Comments by
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at
PUBLIC HEARING ON
ADVANCE PRICING AGREEMENT PROGRAM

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I am an unabashed fan of the APA Program, dating back to its development some fifteen years ago. The Program has come full circle – due to the replications it has spawned, there is an international imperative for the Program to continue and thrive. In that interest, I submit six suggestions. They relate primarily to reducing the time it takes to get an APA and preserving some ability to respond to changing business conditions during long APA terms.

1. DON'T OVEREMPHASIZE PERFECTION OR CONSISTENCY -- Transfer pricing is a subtle analytical exercise, seasoned with judgment calls. Trying to achieve perfect resolutions bogs down what should be a speedy process. Consistency is a somewhat different concept – trying to be even-handed among taxpayers – but encounters the same obstacles. While the concept sounds good, perfect consistency on substantive aspects is difficult to achieve – or measure – both because even "similarly situated" taxpayers almost inevitably are not and because we must accommodate different approaches of our various treaty partners. Moreover, an overemphasis on consistency poses the risk of perpetuating inappropriate methodologies (whether caused by bad or poorly explained facts or just the vagaries of APA negotiations) and flattens out the learning curve. In addition, rigid IRS insistence on asserted consistency puts the taxpayer at an unreasonable disadvantage because the taxpayer cannot know the details of other cases.

Ultimately, the goal should be fairness, tempered with practicality. "Rough justice" – to borrow from former Commissioner Goldberg – should be recognized as a satisfactory objective; then move on. In an increasingly sophisticated bilateral setting, things should balance out over time.

Consistency <u>can</u> be enhanced by continuing to issue policy guidance on substantive issues and APA Office practices (as in the APA Training Manual). And both consistency and expediency could be promoted by considering safe-harbor-type methods or ranges for cases with high-tax treaty partners – provided the methods are bilaterally agreed to be available on both inbound and outbound cases to minimize concern with adverse selection. (Frankly, if set at reasonable levels, adverse selection should not in any event be feared.)

2. FOCUS EARLY ON THE BILATERAL ASPECT OF THE PROCESS – Most APAs today are bilateral. The APA Office's statistics also show that Competent Authority proceedings more than double the duration of the APA process, and CA is both a black box and often contentious. USCA representatives are assigned to a bilateral APA when it enters the APA process. But my experience is that the USCA representative doesn't really become engaged until the torch is passed a year or so down the road with the issuance of the APA Office's

recommended negotiating position – and that the CA process and staffing levels don't lend themselves well to focusing on factual or theoretical details. This situation has the potential to waste time and resources, and sometimes impedes good results. USCA folks are intimately aware of the posture of the pertinent foreign competent authority. They should be more actively involved from the start, both to infuse the process with their relevant insight and to take advantage of the fact-finding and economics resources of the APA Office. The goal should be to avoid wasting time on unlikely-to-succeed approaches.

3. CONSIDER NOVEL APPROACHES TO SPEED UP CASES – A considerable amount of the time spent on APAs by all involved relates to refreshing recollections and gearing up to work on an issue last touched several months before. Perhaps consideration should be given to an optional "blitz" approach, where all parties commit to extremely intense focus and short turn-around in order to get to the negotiating position quickly – e.g., within 3 months.

4. SIMPLIFY SUBMISSION REQUIREMENTS IN ROUTINE RENEWALS – The APA Office is to be commended for the expedited renewal process described in Rev. Proc. 2004-40 – but it would be even better if the Rev. Proc. provided for streamlined submission requirements as well. At a minimum, the Rev. Proc. could require that this topic be seriously addressed at a PFC or in another pre-filing communication. Renewals must be made easier to keep the Program attractive to taxpayers.

5. PERMIT SOME FLEXIBILITY IN LONG APAS – Most taxpayers view the core goal of an APA to be certainty (and, concomitantly, maximum feasible coverage). In the typical bilateral APA involving another high tax country, the taxpayer does not particularly seek to reduce its US tax other than as part of the balancing act necessary to obtain the other country's agreement so as to eliminate <u>double</u> tax. One often hears: "I have no problem with that higher range so long as [fill in name of country] agrees." This balancing act is appropriate.[1]

However, Rev. Proc. 2004-40 now endorses quite lengthy APA terms, specifically, at least five years or three years past the start of the CA negotiation phase. The prospectivity goal is laudable, and should reduce the audit-like features of retrospective pricing determinations. But longer APAs can be problem given the increasingly fast pace of business change. Modern businesses are seldom static or merely evolutionary for lengthy periods.

This sets up a potential clash between the desire for certainty and the somewhat antithetical need for some degree of flexibility to make the deal acceptable as a business matter. Moreover, the "standard" critical assumption can undo an APA altogether if there are "material" business changes. There are certain ways to balance these considerations now:

- Use formulaic or contingent TPMs, e.g., where profit requirements are negotiated to change at different volume levels or system profit levels, or where different TPMs apply in different circumstances

[1] Unilateral APAs may be different, for there the taxpayer may need to hedge against possible inconsistent taxation by the other country.

- Incorporate critical assumptions based on objective business factors, such as sales volume, interest rates, currency rates, or particular industry factors – but unless these trigger formulaic adjustments, they lead to the uncertainties of fully renegotiating the APA

- Broadly define covered transactions and other aspects (such as corporate structure)

- Seek to amend the APA.

As part of the push for longer APA terms, it would behoove the APA Office to anticipate and deliberately work with taxpayers to plan more for these situations. Possible approaches would be:

- Consciously strive for broad definitions of covered transactions, including catch-all provisions anticipating product developments

- Develop generic concepts of permitted minor changes – e.g., acquisitions or dispositions of less than __% of sales, expanded or contracted product lines – that would not be considered "material" differences. These could be incorporated into model critical assumption language, for potential customization in individual cases. Importantly, this could also avoid the need for burdensome ongoing bilateral involvement.

- Develop a streamlined process for certain APA amendments. This could entail defining eligible situations (such as small acquisitions or dispositions, added/deleted product lines within prescribed limits, modest realignment of functions, corporate restructurings, or third-party joint ventures) and providing an expedited procedure that does not open up unaffected areas. At the same time, it is important to preserve the general concept of a fixed, risk-sharing agreement and avoid unduly burdening the APA Office. To help strike this balance, some procedural constraints could be imposed, such as:
    - Limiting the frequency of amendments
    - Requiring a minimum number of years to have elapsed
    - Taking into account the past margin of compliance
    - Limiting eligible amendments to either coverage or TPM, but not both
    - Limiting availability of the process to unilateral APAs or to bilateral APAs that expressly permit and commit to such a process

  The principle should be that the amendment was reasonably within the intendment of the APA and likely to have been covered had it been known, yet not reasonably anticipated or within the risks assumed by both parties in designing the TPM. The key would be to convey a sense of potential amendability so that long APAs reaching out into the business unknown are not so daunting as to undermine the popularity of the Program.

6. PONDER THE TRANSFER-PRICING IMPACT OF THE APA ITSELF – An intriguing topic in the Announcement for these hearings was "the appropriateness/feasibility of reflecting in the legal and economic analyses underlying an APA the impact that the execution of the APA may have on the relationship between the APA taxpayer and its related party" – colloquially referred to by Director Frank as the "Heisenberg principle."

The prototypical candidate for this rather circular concern is the effect of an agreed TPM on the tested party's risk thereafter. For instance, if a CPM operating margin range of 2-4% for a full-service distributor subsidiary is developed based on full-service comparables, does the resulting APA agreement to maintain the subsidiary's profits at 2-4% convert it into a limited risk distributor for future years, so that different comparables or some kind of adjustment are needed? Indeed, should you start there, by assuming that a profit-defining APA agreement will ultimately be in place? Several recent articles have addressed the effect on arm's length returns of risk-limiting intercompany profit guarantees.[2] Should APA agreements (at least in bilateral cases) have the same effect? While technically an APA is an agreement between the tested party and the IRS, not between the related parties, in bilateral contexts the foreign counterpart agreement, connected by a CA agreement, effectively binds the related parties – perhaps even more so than when only related parties are involved. Carried to its logical extreme, this approach would suggest that many APA-covered tested parties must be compared to limited risk companies – which would not only narrow the spectrum of appropriate comparables but also result in an effective "discount" for APA participation.

This is certainly not, in my experience, how the Program has been administered in the past. Yet it is, in fact, how taxpayers operate under a CPM-based APA – business problems of the tested party are explicitly subsidized by the related party through intercompany pricing adjustments to achieve the mandated return, removing the risk of adversity from the tested party. Had the related parties contracted in advance to provide a guaranteed return, the section 482 regulations would ordinarily respect the contractual terms allocating risk and require comparison to uncontrolled taxpayers under the same circumstances – that is, to limited risk companies – provided that the allocation of risk is consistent with the economic substance of the transactions.[3] This circularity is, rather perversely, the consequence of the development of profit-based testing methods. The problem does not arise (or certainly not to the same degree) if only specific intercompany <u>prices</u> are assured.

The prospective effect of an APA could – as a theoretical matter -- legitimately be taken into account for comparability and range-setting purposes, particularly if backed up by a consistent direct intercompany agreement to eliminate any uncertainty about intercompany enforceability and consistent with the economic substance of the transactions. There would, however, be some major practical issues: (1) determining whether any prior undertakings or commitments are inconsistent with a risk-less environment so that transitional adjustments are required (e.g., to correct for high promotional expenditures undertaken with a long-term right to profit upside), (2) differentiating the methodology for completed years, where risks existed, from that for prospective risk-free years, and (3) not insignificantly, how to determine the arm's length return of a financially risk-less distributor and whether sufficient data exists to make reliable comparisons or adjustments. In effect, the tested party would prospectively become much like a

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[2] Horst, "Using Discount Rates to Adjust Transfer Prices Under Long-Term Agreements for Differences in Risk," 13 BNA Transfer Pricing Report 878 (December 22, 2004); Urken, Barbera & Cole, "Adjusting for Differences in Risk Levels Between Tested Parties and Comparable Firms," 12 BNA Transfer Pricing Report 39 (May 14, 2003).

[3] Treas. Reg. § 1.482-1(d)(3)(iii)(B).

contract service provider (subject to credit risk with respect to its principal related party), and the particular types of functions performed would be relatively unimportant.

Yet standing back, this result may not only confound the parties' business expectations but may also be questionable from a policy perspective. An APA is, after all, just to be an agreement on the tax consequences of a relationship, not to change or mandate the relative business risks of the parties. It would seem feasible to administratively direct that the APA's impact on risk be ignored, on the basis that the APA just governs tax reporting and that intercompany payments to reflect the tax result are not mandated by the APA, but rather are at the option of the taxpayer (subject to the impact of secondary adjustments or relief procedures under Rev. Proc. 99-32). Moreover, attention should be paid to the current regulations' stress that the extent to which the purported risk-bearer exercises managerial control over the business activities that directly influence profitability is a relevant factor in the economic substance determination.

Alternatively – although this might be a bit more strained -- the regulations could clarify that CPM is just a proxy for arm's-length intercompany prices, and that an intercompany agreement to maintain profit levels to comply with section 482 should be interpreted as an agreement on pricing (not profit) that does not affect risk. Absent such a provision, taxpayers in either APA or non-APA situations could self-help themselves into the risk-less circularity if desired, simply by entering into binding profit guarantees.

As you can see, rational arguments can be made on both sides. Preparing this testimony has impressed on me both the difficulty and the importance of this issue, which merits considerable additional study and debate.

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In conclusion, I commend the leadership and staff of the Program over the years for developing this trailblazing Program and for being committed to identifying and institutionalizing its best practices.