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OVERVIEW

NAT 12082-10.2004

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Australian Government

Australian Taxation Office

ADVANCE PRICING ARRANGEMENT PROGRAM

Report on developments in 2003–04

OCTOBER 2004



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PUBLISHED BY

Australian Taxation Office
Canberra
October 2004

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INTRODUCTION

This report covers the financial year ended 30 June 2004 and updates the previous reports on the APA program.

The Advance pricing arrangement (APA) program continues to be an important part of our international tax strategy because of the complementary benefits it provides both to taxpayers and to the Tax Office.

An APA establishes which transfer pricing methodology is agreed to be used to determine arm's length prices or results for future transactions, agreements or arrangements covered by the APA. It also provides an opportunity for taxpayers to reach an agreement with the Tax Office on the future application of the arm's length principle in their dealings with international related parties.

The APA can be concluded on a bilateral or unilateral basis. Generally an arrangement is made between a taxpayer, the Tax Office and a foreign tax authority regarding the income tax treatment of international transactions, agreements or arrangements between related parties or associates.

We do not impose fees or charges in making an arrangement.

The APA generally covers a period of three to five years and may be rolled over or reviewed if the trading circumstances of the taxpayer require adjustment.

We promote an APA as a way of creating greater certainty for all parties while reducing compliance costs and the risk of audit and penalty.

Our approach to an APA is described in Taxation Ruling TR 95/23 *Transfer Pricing – procedures for bilateral and unilateral advance pricing arrangements* and our publication *International transfer pricing – Advance pricing arrangements*. This approach is consistent with OECD guidance.¹

At 30 June 2004, we had 117 operating APAs.² Eleven have been renewed one or more times. Three companies have previously negotiated APAs which had expired but not been renewed due to them ceasing or changing the business. We are encouraged by the very high level of APA renewals which indicates the acceptance and practical success of the process.

The first report on the APA program was issued in February 2001 covering the first 10 years of the program. The next was issued in March 2002 for the period July 2000 to March 2002, and November 2003 for the financial year ended 30 June 2003. A detailed analysis is provided in this report to highlight trends and indicators.

We completed 23 APAs in the 2004 financial year – four were renewals of previously negotiated APAs. This exceeded the expectation of 20 APAs that we forecast in the Tax Office *Compliance Plan 2003–04*.

1 Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, OECD, para 4.124 et seq.

2 Includes APAs where the first renewal is being negotiated.

BENEFITS FROM APAs

We promote and accept APAs because of their close fit with our strategic direction, especially the cooperative compliance model in which a cooperative, self regulatory approach is the most desirable behaviour for us and for business.

We continue to see benefits in the APA process and believe that it:

- may provide **solutions to situations** where there is no realistic alternative way of both avoiding double tax and of ensuring that all profits are correctly attributed and taxed
- provides **certainty on an appropriate transfer pricing methodology (TPM)** for the taxpayer and therefore enhances the predicability of tax treatment of their international transactions
- substantially **reduces or eliminates** the possibility of **double taxation** in the future
- **limits costly and time consuming examinations** of major transfer pricing issues which may arise as a result of a future transfer pricing audit and lessens the possibility of protracted and expensive litigation, and
- puts the **taxpayer in a better position** to predict costs and expenses, including tax liabilities.³

For example, in Taxation Ruling TR 2000/11⁴ we explain how agency permanent establishments needed to have profit attributed to them. This directly affects operations conducted in Australia under commissionaire-style selling structures and under toll manufacturing arrangements. Some affected taxpayers have sought APAs.

We have found APAs to be particularly useful in resolving these issues in a practical way that produces an agreed outcome without additional record keeping and compliance costs. Enterprises with commissionaire and toll arrangements may wish to consider APAs to gain certainty in this complex area.

Some further examples of the benefits to taxpayers and the Tax Office are listed in **Appendix 1**.

TAX OFFICE PROCESSING OF APAs AND PROGRAM RESULTS FOR 2003–04

OVERVIEW

APAs are normally initiated upon lodgment of a formal application, after pre-lodgment meetings⁵ held between the Tax Office and the taxpayer. While APAs can be lodged by taxpayers in both the large and SME market segments, in 2003–04 they were principally used by companies with revenues in excess of \$100 million. Only six of the 23 APAs that were completed had a turnover of less than \$100 million.

Typically the 2003–04 participants were:

- highly recognised, publicly owned industrial companies
- leaders in their industry sector
- involved in either:
 - the business-to-business sale of intermediate goods, or
 - the importation of finished goods or in retail or services sectors where product branding was important.

The applications are considered by teams from our International Strategy and Operations (including the economist staff) and industry segment areas. Depending upon whether they are multilateral, bilateral or unilateral, and the complexity of the case, the transfer pricing practice from International Strategy and Operations may also be involved.

Bilateral and multilateral APAs are concluded under the mutual agreement procedure article of the relevant double tax agreement, while unilateral APAs are concluded under the Commissioner's power of general administration of the income tax legislation.

INVOLVEMENT OF INTERMEDIARIES

Taxpayers choose to involve their advisers in the majority of cases – only two of the 23 cases completed in 2003–04 involved direct negotiation between us and the taxpayer.

Neither second tier accounting firms nor legal advisers were represented this year with the *big four* consolidating their position as the principal advisers to taxpayers making APA applications. The expected wider participation by companies and agents in the SME segment, due to reviews of schedule 25A compliance, did not eventuate although this may occur in 2004–05.

PRE-LODGMET DISCUSSIONS

We encourage potential APA participants to take full advantage of the pre-lodgment discussions. Of the cases completed in 2003–04, eight had three or more pre-lodgment meetings. This also reflects the complexity of the issues addressed in these cases.

The time in preliminary discussion is case dependent. The duration of cases completed in 2003–04, ranged from one month to an extreme of 34 months for a complex bilateral application arising from a compliance project. Cases where there were compliance issues averaged 20 months in pre-lodgment discussion while those without averaged seven months.

³ TR 95/23 para 65

⁴ Income Tax: international transfer pricing – operation of Australia's permanent establishment attribution rules. Paragraphs 5.37–5.42

⁵ See the publication *International transfer pricing: Advance pricing arrangements (APAs)* for a flowchart of the APA process.

To assist potential applicants understand the pre-lodgment process we have included as **Appendix 2** a typical agenda for a pre-lodgment meeting.

Sometimes the matters raised need a considered answer or some research by both parties. Sometimes supplying material before the meeting helps the process.

The number of pre-lodgment meetings varies with each case and ranged from one to seven in 2003–04. APAs where there is a high level of agreement at the pre-lodgment stage are processed more quickly.

TIME TO PROCESS APAs

Our processing standard for APAs is explained in Taxation Ruling TR 95/23 at paragraphs 120–121.

120. After having received the formal application, the ATO would normally aim to have the APA completed within 12 months and expects the taxpayer to cooperate and provide timely, detailed and accurate information. If the provision of information by the taxpayer becomes too protracted, the ATO reserves the right to discontinue the APA process. The ATO will also endeavour to examine and convey conclusions regarding data and other information in a timely fashion.

121. Completion of the APA process within 12 months will nevertheless depend on the ready availability of information and the extent of cooperation between the taxpayer, the ATO and, where appropriate, the foreign tax authority as well as the availability of suitable ATO resources to undertake the process.

The APAs completed in 2003–04 took an average of 13 months to process. The average time for completion of unilateral applications was 12 months (compared with eight months in 2002–03) and 17 months for bilateral applications (compared with 13 months in 2002–03). No multilateral applications were considered in 2003–04. Median processing times were equivalent to the average processing time, shown in **figure 1**.

There were two cases which adversely affected the average processing time for bilateral APAs.

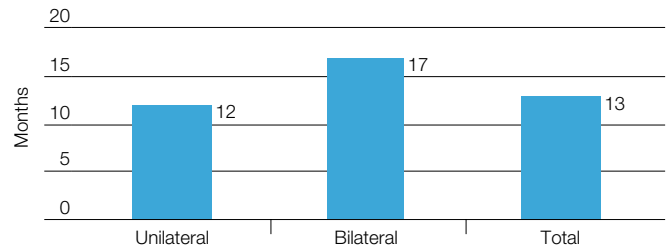
One case that took 34 months was agreed without change but was delayed due to difficulties in finalising mutual agreement procedures (MAP) on adjustments to the prior years.

Another case which took 26 months was agreed to by the Tax Office in eight weeks but was substantially delayed in the other jurisdiction. The proposal was finally agreed virtually unchanged.

When these two cases are excluded from the results, the processing time for bilaterals is the same as unilaterals.

The complexity of a matter and the differing technical positions of the Tax Office and foreign revenue authorities also impacts on the completion times of bilateral and multilateral applications. These matters have also caused delays to processing some APAs.

FIGURE 1: Average time to process APAs in 2003–04



UNILATERAL, BILATERAL, MULTILATERAL

The number of unilateral, bilateral and multilateral applications completed during the 2003–04 is represented in **figure 2**.

We have found that two factors influence the choice of the type of APA made. In five cases this year the APA was concluded with a multi-national enterprise (MNE) group member located in a regional coordination centre (Europe/Asia/Bermuda) that differed from the country of residence of the ultimate parent company. These centres do not have active APA programs. In two further cases the Australian resident had dealings with a wide variety of jurisdictions that made a bilateral APA too difficult or costly to obtain.

Bilateral APAs were completed with Canada, Japan, the Netherlands, New Zealand and the USA.

Over the life of the program, the number of bilateral and multilateral APAs has averaged approximately 40% (42% in 2002–03) of total APAs completed, but as **figure 3** indicates the number fluctuates each year. In 2003–04 the percentage of bilateral APAs was 35% (28% in 2002–03).

Relatively fewer APA applications and expressions of interest were received this year. In part, this reflects the relative decline in the level of our transfer pricing risk assessment activity. We anticipate this will increase for 2004–05 due to expanded fieldwork and more APAs becoming due for renewal.

BILATERAL APAs WITH CANADA, JAPAN AND THE USA

In June 2004, the members of the Pacific Association of Tax Administrators (PATA), Australia, Canada, Japan and the USA, released guidance on their common approach to processing bilateral APAs. This document, *Bilateral APA operational guidance for member countries of the Pacific Association of Tax Administrators (PATA)* can be found at www.ato.gov.au

It notes that PATA members are committed to the promotion of programs, such as bilateral APAs that are designed to increase certainty for taxpayers who have cross-border dealings between associated enterprises. PATA members also endeavour to make APAs available to taxpayers in an efficient and cost-effective manner. While the PATA documentation indicates the member's commitment to complete APAs within two years, the members attempt to finalise the APAs as quickly as practicable, and as explained earlier, the Tax Office uses a 12 month processing standard.

FIGURE 2: APAs by type 2003–04

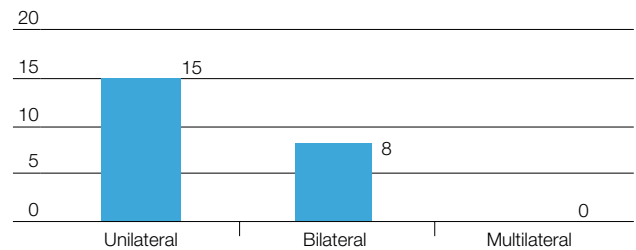
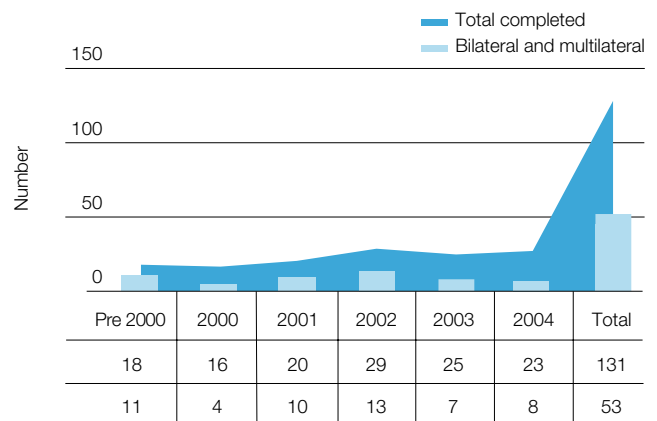


FIGURE 3: Number of bilateral and multilateral APAs compared to total APAs completed over program life (includes renewals)



INDUSTRY SEGMENTS

The spread of APAs completed in 2003–04 across industry based segment groups are shown in **figure 4**.

National client group (NCG) completed the majority of cases or 52% in 2003–04 (17 cases or 68% in 2002–03). NCG covers manufacturing, wholesaling, services, property and construction.

Other segments represented were:

- Multi-media and information technology (MMIT) with 6 cases completed in 2003–04 (2 in 2002–03)
- Financial service industry group (FSIG) with 2 cases completed in 2003–04 (1 in 2002–03)
- Energy and resources group (ENRG) with 3 cases completed in 2003–04, (2 in 2002–03), and
- Small Business (SB) with nil cases completed in 2003–04 (3 in 2002–03).

For 2004–05, six cases would be regarded as SME clients due to having revenues below \$100m, but due to the nature and complexity of the issues they were completed by the large business and international area.

WORK IN PROGRESS AT 30 JUNE 2004

The current workload involved in APA application and negotiation work is shown in **figure 5**.

The increase in renewals reflects the expiry of APAs concluded in the early years of our global profit allocation strategy. Our practice on renewals is explained in paragraphs 165–168 of Taxation Ruling TR 95/23.

165. An APA may be renewed with the consent of all the parties to it. A request for renewal of an APA should follow the same procedures that apply to the initial APA request.
166. A request to renew the APA may be lodged at any time prior to the expiration of the initial term of the APA, bearing in mind the need for sufficient lead time between the expiration of the APA and the period for which it is to be renewed.
167. When requesting a renewal of an APA, the taxpayer must establish to the satisfaction of the Tax Office that the terms and conditions of the APA were substantially complied with and all material facts were disclosed and properly stated.
168. Where the material facts, critical assumptions or computations remain valid, the Tax Office may still require new or updated economic studies, analyses and supporting documentation before it agrees to any extension. However, it is not anticipated that the renewal application will need to be as detailed as the original submission.

FIGURE 4: APAs completed by industry segment 2003–04

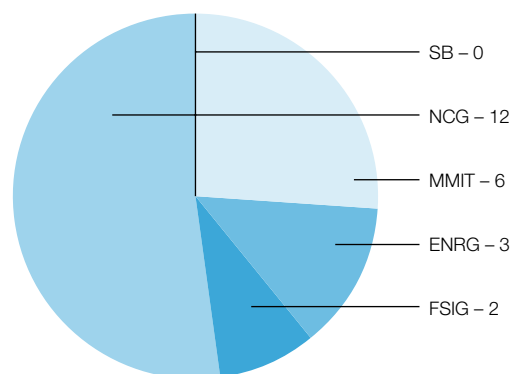


FIGURE 5: APA application and negotiation workload

	At 30 June 2004	At 30 June 2003
Discussions	24	21
Pre-lodgment	17	21
Lodged and in progress	26 (includes 18 bilateral)	18 (includes 12 bilateral)
Other APAs where renewal discussion expected in 2004–05	15 (includes 2 multilaterals)	6

ISSUES AND METHODOLOGIES

During 2003–04 the spread of subject matter of APAs completed is shown in **figure 6**.

These broad categories cover:

- pricing of goods by marketers, distributors and manufacturers (both inbound and outbound)
- commodities and semi/completed goods, licensing of intellectual property (inbound and outbound), and
- services including head office management fees, financial services businesses and sales support services.

The transfer pricing methodologies agreed in the APAs are shown in **figure 7**.

As in previous years, the transactional net margin method (TNMM) continues to be the most common methodology used. This is due largely to taxpayers having ready access to independent comparable data in Australia and elsewhere to show that related party pricing is at arm's length.

No APAs were concluded this year using the hybrid profit split methodology which incorporates elements of the profit split and modified resale price methods. This method has previously been used in bilateral APA cases with Japan involving Australian marketer/distributors. Several cases where this method is being used are at advanced stages of completion with the National Tax Agency of Japan. With the introduction in April 2004 of TNMM into Japanese transfer pricing rules, we do not expect to apply this methodology in cases with APA periods commencing after April 2004.

APAs INVOLVING INTANGIBLE PROPERTY

Every year we have a range of APAs that involve the inbound or outbound licensing of intangibles. It is widely recognised that intangible and intellectual property can present particular problems when examining comparability, usually because of the specialised nature of the property.

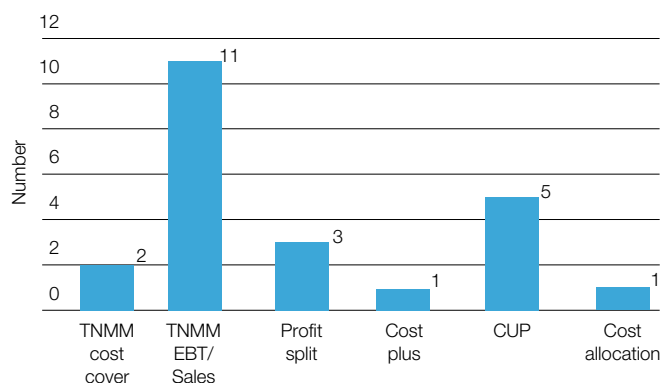
The covered dealings of APAs also frequently include intangibles that represent a bundle of commercial property that when combined, form an entire business system. This can encompass knowledge/know-how, business and IT systems, processes and procedures, specifications, trademarks, trade names and branding. Some elements may be protected by trademark and copyright and others by confidentiality agreements.

In these types of cases we try to spend time ensuring that the intangibles are clearly identified before they are rewarded. We have found it is necessary to clearly establish the existence and nature of the intangibles before attempting to attribute to them any value or take them into account in applying an arm's length methodology.

FIGURE 6: APAs completed by subject

Type of dealing	2003–04	2002–03
Tangibles (import, export and manufacture)	11	15
Intangibles	4	4
Services	8	6
Total completed	23	25

FIGURE 7: APAs completed by primary method 2003–04



Questions we are likely to ask about the intangible are:

- what is the property?
- is the property protected?
- how is it documented?
- how is it transferred and what are the contractual terms?
- who developed the intangible?
- how is it used in the business?
- how does it add to the business?
- how has it been valued?

These key questions will help identify and articulate what the intangible is, how it is used in the business and how it adds to profitability. We believe the questions are consistent with chapter 6 of the *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD.

While it can be expected that valuable intangibles which contribute significantly to profit will receive greater reward, we also consider the reasonableness of the proposal by looking at the outcome of the dealings from both sides.

COMPLIANCE PLAN PROMOTES APAs

The effect of our compliance activities can be seen in nine APAs that were completed in 2003–04. These nine APAs followed contact to either assess the risk of a transfer pricing audit or to undertake an audit.

THE FUTURE

We remain committed to the APA program and encourage multi-national enterprise groups with significant levels of international related party dealings to consider APAs.

CONTACT POINTS

The first point of contact for taxpayers and advisers for the APA program follow.

Keith Johnson
For bilateral, unilateral and multilateral APAs.
Phone: **(02) 937 48409**
Fax: **(02) 937 42588**
Email: **keith.johnson@ato.gov.au**

Chris Thomas
For bilateral, unilateral and multilateral APAs.
Phone: **(02) 621 61176**
Fax: **(02) 621 62362**
Email: **christopher.thomas@ato.gov.au**

APPENDIX 1

EXAMPLES OF BENEFITS AN APA CAN DELIVER

Benefits to taxpayers

APAs have been used by Australian and foreign owned enterprises:

- to resolve Tax Office concerns about the outcome of related party international dealings
- where a functional reorganisation alters the functions, assets and risks of the Australian entity, an APA allows clarification at the planning stage and provides certainty when change is made
- to help resolve audit disputes in a foreign jurisdiction
- to get quickly to competent authority discussions
- to help resolve the deductibility of losses incurred in prior years where a question has arisen about the application of the arm's length principle
- to obtain certainty for new investments
- to gain a bilateral APA between Australia and another jurisdiction, which may be used by the taxpayer as an unofficial precedent for action in similar situations between other countries, and
- to gain agreement for use of extremely complex and unique transfer pricing methods.

Benefits to the Tax Office

In dealings with taxpayers, APAs are widely regarded by the Tax Office as a way to:

- secure future tax compliance and reduce Tax Office concerns about taxpayer activity increasing the risk of past and future year audit
- enable difficult or unusual cases to obtain certainty
- expand Tax Office industry knowledge and appreciation of how multi-national enterprises operate
- provide an alternative dispute resolution process without the need for costly litigation or protracted negotiation involving taxpayer advisers, and
- to help resolve the deductibility of prior year losses.

APPENDIX 2

APA PRE-LODGMET CONFERENCE AGENDA

While APAs are individually tailored to the taxpayer's circumstances, there are many common matters that are covered during the pre-lodgment conference.

While it may not be necessary to specifically list all of the following items on the agenda, we would anticipate discussion about the following issues.

Background to the process

Usually company representatives are interested in hearing the following matters first hand from the Tax Office:

- purpose of the program
- history and experiences
- confirmation of the non-binding nature of the pre-lodgment conference
- the Tax Office views about the APA process (Taxation Ruling TR 95/23 and guide), and
- the Tax Office preferred method for establishing an arm's length consideration (the 4 steps in Taxation Ruling TR 98/11).

Specific matters for discussion

These matters may include:

- whether the APA will be bilateral or unilateral, and
- the term of the APA.

Step 1

- explanation of the company's position in the industry
- explanation of the business model adopted by the company
 - any restructure?
- explanation of the ownership structure
- capital structure of the business
- A description of:
 - the size, nature and value of the covered dealings
 - identity of the other parties
 - nature of the international agreements
- a description of functions undertaken, assets used and risks assumed, and
- how the company's functions are characterised?

Step 2

- the methodology proposed
- the profit level indicator that is being proposed, and
- the likely source of comparable data.

Step 3

- the process by which any necessary adjustments to the results may be made (compensating adjustments)
- secondary tests of the reliability of the primary result
- likely outcomes from the methodology
- proposed form and structure of the APA
- proposed critical assumptions
- forecast and hind-cast of the financials using the method
- whether there are any issues affecting prior years. Is there to be any roll back of the APA results? This is particularly an issue where active compliance is being undertaken
- any other collateral issues, eg capital gains, GST, non-covered dealings?
- timetable, what is to happen? Processes.

