

Senate Economics Legislation Committee

Inquiry into the Tax Laws Amendment (Cross-Border Transfer Pricing) Bill (No. 1) 2012

ANSWERS TO QUESTIONS ON NOTICE

Treasury Portfolio

26 July 2012

Topic: MAP agreements resolved over 8 years and amounts involved

Hansard Page: 54

Question: 1

**CHAIR:** Double taxation?

**Mr T McDonald:** This goes to the operation of the mutual agreement procedures. Obviously, because this legislation is only applicable to treaty partners and the mutual agreement procedures are an element of our treaties, all relevant cases have the mutual agreement procedures available to them. The way these procedures operate is for the ATO to work through with our treaty partners. My observation is that, while these processes can be lengthy, they do in the vast majority of cases result in a resolution and the ATO has a very good record in this area. But I might ask my ATO colleagues if they would expand upon that.

**Mr Jenkins:** To amplify a couple of the points made by Mr McDonald, the ATO has a good record of settling disputes at the MAP table. Over a long period of time there have been only two matters, I think, where we have not been able to reach full relief on the double tax issue, and that has not been the totality of the double tax in question; it has just been a portion of that.

**CHAIR:** Could you give me some sort of idea of the volume of these MAP agreements and negotiations that might be conducted on an annual basis?

**Mr Jenkins:** It is difficult to annualise it because it is lumpy and they come on the back of the audit program, so not every audit matter—

**CHAIR:** I picked that. This has some retrospective effect—the last eight years.

**Mr Quigley:** I would not have that in front of me. In the last 12 months there were, I think, five transfer-pricing matters that were concluded around the MAP table. I would not be comfortable extending that to say that that is indicative of what we do every year. I would take that on notice.

**CHAIR:** Why don't you just take on notice the number of MAP agreements that have been resolved each year for the last eight years and the annual amounts involved for each of the last eight years. We just want an indicative response around what has happened.

**Mr T McDonald:** We are happy to do that. We will also check to see to what extent there is international data available that may be able to assist the committee, including by putting Australia's performance in context.

**CHAIR:** That would be useful.

Question 1

Senator Bishop (Chair): Why don't you just take on notice the number of MAP agreements that have been resolved each year for the last eight years and the annual amounts involved for each of the last eight years. (page 54, proof Hansard transcript)

The number of transfer pricing Mutual Agreement Procedure (MAP) cases that have been resolved over the last eight years and the associated agreed income adjustment is set out in Table 1 below. The cases comprise of both inbound and outbound matters i.e. matters where the ATO is seeking relief from the other jurisdiction on an item of income otherwise taxable in the other jurisdiction; and matters where another jurisdiction is seeking relief on an item of income otherwise taxable in Australia.

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Table 1

Year	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12
Number of cases resolved	10	12	3	9	8	5	11	5
Agreed income adjustment (\$m)	113	338	40	371	466	530	24	434

The data in Table 1 refers solely to MAP cases specific to transfer pricing. In terms of Australia's performance in the area of MAP more generally, further data from the period 2006 to 2010 is available from the OECD. In 2006 the OECD began to compile annual statistics on the MAP caseloads of all its member countries and of non-OECD economies that agree to provide such statistics. This data covers all MAP caseloads – including both treaty interpretation cases generally and cases specific to transfer pricing. It is therefore broader in terms of the number of MAP cases than the data covered in Table 1 above, but does not cover detail on the amounts of income in dispute. It should be noted that transfer pricing MAP matters tend to be more complex and frequently involve significant amounts of income.

In all cases over the last eight years, double taxation has been significantly relieved through MAP negotiations. In fact, in all but two cases there has been complete elimination of double tax.<sup>1</sup>

Although Australia has generally had fewer MAP cases when compared against the average for the OECD reporting countries (see columns A and B of Table 2 below), Australia has completed and/or closed a higher percentage of cases over recent years in comparison to the OECD average (see column C of Table 2 below).

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<sup>1</sup> OECD Country Mutual Agreement Procedure Statistics 2006-2010

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Table 2

OECD reporting period	Total of <u>opening cases and cases initiated</u> during the reporting period (A)		Number of <u>completed/closed</u> cases during the reporting period (B)		Completed/closed cases during the reporting period as a percentage of opening and initiated cases (C = B/A)	
	OECD reporting countries average	Australia	OECD reporting countries average	Australia	OECD reporting countries average	Australia
2010	144	37	43	18	30%	49%
2009	129	41	35	18	27%	44%
2008	119	31	35	10	29%	32%
2007	115	26	30	5	26%	19%
2006	109	32	33	18	30%	56%

Source: Treasury calculations based on OECD Country Mutual Agreement Procedure Statistics 2006-2010

Topic: Penalties on retrospective findings

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Question: 2

**Senator BUSHBY:** I am concerned here about the potential for penalties on retrospective findings. I understand, and the point was made, that as a result of consultation an exemption will be inserted or has been inserted so that people who are subject to retrospective findings do not have to pay penalties if they would not have been outside the law as it currently stands. But, if all you are doing is clarifying the law as it currently stands, and the extent to which it currently goes is unclear anyway, how do you actually know what that is?

**Mr Quigley:** I will start and I will get Mr Jenkins to follow on. I believe that what these transitional penalty rules will do is ensure that the processes and procedures that the ATO has used in cases up until now will just continue. We have obviously quite extensive procedures that our officers have to follow when they are applying penalties in all sorts of situations, including transfer-pricing ones. Mr Jenkins might want to expand a bit.

**Senator BUSHBY:** I do not want to spend too much time on this, but it was something that I wanted to raise because it seemed inconsistent. I just could not see how it was going to work.

**Mr Quigley:** From the administrator's point of view, it would be the status quo. We would not impose penalties—

**Senator BUSHBY:** Could you take on notice for me how you would actually approach this. That is probably the best way to do it. Could you just give us a short explanation of how this will not affect those people who are retrospective, and why, and how you will actually assess whether they would have been caught under current laws, given that there will be new laws in place.

**Mr Quigley:** It all goes back to what I said before—and we will do that, for sure. This is meant to clarify the view that we have held since at least 1982 and how we have applied the law.

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**Senator BUSHBY:** I understand that. I really do not want to labour this point, but, if someone is a taxpayer who is subject to an audit, and you come along and say, 'We want to hit you for some more transfer-pricing tax because we have adjusted this under the profit method and you owe us more,' they object and they go to court under current laws, they have the potential that they could win, in which case they would not be subject to any penalties. That same taxpayer now, currently under audit, this law gets passed and they no longer have the path with the same laws in place to be able to go through that process, prove that what they had done was right and to prove that they should not have to pay a penalty. Under this they may well be caught and so they have to pay up, but how do you know that they would not have been caught under the current regime?

Question 2

Senator Bushby: Could you just give us a short explanation of how this will not affect those people who are retrospective, and why, and how you will actually assess whether they would have been caught under current laws, given that there will be new laws in place. (page 58, proof Hansard transcript)

The ATO already administers the existing law on the basis that the transfer pricing rules contained in Australia's tax treaties provide an independent basis for making transfer pricing adjustments. This measure ensures that the treaty rules can be applied in this way and will not change the way the ATO approaches existing cases.

Taxpayers facing a transfer pricing adjustment in relation to income years prior to 1 July 2012 will in no way be affected by the introduction of this legislation in so far as the adjustment relates to the application of penalties.

To the extent that any part of the primary tax adjustment would not currently be subject to a penalty under the existing law, the taxpayer will not be subject to an additional penalty as the result of the application of this measure to prior income years – that is, the Commissioner must establish that a penalty would have been payable under the previous law.

The ATO's approach to the application of penalties will be unchanged in respect of these years. The ATO's current approach to penalties is extensively outlined in its guidance material.

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Topic: Transfer pricing transaction methods and adjustments

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Question: 3 & 4

**Senator BUSHBY:** But there are a number of companies that do set up their affairs along those lines. Presumably the \$1.9 billion that you have identified is likely to be coming from companies that have set up their affairs along those lines.

**Mr Jenkins:** Without being specific on the audit stock, again I would not think that in every case—

**Senator BUSHBY:** There may well be some where the profit method provides a lower outcome; is that what you are saying?

**Mr Jenkins:** No. I am saying that it is quite common practice on the part of both the ATO and taxpayers to use profit methods in their transfer pricing work.

**Senator BUSHBY:** But not all of them are, and that is why we are here today with submitters on one side saying one thing and the government on the other side, through you, saying something else.

**Mr Jenkins:** I think I have probably made the point, but it is the most commonly used method—and I would extend past the ATO's experience and I would make an observation about—

**Senator BUSHBY:** How many companies are we talking about, who operate across borders and who are subject to transfer pricing adjustments?

**Mr Jenkins:** There are a few ways I could answer that question.

**Senator BUSHBY:** Could you take notice for us how many companies there are in general—not necessarily an exact thing that we will hold you to—and what proportion of them are using traditional transaction methods and what proportion are using profit?

**Mr Jenkins:** It would be difficult to give you a precise—

**Senator BUSHBY:** That is all right—just a general percentage type of thing, not an exact 'point something'. Give us an indication.

**Mr Jenkins:** I can give you an indication right now about the APA program. Under the APA program, you would see—and this is on the public record—that, of the 53 APAs that were concluded last year, 39 of them involved the use of profit methods. On your other question: there are about 6,000 Australian taxpayers who report related party dealings.

**Mr Heferen:** It may also be useful to give you, of the \$1.9 billion of tax at risk in audit—whilst obviously the identity of particular taxpayers cannot be divulged—the number that would be largely responsible for that, to give the sense of scope about how many companies we are talking about here.

Question 3

**Senator Bushby:** Could you take notice for us how many companies there are in general—not necessarily an exact thing that we will hold you to—and what proportion of them are using traditional transaction methods and what proportion are using profit? (page 61, proof Hansard transcript)

Use of transfer pricing methods

Information that may inform this question is from tax return schedules. Australian taxpayers with related party dealings are required to complete a schedule to the tax return which contains, among other things, disclosures relating to the type and quantum of the dealings; and whether they have transfer pricing documentation. Where taxpayers report having transfer pricing documentation they are also required to disclose the type of transfer pricing method applied.

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While information provided by taxpayers has not necessarily been verified by the ATO (and ATO fieldwork indicates significant variability in the quality of transfer pricing documentation), the data indicate that 85% of the 6,270 taxpayers disclosing related party dealings have applied a transfer pricing method to price dealings. Information related to method usage assessed from the tax return schedules is set out below (see Table 4)

Table 4

Method category	Percentage by value of dealings	Method type
Transactional	53%	<ul style="list-style-type: none"><li>• 29% related to applying a comparable uncontrolled price (CUP) method.</li><li>• 24% related to applying another 'traditional transaction method' such as the cost plus or resale price methods.<sup>2</sup></li></ul>
Profit based	34%	<ul style="list-style-type: none"><li>• 32% related to applying the transactional net margin method (TNMM)</li><li>• 2% related to applying the profit split method.</li></ul>
Other	13%	<ul style="list-style-type: none"><li>• Other methods could include cost contribution arrangements, Marginal cost pricing or Apportionment of costs.</li></ul>

Reference was made in the Senate Economic Legislation Committee hearing on the Bill as to data from the ATO's Advance Pricing Agreement (APA) program as one source of information regarding the use of transfer pricing methods. APAs are negotiated and agreed by the ATO and taxpayers. Taxpayers seeking certainty in respect of their transfer pricing arrangements always have the option of seeking an APA with either the ATO or the ATO and other tax administrations.

The ATO publishes an annual 'APA Program Update' which includes information regarding transfer pricing methods. In APAs, profit based methods (and the transactional net margin method (TNMM) in particular) are consistently the most frequently used methods. This reflects that APAs are forward looking, and that taxpayers and administrators can often more readily obtain and verify profit related data rather than data on comparable prices for transactions that have not yet occurred.

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<sup>2</sup> In practice, the distinction between 'transaction' and 'profits-based' methods is not always clear. For example in applying cost plus or resale price methods, amounts will often be derived with reference to profits or margins.

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The following table highlights the use of the profit based methods in the APA program:

Table 5

Year	Total APAs concluded	Total APAs using profit methods (TNMM and profit split)	Percentage use of profit methods
2010-11	53	39	74%
2009-10	39	30	77%
2008-09	29	22	76%

Question 4

Mr Heferen: It may also be useful to give you, of the \$1.9 billion of tax at risk in audit—whilst obviously the identity of particular taxpayers cannot be divulged—the number that would be largely responsible for that, to give the sense of scope about how many companies we are talking about here. (page 61, proof Hansard transcript)

This measure has been described as having no financial impact as it is a revenue protection measure (that is, it protects the existing revenue base rather than expands it). The financial impact is conceptually and factually different from the estimated \$1.9 billion of tax in dispute under current audits based on the existing law.

Information regarding the estimated primary tax in dispute as part of the transfer pricing audit program represents the ATO's best estimate at a 'point in time'. There are around 50 cases involving transfer pricing related issues under the current audit program.

At any point in time, a large proportion of the primary tax in dispute figure is attributable to a relatively small number of cases. At this point in time, the 10 largest cases account for around 80% of the primary tax in dispute in the transfer pricing audit program.