

Advance Pricing Agreements: The What, Why, and How from the Valuation Analyst Perspective

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Intercompany transfer pricing continues to be a significant income tax issue facing multinational corporations. This has led to the increased popularity of advance pricing agreements. An advance pricing agreement (APA) is a prospective arrangement negotiated between a taxpayer and the appropriate tax authority that confirms the proper transfer pricing method used in an intercompany property or service transfer transaction. An APA can help minimize the risk of tax authority penalties related to an intercompany property or service transaction. The valuation analyst can provide significant value to a multinational taxpayer by assisting with the development and negotiation of an APA with the proper tax authority. This discussion focuses on the mechanics and recent popularity of an APA, and provides guidance as to the role the analyst can play in assisting in the APA process.

INTRODUCTION

Many multinational taxpayers find an advance pricing agreement (APA) to be a useful tool for managing multinational income tax risks. An APA is an agreement negotiated between a taxpayer and the national tax authority that details the appropriate transfer pricing method that will be used to price an intercompany transaction for income tax purposes.

Since the inception of the U.S. APA program, the use of APAs has increased in popularity. One reason for this increase in popularity is the increased scrutiny of transfer pricing (TP) and the uncertainty and scope of potential TP-related penalties levied by taxing authorities.

Taxpayer participation in the APA program is purely voluntary. An APA is a strategic tool that a taxpayer may use in order to (1) decrease the burden of tax authority compliance, (2) provide clarity as to the appropriate transfer pricing method used in a transaction, and (3) foster a cooperative relationship with the relevant tax authorities.

To that end, the valuation analyst can provide significant value by assisting the multinational tax-

payer in negotiating and finalizing an APA with the appropriate tax authority.

This discussion describes the procedures associated with the formation and use of an APA. Included in this discussion are several TP- and APA-related issues that the analyst should address when assisting in the APA process. In addition, this discussion summarizes recent movements in the U.S. APA program, which is now titled the advance pricing and mutual agreement (APMA) program.

TRANSFER PRICING AND INTERNAL REVENUE CODE SECTION 482

Over the past few decades, intercompany transfer pricing has become a significant area of concern for businesses that are looking to expand operations internationally. This is because the Internal Revenue Service (“Service”) and other taxing authorities have increased their focus on, and enforcement of, TP regulations.

Major corporations have recently been in the news as a result of TP disputes with the Service. These disputes relate to potential TP income tax

adjustments that total more than a billion dollars in certain instances. These TP disputes are one of two primary areas of international taxation where an analyst can provide guidance and assistance.

While a detailed description of the regulations and procedures associated with TP is beyond the scope of this discussion, a limited background on the mechanics of TP is relevant.¹

A transfer price is the price charged between related parties, such as a parent company and a foreign subsidiary, in an intercompany transaction of property or services. Any intercompany transaction of economic value among related parties falls under Section 482, and includes:

1. the transfer of tangible and intangible property,
2. the transfer of intercompany services, and
3. certain intercompany cost-sharing agreements.

Internal Revenue Code Section 482 and the associated Treasury regulations govern the federal income tax aspects of TP. Section 482 is intended to prevent taxpayers from being able to allocate income, expense, or deductions between related entities in order to avoid federal income taxes.

Section 482 provides the Service with the authority to adjust taxable income between related entities to more accurately reflect the income earned by each entity.

The Section 482 standard for determining the appropriate taxable income of a controlled taxpayer (i.e., a related foreign enterprise) is the arm's-length standard. According to the arm's-length standard, the appropriate transfer price of a property or service is the price that unrelated parties would pay in a comparable transaction under comparable circumstances.

The Section 482 regulations provide specific methods for evaluating whether or not an intercompany transaction meets the arm's-length standard. The method selected and the underlying assumptions used to estimate the intercompany transfer price of an asset or service is generally one of the main areas of focus in a Service TP inquiry.

As presented in the Section 482 regulations:

The purpose of section 482 is to ensure that taxpayers clearly reflect income attributable to controlled transactions and to prevent the avoidance of taxes with respect to such transaction. Section 482 places a controlled [affiliated] taxpayer on a tax parity with an uncontrolled taxpayer by determining the true taxable income of the controlled taxpayer.²

In other words, Section 482 was designed to determine the true taxable income of a controlled taxpayer by equating controlled transactions (i.e., affiliated transactions) with uncontrolled transactions (i.e., nonaffiliated transactions).

Therefore, Section 482 applies only (1) when two or more entities are under common control and (2) when the reallocation of income or deduction is necessary to reflect each entity's proper income, or to prevent an evasion of federal income tax.³

Treasury Regulation 482-1(i)(4) defines control as follows:

Controlled includes any kind of control, direct or indirect, whether legally enforceable or not, and however exercisable or exercised, including control resulting from the actions of two or more taxpayers acting in concert or with a common goal or purpose. It is the reality of the control that is decisive, not its form or the mode of its exercise. A presumption of control arises if income or deductions have been arbitrarily shifted.

For TP purposes, common control is determined by the Service on a transactional basis, and typically the initial Service inquiry into a TP issue is whether the related entities were subject to common control.

In overseeing TP activity in the United States, the Service possesses the authority to directly adjust the allocation of the transfer price between the related entities as a result of Section 482.

The regulations state the following:

Authority to make allocations. The district director may make allocations between or among the members of a controlled group if a controlled taxpayer has not reported its true taxable income. In such case, the district director may allocate income, deductions, credits, allowances, basis, or any other item or element affecting taxable income (referred to as allocations). The appropriate allocation may take the form of an increase or decrease in any relevant amount.⁴

As an aside, it would be interesting to analyze the percentage of Service allocations that result in a decrease in the price of an intercompany transaction; however, that is a topic for another discussion.

Transfer Pricing Changes Lead to Development of Advance Pricing Agreements

TP disputes between taxing authorities and taxpayers can arise from many factors. Tax-related TP disputes typically fall into three categories:

1. Tax authorities question the underlying assumptions used when a taxpayer or tax-paying entity applied a certain TP valuation method.
2. Tax authorities question the decision to select a certain TP valuation method.
3. Tax authorities disagree with the tax-paying entities' representation of the value chain within the TP group.

In the mid-1980s, and prior to the creation of the APA program, the U.S. government and certain taxpayers that were involved in transfer pricing issues began to address the possibility of an APA mechanism. In 1989, the Service collaborated with several taxpayers to negotiate and ultimately develop what were termed "advance determination rulings," the precursor to APAs.

During the 1990s, two significant changes to the legal and regulatory transfer pricing environment in the United States were implemented. The Treasury's 1993 Section 6662(e) transfer pricing penalty legislation and the Treasury's 1994 revised Section 482 regulations materially altered the transfer pricing approach of taxpayers. In conjunction, these regulatory and legal changes accomplished the following:

1. Introduced an arm's-length transfer pricing transaction range
2. Provided a transfer pricing best method rule
3. Allowed for use of inexact comparable transactions in estimating the appropriate transfer price
4. Imposed substantial monetary penalties as a result of a Service transfer pricing audit adjustment

Of the above-mentioned regulatory and legal changes, items (2) and (4) contributed substantially to the development of the APA program.

ADVANCE PRICING AGREEMENTS

In general, an APA is an agreement between a taxpayer (i.e., multinational enterprise) and the Service that sets forth, in advance of controlled transactions (of both tangible and intangible prop-

erty and service), the appropriate pricing method to be used in allocating taxable income between the related entities.

Revenue Procedure 2006-9 describes an APA as follows:

An APA is an agreement between a taxpayer and the Service [IRS] in which the parties set forth, in advance of controlled transactions, the best transfer pricing method (TPM) within the meaning of 482 of the Code and the regulations. The agreement specifies the controlled transactions or transfers ("covered transactions"), TPM, APA term, operational and compliance provisions, appropriate adjustments, critical assumptions regarding future events, required APA records, and annual reporting responsibilities.⁵

The 1993 Section 6662(e) penalties-related legislation and regulations require taxpayers to develop adequate documentation in order to support the selection and application of the transfer pricing method (under the best method rule) and to do so prior to the filing of the tax return for the year in question.

Taxpayer reaction to the documentation requirement and the substantial penalties for filing an inappropriate transfer price resulted in the development of the APA program.

The APA Process

The goal of an APA is to enable tax authorities and taxpayers to collaborate and ultimately agree on the appropriate methods and procedures used to establish the transfer price of property and services. An APA is a legally binding agreement between the taxpayer and the Service.

An APA is not required to be inclusive of all of the taxpayer's affiliate transactions. Rather, it may be limited to specific years, specific affiliates, specific goods or services, and specific affiliate transactions.

In initiating the APA process, a taxpayer would approach the Service with a proposed APA. Alternatively, a taxpayer may request a formal prefilings conference with the Service to discuss, informally, the appropriateness of a proposed APA. The proposed APA would describe a transfer pricing method (TPM) for an affiliate transaction, along with supporting data.

In the proposed APA, the taxpayer should represent that the proposed TPM is the best method for establishing the affiliate transaction arm's-length

price. According to the Section 482 regulations, the best method is generally determined by using third-party comparable data (if available) in order to estimate an appropriate transfer price for the subject asset or service.

Upon receiving a proposed APA, the Service, through a specialized APA team, will evaluate the proposed APA by analyzing all relevant data and information that was submitted by the taxpayer in the initial request, as well as any additional subsequent data provided by the taxpayer.

There are three types of APAs: (1) unilateral APAs, (2) bilateral APAs, and (3) multilateral APAs. A bilateral or multilateral APA encompasses a request from a taxpayer for an APA between the taxpayer and the Service, and also includes a request for a collaborative agreement between other relevant tax authorities (i.e., foreign tax authorities).

These are the preferred APAs, as proffered by the Service, due to their ability to ensure that there will be no double taxation related to an affiliate transaction. A unilateral APA involves only an agreement between the taxpayer and the Service.

Upon review of the APA request, in a bilateral or multilateral scenario, the Service will prepare a formal recommended negotiating platform for the U.S. competent authority (USCA). This negotiating platform is a basis for further discussions with the other relevant tax authorities (i.e., foreign tax authorities). In advance of finalizing its recommendation, the Service will convey the substance of the APA team's position to the taxpayer, allowing for any additional taxpayer comments. The Service will consider the additional taxpayer comments in finalizing its recommendation.

If the USCA and the other relevant tax authority(ies) come to a mutual agreement based on the USCA's recommended position, the taxpayer and the Service are approved to execute one or more APAs that are consistent with the mutual agreement.

The Analyst and the APA

Within the scope of providing transfer price services for clients, the analyst may be proactive in offering his or her services to those clients that have the potential for transfer pricing issues.

The analyst may look to collaborate with corporate counsel (or the corporate tax department) and provide assistance with the following:

1. Determining whether an APA is appropriate for a given transaction
2. Negotiating with the APA program and the USCA

3. Ensuring an accurate and reliable analysis of a potential APA
4. Dealing with any subsequent Service inquiries associated with the APA

This does not infer that the analyst should become an advocate for his or her client; rather, the analyst should thoroughly understand the applicable Internal Revenue Code Sections, regulations, and revenue procedures associated with APAs in hopes of minimizing the potential of an Service dispute.

Analysts can provide guidance in determining whether an APA may be a suitable strategy for a multinational enterprise.

Generally, an APA can assist a multinational enterprise that has experienced consistent transfer pricing audits with respect to similar disputes, has reached a negotiating impasse with a tax authority transfer pricing audit team, or has made significant changes to its business model and value chain.

In assisting with the up-front vetting of a potential APA, the analyst should also be prepared to provide support in comparing the up-front costs associated with finalizing an APA (i.e., direct and opportunity costs associated with the research, development, negotiation, and finalization of an APA) to the costs associated with preparing contemporaneous documentation as a result of a tax authority audit, defending against a tax authority audit, and obtaining final resolution of double taxation through negotiation or litigation with the relevant tax authority.

Generally, multinational corporations look for analysts and other APA advisers who possess the following skills:

1. Strong technical or analytical skills to apply to the APA process
2. Strong working relationships with tax authorities, including in-depth knowledge of the tax authority standard positions, practices, and strategies
3. Strong subject-industry knowledge and stakeholder engagement
4. Strong presentation and communication skills to assist in negotiating with the relevant tax authorities
5. A background in litigation assistance as well as tax-related assistance, which will provide value to the taxpayer should an APA result in tax-authority-based litigation

Other tasks that the analyst can assist a multinational enterprise with in navigating the APA process include the following:

1. Reviewing the details and circumstances surrounding transfer pricing issues and any ongoing tax authority audit activities
2. Developing transfer pricing strategies and policies for purposes of negotiating with the relevant tax authority
3. Assisting in the formal preparation of an APA, including providing guidance as to the appropriate transfer pricing method to be used in a transaction
4. Facilitating and assisting with APA prefilings conferences, site visits, post-filing inquiries, and document drafting
5. Assisting with the preparation of APA annual reports

Clearly transfer pricing is a relevant issue for both the Service and multinational corporations. Many recent professional periodicals have increased their focus on transfer pricing and APAs.

As presented in the *Journal of Accountancy*:

Transfer pricing is in the cross hairs of tax policy as it relates to the competing objectives of three parties: the revenue-maximizing objective of the domestic tax authority, the revenue-maximizing objective of the foreign tax authority, and the tax-minimizing objective of the taxpayer. Because of the inherent differences in judgment and interpretation of facts when analyzing a company's transfer pricing, together with the clashing revenue objectives of multiple tax authorities and taxpayers, the risk of adjustments to taxable income, double taxation, and potential for penalties is nontrivial, even for multinationals that make good-faith efforts to comply with Sec. 482.⁶

As further documented in the *Journal of Accountancy*:

The risk and uncertainty associated with transfer-pricing positions is expected to increase in coming years. Under pressure to raise revenue, governments are directing tax authorities to increase transfer-pricing audits. The Service has made a substantial investment in its transfer-pricing resources. Last year, the Large Business and International (LB&I) Division launched its international practice networks to unify international compliance functions and bring institutional expertise

to bear on them. Transfer pricing is among the networks' top concerns (see "New LB&I Knowledge Management Strategies: IPGs and IPNs," *The Tax Adviser*, Oct. 2012, page 668). In the next two years, the Service will focus more transfer-pricing examination resources on medium-size taxpayers, those with assets as low as \$10 million, than before (see "Practitioners Warn Middle-Market Companies of Heightened Transfer Pricing Scrutiny," *Tax Notes Today*, July 18, 2013).⁷

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The analyst, using expertise with regard to tangible and intangible property transfer pricing and experience with Service standard operating procedures and strategies, can provide significant value to multinational taxpayers looking to:

1. minimize the risk of taxing authority audits on APA-related issues and
2. develop a coherent organization-wide APA plan and strategy.

CURRENT APA ENVIRONMENT

Since the inception of the APA program, an annual report detailing the current environment of APAs is required to be presented to the public by the Secretary of the Treasury. As mentioned, one of the recent updates to the APA program was the changing of the name to the APMA (advance pricing and mutual agreement) program.

The annual APA program reports, covering the years 1991 through 2013, detail the experience, structure, and activities associated with the APA program for a given calendar year. Below is a summary of certain material APA program statistics as presented in the *Announcement and Report Concerning Advance Pricing Agreements*:

1. For the second year in a row the number of executed APAs increased (from 140 in 2012 to 145 in 2013).

Table 1
APA Applications Filed in 1991-2013

	Unilateral APAs	Bilateral APAs	Multilateral APAs	Total APAs
APA Applications Filed in 1991-1999				401
APA Applications Filed in 2000-2012	439	904	1	1,344
APA Applications Filed in 2013	20	89	2	<u>111</u>
Total APA Applications Filed in 1991-2013				1,856

Source: Richard J. McAlonan Jr., "Announcement and Report Concerning Advance Pricing Agreements" (March 27, 2014).

2. The median completion time of an APA decreased from 39.8 months (2012) to 32.7 months (2013).
3. The number of executed APAs (145) surpassed the number of applications filed (111) in 2013.
4. Of the bilateral APAs filed in 2013, nearly 75 percent involved Japan or Canada.
5. Of the APAs finalized or renewed in 2013, approximately 41 percent were for the wholesale/retail industry and approximately 35 percent were for the manufacturing industry.
6. Of the APAs executed in 2013, approximately 77 percent applied the comparable profits/transactional net margin method as the primary transfer pricing method.

In addition, Table 1 provides a historical view of APA activity since inception. It is apparent that the popularity of APAs has increased over the years, and will likely continue to do so as a result of the continued globalization of certain industries (and their respective multinational enterprises) and the tax authorities' constant goal of increased income tax revenue.

SUMMARY AND CONCLUSION

APAs are prospective arrangements negotiated between a taxpayer and the appropriate tax authority that confirm the proper pricing method and overall approach in an asset or service transaction between related entities.

The APA program was created as a result of the competing objectives of three parties:

1. The revenue-maximizing objective of the domestic tax authority
2. The revenue-maximizing objective of the foreign tax authority
3. The tax-minimizing objective of the taxpayer (i.e., multinational enterprise)

APAs represent a collaborative effort between the taxpayer and tax authorities in order to limit the inefficiency and risk associated with estimating an appropriate transfer price for relevant transactions. Due to the increased scrutiny of transfer prices by the Service and other taxing authorities, APAs are gaining in popularity.

A thorough and well documented APA can help a taxpayer minimize the risk of income tax penalties related to an intercompany property or service transaction. Analysts can provide significant value to a multinational taxpayer by assisting with the development, negotiation, and finalization of an APA with the appropriate tax authority.

This discussion focused on the APA process and the recent popularity of advance pricing agreements. This discussion also highlighted the role that analysts can play in the APA process.

Notes:

1. The other area of international taxation where an analyst can provide guidance and assistance is customs valuation.
2. Treas. Reg. Sec. 1.482-1 (2012)
3. Local Finance Corp. v. Comm'r, 407 F.2d 629 (7th Cir. 1969).
4. Treas. Reg. Sec. 1.482-1 (2012)
5. Service Revenue Procedure 2006-9, page 3.
6. John McKinley, "Transfer Pricing and Its Effect on Financial Reporting—Multinational Companies Face High-Risk Tax Accounting," *Journal of Accountancy* (October 2013): 51.
7. Ibid.: 52.

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