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To What Extent do APAs Confer Greater Certainty With Respect to Transfer Pricing Issues?

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Keywords
transfer pricing, tax planning, MNEs

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*Dylan Democrat Damon**

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Introduction

Within the last ten years there has been a fundamental shift in the attitude of multinational enterprises (MNEs) towards transfer price issues. Whereas traditionally transfer pricing was seen as means to procure a special tax-benefit through the after-the-fact shifting of income between jurisdictions, the strategy is now one of *risk minimization*.[1] This change has arisen in response to the fact tax authorities have identified transfer pricing as an area of significant opportunity for improved compliance with the arm's length principle and increased collection of tax revenue.[2]

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1 Paul Koenig, 'Transfer Pricing audits become more frequent' (2005) 16(4) *International Tax Review* 69, 69.

2 Stuart Edwards, Peter Calleja and Douglas Fone, 'Optimizing returns for Shareholders' (2004) 17 *International Tax Review* 3, 4.

This has translated to more aggressive policies towards the enforcement of transfer-pricing rules, in the form of increased powers to allocate income among related persons[3] and harsher penalties for non-compliance.[4] Some jurisdictions have imposed more stringent administrative burdens on MNEs, such as the requirement to provide contemporaneous documentation to support the methods they use to establish their transfer prices.[5]

In response to these developments many MNEs are electing to prospectively resolve their transfer pricing disputes with the relevant tax authorities, through participation in advance pricing arrangements (APAs).[6] One of the aims of the APA process is to identify the preferred transfer pricing methodology (TPM) for the taxpayer's circumstances and to reach an agreement to apply that methodology.[7] However, the reasons an MNE may enter the APA process are more expansive. In particular, the increased potential for double taxation which arises where taxing jurisdictions 'compete' over the allocation of the income of the MNE through the ardent application of their respective transfer pricing rules has compelled many MNE to seek coordination with tax authorities. Further, MNEs have sought to avoid the costly and laborious ramifications of prolonged litigation in transfer-pricing issues.

APAs: Creating Greater Certainty to International Transfer Pricing Issues

An often cited benefit of APAs is that they confer greater certainty in respect to the tax liability of the MNE for their transfer pricing arrangements. APAs facilitate legal certainty to the taxpayer because they:

> determine the appropriate TPM for the specific circumstances of the taxpayer;
> resolve adversarial transfer pricing disputes with the tax authorities; and
> avoid potential double taxation.[8]

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3 George Rozvany, 'Beyond Price' (1997) 31(8) *Taxation in Australia* 442.

4 Ibid.

5 Brian Arnold and Michael McIntrye, *International Tax Primer* (2nd, 2002) 59.

6 The preferred term by the ATO is 'advance pricing arrangements' which is said to reflect the fact the ATO view APAs as administrative accommodation and not a legal agreement; Roger Hamilton, Robert Deutsch, and John Ranieri, *Guidebook to Australian International Taxation* (7th, 2001) 5.265.

7 Kevin Wunsh, 'APAs and TR 95/23' (1995) 30(3) *Taxation in Australia* 146, 146.

8 Alexander Vögele and Markus Brem, 'Do APAs Prevent Disputes?' (2003) 14(1) *International Tax Review* <http://search.epnet.com/login.aspx?direct=true&db=buh&an=9059852>.

However it is noted that the benefit of greater certainty through APAs is not without qualification. Each will be examined below.

Determination of the appropriate TPM APAs as a cure for Transfer-Pricing Ectopia

As mentioned above, one of the principal reasons why an MNE taxpayer would enter into an APA is to determination the appropriate TPM to their circumstances. In transfer pricing this is a contentious issue because of the existence of an ectopic problem[9] which arises when esoteric transfer-pricing methods are applied in the real world. It is argued that in the practical realities of international commerce, transfer pricing is often a multi-entity issue that incorporates diverse functions which are performed in several jurisdictions along the different stages of production of the MNE.

A distinction is often made between the 'routine' and 'non-routine' functions of the MNE.[10] A 'non-routine' function may be described as a transaction which embodies a particular attribute or element, usually pertaining to the constitution of the good itself, which is unique to the MNE. Although non-routine functions are more commonly ascribed to intangible goods, they may apply equally to tangible goods. An attribute which is commonly identified is the degree 'integration'. A highly integrated good is one which has value-added at different taxing jurisdictions within the MNE group. For example, one member of the MNE may develop a product another member may expend considerable effort marketing the intangible in a specific geographic location.[11]

As global transactions encompass more 'non-routine' and 'highly integrated' functions the traditional methods used by tax authorities of ascertaining the arm's length standard are precluded from providing valid outcomes. Therefore, if there are strong economic and commercial relationships between separate transactions, only a combined analysis of separate transactions will be reliable.[12] By contrast;

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9 'Taxation ectopia' is a concept propounded by the esteemed international taxation academic, Professor John Prebble, who has identified the problem of applying the rigid artificial concepts found in tax law to the real world. See John Prebble, 'Ectopia, tax law and international taxation' (1997) *British Tax Review* 383.

10 Alexander Vögele and Markus Brem, above n 8.

11 Canada Customs and Revenue Agency, 'International Transfer Pricing' *Information Circular* 87-2R 27 September, 1999 <http://www.cra-arc.gc.ca/E/pub/tp/ic87-2r/ic87-2r e.pdf [98].

12 Vögele and Brem, above n 8.

Tax-world transfer pricing in the form of the OECD model treaty, the OECD transfer pricing guidelines, and the country-specific treaties and regulations is based on a simplified concept where two controlled entities exchange goods or services between two countries.[13]

The main consequence of this disparity is that it will give rise to conflicts between the transfer pricing objectives of the management of the MNE and those of the relevant tax authorities.

MNEs have considered themselves constrained in their choice of TPMs as many tax authorities have demonstrated an unequivocal preference for transaction-based methods of ascertaining the arm's length standard. In this regard, the OECD Guidelines state that transactional transfer pricing methods must be the first approach used by taxpayers in determining the arm's-length nature of their controlled transactions. Profit-based methods are recommended only be used 'when traditional transactional methods cannot be reliably applied'.[14]

It is suggested that transactional based methods are more susceptible to the distortions of the 'ectopia' phenomenon, because they place more weight on separate transactions in isolation. In this context, APAs may partially ameliorate the problem of taxation ectopia in respect to transfer pricing arrangements because they provide greater flexibility to the taxpayer to justify their preferred TPM. This allows the MNE to account for more 'non-routine' functions in the transfer price. It is said that APAs provide an 'inherently individualised approach to transfer pricing transactions'[15] because they confer an ability to the taxpayer to use more than one methodology in order to ascertain the arm's length standard.

The corollary to this argument is that if an APA fails to address the above stated problem, its usefulness may be called into question. It is perhaps in recognition of this that most tax authorities have propounded guidelines for the conduct of APAs. Some of these guidelines purport to make the APAs more applicable to the real-world. For instance, the Australian Tax Office (ATO) has stated a preference for APAs to be conducted on a multi-lateral basis,[16] which is a requirement for the APA to be effective

13 Ibid.

14 Henrik Lund and Christian Scholz, 'How keep-well agreements can reduce costs and risks' (2004) 16 *International Tax Review*, Transfer Pricing, <http://search.epnet.com/login.aspx?direct=true&db=buh&an=17816613>.

15 Michelle Markham, *The Transfer Pricing of Intangibles* (2005) 297.

16 Australian Tax Office, Tax Ruling 95/23 Income Tax: Transfer Pricing – Procedures for Bilateral and Unilateral Advance Pricing Arrangements, [12].

against eliminating double taxation. Notwithstanding this, the ATO is still prepared to enter into unilateral APAs. Up to this point the ATO has entered into more unilateral APAs than bilateral/multilateral arrangements although this ratio may be reversing.[17] The implications of the distinction between unilateral and bilateral APAs are discussed in Part 3.

Another such guideline is provision for the tax authority and the taxpayer to agree in advance on a list of 'critical assumptions' which may render the APA void 'if neither party in an arm's length situation would continue to be bound if any of them change.'[18] Where a 'critical assumption' is infringed the ATO makes allowance for the MNE to renegotiate the APA with the relevant parties,[19] however no such provision expressly stated under the United States guidelines.[20]

Trends in preference of methodologies under APAs

The empirical evidence suggests a trend from away from traditional transaction-based methods towards the use of profit based methods. In Australia, the trend is towards the transitional net margin method (TNMM) as the preferred methodology utilized in APAs.[21] In the United States more than 50% of the APAs concluded in the last 4 years have used the comparable profit method (CPM) as the principal methodology.[22] Both of these methodologies adopt a similar approach to ascertain the arm's length standard.[23] The subject matter of the APAs referenced predominately entail intercompany transactions in respect to tangible goods[24] This is an intriguing

17 Of the 38 APAs concluded by the ATO in the 2004-05 financial year, 20 were concluded on a unilateral basis, while 18 were on bilateral/multilateral basis. With is compared with 78 unilateral, 53 bilateral/multilateral in the previous years of the program; Australian Tax Office, 'Advance Pricing Arrangement Program: 2004-05 Update' at September 2005 [5].

18 Australian Tax Office, Tax Ruling 95/23 Income Tax: Transfer Pricing – Procedures for Bilateral and Unilateral Advance Pricing Arrangements [28].

19 Ibid [29].

20 Richard Hammer, 'Advance Pricing Agreements under the Microscope' (2005) 34(4) *Tax Management International Journal* 235, 237.

21 Steven Harris, Damian Preshaw and Daisuke Horiguchi, 'Trends in APA tangible goods transactions methodologies' (2004) 16 *International Tax Review* <http://search.epnet.com/login.aspx?direct=true&db=buh&an=17816620>.

22 Internal Revenue Service, 'Announcement and Report Concerning Advance Pricing Agreements' IRS Announcement 2005–27, Table 18: Transfer Pricing Methods Used For Transfers Of Tangible And Intangible Property.

23 For a comparative evaluation of the CPM and the TNMM see Markham, above n 15, 115-6.

24 Steven Harris et al, above n 21.

development since profit based methods are normally associated with ascertaining the arm's length standard in respect to intangibles.[25]

The essential feature of the TNMM method is that it designates an arm's length range of profits on a set of transactions. Profits that fall within that range are deemed acceptable by the tax authorities.[26] This range is ascertained by reference to ratio between the taxpayer's profit and a profit level indicator. The PLI is a ratio that measures relationships between profits and costs incurred or resources employed, commonly operating profit or return on capital. The choice of PLI will depend on the nature of the activities of the MNE, the reliability of the available data with respect to uncontrolled comparables and the extent to which the PLI is likely to produce a reliable measure of the income that the MNE would have earned had it dealt with controlled taxpayers at arms' length. Crucially, this approach adopts a more holistic analysis to the taxpayer's circumstance because the profit earned on a set of transactions may be deemed a final reflection of all the MNE taxpayer's activities.

An APA using the TNMM as the principal methodology gives rise to two potential advantages for a taxpayer. First, it helps to minimize one of the principal drawbacks for a taxpayer participating in an APA, namely that APAs are susceptible to changes in economic or industry conditions which may become obsolete with the period for which it operates. The TNMM may preserve the relevance of the APA against such changes as long as the taxpayer's profit falls within the designated range. However, because there is often a strong nexus between profit and the changes in economic conditions, the implication is that the unrelated company's profit will be affected to a similar extent and therefore the taxpayer will stay within the designated range.

It should be noted that although the OECD guidelines and some tax authorities make provision for a 'safe harbour' range of expected results in an APA, irrespective of the TPM used, the availability of this to the taxpayer is contingent on a number of different factors.[27]

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25 It may also be seen as a possible indication of a trend that MNEs are avoiding negotiating APAs in respect to intangibles. It has been suggested that this is a result of 'the binding nature of APAs, its impact on business flexibility, fear of revealing sensitive commercial information and the length of negotiation': Vögele and Brem, above n 8.

26 Brian Arnold and Michael McIntrye, above n 5, 66.

27 A conceptual difficulty may arise if the APA is conducted on a multilateral basis. In such a case, adjustment may require consensus between the relevant tax authorities; Michelle Markham, above n 15, 254.

The second advantage of an APA concluded under the TNMM is that it has greater appeal to an MNE with a diverse product range. Previously, MNEs with diverse product ranges were restricted from enjoying the full benefits of the APA process, because of the cost and time associated with the negotiation of a comprehensive APA over the entirety of its product range. In such circumstances, the MNE typically restricted the operation of the APA to a selected range of products.[28]

An APA concluded with the TNMM may be beneficial for a taxpayer with a diverse product range for two reasons. Firstly, as noted by the ATO the preference towards the TNMM stems from the availability of independent comparable data demonstrating that the related party transfer price is at arm's length.[29] The availability of pre-existing data means that the MNE is able to conclude the APA over a broader spectrum of its goods at a lower marginal cost.

The second reason is that it the TNMM may be applied equally to tangible and intangible goods. This permits the taxpayer to employ the same methodology over its product range. This may be particularly useful in circumstances where the subject matter of the transaction embody both a tangible and intangible elements. It is significant to note that an APA conclude over a wider range of goods is consistent with the ATO's preference that an APA should cover all of the taxpayer's international related party transactions.[30]

The objectives of the APA process compliment the TNMM in respect to complex intangibles transactions. It is noted that there are problems applying the TNMM to non routine, high value intangibles due to the absence of comparative data.[31] However, under an APA the taxpayer is in a stronger position to justify a non-routine function. This allows the taxpayer to retain the TNMM as the principal methodology.

The ATO also appears to be showing an increasing preference for the use of the TNMM, and not only in its APA program. It has recommended that taxpayers to use 'some other basis' to check transfer-pricing outcomes in cases where a traditional transaction method has been selected and there is some uncertainty as to the reliability of the outcome.[32] On a broader level, it has been suggested that the proliferation of

28 A case in point is the APA concluded between Apple Computers, Inc, the United States and Australia; R Duncan Bentley, Dean of Law, Bond University Paper on 'Transfer- Pricing' delivered on 29 July 2005, Bond University, Gold Coast, Australia.

29 Steven Harris, et al, above n 21.

30 TR 95/23 above n 16 [53].

31 Michelle Markham, above n 15, 116.

32 Steven Harris et al, above n 21.

the TNMM to test related party tangible transactions may form the basis of a common platform for negotiations between two or more treaty countries in an APA setting.[33]

Resolution of Transfer Pricing Disputes

It is said that the APA process provides a 'different psychology'[34] to transfer pricing dispute resolution compared with an audit or litigation. This arises in part because the APA process fosters a 'cooperative and resolution seeking environment'.[35] Moreover, the willingness of an MNE to participate in an APA may be interpreted by the tax authorities as indication that the taxpayer is not concerned with unlawfully avoiding its tax liability. It is suggested that in recognition of this the tax authorities may not require the taxpayer to justify their transfer pricing outcomes to the same extent as they would in an audit situation.

Notwithstanding the aura of camaraderie and harmony that it is emphasized by proponents of APAs it is important to remember that the objectives of the taxpayer and the tax authorities remain divergent. This means that either party may exploit their position in the APA process to derive a benefit. In the United States, there is a perception among some participants of APAs have likened the process to an audit.[36] This is likely to discourage broad-base participation. Although such a view may be regarded as extreme, the tax authorities need to bear in mind that the APA process will not succeed if the taxpayers refrain from 'coming to the table' for fear of further inquisition into their affairs.

In Australia, the ATO has not endeared itself to prospective APA entrants in this regard by removing the 'without prejudice' privilege from information obtained the prelodgement meeting.[37] The underlying inference is that the ATO may use the APA process to conduct 'fishing expeditions' into an MNE's affairs to use in the event of subsequent transfer pricing audit or perhaps even in an audit selection process.[38]

33 Ibid.

34 R Duncan Bentley, Lecture on 'Transfer- Pricing' delivered on 29 July 2005 at Bond University, Gold Coast, Australia.

35 TR 95/23 above n 16 [64].

36 Hammer, above n 20, 235.

37 Hamilton, above n 6, 5.265.

38 Ibid.

APAs for Small to Medium Business Taxpayers

The Australian tax authorities have adopted a somewhat inconsistent stance in respect to the availability of APA to prospective entrants. Although the ATO views APAs favourably as a highly effective means to ensure compliance with transfer-pricing regulations[39] the ATO itself will refrain from entering into the APA process in circumstances where the taxpayer's benefit is it deemed to be significantly greater than the benefit to the Commissioner.[40] Therefore, the ATO may deem a request for an APA by a Small to Medium Enterprise (SME) to be 'time consuming' and 'uneconomical.'[41] The ATO will also be less inclined to participate where the taxpayer has not taken preliminary steps to address its transfer pricing arrangements,[42] as this is likely to significantly prolong the process.

The rationale for the ATO's stance on SME's presumably derives itself from the belief that the ATO will not devote resources to participate in APA negotiations for the exclusive benefit of the taxpayer. The clear implication here is that the ATO does not conduct APAs for altruistic reasons; in order for it participate there must a benefit to the ATO which probably extends beyond the saving of the cost of conducting an audit, namely that the APA helps to secure a discernable tax base.

It may be argued that this imposes an unnecessary restriction on the ability of taxpayers to enter into APAs. The proposition is problematic because it is contrary to the goal of the APA program, namely to assist taxpayers in solving potentially complex transfer pricing issues in accordance with the established guidelines in conjunction with the relevant tax authorities. It is suggested that a far more logical approach is the one used by the Inland Revenue in the United Kingdom, which uses APAs only for complex issues, stating that it may decline to accept APA applications for issues about which there is 'no significant doubt as to the manner in which the arm's length principle should be applied.'[43]

In the United States, the IRS has recognised the need to make APAs more accessible for Small Business Taxpayers (SBTs)[44] in order to reduce the compliance burden of

39 Stuart Edwards et al, above n2, 4.

40 Wunsh, above n 7.

41 TR 95/23, above n 16 [68].

42 Hamilton, above n 6, 5.265.

43 Steven Wrappe, 'Advance Pricing Agreement Procedures: US v UK' (1999) *Tax Notes* 709, 711.

44 The monetary limit for an SBT is a gross income of $US200 million or less, or the

assessments made pursuant to §482 of the Internal Revenue Code. The intention is to address an SBT's need to achieve the compliance certainty at a cost that is reasonably relative to the size and complexity of the various transactions involved.[45] Accordingly, the IRS has taken steps to 'coordinate special APA procedures' with prospective SBT entrants which are predominately aimed at reducing the costs associated with negotiating APAs.[46] This entails more simplified procedures that depart from standard procedures to meet the needs of the particular SBT.[47] In addition to administrative and financial concessions it is suggested the tax authorities should review the criteria for eligibility (eg monetary limits) on a more frequent basis. This will aid the overall efficacy of the APA program.

The fact tax authorities may be eclectic in their willingness participate in an APA may ultimately affect the outcome of the negotiation process, mainly to the benefit of the taxpayer. Since a taxpayer may withdraw from an APA anytime after it is concluded, it is unlikely the tax authority will make a determination which is grossly unfavourable to the taxpayer. This, in turn, suggests that the tax authority may be more inclined to reach a compromise on a particular issue, rather than to waste the opportunity to reach consensus with the MNE. The implication here is that tax authorities should adopt an 'MNE-friendly' image in order to enhance their potential tax base.

The Conduct of Audits and Litigation in Transfer Pricing Cases

One of the perceived benefits of APAs for the tax authorities is that they reduce the profligacy of audits and litigation, and generally offer more cost effective form of compliance. The audit process in respect to transfer price arrangements can be an extremely cumbersome process. It requires the relevant tax authorities to partake in:

1 The collection and analysis of taxpayer provided information (this usually includes carrying out on-site visits and interviewing key operational personnel).

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aggregate value of the covered transactions does not exceed (i) $50 million annually, and (ii) $10 million annually with respect to covered transactions involving intangible property.; Internal Revenue Service, *Internal Revenue Bulletin 2006-2 Revenue Procedure 2006-9* Section 4.12 (5) <http://www.irs.gov/pub/irs-drop/rp-06-9.pdf>.

45 Effective 1 February, 2006, the user fee for a small business APA request is USD22,500. By comparison, the standard user fee for an APA request is USD50,000, and USD35,0000 for a renewal; Ibid Section 4.12(3)-(5).

46 Anonymous, 'Advance pricing agreements for smaller businesses' (1998) (31)(3) *Practical Accountant* 39 citing IRS Notice 98-10.

47 Advance pricing agreements for smaller businesses, above n 44.

2 Finding a basis for and justifying a proposed adjustment;

3 The sustaining the proposed adjustment in administrative and/or judicial proceedings.[48]

It has been noted that in many jurisdictions the taxpayer bares the ultimate onus of proving that the assessment is excessive.[49] Notwithstanding this, any perceived benefit for the tax authority that flows from this may be illusory. The reason for this is two-fold; Firstly, where a taxpayer merely needs to discharge the burden on the balance of probabilities,[50] it is suggested that the taxpayer merely has to 'tip the scales, however slightly in his favour'.[51]

Secondly, even in jurisdictions where the taxpayer bears a heavier than normal burden of proving the tax authority's assessment was unreasonable[52] it has been noted that this has 'rarely' helped the tax authority.[53] The reason for this presumably stems from the fact that the court is not required to be satisfied that the taxpayer's pricing methodology is correct. Rather the taxpayer merely needs to discharge the burden of proof in respect to the tax authority's assessment. Therefore, as it was illustrated in the *Bausch & Lomb* case,[54] in circumstances where the tax authority has made an excessive adjustment it is argued that the burden for the taxpayer is easier to discharge.

The emphasis of the APA program is *self-compliance*. In Australia, the taxpayer is required to submit an annual compliance report on a yearly basis, demonstrating compliance with the terms of the APA and addressing the critical assumptions discussed earlier in this paper.[55] The upshot of these arrangements is that it provides an inexpensive and effective mechanism for compliance with transfer pricing

48 Robert T Cole, 'Fourteen Facts Offered to the Senate Finance Committee to Assist In Its Review of the Advance Pricing Agreement Program' (2004) 33(3) *Tax Management International Journal* 178, 178.

49 For example, *Tax Administration Act 1953* (Cth) s 14ZZK(b).

50 Robin Woellner, Stephen Barkoczy, Shirley Murphy and Chris Evans, *Australian Taxation Law* (15th ed, 2004).

51 *Nixon v FC of T* 79 ATC 4377, 4381 (Hunt J).

52 For instance, under the Internal Revenue Code of 1986 (26 USC 482).

53 Robert Cole, above n 48, 183.

54 *Bausch & Lomb, Inc and Consolidated Subsidiaries v Commissioner of Inland Revenue* (1989) 92 TC 525.

55 Tax Ruling 95/23, above n 15 [31].

regulations, and is clearly a cheaper alternative from the tax authority's perspective than conducting an audit.

The Disclosure of Taxpayer Provided Information during the APA Process

Tax authorities may be able to derive a further advantage from the APA process through the collection of information about the taxpayer's activities. This is normally a very burdensome and costly process for the tax authority. However, the mere fact the taxpayer is incurring most of the expense of collating the information under an APA represents a substantial benefit to the tax authority. More importantly, as indicated above, this also satisfies the first stage in the conduct of an audit. However, does it necessary follow that an audit will ensue?

The answer depends in part on the outcome of the APA process itself. If the taxpayer is unable to conclude an agreement with the tax authority then it is more probable that the information provided by the taxpayer may be used in an audit. However, if an APA is concluded then the tax authority is likely to rely on the self-compliance aspects of the APA process than go to the further trouble of conducting an audit.

Some authors have suggested that disclosure of information during the negotiating of an APA may lead to the dissemination sensitive and confidential information against the taxpayer's interests.[56] This information may harm the MNE competitively, or exert an adverse impact in a subsequent audit.[57] The counter-argument to this that where an MNE takes the initiative to enter the APA process, it has a high degree of control over the information that it provides the tax authority. From the taxpayer's perspective it is noted that there is no positive obligation for full and frank disclosure in the course of negotiating the APA. Rather it is suggested the taxpayer must act in good faith.[58] Therefore, as long as the taxpayer is able to identify a potential auditing issue that may arise in the future, and the information is not integral to the negotiation of the APA, the taxpayer is not obliged to provide this information. This will reduce the possibility the information will be used against the taxpayer.

APAs and the Elimination of Double Taxation

In order for an APA to be effective in providing greater certainty in respect to the elimination of double taxation it must be concluded on a bilateral or multilateral basis.

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56 For example, Michelle Markham, above n 15, 276-7.

57 Hammer, above n 20, 237.

58 Sean Foley and Paul Burns, 'The APA program as a model for successful alternative dispute resolution' (2003) 32(9) *Tax Management International Journal* 451, 453.

The reason for this is that when an MNE has operations across two taxing jurisdictions, the transfer price it sets is subject to scrutiny by two tax authorities, each of whom have revenue maximisation as an objective. The upshot of this is that both tax authorities will make excessive allocations of income to their jurisdictions pursuant to their respective statutory powers.[59] Under a unilateral APA, the pricing method agreed to with the local tax authority will still be subject to inquiry by the foreign jurisdiction. By contrast, a bilateral APA is binding on both governments for the agreed upon period.

This does not necessarily imply that unilateral APAs are of no utility. If there is a subsequent need for negotiation with a foreign tax authority on the tax implications of the international dealings, the unilateral APA will form the basis of the negotiating position.[60]

Under the ATO rules, a taxpayer may apply to negotiate an APA on a unilateral basis, provided it has 'good and sufficient reasons.'[61] These reasons normally arise in circumstance where the 'competent authority' in the foreign jurisdiction does not wish to participate. It is has been noted that where foreign governments are involved, the APA process becomes prolonged (more than usual). This is also likely to apply in circumstances where the MNE has dealings in a wide variety of jurisdictions, or where the taxpayer is a SME. The increased cost and time associated with participating in a multilateral APA could discourage a potential entrant. Nevertheless, it is important that the taxpayer has regard for the threat of double taxation which represents a far more insidious hazard to the MNE when assessing the costs and benefits of entering into an APA.

There is scope within the OECD Treaty[62] to allow a tax authority to negotiate directly with foreign tax authorities in the absence of the MNE, through the 'Mutual Agreement Procedure' ('MAP').[63] In such circumstances, it is possible that the ensuing APA may not represent the preferred transfer pricing strategy for the MNE. As with any APA the MNE will not be bound to comply with it, however it may still be advantageous for the MNE to adhere to the APA if it is effective against eliminating

59 Robert Cole, above n 48, 180.

60 Australian Tax Office, International Transfer Pricing: Advance Pricing Arrangements – Guidelines. AGPS, 2005, 3.

61 Tax Ruling 95/23, above n 15 [41].

62 Organisation for Economic Cooperation and Development, Articles Of The Model Convention With Respect To Taxes On Income And On Capital, Article 25. 2-3.

63 John Neighbour, 'OECD Issues Guidance on Mutual Agreement APAs' *Tax Notes International*, November 1999, 1954, 1955.

double taxation. Furthermore, the MNE will obtain prospective knowledge of when it is deemed to have breached the arm's length standard and take the appropriate measures.

Finally, it is worthwhile to note that APAs in the bilateral or multilateral context can exert pressure on the relevant tax authorities to agree upfront to the proposed cross-border pricing arrangement.[64] This creates a mutual beneficial arrangement for the taxpayer as well as the two (or more) relevant tax administrations.[65] An important flow-on effect of greater certainty from participating in a multilateral APA is to allow the MNE to conduct long-term strategies in respect to their commercial or investment in the foreign jurisdiction.

Concluding Remarks and Recommendations

APAs provide an important contribution to tax practice as they represent a genuine alternative for resolving transfer-pricing disputes.

An APA would normally be deemed appropriate when it is difficult to establish reliable market comparables or when there is doubt about how a transfer pricing method can be accurately employed to determine an arm's-length result under OECD guidelines.

Although tax authorities have retained a preference for transactional methods, they are more amenable to profit-based methods, in particular the TNMM, under an APA. For this reason, it is suggested that MNEs may be seeking entry into an APA program in order to access a TPM, which may otherwise not be available to it.

APAs cannot guarantee to safeguard against the threat of litigation, although the environment under which such agreements take place purportedly fosters consensus. Nevertheless, an MNE taxpayer must be aware that as unattractive as the consequences of litigation are, sometimes it may remain the only means to overcome an aberrant assessment by the tax authorities.

The advantages of participating in the APA process from the perspective of the tax authorities extend beyond securing their tax base. There are cost advantages associated with a low compliance monitoring requirement of MNEs with concluded APAs and also benefits derived from the availability of information. Such

64 Hammer, above n 20, 236.

65 Ibid.

considerations should be taken into account by the tax authorities when assessing the suitability of prospective APA entrants.

If the ATO is bound by budgetary constraints which limit the availability of APAs to certain classes of taxpayer, then it is suggested it should follow the lead of other taxing jurisdictions which charge the taxpayer a user fee for participating in the APA (often in proportion to the size of the transactions that form the subject matter of the APA). This should free the restrictions that the ATO has placed on the requirements for participating in the APA, especially for SMEs.

Finally, the importance of the MNE engaging in a multilateral APA wherever it is possible is paramount. Not only do multilateral APAs represent the only effective strategy against the imposition of double taxation, but they may used as the cornerstone to its long-term international investment and business strategies.