

# Advance Pricing Agreements: A Chance for Certainty Amidst Chaos, Part 2

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## IN LAST MONTH'S COLUMN, WE ADDRESSED

the issues involved in transfer pricing for a multinational company. This month we will address the question, "How do Advance Pricing Agreements (APAs) help?"

The APA helps by reducing the uncertainty a company may face regarding its transfer pricing. For example, a similar issue in international trade is currency fluctuation. When selling into foreign markets and being paid in local currency—as opposed to the firm's base currency—a company will use a hedge to lock in the profit. In such a case, it isn't trying to take advantage of a potential currency gain. On the contrary, it's recognizing that currency speculation isn't the company's area of expertise and that it's willing to incur the expense of the hedging contract in order to lock in the remaining profit.

An APA accomplishes a similar type of action. A firm isn't "getting one over" on the government. Instead, the company is obtaining more certainty but is incurring substantial amounts of lost time for personnel and document creation, as well as the cost required to secure the APA. As Robert Cole pointed out in his article, "Fourteen Facts Offered to the Senate Finance Committee to Assist in Its Review of the Advance Pricing Agreement Program," in the March 12, 2004, *Tax Management International Journal*, "In some cases, the APA Office is stricter than the regulations require. However, APA taxpayers are

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generally less concerned with the transfer pricing methodology (TPM) used in the APA and its effects than avoiding uncertainty and the threat of double taxation." In addition to the substantial costs of preparing the documentation necessary to secure the APA, a user fee of \$25,000 is imposed by the IRS. (This fee is reduced in the case of smaller taxpayers.) The key benefit of all this is

the increased certainty that the agreed price will be respected by the taxing authority. In the case of a multilateral APA, both taxing authorities will agree to respect the price.

The use of the APA has some benefits to the IRS as well. The filing documents for an APA represent work that would otherwise have to be collected by the IRS through the audit process. So the idea that tax dollars are walking away through the IRS granting the agreements

assumes that the company would be (1) selected for audit, (2) that the auditor would recognize the transfer pricing issues, (3) that the company hadn't used a proper method of transfer pricing, (4) that the IRS would win litigation of the pricing issues, and (5) that the IRS doesn't incur any costs to accomplish this audit and collection process.

We are unconvinced that the IRS is "giving away" anything by its use of an APA. For the large multinational, the audit is an ongoing event and is conducted by specialists, which means the first, second, and fifth issues are largely moot. The large firm also is the most likely to have prop-

erly documented its transfer pricing strategy and have the legal tax counsel available internally to fight the Service's position. In addition, the lack of a multilateral APA invites the foreign jurisdiction to attack the pricing method used as well. Such action would likely result in the company appealing to a competent authority to resolve the disagreement. This would result in even more of the IRS's and the foreign authority's time and resources.

Taxpayers have a responsibility to maintain documentation related to their transfer pricing method. Part of setting the transfer price must be a consideration of the allowable methods. Failure to produce these records within 30 days of an IRS request can result in the imposition of the substantial valuation misstatement penalty under IRC §6662(e). The penalty is 20% in most cases, but it increases to 40% in the case of gross misstatements and is in addition to any tax adjustment and interest due on the understatement. Even if the company maintains the records to avoid a penalty, this doesn't guarantee that the price will be respected. The IRS may attempt to require the use of what it feels is a more appropriate method based on the facts provided. By completing the APA process, the company guarantees itself a safe harbor from both penalties and adjustments. Those firms that choose to go through the process of obtaining the multilateral APA will have even greater benefit but will have a longer period to obtain the APA because both authorities must examine the agreement. Basically, the IRS will take its recommended position to the competent authority of the foreign jurisdiction after an agreeable position is reached

between the taxpayer and the Service. IRS Announcement 2004-26 (I.R.B. 2004-15, March 30, 2004) reports that the average (mean) time to obtain a new unilateral APA is 22.3 months, while the median is a much lower 8.5 months. In the base of multilateral agreements, the average (mean) time is 41.2 months, with a median of 35.4 months.

There are some disadvantages involved in the APA process other than simply the time and fee. Companies may not want to disclose the information necessary to obtain the APA. This applies to both the IRS and competitors. While the IRS can compel firms to produce the documents mentioned last month in Part 1, this isn't automatic. It's possible that some companies aren't regularly audited and/or that the transfer pricing issue would be caught during an audit. Similarly, companies may feel that confidential information will be available to competitors if these companies are able to force the IRS to provide data from approved agreements in their court cases. Two current examples of this are the Glaxo and Xilinx cases.

In conclusion, for companies involved in transfer pricing transactions, the cost of obtaining an APA is likely to exceed the cost of maintaining the internal documentation necessary to avoid a penalty in regard to how the transfer was priced. This is because, in addition to maintaining the minimum records required, the company basically performs much of the work of an audit for the IRS. On the other hand, an APA provides certainty of the pricing method to the IRS and the company, as well as providing value to both. In multilateral agreements, the APA is even more valuable because it's binding on the foreign taxing authority as well.

If you feel that your company could benefit from the use of an APA, you would be wise to make your opinion known to your senator or to a member of the Senate Finance Committee. For those of you who want more detail on the process of obtaining an APA but aren't yet ready to venture into the realm of §482 and its related regulations, procedures, and notices, we recommend a perusal of Boris I. Bittker and Lawrence Lokken's *Fundamentals of International Taxation*, ¶79.14. ■

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