Transfer Pricing Thoughts: North America

By Patricia G. Lewis and Matthew W. Frank

Thoughts on APA Disclosure

A: Redacted APA
Q: What's the newest multinational invective?

Those multinationals fortunate enough to have completed Advance Pricing Agreements ("APAs") with the Internal Revenue Service ("IRS") have recently received undesired sequels from the IRS – copies of their APAs as proposed to be redacted by the IRS in anticipation of public disclosure. In the IRS lexicon, "redaction" means removing "identifying" or otherwise protected information from a document, prior to making it available for public inspection under federal disclosure rules. In January, the IRS abandoned its long-held position on the confidentiality of APAs and decided that APAs should be disclosed under Code Sec. 6110 in the same way as "private letter rulings." IRS Information Release 1999-05 explained, "[t]he IRS believes releasing APAs under IRC section 6110 will fully protect the confidentiality interest of those directly involved in the APAs while helping taxpayers better understand the issues involved in APAs and increasing public confidence in the fairness of the tax system as a whole."

How did this come about? What is at stake? This month we will summarize the current state of affairs and identify key issues. We will leave for a future column critical observations on merits and prognosis, since this is a work in progress.

From the inception of the APA Program, the IRS was staunchly of the view that information received or generated during the APA process related directly to the potential tax liability of taxpayers so that APAs were subject to the confidentiality provisions of Code Sec. 6103. Code Sec. 6103 protects "returns and return information" from public disclosure under the Freedom of Information Act ("FOIA") except in carefully delineated situations. This IRS view was ensconced in the Revenue Procedures that govern the APA Program and was a vital assurance in persuading taxpayers and foreign governments to participate in the fledgling program. Many APAs expressly incorporate the confidentiality protections of Code Sec. 6103.

> A particular concern expressed by taxpayers is the potential disclosure of background file documents, the large body of financial data and other material submitted by taxpayers . . . during the APA process.

But there is a long history of tax publishing companies seeking disclosure of various IRS materials with the avowed objective of eliminating so-called "secret law" known only to large taxpayers and experienced practitioners. Litigation by Tax Analysts and Advocates and others has gradually brought private letter rulings, general counsel memoranda, actions on decisions, field service advices, and even the Internal Revenue Manual into the public domain.

Patricia G. Lewis and Matthew W. Frank are members of Caplin & Drysdale, Chtd., in Washington, D.C.

In this vein, The Bureau of National Affairs, Inc. ("BNA"), publisher of the *Daily Tax Report* and other government-related materials, initiated administrative proceedings seeking disclosure of APAs. These proceedings ripened into litigation in the U.S. District Court for the District of Columbia. BNA claims that APAs either are "written determinations," such as private letter rulings, subject to public inspection under Code Sec. 6110 *or* are disclosable under FOIA without exception under Code Sec. 6103 because they do not meet the definition of "return information."

After resisting BNA's claims for several years, IRS suddenly capitulated in January and proposed that APAs were in fact written determinations disclosable under Code Sec. 6110. The IRS attributed its change of heart to adverse precedent in a 1997 Tax Analysts case requiring the disclosure of legal analysis in IRS field service advices, as well as the increased "standardization" of APAs and the transfer pricing methods ("TPMs") reflected therein. BNA and the IRS are currently skirmishing over the procedures and schedule for redaction of the APAs covered by the litigation (all APAs completed through mid-1998), although the court has yet to rule on either the merits of the case or the applicable procedures and schedule.[1] Nevertheless, the IRS is proceeding down the redact-and-disclose path, and has devoted considerable APA Office resources to preliminarily redact the 132 APAs at issue. (The IRS has deleted "identifying" information and certain treaty-protected materials, leaving it to taxpayers to propose redaction of confidential business and financial information.) The IRS anticipates that it will take six months to complete the redaction process, including obtaining comments from taxpayers and treaty partners, with release of the redacted APAs targeted for October. Controversy over specific redactions could delay release in individual cases, under various administrative and judicial procedures.

A particular concern expressed by taxpayers is the potential disclosure of "background file documents," the large body of financial data and other material submitted by taxpayers or sent out by the IRS during the APA process. Under Code Sec. 6110, background file documents pertaining to written determinations are disclosable (in redacted form) at the request of any third party. Although background file documents have not been requested in the BNA case – leading the IRS to try to downplay this issue – they would automatically be available by reason of Code Sec. 6110 coverage, and one must expect these requests to be forthcoming from someone (*e.g.*, Tax Analysts – who attempted to obtain APAs and background documents several years ago - or business competitors of APA-holders). Removing protected information from these voluminous, dense and sensitive documents is particularly problematic (by contrast, APAs tend to have many standard provisions, with the sensitive material concentrated in a few places), and would absorb extensive IRS and taxpayer resources.

> The APA program has been justifiably acclaimed as an IRS success and a model for other governments. The BNA litigation situation severely tests the foundations of this archetype.

These developments have left taxpayers and foreign tax authorities confounded and often angry. The IRS that had vowed to protect some of the most sensitive taxpayer information (prices, profits, competitive strategies, etc.) had turned 180 degrees without being forced to do so and without consulting its key treaty partners. Yet the IRS insists that its change is in the best interests of taxpayers: for APA-holders, providing an established redaction process, with various built-in rights, in the face of what IRS now perceives as inevitable disclosure; for other taxpayers, providing "sunshine" into methodologies used in evaluating transfer pricing. Efforts are nevertheless underway by certain groups of interested parties to seek legislative relief of some sort.

Some issues to mull over – to be explored further in a future column – include:

- *Is it correct that disclosure of APAs is inevitable?* Are APAs closer to (1) rulings (written statements issued by the IRS National Office that recite relevant facts, set forth applicable legal provisions, and show the application of the law to the facts) that are disclosable under Code Sec. 6110, or (2) closing agreements (negotiated bilateral agreements) that are protected from disclosure under

©1999 **CCH** INCORPORATED

Code Sec. 6103? Do APAs contain generic, non-taxpayer-specific legal analysis akin to that in the field service advices that were held disclosable in the 1997 *Tax Analysts* case?

■ *Is it possible to redact APAs in a way that is simultaneously fair to APA-holders and useful to other taxpayers?* Procedural squabbling aside, both Code Sec. 6110 and FOIA require redaction of (1) identifying information and (2) trade secrets and confidential business and financial information; tax treaties protect information exchanged between treaty partners. Application of these rules in the context of APAs will present excruciating line-drawing exercises and could generate a spate of litigation. Yet the fact-specific basis of APA TPMs might render even the least-redacted APA of little use to others.

■ *Is release of redacted APAs the best way to provide pertinent information about IRS transfer-pricing policies?* Early in the APA Program, IRS promised to provide generic information on TPMs and other APA features once it collected enough information and experience to be able to do so without violating taxpayer confidentiality. The IRS has so far only done this in two instances (a 1994 revenue procedure regarding global trading of financial products, and "model" APA administrative provisions). Would this be a better approach than haphazard snippets of lengthy legal and financial documents?

■ *Are APAs really "binding agreements" as stated in the governing Revenue Procedures?* If the IRS can unilaterally abrogate provisions relating to confidentiality, of what effect are the other provisions? What contractual remedies do APA-holders have?

■ *What is protected by the secrecy provisions in treaties?* To what extent is this restriction independent of U.S. disclosure law? What role should treaty partners have in the APA redaction process?

■ *Will the APA Program continue as a popular and stellar IRS program under the new disclosure regime?* What is the risk that the new disclosure policy will result in "homogenized" APAs that are less responsive to the complex needs of multinational businesses?

■ *Will the proposed cloning of the APA Program to fact-intensive domestic tax issues succeed or fail because of the disclosure issue?* The IRS' assurances of confidentiality were clearly a significant factor in obtaining taxpayer participation in the APA program at the outset. Do different dynamics, ranges of potential variations – and sensitivity levels – apply to domestic issues, such as valuation?

■ *What other fallout may result from the IRS disclosure course?* Jeopardy to competent authority agreements or closing agreements? Balky bilateral APA and other treaty negotiations? Taxpayer skittishness about IRS promises?

The APA Program has been justifiably acclaimed as an IRS success and a model for other governments. The BNA litigation situation severely tests the foundations of this archetype. As the litigation moves forward, rest assured that we will continue to keep readers apprised of the status of those foundations and any collateral structures.

ENDNOTES

[1] In the interest of full disclosure — the columnist represents a group of trade associations and anonymous taxpayers who seek to be *amicus curiae* in this litigation, primarily to urge judicial consideration of the proper application of Code Secs. 6103 and 6110, notwithstanding the IRS's concession, toward a conclusion that APAs are not disclosable at all.