

The APA Application Process and Intercompany Transfer Price Considerations

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Domestic taxpayer corporations that transfer tangible property (e.g., inventory), intangible property (e.g., trademarks), or services with controlled foreign affiliates must comply with the statutory arm's-length price (ALP) intercompany transfer price requirements. In order to avoid surprises on audit (and statutory penalties), many such taxpayer corporations have entered into an advance pricing agreement (APA) with the Internal Revenue Service. This discussion summarizes (1) the taxpayer procedures in the APA application process and (2) some of the taxpayer management considerations related to the APA application.

INTRODUCTION

Any taxpayer corporation (regardless of its size) that transfers tangible property, intangible property, or services to a controlled foreign affiliate is subject to the statutory arm's-length pricing requirements related to such intercompany transfers. That is, any cross-border transfers between commonly owned corporations (e.g., domestic parent corporation and foreign subsidiary) must be made at a market-derived arm's-length price.

This arm's-length price (ALP) requirement includes intercompany transfers of tangible property (e.g., products), intangible property (e.g., intellectual property use), or company service costs. If the Internal Revenue Service (the "Service") audits the taxpayer corporation and does not agree with the taxpayer's intercompany prices, the Service can adjust the taxpayer's income so that it properly reflects an ALP intercompany transfer price.

This discussion summarizes the procedures that a taxpayer corporation can use to obtain an advance pricing agreement (APA) with the Service. From the taxpayer corporation's perspective, the purpose of the APA is to minimize the taxpayer's exposure to intercompany transfer price adjustments on audit.

The ALP for intercompany transactions between controlled affiliates is a statutory requirement for proper tax compliance in the United States. The taxpayer's failure to comply with the ALP requirement can result in a penalty of either 20 percent or 40 percent of the tax due, according to Section 6662.

Also, virtually all major foreign countries have their own provisions for managing intercompany pricing for their own jurisdictions. Most foreign countries belong to a multinational association of tax administrators who attempt to unify intercompany pricing regimes. The Service regularly works with its counterparts in foreign countries where the United States has tax treaties in order to assure a proper allocation of taxpayer income and expenses across foreign borders.

INTERCOMPANY TRANSFER PRICING METHODS

There are six intercompany pricing methods for the transfers of tangible property or intangible property. The comparable uncontrolled price method, the resale price method, the cost-plus method, the comparable profits method, and the profits split method are allowed by the regulations to determine

the ALP of transferred tangible property. The comparable uncontrolled transactions method, the profits split method, and the comparable profits method are allowed by the regulations to determine the ALP of transferred intangible property.

The Service also allows an undefined “other reasonable method.” A full discussion of all of these allowable intercompany transfer pricing methods is beyond the scope of this discussion.

WHAT IS AN APA?

An APA is an agreement between a taxpayer corporation and the Service. The APA determines the best transfer price method (TPM) of the taxpayer controlled transactions under Section 482. Generally, the agreement describes: the controlled intercompany transaction, the APA term, any analytical assumptions used, the taxpayer records that must be maintained, and the taxpayer reporting responsibilities.

But, the APA can also “provide a process whereby the Service and taxpayers may resolve other issues arising . . . under income tax treaties, the Code or the . . . regulations for which transfer pricing principles are relevant” (Revenue Procedure 2008-31).

The APA process is intended to:

1. resolve whether taxpayer income is effectively connected to a U.S. trade or business and
2. determine amounts of taxpayer income derived from sources partly within and partly outside the United States (Revenue Procedure 2008-31).

All taxpayer corporations that have transactions with controlled affiliates should periodically consider their intercompany transfer pricing procedures. However, there is no requirement for the taxpayer corporation to obtain an APA. The APA process is entirely voluntary, and it is initiated by the taxpayer corporation.

For many smaller taxpayers, the costs of obtaining an APA—even without outside experts—may be prohibitive. The Service application filing fee alone is \$22,500. The APA application should be undertaken with due consideration. However, cost alone should not cause the taxpayer corporation to dismiss the prospect of an APA out of hand. This is because the taxpayer preparation for the APA can ultimately reduce the taxpayer cost of tax compliance over the years for which the APA is effective.



The cost of compliance, notwithstanding the cost of the APA, is not an adequate excuse to neglect Section 482 or the intercompany transfer price regulations. This is because the taxpayer corporation failure to comply with the ALP requirements can incur the Section 6662 penalties mentioned above.

The effective “cost” of the APA over its term should be measured as the cost that exceeds the taxpayer’s cost of regular Section 482 compliance for the same term. This compliance “cost” should include any penalties and any ALP defense that may arise during the APA term.

When those costs are considered, an APA may very likely be more cost effective for the taxpayer than preparing the transfer price documentation and a defense for each tax year—with no assurance that the Service will accept the taxpayer’s selected TPM.

APA APPLICATION CONSIDERATIONS

Most taxpayer corporations with controlled foreign affiliates will at least want to take preliminary steps to consider an APA. These preliminary APA considerations will bring the taxpayer into better compliance with the ALP regulations and may reveal any transfer price shortcomings that the taxpayer can correct. Perhaps most important, preparing for an APA will put the controlled transaction ALP front and center in the minds of the taxpayer corporation executives. These taxpayer executives may otherwise neglect the intercompany transfer ALP requirements, ultimately with tax penalty consequences.

For many taxpayer corporations, going through the exercise, considering the importance of ALP

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to clients, compiling the documentation, and reflecting (or disclosing) the results on the taxpayer tax return, even without formally completing the APA, may have a positive effect on the taxpayer management. The documentation accumulated in preparing for an APA can be invaluable in proving that the taxpayer management was duly diligent in assessing the taxpayer corporation's intercompany transfer prices.

For the taxpayer corporation that obtains an APA with both the Service and the tax authority of the controlled foreign affiliate (in a bilateral or multilateral APA), there is the assurance that the U.S. tax treaty competent authorities will seek to achieve substantially identical (i.e., offsetting) treatment with the foreign jurisdiction.

If the APA determines that the transfer price charged by the U.S. taxpayer corporation for inventory it sold to its foreign affiliate is appropriate, then the competent authorities would try to ensure that the tax authorities in the foreign affiliate's country increase its cost of goods sold. That adjustment would decrease the affiliate's taxable income in the foreign tax jurisdiction.

Most importantly, taxpayer corporations that obtain an APA—and adhere to it in their tax reporting—can generally rest assured that their intercompany pricing of covered transactions will not be challenged by the Service on audit.

THE APA APPLICATION PROCESS

All APAs are initiated by the taxpayer. The formal APA process begins with the taxpayer corporation defining the scope of the APA.

First, the taxpayer should select the controlled transactions that the APA is to cover. Taxpayers can “cherry pick” the controlled transactions they submit for an APA. However, the Service may opt to expand (or narrow) the scope.

The Service cautions that the taxpayer corporation should (1) complete its analysis of each of the transfer price methods of the covered transactions and (2) compile all the required documentation well in advance of approaching the Service. Of

course, the taxpayer corporation should compile this documentation and analysis annually for controlled transactions. This statement is true even if the taxpayer corporation determines not to pursue the APA application.

Second, the taxpayer corporation management determines whether the scope should be (1) unilateral (with the Service only), (2) bilateral (with the Service and the tax authority of another country), or (3) multilateral (with the Service and two or more other taxing jurisdictions in which the entities in a controlled transaction are located).

Third, the content of the APA is strictly confidential. It cannot legally be disclosed to the public. Nonetheless, the taxpayer corporation management may have considerable trepidation about exposing what may be the company's most sensitive trade secrets to the Service scrutiny.

Such fears may multiply when the taxpayer management seeks a bilateral or multilateral APA. This is because the Service puts the burden on the taxpayer, not on itself, to clearly identify relevant concerns that may affect the negotiations of the APA request with the tax authorities of foreign jurisdictions.

Fourth, the taxpayer management then goes about compiling the data used to support the transfer price methodology for the controlled transaction for tax return purposes. That way, the taxpayer corporation can assess whether it is adequate to fulfill the Section 482 regulations.

If data are missing or inadequate and the taxpayer corporation can readily obtain the data, then it should do so. However, if missing data seem extraneous to the transfer price method and are difficult or expensive to obtain, then the taxpayer management should just note the shortcoming. This is because the Service may not require the missing data.

Once these steps are completed, the taxpayer corporation may approach the Service in Washington, DC (or in California where an APA program office is located) for an APA prefiling conference. The Service allows such arrangements to be made anonymously if the taxpayer management requests it.

According to Revenue Procedure 2006-9, the purpose of the APA prefiling conference is to:

clarify what information, documentation, and analyses are likely to be necessary for the Service to consider an APA request. Among the areas of discussion are the covered transactions, the potentially applicable TPMS, the probability of agreement among the competent authorities, and the APA Program's schedule and method for coordinating and evaluating the request.

The taxpayer corporation management can also use the meeting to determine (1) whether the APA application should proceed, (2) whether management is comfortable with the scope of the matters the Service appears to have interest in, and (3) whether the Service's schedule for meetings, other discussions, and ultimate completion will comport with management's own schedule.

Ordinarily, the formal submission of the APA application only begins when the taxpayer corporation pays the APA fee and files the APA request. The information required for the APA request is detailed in Revenue Procedure 2006-9.

Once the taxpayer corporation submits the application, a representative of the APA program will contact the taxpayer corporation (or its representative) (1) to discuss any preliminary questions and (2) to request additional information that may be necessary. When the taxpayer management answers the questions and provides the information, the APA program will begin the process.

A Service leader will be appointed who will appoint an APA team. The APA team will consist of an economist, an international examiner, an attorney, and, for bilateral and multilateral applications, a competent authority analyst. The team members' supervisors may also be team members, in addition to a representative from Appeals, if the taxpayer management requested an APA rollback for a year that is before Appeals.

Normally within six weeks of submitting the APA application request, the APA team leader will contact the taxpayer and arrange the first APA meeting. At the meeting, the Service and the taxpayer management will work:

1. to clarify any points that are not clear from the APA request and
2. to set the scope and nature of the APA team's due diligence.

The meeting will also set, and the parties will agree to, a case plan wherein firm dates are set for both the Service and the taxpayer management to provide and evaluate data, visit the taxpayer corporation headquarters, and arrange for follow-up meetings.

The taxpayer management consistent failure to abide by the dates in the case plan will be viewed as a withdrawal of the APA request. While the taxpayer management requests are supposed to be handled as expeditiously as possible, the taxpayer management can still expect a fairly lengthy process with the Service, averaging two years. During this period,

meetings and negotiations are required before the APA is completed.

Among the first things the APA team will evaluate is any portion of the APA request that is a "non-starter"—that is, elements of the submitted request that are outside the scope of the Service to rule upon or that the taxpayer management may have submitted as a "throwaway" position to be used in negotiations.

Early in the process, the APA team and the team leader will evaluate the taxpayer APA request to achieve the best TPM under Section 482. The Service team will perform due diligence to familiarize themselves with the taxpayer corporation. And, the Service team will make various preliminary computations of performance ratios of the taxpayer corporation financial statements to measure the taxpayer business operations.

The APA team will then reconcile the financial data to the taxpayer corporation income tax return. These performance ratios are compared with the industry comparable companies. The APA team economist will attempt to match the comparable companies selected by the taxpayer corporation in the APA request using commercially available databases.

TAXPAYER MANAGEMENT CONSIDERATIONS DURING THE APA NEGOTIATIONS

The taxpayer corporation often has unique circumstances. Therefore, it is important for the taxpayer management (and the taxpayer representatives) to understand the importance of selecting the right data set in its negotiation with the APA team.



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requests. Nonetheless, the taxpayer management should strongly consider engaging its own financial advisers to work with management or with the taxpayer's tax advisers.

The selection of the data set of potential comparable companies will fix the upper and lower limits of what will ultimately be (1) the TPM and (2) the agreed intercompany transfer price. Therefore, the taxpayer management should (1) be particularly attentive to the selection and (2) be prepared to recommend and justify alternative databases.

In particular, the Service has stated (1) that “it is important to understand the U.S. tax effects of ‘the bottom line’ of any proposed TPM” and (2) that the APA team leader should determine the TPM's tax effect.¹

Therefore, the APA applicant taxpayer management would be naive, and unprepared, not to be equally focused on this technical issue.

Another APA aspect that is important to both the Service and the taxpayer management is the critical assumptions of the analysis. These assumptions are intended to define the environment in which the TPM is acceptable to both the Service and the taxpayer management.

Where critical analysis assumptions are not achieved (for example, if taxpayer corporation revenue fails to meet the minimum threshold in the critical assumptions because the taxpayer corporation experiences some type of unexpected event, such as a fire that destroys a plant), the failure to meet those assumptions should render the APA TPM void.

Let's consider the APA request is bilateral or multilateral. In these cases, the APA team will conduct these processes in order to develop a negotiating position for use by the competent authority to negotiate the APA with the treaty partners. If the APA request is for a rollback period, then the APA team will evaluate the APA request for its effect on the tax amount already at issue.

There are a number of factors that may affect the criteria for selecting comparable companies. Regulations Section 484-1(d)(3) presents a partial list of factors to consider in determining the comparable company selection criteria. The Service offers assistance with economic analysis to taxpayers that submit APA

After all these processes are completed, the APA will be executed by the taxpayer management and the APA director. The APA will be effective as a binding agreement between the taxpayer corporation and the Service for its term. The typical APA term is usually no less than five years.

It is noteworthy that the APA program may reject the APA request or refuse to execute it. This may occur even after the APA due diligence process has been completed. If the APA rejection occurs after the due diligence, the Service is likely to retain the user fee.

For each year covered by the APA, the taxpayer corporation must submit a complete report showing compliance with the APA. An original and four copies of the report must be filed with the APA director within 90 days of the date for filing the taxpayer corporation tax return (including extensions).

The report will show, among other things, how the taxpayer management applied the TPM agreed to in the APA in its actual tax return. The taxpayer management files the report under penalty of perjury. The taxpayer failing to submit the report as required can cause the APA to be canceled or revoked.

SUMMARY AND CONCLUSION

The APA application process can be demanding. However, the APA application process does provide substantial assurance that the Service will respect the intercompany transfer prices used by the taxpayer corporation. When it is made as a bilateral or multilateral APA, the taxpayer corporation intercompany transfer prices will also be respected by the U.S. tax treaty partners.

Even if a taxpayer corporation does not make formal application to the Service for an APA, the taxpayer management dealing in cross-border transfers should undertake the steps for applying for an APA. That understanding will help the taxpayer management comply with the U.S. and foreign arm's-length pricing laws and may help limit the taxpayer corporation potential tax exposure.

Note:

1. Internal Revenue Service, “Case Analysis and Fact Development” at 4, www.irs.gov/pub/irsapa/case_analysis1.pdf.

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