Insights from the Advance Pricing and Mutual Agreement Program

December 4, 2019

In brief

During PwC’s Annual Global Tax Controversy and Dispute Resolution (TCDR) Conference recently held in Washington, DC, David Swenson, Global Leader of PwC’s Global TCDR Network, interviewed John Hughes, Director of the IRS Advance Pricing and Mutual Agreement (APMA) program, which also represents the office of the U.S. competent authority. The interview ranged across a number of important topics and issues facing taxpayers in today’s environment.

Most notably, Mr. Hughes discussed APMA’s Functional Cost Diagnostic (FCD) model (or workbook), which he said will be released in an enhanced form in the near future. First released in March 2019, the FCD workbook is an Excel-based tool for collecting and analyzing taxpayer financial data in cases where APMA believes that two or more parties may be making significant value-added contributions to the relevant business operations, regardless of industry or whether the proposed covered transaction is inbound or outbound to the United States. The enhanced FCD workbook will include new features, including a requirement that taxpayers identify and provide certain information with respect to entities and transactions within the related-party group and supply chain that may impact the profitability of US operations.

Other important topics covered during the interview included the circumstances under which APMA may withdraw a US-initiated adjustment, as well as Mr. Hughes’ views on improving dispute resolution mechanisms in an environment where taxpayers increasingly are seeking advance tax rulings or correlative relief as a result of audits in other countries. The interview also touched on tax reform and tariffs, and, in general, how APMA envisions handling the impact of both on the transfer pricing results of taxpayers.

In detail

The APMA Program

Action 14 of the Organisation for Economic Co-operation and Development’s (OECD’s) Base Erosion and Profit Shifting (BEPS) project sets forth a minimum standard for countries to follow in the interest of improving cross-border dispute resolution processes. Toward this end, the United States and other members of the Inclusive Framework have been working individually and collectively to improve dispute prevention and resolution processes and thereby increase tax certainty for taxpayers. Evidence of the strides that the United States has made in this regard is reflected in the favorable first- and second-stage
reviews the United States has received from its peers under the peer review program established by Action 14 and administered by the OECD’s Forum on Tax Administration (FTA) MAP Forum, of which Mr. Hughes is the current chair. Mr. Hughes explained that, in addition to successfully conducting peer reviews under Action 14, the MAP Forum is helping establish and foster strong relationships among competent authorities, as well as monitoring critical competent authority issues like improving access to MAP around the world.

Mr. Hughes also addressed topics in this area specific to APMA, including a recent report issued by the US Government Accountability Office (GAO), which outlined eight recommendations on the US competent authority’s handling of the mutual agreement process under US tax treaties. One aspect of the GAO report notes a relatively high percentage of US-initiated adjustments that were unilaterally withdrawn by APMA in a given period.

When asked about this particular finding, Mr. Hughes explained that the MAP article of US tax treaties obligates each competent authority to consider whether it can unilaterally address the taxpayer’s request that has given rise to double taxation (or taxation not in accordance with the treaty) before it presents the case to the treaty partner. Mr. Hughes said that APMA, and the US competent authority, takes this obligation seriously. This means APMA always will consider the merits of a US-initiated adjustment to determine whether it is “justified” under the relevant income tax treaty. If, after considerable deliberation, APMA determines the adjustment does not satisfy this standard, it will withdraw the adjustment and will not present the case to the treaty partner.

In this vein, Mr. Hughes noted the importance of the memorandum issued by the Commissioner of the IRS Large Business and International Division (LB&I) that would require LB&I issue teams examining transfer pricing issues involving a treaty partner to consult with APMA as early as possible in their analysis. Mr. Hughes explained that the memorandum is intended to extend “global awareness” within LB&I by ensuring issue teams have relevant background and perspective before the adjustment is made and thus before a MAP request is filed.

Mr. Hughes remarked that the approach set forth in the memorandum is working. He said LB&I issue teams are consulting with APMA managers and team members in real time. Mr. Hughes did emphasize that, although it is consulted by issue teams, APMA will not determine whether an issue should continue to be pursued on audit; that determination is made solely by the issue team.

Mr. Hughes also spoke about APMA’s APA inventory. He said the program has seen material increases in advance pricing agreement (APA) applications in recent years. Mr. Hughes said the increase may be attributable, in part, to factors specific to APMA (such as the recent increase in APA user fees), but that it also may reflect taxpayers seeking certainty amid the growing uncertainty around the world. To address APMA’s significant number of APA (and MAP) cases, Mr. Hughes noted the APMA team seeks to improve its processing of cases, but the ultimate resolution of each depends upon all stakeholders, including the treaty partners and taxpayer(s), being committed to resolving the case in good faith and in a timely manner.

FCD Workbook

Released March 1, 2019, the FCD workbook is an important new analytic tool developed by APMA. Mr. Hughes indicated that in recent months, the FCD workbook has attracted more attention and that APMA has received more inquiries about its application in specific cases. Mr. Hughes noted that there historically has been (and there will continue to be) cases in which two or more parties to an intercompany transaction may contribute non-routine value to the operations under analysis. In such cases, Mr. Hughes said, APMA generally has been presented with APA requests that propose one-sided methods. However, from APMA’s perspective there may be legitimate questions as to whether contributions made by all parties to the value drivers of the business have been adequately identified, measured, and reflected in the proposed transfer pricing method. The FCD workbook is designed to be a tool for capturing and analyzing data relevant to these questions.

Mr. Hughes stated that taxpayers will need to collect and populate certain financial data into the FCD workbook, which, in general, will produce a pro forma split of residual profits or losses, based on the relative stocks of accumulated and capitalized functional costs. Mr. Hughes referred to this process as an exercise where taxpayers should “self-reflect” on their overall operating model and determine where the business is deriving value and corresponding profits. Mr. Hughes indicated that taxpayers should consider that contributions to value can often derive from a combination of activities,
notably those involving the development, enhancement, maintenance, protection, and exploitation of technical and marketing intellectual property. True to the text and spirit of the OECD Guidelines, he said careful consideration thus needs to be given to the delineation of transactions involving these functions and the costs that are incurred in performing them.

Importantly, Mr. Hughes also announced that an enhanced version of the FCD workbook will soon be released. This version will include added features and diagnostics that will allow tracking of the source of revenues and costs, and in turn, will help identify additional related-party transactions that may not be captured in the current version of the FCD workbook. Mr. Hughes indicated that, in certain cases, those transactions may not be material or ultimately relevant to the analysis, but the aim is to capture a broader range of data related to the overall supply chain and understand potential interrelated transactions in other jurisdictions that may need to be addressed on a multilateral basis.

On the question of whether use of the FCD workbook may change the current trend, where more than 85% of APAs employ the comparable profits method (CPM) as the applicable transfer pricing method, Mr. Hughes stated that it is too early to predict in how many cases APMA will request that the FCD workbook data be provided; however, it is anticipated that it will be a relative minority and thus this statistic about the CPM should not change dramatically. In particular cases, however, if the workbook indicates contributions by multiple parties need to be recognized, he acknowledged that the FCD workbook output could provide a principled basis to apply a residual profit split approach, or otherwise make quantitative adjustments to a one-sided method.

Lastly, although Mr. Hughes recognized that other jurisdictions are still studying the workbook and have not yet said they will adopt it, he is hopeful that eventually other competent authorities will recognize the value of the tool to address multi-party contributions to value creation within an overall supply chain.

US Tax Reform and Tariffs

The interview also touched on APMA’s current role in the administration of tax reform, especially the provisions of the Base Erosion Anti-Abuse Tax (BEAT) and issues surrounding tariffs in the context of APAs.

Mr. Hughes emphasized the scope of APMA’s role with regard to BEAT. APMA prices the transactions that may give rise to payments subject to BEAT, but APMA’s jurisdictional purview does not include the characterization of those payments for purposes of applying BEAT. Such questions of characterization are within the purview of other programs and practice areas in LB&I. Mr. Hughes indicated that APMA is liaising with other IRS offices to develop a coordinated approach to addressing such questions, as well as other tax reform developments that could implicate APA and MAP cases.

Recognizing that taxpayers are asking APMA about tariffs and their impacts on transfer pricing results in pending and past APA cases, Mr. Hughes acknowledged this is an area requiring attention. He foresees open discussions with treaty partners where tariffs are involved, especially if a taxpayer in the APA program is instructed to handle tariffs in a certain way that is detrimental to the legitimate interests of the United States. Mr. Hughes indicated these situations will need to be handled in a principled manner and on a case-by-case basis.

The takeaway

Mr. Hughes spoke about a broad range of developments across the globe that are impacting the tax controversy and dispute resolution environment, in the United States and elsewhere. He underscored the US competent authority’s commitment to reduce, prevent, or resolve disputes in a principled manner and in a timely fashion. The FCD workbook will continue to be of interest to many stakeholders, and, in time, its application in the context of APAs will be further developed and enhanced. Lastly, in a world where tax reform and tariffs continue to create uncertainty, APMA is aware of the impact that these items have on APA and MAP matters. APMA is working with its stakeholders within and outside the IRS to find solutions that potentially will provide taxpayers with more clarity and certainty.
Let’s talk

For a deeper discussion of how this issue might affect your business, please contact:

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