Remarks of
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On Advance Pricing Agreements

Internal Revenue Service Hearing
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My name is Bob Cole and I have been working with transfer pricing for 45 years, of which some 6 years were as a lawyer in the US Treasury Department, where I became the first International Tax Counsel in 1971. I am joined today by Henry Birnkrant, a colleague at Alston & Bird who also devotes considerable time to helping clients and tax authorities reach agreement on correct transfer pricing.

First of all, we would like to congratulate the Chief Counsel for his interest in APAs and he and his colleagues for holding these hearings and giving the private sector this opportunity to comment on the APA program.

We represent the International Electronics Manufacturers and Consumers of America (IEMCA), a US trade association founded in 1987 and headquartered in Washington, D.C. IEMCA's members are US manufacturers and distributors of the full spectrum of leading electronics and IT products, both consumer and commercial. IEMCA's members employ over 100,000 workers located in every state in the nation. All of IEMCA's members are US subsidiaries of overseas corporations, and all engage in a large volume of transactions with their parent companies and other related parties outside the US. Accordingly, members of IEMCA have a very strong interest in fair transfer pricing tax policy and law, in order to ensure proper payment of tax and to avert double taxation, both in the US and in every other nation in which they do business.

Henry and I, as well as our Alston & Bird colleague, Brian Lebowitz, represent a variety of multinationals, foreign based and US based, in securing APAs -- in most cases, bilateral APAs that must satisfy the transfer pricing requirements of the US and one or more other countries. We also assist in resolving transfer pricing disputes with respect to transactions that are, for one reason or another, not covered by an APA.

We will address the issues raised by the chair and ranking minority member of the Senate Finance Committee in their letter of January 28 to Commissioner Everson, and offer ideas for improving the APA process. Before addressing the Senate Finance Committee issues, we will briefly present an overview of transfer pricing and the dispute resolution mechanisms that are built in to our system.

Overview of Transfer Pricing

Whenever a member of a multinational group in one country (Country A) provides goods, services, funds or intangibles to another member in a different country (Country B), the amount of the associated payment obligation is the "transfer price."

Transfer prices affect the tax base of both Country A and Country B. The United States and most other countries protect their tax base by having transfer pricing rules for tax purposes. Accordingly, the transfer price in each international transaction has to meet the transfer pricing rules enforced by the tax authorities of both Country A and Country B, and inconsistencies in transfer pricing rules or their application generally lead to double taxation in the absence of relief. If one country (for example, Country B) finds a transfer pricing error and makes a tax adjustment to increase the taxable income reported in that country, in most cases double taxation can be avoided only if the other country (in our example, Country A) provides a corresponding (or correlative) adjustment to reduce the taxable income of the taxpayer in its country. From the perspective of the multinational, any double taxation is unacceptable. For example, the top effective corporate rate in the US is generally around 40% and the top effective corporate rate in Japan is generally around 41%. A business that pays tax at an 81% rate is not a business that will continue.

Ending a business because together the governments impose an 81% tax rate is a detriment to both the economies and the tax collections of the two governments. Of course Country A can defer to country B and forego tax on profits taxed by country B in order to "protect" its multinationals from double taxation. Indeed, that is what the United States did for a time with Revenue Procedure 64-54 until, as International Tax Counsel, I convinced my bosses at Treasury to let Revenue Procedure 64-54 expire in order to stop ceding out proper tax base to other countries. The basic question, therefore, is how the United States can protect its tax base while at the same time eliminating double taxation.

Mechanisms for Avoiding Double Taxation

Under the lead of the United States, mechanisms have been developed to avoid double taxation without Country A or Country B foregoing its proper tax base. The APA is the most effective of these mechanisms.

Why do we need these alternative mechanisms, given that we have a domestic dispute resolution system? Our answer is that the domestic dispute resolution procedures are inefficient and costly to use to resolve transfer pricing disputes and they cannot avoid double taxation. On the first point, transfer pricing cases involve extensive and complex factual development and analyses of economists and other experts. The need for extensive and detailed factual development and expert analyses in an adversarial setting makes resolving transfer pricing cases through the use of Appeals Officers and the Tax Court costly for both taxpayers and the Government. While the Tax Court can handle complexity, the evidentiary requirements and the limited number of Tax Court judges limit how many transfer cases it can handle. Indeed reports suggest that in the last 10 years the Tax Court has decided only some 20 transfer pricing cases.

The second point is even more compelling. A transfer pricing adjustment by Country B, no matter how justified, leads to double taxation unless Country A allows a corresponding adjustment.

A unilateral APA eliminates the risk of a transfer pricing adjustment being initiated by the United States. In many cases, the elimination of the transfer pricing adjustment by the United States is sufficient to reduce substantially the risk of double taxation.

In most cases, however, the elimination of a transfer pricing adjustment and double taxation requires concerted action by the tax authorities that have jurisdiction over the taxpayers that are parties to the transactions at issue. Tax treaties, and the mutual agreement procedure (Competent Authority procedure or MAP) established therein, provide a mechanism to eliminate double taxation. Under MAP, if Country B makes a transfer pricing adjustment, the taxpayer can request that the tax authorities of Country B and Country A consult in an effort to avoid double taxation. Generally, MAP has worked well. Typically Country B will reduce its adjustment and Country A will provide a corresponding adjustment for the reduced amount.

Unfortunately, difficulties in resolving MAP cases are increasing and leaving double taxation unresolved. Also until a MAP is concluded, the taxpayer lives in uncertainty. Moreover, MAP typically does not deal with inconsistent laws with respect to refund and deficiency interest or with imposition of penalties for failing to satisfy inconsistent tax rules, while an APA would generally eliminate the taxpayer's risk of incurring these costs in the country or countries issuing the APA.

Bilateral advance pricing agreements (BAPAs) avoid all of these problems. The members of the multinational group that are the parties to the covered transactions, the IRS and the foreign tax authority or authorities, provide specific guidance that the multinational group can follow to satisfy the transfer pricing requirements of all of the jurisdictions that can examine the transactions at issue, thereby eliminating the risk of double taxation, penalties and interest .

The BAPA is produced by a voluntary proceeding before all of the tax years have closed. The fact that the taxpayer initiates the APA process by providing the information needed to apply the arm's length standard to the transactions to be covered by the APA is in itself a significant cost saving to the tax authorities. In addition, reaching an agreement on a methodology is much easier and quicker than reaching agreement on a transfer pricing adjustment that requires a refund of tax previously collected. The BAPA process therefore is generally easier and less expensive for all concerned than the MAP process.

BAPAs also overcome the problems inherent in the general language of the OECD Transfer Pricing Guidelines. In 1979, the OECD issued a Report on transfer pricing, the predecessor to its current Transfer Pricing Guidelines, which were first issued in 1995. The Guidelines establish transfer pricing principles and methods that most countries accept and follow. The Guidelines established the arm's length principle as the international norm and transfer pricing methods generally consistent with the US regulations. But the Guidelines get us only so far. The Guidelines have a large measure of generality and an effort to follow the Guidelines is often not sufficient to avoid a

transfer pricing adjustment and the risk of double taxation.

Issues Raised by the Senate Finance Committee

Procedures to assure consistency and similar treatment of similarly situated taxpayers

Of course the US Government needs to strive for consistency and similar treatment of similarly situated taxpayers in transfer pricing, as in the application of other tax rules. In the case of transfer pricing, there are two types of consistency that the IRS should be striving to achieve: (i) consistency in the transfer pricing standards imposed on similarly situated US taxpayers ("domestic consistency"), and (ii) consistency in the transfer pricing standards imposed on the two affiliated entities in different countries that are parties to the transaction ("international consistency"). Ideally, the IRS would achieve both types of consistency in every case.

While the ideal is not possible, the APA Program probably does a better job of achieving domestic consistency than the alternative procedures and processes that the IRS and other branches of the Federal Government would apply in the absence of an APA. A single office that works only on transfer pricing for all APA cases achieves more consistency than the other procedures and processes, especially since the APA Director sees and must approve the result in every case. In comparison, the Appeals function is decentralized. Most Tax Court cases are decided by a single judge. For the some 20 Tax Court cases decided in the last 10 years, there were some 15 different judges. Also there are alternative courts for refund cases (the District Courts and the Court of Federal Claims) and there are 13 Circuit courts to which cases from the Tax Court and alternative courts can be appealed. The potential unifying function of the Supreme Court is not relevant for transfer pricing case as the Supreme Court has decided only one transfer pricing case in the last 35 years.

In addition, the "audit lottery" generates domestic inconsistency for non-APA taxpayers. Many taxpayers with large international transactions are not audited at all, because the IRS does not have the resources. There are also cases in which an audit occurs but the taxpayer's transfer pricing is not subject to the type of careful scrutiny that is undertaken in the context of an APA.

While the APA program is more likely to assure domestic consistency than alternative procedures, one should recognize the "inconsistency" that exists among taxpayers. Differences exist among taxpayers in the same industry in the functions they perform, the tangible and intangible property they own or use, the markets in which they operate, the allocation of currency risk, the information available from their accounting systems, etc.. Under the Section 482 regulations, such differences must be taken into account in determining arm's length pricing.

Related to the foregoing is the question of whether taxpayers should have a say in the transfer pricing method under which their transfer prices will be tested. We believe

the answer should be "yes." As long as the result of the method chosen by the multinational enables the IRS to tax an appropriate share of its worldwide revenue, differences are appropriate in a free enterprise society.

Finally, one can imagine that as the APA Program accumulates experience, there will be differences in the APAs it is willing to issue. Such an evolution in the APA program is to be applauded and not criticized.

We do not want to end this section by leaving the impression that consistency is not desirable. As long as it is not thought to mean a strait-jacket, we should strive for consistency and foster it through the best mechanism we have for achieving that goal, the APA program.

Strategies for ensuring that the case backlog is reduced at the same time taxpayers are treated fairly

Our suggestions discussed below are designed to reduce the case backlog and maintain fairness to taxpayers.

Ways of handling conflicts between US and international laws, codes and regulations (achieving international consistency)

In the 40 years since the US started vigorous enforcement of the transfer pricing requirements of Section 482, we have been able to achieve a remarkable degree of consensus on transfer pricing, largely through having the OECD adopt the arm's length standard first promulgated in the US regulations of 1968. Consensus on the arm's length standard means that the comparability factors to which I have referred (and which were adopted by the OECD) and other matters that are involved in testing transfer prices are judgment questions. For that reason tax administrators in different countries often disagree on appropriate transfer prices when presented with actual cases. Thus, international consistency can only be achieved through recognition that transfer pricing involves judgments and hard work on a case by case basis under international procedures to reach consistent judgments. BAPAs provide the best procedure for producing consistent judgments by affected tax authorities.

Let me add a word about the taxpayer's role in achieving international consistency. Both tax authorities are sovereign and have the ability to make transfer pricing adjustments to protect their respective tax base. The BAPA process recognizes the reality that the tax authorities must work together, rather than independently enforcing their own tax laws, to enable business to operate efficiently in the jurisdiction in which each tax authority operates. Yet it is the taxpayer that is the stakeholder between two tax authorities seeking to tax the same profits and for that reason the APA process contemplates a major role for the taxpayer in developing the APA with the IRS or the BAPA. (Mr. Birnkrant will make specific suggestions to make sure that the taxpayer's role is appropriately recognized.)

Whether the APA Program allows foreign subsidiaries to "buy-in" to US technology transferred offshore after the risks of development have been borne by US parent companies?

Since the beginning of APAs through 2003, there were only some 14 buy-in APAs. Our experience suggests why there have been so few. One of our clients arranged a pre-filing conference with the APA Program to discuss the possibility of an APA that would have covered a buy-in. When, at the conference, the IRS insisted, in our view, overvaluing the intangibles in question, the client decided not to proceed.

We understand that there are a significant number of buy-in transactions, the vast majority of which do not involve an APA. Thus, while valuing buy-ins is an important issue, and I have expressed my views thereon elsewhere and plan to do so again, given the limited utilization of APAs to deal with that issue, an APA hearing does not seem to be the appropriate forum to address buy-ins.

Ways to ensure that prospective transfer pricing models are appropriately applied and comply with the arm's length standard.

The Service makes the determination that a prospective transfer pricing methodology (TPM) complies with the arm's length standard at the time that it enters into an APA. Also, APAs contain "critical assumptions" to deal with unforeseen circumstances. The annual report requirement and the review of the annual reports in the APA Program then assure that the TPMs of an APA have been appropriately applied. Upon the renewal an APA, the Service can choose to reconsider whether the TPMS of an APA have, in fact, required pricing that reasonably satisfies the arm's length standard.

Circumstances under which it is not in the interest of tax administration to continue negotiations or agreeing to an APA.

The trade-off for a taxpayer seeking the certainty provided by an APA is that it is to provide all necessary information, including the results of a comparable search and a full explanation of the process used. This includes post-filing requests for further information. If a taxpayer does not provide requested and necessary information, then it is appropriate for the IRS to terminate the process for that taxpayer. Of course the IRS should make sure that its requests for information are reasonable. Other reasons to terminate the APA process include: (i) the intentional or negligent failure of the taxpayer to be truthful, (ii) material failure to satisfy the terms of an agreed APA, (iii) lack of success in securing agreement between the IRS and taxpayer after a more than reasonable time.

While sometimes it makes sense for the IRS to give up on agreeing to an APA with a taxpayer or a taxpayer and a foreign tax authority, in my view it is almost never right to give up in a MAP when double taxation has already been proposed or imposed. In my view, the Competent Authorities have a moral obligation to provide relief from double taxation with respect to past years, and they should continue to endeavor to do so

until that has been accomplished. Some day we hope there will be mandatory arbitration to address cases that remain unresolved after there has been adequate time for MAP resolution, but until then, MAP should be made to work.

The other two issues raised by the Senate Finance Committee will be discussed by Mr. Birnkrant when he offers suggested improvements in the APA program.

APAs from the Perspective of the IRS

Implicit in the work of the Senate Finance Committee, is the question: what does the IRS get out of the APA program and what does it lose? If customer service is still a goal of the IRS, the APA program provides a service to those taxpayers that want to sort out their transfer pricing obligations in advance. From the perspective of the other function of the IRS, collecting the tax that is due, the APA program gets a certain number of taxpayers to come forward with the facts necessary for the IRS to make an efficient determination of their transfer pricing obligations, making it unnecessary for the IRS to find the resources to do an audit, to elicit the relevant facts and, if called for, to propose an adjustment that it will have to defend in a dispute resolution proceeding. With the resources devoted to the APA program, the IRS is able to review the transfer pricing of more taxpayers than it would through the audit and dispute resolution process. Thus, it is able to achieve more transfer pricing compliance with a given amount of resources through the APA program than it would otherwise. However, as we will discuss below, it could use more APA resources to assure more transfer pricing compliance and use its existing resources more efficiently.

Although it is true that only the taxpayers that want to be certain of being in compliance with IRS requirements seek APAs, the existence of APAs makes it more feasible for these taxpayers to be in compliance with these requirements and results in more taxpayers doing so.

What about the suspicion that the IRS makes the APA program work by foregoing part of the appropriate US tax base that it could obtain under the traditional audit and dispute resolution process? First of all, our experience after 15 years of representing taxpayers seeking APAs is that the IRS simply does not do that. Second, the job of the IRS is not to obtain as much tax base as possible from transfer pricing enforcement, but to obtain a tax base that is consistent with applying the arm's length standard. To tax more would be inconsistent with the law and make double taxation all the more likely. Of course, applying the arm's length standard is an art and not a science. With any given case, one can argue for a different tax base than provided for by an APA or Appeals settlement or MAP resolution or court decision. In some cases in which I participated or have heard about, in my view, the IRS ended up with more than its fair share of tax base and in others it might have achieved more. Along the same lines, one IEMCA member expressed the view that with its APA the IRS was successful in negotiating a more than ample profit requirement for the US taxpayers. In its dealings with the IRS APA team, it was more than implicit that a premium is exacted for the

certainty resulting from negotiating transfer prices in advance; the member acquiesced in the result because the MAP with the foreign treaty country resulted in an agreement that avoided double taxation, even though it preserved a premium for the US Treasury. While exacting a premium from APA taxpayers is wrong, this comment indicates that the IRS is not giving up tax base that belongs to the US through the APA program.

In our experience, the IRS does not do worse in APA cases than in other cases but does better, because it has a more complete understanding of the relevant facts. It does even better if one takes into account that for APA taxpayers they have given up the possibility of benefiting from the audit lottery and the resource efficiencies that it achieves, and are achievable, through the APA program.

Another way to look at the APA program is to consider that some group of Government personnel is needed to decided transfer pricing cases. The APA Program, including the review of APAs by the Office of the Associate Chief Counsel (International), decides a subset of these cases through the APA process. We have found the resulting decisions in the form of APAs often to be better than those of the judges and other officials that decide transfer pricing cases. To move the responsibility for advance transfer pricing decisions to another group in the Government or to go back to the days when the IRS was limited to reviewing transfer pricing after the fact would either accomplish nothing or decrease the level of transfer pricing enforcement and increase double taxation.

APAs as a Restraint on Foreign Excesses

While we often look at taxes from the perspective of the US corporate income tax, one of the great achievements of BAPAs, foreign APAs, and the other international measures discussed is their ability to avoid excessive and double taxation of US multinationals resulting from foreign transfer pricing adjustments. Foreign transfer pricing rules and enforcement thereof are now the norm, making BAPAs and foreign APAs very important to US multinationals. BAPAs and APAs restrain the potential transfer pricing excesses of the foreign countries in which US multinationals have business operations. We learned last week that Japan has persuaded China to work through the BAPA process and so far it has been a success for Japanese multinationals with operations in China.

If we give up on APAs or make them so onerous as to limit their usefulness, we signal to foreign countries they can do the same. This would hurt US multinationals, the US economy and eventually US tax collections.

Improving the APA Program

We suggest the following measures to improve the APA program:

- Suggested measure No, 1. With respect to BAPAs, take the OECD Transfer Pricing Guidelines and treaty country views into account at an earlier stage, facilitate the simultaneous development of the case by the foreign tax authority and the IRS (and recognize that it is appropriate for the taxpayers to work with the foreign tax authority at the same time the US Position Paper is being developed), supply visual access to communications from foreign treaty countries except in unusual cases, and accept requests of the taxpayer to appear before both tax authorities except in unusual circumstances.

- Suggested measure No, 2. Stop the tendency of the Field to use the APA due diligence process to request information that more careful consideration would have identified as marginally relevant, and to present a position that maximizes the US tax base even though a better application of the arm's length principle would call for a smaller tax base. It is particularly important for the IRS APA team not to abandon tentative agreements that reflect appropriate transfer pricing principles when it learns that other approaches would increase the US tax base. Such practices encourage foreign field personnel to do likewise, which creates inefficiencies and delays the process.

- Suggested measure No, 3. Increase the efficiency of the IRS decision-making process by eliminating the practice that each and every member of the IRS APA team agree to each and every aspects of the IRS position paper for a BAPA. The current practice allows one person on the IRS side to impose additional and costly terms or procedures and thereby delay the APA. The IRS should be able to have its senior people on an APA team make decisions.

- Suggested measure No, 4. Insist that the IRS APA team work so as to meet the timing goals of the APA Program in general and the Case Plan agreed to with the taxpayer in particular. If for some reason the overall timing goals cannot be met, it is better if that be reflected in the Case Plan. In other words, the IRS APA team should not propose a plan that it cannot meet. The IRS should consider these plans as commitments to which it will devote appropriate resources to meet the agreed goals and targets. If resources are insufficient, as they appear to be, more should be made available.

- Suggested Measure No. 5. Streamline the renewal process. If the methodology is not changing, the APA team should be able to base its review of the renewal request on annual reports and a much reduced formal Request.

- Suggested measure No, 6. Demonstrate the high level of review in the National Office process by having the Associate Chief Counsel (International) or a Deputy sign APAs for the IRS.

- Suggested measure No, 7. Provide that during the pendency of an initial APA request or renewal request, the Section 6662 documentation requirements are suspended for the proposed covered transactions for the proposed APA years. If

an APA is agreed to, the APA annual report replaces the Section 6662 documentation. In the rare cases in which there is no agreement, only then should APA applicant be required to provide the Section 6662 documentation, within a reasonable period after the APA process has been abandoned.

- Suggested measure No, 8. Allow the APA staff, with taxpayer consent and appropriate safeguards, to use modern communication, including emails. It is ridiculous that the IRS is still communicating through fax machines.

- Suggested measure No. 9. Recognize the importance of flexibility in the APA process. The ultimate objective of transfer pricing enforcement is to subject a proper amount of multinational income to US income taxation. The APA Program has historically permitted, and should continue to permit, taxpayers to find practical solutions that meet this objective, even if not precisely consistent with the details of the US regulations. If the IRS can be satisfied that the proposed methodology subjects a correct amount of multinational income to US income taxation, accept the APA and move on. A significant benefit of the APA program is practicality.

- Suggested measure No. 10. Field examinations of transfer pricing for transactions covered by an APA should be limited to confirming compliance with the APA. A recent IDR, after stating that producing a copy of the APA is "mandatory in APA situations," requested sales invoices, shipping documents, Customs statements, and numerous other documents that were not at all relevant to determining whether transfer pricing was in conformity with the requirements of the APA. It would appear that the Field is trying to determine whether compliance with the APA by the taxpayer violates Section 1059A. The regulations thereunder make it clear that Section 1059A does not limit the authority of the Commissioner to increase or decrease the inventory cost under Section 482, and it is clear to us that in entering into an APA the Commissioner is so exercising its authority. The Service should make it clear that the Field should not be issuing IDRs of this type to taxpayers that have negotiated APAs.

When focusing on potential improvements to the APA process, it should be recognized for the success it is. Constant reviews and negative comments about participants in the APA program threaten to destroy the program in bits and pieces. One danger is that the IRS APA teams will conclude that they can avoid criticism by seeking to increase US tax revenue regardless of whether that is appropriate and regardless of the risk to double taxation that causes. Another danger is that the IRS will establish unnecessarily large teams that slow down the process. The IRS leadership should actively discourage both of these practices.

We recognize that there have been suggestions that there should be more public information on APAs. While we are against secret law, we also do not advocate making tax returns and non-judicial tax dispute resolutions public. The statutory annual report on

the APA program was a good effort to balance these goals. Now is the time to see if more information can be provided therein without compromising taxpayer confidentiality, causing treaty countries to withdraw from (or not enter) the BAPA process, and without diverting excessive resources from doing APAs. We believe this can be accomplished, but the expansion of information should be done carefully and incrementally, including working with the treaty countries that are parties to BAPAs to make sure they do not think the IRS would be publishing more information than is appropriate, given the secrecy provisions in the exchange of information articles of tax treaties.

Finally, if the IRS implements the foregoing suggestions, through the OECD, PATA and the Group of Four, it should seek to persuade other countries to do likewise so the benefits to be derived are available in foreign countries as well as in the US.