

# Global View: The IRS Updates The Advance Pricing Agreement Procedures

Determining the arm's length transfer price of intercompany transactions has created some of the most resource consuming controversies in taxation and may result in a transfer pricing penalty. To avoid a transfer pricing penalty, a taxpayer must prepare contemporaneous documentation that shows the arm's length pricing of intercompany transactions.<sup>[1]</sup> To avoid both a transfer pricing penalty and an adjustment, a taxpayer may enter an advance pricing agreement (APA) with the IRS (and possibly the other country's taxing authority).

Pursuant to the APA procedure, the IRS reviews and agrees to the taxpayer's transfer pricing method before the taxpayer implements the method. An APA spells out the factual nature of the related party transaction and an appropriate pricing method. Assuming that the taxpayer properly applies the agreed-upon method to the transaction, the IRS will not audit the issue.

Assume, for example, that NordCo, a Nordic company, manufactures widgets and sells them to its U.S. subsidiary (USDist) for resale in the United States. When evaluating USDist's transfer pricing practices, the taxpayer's economist determines that USDist should have a cost of goods sold between \$9 and \$10.

Desiring to avoid the expense of annual documentation for the next five years, USDist seeks an APA with the IRS. Subsequently, the IRS and USDist agree that, barring any material changes to the way

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USDist operates, USDist will annually report a cost of goods sold between \$9 and \$10. Assuming that USDist reports a cost of goods sold within this range, the IRS will not make a transfer pricing adjustment, will not impose a transfer pricing penalty, and will not even audit the transfer pricing issue.

The IRS has announced a long-anticipated update to the advance pricing agreement ("APA") procedures in Rev. Proc. 2015-41. <sup>[2]</sup> The fundamentals for pursuing an APA remain the same as in old Rev. Proc. 2006-9.<sup>[3]</sup> The taxpayer submits pre-filing materials for a pre-filing conference that may either be on a

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named or an anonymous basis. After the taxpayer's attorney conducts a pre filing conference, in which the Advance Pricing and Mutual Agreement (APMA) program provides its comments, the taxpayer can file for an APA (along with the user fee). Subsequent to further negotiations, the taxpayer would agree to an arm's length range pursuant to the agreed-upon method for a five-year duration.

The update in new Rev. Proc. 2015-41 provides several new features. The major changes to the APA process include the scope of issues covered, a rollback of the method to prior years, pre filing and filing materials, and increased user fees.

## Scope of Issues Covered

Previously, the taxpayer made a request to have the APA cover what the taxpayer defined as covered transactions. New Rev. Proc. 2015-41 now allows the IRS to expand the scope of the APA to include interrelated issues.[\[4\]](#)

For example, suppose that NordCo, a Nordic company, manufactures widgets and sells them to its U.S. subsidiary (USDist) for resale in the United States. If NordCo's widgets, which are notoriously fragile products, come with the NordCo backed warranty for which NordCo will provide repair services to USDist, the repair services may constitute an interrelated matter that the IRS could include by expanding the scope of the covered transactions.

Moreover, new Rev. Proc. 2015-41 indicates a specific preference for bilateral to unilateral APAs.[\[5\]](#) For example, a bilateral APA would include reaching an agreement between the taxpayer, the IRS, and a foreign country's taxing authority. If a taxpayer seeks a unilateral APA, the taxpayer must explain why it is not seeking a bilateral APA.

## Rollbacks to Prior Years

New Rev. Proc. 2015-41 specifically provides for a rollback to prior years. A rollback would apply the agreed upon transfer pricing method not only to prospective years, but to retroactive open years. For example, suppose NordCo sells widgets to USDist for distribution in the United States and USDist seeks an APA for years 2017, 2018, and 2019. If the IRS and the taxpayer agree, the agreed-upon method for the 2017 to 2019 years would also apply to the 2012 to 2016 years. The IRS expects taxpayers to agree to sign consents to extend the statute of limitations for any rollback years.[\[6\]](#) Moreover, if appropriate, APMA

may coordinate the rollback with any issues before Competent Authority.<sup>[7]</sup>

## Pre-Filing and Filing Materials Specified

Rev. Proc. 2015-41 provides new guidance regarding materials to file for both a pre-filing conference and an APA.

The pre-filing conference has always been a critical part of the APA process. Constructive feedback from the IRS helps a taxpayer decide whether to file for an APA. New Rev. Proc. 2015-41 attempts to specify the required contents of a pre-filing memorandum. In addition to proposing dates for a pre-filing conference and providing a covered issue's diagram, new Rev. Proc. 2015-41 states that the memorandum "must have a length and content appropriate to the size and complexity of the covered issue(s) proposed by the taxpayer, and must be primarily in memorandum form but may be accompanied by diagrams, slides, spreadsheets, and similar supporting materials."<sup>[8]</sup> It is in the best interest of the taxpayer to provide as much information as possible to have a meaningful pre-filing conference, and contemporaneous documentation that is sanitized (to prevent identifying the taxpayer) should be sufficient for the taxpayer's attorney to provide as a pre-filing memorandum.

New Rev. Proc. 2015-41 offers the opportunity to provide abbreviated filing materials in certain unique circumstances.<sup>[9]</sup> This is a good development, but the provision of the abbreviated materials may result in delay if there are misunderstandings regarding the nature of the abbreviation.

## Increased User Fees

Although there is not a user fee for a pre-filing conference, the IRS has increased user fees to file for an APA. The user fee for a regular APA has increased from \$50,000 to \$60,000. The IRS has also increased the small APA user fee from \$22,500 to \$30,000 while making qualification for a small APA more rigorous. More specifically, the small APA user fee is only available as long as (a) the multinational group has consolidated revenues of less than \$500 million in each of its three most recent years, (b) the covered issue is not expected to exceed \$50 million in any given year, (c) the aggregate value of any transfer of intangible is not expected to exceed \$10 million in any given year, and (d) there is not an intangible development arrangement.<sup>[10]</sup>

Suppose, for example, that the NordCo-USDist group earned gross revenues of

\$1 billion even though USDist's widget sales were only \$40 million. Because \$1 billion exceeds \$500 million, USDist would not be eligible to pay the small APA user fee.

## Conclusion

Rev. Proc. 2015 41 does a good job of clarifying and updating the APA procedures. As always, an increase in user fees is an unwelcome, although hardly unexpected, development. However, expanding the scope of the APA, specifying the ability to do rollbacks, and further guidance on pre filing and filing materials are progressive developments. Based on Rev. Proc. 2015-41, APAs will continue to be the recommendation of choice to clients who want certainty with respect to their transfer pricing issues.

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[1] Code Sec. 6662(e).

[2] I.R.B. 2015-35.

[3] 2006-1 C.B. 278.

[4] *Id.*, at Section 2.02(4).

[5] *Id.*, at Section 2.02(4)(c).

[6] *Id.*, at Section 1.01(5); Notice 2013-79, Section 3.04(e).

[7] *Id.*, at Section 2.02(4)(c). The IRS simultaneously issued the new Competent Authority procedure, Rev. Proc. 2015 40, which was discussed in the last "Global View," with Rev. Proc. 2015 41. I.R.B. 2015 35.

[8] *Id.* at Section 3.02(6).

[9] *Id.*, at Section 3.04(2).

[10] *Id.*, at Section 3.04; Appendix.

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