

# Outlook for U.S. Advance Pricing Agreements

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Steven C. Wrappe



Cameron Taheri

Steven C. Wrappe is a principal in the economic and valuation services practice of KPMG LLP and deputy head of global transfer pricing dispute resolution for the firm, and Cameron Taheri is a managing director in the economic and valuation services practice and member of the transfer pricing dispute resolution team. They are both based in Washington. Email: [swrappe@kpmg.com](mailto:swrappe@kpmg.com), [ctaheri@kpmg.com](mailto:ctaheri@kpmg.com)

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In this article, the authors examine changes in the transfer pricing environment on both an international level and in the United States specifically, including changes in the IRS's approach to transfer pricing enforcement and in the advance pricing agreement process, to determine how these shifts affect taxpayers' desire to pursue an APA in the United States.

The IRS's advance pricing agreement process is a well-known alternative to the regular transfer pricing enforcement process, which includes examination, administrative appeals, litigation, and the mutual agreement procedure. Therefore, the value of an APA to a taxpayer may be best

determined by comparing the anticipated cost, effort, and outcome of the APA process against the anticipated cost, effort, and outcome of the regular enforcement process.

Most taxpayers seeking an APA want some form of certainty, whether it is freedom from penalty exposure, freedom from double taxation, certainty of characterization, official acceptance of a transfer pricing method and range of results, or the ability to eliminate uncertain tax positions from their financial reports. However, a comparison between the cost and effort required to obtain the APA and the cost and effort spent in the regular enforcement process is also relevant to the business decision of whether to pursue an APA.

This article reviews the impact of recent changes in transfer pricing enforcement, both globally and domestically, and changes in the U.S. APA process to determine how these changes affect the desirability of an APA.

### Changes to Transfer Pricing Enforcement

#### Increased Global Transfer Pricing Enforcement

Every year more countries undertake active transfer pricing enforcement, thus increasing the number of transfer pricing disputes. The OECD's inventory of pending MAP disputes — the majority of which involve transfer pricing issues — has risen to an all-time high, with 7,190 cases remaining to be resolved at the end of 2016.<sup>1</sup>

The increased global exposure to transfer pricing examinations and disputes also increases the anticipated costs and effort involved in the regular transfer pricing enforcement process.

<sup>1</sup>OECD, "Mutual Agreement Procedure Statistics for 2016" (Nov. 27, 2017). The 7,190 figure is the sum of the pending number of cases initiated before and during 2016.

## BEPS Changes

In 2015 the OECD released its base erosion and profit-shifting report and the accompanying BEPS explanatory statement encouraging some countries to enhance the rigor of transfer pricing rules and ensure greater compliance. The OECD has acknowledged in the “Public Discussion Draft – BEPS Action 14: Make Dispute Resolution Mechanisms More Effective” and elsewhere that BEPS-related changes to transfer pricing rules, especially the country-by-country reporting requirements, are likely to further increase the number of transfer pricing disputes. The BEPS plan called for countries to exchange CbC reports in mid-2018. Tax auditors would decide which companies to examine based on potential risk indicators, including disparities between profits and functions. Both taxpayers and countries have expressed concern about the ability of governments to keep up with transfer pricing disputes that the BEPS project may generate.<sup>2</sup> This escalating risk of transfer pricing disputes around the globe substantially increases the cost and effort needed to maintain regular transfer pricing compliance as well as the anticipated cost and effort involved in the enforcement process.

## U.S. Tax Reform

Although very little of the Tax Cuts and Jobs Act (P.L. 115-97), enacted by the United States in December 2017, directly changes transfer pricing rules, transfer pricing will nonetheless be an important issue as taxpayers and tax authorities determine the amount of income subject to newly created tax regimes. In addition to reducing the corporate federal tax rate from 35 percent to 21 percent, the TCJA introduces the base erosion and antiabuse tax in section 59A, the concept of global intangible low-taxed income in section 951A, and the foreign-derived intangible income (FDII) regime in section 250. It also changes the definition of intangibles in section 936, modifies the valuation rules in section 482, and revises the interest expense limitation rules in section 163(j). Taken together, these changes create multiple

<sup>2</sup> See, e.g., OECD, “Action 13: Guidance on the Implementation of Transfer Pricing Documentation and Country-by-Country Reporting” (2017).

competing tax regimes — and each regime relies on income characterization and allocation to determine tax outcomes. Given the importance of transfer pricing decisions for the proper allocation of income under these new tax regimes, the TCJA will likely increase the cost and effort involved in transfer pricing compliance.

## U.S. Transfer Pricing Enforcement

In recent years, the IRS has more actively pursued transfer pricing issues in examination proceedings and beyond. An internal IRS memorandum released as part of a summons enforcement action against Microsoft in 2015<sup>3</sup> stated that the international business compliance and transfer pricing units of the IRS’s Large Business and International Division had 1,060 cases under examination as of December 31, 2013, involving estimated potential adjustments of between \$90 billion and \$194 billion.<sup>4</sup>

To handle its inventory of transfer pricing disputes, the IRS released five LB&I directives January 12 that modified the IRS’s examination and advance pricing and mutual agreement procedures, and further explained existing rules. Addressing transfer pricing information document requests (LB&I-04-0118-001), penalties (LB&I-04-0118-003), cost-sharing arrangements (LB&I-04-0118-004 and LB&I-04-0118-005), and best method selection (LB&I-04-0118-006), these directives have important implications for transfer pricing planning and controversy management. The IRS has more than 20 transfer pricing cases pending under the jurisdiction of the U.S. Tax Court.<sup>5</sup>

This increased exposure to U.S. transfer pricing examinations and disputes raises taxpayers’ anticipated cost and effort associated with transfer pricing compliance and the defense of these positions. It also makes a favorable outcome for those disputes less certain.

<sup>3</sup> Available as part of the exhibits in *United States v. Microsoft Corp.*, No.2:15-cv-00102 (W.D. Wash.), released Sept. 4, 2015.

<sup>4</sup> Dolores Gregory and Paul Shukovsky, “IRS: As of 2014, 1,000 Transfer Pricing Cases Under Audit,” 24 *Transfer Pricing Rpt.* 553 (Sept. 8, 2015).

<sup>5</sup> Ryan Finley, “IRS Focused on Better Transfer Pricing Case Selection, Kane Says,” *Tax Notes Int’l*, June 12, 2017, p. 1075.

## Overall Impact of Changes

The stepped-up global transfer pricing enforcement and the incremental reporting suggested by the OECD in its BEPS project have substantially increased the anticipated cost and effort devoted to global transfer pricing compliance and defense. The new U.S. tax regimes and additional IRS enforcement also increase uncertainty regarding transfer pricing outcomes. Taken together, these changes greatly increase the value of the certainty that an APA can provide.

### Recent Changes to the U.S. APA Process

#### Advance Pricing and Mutual Agreement Program

The U.S. APA program has undergone structural and staffing changes in recent years. In 2012 the program moved from the IRS Office of Chief Counsel to the LB&I division and merged with the competent authority function to create the APMA program. This move, which the IRS discusses in IR-2012-38, created substantial case management efficiencies by allowing the same team leader to develop an APA case with the taxpayer and negotiate that case with representatives from the treaty partner. More recently, the IRS restructured to reduce the number of APMA teams while also putting economists and non-economists on the same team. APMA has also experienced a recent reduction in staffing. At the end of 2016, APMA had 62 team leaders, 20 economists, and 10 senior managers according to Announcement 2017-3, 2017-15 IRB 1. At the end of 2017, according to Announcement 2018-8, 2018-19 IRB 552, APMA had 55 team leaders, 17 economists, and 10 senior managers.

Generally, stakeholders have perceived the structural changes as creating efficiency and have not viewed the staffing losses as slowing down the APA process.

#### New APA Revenue Procedure and APA Template

Rev. Proc. 2015-41, 2015-35 IRB 263, offers relatively new guidance on requesting and obtaining APAs. Rev. Proc. 2015-41 clarifies that APMA may limit taxpayer flexibility regarding the scope of coverage, it requires more upfront provision of information, and it increases the user fee for the APA process.

Under section 2.02(4)(a) of Rev. Proc. 2015-41, as a condition of continuing the APA process, APMA may require that the taxpayer expand its APA request to cover interrelated issues, other years, other countries, or a combination thereof. The rules also require taxpayers in the APA process to extend the statute of limitation. Although each of these restrictions was possible under the previous APA revenue procedure, Rev. Proc. 2015-41 makes APMA's ability to impose these conditions clear.

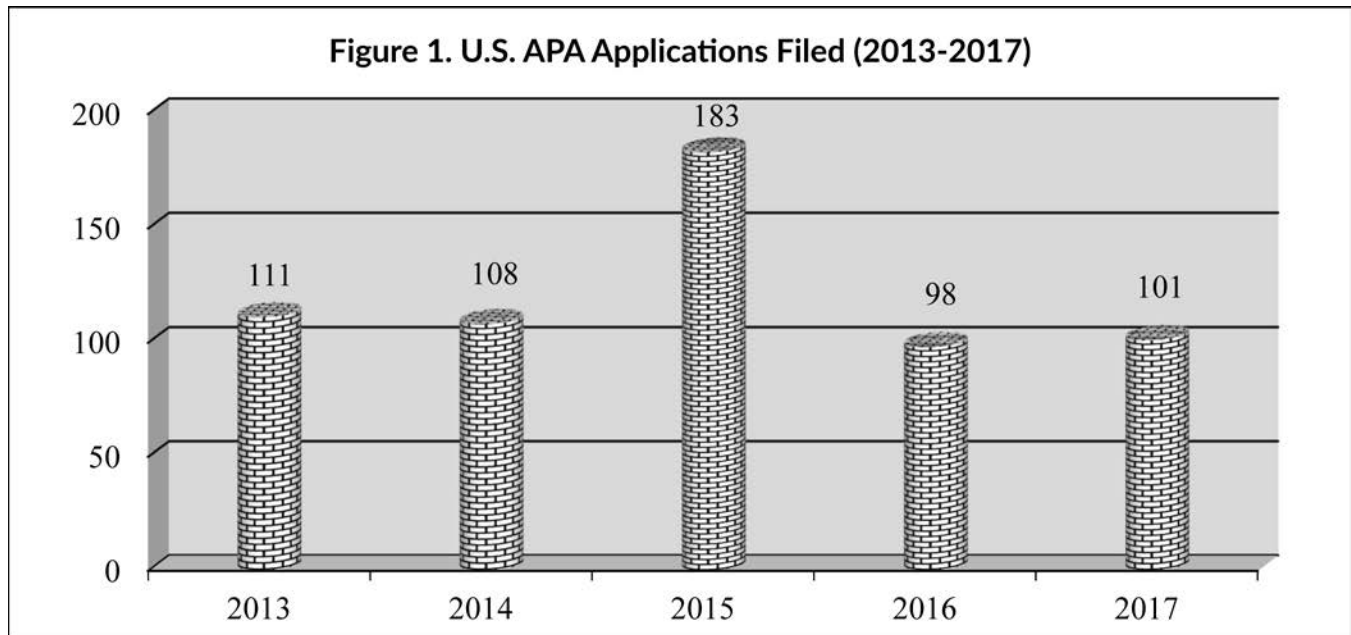
Exhibit 15 to Rev. Proc. 2015-41 also imposed a requirement that the taxpayer submit a proposed draft APA. While this requirement may add additional taxpayer effort to the process, it is also likely to expedite the drafting of the APA document. In 2017 the IRS shared a draft APA template, which it finalized in 2018. Both the draft and the final new APA template largely track the previous template, but with one important change: The draft APA template would have imposed subpart F income treatment on the repatriation of some adjustment amounts and the final template retains that treatment in more limited circumstances.

The changes in Rev. Proc. 2015-41 are largely positive. The IRS intends the additional upfront effort by the taxpayer to expedite the process without affecting the outcome. In some instances, however, either Rev. Proc. 2015-41 or the APA template restricts taxpayer behavior or produces a less desirable outcome.

#### Internal APA Process Changes

Some internal APA process developments that have occurred since Rev. Proc. 2015-41 have not been the topic of formal guidance. APMA has developed an intake process, ranking APA requests by size and level of complexity before assigning APMA team leaders and economists. APMA has tried to streamline the process and encourages the elevation of issues that could prevent a case from moving forward. Also, APMA has experimented with using reference sets of comparables to limit the time and effort devoted to developing arm's-length ranges.<sup>6</sup> The

<sup>6</sup> Alexander Lewis, "IRS Developing 'Reference Sets' of Comparables to Speed Up Cases," *Tax Notes Int'l*, Aug. 28, 2017, p. 873.



IRS hopes that these internal changes will improve the overall efficiency of the APA process.

Generally, these changes enhance efficiency without requiring additional taxpayer effort. However, APMA-generated reference sets may differ substantially from those that taxpayers and treaty partners believe are best, thus requiring additional effort to achieve a reasonable outcome.

### Revised APA User Fees

On February 6, the IRS announced a two-stage increase to APA user fees.

For requests filed after June 30, fees will increase to:

- \$86,750 from \$60,000 for new APAs;
- \$48,500 from \$35,000 for APA renewals;
- \$42,000 from \$30,000 for small case APAs (eligibility rules discussed in section 3.04 of the appendix to Rev. Proc. 2015-41); and
- \$17,750 from \$12,500 for amendments to APAs.

After December 31, user fees will increase to:

- \$113,500 for new APAs;
- \$62,000 for APA renewals;
- \$54,000 for small case APAs; and
- \$23,000 for amendments to APAs.

Taxpayers can make a dollar filing, a procedure discussed in section 3.03(3)(b) of Rev. Proc. 2015-41, to secure the lower user fee before the increase takes effect by doing all of the following:

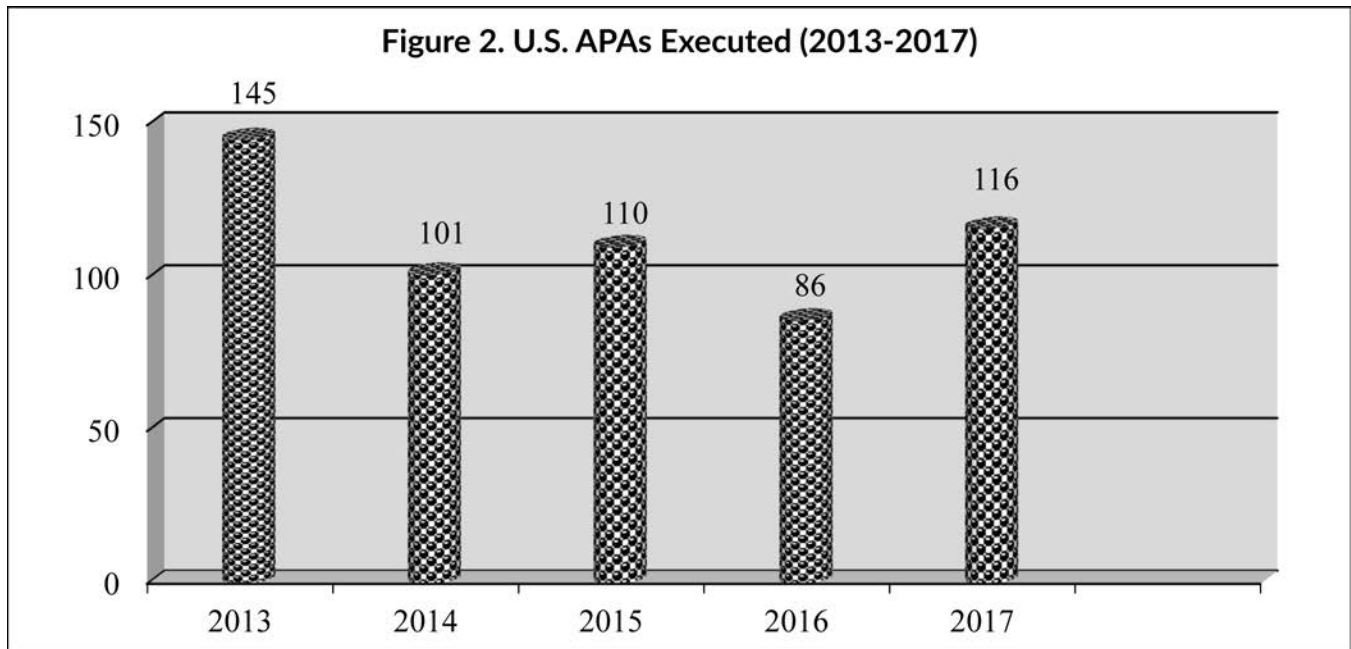
- paying the user fee before the date the fee increases;
- filing the comprehensive APA request within 120 days; and
- addressing any minor deficiencies promptly.

These fee changes do not relate to any change in the APA process — they increase the delivery price of an APA outcome without any other impact. This will disproportionately affect smaller APA cases.

### The Compliance Assurance Process

Recently, in IR-2018-174, the IRS announced changes to the compliance assurance process that may require some taxpayers participating in the program to resolve transfer pricing issues through the APA process. CAP is a cooperative program that allows some large taxpayers to resolve tax issues with the IRS before filing their tax returns. The IRS has made some changes to the CAP program for the 2019 application period that could affect taxpayers dealing with transfer pricing issues.

The revisions require the taxpayer to provide a preliminary list of material issues as part of the application, including transfer pricing issue information. The IRS may require that some transfer pricing issues be resolved through the APA program. While it is too soon to comment on experiences with the changes, it seems likely that



more CAP program participants will consider using an APA to resolve their transfer pricing issues.

#### Overall Impact of Changes to the APA Process

The IRS introduced changes to the APA process and made structural changes to APMA to make the process more efficient. Interest in the CAP program may also lead more taxpayers to consider an APA. Although some requirements will effectively front-load taxpayers' efforts in the APA process, practitioners expect the ultimate results will be positive for most taxpayers. Restrictions in Rev. Proc. 2015-41 and the new APA template, however, may reduce the availability of these benefits in some circumstances. Fee increases of 40 to 100 percent, however, may deter some from engaging in the APA process.

#### Observations From the APA Annual Report

For the most part, the key indicators of APA desirability — that is, the number of APA applications filed and APAs executed — have remained relatively stable. As the figures illustrate, the volume of APA applications has been very consistent for four of the past five years. There was an exceptionally high number of applications in 2015, probably because it was the last year to file before Rev. Proc. 2015-41 took effect.

According to Announcement 2014-14, 2014-16 IRB 948, in 2013 the APMA program completed 145 APAs, breaking the record set the previous year. Staff turnover, case complexity, and increased workload (including annual report review) have prevented APMA from maintaining that level of completions. The IRS's annual reports show that APMA executed 86 APAs in 2016 (Announcement 2017-3, 2017-15 IRB 1077) and 116 APAs in 2017 (Announcement 2018-08, 2018-16 IRB 552).

#### Conclusion

Individual companies will decide whether to pursue APAs based on company-specific facts and company-specific goals. However, recent changes in global transfer pricing enforcement and changes to the U.S. APA process have made APAs even more desirable. The rise in global transfer pricing enforcement and new BEPS CbC reporting requirements have increased the cost and effort taxpayers spend defending transfer pricing determinations through the regular enforcement process. The same forces have also reduced the certainty of a favorable outcome. Most practitioners expect that the recent structural and process changes at APMA will make the APA process more efficient, but fee changes will increase the cost to taxpayers. Overall, the favorable impact of recent changes is reflected in the continued level of taxpayer requests for U.S. APAs and the number of APAs executed. ■