Transfer Pricing Thoughts: North America

By Patricia G. Lewis and Matthew W. Frank

More Thoughts on APA Disclosure

A: Redacted APA

Q: What is history?

In an earlier column,[1] we griped about the IRS' capitulation in pending litigation that threatened to end the confidentiality of Advance Pricing Agreements ("APAs") with the IRS regarding intercompany transfer pricing. In January 1999, the IRS reversed its long-held position and decided that APAs should be disclosed publicly under Code Sec. 6110 in the same way as letter rulings, *i.e.*, in full text but with identifying or otherwise protected information deleted ("redacted").[2] Had the IRS prevailed in this position, its new treatment of APAs would have ultimately resulted in the publication, similarly redacted, of voluminous and sensitive "background documents." Of particular concern, this treatment would apply to already completed APAs, notwithstanding the clear representations by the IRS and the vital understanding of taxpayers that materials submitted and developed in the APA Program would be fully confidential tax return information.

The IRS' change of position in the BNA litigation[3] triggered great consternation in the international taxpayer community, as well as with the United States' treaty partners, and threatened considerable harm to both the APA Program and the Competent Authority process. Concerned groups and taxpayers sought to reverse the apparent course of the litigation,[4] treaty partners complained vociferously, and a legislative initiative to correct the situation was begun.

In the end, the legislative effort prevailed (or at least prevailed first). On December 17, 1999, President Clinton signed into law amendments to Code Secs. 6103 and 6110 that clearly characterize APAs as "return information" exempt from disclosure under both the Freedom of Information Act and the Code Sec. 6110 rules regarding written determinations. The legislation was effective upon the date of enactment to preclude disclosure after that point of any APAs. It thus effectively mooted the still-pending BNA litigation in which no APAs had yet been publicly disclosed.[5]

In a commendable compromise of competing concerns, however, the new legislation went beyond mere confirmation that APAs are confidential. When explaining its change in position last year, the IRS expressed its belief that releasing APAs would "help taxpayers better understand the issues involved in APAs and increas[e] public confidence in the fairness of the tax system as a whole."[6] Likewise, the elimination of so-called "secret law" was BNA's avowed litigation objective. In this vein, the new statute requires the U.S. Treasury Department to publish an extensive annual report on the status of APAs, containing both statistical information on APAs and the APA Program as well as general descriptions of taxpayer characteristics, covered transactions, transfer pricing methodologies and other features of issued APAs.[7] The published descriptions will be on an aggregated basis, and they are subject to proscriptions against releasing information that might directly or indirectly identify particular taxpayers. The first report, due March 31, 2000, is to cover all APAs issued through the end of 1999 (which includes all of the APAs covered by the BNA litigation).[8]

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

Although the process of reaching the APA compromise was not easy, the end result should serve taxpayer interests well. Public guidance on the nuances of APA-agreed methodologies is highly desirable, and the legislation forces the IRS to make good on its promise at the inception of the APA Program to provide guidance. Indeed, the annual report approach is bound to be more useful and understandable than radically redacted individual APAs, and it will avoid much of the administrative and judicial sparring that would have inevitably accompanied a redaction approach.

Let us revisit, then, the issues we promised in our earlier column to explore further:

- *Is it correct that disclosure of APAs is inevitable?* The answer is a resounding "No." Confidentiality has now been conclusively determined through statutory amendments. (Absent this outcome, we would have elaborated here on our strong belief that the correct legal answer under prior law was that APAs were "return information" protected from disclosure under Code Sec. 6103, not rulings disclosable under Code Sec. 6110 or generic legal analysis of the sort in IRS Field Service Advice that was held disclosable in 1997 litigation.)
- *Is it possible to redact APAs in a way that is simultaneously fair to APA-holders and useful to other taxpayers?* We thought not, based on experience in the preliminary stages of the APA redaction process. Fortunately, this question need not be answered, although we do anticipate some touchy line-drawing exercises as the IRS prepares the APA annual reports.
- *Is release of redacted APAs the best way to provide pertinent information about IRS transfer-pricing policies?* As above, no. Congress has embraced the view that generic IRS guidance is considerably more promising.
- *Are APAs really "binding agreements" as stated in the governing Revenue Procedures?* The IRS's ability to unilaterally abrogate APA provisions (along with potential remedies of APA-holders) will fortunately not need to be tested in this context.
- *What is protected by the secrecy provisions in treaties?* Most U.S. tax treaties contain provisions protecting information that is exchanged between treaty partners from disclosure. While these provisions are consistent with (and in many cases incorporate by reference) our domestic law, including the new legislation, there remains an interest in the extent to which the treaty restrictions are independent of and/or supercede U.S. disclosure law. Pending litigation by another tax publisher in connection with the disclosure of IRS Field Service Advices poses this issue in a judicial setting.[9] Our treaty partners have strong views on this issue, which remains an open one at this time.
- *Will the APA Program continue as a popular and stellar IRS program under the new disclosure regime?* Even though the only APA "disclosure regime" is now the generic annual report approach, there remains some risk that even this will lead to increasingly "homogenized" APAs that are less responsive to the complex needs of multinational businesses. Time will tell. The ultimate location of the APA Program in the restructured IRS could also have an impact on the Program. Although the Program will currently stay in IRS Chief Counsel's Office, the dynamics might change if it were eventually moved closer to the Field examination level.
- *Will the proposed cloning of the APA Program to fact-intensive domestic tax issues succeed or fail because of the disclosure issue?* The new statutory protections literally cover only "advance pricing agreements," which are not defined by statute. (The Conference Report refers to the APA Program conducted by the IRS to resolve international transfer pricing issues.) Absent legislative or regulatory clarification, expansion or "cloning" of the APA Program to resolve domestic issues raises the specter of reenacting the whole disclosure controversy. The IRS has recently initiated[10] a broader advance resolution process (called "Pre-Filing Agreements") in the "New IRS." It would be well advised to consider the confidentiality issue most carefully and cautiously before proceeding–as would interested taxpayers.

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- *What other fallout may result from the IRS disclosure course [last year]?* Events of the past year cast a pall over some bilateral APA competent authority negotiations; hopefully this will now abate. However, residual concerns about treaty secrecy and IRS commitments spawned by these events, as well as upcoming changes in IRS structure, will require redoubled efforts to reassure treaty partners and taxpayers of the contours of various IRS programs. Broader legislation may ultimately be necessary to conclusively assuage these concerns without protracted litigation or litigation anxiety.

The APA Program is moving back on track. Careful future handling by all concerned is imperative to preserve this exceptionally valuable process and restore taxpayer confidence and international credibility.

ENDNOTES

1 Patricia G. Lewis and Matthew W. Frank, Transfer Pricing Thoughts: North America, *Thoughts on APA Disclosure,* J. GLOBAL TRANSFER PRICING, June-July 1999, at 5.
2 IRS Information Release 1999-05.
3 *The Bureau of National Affairs, Inc.*, Nos. 96-376, 96-2820, and 96-1473 (D.D.C.). BNA claimed that APAs were either "written determinations," such as private letter rulings, subject to public inspection under Code Sec. 6110, or disclosable under the Freedom of Information Act, without protection under Code Sec. 6103, because they did not meet the definition of "return information."
4 In the interest of full disclosure: our firm represents a group of trade associations and anonymous taxpayers who participated as *amicus curiae* in the BNA litigation, to urge judicial consideration of the proper application of sections 6103 and 6110 toward a conclusion that APAs are not disclosable at all.
5 The BNA case was dismissed by agreement of the parties on January 6, 2000.
6 IRS Information Release 1999-05.
7 Among the features to be covered are critical assumptions, sources of comparables, comparables' selection criteria, nature of adjustments to comparables and tested parties, ranges, adjustment mechanisms, term lengths and approaches for sharing currency or other risks.
8 The lengthy report was issued on March 30, 2000, with IRS Announcement 2000-35.
9 *Tax Analysts,* (DC-D.C.) 98-1 USTC ¶50,407, 117 F3d 607, 620.
10 I.A. 2000-7 (2/11/2000).

Transfer Pricing Controversies

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it did have. Whether the taxpayer can later justify a cost is irrelevant."[3]

Unlike the taxpayer's burden of proof under Code Sec. 482, which can be discharged with the benefit of hindsight, the taxpayer can set aside a determination under Code Sec. 6038A(e)(3) only with "clear and convincing evidence that the Secretary abused that discretion, while accepting as true all allegations and inferences that may support the Secretary's position."[4]

In *UPS*, the IRS allocated the insurance premiums paid by a U.S. corporation to a Bermuda affiliate under Code Secs. 482 and 61. The alternative adjustment was based on the IRS' characterization of the intercompany transaction as a sham, devoid of any business purpose or economic substance. In sustaining the proposed adjustment under Code Sec. 61, the Court decided the case under the lower preponderance of the evidence standard, rather than the arbitrary, capricious and unreasonable standard applicable to Code Sec. 482 allocations. While several very old transfer pricing cases involved sham theories, *UPS* is the first case in many decades to apply the sham theory to an intercompany transaction. In the wake of *UPS*, international examiners recently have been asserting the sham theory in a number of pending transfer pricing audits.

Conclusion

The IRS' success in winning transfer pricing issues and imposing penalties since 1995 should be a sobering "wake-up call" to all taxpayers. While a taxpayer with strong factual support for its intercompany prices still can prevail in litigation, the risk of loss has substantially increased for those intercompany transactions not adequately supported by real world comparables or well-developed economic analyses. Taxpayers that fail to contemporaneously document a result attempt to apply arm's length principles in determining their return positions are certain to incur substantial penalties under Code Sec. 6662.

ENDNOTES

1 *See, e.g., Sundstrand Corp.*, 96 TC 226, Dec. 47,172.
2 *See, e.g., Podd* (Code Sec. 482 and Code Sec. 162 alternative legal theories); *BTR Dunlop Holdings* (Code Section 482 and fair market value alternative legal theories).
3 *ASAT, Inc.*, 108 TC at 171.
4 *See id.*