The little program that could: 20 years of the APA program

18 March 2011, marks the 20th anniversary of the Internal Revenue Service (IRS) Advance Pricing Agreement (APA) program. The APA program was established as an alternative dispute resolution (ADR) process for transfer pricing controversies that was aimed at encouraging taxpayer compliance by offering a flexible and commonsense multi-functional approach to transfer pricing disputes. For the past twenty years, APAs have been an important tool available to taxpayers looking to prevent controversy, achieve certainty, and mitigate the risk of double taxation.

Beginning with a small staff and only a handful of APA requests the IRS APA program has received more than 1300 requests and has completed over 900 APAs across a broad range of industries with more than a dozen of its treaty partners since it began.

Because of the global economic recession, governments are looking for ways to bring in additional tax revenues, and transfer pricing is one of the areas that’s drawing increased attention on a worldwide basis. This is evident in transfer pricing audits that are increasing in significance, intrusiveness, and scope.1 As a result, companies have to put more into substantiating their transfer pricing positions and confirming arm’s-length treatment from the outset to defend against a possible audit and avoid an adjustment or potential controversy. It is not a coincidence that in 2009, the APA program received the largest number of APA requests to date.

The APA program was born out of a need for an ADR approach to resolving transfer pricing issues. At the time of its inception, the IRS was experiencing a large compliance problem with respect to transfer pricing issues, and the US Tax Court was becoming overwhelmed with the number of transfer...
pricing cases on the docket. Because an APA allows the taxpayer and the IRS to prospectively negotiate the appropriate transfer pricing method for future intercompany international transactions, the APA process was an innovative new approach to transfer pricing. Unlike traditional ADR processes, the APA process was envisioned as one of dispute avoidance. The taxpayer and the IRS APA team would negotiate an agreement regarding the taxpayer’s transfer pricing before the taxpayer even files its tax return, thus agreeing to a solution before a dispute arises. Because the APA negotiations occur pre-dispute, the process was meant to be less adversarial and more cooperative than the traditional route of IRS appeals and/or litigation.

The APA program, as it was envisioned, offered numerous benefits to both the IRS and taxpayers. First, the process was meant to ensure certainty of tax treatment. Uncertainty has become a particularly important issue since the implementation of FIN 48, which caused a dramatic change in how companies recognize, measure, and report tax benefits. Additionally, the potential cost of uncertainty has risen dramatically in recent years. In addition to possible IRC section 6662 penalties, the IRS has increased penalties for failure to accurately file related-party transaction disclosure forms and it has also introduced Schedule UTP, which requires the disclosure of detailed information on uncertain tax positions, including transfer pricing positions. At the same time, the IRS has been developing protocols to conduct joint audits with its treaty partners.

Second, the APA process was intended to provide both the IRS and taxpayers with substantial time and cost savings. Transfer pricing examinations are often time-consuming and expensive. Transfer pricing disputes involve complex factual and economic issues requiring both objective and subjective judgment. Moreover, the confrontational approach often employed in an examination, combined with poor communication, can produce an impasse between the IRS and the taxpayer. In a transfer pricing examination, the IRS will request extensive information about the taxpayer and the related parties involved in transactions with the taxpayer. These requests often require the taxpayer to expend significant time and money providing great quantities of information.

The APA process on the other hand, offers more open communication between the taxpayer and the IRS, is nonadversarial in nature and has more narrowly defined information disclosure requirements. Combined, these elements produce substantial time and cost savings for both the taxpayer and the IRS. Compared to the time and money spent on a transfer pricing dispute that could involve going through examination, appeals, litigation and/or competent authority, the APA process is meant to be much more efficient.

Evolution of APA guidance

The first procedures for obtaining an APA were laid out in Revenue Procedure 91-22 issued in March of 1991. According to the Revenue Procedure, the goal of the APA process was to arrive at an understanding between the taxpayer and the IRS on three basic issues: (1) the factual nature of the intercompany transactions to which the APA applies; (2) an appropriate transfer pricing methodology (TPM) to apply to those transactions; and (3) the expected range of results from applying the TPM to the transactions.


APA Directors through the years
- Robert Ackerman
- Michael Durst
- Richard Barrett
- Sean Foley
- Matthew Frank
- Craig Sharon
- John Hinding
On 19 December 2005, the IRS again updated the procedural rules for processing and administering APAs with the release of Rev. Proc. 2006-09. On 21 May 2008, the IRS released Rev. Proc. 2008-31, which revised Rev. Proc. 2006-09 to expand the types of issues that may be resolved in the APA process. Specifically, Rev. Proc. 2008-31 added a new sentence to Section 2.01 of Rev. Proc. 2006-09 to advise that the APA process may be used to resolve any issue for which transfer pricing principles may be relevant such as: (1) attribution of profit to a permanent establishment under certain US income tax treaties; (2) the amount of income effectively connected with the conduct of a US trade or business; and (3) the amount of income derived from sources partly within and partly without the United States.

APA program today
While transfer pricing continues to remain a key tax challenge for the world’s leading companies, the transfer pricing landscape has changed significantly in the past twenty years. Today, transfer pricing is one of the most significant problems in modern international taxation. Worldwide, tax authorities are increasing their focus on transfer pricing, which is evident in increased enforcement and regulatory activity, as well as the increasing variety of transfer pricing issues facing multinational corporations. According to Ernst & Young’s 2010 global transfer pricing survey, multinational companies identify transfer pricing as the “most important tax issue they face,” and most multinational companies believe that transfer pricing will be “absolutely critical” or “very important” to them in the coming years.² Seventy-four percent of the parent company respondents believe that transfer pricing documentation is more important now than it was two years ago.³

When the APA program first began, only a handful of countries had programs similar to the APA program. As of January 2011, more than 30 countries allow for such agreements. Ernst & Young’s most recent transfer pricing survey suggested that even more jurisdictions are committing to the introduction of APA programs.⁴

Although the transfer pricing landscape has changed, the APA office still struggles with some of the same issues it faced at its inception; most notably staffing and resource issues. Back in 1991, the projected workload for the APA program was 150 to 200 cases per year with an expectation that the APA office would have 18 full-time employees with additional support from National Office and field attorneys as well as examination personnel in the field. As of December 2009, the APA program had 19 team leaders and a total staff of 39 full-time employees with offices in both Washington and California. The inventory of the program included 222 active APA cases (either unilateral APAs or bilateral APAs for which the APA program had not yet completed a recommended negotiating position). Over the past three years, the APA Program has received record-high numbers of APA applications. In 2009, the APA program received the largest number of requests to date with 127 new APA applications filed.

Twenty years ago, the APA program typically reached an agreement with the taxpayer within six to nine months after receipt of the taxpayer’s formal APA request. Presently, the IRS has set a goal of concluding unilateral APAs, and completing the US competent authority negotiating position for bilateral APAs, within 12 months.
However, in 2009, the median time to complete a unilateral APA was 24 months, the median time to complete a competent authority position paper for a bilateral APA was 19 months and the median time to complete a bilateral APA was 40 months.

The APA Program continues to lack the resources it needs to function optimally. Currently, there can be a delay of between six and twelve months after submission before an APA request is assigned to a team leader because there are too few team leaders and economists available to handle the new cases. Further, the IRS has not been funding new hires for the APA program to meet the increased demand. However, on a per capita basis, the IRS is functioning more efficiently than it has in the past and the IRS, like other tax authorities around the world, is increasing its dedicated transfer pricing resources and improving their specialist capabilities as an organization.\(^5\)

In October 2010, the Large and Mid-Size Business Division (LMSB) was renamed the Large Business and International Division (LB&I) as part of a realignment aimed at centralizing the organization in order to improve international tax compliance. As part of this realignment, LB&I added approximately 875 employees to the international program, consisting of examiners, economists and technical staff drawn from other parts of the former LMSB. New positions, including chief economist and transfer pricing director, have also been added to the LB&I. Moreover, LB&I is establishing its own APA program in order to pool the APA and competent authority's resources. This new pooling is designed to solve the APA program's resource problem at a time when the demand for APAs continues to increase.

Many perceive that the APA program has changed its mission over the years. The original purpose was to create a program that would provide an ADR process for addressing complex, factually intensive transfer pricing issues in order to reach a reasonable conclusion in a non-adversarial and collaborative environment. When the process first began, decision-makers for both sides would sit at the table and work through the issues together, coming to a reasonable result that satisfied the arm's-length standard. Today, the Program appears to be more focused on finding the right balance between a practical solution and economic precision. However, economic precision is not something that readily exists in the realm of transfer pricing and the arm's-length standard. But as the transfer pricing rules and guidance have evolved over the years, and the APA Program has become more institutionalized and been subject to greater outside scrutiny the flexible problem solving program now is a little less willing to settle on a reasonable result unless firmly supported by those rules and guidance.

**Conclusion**

Although there have been some bumps in the road, the APA Program has largely lived up to its expectations and an APA remains a viable alternative for companies seeking transfer pricing certainty over a large number of years who are willing to openly discuss the issues in a principled, nonadversarial environment. While not a certainty, we believe Taxpayers can look forward to improvements in the process that will surely come with the IRS’s renewed focus on transfer pricing and the added resources from LB&I.

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**Endnotes**

1. Ernst & Young, 2010 Global Transfer Pricing Survey 2 (December 2010).
2. Ernst & Young, 2010 Global Transfer Pricing Survey 7-8 (December 2010).
3. Ernst & Young, 2010 Global Transfer Pricing Survey 7-8 (December 2010).
5. Ernst & Young, 2009 Global Transfer Pricing Survey - Tax Authorities Interviews 6 (September 2009).
For additional information with respect to this Alert, please contact the following:

**Ernst & Young LLP, International Tax Services/Transfer Pricing, Washington, DC**

- David J. Canale  
  +1 202 327 7653  
  david.canale@ey.com
- Richard J. McAlonan  
  +1 202 327 6025  
  richard.mcalonan@ey.com
- Steven C. Wrappe  
  +1 202 327 7956  
  steven.wrappe@ey.com
- Denen N. Boyce  
  +1 202 327 5602  
  denen.boyce@ey.com

**Ernst & Young LLP, International Tax Services**

**US Transfer Pricing Controversy Services**

- Bob Ackerman  
  +1 202 327 5944  
  bob.ackerman@ey.com
- David Arnold  
  +1 513 612 1595  
  david.arnold@ey.com
- David Canale  
  +1 202 327 7653  
  david.canale@ey.com
- Purvez Captain  
  +1 713 750 8341  
  purvez.captain@ey.com
- Paul Chmiel  
  +1 732 516 4482  
  paul.chmiel@ey.com
- Ken Christman  
  +1 202 327 8766  
  kenneth.christmanjr@ey.com
- Per Juvakam-Wold  
  +1 214 969 8949  
  per.juvakam-wold@ey.com
- Dan Karen  
  +1 404 817 5921  
  dan.karen@ey.com
- Karen Kirwan  
  +1 202 327 8731  
  karen.kirwan@ey.com
- Stephen Meadows  
  +1 202 327 6020  
  stephen.meadows@ey.com
- Richard McAlonan  
  +1 202 327 6025  
  richard.mcalonan@ey.com
- Michael Picariello  
  +1 617 375 1493  
  michael.picariello@ey.com
- Peyton Robinson  
  +1 949 437 0470  
  peyton.robinson@ey.com
- Miller Williams  
  +1 404 817 5077  
  miller.williams@ey.com
- Jim Wisniewski  
  +1 312 879 3657  
  jim.wisniewski@ey.com
- Steven Wrappe  
  +1 202 327 5956  
  steven.wrappe@ey.com

**International Tax Services Transfer Pricing**

**Transfer Pricing Leaders**

- **Americas, Washington, DC**  
  Bob Ackerman  
  +1 202 327 5944
- **Americas, Houston**  
  Purvez Captain  
  +1 713 750 8341
- **Canada, Toronto**  
  Sean Kruger  
  +1 416 941 1761
- **Mexico and Central America, Mexico City**  
  Jorge Castelon  
  +1 305 415 1391
- **South America, Caracas**  
  Katherine Pinzon  
  +1 305 7997674
- **Israel, Tel Aviv**  
  Lior Harary Nitzan  
  +972 3 623 2749
- **US Area Leaders**  
  Jay Camillo, Atlanta  
  +1 404 817 5443
  Colleen Warner, Chicago  
  +1 312 879 3633
  Mark Camp, Houston  
  +1 713 750 4883
  Maison Miscavage, McLean, VA  
  +1 703 747 0529
  Russ O’Haver, New York  
  +1 212 773 5251
  Barbara Mace, New York (Financial Services)  
  +1 212 773 2502
  Curt Kinsky, San Jose  
  +1 408 918 5955
  David Canale, Washington, DC (National Tax)  
  +1 202 327 7653

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