

APAs: A leading practice to resolve and avoid TP disputes



Multinationals are increasingly resorting to advance pricing agreements (APAs) to manage tax disputes globally. With costs and processing times falling, Deloitte's Kerwin Chung, Aldo Castoldi, and Luke Tanner discuss their implications in the US, Japan and Europe.

In its final BEPS Action 14 Report, the OECD acknowledged the increasing number of global transfer pricing (TP) disputes and identified the use of bilateral APAs as a leading practice for tax authorities to provide an increased level of TP certainty, lessening the likelihood of double taxation and preventing disputes.

As per the OECD's guidelines, an APA determines in advance of controlled transactions (typically referred to as 'covered transactions'), an appropriate set of criteria (such as method, comparables and appropriate adjustments, critical assumptions) for the determination of the TP for those transactions over a fixed period of time. Advance pricing agreements offer a way of obtaining tax authority approval of TP policies as an alternative to maintaining TP documentation. Even before the BEPS initiative, taxpayers globally were increasingly using APAs to manage their TP risk, and this trend will likely accelerate over the next few years.

An increasing number of tax disputes

Transfer pricing enforcement is expected to increase throughout the world as countries adopt the OECD's BEPS final recommendations, including the enactment of country-by-country reporting (CbCR). Without an APA, transactions are subject to audit, resulting in the need to assign resources to defend the taxpayer's position before the tax authority over a period of many years.

Resolving and avoiding transfer pricing disputes

Advance pricing agreements help to resolve transfer pricing disputes by allowing the taxpayer to negotiate with tax authorities while the covered transactions are ongoing. Once an APA is concluded, the local tax authorities (or APA team) will only review the taxpayer's compliance with the terms of the APA, and the taxpayer will not be subject to a separate local tax authority audit of the covered transactions.

APAs can also be used to avoid TP disputes involving some of the most complex issues. One example of such an area of complexity is transactions relating to intangibles, particularly in light of the recent OECD work on hard-to-value intangibles (HTVI), which allows tax administrations to consider ex post outcomes as presumptive evidence

about the appropriateness of the ex-ante pricing arrangements. The OECD's HTVI guidance at paragraph 6.193(ii) provides an exception to such ex-post evaluation when the transaction is covered by a bilateral or multilateral APA, in effect for the period in question between the jurisdictions of the transferee and the transferor.

Similarly, the US's APA procedures provide for a potential waiver of the Internal Revenue Code (IRC) Section 482, commensurate with income rules, if the taxpayer enters into an APA (Rev. Proc. 2015-41, Section 6.03). APAs also may help large multinationals avoid TP disputes if they negotiate a portfolio of such agreements with major treaty partners, and then use that portfolio of tax authority agreements to show other tax authorities that their positions have previously been reviewed and accepted.

Several of these areas are explored in more detail elsewhere in the 2019 edition of the Transfer Pricing Controversy Guide. However, this article focuses on how businesses may respond to the increased demands, challenges and technical uncertainties that have developed in the area of TP controversy in recent years.

APA negotiation process

Compared to a tax authority audit, APAs are generally prospective in nature, and may allow taxpayers to lock in transfer pricing outcomes for covered transactions. The APA process brings information gathering and negotiation with tax authorities up front, which may reduce or remove audit risk for covered transactions. This may provide the ability to plan resources and budgeting for the APA process, and potentially a substantial reduction in compliance costs.

An APA may be unilateral (involving the tax authority in one country), bilateral (involving the tax authority in two countries), or multilateral (involving the tax authority in more than two countries). A unilateral APA has the benefit of generally being a simpler, shorter and more cost-efficient process, while still mitigating some risk (on one side of a transaction).

However, to mitigate audit risk on both sides of a transaction and the risk of double taxation, a bilateral APA (or a multilateral APA) is needed. For this reason, bilateral APAs are often the preferred approach for taxpayers with complex or high-risk transactions. The procedures for obtaining bilateral APAs are based on local laws and regulations, and as a result the procedures differ by country. In general, the process for a bilateral APA may involve:

- Information gathering, analysis, strategy and drafting of an APA application. The contents of the application may be specified in local rules. In some countries (such as the US), detailed and prescriptive regulations exist as to the information that must be included in the submission document;
- Preparing pre-filing documentation and attending a pre-filing meeting with tax authorities in each country. This would generally involve the taxpayer and the APA team at the tax authority discussing and agreeing on the scope of the APA, TP issues, and providing a summary of the taxpayer's submission position. The tax

authority may request changes to the taxpayer's submission position or that specific information is included in the APA application. Some countries, such as the US, allow taxpayers to explore the possibility of an APA through an anonymous pre-filing meeting;

- Submission of an APA application to the tax authorities in each country and payment of a fee (if applicable in the relevant country);
- Tax authority review of a APA application and meetings with the tax authority. This would generally involve multiple rounds of information requests and responses, and for the taxpayer to substantiate its position;
- The tax authority typically will convey the substance of its views on the position included in the APA application to the taxpayer, and may request comments from the taxpayer, in advance of providing its formal position paper to the foreign competent authority;
- Negotiation between tax authorities. The competent authorities (CA) of each country will negotiate the terms of the APA at regular meetings between the authorities. While the taxpayer is not involved in the face-to-face negotiations between the tax authorities, the taxpayer will generally have an understanding of both sides' likely position, and where a potential settlement may be reached;
- Agreement. When an agreement is reached, the taxpayer will be notified to confirm it accepts the settlement. The taxpayer will subsequently receive a draft APA/letter of agreement for review. The APA/letter of agreement will then be finalised; and
- Annual reporting by the taxpayer to demonstrate compliance with the APA.

US APA environment

The US has had a formal APA programme since the early 1990s, and has completed more than 1,700 APAs since the programme's inception. The US APA programme is popular, and many taxpayers have renewed their initial APAs and have been active US APA participants for more than 20 years. The IRS APA process is transparent, as the IRS regularly updates and publishes its APA procedures.

The most recent IRS APA annual report indicates that nearly three quarters of the

total number of bilateral APAs executed by the US in 2017 involved bilateral APAs with either Canada or Japan.

Other treaty partners with material numbers of APAs in process include India, China, France, Germany, Korea, Mexico, Switzerland, and the UK.

In 2017, the median time to complete a bilateral APA was 35.9 months. Taxpayers renewing APAs benefitted from faster processing times for their APA requests. Forty-four percent of the transactions covered in APAs executed in 2017 involved the sale of tangible goods, 35% involved the provision of services, and 21% involved the use of intangible property.

Over the past few years, the IRS has taken material steps to improve one of the most common global concerns about the APA process, namely, the length of time to negotiate an APA. These initiatives have included:

- CA framework agreement with India to resolve large numbers of MAP cases and allowing for the negotiation of bilateral APAs to commence;
- In 2015, the IRS introduced new APA procedures setting forth a uniform format for APA submissions;
- 2016 and 2018 agreements with Mexico, providing that US taxpayers with maquiladora operations in Mexico will not be subject to double taxation if they enter into a unilateral APA with the large taxpayer division of Mexico's Servicio de Administración Tributaria (SAT);
- Issuing an updated APA template in 2018 for taxpayers to prepare as part of the APA submission process. The new APA template notes that it is intended to:

1. Systematise how taxpayers propose terms for their APAs;
2. Standardise language used in executed APAs;
3. Improve efficiency in the APA process;
4. Enhance consistency in the administration of the APA programmes; and
5. Minimise editing by using an options-based format for selecting from terms presented in certain sections of the model APA.

The IRS advance pricing and mutual agreement (APMA) programme has also adopted internal processes to manage its APA inventory caseload to review processing time and ensure that similar transactions are resolved in a consistent manner

Japanese APA environment

Japanese multinationals are consistently among the top users of bilateral APAs globally, and have been the top counterparty jurisdiction for APAs with US multinationals for a number of years.

Based on recently released statistics from the Japanese National Tax Agency (NTA), the number of bilateral APA applications in Japan increased by more than 25% from 131 applications in 2016 to 166 applications in 2017 (the most recent year reported), and an almost 50% increase in the number of applications from 2011.

The number of bilateral APAs resolved each year by the NTA also has been generally increasing, but not at the same rate as the number of applications received (including a decrease from 2016 to 2017). The average processing time for bilateral APAs in Japan was 30.7 months in 2017 (also representing an increase from 28.9 months in 2016). However, this includes an increasing number of APAs with non-OECD countries that historically have taken longer to conclude (52 months in 2017).

In terms of future trends, processing times and the annual number of cases resolved by the NTA can be expected to improve as a result of Action 14 of the OECD BEPS initiative, under which tax authorities have committed to resolve cases in a shortened time frame. Recent changes to the Japanese APA guidelines (discussed below) can also be expected to improve the timing of concluding APAs, particularly for non-OECD countries.

In addition, an increase in APA applications can be expected, particularly in the context of increasing audit activity currently being observed among foreign multinationals operating in Japan. The Japanese tax authorities now have access to CbC reports and master files (which are required to be submitted locally), and also appear to be requesting TP documentation (that is, local files) at the commencement of all corporate income tax audits.

Finally, the Japanese government is widely expected to introduce HTVI rules, which would allow the authorities to make TP adjustments based on after-the-fact outcomes and data. In this context, the risk mitigation provided by an APA is expected to be an attractive option for many taxpayers.

Recent changes to Japan's administrative guidelines

Japan's administrative guidelines (the Commissioner's Directive on the Operation of Transfer Pricing) does not have the force of law, and is not binding on Japanese taxpayers. They are intended to encourage a consistent application of Japan's transfer pricing rules at the various levels of the tax authorities. They are an important source of guidance on how the Japanese authorities are likely to proceed. In 2018, the NTA released a revised version of the administrative guidelines, which made four important changes to the APA landscape in Japan.

Clarification on the relationship between audits and APAs

Historically, there was no clear guidance in Japan on the relationship between tax audits and APAs, other than a statement that an APA application does not preclude the tax authorities from conducting an audit, and that information provided during the APA process generally cannot be used in tax audits.

In practice, however, there was a tacit understanding among taxpayers and practitioners that, when a taxpayer requests an APA, the APA-covered years would not be subject to tax audits, and that this would include any years covered by a retroactive application of the APA (an APA rollback).

The 2018 amendments to the administrative guidelines clarify the NTA position that even when a taxpayer requests a rollback in an APA application, a tax examiner is not barred from carrying out an audit of the rollback years. The changes also clarify that relevant filings would not be subject to tax audits for the APA years while an APA is being discussed or agreed.

Introduction of deadlines for information requests

The 2018 amendments also introduced a deadline for responses to information requests from the Japanese tax authorities during their review of APA application. The administrative guidelines now state that an information request must be answered before the deadline set by the APA review officer, which will not exceed 45 days from the date of request.

If the deadline is not met, the tax authorities may classify the application as not appropriate to review or conclude an APA, resulting in either a withdrawal of the APA application by the taxpayer, or a denial of the APA application by the Japanese tax authorities. The new deadline is consistent with the timing for large companies to submit their local file after a request, indicating that the tax authorities deem 45 days a reasonable amount of time for taxpayers.

Importance of pre-filing

A newly added article to the administrative guidelines states that the Japanese tax authorities should direct taxpayers to hold a pre-filing meeting before filing an APA application. Although pre-filing meetings are not mandatory under law, the addition of this article suggests that the Japanese authorities place great importance on holding the pre-filing meeting before filing an APA application.

A pre-filing meeting presents an opportunity for the Japanese tax authorities to present their comments and guidance to taxpayers as to what they would prefer to see in the APA application. The changes to the administrative guidelines are consistent with comments in the NTA's TP Guide Book for Taxpayers issued in 2017, further demonstrating the importance the tax authorities place on the pre-filing meeting.

While it is within a taxpayer's right not to hold a pre-filing meeting, and there may be reasons a taxpayer chooses not to do so, careful consideration of this issue would be warranted, given the risk of prejudicing the APA negotiation process.

Special conditions for suspending an APA review

Changes were also made to allow the tax authorities to suspend review of bilateral APA applications in the event of delay. Recently, the NTA has noted an increasing number of bilateral APA applications involving countries whose CA's have limited APA experience (for example, non-OECD countries).

The 2018 amendment provides that a bilateral APA application must be withdrawn or converted to a unilateral APA if the application is not (or is unlikely to be) received or accepted by the counterparty competent authorities within three years from the day after the filing deadline.

For APAs filed before the amended administrative guidelines were published, the three-year period begins on the date of the amended administrative guidelines, rather than the standard timing. This change is aimed at assisting the NTA to clear its APA inventory of cases in which there is a long delay, which can be observed in the statistics described above.

European APA environment

APAs have become increasingly popular with European MNEs in recent years as a mechanism for obtaining certainty and alleviating the risk of double taxation. In Europe, they often start with unilateral APAs, but then move quickly to negotiating bilateral and even multilateral agreements. According to the European Commission, there were only 399 APAs in the region in 2013.

This number increased to 804 in 2014, 1,252 in 2015, and 2,053 at the end of 2016. The number rose by approximately 64% from 2015 to 2016, and this trend is continuing. Belgium had the greatest number of APAs in place in 2016 (1,081), followed by Luxembourg (599). Italy, which is third on the list, had substantially fewer APAs in place (73), followed closely by Hungary (63), and the Czech Republic (54).

The following member states reported to the European Commission that they did not enter into any unilateral APAs in force in 2016: Austria, Bulgaria, Croatia, Cyprus, Denmark, Estonia, Germany, Ireland, Malta, Slovenia, and Sweden.

Belgium recorded the highest increase in the number of APAs in force, from 157 in 2014, to 396 in 2015, and 1,081 in 2016. The number of APAs in Luxembourg rose from 347 in 2014, to 519 in 2015, and 599 in 2016. The majority of unilateral APAs in force in the EU concern only other EU member states. However, roughly 25% also involve non-EU countries.

Average completion times for bilateral and multilateral APAs in EU countries vary significantly. For example, based on recent statistics, the UK and France represented a lower average completion time of 25 and 26 months respectively, whereas Italy and Germany's average completion times for APAs were 28 and 52 months, respectively.

Recent changes and guidance

While a growing number of jurisdictions have implemented legislation or formal guidance establishing an APA programme, some countries such as Belarus, Bulgaria, Croatia, Estonia, and Iceland lack formal guidance or legislation. Other countries such as Slovenia have formal rules, but lack detailed guidelines for taxpayers, while Norway has recently introduced a pilot programme to expand APA availability to the oil and gas industry.

The approach taken within Europe, and even in the EU itself, is not uniform. Considerations such as eligibility for an APA, filing fees and deadlines, procedures specifically designed for small and medium-sized enterprises (SMEs), and rollback availability, can vary significantly. Such factors currently need to be taken into account on a country-by-country basis before initiating the APA application process.

Taxpayers need to ensure that the covered transactions under the APA meet relevant acceptance criteria first. Some jurisdictions have guidance or discretionary practices that will be considered by the CA on determining whether a taxpayer is eligible to proceed with a formal APA application. Factors include the size of the taxpayer's organisation and the revenue it generates, the complexity of the transactions to be covered by the APA, and any collateral issues such as outstanding administrative or judicial proceedings.

For instance, Albania, Georgia, Russia and Ukraine have set a minimum threshold value of the relevant intercompany transactions for an APA application. On the other hand, countries such as France, Germany, and the Netherlands have specific procedural guidance for APA-seeking SMEs whose transactions are sufficiently complex and that face double taxation risk as a distinct possibility without APAs.

The filing fee for an APA also varies considerably among EU jurisdictions. In a number of continental European jurisdictions (including Albania, Austria, Czech Republic, Germany, Greece, Hungary, Latvia, Luxembourg, Poland, Portugal, Romania, Slovakia, Sweden and Turkey) a filing fee is payable, whereas the Finnish CA charges a fee on the implementation of the ruling that depends on its complexity.

Other countries, such as Belgium, Denmark, France, Italy, Ireland, Kazakhstan, Lithuania, the Netherlands, Spain, Switzerland and the UK do not charge a fee. In a number of jurisdictions, taxpayers willing to apply for an APA may discuss with the CAs at a pre-filing stage the term of the proposed APA.

Consistent with global norms, in Europe, a typical APA would have a five-year term. However, this varies depending on the jurisdiction and how flexible any local regulations are. Some jurisdictions allow for the outcome of an APA to be applied retroactively to previous years (an APA rollback).

Expected future trends

In line with global trends, there is increasing scrutiny by governments and tax authorities, as well as growing complexity of transfer pricing issues within the EU and Europe. In this context, European multinationals are seeking to manage their tax and TP risks proactively.

APAs, to the extent they are made available by the countries where multinationals carry out operations, are becoming the preferred strategy that many choose as a way to prospectively apply approved TP methods to mitigate the risk of future adjustments or double taxation.

Further increases in the use of APAs are expected, particularly when taking into account the recent recommendations of the OECD/G20, that countries should seek to implement bilateral APA programmes as soon as they have the capacity to do so. In a cross-border transaction scenario, bilateral APAs, which contemporaneously bind the applicants and both tax authorities involved, are intuitively more effective than unilateral APAs in ensuring that the agreed TP policy is accepted in both countries.

As a consequence, a large number of European countries have in the last few years directly introduced the right to access bilateral APA programmes, or clearly shifted their focus from unilateral to bilateral (or even multilateral) APAs, encouraging taxpayers to use the APA programme.

Final thoughts

In the opinion of many observers, the OECD BEPS initiative and the resulting changes in domestic legislation may lead to increased global tax controversy and uncertainty relating to future transfer pricing outcomes. This, combined with the current tax environment (a growing number of countries with nationalist interests and more assertive tax authorities), may lead taxpayers to find it even more advantageous to consider APAs as a leading practice to navigate uncertainty and to manage multilateral tax controversy.

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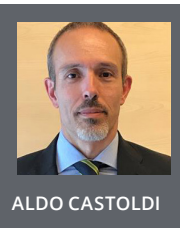
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