US Inbound Corner

Advance pricing agreements as a cure for multiple inbound tax risks

Advance pricing agreements (APAs) are known for providing transfer pricing certainty for intercompany transactions. This article provides some background on APAs, discusses new Internal Revenue Service (IRS) funding and recent IRS developments to enforce transfer pricing compliance, and considers the potential to use an APA as a cure to address multiple tax issues beyond the pricing of intercompany transactions.

In this edition

Background

Since 1991, the IRS has provided taxpayers with the opportunity to enter into APAs.[1] An APA offers transfer pricing certainty for specified transactions ("covered transactions") for a specified number of years, which may be prospective tax years and may also include open filed tax years under a rollback. An APA sets for an agreed-upon transfer pricing method for the covered transactions.

Initially, most United States APAs were solely between the US taxpayer and the IRS in what we refer to as a unilateral APA. Today, as has been the case for many years now, most US APAs involve both US and foreign taxpayers, the IRS, and a foreign tax authority in what we refer to as a bilateral APA. Occasionally, more than two tax authorities may be involved in what is referred to as a multilateral APA, which had been more commonplace for financial services companies with global trading operations but has more recently become more common in other contexts. Since the start of APAs in the United States, foreign multinationals have utilized APAs to a greater extent than US multinationals. From 2019 through 2022, more than 60 percent of US APAs involved a foreign-parented company and its US subsidiary.

During the 1980s, many US subsidiaries of Japanese multinationals were being audited by the IRS for transfer pricing. After battling with the IRS over many years in audit and in court, many of these Japanese multinationals entered into APAs, when they became available, to achieve transfer pricing certainty. Even today, the IRS enters into more APAs with Japan than with any other country. That said, other countries are catching up. The IRS also regularly executes bilateral and multilateral APAs with tax authorities in Australia, Belgium, Canada, China, Denmark, Finland, France, Germany, Korea, India, Italy, Netherlands, Switzerland, the United Kingdom, and other countries.

The traditional use of an APA addresses a multinational's largest and/or riskiest intercompany transactions that occur on a recurring basis—for example, a foreign automotive OEM selling automobiles for distribution by its US subsidiary. Another example is a foreign chemical manufacturer licensing its technology to its US subsidiary that manufactures and distributes chemicals in the United States. In 2008, the IRS expanded the potential scope of APAs to any issue for which transfer pricing principles may be relevant, such as attribution of profits to a permanent establishment under an income tax treaty, determining the amount of income effectively connected with the conduct by the taxpayer of a trade or business within the United States and determining the amounts of income derived from sources partly within and partly without the United States.[2] We devote much of this article to discussing these additional issues.

New IRS funding and initiatives focus on foreign multinationals and transfer pricing compliance

Additional IRS funding and certain IRS initiatives are expected to result in increased scrutiny of taxpayers' transfer pricing policies. The 2022 Inflation Reduction Act provided the IRS with approximately $80 billion in additional funding over the next 10 years (fiscal years 2022 through 2031), of which $45.6 billion was designated for tax enforcement activities such as hiring more enforcement agents (possibly as many as 87,000 new agents, nearly doubling the current number of agents), providing legal support, and investing in technology. Subsequently, in connection with a legislative compromise on the debt ceiling, the original funding of approximately $80 billion was reduced by $21.4 billion to approximately $58.6 billion, which still leaves plenty of funding left for increased enforcement activities. Treasury Secretary Janet Yellen has indicated that the IRS must use the additional enforcement funding to focus on high-end noncompliance, which we understand to include transfer pricing.

As we conveyed in the January 2022 US Inbound Corner, the IRS continues to scrutinize the transfer pricing policies of inbound taxpayers by challenging historical losses, methods not based on a targeted net operating profit, and adjustments to take into account the impact of tariffs and COVID-19 on taxpayers' businesses. As recently as October 20, 2023, the IRS announced a new "large foreign-owned corporations transfer pricing initiative."[3] In this most recent initiative, the IRS targets US subsidiaries of foreign companies that distribute goods in the United States and report consistent losses or exceedingly low margins year after year. In some sense, this most recent initiative is a revival of the 2017 "Inbound Distributor Campaign" that the IRS had in place for several years.[4]

Another IRS audit campaign, the "Captive Service Provider Campaign," is seemingly more of an issue for outbound taxpayers, as it focuses on service fees paid to foreign affiliates of US multinationals; in practice, the IRS is reviewing service fees paid by any US taxpayer (i.e., US multinational or a subsidiary of a foreign multinational) to Indian affiliates, which may affect inbound taxpayers receiving services from such affiliates.

While the transfer pricing policies of many inbound taxpayers involve achieving a targeted level of operating profit, in certain instances the IRS may consider reviewing not only the results of the inbound taxpayer but also the results earned by its related affiliates that are engaged in transactions with the inbound taxpayer (i.e., the IRS may consider the entire system profit). Using an Excel-based workbook the IRS refers to as the "Functional Cost Diagnostic Model," the IRS will determine whether a profit split method—a method based on measuring the relative contributions of the parties to the related party transactions—is more reliable than testing the profitability of just one taxpayer. The typical inbound taxpayer profile that the IRS has focused on for applying the profit split method are those taxpayers that both sell consumer products and incur high levels of advertising costs (e.g., foreign auto original equipment manufacturers).

This new IRS funding and initiative provides taxpayers with ample reason to consider an APA to achieve transfer pricing certainty as well as certainty on other issues.

Non-recurring intercompany transactions
Many multinational companies engage in certain non-recurring transactions for which an APA may be requested. Frequently, such transactions relate to either a business restructuring or restructuring of intangible property (IP) ownership within the multinational group. Sometimes such transactions arose because of an acquisition where the purchaser, the acquired company (target), or both may have cost-sharing arrangements in place. IP valuations are associated with higher levels of uncertainty than many other types of intercompany transactions. Also, large intercompany charges for business restructuring services from a foreign parent to its US subsidiary may result in the IRS questioning the benefit of such services to the US subsidiary. An APA can resolve the uncertainty of these types of non-recurring, one-off transactions.

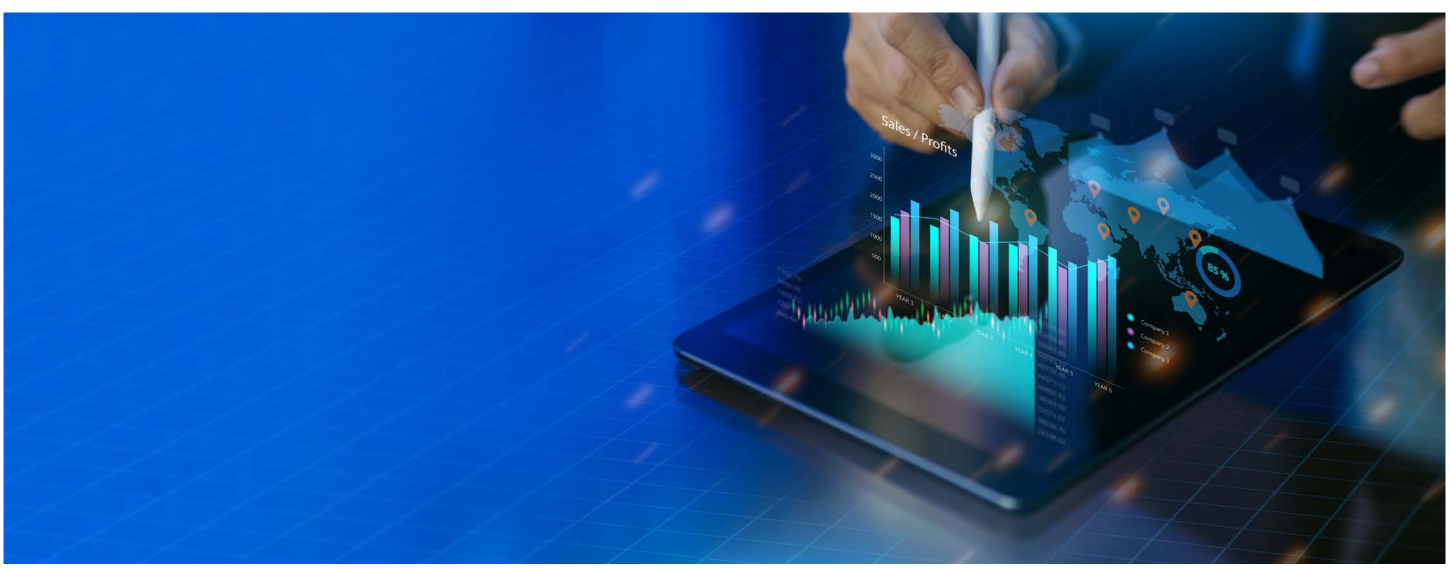
Character of intercompany transactions
In addition to addressing pricing of certain intercompany transactions, an APA can address the character of such transactions—for example, whether a transaction is a service or license of intangible property, a sale or service, or a sale or a license. The character may be determinative of how the transactions are sourced and whether corresponding payments are subject to withholding tax or whether a reduced rate applies.

Attribution of profits to a US permanent establishment
Some foreign multinationals have a taxable presence in the United States through a permanent establishment (PE) under a relevant tax treaty. If the treaty is considered one that incorporates the Authorized OECD Approach (AOA)[5], then transfer pricing principles will be relevant for purposes of attributing profits to a PE. The US Treasury Department and IRS consider the following seven treaties as AOA-compliant US tax treaties: (1) US–UK treaty, (2) US–Japan treaty, (3) US–Belgium treaty, (4) US–Germany treaty, (5) US–Canada treaty, (6) US–Iceland treaty, and (7) US–Bulgaria treaty.[6] Where one of these treaties applies, a foreign multinational with a US PE may obtain an APA to address profits to be attributed to the US PE applying the AOA.

While the United States does not view the AOA as applicable to other treaties, sometimes transfer pricing principles are relevant as well. For example, certain expenses may need to be allocated to the PE from the head office. Guidance for expense allocations is provided in both the US transfer pricing regulations and the OECD Guidelines, respectively.[7]

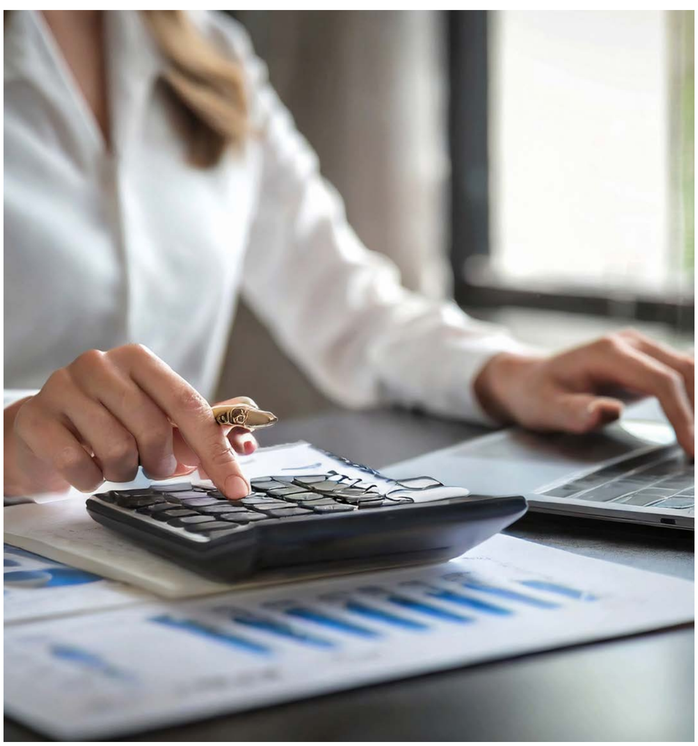
Sourcing of revenue and expenses for a US trade or business
Sometimes a foreign multinational will have a US trade or business, but there is no applicable US tax treaty—e.g., a Taiwan multinational. In such case, sometimes sourcing regulations apply transfer pricing principles. For example, the sourcing of services is addressed by Treas. Reg. § 1.861-4(b)(1)(i) ("Compensation for labor or personal services performed by persons other than individuals"). Such regulation authorizes the use of transfer pricing principles to determine the source of income that most clearly reflects the proper source of transaction processing income earned from sources partly within and partly without the United States under the facts and circumstances.

For example, assume a Taiwanese company has a contract with a customer, and the services are performed by the Taiwanese company's employees in multiple jurisdictions including the United States. The sourcing of the service revenues may be addressed by determining the relative value of services performed within and outside the United States. As the sourcing is depending on the relative values of services performed, transfer pricing principles are relevant, allowing the Taiwanese company to consider a unilateral US APA. In such case, the APA would have to be a unilateral APA because the United States does not have a tax treaty with a mutual agreement article with Taiwan.



Coordination of transfer pricing and customs valuation: APA and customs ruling

In a few instances in the past, at the request of the taxpayer/importer, the IRS worked contemporaneously with US Customs and Border Protection (CBP) to coordinate transfer pricing and customs values to avoid inconsistent treatment. A 2000 CBP ruling approved the use of transaction value for an importer that had obtained a bilateral US–Japan APA and when CBP participated in discussions with the IRS from the prefiling conference forward.[8] CBP held that the APA set forth valuable information in determining that customs values were an arm's length under CBP regulations[9] because both the IRS and Japan's National Tax Administration had negotiated fair results for the Japanese parent and US subsidiary/importer and because CBP could contemporaneously review the selection of the tested party, how the comparable companies were selected, how the determination of financial results related to the controlled transactions, the selection of the years for comparison, what accounting adjustments were made to the financial statements of the comparable companies and of the importer, the selection of the most reliable profit level indicator, the capital adjustments, and the use of the interquartile range. Although not commonplace, a taxpayer/importer may contemporaneously seek an APA and CBP ruling on coordinated basis to reach consistent results and bring welcome relief for a taxpayer being whipsawed by the IRS and CBP.



Coordination of transfer pricing and customs valuation: Section 1059A

Section 1059A[10] is a statutory coordination provision that requires, with certain adjustments (e.g., freight and insurance) and with certain exceptions, that the cost of goods sold (inventory basis) cannot exceed liquidated customs values.[11] Under the US Customs laws, liquidation is the final determination of admissibility and calculation of duties, taxes, and fees owed on entries. Liquidation generally occurs approximately 314 days after the entry of goods and no later than 360 days by operation of law unless liquidation has been otherwise extended (e.g., flagged for value reconciliation) or suspended. If an importer routinely has post-year-end retroactive transfer pricing adjustments, this can create a Section 1059A issue if the adjustments are the type that require corresponding, retroactive customs value corrections/reconciliations that are not effectively made. For example, if a US tested party's operating profit is above the arm's length range requiring an adjustment to increase the price of imported product, section 1059A may prevent the deduction and result in double taxation if the corresponding customs values were not also adjusted when required. Sometimes, the IRS will allow a provision in the APA that protects a taxpayer from a Section 1059A adjustment in the event of any transfer pricing adjustments required to comply with the APA.

Base erosion and anti-abuse tax

The Tax Cuts and Jobs Act introduced the base erosion and anti-abuse tax (BEAT), which is a tax on a base that excludes deductions for base erosion payments to foreign related parties beginning in taxable years beginning after December 31, 2017.[12] Some types of payments to foreign related parties are excluded. Of particular interest is that the cost to provide services that qualify for the Services Cost Method (SCM) under Treas. Reg. §1.482-9(b) without regard to the "business judgment rule" are not considered base erosion payments.[13] The SCM is an elective safe harbor that allows the pricing of certain intercompany services at cost. For purposes of the BEAT, it is irrelevant whether the taxpayer applied the SCM as a transfer pricing policy; what is relevant is whether the services otherwise qualify for the SCM without regard to the business judgment rule.

In addition to addressing pricing of intercompany services transactions in an APA as a Covered Transaction, the IRS's Advance Pricing and Mutual Agreement Program has expressed willingness under certain circumstances to address in an APA whether those services qualify for the SCM without regard to the business judgment rule. Including this issue in the APA provides a taxpayer with certainty that the cost to provide these services is not considered a base erosion payment.

COVID-19 pandemic adjustments
Due to the COVID-19 pandemic, many taxpayers experienced lower levels of profitability that may receive attention from the IRS. An APA with a rollback can address this issue before being spotted by an IRS examination team. Of notable interest, at the end of 2020, the OECD issued guidance on COVID-19 considerations that can assist governments in resolving this issue on bilateral basis through an APA.[14]

Conclusion

Recent increased IRS funding and enforcement initiatives are increasing the risk profile for transfer pricing and other tax issues faced by inbound companies. APAs are a versatile tool to cure transfer pricing and other tax risks—e.g., non-recurring intercompany transactions, attribution of profits to a PE, sourcing of revenue and expense for a US trade or business, coordination with customs values, BEAT, and COVID-19 pandemic adjustments. Any tax issue where transfer pricing valuation issues are relevant may considered appropriate for inclusion in an APA.

Contact

Darrin Litsky
Managing Director, Deloitte Tax LLP
dlitsky@deloitte.com

Calendars to watch

Upcoming Tax Dbriefs:	
March 12 **1:00 PM ET**	**How to prepare for increased transfer pricing enforcement**
March 22 **1:00 PM ET**	**Financial accounting and reporting for income taxes: Important updates**

Endnotes

01. In 1991, the IRS issued Rev. Proc. 91-22, its first formal APA procedures in the United States. These procedures have been updated several times over the years. The current procedures are found in Rev. Proc. 2015-41.
02. Rev. Proc. 2008-31, modifying Rev. Proc. 2006-9.
03. Internal Revenue Service (IRS), "IRS launches new initiatives using Inflation Reduction Act funding to ensure large corporations pay taxes owed; continues to improve service and modernize technology with launch of business tax account," press release, October 20, 2023.
04. IRS, "Large business and international—not currently active campaigns," last updated November 22, 2023.
05. The Organisation for Economic Co-operation and Development's (OECD) 2010 Attribution of Profits Report ("2010 AOA Report") provides guidance on the AOA describing it as a hierarchical multi-step process. The first step hypothesizes the permanent establishment as a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, which considers the functions performed, assets used, and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise. The second step of the AOA applies the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations to any economic relationships (dealings) between the hypothesized separate enterprises (i.e., the PE) and the rest of the enterprise.
06. OECD, "United States Transfer Pricing Country Profile," February 2022.
07. Treas. Reg. § 1.482-9(k) and OECD Guidelines, ¶7.23 *et seq.*
08. HQ 546979 (August 30, 2000).
09. The regulations applicable to determining arm's length for customs purposes are entirely different from determining arm's length for tax purposes.
10. Section references are to the Internal Revenue Code of 1986, as amended and currently in effect.
11. Section 1059A does not apply to duty-free or conditionally free merchandise. Additionally, "first sale for export" is an exception to this rule. See IRS Memorandum No. 201043028 (October 13, 2010).
12. Section 59A.
13. Treas. Reg. § 1.59A-3(b)(3)(i).
14. OECD, *Guidance on the transfer pricing implications of the COVID-19 pandemic*, December 18, 2020.

Tax News & Views podcasts

Need to keep up with tax policy updates? Tax News & Views, our current events–focused tax podcast, can help provide clarity on the latest tax news and developments that could affect your business.

Deloitte Tax podcasts are available on several streaming services: *Apple, SoundCloud, Stitcher, Google Play, Spotify.*

Tax News & Views Podcast Series | Deloitte US