
Testimony

of

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on behalf of

TAX EXECUTIVES INSTITUTE, INC.

on

**The IRS's Advance Pricing
Agreement Program**

**Public Hearing before
the Internal Revenue Service**

February 22, 2005

Good afternoon. I am Judith P. Zelisko, Vice President-Tax for Brunswick Corporation in Lake Forest, Illinois. I am here today as President of Tax Executives Institute. Thank you for the opportunity to present TEI's views on the Advance Pricing Agreement program.

BACKGROUND

Tax Executives Institute is the preeminent association of business tax executives in North America. Our more than 5,400 members represent 2,800 of the leading corporations in the United States, Canada, and Europe. TEI represents a cross-section of the business community, and is

dedicated to developing and effectively implementing sound tax policy, to promoting the uniform and equitable enforcement of the tax laws, and to reducing the cost and burden of administration and compliance to the benefit of taxpayers and government alike. As a professional association, TEI is firmly committed to maintaining a tax system that works — one that is administrable and with which taxpayers can comply in a cost-efficient manner.

Members of TEI are responsible for managing the tax affairs of their companies and must contend daily with the provisions of the tax law relating to the operation of business enterprises. We believe that the diversity and professional training of our members enable us to bring an important, balanced, and practical perspective regarding the Advance Pricing Agreement program.

TEI commends the IRS for holding these hearings on the APA program and appreciates the willingness of the agency to consider refinements to make the program more effective.

IMPORTANCE OF APA PROGRAM

Begun more than a decade ago, the Advance Pricing Agreement (APA) program is an alternative dispute resolution program that has worked well for both the Internal Revenue Service and taxpayers. This process permits taxpayers to work with the IRS (and, in certain instances, tax administration agencies in other countries) to determine the appropriate price for transferring goods and services across international borders between related entities. Taxpayers enter into the program not because it gives them a “better deal” on transfer pricing issues — TEI members generally do not believe they have reduced U.S. taxes as a result of their APAs — but because the APA provides a

mechanism by which taxpayers can obtain more quickly the business certainty they need to operate effectively and efficiently on a global scale.

Transfer pricing is the inevitable consequence of a global economy, and transfer pricing controversies — differences of opinion over how income from the transnational transfer of goods and services is to be allocated among the different jurisdictions involved — are all too common given the complex, integrated nature of today’s multijurisdictional corporate enterprises and, quite candidly, the revenue constraints faced by taxing authorities around the world. A study performed two years ago found that 86 percent of parent companies identified transfer pricing as the most important international tax issue they face.¹ Traditionally, transfer pricing issues arose after the taxpayer filed its return and often led to disagreements not only among the taxpayer and the taxing authorities in the countries involved, but between the governments themselves. The Advance Pricing Agreement program is designed not to “give away the store” — as some have intimated — but rather to produce a fair and equitable resolution of potentially contentious issues (between governments as much as among the taxpayer and the governments) *before* the return is filed.

As the program has expanded to include more bilateral agreements, it has eased pressures on competent authorities and taxpayers over the inevitable “tug of war” that occurs when several governments claim the same revenues. In the absence of the APA program, taxpayers must determine the amount of income subject to U.S. tax on their own; the IRS must then review the taxpayer’s documentation and audit its transfer pricing, ultimately defending any reallocations in

¹ See Tropin, *Concern Increasing Over Lack of Uniformity in Transfer Pricing Enforcement*, *E&Y Says*, BNA DAILY TAX REP., No. 218, at G-4 (November 12, 2003).

judicial proceedings. In addition, the taxpayer's transfer pricing decisions (or the U.S. government's reallocation) may be challenged in one or more countries, leading to double or even greater taxation, including interest on any deficiencies. The process can take years to conclude and consume significant resources in terms of money and internal time commitments; the resulting uncertainty for both taxpayers and governments can impede the taxpayer's ability to plan.

In TEI's view, the APA program has served to reduce complex transfer pricing controversies. It also furthers the goal of reaching currency by forestalling audit controversies. Accordingly, the program has benefitted both taxpayers and the U.S. government. While it is appropriate to review and improve the efficiency of the APA process, it would be a serious error to scale back or eliminate the program.

That being said, TEI believes there are ways to streamline the APA process to make it more efficient and effective. The more daunting and difficult the process, the less likely taxpayers are to use it. Indeed, given its current form, unless a taxpayer has in-house personnel experienced in the process, the use of outside consultants is almost mandatory. Engaging outside practitioners not only increases the cost, but also requires more time to familiarize practitioners with the taxpayer's facts. Lessons could be learned from other countries such as the United Kingdom, which has a more streamlined process.

CONSISTENCY IN THE APA PROCESS

The IRS has asked for ideas concerning how the agency can ensure consistency in the APA process. Although consistency is a laudable goal in the process, it cannot be the predominant goal

because transfer pricing is not an exact science. Indeed, because transfer pricing is a fact-intensive exercise, it may be rare that any two taxpayers will truly be “similarly situated.” (The challenges the IRS and taxpayers have identifying “comparables” confirms this.) Fairness and equity — for the taxpayer, the government, and other companies — must also be key in negotiating an APA.

To ensure that taxpayers are treated fairly while protecting the government’s interests, several safeguards have already been built into the APA process:

- A multifunctional IRS team from the National Office and the Field represents the IRS in the APA process.
- Before the proposed APA is submitted to the APA Director, it is circulated to the members of the IRS team, any of whom can object to the proposed APA. If an objection is received, it is considered by the APA Director.
- The APA Director signs only those APAs determined to be appropriate.
- Before signing an APA, the APA Director submits a memorandum to the Office of the Associate Chief Counsel (International) explaining the APA, and only when there is clearance by a Deputy Associate Chief Counsel (International) is the APA signed.
- The APA Director and the Deputy Associate Chief Counsel (International) are consulted throughout the process to provide input on the IRS negotiating position.
- For multilateral APAs, the APA program team suggests negotiating positions for the Tax Treaty Division to use in negotiating the terms. In negotiating such APAs, the Tax Treaty Division works closely with the APA program team.

Although APAs are generally binding on the IRS, the IRS may still audit a taxpayer to determine whether the taxpayer’s application of the APA was accurate, whether critical assumptions were complied with, and whether the taxpayer fulfilled its annual report filing obligation. These procedures ensure a check and balance on the negotiation of individual APAs.

Finally, the IRS must report annually concerning the APA program. This report provides details on the methodologies and transactions, the comparability adjustments, the critical assumptions, the sources for data on comparable transactions and businesses, the criteria to select comparable transactions and businesses, and the types of approved ranges. These reports successfully balance the need to maintain confidentiality about the factual details and proprietary business information with the desire for information about the operation of the APA program.

TEI does not support publication of APAs, even in a redacted format. Companies have a legitimate confidentiality concern in the sensitive pricing information and background materials they submit to the IRS. It is important for taxpayers to know that this information will remain confidential in the same manner as if it were provided to the IRS during the course of an examination. In our view, release of this information would run the risk of irreparably harming the program.² Moreover, it is doubtful that redacted APAs — which section 6103 would require *not* include proprietary pricing information — would provide any useful data for comparison purposes.

IRS RESOURCES

Effective management of human resources is not a new challenge, but it is one that is garnering more attention and importance as the government faces resource constraints and its workforce ages. Like many other government agencies, the IRS is experiencing a “graying” of its workforce. The success of the APA program — like many others within the IRS — depends on an

² In 1999, when Congress enacted legislation to protect the confidentiality of APAs as tax return information, the House Ways and Means Committee report noted that the “continued confidentiality of [APAs] is vital to the APA program. Otherwise the Committee believes that some taxpayers may refuse to participate in this successful program causing a decline in its usefulness.” H.R. Rep. No. 106-238 (1999).

effective, efficient, well-trained, and motivated staff. TEI has long supported adequate staffing and funding for the IRS.

All of us work under budget constraints. It is a fact of life that when budgets are cut, staff training and travel are often the first items to be scaled back. Although many IRS programs may suffer from the lack of funding, efficiencies could be accomplished through more streamlined use of current resources. For example, not all staff need to attend every meeting on a taxpayer's APA request; conference calls or meeting minutes could be used to keep all team members apprised of the progress of an APA request. In addition, although the Examination team may be involved at the front-end of the APA process, its role should be limited as the process develops, particularly when Mutual Agreement Procedures are used. Finally, we recommend that the APA team move toward the use of secure email to communicate more efficiently with taxpayers.

In addition, in order to ensure a well-qualified staff, TEI recommends that the IRS consider elevating the grade levels and providing retention bonuses for APA personnel. This should increase the retention rate of the staff and bring in more qualified individuals. It will also improve the efficiency of the APA process by reducing the need to re-educate government staff because of frequent personnel turnover. Finally, the recruitment of personnel with industry experience will facilitate the understanding of the taxpayer's business model and help speed up the process.

APA RENEWAL PROCESS

The IRS should consider streamlining the renewal process for an APA. Once the initial APA has been reviewed and completed, its renewal — absent a change in material facts — should not be

as protracted as the initial agreement. In other words, once a taxpayer's methodology has been accepted, the renewal process should not start from scratch in reviewing the taxpayer's facts and circumstances. Particularly in the case of bilateral APAs, settled issues should not be constantly re-hashed. The scope of inquiry for a renewal of an APA should be significantly reduced. Without a more efficient renewal process, taxpayers may well prefer to risk an audit of their transfer pricing than undertake the time and expense of a renewal.

USE OF MEDIATION

One way to conserve government and taxpayers resources in respect of unilateral APAs is to consider the use of other alternative dispute resolution techniques, such as mediation, to resolve particularly thorny transfer pricing issues. Since the Fast-Track Mediation procedure was introduced approximately four years ago, the IRS Appeals Office has gained significant experience in working with Examination teams and the taxpayer to reach an agreement. We believe that the APA process could also benefit from the use of this alternative dispute resolution technique.

TAXPAYER INVOLVEMENT IN THE APA PROCESS

Negotiation of a bilateral APA is generally a government-to-government process. The involvement of taxpayers in this process is not always consistent. TEI believes that involving taxpayers directly will provide timely clarification of factual issues, minimize the potential for miscommunication, and assist in reaching a three-party agreement on a more timely basis.

OTHER ISSUES

a. *Audited Financials.* A standard requirement in APA reporting is that the U.S. tax group have audited (or at least reviewed) financial statements. Many multinational companies do not have separate audited financials for their U.S. affiliated group. This requirement results in significant annual costs with doubtful benefit. Some flexibility should be built into the process.

b. *Use of Program by Companies Not Under Audit.* Some members have reported applying for an APA, but being turned down because they were not under audit (and there was no field team currently in place). TEI suggests that procedures be adopted to permit these taxpayers to gain the benefit of an APA.

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TEI appreciates this opportunity to testify on the APA program. We commend the IRS for its willingness to consider recommendations for changes to streamline the process and make it more efficient.

I would be pleased to respond to any questions you may have.