

Advance Pricing Arrangement Program

2006–07 Update

September 2007



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INTRODUCTION

This report covers the financial year ended 30 June 2007 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 Tax Office. 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 establishes the transfer pricing methodology to be used and generally covers a period of three to five years. It may be reviewed if the trading circumstances of the taxpayer materially change.

The APA 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. We do not impose fees or charges for APAs.

APAs are normally initiated after prelodgment meetings and lodgment of a formal application³ between us and the taxpayer. Applicants should consider providing a soft 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.

1 Reports on the APA program for financial years ending 30 June 2003 to 30 June 2006 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 2006–07

OVERVIEW

We completed 31 APAs in the 2007 financial year. This comprised 11 renewals, five new APAs which were encouraged by compliance activity and fifteen which were unprompted. Perhaps influenced by the focus on intangibles in the Tax Office *Compliance program*, many of the unprompted APAs involved the licence or use of intangible 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 2006–07 year, two-thirds of completed APAs were with taxpayers with revenues greater than \$100 million.

The related party international dealings in completed APAs:

- were with enterprises in the industrial, consumer and energy and resources sectors
- were overwhelmingly about acquisitions of property or services by Australian resident companies that are members of foreign controlled multinational enterprise groups
- included several dealing with the international exploitation of valuable Australian developed intangible property.

PRELODGMENT DISCUSSIONS

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

The prelodgment meeting(s) with the Tax Office should be used to discuss the suitability of the particular case for an APA, the taxpayer's preliminary views on the transfer pricing methodology and the information required to enable a proper determination of their request prior to lodging a formal application.

Many proposals are complex or unique. Applicants should provide background material and an outline of the proposal well in advance of the meeting in order that the best use can be made of the meeting and considered views can be offered. Having an understanding of the scope and nature of the application can assist us to ensure that we have the most appropriate staff attend the meeting.

An example of a prelodgment conference agenda that was previously included in the Update for 2003–04 is again reproduced as Appendix 1. General questions relevant to intangible property issues have also been included for general guidance.

The agenda provides for discussion on the process by which any necessary adjustments to the results may be made (compensating adjustments). These adjustments can arise where intercompany dealings are tested under the APA using a methodology that is different to the method by which the transactions are actually priced. Applicants should expect that the Tax Office would seek to confirm that an applicants transfer price setting mechanism was likely to produce results that are in conformity with any transfer price testing methodology agreed in the APA so that the number and size of any compensating adjustments is kept to a minimum.

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.⁵

We strongly recommend to applicants that they lodge bilateral applications simultaneously in both jurisdictions. Further, applicants should ensure that both administrations are provided with any additional material that may need to be prepared. For example, replies to questions or the submission of further analysis should to be provided to both sides in order that they each have a shared understanding of all the issues. This gives both revenue authorities the opportunity to evaluate the case at the same time and with the same information. We have found that delays arise when this approach is not adopted.

Applicants should also give careful consideration to including a statement detailing the proposed terms of the APA agreement with the application. This helps to focus both the applicant and the administrations on reaching an accurate description of the covered dealings, the transfer pricing methodology and its application including, where applicable, the mechanism for making any compensating adjustments.

As shown in **figure 1**, APAs completed in 2006–07 took, on average 13 months (compared with 12 months in 2005–06) to process from lodgment to finalisation. The average time for completion of unilateral applications was eight months (7 months in 2005–06) and 17 months for bilateral applications (17 months in 2005–06). Median processing times overall and for bilateral APAs were similar to the average.

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 renewal application took about 40% less time than a new application (45% in 2005–06), and
- an application involving an SME taxpayer took about 45% less time than one involving a large business taxpayer (70% in 2005–06).

Our target processing time to complete an APA is 12 months. Our performance over an extended period is shown in **figure 2**.

FIGURE 1: Average processing time (2006–07)

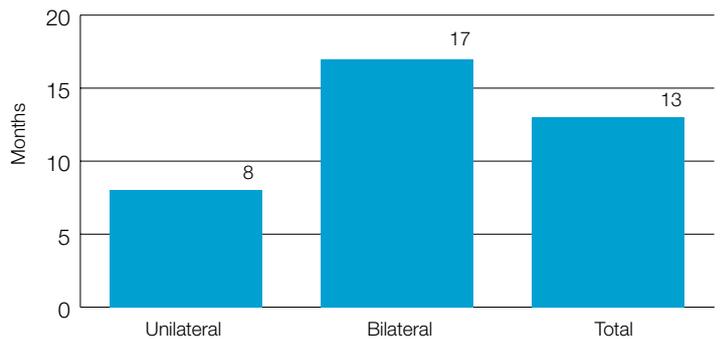
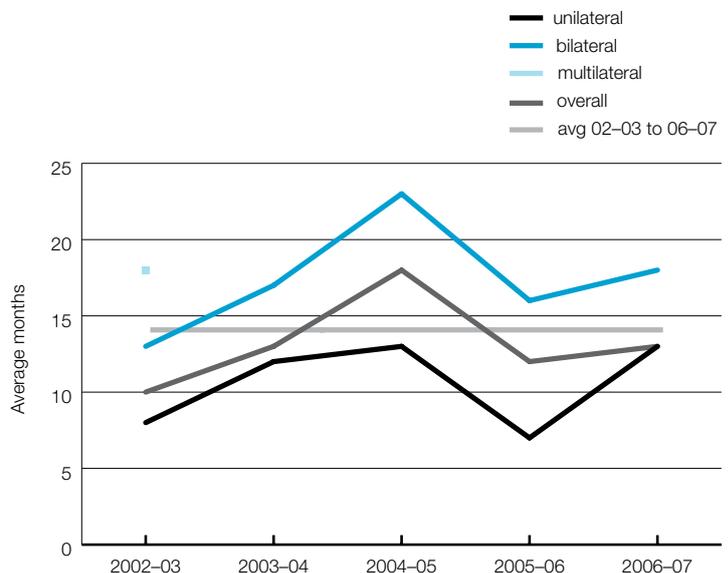


FIGURE 2: Average time in process: APAs by type (2006–07)



⁵ 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 2006–07.

66% of our new APA work was bilateral (same as in 2005–06) while 45% of our APA renewals were unilateral (75% in 2005–06).

In 2006–07, bilateral APAs were completed with Japan, New Zealand, Switzerland, the UK and the USA.

Over the life of the APA program, the number of bilateral and multilateral APAs has averaged approximately 45% of the total APAs completed, but as figure 4 indicates, the level fluctuates year-on-year.

FIGURE 3: APAs by type 2006–2007

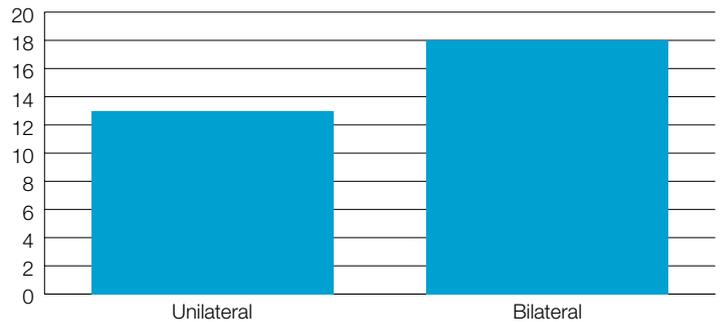
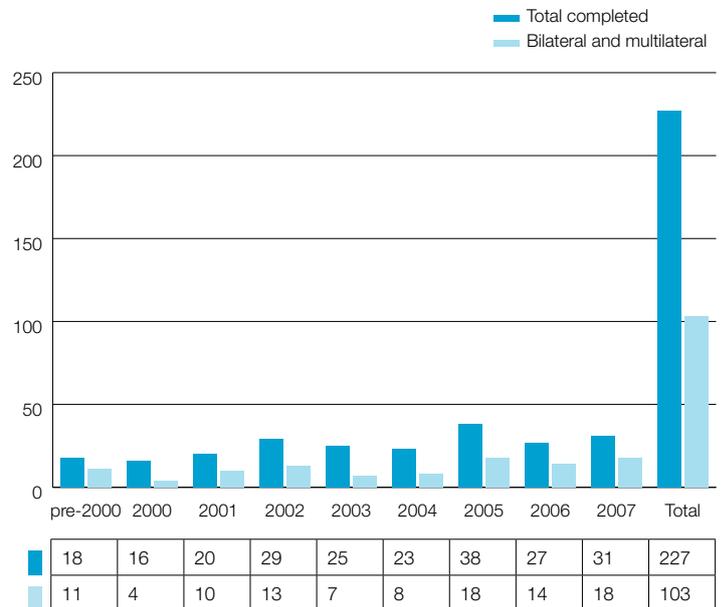


FIGURE 4: Bi and multilateral APAs completed over program life (includes renewals)



INDUSTRY SEGMENTS

Twenty of the APAs completed in 2006–07 were agreed with enterprises in the national client group (NCG) industry segment. That segment covers manufacturing, wholesaling, services, property and construction (14 cases or 52% in 2005–06).

Other segments represented were:

- 2 energy and resources (E&R) (3 in 2005–06), and
- 9 for SME (8 in 2005–06).

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

WORK IN PROGRESS AT 30 JUNE 2007

A snapshot of our APAs on hand at 30 June 2007, at the various stages of progress is listed in **figure 6**.

ISSUES AND METHODOLOGIES USED

The types of dealings covered by APAs completed in 2006–07 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.

FIGURE 5: APAs completed by segment (2006–07)

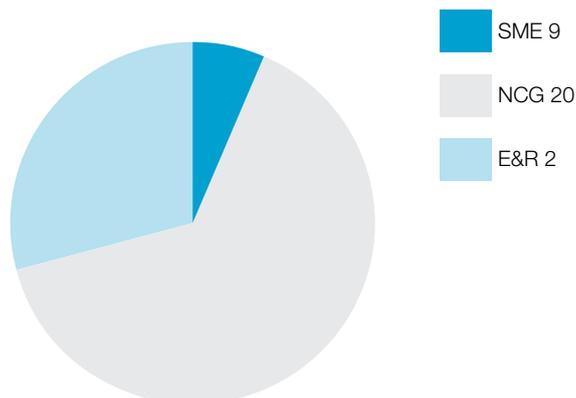


FIGURE 6: Current APA workload

	At 30 June 2006	At 30 June 2007
Discussion stage	15	18
Prelodgment stage	12	3
Lodged and in progress	33 (includes 27 bilateral)	41 (includes 18 bilateral)

FIGURE 7: APAs completed by subject (2006–07)

Type of dealing	Primary dealings	All dealings
Tangible property	22	22
Intangible property	6	6
Services	3	10
Total completed	31	

CONTACTS

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. A TNMM can also be used to establish routine returns in a residual profit split.

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

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

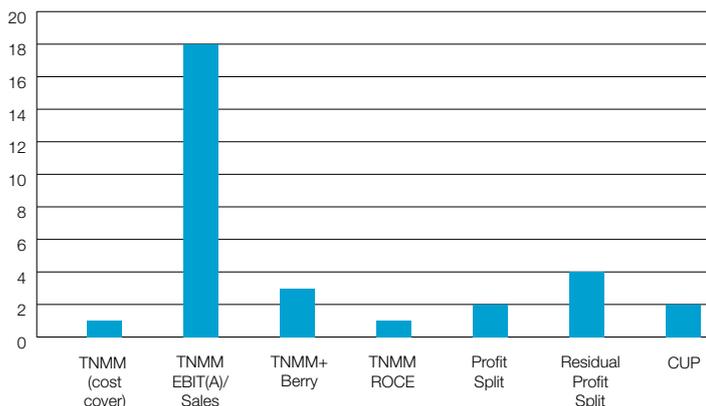
Sydney

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

FIGURE 8: APAs completed by primary method (2006–07)



REVIEW OF THE ADVANCE PRICING ARRANGEMENT PROGRAM

In June 2007 the Tax Office tendered for consultancy services to evaluate the role and performance of the APA Program. The wide ranging review will examine the purpose and benefits of the program against Tax Office objectives and performance indicators and against stakeholder needs.

The review will examine issues surrounding the process of accepting, reviewing and negotiating APA applications to improve effectiveness and efficiency. The consultant has also been asked to advise on the most appropriate organisational model for undertaking the work and to identify significant issues being encountered.

A report is anticipated in the first half of the 07–08 year.

APPENDIX 1

APA – PRE LODGMENT 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 as an agenda, the Tax Office would anticipate discussion concerning:

Background to the process

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

- purpose of the programme
- history and experiences
- confirmation of the nonbinding nature of the pre-lodgment conference
- the Tax Office's views about the APA process (Taxation Ruling TR 95/23 and booklet)
- The Tax Office's preferred method for establishing an arm's length consideration. (The four steps in Taxation Ruling TR 98/11).

Specific matters for discussion

- bi or unilateral term

STEP 1

- explanation of the company's position in the industry
- explanation of the business model adopted by the company and 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
 - how are the company's functions to be characterised?

STEP 2

- the methodology proposed
- The profit level indicator that is being proposed
- 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 hindcast 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: e.g. capital gains, GST etc, non-covered dealings
- timetable, what is to happen?

Processes

Intangible and intellectual property matters can require answers to key questions that will help identify and articulate what the intangible is, how it is used in the business and how it adds to profitability. 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.

Questions we are likely to ask to be explained 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?