

1-1-2004

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Recommended Citation

Markham, Michelle (2004) "Complying with Australian and PATA Transfer Pricing Documentation Rules - A Sisyphean Task?," *Revenue Law Journal*: Vol. 14 : Iss. 1 , Article 8.
Available at: <http://epublications.bond.edu.au/rlj/vol14/iss1/8>

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Complying with Australian and PATA Transfer Pricing Documentation Rules - A Sisyphean Task?

Abstract

With the increase in international trade, revenue authorities are taking an aggressive approach to transfer pricing. This article argues that Australian documentation requirements are particularly cumbersome and can give rise to unreasonable application of penalty provisions, given the lack of clarity in the rules. It recommends improved rule clarity and a 'one-strike' safe harbor. Australia has joined with the United States, Canada and Japan to produce a multilateral transfer pricing documentation package in response to concerns that the documentation burden is excessive. This article argues that although the package is a good first step, it does not yet meet its goals of certainty, flexibility and cost-saving.

Keywords

international trade, transfer pricing, tax

Cover Page Footnote

This is an adaptation/extract from Michelle Markham, *The Transfer Pricing of Intangibles* (2005 Kluwer Law International) (forthcoming).

COMPLYING WITH AUSTRALIAN AND PATA TRANSFER PRICING DOCUMENTATION RULES - A SISYPHEAN TASK?¹

*Michelle Markham**

With the increase in international trade, revenue authorities are taking an aggressive approach to transfer pricing. This article argues that Australian documentation requirements are particularly cumbersome and can give rise to unreasonable application of penalty provisions, given the lack of clarity in the rules. It recommends improved rule clarity and a 'one-strike' safe harbor. Australia has joined with the United States, Canada and Japan to produce a multilateral transfer pricing documentation package in response to concerns that the documentation burden is excessive. This article argues that although the package is a good first step, it does not yet meet its goals of certainty, flexibility and cost-saving.

The multiple, highly nuanced, and sometimes conflicting, interpretations of the arm's-length standard, reflected in the substantive transfer pricing rules and administrative requirements of various jurisdictions, impose significant compliance burdens on taxpayers. Indeed, adherence to the arm's length standard and administrative practices of a single jurisdiction is more art than science.²

It is one thing to beat your chest and scare people into compliance. But tax law is so 'absurdly complex' that both taxpayers and tax officers have trouble understanding it.³

1 This is an adaptation/extract from Michelle Markham, *The Transfer Pricing of Intangibles* (2005 Kluwer Law International) (forthcoming).

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2 Letter submitted on 5 September 2002, by TEI President Drew Glennie to Carol Dunahoo, Director of International for the Internal Revenue Service, and Tom Crowe of the International Directorate of Canada Customs and Revenue Agency, commenting on a transfer pricing documentation package developed by the Pacific Association of Tax Administrators (PATA), 1-2. See: <<http://www.tei.org/PATA.html>>.

3 'Taxman's next targets' (June 30, 2004) *The Age*, quoting S Wolfers, Tax partner with the Australian legal firm Thomson Playford.
<[http://www.theage.com.au/articles/2004/06/30/1088488000233.html?from+storylhs\\$oneclick=true](http://www.theage.com.au/articles/2004/06/30/1088488000233.html?from+storylhs$oneclick=true)> 'Taxman's next targets', *The Age*, June 30 2004, <<http://www.theage.com.au.htm>>

Introduction: Local and International concerns with transfer pricing documentation requirements

International transfer pricing, essentially the pricing of intercompany transactions between international associated enterprises and the determination of the amount of income to be allocated to each party, is one of the most important international tax issues facing a multinational enterprise (MNE) in the 21st century. A corollary of the significant increase in global trade, especially via international inter-affiliate transactions, has been a rise in government concerns with the loss of potential tax revenue. Many tax authorities around the world are now aware of the necessity of safeguarding their tax base through stringent transfer pricing documentation rules and concomitant penalties for failure to comply with these rules, and Australia has proved to be no exception.

The Ernst & Young 2003 Global Transfer Pricing Survey,⁴ conducted biannually since 1997, confirmed trends identified in earlier surveys. Among these were that transfer pricing is the major international tax issue facing MNEs and tax administrations alike, and that the compliance aspects of transfer pricing outweigh other aspects in importance.⁵ Although MNEs have witnessed an era of economic uncertainty and a decline in the pace of expansion following the events of September 11, 2001, inter-affiliate trade has continued to maintain its significant role in the international economy. At the same time, revenue authorities around the world have been stepping up their efforts to scrutinise transfer pricing transactions. There has been an increase in audits as well as more aggressive legislative enforcement efforts, including increasingly burdensome transfer pricing documentation requirements and the imposition of onerous penalties for non-compliance with these requirements. In the US, for example, it has been said that:

In effect, Congress has transferred the burden of conducting a transfer pricing audit to taxpayers, has required that inter-company transfers be supported with complete documentation and has backed up these Regulations with heavy penalties.⁶

4 Ernst & Young, *Transfer Pricing 2003 Global Survey: Practices, Perceptions and Trends in 22 Countries Plus Tax Authority Approaches in 44 Countries* (2003).

5 C Casonovas et al, 'Ernst & Young 2003 Global Survey: Transfer Pricing Is Once Again #1 With a Bullet' 15 *Journal of International Taxation* 10, 10.

6 Connors PJ and Patton MF, 'United States: New Transfer Pricing Penalty Regulations Require Immediate Action To Avoid Overvaluation Penalties' (1994) 48 *Bulletin For International Fiscal Documentation* 529, 532.

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Michael Carmody, the Australian Commissioner of Taxation, has commented that:

Transfer pricing has been an area of Tax Office focus for some time and with globalisation and the significant increase in related party cross border transactions this will continue. Since 1999 we have undertaken more than 400 transfer pricing risk reviews and completed nearly 100 audits resulting in \$615m additional tax and penalties being raised.⁷

Australia was one of the first of the world's major economies to introduce effective transfer pricing rules.⁸ In the past, MNEs in Australia merely set their transfer prices. Now they face onerous documentation rules, harsh penalties, and an increased risk of audit. Where the Australian Taxation Office (ATO) does not agree with an MNE's transfer pricing policy, as is increasingly the case, this can lead to lengthy and expensive disputes. The Australian Tax Office is becoming internationally renowned for being 'among the most aggressive in pursuing transfer pricing audits.'⁹

The Commissioner has further commented that in relation to the ATO's 2004-05 Program, the plan is to use just over 50% of its budget on compliance, with around two-thirds of this amount being directed at 'active compliance',¹⁰ in other words on risk identification and resulting reviews, audits, investigations and prosecutions. The number of staff engaged in active compliance in 2004 is up by 600 over the previous year. The aggressive review and enforcement of transfer pricing documentation regulations forms part of this focus on taxpayer compliance, and is clearly on the rise in Australia.

The arm's length standard

Tax compliance practices are developed according to each country's own domestic legislation and administrative procedures, therefore each country enforces its own specific documentation rules and regulations, as well as its own particular penalties for non-compliance. At first glance, a unifying theme is that these competing enforcement regimes have introduced transfer pricing documentation requirements

7 Michael Carmody, 'Large Business And Tax Compliance A Corporate Governance Issue' Leader's Luncheon Address by Commissioner of Taxation, 10 June 2003, Sydney, NSW, 5.

8 Ernst & Young, *Transfer Pricing 2003 Global Survey*, above n 4, 4.

9 MM Levey and D Balaban, 'Global Documentation - Many Considerations?' (2003) 44 *BNA Tax Management Memorandum* 1, 7.

10 Michael Carmody, *The 2004-05 Compliance Program* (2004) Commissioner of Taxation, Address to the Chatswood Chamber of Commerce, 17 August 2004, Sydney, NSW, 2.

that enforce compliance with the internationally accepted arm's length standard. This standard has been endorsed by the Organisation for Economic Cooperation and Development (OECD) in its Transfer Pricing Guidelines for Multinational Enterprises and National Tax Administrations (the 'OECD Guidelines'), introduced in 1995.

In Australia the term 'arm's length' appears in Division 13 of the Australian Income Tax Assessment Act 1936 (Division 13). Division 13 applies to both residents and non-residents, and refers to the arm's length consideration as determined by the Commissioner.¹¹

Although the term 'arm's length' is used, no definition of the term is provided in the legislation. However, the ATO offers the following explanation:

The arm's length principle uses the behaviour of independent parties as a guide or benchmark to determine the allocation of income and expenses in international dealings between associated enterprises. It requires a comparison between what the taxpayer has done and what a truly independent party would have done in the same or similar circumstances.¹²

All OECD countries comply with this so-called arm's length standard, but the problem is the lack of a single definition that is used on a global basis, and thus there are national variations on its application. This lack of consistency is understandably a source of confusion to MNEs. While the OECD provides a general framework for transfer pricing legislation or rules, no two countries have synonymous transfer pricing rules. MNEs are thus compelled to comply with differing transfer pricing rules and documentation requirements in the countries in which they do business - a time-consuming and costly procedure.

11 Section 136AD(1) provides:

Where:

a taxpayer has supplied property under an international agreement;

the Commissioner, having regard to any connection between any 2 or more of the parties to the agreement or to any other relevant circumstances, is satisfied that the parties to the agreement, or any 2 or more of those parties, were not dealing at arm's length with each other in relation to the supply;

consideration was received or receivable by the taxpayer in respect of the supply but the amount of that consideration was less than the arm's length consideration in respect of the supply; and

the Commissioner determines that this subsection should apply in relation to the taxpayer in relation to the supply, then, for all purposes of the application of this Act in relation to the taxpayer, consideration equal to the arm's length consideration in respect of the supply shall be deemed to be the consideration received or receivable by the taxpayer in respect of the supply.'

12 Australian Taxation Office, *International Introduction to Concepts and Risk Assessment* (1998) 1.

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In recent years, the US regulations, as well as transfer pricing regulations in other OECD countries (such as Australia), have come to rely more heavily on self-assessment and related documentation requirements, thus placing the burden of transfer pricing compliance on taxpayers. In 1999, the Australian *Ralph Report* recommended that Australia's international transfer pricing rules be modified to apply on a self-assessment basis.¹³ This is part of an ongoing trend: since 1986 Australia's tax system has been one of voluntary compliance, based on self-assessment. Because Australian transfer pricing rules are currently not part of the self-assessment system, they have not been drafted with sufficient clarity and certainty to facilitate voluntary compliance. A move to self-assessment could thus be a positive step forward in devising clear and user-friendly legislation.

In any jurisdiction, the transfer pricing documentation requirements and the penalties imposed for non-compliance are of necessity inextricably connected. However, transfer pricing compliance practices and penalties differ widely according to the characteristics of the tax system involved, and the OECD cautions that care should be taken in comparing different national penalty practices and policies.¹⁴ Documentation requirements which may be regarded as fair and reasonable in one jurisdiction may be regarded as unnecessarily cumbersome and detailed in another jurisdiction, depending on a host of different factors, including the number of MNEs in the particular jurisdiction, the overall compliance measures taken, the judicial system, the sophistication of the revenue authorities, etc. The OECD also makes it clear that the information relevant to an individual transfer pricing enquiry depends on the facts and circumstances of the particular case at hand, making it impossible to make generalisations as to the precise extent and nature of information that it would be reasonable for a tax administration to require.¹⁵

13 *Review of Business Taxation Report - A Tax System Redesigned*, 1999 ¶22.12, ('*The Ralph Report*'). The commentary on this recommendation states that:

Consultation and submissions supported this approach...and indicated that many businesses currently self-assess in practice. This is despite the current provisions formally requiring the Commissioner to exercise a statutory discretion to apply an arm's length consideration to dealings which have been undertaken on a non-arm's-length basis and that reduce Australian revenue (that is, where profits have been shifted offshore). This recommendation is consistent with the general self-assessment structures of the income tax law.' Interestingly, a further comment made was that: 'Some submissions also raised the question whether self-assessment for transfer pricing should extend to non-arm's length dealings that increase Australian revenue (that is, where profits have been shifted to Australia). This is not internationally accepted practice and is not recommended. Countries typically only provide for a reduction in their tax revenue as a result of transfer pricing adjustments through DTAs.

14 OECD Guidelines, 4.19.

15 Ibid 5.16.

Tax jurisdictions may adopt a number of different types of penalties - there is no uniform penalty. As a general rule, compliance is promoted through civil rather than criminal sanctions in OECD Member countries, and typically a monetary sanction is involved. The OECD warns that it is difficult to evaluate in the abstract whether the amount of a civil monetary penalty imposed is excessive.¹⁶

While the OECD offers advice to revenue authorities concerning their national documentation rules, it also encourages both tax administrations and taxpayers to commit themselves to greater international levels of cooperation in addressing documentation issues.¹⁷ This is seen as a concrete way of curtailing the need for excessive documentation, while still providing sufficient information for the application of the arm's length principle. There is a growing realisation that revenue authorities could save themselves and taxpayers time and money by adopting a global standard for transfer pricing documentation. New legislation setting out clear and workable rules would form an appropriate starting-point for an internationally harmonised regime.

Australia is part of a new initiative to seek a common understanding on transfer pricing documentation requirements between four nations. A multilateral transfer pricing documentation package has been proposed by the Pacific Association of Tax Administrators (PATA). The PATA members are Australia, Canada, Japan and the United States. This package has been developed in response to taxpayer comments on the increasingly burdensome task of understanding and satisfying the differing documentation requirements in each jurisdiction. According to the Australian Assistant Commissioner: 'In effect, the PATA Documentation Package creates a voluntary procedure which, if satisfied, will protect the taxpayer from otherwise applicable transfer pricing documentation penalties, if any, in each of the four jurisdictions.'¹⁸

The problems encountered with Australia's national practices in the transfer pricing documentation realm require careful consideration, along with the possible advantages and disadvantages flowing from the PATA Agreement, released in March 2003.

16 Ibid 4.24.

17 OECD Guidelines, 5.29.

18 DV Lewis, Assistant Commissioner, International, Competent Authority, Australian Taxation Office, Letter entitled: '*PATA Transfer Pricing Documentation Package Draft For Consultation*' 17 June 2002.

Transfer pricing documentation requirements in Australia, and the penalties for non-compliance

In Australia, a penalty tax may be imposed under Division 13 where a transfer pricing adjustment is made.¹⁹ If the arrangement was entered into for the sole or dominant purpose of reducing or eliminating tax, a penalty of 50% of the tax avoided must be paid. If the taxpayer had a reasonably arguable position, this is reduced to 25% of the tax avoided. The Commissioner must find that the adjustment relates to a 'scheme' under Part IVA (the anti-avoidance provision). In other cases, a 25% penalty is imposed, or a 10% penalty where the taxpayer has a reasonably arguable position.²⁰ The magnitude of the penalty is thus related to the taxpayer's culpability regarding the reasonableness of its compliance. The problem is that no definition of reasonableness is provided, either in Division 13 or in ATO rulings, and the taxpayer is in effect left 'shadow-boxing' with a nebulous requirement.

According to one Australian transfer pricing partner:

Businesses - particularly smaller to medium sized enterprises already struggling with the weight of tax paperwork - are frankly worried. The increase in information demands from the ATO is becoming a real burden to them in terms of cost, time and the difficulty of matching the output from their accounting software, systems and procedures to the regulatory requirements.²¹

A survey by PricewaterhouseCoopers recently revealed that 97% of businesses surveyed believed that the burden of complying with Australia's transfer pricing regime has increased significantly in the last five years.²²

The message that the increasingly burdensome documentation and penalty requirements is sending to MNEs is that supplying the ATO with sufficient information regarding dealings with associated enterprises is vital in order to avoid penalties, and it is up to the taxpayer to estimate the lengths they need to go to

19 Transfer pricing adjustments are made where a revenue authority decides that an enterprise has not accurately reflected their taxable income from an inter-affiliate transaction.

20 TR 98/16 *Income tax: international transfer pricing - penalty tax guidelines*, Part A Transfer pricing penalties.

21 L James, *Tax compliance burden and audit risk leave business vulnerable to ATO pressure* 23 April 2002, PricewaterhouseCoopers 1.

22 S Edwards, *International tax initiative offers "win-win" for business and the ATO*, 18 July 2002, PricewaterhouseCoopers 1.

establish the arm's length nature of their transactions. From the taxpayer point of view, there is pressure on MNEs to be strategic in their preparation of transfer pricing documentation. They must decide how much information should be supplied to revenue authorities, and whether separate documentation tailored to national priorities and requirements should be drawn up, or whether a single global analysis should be performed for all the regions involved in the inter-affiliate transaction. International transfer pricing practitioners have pointed out that:

Merely preparing documentation, whatever the format or scope, may allow an MNC [multinational corporation] to avoid penalties, but it must be observed that preparation of documentation by no means assures that tax deficiencies will not be assessed. The point simply stated is that, from any documentation perspective, sometimes too much can be as problematic as too little.²³

Schedule 25A documentation

In examining whether an MNE has adopted the arm's length standard, the ATO looks for documentation arising when the transaction was entered into, known as 'contemporaneous' documentation. Maintaining such contemporaneous documentation is no easy task, even for a large MNE with enormous resources at its disposal. Detailed and complex regulations must be adhered to, and there are many pitfalls to be avoided. Keeping up-to-date, accurate and in-depth records of a plethora of details regarding all aspects of transfer pricing transactions is a difficult task - certainly not one that can be adequately fulfilled by maintaining records established in the ordinary course of business of an MNE.

However, such data is required in terms of Division 13, according to Australia's Double Taxation Agreements and also in relation to s 262A of the Income Tax Assessment Act 1936. Taxpayers who are involved in international transactions with related foreign entities are required to lodge an additional tax form, the Schedule 25A, with their annual return.²⁴ The information requirements of this Schedule have been described as 'onerous'.²⁵

The Schedule requires taxpayers, inter alia, to list the four principal methodologies used by total dollar value of revenue derived and expenses incurred. (Transfer

23 Levey and Balaban, above n 9, 3.

24 TR 98/11, 'Income tax: documentation and practical issues associated with setting and reviewing transfer pricing in international dealings' ¶2.7.

25 J Elliott, 'Transfer Pricing: Lessons from Australia' *Discussion Papers in the Department of Management* (University of Southampton 1997) 13.

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pricing methodologies are a means of determining arm's length prices in respect of cross-border transactions). Twelve methodologies are listed, with the proviso that 'not all the methodologies are considered to provide an arm's length outcome, but may be arm's length in some cases'.²⁶ Supporting documentation is also to be provided.

In choosing a methodology for the determination of arm's length pricing, the ATO envisages a '4-step process', namely:

- Understanding the cross-border dealings in the context of the taxpayer's business - that is, characterisation
- Selecting the most appropriate methodology or methodologies
- Applying that methodology
- Establishing review and adjustment processes.²⁷

The ATO acknowledges that the first two processes may be complex, but declines to offer guidance in the Schedule in relation to characterisation and selection. The taxpayer must not only go through these steps, but also provide adequate documentation to demonstrate how and why these steps were taken. Taxation Ruling 98/11²⁸ states that the most important aspects of characterisation are the identification of the scope, type, value and timing of international dealings with associated enterprises in the context of the taxpayer's business, and a functional analysis, ascertaining the most economically important functions, assets and risks and how these might be reflected by a comparable price, margin or profit on the dealings. The problem is that the documentation requirements to achieve this are not only extensive, but may prove difficult to establish.

The ATO makes it clear that in documenting their choice of method to determine arm's length pricing, the prudent taxpayer will not only document the processes of characterisation of the cross-border dealings and the selection of the appropriate methodology, but also the reasons for the final choice of method and the reasons why

26 Schedule 25A instructions 2003, Item 5, 9. The pricing methodologies listed are as follows: comparable uncontrolled price method, resale price method, cost plus method, profit split method, transactional net margin method, marginal costing, cost contribution arrangement, apportionment of costs, apportionment of income, fixed mark-up applied to cost, fixed percentage of resale price, other arm's length methods.

27 Ibid 6.

28 TR 98/11, above n 24, ¶ 5.18.

other methods were considered and rejected.²⁹ It is therefore assumed that taxpayers will undertake the burdensome task of applying more than one methodology to their transaction, and documenting each application. This is in direct contrast to the approach taken by the OECD Guidelines, which explicitly state that the arm's length principle does not require the application of more than one method.³⁰ The complexity of the dealings is supposed to indicate the extent to which analysis and supporting documentation is required, and therefore no guidelines are provided as to what will constitute adequate documentation in any particular situation.

Furthermore, the applicability of the chosen pricing method will usually require two separate processes involving, firstly, an assessment of comparability, and secondly, the collection of supplementary data. The assessment of comparability includes:

- Searching for comparable transactions or enterprises
- Identifying sources of information used in the search
- Adopting transactions or enterprises as being comparable
- Rejecting other transactions as not being comparable
- Providing reasons and amounts where an independent enterprise has been adjusted to make it comparable with the dealings under examination, and
- Applying the pricing method, and any checking method - such as sampling - to ensure the validity of the chosen method and resultant arm's length price.³¹

This first process involves a rigorous assessment of the search for comparable transactions. In reality, revenue authorities as well as taxpayers often have difficulty in obtaining sufficient information about comparable transactions to properly apply the arm's length principle. A substantial amount of data may be needed to evaluate uncontrolled transactions and their similarity to the transactions of associated enterprises. With the globalisation of corporations, and as the trend towards mergers and acquisitions continues, the availability of comparable transactions is becoming increasingly problematic in certain industries.³² This search may prove to be an

29 Schedule 25A instructions 2003, Item 4 *Choice of method to determine arm's length pricing*, 8.

30 OECD Guidelines, 1.69.

31 Schedule 25A instructions 2003, Item 4 *Application of pricing methods*, 8.

32 DR Wright, 'Transfer Pricing in the United States: Recent Events and Expectations for the Future' 55 (2001) *Bulletin For International Fiscal Documentation* 417, 425.

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arduous one, especially where the inter-affiliate transaction concerns assets for which no comparables are readily ascertainable, such as high-profit or unique intangibles.

The Schedule 25A instructions offer no guidance as to what the prudent taxpayer should do in this situation. The question arises as to why it is necessary to compel the taxpayer to spend time documenting why certain transactions are not comparable, rather than concentrating on those independent transactions where comparability is possible. Perhaps the ATO might heed the concerns voiced by the EU Joint Transfer Pricing Forum (EU JTPF) in its 2003 Transfer Pricing Documentation Paper as to whether taxpayers and tax authorities have conflicting or congruent interests.³³ The Forum concluded that both sides have an interest in limiting pointless enquiries, which, quite apart from the frustration that is often involved, waste the resources of both parties. It made the point that if:

tax authorities regard a documentation requirement as a cheap and effective way of generating all the information they might conceivably require then the interests of the two sides will conflict. Taxpayers object when they are forced to spend resources on exercises of limited or questionable relevance to their tax liability.³⁴

Following the assessment of comparability, the ATO specifies that the second process, namely the collection of supplementary data, should involve the assembly of data on profit projections and the creation or acquisition of records to supplement the analysis of comparability and function.³⁵ It should also include the collection of data used to calculate financial performance ratios, as part of the application of the chosen pricing methods. The taxpayer is expected to prepare and retain relevant documentation in relation to both of these processes.

Taxpayers are further warned in Taxation Ruling 94/14³⁶ that the Commissioner is under no obligation to sanction the methodology they finally select and document unless, on an objective analysis, it produces the most accurate calculation of the arm's length consideration in the particular case. In selecting and documenting the most appropriate methodology, they must recognise that Australia should not be denied

33 'EU Joint Transfer Pricing Forum - Business Representatives Transfer Pricing Documentation Discussion Paper' Doc.JTPF/014/BACK/2003/EN, ¶ 2.6

34 Ibid.

35 Schedule 25A instructions 2003, Item 4 *Application of pricing methods*, 8.

36 TR 94/14 'Income tax: application of Division 13 of Part III (international profit shifting) - some basic concepts underlying the operation of Division 13 and some circumstances in which section 136 AD will be applied', ¶ 344.

its fair share of tax, but also that a fair share does not necessarily mean a result that produces the highest amount of Australian tax, or a result that produces the most favourable taxation outcome for the MNE. The most relevant and practical advice given is that the most appropriate method will be the one that produces the highest practicable degree of comparability. However, the proviso is added that there will be unique situations and cases involving valuable intangibles where it is *not* practicable to apply methods based on a high degree of direct comparability. No further guidance is given on the procedure to be adopted in these circumstances. Considerable difficulties thus arise when an MNE involved in, for example, intangible asset transactions has to document exactly why its chosen methodology is appropriate, given the lack of direct comparability inherent in such transactions.

It is to be hoped that the ATO will take note of the OECD's encouragement of tax examiners to take into account the taxpayer's commercial judgment about the application of the arm's length principle, so that the documentation supporting the transfer pricing analysis is tied to business realities. In fact, the OECD suggests that tax examiners should take as a starting point in their transfer pricing analysis the perspective of the methodology that the taxpayer has chosen in setting its prices.³⁷

As mentioned above, applying and documenting the chosen methodology will require the separate processes of a) an assessment of comparability and b) the collection of supplementary data. Finally, processes for review and adjustment to the chosen methodology should be provided by the taxpayer, in the event that the ATO deems such alterations to be necessary. Although following this approach is not compulsory, according to the ATO, where taxpayers properly develop, implement and document these four steps they are less likely to expose themselves to transfer pricing adjustments.³⁸ Few taxpayers would rashly disregard following this 'non-compulsory' approach, thereby leaving themselves open to the above-mentioned penalties imposed for the lack of a 'reasonably arguable position'.

Practitioners are concerned that Schedule 25A could be used to target certain taxpayers for audit, according to the methodology or methodologies selected, and the documentation provided to substantiate this choice. In practice, subsidiaries may bargain with the parent company rather than use an approved methodology, but in order to comply with documentation requirements and not arouse undue ATO interest they are compelled to carry out extensive and expensive (non-value-added) reviews of their pricing to demonstrate compliance with Schedule 25A

37 OECD Guidelines 4.9.

38 TR 98/11, above n 24, ¶ 5.4.

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requirements.³⁹ There is some irony here, as 'real bargaining' is often taken as a sign of the arm's length treatment of a transaction.

In early 2003, it was reported that the ATO had announced that it would be reviewing more than 500 taxpayers and that it may select a company based on its transfer pricing disclosures in its Schedule 25A, where it did not measure up to the ATO's risk assessment model.⁴⁰ A tax practitioner observed that in his view, many smaller businesses fell into the trap of believing that documentation created as part of ordinary business operations, and used to set prices, would satisfy the ATO.⁴¹

Unfortunately, the ATO does not specify the extent of the documentation required, other than to state that it 'does not expect taxpayers to prepare or obtain documents beyond the minimum needed to make a reasonable assessment of whether they have complied with the arm's length principle in setting prices or consideration'.⁴² Without specific guidance as to revenue interpretation of the terms 'minimum' and 'reasonable', this statement is too vague to be helpful. Documentation created in the ordinary course of the taxpayer's dealings to establish prices in international related party dealings, such as invoices and orders, are not regarded as evidence of the arm's length nature of such prices, so taxpayers are compelled to create documentation over and above this. No checklist of documentation that would be adequate or desirable is provided, the ATO maintaining that this will depend on the individual facts and circumstances of each case, with taxpayers using their commercial judgment according to what a prudent business person would do in such circumstances.⁴³

The EU JTPF's comments that every day commercial judgements are exercised by hundreds of business managers within MNEs, on the basis of proper economic and commercial conclusions with respect to the profitability and cost price calculations necessary to maintain the business.⁴⁴ It observes that these decisions should not have to be documented beyond what is necessary for the proper functioning of the business, as this is not only impractical but adds no economic value to the business. It further advises that a great deal of wasted time and effort could be spared if transfer pricing documentation requirements were in line with the normal

39 Elliott, above n 25, 15.

40 M Fenton-Jones, 'Offshore Dealings Under Scrutiny' *Australian Financial Review*, March 4, 2003.

41 Ibid, quoting BDO partner Cameron Allen.

42 Schedule 25A instructions 2003, Item 4, *Adequacy of documentation* 7.

43 Ibid.

44 EU Joint Transfer Pricing Forum, above n 33, 1-2.

reporting/accounting systems required for proper management and compliance with annual financial reporting regulations. Additional information should only be requested where this is strictly necessary, as it may be of no material value to the revenue authorities. This sensible approach takes into account the needs of both tax authorities and taxpayers, and provides food for thought regarding the Australian documentation requirements.

In Australia, practitioners are also concerned about the 'contemporaneous' nature, or timing of the preparation of the documentation. The Transfer Pricing Partner for Deloitte Touche Tohmatsu has commented that taxpayers who conduct post lodgement prudential reviews and create documentation of a non-contemporaneous nature will not be safe from penalties, adding that taxpayers who have made the effort to create such documentation should not face penalties in addition to any proposed adjustments: 'while we acknowledge that the ATO's aim is to encourage companies to get their documentation in order, the lack of reduced penalties in relation to non-contemporaneous documentation ... may be seen as a disincentive'.⁴⁵

In addition, if the documentation supplied by the MNE is incomplete, ie if it lacks sufficient supporting evidence of an arm's length methodology, the taxpayer will find it difficult to avoid the imposition of penalties. Under this self-assessment system, the onus is on the taxpayer to supply all the necessary documentation on intrafirm transactions, and to ensure compliance with the arm's length principle. A study conducted by the ATO in 1999 revealed that most companies do not meet revenue documentation requirements, and a decision to increase audit activity has been made by the Commissioner.⁴⁶ It is submitted that a move by the ATO to clarify what revenue's requirements are would go a long way to solving this problem.

Recommendation on simplicity, ease of administration, fairness and clarity of documentation/penalty rules

A general recommendation that penalty provisions should be simple, easy to administer, fair and clear may be seen as an idealistic but impractical response to the issue at hand. Experience has demonstrated that *simplicity* is almost impossible to achieve: inter-affiliate transfer pricing transactions are inherently complex transactions, necessitating a detailed examination involving extensive documentation

45 D Goldner, 'ATO Adopts "No Fault-No Penalty" Line to Transfer Pricing', Press Release 5 November 1998 <<http://www.deloitte.com.au/library/677.asp>>.

46 'Tax Office Steps-Up Action On Transfer Pricing', Media Release - Nat 99/36 5 July 1999, 1.

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individually tailored to a particular taxpayer's operations and transactions in order to determine whether an arm's length price was paid. Complex legislation and rules regarding documentation are rarely *easy to administer*, but some suggestions can be made which will simplify administration and reduce the costs of monitoring transfer pricing transactions in the long term. Finally, *fairness* and *clarity*, perhaps the two most important characteristics required of taxation regulations, are not impossible aims, and some suggestions will be made to this end. As these criteria are often interconnected, they will be discussed together.

The problems associated with the lack of clarity of documentation rules can be discussed on two levels: on a general basis and on a specific basis applicable to individual taxpayers.

Clarifying rules on a general basis

In Australia there is a lack of clarity as to the specific nature and extent of transfer pricing documentation required: the guidelines provided are at too high a level of generality. It is recommended that the ATO outline more specific requirements, as it is obviously extremely dissatisfied with the level of documentation to date. According to the Commissioner of Taxation:

I am concerned in particular about the very poor level of documentation we found in the record reviews of 190 companies to evidence the arm's length nature of their transfer pricing activities ... Only one company was assessed as having high quality documentation to support its transfer pricing with its offshore associates, while 84 per cent of companies examined had documentation that was inadequate in some way.⁴⁷

From the taxpayer point of view, the uncertainties associated with the transfer pricing requirements currently incorporated into Schedule 25A do not lead to corporate confidence. In the words of the Australian Commissioner of Taxation: 'Any revenue system relies on the willingness of the community to by and large meet their obligations. People are more likely to do that if they understand the rationale for changes. Certainly they will not do it if they simply do not understand what the law requires of them.'⁴⁸ Clarifying the 25A requirements consequently requires urgent attention.

⁴⁷ Ibid.

⁴⁸ Michael Carmody, *Tax Reform: the lessons for tax administration in Australia* Address to the American Chamber of Commerce 2 May 2000, Sydney, 1, 5.

The OECD has expressed the view that *clear* procedural rules are necessary for three reasons.⁴⁹ Firstly, to ensure the *fair* application of the arm's length principle, secondly to adequately protect the taxpayer and lastly to ensure that revenue is not shifted to countries with overly harsh procedural rules, thus resulting in pricing distortions. Increased guidance and clarity on what constitutes compliance is certainly required.⁵⁰

The ATO would be well advised to propose for public consideration clear, definitive, workable, specific, fair and prospective rules that take a step-by-step approach. Such rules should make it clear to taxpayers what is expected for the determination of net income or loss from international business transactions between members of an MNE. Vague guidelines that can be interpreted in a myriad of different ways should be replaced with solid rules. This is especially important when an unwelcome side effect of complex rules with insufficient guidelines is a lack of consistency of application on the part of the tax administration. A corollary of the clarification of basic guidelines would be the coordination of penalty application, resulting in greater fairness in the system.

Providing certainty of compliance as to what is required of taxpayers and thereby ensuring conformity and lessening the risk of audit activity benefits the resources employed by both taxpayers and tax authorities. This certainty as to general rules could be further enhanced by introducing global standards of transfer pricing documentation.

49 OECD Guidelines, 4.4.

50 It is surprising, that no major country, apart from the US, has provided definitive legislative rules as to how its tax authorities will interpret the OECD guidelines. Canada has provided some assistance, but important trading nations such as the UK have produced little, if anything, of practical value. Why this is so is unclear: it may just be too difficult. In Australia, there are voluminous draft rulings which have emanated from the Australian Taxation Office ... Although one should commend the ATO for attempting to publish guidance, it is fair to say that the literally thousands of words which they have so far written are little more than a repetition (in a far more verbose form) of the OECD guidelines. This is a lost opportunity as the ATO had the chance to lead with the US in providing real assistance to taxpayers. It is to be hoped that with the cooperation of the Australian professional bodies (including the Law Council of Australia, the Institute of Chartered Accountants and others) that the present draft rulings will be substantially revamped, possibly by way of myriad examples (following the US regulatory practice) and culminate in meaningful and pragmatic publications.' McLean, 'Transfer pricing (1997) *CFO Magazine Online* M McLean, 'Transfer Pricing' (1997) *CFO Magazine Online* <<http://www.cfoweb.com.au/stories/19970501/7183.asp>. >

Clarifying rules on a specific basis

There is merit in a general list of useful information for determining transfer pricing, and tax administrations such as Australia and the US incorporate some elements degree into their documentation requirements. There is also value in clarifying these requirements with guidelines and extensive examples. Another useful tool would be the introduction of a revenue database of 'frequently asked questions' on transfer pricing documentation for taxpayers via a website. This could be used to communicate a clear standard of conduct to taxpayers.

However, because of the emphasis laid on *individual* circumstances, the production of an exhaustive global checklist would have the effect of imposing unnecessary work (and expense) on a number of taxpayers, and as far as the tax administration is concerned, the information would at best be useless and at worst, cause delays. Also standardised documentation rules giving extensive guidance on the general documentation requirements can vex taxpayers, because of the *extensiveness* of the information demanded in their particular and perhaps unique circumstances.

The OECD Guidelines do not specify the form that transfer pricing documentation should take, or offer a prototype. However, they do state, that tax administrations must balance their need for documentation against the cost and administrative burden to the taxpayer of creating or obtaining them.⁵¹ In Australia, taxpayers are required to use their individual judgment, as each case will be dealt with on its individual facts and circumstances. They are warned that adequate documentation should be provided to avoid adjustments and penalties. The OECD states that the taxpayer should not be expected to have prepared or obtained documents beyond the *minimum* needed to make a reasonable assessment of whether it has complied with the arm's length principle.⁵² This 'minimum' will of course vary from taxpayer to taxpayer. It could be argued that the 'minimum' needed would be higher for taxpayer's engaging in inter-affiliate transfers of intangible products than for those transferring tangible products, for which there may be a greater number of comparables available. It would appear that the 'minimum' required would shift according to the individual taxpayer involved and the particular transactions engaged in.

Echoing the OECD, the ATO 'does not expect taxpayers to prepare or obtain documents beyond the minimum needed to make a reasonable assessment of

51 OECD Guidelines 5.6.

52 Ibid 5.7.

whether they have complied with the arm's length principle in setting prices or consideration',⁵³ with taxpayers using their 'commercial judgment' according to what a prudent business person would do in such circumstances.

Requirements that refer to a standard of 'reasonableness', or to what constitutes the 'minimum' necessary, which fluctuate according to the taxpayer's individual circumstances, violate the principle that tax legislation should be written with a clarity that allows taxpayers to consistently comply with the law (and not simply on a 'hit-and-miss' basis). Penalties that are applied according to whether the taxpayer has met their individual documentation requirements require an individualised solution.

Recommendation: a 'one-strike' safe harbour, with revenue guidance

It is suggested that a company should not be penalised on its initial presentation of any documentation, where certain specified steps have been taken. While this may be regarded as an excessively lenient approach, it should be borne in mind that the purpose of penalties is to punish intentional misconduct. They should not be used simply to raise revenue, as this undermines any belief in the fairness of the system.

This more flexible approach is in line with a statement made by Australia's Deputy Commissioner to taxpayers in respect of their transfer pricing documentation: 'If you make a fair dinkum attempt to get it right we will not penalise you'.⁵⁴

If the information provided is insufficient or incorrect, the ATO should, in an educational notice, make it clear to the taxpayer exactly what documentation is required by that particular company, and in what depth. Such a notice should inform the taxpayer of the amount of the penalty if it had been assessed. It should also contain information on what steps the taxpayer should take to avoid the penalty in the future. Perhaps various templates of requirements could be drafted, which could be selected according to the needs of the individual taxpayer. The taxpayer should then be given sufficient time, tailored once again to their specific circumstances, to revise their documentation according to the requirements of the tax administration.

Once the taxpayer has successfully presented the information to the ATO, it should be up to the taxpayer to maintain the specified records. If the specified mistakes are

53 Schedule 25A instructions 2003, Item 4, *Adequacy of documentation* 5.

54 D Evans, 'Rewriting your books' *CFO Magazine Online*
<<http://www.cfoweb.com.au/stories/19980901/6096.asp>> quoting J Killaly.

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not subsequently amended, a penalty should be imposed. This 'one-strike' approach would encourage voluntary compliance by taxpayers.

If, at a later date, there is a need for more in-depth or alternative information, the ATO should notify the taxpayer of this, again stating their specific documentation requirements. If the taxpayer subsequently fails to comply with documentation requirements due to a new set of facts and circumstances, the taxpayer's historical record of compliance should be taken into account when the imposition of a penalty is considered. Imposing penalties on taxpayers that have a good track record of compliance is counterproductive, as 'assessing penalties against these taxpayers often contributes to the perception that the system is unfair and may not be conducive to encouraging voluntary compliance.'⁵⁵

The Australian Commissioner of Taxation has stated that:

People also have a rightful expectation to be treated as human beings and have their different circumstances acknowledged in their personal dealings with us. Put simply by way of example, people who have paid their taxes on time for years and slip up once do not expect to be treated the same as determined, habitual non-payers.⁵⁶

This individually tailored approach to documentation requirements will initially place heavy demands on revenue resources, but there would be immense long-term benefits. Once the comprehensive educational notice has been supplied to the taxpayer, the penalty system will become much easier to administer, and will have the added benefits of clarity and fairness.

It should be mentioned that there is evidence that both parent companies and subsidiaries are becoming increasingly aware of the importance of maintaining appropriate transfer pricing documentation, and are therefore likely to be highly aware of the need to submit comprehensive returns.⁵⁷

55 Letter by M H Ely, National Partner-in-Charge, Tax Controversy Technical Services, KPMG and H L Gutman, Partner-in-Charge, Tax Legislative and Regulatory Services, Washington National Tax, KPMG, to the Subcommittee on Oversight of the Committee on Ways and Means, US House of Representatives, Written Comments on Taxpayer's Rights, 2 April 2001 (107th Congress, 1st Session) 1, 3.

56 Michael Carmody, above n 48, 4.

57 Ernst & Young, above n 4, 19. The survey reports that nearly two-thirds of parent companies see the maintenance of appropriate transfer pricing documentation as more important than they did two years ago, along with 56% of subsidiary respondents.

The PATA Agreement

Having examined some of the problems associated with Australia's national practices in the transfer pricing documentation realm, this paper will now look at a new initiative with regards to the harmonisation of documentation requirements, of which Australia is a member. The efficacy of this undertaking will be examined, along with potential problems that may be encountered.

Transfer pricing experts have frequently commented on the difference between tax authority thinking, which is national in focus, compared with MNE commercial thinking, which is global in focus.⁵⁸ Domestic tax systems set up for domestic purposes are poorly designed to handle the global activities of MNEs, and conflict seems inevitable as domestic tax authorities grapple for their 'fair' share of the profits of MNEs demonstrating an increasingly mobile tax base.

Now, however, an initiative to create principles for uniform transfer pricing documentation has been formulated by PATA, an inter-governmental tax organisation whose members are Australia, Canada, Japan and the United States. The proposed documentation package was released in June 2002, along with an invitation for public comment. This was followed, in March 2003, by a revised agreement.

The 2003 revision clarified that no penalties would be imposed on taxpayers complying with the PATA principles.⁵⁹ This is a tremendous breakthrough in the transfer pricing arena. On the other hand, it also specified that even where these principles are complied with, the PATA tax administrations may still make transfer pricing adjustments and assess any interest due on those adjustments.⁶⁰ This is an unusual inclusion, as transfer pricing documentation is usually designed to afford protection against both penalties and adjustments.⁶¹ The stated motivation behind this uniform package is that one set of transfer pricing documentation would be sufficient for all PATA members, and thus save the duplication of costs. The PATA members consider the package to be consistent with the principles espoused in Chapter V of the OECD Guidelines.

58 J C Pagan and Scott J Wilkie, *Transfer Pricing Strategy In A Global Economy* (1993) ¶ 1.31.

59 Pacific Association of Tax Administrators (PATA) Transfer Pricing Documentation Package, <http://www.ato.gov.au/taxprofessionals/content.asp?doc=/content/30275.htm&page=1>, last modified Tuesday, 11 March 2003, 1.

60 Ibid.

61 G J Ossi, K Chung and S J Sidher, 'The search for consistency: A global approach to transfer pricing' 32 (2003) *Tax Management International Journal* 283, 290.

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The use of the so-called PATA Documentation Package (the 'Package') is voluntary, but if a taxpayer chooses to use the Package in order to avoid the imposition of transfer pricing penalties in relation to an international inter-affiliate transaction, three operative principles need to be satisfied.

Firstly, MNEs need to make reasonable efforts to ensure that their transfer prices are established in compliance with the arm's length principle. Such 'reasonable efforts' are to be determined by each PATA member tax administration. They include, but are not limited to, an analysis of controlled transactions, searches for comparable uncontrolled transactions (ie comparable transactions between independent enterprises dealing at arm's length), and the selection and application of arm's length methodologies 'reasonably concluded to produce arm's length results in accordance with PATA member transfer pricing rules and the relevant treaty, consistent with the OECD Guidelines'.⁶² A problem here is that as these reasonable efforts appear to be country specific, it does not seem likely that one set of documentation may in fact be uniformly applied across the four tax jurisdictions.

Another difficulty in relation to the arm's length methodologies requirement is the Package's stated consistency with the OECD Guidelines. The OECD and the US, a PATA member, have notoriously differing views with regards to the appropriateness of certain arm's length methodologies. While the official position of the US is that its final transfer pricing regulations are consistent with the OECD Guidelines, some OECD member countries disagree. This has had the unfortunate result that MNEs risk antagonising certain revenue authorities if they undertake what appears to be a US transfer pricing approach. Multinational taxpayers are therefore compelled 'to account for multiple and sometime[s] disparate rules when setting, documenting, and defending cross-border transfer prices'.⁶³

A prime example of the different approaches to transfer pricing methodologies is the US preference for the Comparable Profits Method (CPM). The OECD, on the other hand, is hostile to this methodology and instead requires the use of the Transactional Net Margin Method, or TNMM. Different economic data and comparability standards are used to support these two transfer pricing methodologies, and this may lead to different results. An MNE utilising the Package would therefore need to take into account the taxing authorities' differing transfer pricing methodology

62 PATA Transfer Pricing Documentation Package, above n 59, 2.

63 WW Chip, 'Organization for Economic Cooperation and Development Guidelines' in R Feinschreiber (ed), *Transfer Pricing Handbook* (3rd ed 2001) 33-3.

preferences and practices. This would also appear to detract from the touted advantage of the 'uniformity' of documentation required by PATA members.

What constitutes 'reasonable efforts' needs to be clearly defined in the Package. As with Schedule 25A, without such clarification taxpayers are left in the invidious position of trying to second-guess how these terms will be interpreted. This may discourage taxpayers from utilising the Package.⁶⁴

According to the second operative principle, MNEs must maintain contemporaneous documentation of their efforts to comply with the arm's length principle. The Package includes a schedule describing the documentation necessary to satisfy this principle. It specifies that transfer pricing documentation prepared and maintained pursuant to this Package must be "adequate and of sufficient quality." The quality of this data will be evaluated by each PATA member tax administration, taking into account all the relevant facts and circumstances, including the extent to which reliable data was reasonably available and analysed in a reasonable manner. The significance, importance and complexity of the taxpayer's transfer pricing issues will also be taken into account. Thus both quantitative and qualitative standards are imposed by means of this second principle. Again, the terms "adequate and of sufficient quality" and "reasonable manner" are not clearly defined, and require clarification to provide taxpayers with certainty.

The schedule sets out the transfer pricing documentation to be provided by taxpayers by means of a list of documents that is, according to the Package, 'considered to be exhaustive'.⁶⁵ In other words, it is seen to encompass all documents necessary to avoid transfer pricing penalties being imposed by the PATA tax administrations, although it is acknowledged that not all of these documents may be necessary in every transfer pricing transaction.

In fact, MNEs may find the PATA documentation list to be more onerous to comply with than the local transfer pricing regulations. International tax practitioners have compared the Package with US documentation requirements, generally accepted to impose the most burdensome demands of all jurisdictions. They have found that: 'Not only is the level of detail in the PATA Package requirements much greater than the documentation requirements under the Section 6662(e) regulations, but the

64 M S Lebovitz et al, 'Achieving transfer pricing compatibility' 14 (Sep 2003) *Journal of International Taxation* 14, 17.

65 PATA Transfer Pricing Documentation Package, above n 59, 3.

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amount of information that must be provided is also greater'.⁶⁶ For example, the final documentation list issued in March 2003 not only requires the maintenance of copies of annual reports and financial reports for the year to which the Package relates, but also for the prior five years.⁶⁷

Furthermore, although an extensive schedule is provided, the Package stipulates that in examining the arm's length nature of an MNE's interaffiliate transactions, *additional information* that is not listed on the schedule may be requested by a PATA member tax administration.⁶⁸ This would seem to contradict the 'exhaustive' nature of the schedule. Although the Package claims to be a response to the difficulties and costs which MNEs face in order to meet the transfer pricing documentation standards of the different jurisdiction, it actually imposes the most onerous documentation requirements of all.

Under the third operative principle, MNEs need to produce documentation requested by a PATA member tax administrator in a timely manner. Again, there is no definition of the term 'timely manner' in the Package, and it may therefore be concluded that this term may vary between the four PATA jurisdictions.⁶⁹

Conclusion

The Tax Executives Institute⁷⁰ (TEI) has outlined three goals that any useful and efficient documentation Package should serve.⁷¹ Firstly, it should provide taxpayers with certainty about the minimum standards that they must satisfy, especially to avoid penalties. Secondly, it should be flexible enough for taxpayers to be able to tailor the required documentation to their facts and circumstances, and finally it should minimise costly duplicative administrative and recordkeeping requirements.

66 Lebovitz et al, above n 64, 17.

67 PATA Transfer Pricing Documentation Package, above n 59, 'Nature of the business/industry and market conditions'.

68 Ibid 3.

69 Ernst & Young 'Pacific Association of Tax Administrators (PATA) Transfer Pricing documentation package released' (April 2003) *Transfer Pricing Brief*, 1, 2.

70 The Tax Executives Institute is the pre-eminent association of business tax executives. Its 5,300 professionals manage the tax affairs of 2,800 of the leading companies in Canada, the United States and Europe.

71 Letter submitted on September 5, 2002, by TEI President Drew Glennie to Carol Dunahoo, Director of International for the Internal Revenue Service, above n 2, 3-4.

Although any initiative to provide a common documentation framework should be encouraged, on analysis it would appear that the PATA Package does not at present optimally meet the above three goals of certainty, flexibility and cost-saving. Although it provides an MNE with certainty in relation to the avoidance of the imposition of transfer pricing penalties, no such certainty is provided in relation to transfer pricing adjustments. The observation has been made that local transfer pricing examiners would tend to be biased (either consciously or unconsciously) in favour of documentation meeting local requirements. As the PATA Package differs from the local rules imposed by the four member states, the end result may be that it may 'decrease the exposure to penalties and at the same time increase exposure to adjustments'.⁷²

While the Package has furnished taxpayers with a schedule of documentation to be supplied which is more onerous than national documentation requirements, an element of uncertainty remains in that additional information may still be required. There is also a failure to define certain critical terms, leaving them open to individual interpretation by the PATA members. Tax practitioners have expressed their disappointment that:

None of the PATA members have agreed, under this revised package, to a single standard for either the application of the arm's length principle, 'reasonable efforts' or time limits for the production of transfer pricing documentation. These factors will continue to be governed by local law, regulation and practice.⁷³

There is further uncertainty concerning the application of the OECD Guidelines, especially in relation to its stated preferences in terms of transfer pricing methodologies. Strict compliance with these Guidelines would tend to indicate an inability to meet the second criterion of flexibility. As the US is a PATA member state, this problem requires urgent attention.

The imposition of ten general categories of documentation and 48 specific bullet points in the PATA documentation schedule requires taxpayers to prepare and maintain documentation that may not be required for normal business purposes or under local transfer pricing regulations. This, too, denotes a lack of flexibility. Although the Package acknowledges that in certain circumstances some of the documents would not be needed, further guidance is required here.

72 Ossi et al, above n 61, 291.

73 Ernst & Young, above n 69, 3.

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The Package describes itself as a response to the potential difficulties that an MNE may face in preparing transfer pricing documentation which complies with the laws and administrative requirements of multiple tax jurisdictions, including costly duplicative administrative requirements. On examination, it would seem that although the Package provides a common documentation framework, it does not facilitate transfer pricing documentation that can be uniformly applied in all PATA jurisdictions, as domestic transfer pricing requirements will still need to be complied with.

Diverging national interpretations of taxpayer compliance with the arm's length standard coupled with a penchant among revenue authorities for idiosyncratic local substantive transfer pricing rules mean that transfer pricing documentation costs are unlikely to be minimised. It is submitted that a reduction in both complexity and compliance costs would best be achieved by imposing uniformity across national borders, ie by harmonising the substantive transfer pricing rules of the member states.

The adoption of a consistent transnational transfer pricing policy is a worthwhile and necessary goal for revenue authorities around the world. Australia's role in the Package initiative is to be commended, and may be viewed as a step along the way to the harmonisation of the members' transfer pricing regimes. However, the consensus among transfer pricing practitioners would appear to be that more work needs to be done to clarify areas of uncertainty: 'While the PATA effort is commendable, at this point in time the Documentation Package leaves too many questions unanswered for it to serve fully its goal of providing a practical framework for producing uniform documentation'.⁷⁴

Recommendations

At present, two-thirds of the relevant parent companies and subsidiaries have not finally determined whether or not they will utilise the Package for their transfer pricing documentation.⁷⁵ Of the one-third that have reached a decision, the majority has decided not to use it. From this it can be concluded that MNEs need some incentives to take advantage of this new initiative. It is therefore recommended that the certainty, flexibility and cost-effectiveness of the Package be increased by reviewing and updating certain features.

74 Ossi et al, above n 61, 290.

75 Ernst & Young, above n 4, 21.

In order to increase certainty, terms such as 'reasonable efforts', 'reasonable manner' and 'adequate and of sufficient quality' should no longer be interpreted in a country-specific, but in a country-inclusive manner, ie the PATA members should agree on and clearly define an interpretation of these terms for all their members. Likewise, a unified approach to the application of the arm's length standard, and to the time limits for the production of documents should be adopted. While this may be seen as a tall order, it should be borne in mind that there are only four PATA members, that they have already gone a long way to reach consensus on a number of issues in order to conclude the present Package, and that it is in their mutual interest to increase the utilisation of the Package in order to conserve revenue resources.

Cost-effectiveness could be increased by streamlining the documentation requirements, perhaps via PATA templates of minimum documentation requirements for certain industries or types of transactions. The present schedule of documentation includes much information that is difficult to find and irrelevant to the business management of MNEs. The focus should rather be on documentation that will be of material value, ie highly relevant to the member tax administrations in evaluating transfer pricing transactions. Where particular taxpayers need to provide more essential information, they could be notified and allowed sufficient time to produce this.

Increased flexibility could be introduced in relation to transfer pricing methodologies, by specifically incorporating US-approved methodologies into the PATA-approved methodologies.

The PATA members could also reduce taxpayer exposure to transfer pricing adjustments by sending individual taxpayers a warning of the potential for an adjustment after reviewing their documentation, along with revision guidelines. Taxpayers should then be given the opportunity to implement these documentation revisions, rather than tax administrations simply making an adjustment and imposing interest. As with the recommendations made for improving Australia's local transfer pricing documentation regime, the emphasis should be on taxpayer education, and on 'mechanising' future compliance in order to reduce costs to all parties.

While the abovementioned recommendations admittedly endorse a more broad-brush, flexible approach to transfer pricing documentation, they represent an opportunity for PATA to reduce the current documentation burden on trade between their members, promote greater efficiency and thus benefit member tax

administrations and taxpayers alike. In the words of the Australian Commissioner of Taxation:

Compliance management is not simply about audits, verification and enforcement. It is also about supporting people in meeting their obligations and making it as easy as possible for those seeking to do the right thing.⁷⁶

76 Carmody, above n 10, 7.