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Why Advance Pricing Agreements Work

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The IRS employs many procedures to resolve tax disputes, and most of those procedures have been applied to resolve transfer pricing disputes. However, none of those procedures have been as successful as advance pricing agreements (“APAs”). Since establishment of the APA program in 1991, the taxpayer reaction to APAs has been positive. In two days of public hearings on the APA program in 2005 as part of a “self-examination,” comments from taxpayers and representatives were overwhelmingly positive. Taxpayers specifically praised the fairness and efficiency of the program and the professionalism of the APA staff.¹ More recently, the OECD’s Transfer Pricing Guidelines noted that APAs have increased the level of certainty between jurisdictions, reduced the likelihood of double taxation, and proactively prevented tax disputes.² Further, Action 14 of the OECD Base Erosion and Profit Shifting Report, singled out the adoption of a bilateral APA program as a “best practice” for effective dispute resolution.³

Given the breadth of IRS efforts to develop dispute resolution procedures and the success of APAs, it

makes sense to scrutinize the APA process to determine what aspects of APAs contribute to its success.

PROCEDURAL DESCRIPTION OF APAS

Transfer pricing refers to the pricing of transactions between parties under common control. Because market forces do not necessarily control the price between related parties, governments require taxpayers to establish an arm’s length price between those parties to produce the correct taxable income in the involved countries. Should a taxpayer not satisfy the involved countries’ concerns for the correct arm’s length price, the likely outcome would be double taxation of some portion of the taxpayer’s income.

An APA is a procedural alternative that avoids exposure to a transfer pricing dispute through the negotiation of a prospective agreement with one or more governments. APAs concluded between treaty partners provide an increased level of certainty, reduce the likelihood of double taxation, and proactively prevent transfer pricing disputes. In its simplest form, an APA addresses three basic elements of a transfer pricing issue: 1) the factual nature of intercompany transactions between related parties to which the APA applies; 2) an appropriate transfer pricing method (“TPM”); and 3) an arm’s length range of results. If the taxpayer complies with the APA, the government(s) will not contest the transfer price.

APAs are negotiated in the United States by the Advance Pricing and Mutual Agreement (“APMA”) program within the Large Business and International Division of the IRS. As of December 31, 2021, APMA had 80 team leaders, 25 economists, 9 managers, and

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¹ IRS Announcement 2004-98, Public Hearing on the Advance Pricing Agreement Program.

² 4.134 of OECD TP Guidelines.

³ OECD (2015), Making Dispute Resolution Mechanisms More

Effective, Action 14 — 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. <http://dx.doi.org/10.1787/9789264241633-en>.

3 assistant directors, many of whom have substantial experience working in the private sector.⁴

WHY APAS WORK

Transfer pricing is frequently a contentious and controversial issue. Traditional IRS enforcement has historically polarized the positions of the IRS and taxpayers, creating a difficult environment in which to achieve agreement on the arm's length character of related party transactions. Therefore, the IRS developed the APA process to promote voluntary compliance and reduce the administrative burden on taxpayers and the IRS.

The APA procedure was designed to supplement the traditional administrative, judicial and treaty mechanisms to resolve transfer pricing disputes. In clinical terms, the APA process can be described as a prospective negotiation between the taxpayer and IRS (and possibly the other involved country); however, the small but important differences between APAs and the regular IRS-taxpayer negotiation process in Examination have produced a successful process to resolve transfer pricing issues. The following discussion attempts to identify those differences and note how they combine to make the APA process successful:

Voluntary Taxpayer Involvement/ Commitment

Taxpayers must choose to pursue an APA and must submit a substantial APA user fee (currently \$113,500 for a new APA) and expend substantial professional fees and in-house personnel efforts. These hurdles ensure that any taxpayer that submits an APA request is strongly committed to the successful resolution of its APA.

Taxpayer Responsibility/Opportunity to Provide Information

The taxpayer is required in the APA request to provide a substantial amount of up-front information that might not otherwise be required in the regular course of transfer pricing compliance. This costly effort, and the information made available to the IRS, further strengthen the taxpayer's commitment to resolution of its transfer pricing issues.

One taxpayer benefit from the initial APA request effort is that the taxpayer is allowed to initially decide which transactions will be covered by the APA; describe the taxpayer's industry, operations, and transactions; and propose and support a transfer pricing

methodology and comparables set. This approach allows the taxpayer to persuasively support its APA request and seek a "fresh look" on its transfer pricing issues by the APMA team.

The Pre-Dispute Timing of APAs

APAs are prospective. The APA applies to years for which the tax return is not yet filed at the date of the APA request. This approach allows taxpayers to address contentious issues with "clean hands," reduces the adherence by both parties to historic negotiating positions, and eliminates the need for the governments to disgorge tax revenues already received. Previous open tax years can be covered by "rollback" of the APA methodology after a prospective agreement has been reached.

IRS APA Team Staffing

The IRS APA team is composed of experienced personnel from APMA (possibly a team leader and an economist), with Exam, Appeals, and IRS Counsel personnel available as necessary. This approach is intended to bring all interested IRS parties to the taxpayer's transfer pricing issues up front, offering an effective one-stop process. Further, many of the APMA staff previously worked in private practice and that shared perspective can help with communication and resolution.

The original placement of the APA program under IRS Chief Counsel (International) and staffing of the APA program with personnel with outside experience helped to persuade earlier taxpayers seeking APAs of the technical, non-partisan approach in the APA program. The subsequent movement of APA responsibility to APMA has not seemed to undermine the program's reputation for fairness.

Limited Subject Matter of APAs

APAs only apply to transfer pricing issues and ancillary issues. This single-issue focus allows APMA to build the experience of its staff and monitor all APA cases to develop consistent positions. Further, the limited issue focus reduces APMA exposure to program growth and some of the attendant growing pains.

CONCLUSION

Although the APA process does not differ substantially from the negotiation of a transfer pricing dispute through the regular examination process, the combination of those small differences has allowed the APMA program to become the forum of choice for difficult transfer pricing issues.

⁴ Announcement 2022-7