Advance Pricing Agreements: A Chance for Certainty Amidst Chaos, Part 1

By J. William Harden and Timothy B. Biggart

IN THE GOVERNMENT COLUMN OF THE MARCH 2004 *Strategic Finance*, Stephen Barlas wrote about two senators who are looking into the practices of the IRS in issuing advance pricing agreements (APAs). An APA is a formalized agreement between the IRS and the taxpayer outlining in advance the methodology the taxpayer will use when establishing transfer prices. An article in *The Economist* noted, "A tax partner at one big accounting firm says that 'transfer pricing' is the biggest worry for tax directors at the overwhelming majority of big companies." ("Finance and Economics: A Taxing Battle; Corporate Tax," *The Economist*, January 31, 2004, pp. 71-72.) While you may think this won't have an effect on your company if it's not a *Fortune* 500 multinational, the use of an APA may, in fact, have the greatest potential benefit to the emerging multinational firm. What does this mean to you? It may be time to write that letter to your senator encouraging him or her to support the APA program.

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Why are members of the Senate concerned with the program? Basically, it's the government's view of the old transfer pricing problem studied by many of us in our first cost accounting or financial management courses. Take the case of a product made by a company in one country and then transferred to a foreign affiliate of the manufacturer for sale to end customers in another country. Top management of the combined operation wants the transfer price set so that the maximum amount of possible income is taxed in the lower of the two taxing jurisdictions. On two other sides are the two taxing authorities, each of which wishes to maximize the tax revenue it collects. What does this mean to the operation? It means that the company is subject to two potential audits that will attempt to alter the transfer price to maximize that jurisdiction's revenue at the expense of the other. Such a conflict will result in an appeal to the competent authority between the two jurisdictions. In more simple terms, it means a lot of uncertainty, time, and cost. If a firm were to independently obtain a unilateral APA from both countries, uncertainty about its applicability would still exist. This represents a key advantage of a bilateral APA—it is binding on both governments for the agreed upon period.

In order to fully appreciate these issues and the impact that an APA can have, it's important to have a little background about how the U.S. taxes international transactions between related companies. The IRS more or less derives its authority to regulate transfer pricing from IRC §482. Though it's one of the shortest sections in the Code, it's an extremely powerful one. It provides the IRS with the ability to "distribute, apportion, or allocate gross income, deductions, credits, or allowances…in order to prevent evasion of taxes or clearly reflect income” in the case of businesses under common control.

The regulations under IRC §482 give five methods for arriving at an arm’s-length price—where the price is consistent with what it would be if two uncontrolled taxpayers had engaged in the same transaction (Reg. §1.482-1(b))—in the case of tangible property. The five methods, detailed in Reg. §1.482-3, are: (1) the comparable uncontrolled price method, (2) the resale price method, (3) the cost plus method, (4) the comparable profits method, and (5) the split profits method. According to Reg. §1.482-1(c), the taxpayer must use the method that, “under the facts and circumstances, provides the most reliable measure of an arm’s-length result.” The regulations allow for a sixth method, the “unspecified” method, which can be used when it is a superior method of determining an arm’s-length price when compared to the other five methods (Reg. §1.482-3).

The comparable uncontrolled price method involves examining the sale of the product between uncontrolled parties. The price is then adjusted for factors that affect the price of the good. The key to using this method is the existence of a comparable sale to an uncontrolled party.

The second method, resale price, is based on the gross profit margin that would be realized in a comparable uncontrolled transaction. The regulations point out that this method is most useful in cases when the reseller hasn’t made substantial modifications to the product.

The cost plus method involves using a markup for gross profit that’s comparable to that for uncontrolled sales. This method is most applicable to cases involving the manufacture of goods, and it effectively mirrors the method of costing required for many government contracts, only with the profit percentage based on comparable uncontrolled sales rather than being drafted into the contract.

The comparable profits method looks to the profit margin of other unrelated taxpayers engaged in similar types of business. At first, this method would appear to be impractical. In practice, however, it may be to the advantage of a company’s competitors to share the information necessary to justify the method of pricing used for both parties. The obvious key to using this method proactively is the trade-off of confidentiality in exchange for competitors’ information.

The final method, profit split, is the most difficult to use. This method examines the profit that’s assigned to each transaction in relation to the value of a given unit’s contribution to the combined profit of the product.

If we are allowed to use a bit of sarcasm, “It’s as clear as the nose on one’s face” that all of the real transfer pricing issues fit snugly into one of these five categories and that there can be no question as to the most applicable method and comparable sale or profit percentage. Of course, we all know that these rules also force the inevitable result of dueling experts in the audit appeal process and possibly litigation. What are the end results? Many wasted hours of both the company’s personnel and IRS auditors.

Regulation §1.6662-6(d)(2)(iii)(B) details the document that the IRS will expect to be maintained and presented within 30 days of a request to support a pricing method. The documents must detail the analysis conducted by the taxpayer and include (1) an overview of the business, (2) a description of the organization’s structure, (3) any other documents specifically required by the Code or Regulations, (4) a description of the method chosen and why, (5) a description of the alternate methods and why they weren’t chosen, (6) a description of the controlled transaction, including internal data used to analyze the transaction, (7) a description of the comparable information used, (8) an explanation of the economic analyses used, (9) any data the taxpayer develops between the end of the year and the tax filing date that would indicate the appropriateness of the method chosen, and (10) an index of the documents and a description of the recordkeeping system used.

In next month’s column, we will discuss how the APA can help with these issues. ■

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