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LARGE BUSINESS

OVERVIEW

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ADVANCE PRICING ARRANGEMENT PROGRAM

2005–06 update

SEPTEMBER 2006



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INTRODUCTION

This report covers the financial year ended 30 June 2006 and updates the previous reports on the advance pricing arrangement (APA) program.¹

APAs continue to be an important part of our international tax strategy because of the complementary benefits they provide to both taxpayers and the Australian Tax Office (ATO). They create greater certainty for all parties while reducing compliance costs and the risk of audit and penalty.² Their use constitutes part of our balanced program of help and enforcement.

WHAT IS AN APA?

An APA provides taxpayers with the opportunity to reach an agreement with us on the future application of the arm's length principle in their dealings with international related parties.

The arrangement can be concluded on a bilateral or unilateral basis. Generally it is an arrangement between the Tax Office, the taxpayer and a foreign tax authority regarding the income tax treatment of international transactions, agreements or arrangements between related parties or associates. The ATO does not impose fees or charges for APAs.

An APA establishes the transfer pricing methodology to be used to determine arm's length prices or results for future transactions, agreements or arrangements covered by the APA. The agreement generally covers a period of three to five years and may be reviewed if the trading circumstances of the taxpayer materially change.

APAs are normally initiated after prelodgment meetings and lodgment of a formal application³ between the ATO and the taxpayer. Applicants should consider providing an electronic copy of their application.

Bilateral and multilateral APAs⁴ 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.

As at 30 June 2006, we had 146 operating APAs. Twenty five have been renewed one or more times. Some APAs have expired and have not been renewed for various reasons.

1 Reports on the APA program for financial years ending 30 June 2003 to 30 June 2005 are available at www.ato.gov.au

2 Appendix 1 of the 2003-04 APA report gave examples of the benefits an APA can deliver.

3 See page 4 of *International transfer pricing: advance pricing arrangements* (NAT 2748) for a flowchart of the APA process.

4 Note that the bilateral and multilateral APAs are referred to as 'MAP APAs' by the OECD, as they are conducted under the Mutual Agreement Procedure (MAP).

APA PROCESSING AND PROGRAM UPDATE FOR 2005–06

OVERVIEW

We completed 27 APAs in the 2006 financial year, exceeding the expectation of 20 APAs as forecast in our Compliance program 2005–06. Although fewer than the record 38 APAs completed in the previous year, the 2006 results were in line with the longer-term average number of APAs completed each year since 2000.

There are three sources of APA applications – renewals of previous APAs, applications encouraged by Tax Office compliance activity (eg a risk review) and unprompted applications. In 2005–06, we completed 12 renewals, six new APAs were encouraged by compliance activity and nine were unprompted. Perhaps influenced by the focus on intangibles in the ATO Compliance program, most of the unprompted APAs involved the licence or use of intellectual property.

APAs can be requested by taxpayers in both the large business and the small to medium enterprises (SME) segments, but they remain principally used by large businesses (with revenues in excess of \$100 million). In the 2005–06 year, two-thirds of completed APAs were with taxpayers with revenues greater than \$100 million.

The completed APAs:

- were with enterprises in the industrial, consumer, energy and minerals, services and finance sectors
- were overwhelmingly related to the acquisitions of property or services by Australian residents.

PRELODGMENT DISCUSSIONS

We encourage potential APA participants to take full advantage of discussions with the Tax Office prior to lodgment of a formal APA application. Of the new APAs involving taxpayers with revenues greater than \$100 million, 40% had three or more prelodgment meetings with us.

In last year's APA Update we provided additional guidance as to what circumstances may be suitable for an APA.⁵ Consistent with that guidance we have discouraged applications that have one or more of the following factors:

- timely agreement was unlikely to be reached over the methodology, comparable data and an overall arm's length outcome
- a lack of materiality in the dealings in the context of the business
- insufficient complexity to warrant the level of certainty that is provided by an APA, ie the APA amounts to over-compliance, or
- obtaining a tax benefit in either Australia or overseas was a principal element of the dealings.

In some instances this has been resolved by the applicant recasting their APA proposal.

⁵ *Advance pricing arrangement program 2004-05 update*, available to download at: <http://www.ato.gov.au/large/content.asp?doc=/content/64083.htm> at page 8

APA PROCESSING TIMES

We normally aim to complete an APA within 12 months of the application's lodgment and we expect the taxpayer to cooperate and provide timely, detailed and accurate information. Completion of the APA process within 12 months will nevertheless depend on the ready availability of information and the extent of cooperation between us, the taxpayer, and where appropriate, the foreign tax authority. This timeline also depends on the availability of suitable internal resources to undertake the process.⁶

As shown in **figure 1** APAs completed in 2005–06 took, on average 12 months (compared with 18 months in 2004–05) to process from lodgment to finalisation. The average time for completion of unilateral applications was seven months (13 months in 2004–05) and 17 months for bilateral applications (23 months in 2004–05). Median processing times overall and for bilateral APAs were similar to the average. The median processing time for unilateral APAs was only four months.

No multilateral applications were considered in 2005–06.

The complexity of a matter and the differing technical positions between us and foreign revenue authorities affects the completion time of bilateral APAs.

This year, on average:

- a unilateral took about 55% less time than a bilateral
- a renewal application took about 45% less time than a new application, and
- an application involving an SME taxpayer took about 70% less time than one involving a large business taxpayer.

The average time to complete an APA in 2005–06 fell back to our targeted 12 months (and below the longer term average), as seen in **figure 2**.

FIGURE 1: Average processing time (2005–06)

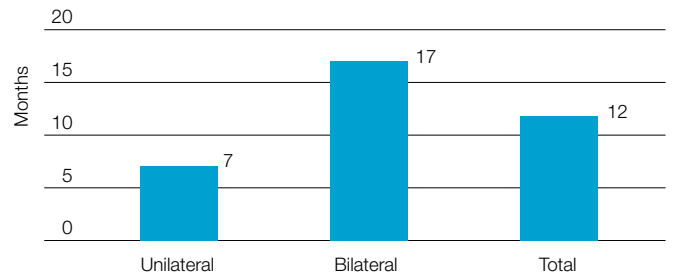
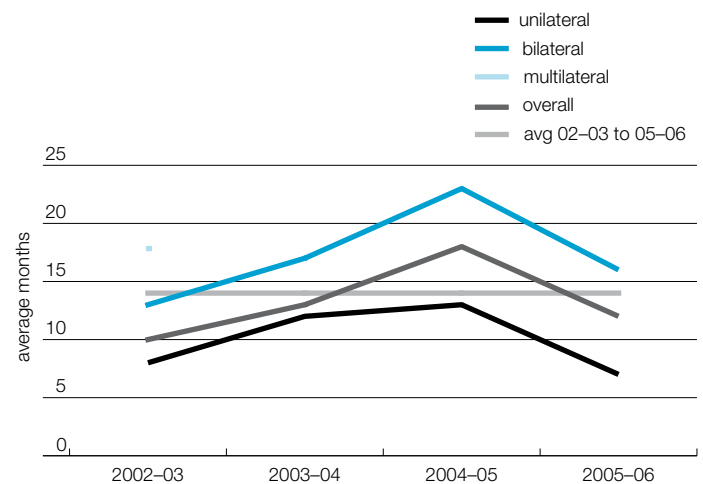


FIGURE 2: Average time in process: APAs by type



⁶ Taxation ruling TR 95/23 *Transfer pricing – procedures for bilateral and unilateral advance pricing arrangements*, paragraphs 120–121.

UNILATERAL AND BILATERAL APAS

Figure 3 shows the number of unilateral and bilateral APAs completed in 2005–06.

66% of our new APA work was bilateral while 75% of our APA renewals were unilateral.

In 2005–06, bilateral APAs were completed with Germany, Japan, New Zealand, Switzerland, and the UK. This was the first time that we have completed a bilateral APA with Germany.

Over the life of the APA program, the number of bilateral and multilateral APAs has averaged approximately 43% of the total APAs completed, but as figure 4 indicates, the level fluctuates year-on-year. In 2005–06 the percentage of bilateral APAs was 52% (47% in 2004–05).

FIGURE 3: APAs by type (2005–06)

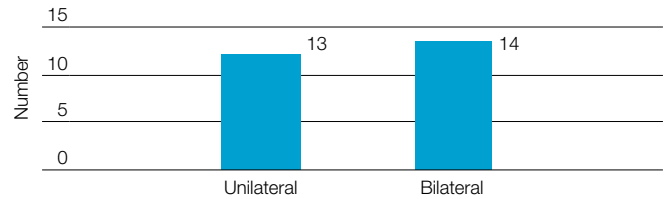
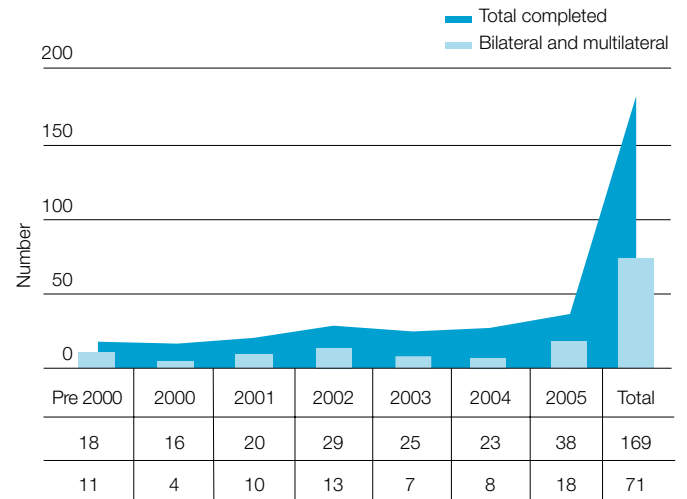


FIGURE 4: Bi and multilateral APAs completed over program life (includes renewals)



INDUSTRY SEGMENTS

Approximately half of the APAs completed in 2005–06 were agreed with enterprises in the national client group (NCG) industry segment (17 cases or 45% in 2004–05). That segment covers manufacturing, wholesaling, services, property and construction.

Other segments represented were:

- energy and resources (ENRG) three (five in 2004–05)
- financial service industry group (FSIG) two (one in 2004–05), and
- eight for SME (nine in 2004–05)
- no APAs were finalised with companies in the IT industry.

Figure 5 shows the spread of APAs between SME and the various large business industry-based segments.

WORK IN PROGRESS AT 30 JUNE 2006

A snapshot of our APAs on hand at 30 June 2006, at the various stages of progress is listed in figure 6.

An increasing proportion of our APAs are bilateral.

The number of APAs falling due for renewal⁷ continues to increase, reflecting the expiry of APAs generally completed three to five years ago. In some of these cases, we will discuss with the taxpayer involved whether their transfer pricing issues are now sufficiently established that they no longer need the high level of certainty that is implicit with an APA. In some cases renewal will not be necessary.

Renewing an existing APA is generally quicker and easier than negotiating a new APA. However, in some instances, significant changes in the business, the business environment, or the transfer pricing approaches of some of our treaty partners, has increased the complexity and time taken to renew an APA.

FIGURE 5: APAs completed by segment (2005–06)

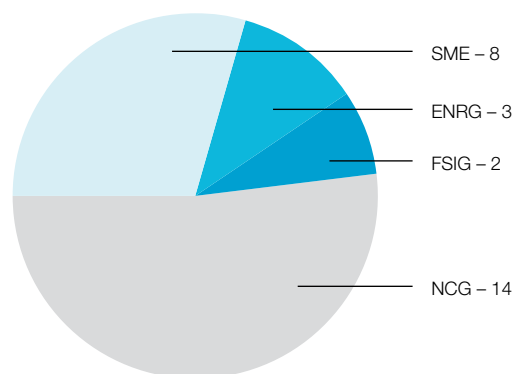


FIGURE 6: Current APA workload

	At 30 June 2006	At 30 June 2005
Discussion stage	15	18
Prelodgment stage	12	18
Lodged and in progress	33 (includes 27 bilateral)	25 (includes 17 bilateral)
Other previously agreed APAs expiring up to 30 June 2007	43	31

⁷ Our renewal policy is explained in paragraphs 165–168 of Taxation Ruling TR95/23.

ISSUES AND METHODOLOGIES USED

The types of dealings covered by APAs completed in 2005–06 are shown in **figure 7**. Several APAs covered more than one type of dealing, for example, the sale of tangible property and the receipt of management services. In these cases the primary dealing is listed first and all dealings are tallied in the right-hand column.

These three broad categories of dealings cover the pricing of goods by marketers, distributors and manufacturers (both purchases and sales), commodities and semi/completed goods, licensing of intellectual property (inbound and outbound), and services including financial, management and other support services.

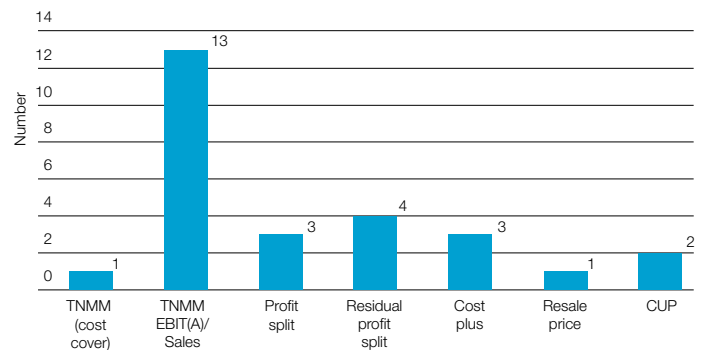
The primary methodologies applied in the APAs completed during the year are shown in **figure 8**. As in previous years, the transactional net margin method (TNMM) continues to be the most commonly used methodology. This is largely due to taxpayers having ready access to independent comparable data in Australia and elsewhere to show that related party dealings achieve an arm's length outcome. With the introduction in April 2004 of TNMM into Japanese transfer pricing rules, we have not concluded any APAs using the hybrid profit split methodology (which incorporates elements of the profit split and modified resale price methods) in the 2005–06 year.

The tested party may be either in Australia or overseas depending on the circumstances of the case.

FIGURE 7: APAs completed by subject (2005–06)

Type of dealing	Primary dealings	All dealings
Tangible property	18	19
Intangible property	5	6
Services	4	15
Total completed	27	

FIGURE 8: APAs completed by primary method (2005–06)



APAS AND THE NEW LAWS ON THE PROVISION OF ADVICE IMPLEMENTED UNDER THE REVIEW OF SELF ASSESSMENT (ROSA)

Under new laws on provision of written advice introduced as part of the Review of Self Assessment, taxpayers are able to seek a private binding ruling (PBR) covering any matter involved in the application of a provision of the tax law, including “issues relating to liability, administration, procedure and collection, and ultimate conclusions of fact. This includes being able to provide a ruling with covers the value of any thing.” Under the new, expanded definition of a private ruling, a PBR might encompass the valuation of property supplied or acquired under an international agreement.

However, we have decided to retain the APA program as it is more flexible than the PBR provisions and enables bilateral APAs to be obtained. This does not affect the right of any taxpayer to seek a PBR, but it may provide a better alternative for matters involving the application of the arm’s length principle.

CONTACTS

The first points of contact for taxpayers and advisors under the APA program are shown below.

Sydney

Keith Johnson

Phone: **(02) 9374 8409**

Fax: **(02) 9374 2588**

Email: **keith.johnson@ato.gov.au**

Canberra

Chris Thomas

Phone: **(02) 6216 1176**

Fax: **(02) 6216 2362**

Email: **christopher.thomas.ato.gov.au**