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Advance Pricing Agreements in Transfer Pricing

Alan W. Granwell

IVINS, PHILLIPS & BARKER
Chartered

Advance Pricing Agreement (APA) Defined

- **An APA is:**

- An agreement between the taxpayer and the Internal Revenue Service (IRS) that binds the taxpayer to a defined Transfer Pricing Methodology (TPM) and that provides, in return, that if the conditions of the agreement are satisfied, the IRS will not challenge on audit whether the specified transactions between the taxpayer and a related party covered by the agreement have been conducted at arm's length.

Types of Transactions Encompassed by APA

- **Sale of Goods**
- **Provision of Services**
- **Transfer or License of Intangibles**
- **Cost Sharing**
- **Global Dealing**
- **Other**

Transactions Not Encompassed by APA

- **Where taxpayer is engaged in a U.S. trade or business or through a U.S. permanent establishment**
- **Attribution of profit to U.S. trade or business or U.S. permanent establishment**
- **Can obtain a pre-filing agreement for these types of transactions**

(Rev. Proc. 2005-12, § 3.05-3.08)

Types of APAs

■ Types of APAs

□ Unilateral

- Parties: Taxpayer, Affiliates, IRS
- Target completion period: 12 months

□ Bilateral

- Parties: Taxpayer, Affiliates, IRS, Foreign Tax Authority
- Target completion period for U.S. negotiating position: 12 months

□ Multilateral

- Parties: Taxpayer, Affiliates, IRS, Multiple Foreign Tax Authorities
- Target completion period for U.S. negotiating position: 12 months

■ Preferred APA Types

- Rev. Proc. 2004-40 §2.08 states a preference for *bilateral* or *multilateral* APAs in the interests of “sound tax administration” and the elimination of any double taxation potential. A *unilateral* APA may be granted if the taxpayer shows “sufficient justification” under §6.06.

Scope of APAs

■ Limited Scope

- APAs identify the *taxable entities, transactions* and *product lines* covered by the agreements
 - There is *no* requirement that all related entities or all transactions or product lines among related parties be covered by an APA.
 - Example: Japanese manufacturer of several electronics products may request an APA between the US and Japan only with regard to its sale of *semiconductor* products to *one* US affiliate, even though the manufacturer has other US affiliates and sells other products through its US affiliates.
- APAs specify the *time period* to which they apply
 - Minimum proposed term of 5 years, unless reason for shorter term
 - Expedited renewals for similar periods allowed
 - Some rollbacks to prior open tax years are allowed

APA Rollbacks

■ Availability of Rollbacks

- APAs can be applied to open tax years “whenever feasible based on the consistency of the facts, law, and available records,” *except* where a rollback of a unilateral APA request would decrease taxable income on a tax return filed for a taxable year not covered by the APA. (Rev. Proc. 2004-40 §7)
 - This limitation encompasses Reg §1.482-(6)(3)
- Taxpayer may request rollback to unresolved transfer pricing issues of previous tax years at any time before the completion of APA negotiations.
 - IRS policy to encourage rollbacks (Rev. Proc. 2004-40 §7)
 - IRS may also act *unilaterally* to apply TPM from APA to prior years
- Determination of rollback availability is within the discretion of the IRS official with jurisdiction over the taxable year subject to the rollback.
- For *bilateral* or *multilateral* APAs, rollback requests constitute applications for accelerated competent authority consideration. (Rev. Proc. 2002-52)
 - Requests pertaining to tax years under Appeals constitute applications for simultaneous Appeals and competent authority consideration

APA Transfer Pricing Methodology (TPM)

■ Transfer Pricing Methodology

- Tax authorities agree on an approved TPM
 - Common TPMs in APAs, which TPMs are followed by most OECD member nations include:
 - Comparable Uncontrolled Price Method (CUP)
 - Resale Price Method (RPM)
 - Cost-Plus Method (Reg. §1.482-2A(e) (1968))
 - Acceptance of other methods (formulary approaches) varies by country
 - Reasonable Profit Split Method
 - Comparable Profits Method (CPM)
 - Cost Sharing
 - Selection of an appropriate TPM requires consideration of the degree of certainty sought, administrability, the availability and sensitivity of supporting data, the tax results generated by the TPM, etc.
- TPM provides a *range* of arm's length results
 - Using approved TPM, results within range are acceptable
 - Compensating adjustments allowed when outside range (Rev. Proc. 2004-40)

Benefits of APAs

■ **Certainty of Result**

- Predictability of tax treatment (Rev. Proc. 2004-40 §9.01)
 - If taxpayer complies with APA terms, IRS will not contest application of approved TPM to transactions, parties and time periods covered by APA
 - For bilateral or multilateral APAs, identified foreign tax authorities also will not contest TPM application
- Avoidance of potential examination/controversy procedures
- Elimination of potential tax understatement penalties
- Narrowing of record-keeping obligations
- Elimination of exposure to U.S./foreign whipsaws
- Reduction of tax reserves on financial statements

■ **Assurance of no double taxation by IRS and foreign tax authority**

■ **Negotiating, rather than adversarial process**

- Allows flexibility and efficiency in arriving at appropriate TPM

Cautions Regarding APAs

■ Disclosure Issues

- APAs require extensive voluntary disclosure to the IRS
 - Concern about exposure to adjustments for open tax years (requires careful screening of information provided to the IRS)
 - *Non-factual* representations made during the APA process cannot be used as evidence in legal or administrative proceedings, unless the proceedings regard a tax year, transaction and person covered by a successfully completed APA
 - No protection if otherwise discoverable, usable or admissible
 - No protection for *factual* representations (Rev. Proc. 2004-40 §9.04-05)
 - Concern about disclosure of sensitive commercial data/trade secrets
 - Information submitted in APA process is considered tax return information and is protected from disclosure by IRC §6103 (Rev. Proc. 2004-40 §12)
 - Information submitted to a treaty partner is subject to treaty confidentiality requirements

Cautions Regarding APAs

■ Time and Expense

- Disclosure process is expensive and time-consuming
 - Disclosure generally *more* extensive than for private letter ruling but much *less* extensive than for transfer pricing examination
 - 2003 Average APA time: 41.5 months (bilateral or multilateral), 20 months (unilateral)
- Other costs
 - Professional fees, expert opinion fees and employee salaries
 - Potential costs to change accounting systems to comply with TPM
 - Potential additional tax payments and interest for open tax years
 - User fees payable to the IRS (see table below)

Taxpayer's Gross Income or Transactions	Original Request or Non-Routine Renewal	Each Additional Separate Request	Routine Renewal
\$1 billion or more	\$25,000	\$7,500	\$7,500
\$200 million to \$1 billion	\$15,000	\$7,500	\$7,500
Less than \$200 million	\$5,000	\$5,000	\$5,000
Small Transactions	\$5,000	\$5,000	\$5,000

APA Process

■ Five Phases

- ❑ Application and Pre-Filing Conference
- ❑ Due Diligence
- ❑ Analysis
- ❑ Discussion and Agreement
- ❑ Drafting, Review & Execution

Note: Special procedures are available for small business taxpayers.

Application Phase

- **Pre-Filing Conference(s)** (Rev. Proc. 2004-40 §3.02)
 - Occurs before formal submission of APA application
 - Taxpayer meets with APA staff to solicit their informal views
 - Ensure that an APA request is appropriate for covered transactions and affiliates
 - Discuss proposed TPMs and probability of agreement among competent authorities
 - Clarify the APA process and what information will likely be required
 - Taxpayer may remain anonymous during conference if desired

- **Application** (Rev. Proc. 2004-40 §4.01)
 - Taxpayer submits APA request to IRS, proposing a TPM, explaining why it is the best method, and illustrating its application using data from three prior years
 - IRS may request further data in order to accept or reject the APA request

- **Opening Conference**
 - Once accepted, taxpayer meets with assigned APA Team within 45 days
 - APA request is evaluated, taxpayer's data verified, and additional data requested
 - APA Team and taxpayer agree on a case plan and schedule

Due Diligence & Analysis Phases

■ Due Diligence

- APA Team must satisfy itself that the taxpayer's submitted facts are complete and accurate.
 - APA Team: generally consists of a Team Leader, an APA or IRS economist, an LMSB international examiner, a Division Counsel attorney and a competent authority analyst.
- Due diligence enables the IRS to reach advance agreements with taxpayers in the highly factual setting of transfer pricing.

■ Analysis

- IRS economists perform a significant part of the analytical work for an APA. This analysis may result in the need for additional information from the taxpayer.
- After analysis, APA Team begins negotiations with taxpayer over various aspects of the APA.

Discussion & Drafting Phases

■ Discussion and Agreement

- In bilateral cases, the APA Team attempts to reach a consensus with the taxpayer regarding the position the U.S. Competent Authority should take in negotiations with treaty partners.
 - U.S. Competent Authority analyst prepares final negotiating position and negotiates with foreign Competent Authority.
 - In unilateral cases, no Competent Authority negotiation is needed.
 - When Competent Authority agreement is reached, taxpayer may approve APA.
- Once the base APA is agreed upon, potential rollbacks are negotiated.
- APA designed as cooperative process of mediation, not adversarial.
 - Reasonableness and flexibility are stressed in negotiations.

■ Drafting, Review and Execution

- Once all parties to an APA are in agreement, drafting the final document takes little time as standard language is often used.

Roles of APA and Service Divisions

■ APA Team

- Responsible for developing an APA that it can recommend for approval by the Associate Chief Counsel (International).
- APA Team leader can act as “arbitrator” with the field.

■ Service Operating Division

- The division responsible for taxpayer’s return aids in identifying cases unsuitable for APAs during pre-filing conferences
 - Attends conferences if taxpayer is not anonymous,
 - Provides information regarding taxpayer’s examination history.
- Responsible division determines feasibility of APA rollbacks.
- Although responsible division also is given the opportunity to review and comment on final, recommended APA, the APA Office can override any field disputes. (Rev. Proc. 2004-40 §§ 3.01, 5.05, 7.05)

APA Administration

■ APA Administrative Issues

- Annual reports
 - Annual filing should include APA items, demonstrate good faith compliance
 - May include request to renew, modify or cancel APA
- Compensating adjustments
 - APA allows taxpayer to make adjustments within a specified range
- Limited Service Division examinations of APA years
 - Service not allowed to reevaluate valid APA, but may evaluate compliance with APA and validity of supporting data
- Record retention
 - Taxpayer required to maintain records sufficient to establish APA compliance
- Revocation, cancellation or revision
 - *Revision* or *cancellation* may occur when critical assumption not met, change occurs in applicable law or treaty, or taxpayer engages in misrepresentation, material mistake or omission or lack of good faith compliance with APA
 - IRS may *revoke* APA for fraud, malfeasance or disregard by taxpayer

Countries With APAs

Countries with Formal APA Guidelines

Australia
Belgium
Canada
Colombia
France
Germany
Japan
Korea
Mexico
The Netherlands
New Zealand
The United Kingdom

OECD Guidelines for APAs

- **Organization for Economic Cooperation and Development (OECD)**
 - The OECD established a procedure similar to the U.S. APA procedure in its Transfer Pricing Guidelines in October 1999, which serve as authoritative guidance to tax administrations in member countries when they develop transfer pricing policies and resolve transfer pricing issues.
 - OECD guidelines are not mandatory, although Member States generally follow them in developing and implementing transfer pricing policies.

Recent APA Developments

Revenue Procedure 2004-40

2005 Additions to APA Procedures

**Senate Finance Committee APA
Recommendations**

Revenue Procedure 2004-40

- **APA Changes in Rev. Proc. 2004-40 (July 1, 2004):**
 - Requires taxpayers to provide the IRS with all relevant information at the *beginning* of the APA process, rather than throughout the process
 - Meant to streamline APA process, not increase taxpayer burden
 - Reflects best practices of prior APA Program
 - Examples of specific changes:
 - Requires explanation for unilateral APA requests
 - Requires explanation of why proposed TPM is “best method”
 - Requires additional information for cost-sharing APAs
 - Creates taxpayer duties such as providing supplementary disclosure
 - Substantially revises compensating adjustment requirements
 - Introduces concept of “sound tax administration”
 - Includes IRS outreach abilities (approach taxpayer about APA, *require* expansion or contraction of proposed covered transactions)
 - Provides expedited treatment for APA Renewals, if conditions met

2005 Additions to APA Procedures

- **2005 APA Case Management Updates**
 - Industry and Issue Coordination Teams
 - Automobiles and Automobile Parts
 - Pharmaceuticals and Medical Devices
 - Cost Sharing
 - Financial Products
 - Semiconductors
 - Repercussions for Missed Deadlines
 - Procedures allow for adjusting milestone dates in Case Plan. If *taxpayer* causes material delay, APA may be removed from inventory.
 - If APA is not completed by date specified in Case Plan, Team leader and taxpayer must submit reports to APA Program director. A new target date is set, with a status conference required if it is not met.

Senate Finance Committee APA Recommendations

- **Draft recommendation of Senate Finance Committee suggests requiring Joint Committee on Taxation to review APAs**
 - Review suggested for large dollar amounts, rollbacks, APAs referred by Field
 - May *discourage* participation in APA Program and *prolong* APA process
- **Other Draft Recommendations:**
 - Place dollar value on covered transactions under proposed TPM, and compare proposed results with prior years' prices and terms and Field results
 - Require bottom-line comparisons and justifications from APA Team, IRS and experts where dissenting opinions or alternatives exist
 - Streamline process for bilateral and multilateral APAs by inviting all relevant parties to the fact-finding/negotiating table, including the foreign tax authority
 - Provide for arbitration when the IRS misses its case management milestones, or when competent authority or mutual agreement talks stall
 - Increase user fees to cover real time costs of APA Program and apply the fees to the program directly rather than placing them in a general fund

Are APAs Still Attractive?

■ Considerations:

□ Success of Program

- Mature, stable program with 14 years of experience
- Over 600 successful APAs executed since Program inception
- Steady increases in APA requests and renewals indicate strong taxpayer satisfaction with Program

□ Stability and Efficiency of Procedures

- Relatively stable procedures, which are desirable in the unstable enforcement environment of global transfer pricing
 - Transfer pricing a top priority in IRS divisions such as the LMSB, as well as similar divisions in other countries worldwide
 - Recent increase in number of transfer pricing penalty assessments
- Prior experience synthesized into Program requirements through procedural changes of Rev. Proc. 2004-40, increasing efficiency