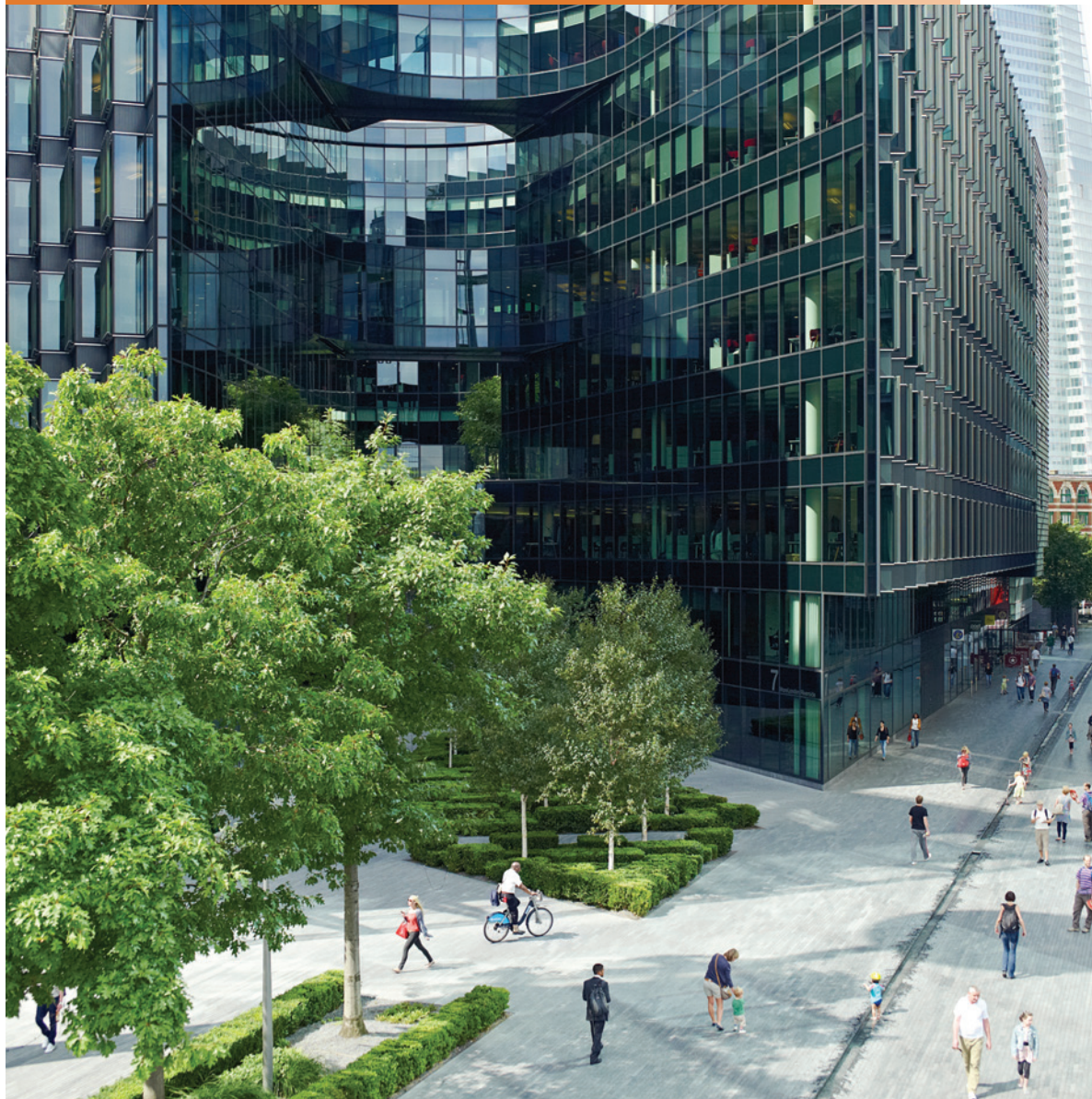


Facilitating successful Advance Pricing Agreements for US-based multinational enterprises

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Summary

With almost three-quarters of all international trade conducted between related parties, according to data published by the United Nations Conference on Trade and Development, companies around the world are looking for certainty and transparency in their dealings with tax authorities with respect to pricing and structuring their intercompany transactions, referred to as “transfer pricing.” Available in many jurisdictions, an Advance Pricing Agreement (APA) allows multinational enterprises to resolve prospectively transfer pricing matters in a principled and cooperative manner with one or more tax authorities. In the United States, recent administrative and organizational changes in the Internal Revenue Service (IRS) have resulted in a more practical and efficient APA process. Corporate tax personnel and their advisors should carefully evaluate the benefits and opportunities afforded by an APA with respect to resolving potential tax controversies proactively.

Advance Pricing Agreement (APA)

In the United States, recent administrative and organizational changes in the IRS have resulted in a more practical and efficient APA process. Corporate taxpayers should re-evaluate the benefits and opportunities afforded by an APA given this new environment.

Purpose of APAs

In the United States, transfer pricing disputes between taxpayers and the IRS may take years to conclude—sometimes more than a decade if the case goes to litigation. Although most transfer pricing controversy matters settle prior to litigation, taxpayers may expend significant resources in the course of resolving

issues under this adversarial model. By pursuing an APA, a taxpayer has the opportunity to work collaboratively with the IRS and (in bilateral cases) one or more other relevant tax authorities to prospectively resolve transfer pricing matters and avoid lengthy and costly future controversy.

History of the US APA program

Although transfer pricing has been a part of the US Internal Revenue Code since the 1930s, the concept of using negotiated advance rulings as an alternative mechanism for resolving transfer pricing issues did not emerge until the early 1990s. Following discussions among and studies by taxpayers, tax professionals, and the government, the IRS issued Rev. Proc. 91-22, 1991-1 C.B. 526, in 1991, essentially creating the APA Program in the United States. Over approximately the next 15 years, the APA Revenue Procedure was updated several times. The current procedural rules for processing and administering APAs are contained in Rev. Proc. 2006-9, 2006-1 C.B. 278. In addition, Rev. Proc. 2008-31, 2008-1 C.B. 1133, expanded the scope of the

APA Program to encompass other issues for which transfer pricing principles may be relevant, such as the attribution of profits to a permanent establishment under certain income tax treaties. The IRS is now in the process of drafting a new APA revenue procedure to reflect the organizational and procedural changes in the APA process implemented in 2012.

Since its inception, the APA program had been led by a small group of specialists in the IRS Office of Chief Counsel, which operated independently of the IRS division in charge of the examination function. In bilateral cases involving an APA negotiated between the governments of two countries under the authority

of a tax treaty, these APA Program personnel coordinated with the IRS's Tax Treaty Office, which led the government-to-government negotiations on APAs as well as other tax treaty Mutual Agreement Procedure (MAP) cases.

In February 2012, the APA function was moved out of the IRS Office of Chief Counsel and combined with the IRS's Tax Treaty Office within the IRS's Large Business & International (LB&I) Division. This new, combined organization was renamed the Advance Pricing and Mutual Agreement (APMA) Program. The new combined APMA organization was designed to offer a more robust and effective platform for the resolution of transfer pricing issues. A major hiring initiative brought in significant additional staff to the APMA organization, augmenting the IRS resources available to negotiate and process APAs. In addition, the

new APMA organization allowed for streamlining the APA process in bilateral cases, because a single team could handle the case from inception to final agreement without the need for coordination between separate APA and Tax Treaty offices.

The results produced by the APMA office in 2012, its first year of operation, suggest that the new organization is fulfilling its promise. The case closing statistics for 2012 reveal that the APMA Program executed a record high 140 APAs during 2012, after only 43 APAs were concluded the year before. The average time to complete APAs also decreased. It is anticipated that the increased productivity of the APMA Office in resolving APAs will continue, as the new APMA Program management continues to place a strong emphasis on efficient analysis and negotiation of APA requests.

Role of Treaties and Competent Authority

Currently, the United States is a party to nearly 70 bilateral income tax treaties with various jurisdictions globally. Each of these treaties has an article addressing the MAP process by which a taxpayer located in one of the treaty countries may request the two tax authorities to reach a mutually agreed resolution of issues arising under the treaty, such as transfer pricing issues on cross-border intercompany transactions between the two countries. APAs are among the items that may be negotiated between the two tax authorities under many of these treaties.

Income tax treaties define the term "Competent Authority" as the designee or representative in each of the jurisdictions who is responsible

for implementing the treaty and its provisions. The role of the Competent Authority is defined broadly in the text of the treaty as the primary point of contact for both for taxpayers and the other Competent Authority in the MAP process. Because treaties differ, there may be a single Competent Authority or different individuals designated as the Competent Authority for different tax matters.

The US Competent Authority responsible for administering the operating provisions of income tax treaties is the Deputy Commissioner (International), IRS LB&I Division, who derives his authority through delegation from the US Treasury Secretary. That position currently is held by Michael Danilack.



Types of APAs

There are three potential APA configurations: unilateral, bilateral, and multilateral. Unilateral APAs are agreements concluded between a taxpayer and one taxing authority. By their very nature nearly all transfer pricing matters are, at a minimum, bilateral. However, depending on the facts and circumstances of the transactions and the impacted jurisdictions, it may not be possible to achieve mutual agreement with all relevant tax authorities. Often a unilateral APA is sought because the foreign jurisdiction does not have a tax treaty with the United States and thus there is no representative of the foreign tax authority with whom the US Competent Authority can negotiate. Although unilateral APAs may provide some comfort to taxpayers with respect to the jurisdiction with which the APA is concluded, there is still uncertainty because the other affected tax authority on the other side of the intercompany transaction is not bound to follow the APA. In 2012, the IRS concluded 37 unilateral APAs, representing approximately 26% of the total number executed that year. In the same year, taxpayers submitted 24 applications for unilateral APAs, representing approximately 19% of the total number of applications.

Historically, the IRS has expressed a strong preference for bilateral APAs

and, recently, has shown more interest in multilateral APAs. Bilateral and multilateral APAs are concluded with the involvement and concurrence of the US Competent Authority and the Competent Authority of one or more relevant foreign jurisdictions. In the case of a bilateral or multilateral APA, the APMA Program will develop a negotiating position after thorough investigation, analysis, and discussions with the taxpayer. The corresponding tax treaty office of the other treaty country will also develop a negotiating position through a similar process. The countries then exchange position papers and engage in negotiations to reach agreement on the transfer pricing method to be applied to the particular intercompany transactions at issue. The taxpayer requesting the APA remains connected to the process, providing comments and additional supporting documentation as requested. In 2012, the IRS concluded 103 bilateral APAs, representing approximately 74% of the total number executed that year. In the same year, taxpayers submitted 101 applications for bilateral APAs, representing approximately 80% of the total number of applications. Although no multilateral APAs were executed in 2012, there was one application for a multilateral APA filed that year.

The APA process

Although not required, the process in the United States often begins with a taxpayer signaling its intent to pursue an APA through a pre-filing conference (PFC). PFCs are informal and in some cases may even be conducted on a no-name basis. The purpose of a PFC is to provide a constructive environment for the taxpayer and the IRS to evaluate the feasibility and appropriateness of an APA given the facts and circumstances of the anticipated transactions. During the PFC, the taxpayer may seek clarification as to what functional and financial data the IRS will require as well as discuss the contemplated transfer pricing methods, potential issues that may be raised by the foreign tax authority, and the timing of the process.

Once a taxpayer decides to pursue an APA, the next step is to submit a formal APA request to APMA.

Rev. Proc 2006-9 details the components of the formal APA application. In addition to a thorough description and analysis of the contemplated transactions to be covered under the APA—including an economic analysis applying the proposed transfer pricing methods—the submission also must include a description of the general history of the business operations, a discussion of the organization and structure of the controlled group, and the

major transaction flows of the parties to the transactions to be covered under the APA.

A critical component of the APA application is the detailed “functional analysis” which should address the functions performed, assets employed, and risks borne by each party to the contemplated transactions along with a discussion of the relevant economic conditions and contractual terms. The functional analysis forms the basis for the conclusions with regard to the economics of the transactions including the selection of the best method—within the meaning of Treas. Reg. § 1.482-1(c)—for determining an arm’s length price.

Certain other factual, financial, and administrative data and statements are also required. This information generally includes the financial data of the relevant parties for recent years, and sometimes financial forecasts, prior transfer pricing documentation reports, company annual reports, and similar documents and data. Additional information is also required if the contemplated transactions include a cost sharing arrangement.

Taxpayers must also provide as attachments any powers of attorney for the taxpayer’s appointed representatives, a penalty of perjury statement, and a statement authorizing the US Competent Authority to disclose

the materials submitted to it by the taxpayer to the Competent Authority office of other relevant foreign jurisdictions (in the case of a bilateral or multilateral APA request).

As part of the APA process, taxpayers may seek a “rollback” of the agreed transfer pricing method to prior years where the transfer pricing issues are still under consideration by IRS Exam or Appeals at the time of the request. Indeed, a rollback to prior years may be requested even where the prior years are not under an IRS examination. Such a rollback request can be an effective way of resolving transfer pricing issues and achieving certainty for a number of past and future years in a single process.

Once the substantially complete submission is tendered along with the appropriate user fee (which now must be paid using the website pay.gov), the APMA Director will designate a Team Leader who will be responsible for organizing the IRS team responsible for processing the request. If a PFC was held with the taxpayer, the Team Leader generally will be selected from among the APA staff in attendance.

Broadly, the APMA Team conducts due diligence and analysis of the APA request by discussing it with the taxpayer, verifying the data supplied, investigating the facts, and requesting and analyzing

additional information if necessary. During the process, the taxpayer may be asked to meet with the APMA Team on one or more occasions depending on the completeness of the initial submission as well as the complexity of the contemplated transactions.

Upon agreement by all relevant parties, the APA is executed by the APMA Director and the taxpayer. Once the APA is executed, the taxpayer must file an annual report for each taxable year covered by the APA to demonstrate that it has complied with the APA.

The length of time from request submission to execution of an APA may vary widely depending on the complexity of the contemplated transactions, the completeness of the initial submission, the responsiveness of the taxpayer to additional requests for information, the current case load of the APMA Program, and the availability and cooperation of the US and foreign Competent Authorities. With respect to APAs executed in 2012, according to the IRS’s Announcement and Report Concerning Advance Pricing Agreements issued on March 25, 2013, approximately 34% had been in inventory for more than 48 months, while 50% had been in inventory for between 24 and 47 months. Of the 140 APAs executed in 2012, only 23, representing approximately 16%, had been concluded in less than 24 months.

IRS officials have publicly stated that increasing the timely adjudication of APA requests is a high priority and that the recent realignment of the APA and MAP teams is contributing to greater efficiencies and faster processing. Despite the historically slow process.

Leading practices

As stated previously, many factors affect the ability of a taxpayer to successfully conclude an APA with the IRS. In addition, as a result of the IRS restructuring, there likely will be a new set of guidance in the near term that may change certain aspects of the US APA process. However, as set forth below, there are overarching leading practices that will continue to allow taxpayers to best position themselves to successfully seek and conclude APA requests regardless of procedural details.

Own the facts

For an effective APA process, it is critical that taxpayers clearly, cogently, and comprehensively present the facts and circumstances underlying the transactions covered by the proposed APA. Corporate tax personnel and their advisors should anticipate the questions the APA Team will raise and answer them proactively in the submission. The APMA Program aims to create a collaborative counterpoint to the frequently adversarial relationship between taxpayers and the IRS. Completely and accurately presenting the contemplated transactions and supporting analysis accurately and transparently is an important step in establishing credibility and a cooperative attitude with the IRS.

Know the endgame

Although it is possible to pursue a unilateral APA in the United States, the IRS is pushing for bilateral APAs in most cases where the transaction involves a treaty country. Taxpayers should select the option that is most appropriate keeping in mind the additional certainty derived from securing agreement with the other taxing authority.

Rethink the presentation of the submission

On its face, the analysis, documentation, and information required for an APA request appears substantially similar to the components of transfer pricing documentation prepared under the standards of IRC § 6662(e). However, presenting the APA request as a rehash of existing documentation reports and merely attaching the additional documents required under Rev. Proc. 2006-9, normally does not result in the most cohesive or persuasive submission. A concise submission that identifies and focuses on the key issues generally can be more effective than a document that seeks to cover every fact and potential issue in detail. Thus, although thorough and comprehensive submissions are expected, corporate tax personnel and their advisors are best advised to consider an approach that avoids restating sections and overwhelming readers. The APA request should contain clearly articulated arguments with the appropriate level of supporting documentation—the adage quality rather than quantity applies.

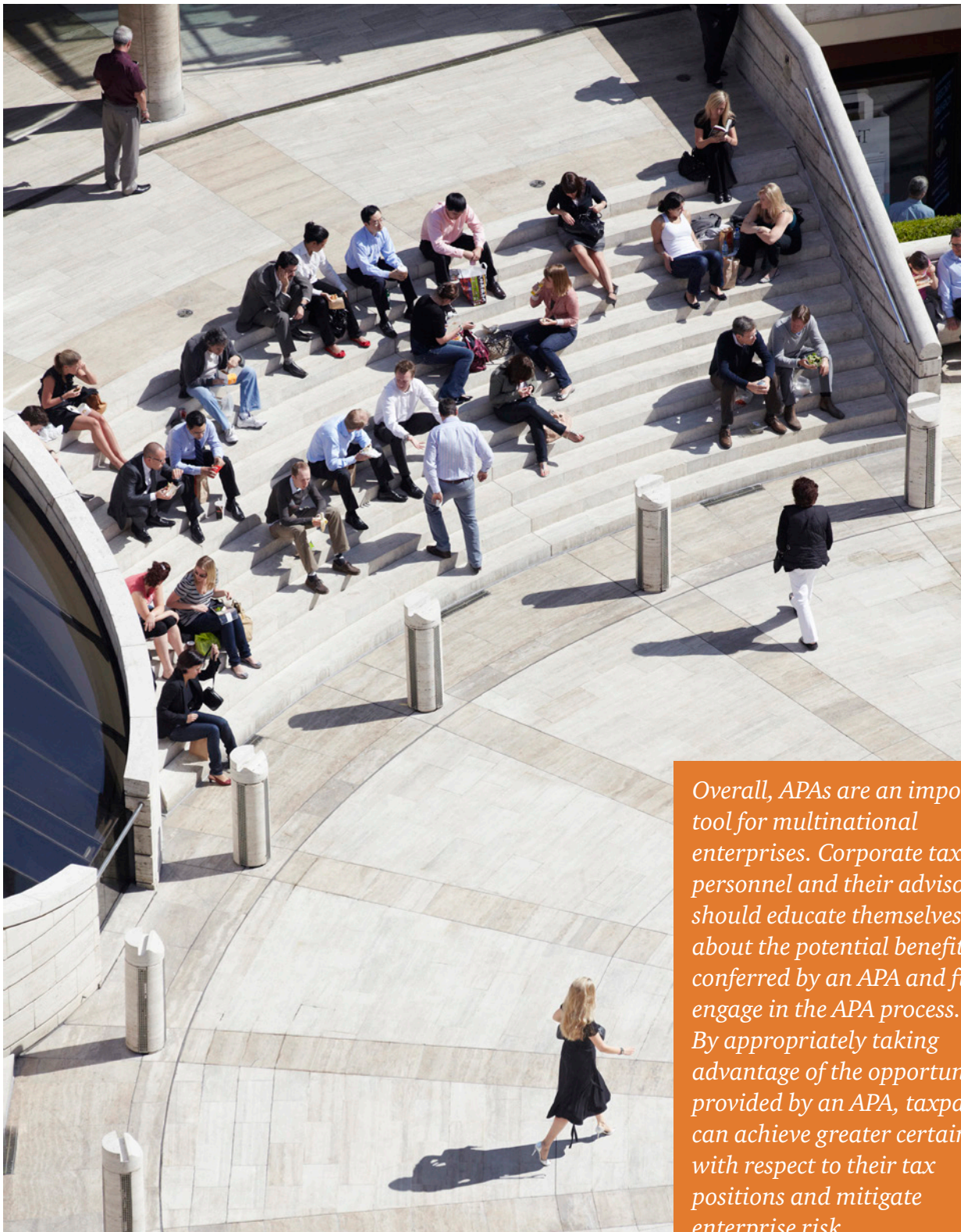


Leverage PFCs

Corporate tax personnel and their advisors should carefully consider the benefits of PFCs in the overall APA process. These informal meetings, which as previously noted may be conducted on a no-name basis, can provide a critical viewpoint into the approach the IRS may take in evaluating the APA request and give the taxpayer valuable insight into the types of questions that may arise and strategies to address any concerns upfront. To derive the best result, taxpayers must provide enough information at the PFC. Furthermore, attitude is critical—the APA process is designed to be “voluntary and cooperative” and corporate tax personnel and their advisors need to have the mindset that they are working with the IRS and not against them.

Not just the Fortune 500

The increased focus on formal transfer pricing audits by tax authorities around the world is directly impacting smaller companies and the resulting transfer pricing adjustments can be costly and disruptive to the business. In comparison, the US APA process is becoming less formal and more efficient, creating opportunities for smaller taxpayers to benefit from the increased certainty afforded by an APA.



Overall, APAs are an important tool for multinational enterprises. Corporate tax personnel and their advisors should educate themselves about the potential benefits conferred by an APA and fully engage in the APA process. By appropriately taking advantage of the opportunities provided by an APA, taxpayers can achieve greater certainty with respect to their tax positions and mitigate enterprise risk.

Contacts

To have a deeper conversation about Advance Pricing Agreements,
please contact:

J. Bradford Anwyll
Principal
+1 (202) 414-4326
brad.anwyll@us.pwc.com

Gregory J. Ossi
Principal
+1 (202) 414-1409
greg.ossi@us.pwc.com

Elizabeth A. Sweigart
Director
+1 (713) 356-4344
elizabeth.a.sweigart@us.pwc.com

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