

# APMA introduces new Functional Cost Diagnostic Model

February 27, 2019

## In brief

On February 26, John Hughes, director of the IRS's Advance Pricing and Mutual Agreement (APMA) program, announced the release of a Functional Cost Diagnostic Model (FCD Model) developed in connection with several prior and pending Bilateral Advance Pricing Agreements (APAs) and Competent Authority/Mutual Agreement Procedure (MAP) cases. The FCD Model is an excel-based tool for collecting and running taxpayer financial data through a residual profit split method (RPSM) model.

APMA has emphasized that a request to complete the FCD Model does not indicate APMA has reached any conclusion regarding a best method selection in individual cases. However, the FCD Model reflects APMA's view that a diagnostic evaluation of taxpayer data under a systematic RPSM model is appropriate in cases where APMA believes that two or more parties may be making significant value-added contributions to the relevant business operations. Taxpayers required to complete the FCD Model may face numerous factual and economic questions that must be considered and addressed in the course of interactions with APMA.

## In detail

### Purpose of the Model

On February 26, APMA announced the release of its new FCD Model, which was prepared in connection with several prior and pending bilateral APAs and Competent Authority/MAP cases. The FCD Model is intended to be used in both US inbound and outbound cases, across a variety of industries, involving more complex multi-transactional fact patterns where APMA believes that two or more parties are making significant value-added contributions to the relevant business operations and that a

simplistic application of a one-sided method may not be reliable. APMA believes this fact pattern makes up a relatively small percentage of APMA's current cases.

**Observation:** Experience suggests that these cases may involve some of APMA's largest and most complex cases. In addition, depending on how broadly APMA applies the model, it could cover a wide variety of industries and varied fact patterns.

In APMA's view, the FCD Model will help stakeholders focus on the material issues of fact, law, and economics to resolve the

issues in individual cases. APMA has stated that the FCD Model is a "data collection diagnostic tool" and is a starting point for discussions and analysis, rather than APMA imposing a particular outcome in advance (such as the RPSM being the best method in each of these cases).

### Operation of the Model

The FCD Model requires that a taxpayer identify all routine and non-routine functions performed by all parties to the proposed covered transactions. For each function, segmented financial data, including profit and loss and relevant balance sheet

information, must then be provided. Separately, “functional costs” by cost center must be provided and identified as either benchmarked or development costs.

Benchmarked costs are applied to routine functions based on the profit loss indicator (PLI) and routine return and relevant balance sheet information, must then be provided. Separately, “functional costs” by cost center must be specified by the taxpayer. For any development costs, an associated lead time and useful life must be specified. Following this data entry process, the model builds capitalization and amortization schedules based on the lead times and useful lives of development costs. The FCD Model then calculates and subtracts the profits for benchmarked functions to create a *pro forma* split of residual profits or losses based upon the relative stocks of accumulated and capitalized functional costs.

### Economic analysis

The FCD model focuses on the functional costs, which are defined as the costs employed by the taxpayer for the covered transactions that relate to one or more business operations within the scope of the proposed covered transactions. Within the FCD template, consideration is given to the economic contributions of the parties relevant to the proposed covered transactions on the basis of investment undertaken, functional activities performed, and risks borne.

The key inputs are the following:

- Segmented financial statements;
- Identification of the functional costs based on OECD Guidelines, General provisions of Chapter I, profit splitting factors in Chapter II Section C.5.1, and Chapter VI;

- Useful life of a “unique and valuable” contribution; and
- Benchmarkable routine functions.

As noted, the outcome of the inputs into the FCD model is the production of a *pro forma* split of residual profits or losses based upon the relative stocks of accumulated and capitalized functional costs.

**Observation:** Taxpayers supplying inputs to the FCD model will need to focus on the proper segmentation of the financial statements relevant to the business and the covered transactions. In addition, taxpayers will need to consider if different valuable contributions produce different useful lives that should be capitalized and amortized separately. With respect to the benchmarkable routine functions, taxpayers also should consider the appropriate point in the arm’s-length range to select and its impact on the residual profits for the proposed covered transactions.

**Observation:** APMA has emphasized that, under certain fact patterns, APMA will not accept the conclusion that the comparable profits method (CPM)/transactional net margin method (TNMM) is the best method without the taxpayer first working through the new FCD Model.

### Factual considerations

The FCD Model assumes that more than one party to the covered transactions is making non-routine contributions to the generation of profits or losses, and APMA expects that a taxpayer’s completion of the FCD Model will provide insight to its views of the value drivers in its business operations. APMA has been clear that it intends the FCD Model to be applied whenever more than one party is making non-routine contributions, regardless of industry or

whether the proposed covered transaction is inbound or outbound to the United States. The FCD Model similarly does not discriminate between cases in which losses, rather than profits, are generated.

**Observation:** APMA’s non-discriminatory approach to application of the model is encouraging, but certain factual considerations must be carefully weighed in addition to the important economic considerations noted above.

The FCD Model serves as an invitation to the taxpayer to identify its functional costs as either routine or generating a unique and valuable contribution. In a transfer pricing analysis, the functional and risk profiles of the parties, as memorialized in intercompany contracts and as demonstrated through actual conduct, play a fundamental role in such determinations. APMA has stated that if the due diligence process in an individual case shows that both parties are not making non-routine contributions, then APMA likely will select the CPM/TNMM or another method as the most appropriate method in those cases.

**Observation:** Consequently, taxpayers must strategically assess how to address any potential conflicts between the entity roles enshrined in legal arrangements and the categorization and classification of costs required under the FCD Model.

**Observation:** Application of the new FCD Model in certain cases potentially represents the most significant change in APMA’s approach in the last 20 years. Some cases have been covered by multiple bilateral APAs and renewals for 10 years or more and have applied one-

sided transfer pricing methods (typically the CPM/TNMM) to determine arm's-length returns for the taxpayer's operations. The new FCD Model could dramatically change the analysis and due diligence in these cases by focusing on the functions, costs, and risks of multiple parties providing contributions relevant to the covered transactions.

APMA is open to considering refinements to the general application of the new FCD Model (as well as other adjustments in specific cases), and will make the model and accompanying general write-up available to the public upon request.

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### The takeaway

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The FCD Model represents a significant change in APMA's approach to evaluating certain fact patterns. Potentially impacted taxpayers should review the FCD Model to assess its implications and identify any specific concerns under their unique facts.

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### Let's talk

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

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