Case Analysis and Fact Development

CASE ANALYSIS AND FACT DEVELOPMENT

Lesson 1 - General Technical

OVERVIEW

Negotiating and concluding an APA requires an understanding of how to evaluate, analyze and factually develop the request . The APA process includes five essential five stages, which require varying skills from the Team Leader and the APA team. These five stages are explained below along with points to consider in evaluating, negotiating and developing a transfer pricing methodology (TPM). This module concludes with a case analysis showing the chronology of an APA from its beginning to conclusion.

THE APA PROCESS STAGES

< Prefile
< Evaluation and Analysis
< Negotiation
< Competent Authority Process
< Drafting the APA

Prefile

The APA Submission process requires that the taxpayer pay a user fee for the subject tax years. Prior to paying the user fee, however, the taxpayers may request a prefiling conference, on either an anonymous or named basis, in order to discuss the APA with Program personnel prior to committing to the process. If a proposed APA Submission is submitted prior to the prefiling conference, the Team Leader should be prepared to discuss its weaknesses. The prefiling conference also provides a good opportunity for the Team Leader to set a case plan, schedule a time-line, and designate responsibility to the APA team members for developing and evaluating the APA.

Evaluation and Analysis

The Team Leader must analyze and evaluate the reasonableness of the taxpayer=s proposed TPM. Evaluation and Analysis of the APA request, including the proposed TPM, is the most important part of the APA process, and the Team Leader must marshal the appropriate personnel and resources to effectively do so. Such personnel will include the IRS International Examiner (or other APA and IRS personnel, such as economists and, in some cases, managers) familiar with the taxpayer=s business and audit history. Regarding bilateral APA requests, the U.S. Competent Authority Analyst should be included in all meetings and discussions with the taxpayer in order to facilitate the eventual negotiations with the foreign country.

In determining the TPM to be applied by the APA, the Team Leader will apply the ABest Method@ TPM in accordance with the 482 regulations. An evaluation of the business operations of the taxpayer must be done to compare different TPMs. Prior to having meetings with the taxpayer, the Team Leader and APA or IRS Economist should learn as much about the taxpayer as possible.

Negotiation

APA Team negotiates any modifications or changes with the taxpayer. Regarding bilateral APAs, the negotiated result serves as the negotiating position, which forms the basis for the mutual agreement reached by the U.S. Competent Authority and the foreign country.

Competent Authority Process

For bilateral APAs, the U.S. Competent Authority analyst opens negotiations with the foreign competent authority and drafts the mutual agreement letter. The Team Leader may be asked to assist in the negotiations.

Drafting the APA

The Team Leader drafts the APA, which is executed by the APA Director and the taxpayer=s representative. With these signatures, a unilateral APA becomes effective. In regard to a bilateral APA, the Team Leader will draft the APA in accordance with the TPM agreed to by the countries in the mutual agreement letter. Once the mutual agreement letter and bilateral APA have been executed by the respective parties, the APA becomes effective.

VARIOUS STEPS

Get Taxpayer Facts

Taxpayers file APA Submissions under penalties of perjury. Nonetheless, the Team Leader must conduct due diligence to confirm the facts and that any TPMs applied to the taxpayer=s covered transactions result in a reasonable allocation of income under section 482.

The accuracy of the facts is critical, as applying different TPMs to the same set of facts may result in a multiple range of answers. In making this determination, the Team Leader should attempt to quantify numerically the details of the covered transactions. This may require the Team Leader to suggest a working relationship with taxpayer personnel not officially designated as part of the taxpayer=s APA team, but which are highly skilled and knowledgeable in specific taxpayer operations. In many APA cases, it is necessary to conduct a site visit of the taxpayer=s operations to completely understand the covered transactions. A site visit may further the APA Team=s understanding of the submitted facts and the relationship among the taxpayer=s operating functions. A site visit also will often uncover taxpayer functions that require additional compensation or refinement of the taxpayer=s APA proposal. For example, while a taxpayer proposal may request a Resale Price Method for a subsidiary operating as a Apure@ distributor, a site visit may reveal a significant selling function, requiring a change in the proposed TPM.

Identify Scope of APA

In evaluating the APA, the Team Leader must first define the covered transactions, especially if the taxpayer failed to properly segregate covered transactions from non-covered transactions.

Determine the Materiality of Issues

Taxpayers expect timely resolutions to their transfer pricing problems and the APA Program attempts to resolve any issues within 9 to 12 months from the start of evaluation and analysis of the APA submission. After identifying the covered transactions, the Team Leader must identify any material factual issues that need further factual clarification and/or economic and legal analysis. Additionally, the Team Leader should determine whether any immaterial issues may result in a legal precedent or result contrary to the normal legal standards and guidelines as applied by the APA Program.

Identify Non-Starters

In some instances, a taxpayer may propose a TPM that results in favoring one country at the expense of another, or asks for certainty on a transaction that is clearly outside the scope or interpretation of U.S. tax law. Such TPMs or issues are considered non-starters. The Team

Leader must identify these non-starters at the beginning of the APA evaluation process and make it clear to the taxpayer that they will not be addressed as part of the APA process. Identifying non-starters may eliminate or expose Agaming@ by a taxpayer: some taxpayers use non-starters for negotiating leverage in an attempt to reach an unreasonable result.

The majority of APA cases include some conflict and tension with the taxpayer, especially in defining the covered transactions and in reaching agreement on the appropriate TPM. By identifying non-starters up-front and resolving the related conflict and tension, the Team Leader is better positioned to control the resolution of the APA. When non-starters are identified late, it can lead to taxpayer misunderstandings as to what is acceptable within the APA.

Rollback Issues

An APA TPM may effect two time periods: prospective years going forward and back years currently under or open for audit by the IRS district examination groups. The retroactive application of the agreed TPM to back years under audit is referred to as a Aroll-back.@ Importantly, a roll-back issues requires the consent of the IRS examination function conducting the audit. The APA Policy Board instituted this policy to prevent taxpayers from using the APA Program to avoid audit issues outside the scope of transfer pricing. Understanding the prior audit history is critical in determining if any roll-back is applicable.

Review and Analyze APA Submissions

The APA Submission should be read prior to any meetings with the taxpayer. Understanding the details of the taxpayer=s proposal before the meeting will enable quick decisions and issue resolution. Meetings with the taxpayer should be used to set and meet strategic milestones, and the Team Leader must have a clear understanding of the transactions that will be ACovered Transactions.@ The APA Submission will detail the proposed TPM requested by the taxpayer, along with an analysis that should substantiate the proposal.

The Team Leader will evaluate the proposal in relation to comparable unrelated companies. When evaluating an APA it is important to understand the U.S. tax effects or Athe bottom line@ of any proposed TPM. The Team Leader should attempt to quantify the amounts related to the Covered Transactions to determine their impact on the taxpayer=s U.S. tax liability. This information will help in later negotiations with the taxpayer and the foreign competent authority. Notably, aggressive representatives may divert attention to legal concepts to avoid focusing on the numbers.

Analyze Financial Statements

After the Covered Transactions are defined, basic economic and operating performance information can be derived from the taxpayer=s financial statements. The Team Leader should review current and at least the prior 3 years financial statements to determine the impact of the proposed TPM on the taxpayer=s most recent and current operations. Financial operating ratios can be calculated for Aoperating margins,@ ABerry ratios,@ Agross profit margins,@ Aadvertising to sales,@ ASGA to sales,@ etc., in order to measure components of the taxpayer=s business operations. The financial statements should also be reconciled to the taxpayer=s tax returns. The Team Leader=s analysis should include an understanding of the proposed TPM=s impact on financial statements and tax return.

Analyze Comparables

The taxpayer=s operating ratios are then compared to identified industry comparables. In many cases the taxpayer will be the Atested party,@ e.g., the one compared to the industry comparables. This stage of the evaluation process leads to the first negotiation, e.g., agreeing to the comparables for determining the arm=s length transfer price for the Covered Transactions. The initial comparables selection is done by the taxpayer and made part of the APA Submission as the Aeconomic analysis.@ The APA Economist attempts to replicate the taxpayer=s proposal without bias, often using the Compustat database to define comparable companies in similar lines of business. In conducting the comparable analysis, the APA economist sets various screening criteria (such as amount of sales, etc.) to facilitate close comparability with the tested party and limit the size of the comparable set. Any differences in comparable selection are negotiable items between the taxpayer and the Service.

Evaluate Existing APA and Annual Reports

If the APA under consideration is a Arenewal@ there will be a prior related APA and working file. All original APAs and working files are maintained in the APA docket room. The taxpayer will probably also have filed required annual reports, which show compliance with the agreed TPM. The Annual Reports are very helpful in providing the yearly dollar amounts allocated under the TPM, recent trends in the taxpayer=s business conditions, and taxpayer-initiated changes that should be considered in processing the APA renewal. These annual reports are kept separately by the Program Analysts. The Team Leader should review the prior APA, working file and all annual reports to determine the resources needed to evaluate the renewal APA.

Calculate Asset Intensity Adjustments

The APA Economist is responsible for computing all asset intensity adjustments to the comparable set. However, it is beneficial for the Team Leader to understand how these adjustments are computed. Asset Intensity Adjustments are generally made for Accounts Receivable, Inventories, Accounts Payable and other operating assets such as Property, Plant and Equipment. The effect of an Asset Intensity Adjustment is to increase or decrease Sales, Cost of Goods Sold, and Operating Expenses of the comparable set in order to put the comparables on the same footing as the taxpayer or tested party. Asset Intensity Adjustments are derived by applying rate based assumptions, either as capital rates of return or interest rates (generally derived from the IRS AFR rate), to the unadjusted asset and liability categories described above.

For a better understanding of the theory of Asset Intensity Adjustments, the Team Leader should read *Lesson 6* of the *IRS Economists Training Manual*. To understand the practical application in making these adjustments, the Team Leader should read A*Compustat Tools For Transfer Pricing Analysis Developed By The APA Program*,@ which includes a computer program designed by APA Economists for computing Asset Intensity Adjustments.

Devise Selection Criteria for Comparables

The Team Leader will review the taxpayer=s comparability analysis or may conduct his/her own analysis to independently verify the taxpayer=s results. Generally, the APA Economist is responsible for this analysis and will use the Compustat data base by determining the applicable Standard Industry Classification (SIC Codes) and researching the taxpayer=s industry competitors or other companies with similar functions and risks. The Economist will review Securities and Exchange (SEC) Forms 10K to determine the level of comparability (generally by product and functions) between selected companies and the taxpayer. The Economist=s objective is to increase comparability by screening companies less comparable to the taxpayer. To increase comparability in an efficient manner, many economists identify potential comparable companies by using Ascreens@ or Afilters@ comprised of financial ratios based on level of sales, expense to sales ratios, etc. The remaining companies will make up the comparable set used to compute an arms= length range to apply to the tested party. Defining the comparable set generally will become one of the first issues, and probably most important, to be negotiated with the taxpayer, as the selection of comparables will set the overall arms length range for determining the agreed upon transfer price. The following comparability factors set forth are in regulation 1.482-1(d)(3) and applicable to all transfer pricing methodologies:

- ***Functions***
  Determining the degree of comparability between controlled and uncontrolled transactions requires a comparison of the functions performed, and associated resources employed, by the taxpayers in each transaction. This comparison is based on a functional analysis that identifies and compares the economically significant activities.

- ***Contractual Terms***
  Volume discounts, upgrades, payment terms, etc.

- ***Risks***
  Market risks; exchange rate and interest risks; credit and collection risks; product liability risks; general business risks.
- ***Economics***
  Demand and supply conditions as evidenced by similarity of geographic markets; level of market (e.g., retail, wholesale); degree of competition in the relevant markets (i.e., market organizations), etc.

- ***Product or Service Similarity***
  (a) Quality; (b) Embedded Intangibles.

Designate Appropriate Tested Party

When using the Comparable Profits Method (ACPM@) the Team Leader must designate the appropriate tested party. In most cases the tested party will be the entity to be covered by the APA. Treasury Regulation 1.482-5(b)(2) states that the tested party will be the participant in the controlled transaction whose operating profit attributable to the controlled transactions can be verified using the most reliable data and requiring the fewest and most reliable adjustments and for which reliable data regarding uncontrolled comparables can be located. In most cases the tested party will be the least complex of the controlled taxpayers and not own valuable intangible property or unique assets that distinguish it from potential uncontrolled comparables.

Select Appropriate Profit Level Indicators (APLI=s@)

A profit level indicator (APLI@) is a ratio that measure relationships between profits and costs incurred or resources employed. A variety of PLIs can be calculated in any given case. Whether use of a particular PLI is appropriate depends upon a number of factors, including the nature of the tested party=s activities, the reliability of the available data regarding uncontrolled comparables, and the extent to which the PLI is likely to produce a reliable measure of the income that the tested party would have earned had it dealt with controlled taxpayers at arm=s length, taking into account all of the facts and circumstances. PLIs should be derived from a sufficient number of years= data in order to reasonably measure returns accruing to uncontrolled comparables. Generally, such a period should encompass at least the taxable year under review and the preceding two taxable years. This analysis must be applied in accordance with Treasury Regulation 1.482-1(f)(2)(iii)(D). PLIs that may provide a reliable basis for comparing operating profits of the tested party and uncontrolled comparables include the following:

< ***Rate of Return on Capital Employed***
The rate of return on capital employed (AROCE@) is the ratio of operating profit to operating assets. The reliability of this PLI increases as operating assets play a greater

role in generating operating profits for both the tested party and the uncontrolled comparable. In addition, reliability under this PLI depends on the extent to which the composition of the tested party=s assets is similar to that of the uncontrolled comparable. Finally, difficulties in properly valuing operating assets will diminish the reliability of this PLI.

< ***Financial Ratios***

Financial ratios measure relationships between profit and costs or sales revenue. Since functional differences generally have a greater effect on the relationship between profit and costs or sales revenue than the relationship between profit and operating assets, financial ratios are more sensitive to functional differences than the rate of return on capital employed. Therefore, closer functional comparability normally is required under a financial ratio than under the rate of return on capital employed to achieve a similarly reliable measure of an arm=s length result. Financial ratios include:

1. Ratio of operating profit to sales.

2. Ratio of gross profit to operating expenses. Reliability under this PLI also depends on the extent to which the composition of the tested party=s operating expenses is similar to that of the uncontrolled comparables.

3. Other PLIs, which may be used if they provide reliable measures of the income that the tested party would have earned had it dealt with controlled taxpayers at arm=s length. PLIs based solely on internal data may not be used because they are not objective measures of profitability derived from operations of uncontrolled taxpayers engaged in similar business activities under similar circumstances.

Arrange/Schedule Plant Tours

For many APAs, the APA Team should prepare a functional analysis in order to completely understand the functions and covered transactions. For many large APAs involving material transaction amounts, it is useful to conduct a plant tour and/or site visit. The plant tour and/or site visit should clarify the facts as presented in the APA Submission. Plant tours and site visits will sometimes point out the flaws in the APA Submission that require rework by the taxpayer and the APA team. Plant tours and site visits can be very useful in identifying intangible issues that will affect the bilateral negotiations between the countries. It may be useful for the Team Leader to include the foreign competent authority when scheduling a plant tour or site visit.

Developing Critical Assumptions

Appendix C of every APA provides Critical Assumptions agreed to by the taxpayer and the Service. Critical Assumptions are used primarily to reach agreements in the event that an applied TPM produces extreme variations unacceptable to one or more parties. Critical Assumptions are generally threshold amounts of sales and/or expenses used in setting operating targets when using less than the full amount of an identified range in applying a TPM. A Critical Assumption can also be used for agreeing to the specific treatment of an identified segment of the taxpayer=s business that effects the allocation under the TPM. Overall, Critical Assumptions can be used as a Acatch-all@ for fostering an agreement on issues that effect the TPM and have a high level of future uncertainty. The violation of a Critical Assumption can force a revocation, renegotiation, or, in some instances, cancellation of the APA. For this reason, Critical Assumptions should never be written so as to allow a taxpayer an automatic Aout@ from the APA if the results under the TPM are unsatisfactory.

Developing a Recommended Negotiating Position

For all bilateral APAs the APA team must develop a recommended negotiating position that will form the basis of a mutual agreement letter with the foreign competent authority. The recommended negotiating position reflects a consensus between the taxpayer and the APA team on the choice and applicability of the TPM to be applied in the bilateral APA. The completion of the recommended negotiation position is the official start of U.S. competent authority negotiations with the foreign competent authority. The Team Leader will work with the U.S. competent authority analyst in devising a negotiation strategy for concluding the bilateral APA with the foreign competent authority. Each foreign country has specific idiosyncrasies pertaining to tax issues and negotiating styles. The U.S. competent authority analyst will have specific experience in dealing with the tax issues and cultural differences that pertain to his/her assigned country.

Compile and Analyze Alternatives

When negotiating the TPM with the taxpayer it may be useful to discuss alternative courses of action or positions if the foreign competent authority is unreceptive to the proposed TPM. As many countries have different negotiating styles and different views to factual determinations, a second round of negotiations must be anticipated, which may lead to different results than previously agreed with the taxpayer. It is important for the Team Leader to have an idea of possible alternatives that can be used to promote a consensus among all parties to the agreement. Compiling a list of alternative methodologies, with their effect on taxable income for all countries to the agreement, will help the Team Leader to anticipate the arguments that may be raised by the foreign competent authority.

Many foreign competent authorities consistently raise similar issues on separate APAs. It is suggested that the Team Leader work closely with the U.S. Competent Authority Analyst to understand and define these country specific issues. U.S. Competent Authority Analysts are assigned by country and are very knowledgeable in the specifics of the countries they cover.

Develop Annual Reporting Requirements

For each APA year the taxpayer must file an Annual Report with the APA Program, showing compliance with the agreed TPM. Appendix D of each APA lists Annual Report requirements. The Annual Report is also used to ensure that the taxpayer has not violated any Critical Assumptions contained in Appendix C of the APA. Under Revenue Procedure 96-53, the taxpayer must make affirmative statements that it has complied with the agreed TPM and not violated any Critical Assumptions.

Appendix D also lists the documents to be submitted annually to show compliance with the agreed TPM. At a minimum, the taxpayer should be required to construct a financial analysis that applies the agreed TPM to its financial results for the reported year. Appendix D differs from Appendix B, Document Creation, Maintenance and Retention, in that records maintained in Appendix B are primarily for the use of IRS international examiners in conducting an audit or verification, for which source documents may be needed.

The Annual Report requirements can be designed to limit the amount of audit activity needed to be conducted by IRS examination functions. In many APAs, various source documents can be included that reconcile the taxpayer's original books and records to the result obtained under the APA. In effect, the Annual Report becomes a proactive audit tool to be used by both the Service and the taxpayer to minimize the amount of audit work to be done by both parties.

CASE ANALYSIS

The following case study provides a APA case chronology. This case study resulted in a negative outcome for the taxpayer, but provides important insight into some of the more difficult APA technical issues and negotiation strategies.