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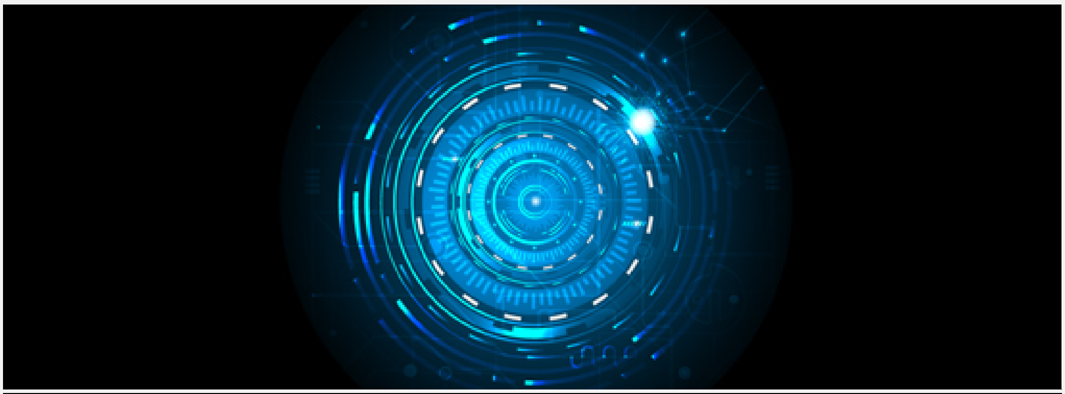

IRS APMA Program releases Functional Cost Diagnostic Model to evaluate potential reliability of profit splits

Global Transfer Pricing Alert 2019-007

The IRS APMA Program recently released an Excel-based Functional Cost Diagnostic Model (FCDM) to assist in its analysis of whether certain intercompany transactions may be more reliably measured by applying a profit split methodology rather than a one-sided comparable profits method (CPM)/transactional net margin method (TNMM) methodology.

The IRS APMA program has requested that several, but not all, taxpayers currently in the advance pricing agreement (APA) process complete the FCDM. Although the FCDM was issued by the APMA Program, it has the potential to be used by the IRS in transfer pricing examinations pursuant to recent IRS guidance requiring coordination between LB&I and APMA on examinations with the potential to generate transfer pricing adjustments involving a country with which the United States has a double tax treaty (see Memorandum for Large Business and International Division employees from Douglas W. O’Donnell, Interim Guidance on Mandatory Issue Team Consultations with APMA for Examination of Transfer Pricing Issues Involving Treaty Countries, dated Feb. 19, 2019, and the IRS Transfer Pricing Examination Process guidance).

The IRS’s use of the FCDM may impact foreign multinational groups that have historically applied CPM/TNMM to evaluate the transfer prices with their US distributors. The FCDM may also impact US multinational groups if the IRS APMA program uses it in MAP cases to evaluate the reliability of profit split-based transfer pricing adjustments issued by foreign tax authorities.

The FCDM was issued in response to the OECD BEPS initiative, as well as positions taken by US and foreign tax authorities in prior transfer pricing examinations and MAP and APA cases, and references the OECD 2017 transfer pricing guidelines. The IRS memorandum issued describes the reason for the FCDM as follows:

> APMA is requesting that the taxpayer complete this model so that APMA can better understand the controlled taxpayers' contributions to the proposed covered transactions, including the respective contributions each controlled taxpayer makes to the exercise of control over the economically significant risks surrounding the proposed covered transactions. Based upon its past direct experience with the taxpayer's prior APAs and its general understanding of the taxpayer's business operations, APMA believes it is necessary to consider whether the arm's length values of the respective contributions to the proposed covered transactions might be more reliably measured by comparing them to one another than by benchmarking returns for the functions a single taxpayer in the proposed covered group performs, the assets it employs, and the risks it assumes.

The FCDM requires the identification, organization, and analysis of "functional" costs, that is, costs incurred by controlled taxpayers within the scope of the proposed APA covered transactions. It also requires taxpayers to analyze the economic value of the contributions associated with the activity for which the functional costs are incurred. The IRS notes that many of the functional costs will be incurred by the controlled taxpayers in performing "routine" functions and that the economic value of such contributions is measurable by reference to benchmarks obtained from comparable uncontrolled transactions.

The FCDM next requires taxpayers to consider which controlled taxpayer(s) incur functional costs having an economic value that would not be measured reliably by referring to benchmarks and that are expected, ex ante, to last beyond a single accounting period. The IRS does not specify what functional costs may meet this description and notes that they will necessarily be specific to the business operations of the proposed covered group and the scope of the proposed covered transactions.

The FCDM directs taxpayers to the 2017 OECD guidelines for guidance on what factors the taxpayer should consider to identify these functional costs. The model addresses these functional costs differently from how it addresses benchmarkable functional costs. The FCDM then accumulates these costs and capitalizes them according to standard formulas and techniques and based on certain assumptions (such as the useful life of a "unique and valuable" contribution) and calculates a pro forma split of residual profits (losses) based on relative accumulated and capitalized functional costs.

The FCDM documentation contains the following important note:

> The fact that the model computes a pro forma residual profit (loss) split does not imply APMA has thereby concluded already that the transactional profit split method – or, more specifically, the residual profit split method ("RPSM") – is the "most appropriate method" for the taxpayer's proposed covered transactions under the OECD Guidelines. APMA will make that determination based upon its review of the facts it obtains through due diligence, including discussions with the taxpayer about the application of this diagnostic model, and the standards set forth in the OECD Guidelines.

This note is significant in that it demonstrates that the IRS APMA Program is evaluating these issues in a reasoned and taxpayer-specific basis. Since not every taxpayer in the APA process has received the request to complete the FCDM, it can be inferred that one-sided CPM/TNMM benchmarking methodologies may continue to be the most common transfer pricing method agreed to in APAs (according to the 2018 Announcement and Report Concerning Advance Pricing Agreements, which covers calendar year 2017, the CPM/TNMM was used for 87 percent of transfers of tangible and intangible property, while all other methods combined accounted for the other 13 percent of such transactions. Most services transactions (86 percent) also used the CPM/TNMM). Nevertheless, it is advisable for taxpayers to evaluate the potential impact of the FCDM as part of their transfer pricing compliance processes.

For further information about how the FCDM may impact transfer pricing policies, please contact your Deloitte Transfer Pricing engagement team or the Deloitte APA specialists listed below.

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