been issued. [↑](#endnote-ref-2)