

# APAs: Navigating Uncertainty in the Pursuit of Certainty

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*Salim Rahim, Summer Austin, Eric Torrey, and Amanda Worcester-Martin of Baker McKenzie discuss the new processes for the review and acceptance of APA requests and highlight areas where more clarity is needed.*

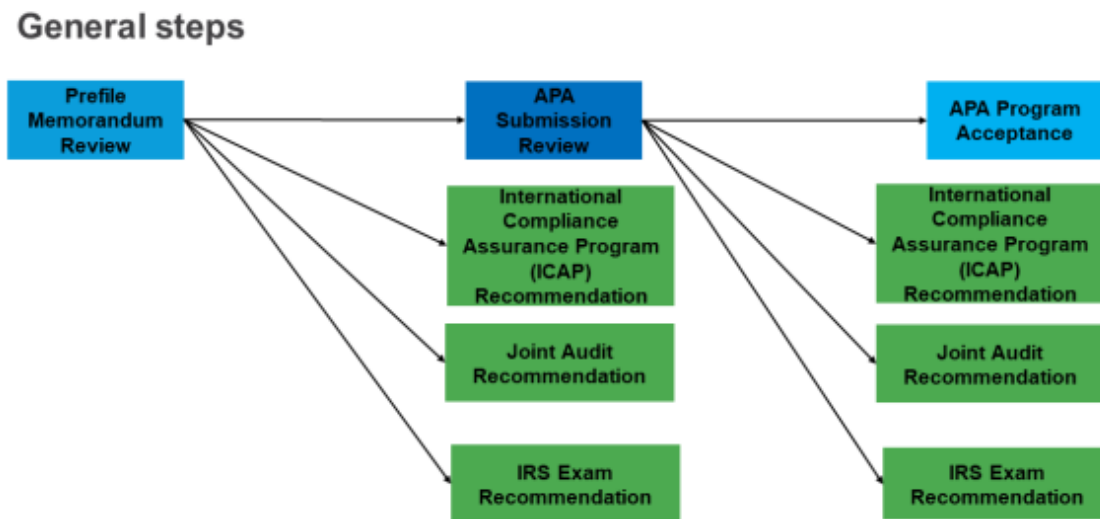
On May 1, 2023, the acting IRS Director of Treaty and Transfer Pricing Operations (TTPO) published interim guidance to TTPO employees on the review and acceptance of APA requests, (the “Interim Guidance”). This Interim Guidance describes a “Procedural Change” that will need to be followed before a taxpayer will be formally accepted into the APA program. Taxpayers that submit an APA prefiling memorandum or APA request may receive a recommendation to pursue what the IRS characterizes as “alternative workstreams” to an APA, including joint audit, IRS Transfer Pricing Practice (TPP) examination, or the International Compliance Assurance Program (ICAP). While the stated goal of the Interim Guidance is “to improve the quality and timeliness of APMA’s APA program” – a goal that should be lauded – the review process and the alternative workstreams outlined in the Interim Guidance may lead to unintended consequences. We recommend that TTPO clarify certain aspects of the Interim Guidance, as discussed below, before it is incorporated into the IRS’s Internal Revenue Manual (IRM).

## Interim Guidance Overview

The Interim Guidance outlines new internal procedures for (1) the review of APA prefiling memoranda and (2) the review and acceptance of APA requests and renewal requests. While the Interim Guidance asserts that it applies to APA prefiling memoranda and APA requests filed from the date of issuance of the guidance, we understand that these procedures are unfortunately being applied to APA requests that were filed prior to this date.

Under the Interim Guidance, the IRS will review an APA prefiling memorandum or an APA request to determine whether the request should be accepted into the APA program or recommended for evaluation through an alternative workstream, such as ICAP, joint audit, or a domestic audit.

According to the Interim Guidance, taxpayers can expect the prefiling review process to take up to four weeks and the APA submission review to take up to eight weeks, though these timelines may be extended if the IRS requests additional information or if a prefiling conference is held. **Figure 1** below is a high-level flow chart that captures the Interim Guidance's review process.

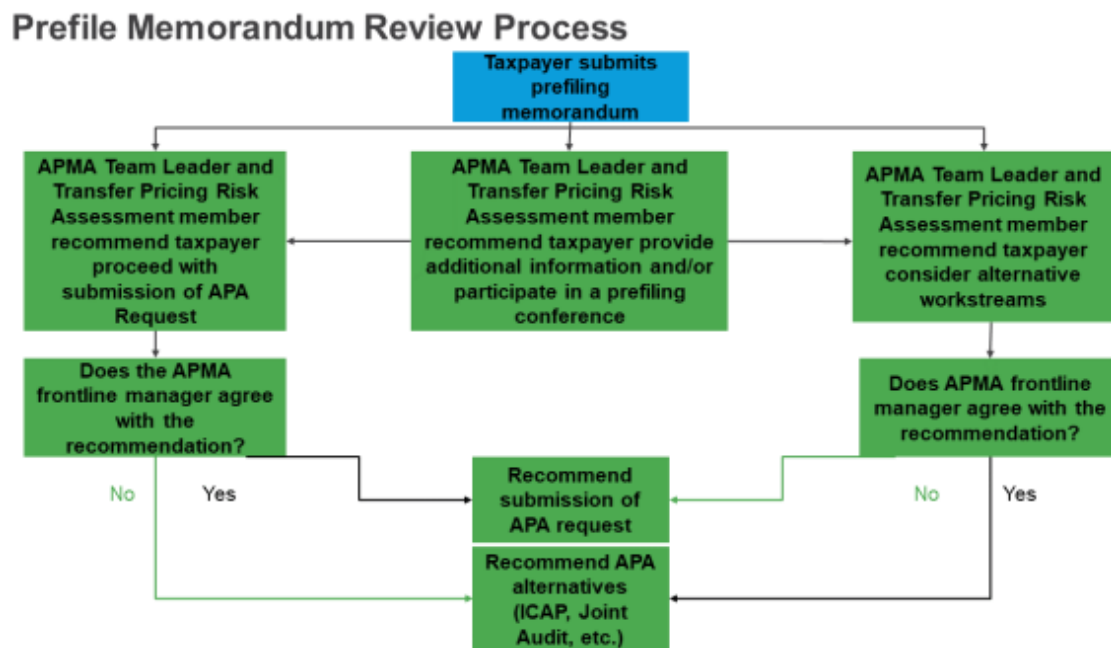


**Figure 1: Interim Guidance Overview**

Under the Interim Guidance, the IRS recommends that taxpayers seeking an APA submit a prefiling memorandum. In order to facilitate a prefiling discussion with the IRS, this memorandum should contain content appropriate to the substantive or procedural issues to be discussed with APMA, which may include background information, the proposed APA term, and a discussion of the proposed covered issues. The recommendation that a prefiling memorandum be filed for all APA cases is a change from the guidance on APAs under Revenue Procedure 2015-41 (the “Revenue Procedure”). Under the Revenue Procedure, taxpayers are required to submit a prefiling memorandum only in particular circumstances outlined in section 3.02(4) of the Revenue Procedure, though taxpayers have the option of voluntarily submitting a prefiling memorandum and are recommended to do so in certain specified instances (e.g., areas that present novel or complex issues). While the recommendation that all taxpayers now file a prefiling memoranda is a modification from the Revenue Procedure, it may not result in a practical change for most taxpayers, as most submitted pre-filing materials under the Revenue Procedure.

Once submitted, an Advance Pricing and Mutual Agreement (APMA) Team Leader or economist and a member of the Transfer Pricing Risk Assessment (TPRA) team will review the prefiling memorandum to determine whether the APA workstream is well suited to achieve certainty for the proposed covered transaction(s). TPRA performs high-level risk assessment using data analytic techniques to identify and evaluate transfer pricing risks in the Large Business and International Division (“LB&I”). The prefiling memorandum review team will evaluate a range of factors, including the significance of the proposed covered transactions, the proposed covered years, the potential for enhancing transfer pricing compliance, and the suitability for resolution through ICAP, among others. Based on the review, the team will recommend to an APMA frontline manager whether to proceed with the submission of an APA request, consider an alternative workstream, or request additional information from the taxpayer. The APMA frontline manager ultimately decides what recommendation to issue at the close of the prefiling memorandum review process. According to the Interim Guidance, this review should be completed and an *oral* recommendation provided to the taxpayer within four weeks of the date of the prefiling memorandum or the date when additional information requested by APMA is submitted by the taxpayer, whichever is later. Before reaching a determination, the reviewers may also request that the taxpayer participate in a prefiling conference, which may further delay obtaining a recommendation. A high-level flow chart of the prefiling memorandum review process can be found in Figure 2.

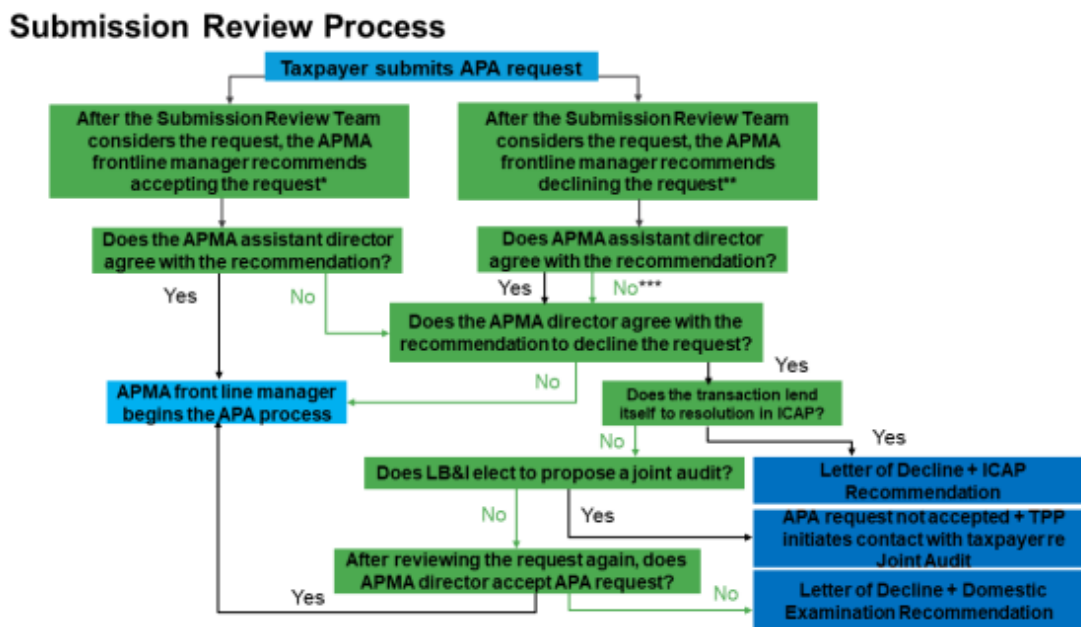
Figure 2: Interim Guidance - Prefiling Memorandum Review Process



If a taxpayer submits a prefiling memorandum, receives an oral recommendation to proceed with the submission of an APA request and submits an APA request, the APA request will still be subject to a second stage of review, as described below.

The APA request review process is significantly more complex than the process currently set forth in the IRM and will be conducted by, and subject to signoff from, several more IRS personnel as compared to the prefiling review stage. In particular, the review of the APA request will be performed by a team that includes an APMA Team Leader, an APMA frontline manager, a Treaty Assistance and Interpretation Team (TAIT) analyst (if non-transfer pricing treaty issues are presented), a member of the TPRA team, and a member of the IRS's TPP (the "Submission Review Team"). This team will consider multiple factors in determining whether to accept the APA request, including the materiality and complexity of the transaction(s), the possibility of a transfer pricing dispute, country-specific strategic considerations, the suitability for ICAP, and the interest of the IRS in examining the transaction(s). Based on this review, the Submission Review Team will make a recommendation on whether the APA request should be accepted or whether the matter should be addressed through an alternative workstream. This recommendation will then be subject to review by the APMA assistant director and potentially the APMA director, the TPP territory manager, and LB&I. According to the Interim Guidance, this process should be completed within eight weeks of receiving the full APA request. If a taxpayer submits an APA request and receives a rejection at the conclusion of the IRS's APA submission review process, this rejection is not subject to administrative review per Section 2.02(3) of the Revenue Procedure. Figure 3 below presents a high-level flow chart of the APA submission review process.

Figure 3: Interim Guidance - Review of APA Submissions Process



**\*Recommendation to accept the APA request may include conditions (e.g., the assignment of a TPP specialist to the APA case team or that certain covered transactions or rollback years not be accepted; communicating to the taxpayer challenges that increase the likelihood that the process could result in a failure to conclude an APA and any specific expectations regarding the taxpayer's provision of information and engagement in the process).**

**\*\*Recommendation to decline should include any alternative workstream the Submission Review Team believes would have a higher probability of success.**

**\*\*\*If the APMA assistance director does not accept the APMA frontline manager's recommendation, the frontline manager's and the assistance director's recommendations will be elevated to the APMA director.**

## Alternative Workstreams

As noted above, during the prefiling review process or the APA submission review process, the IRS may recommend that issues identified in the APA request be addressed through an alternative workstream, including IRS TPP examination, joint audit, or ICAP.

Transfer pricing audits are typically resource intensive for both the IRS and the taxpayer. Indeed, many taxpayers who seek the certainty of an APA do so to avoid a resource intensive and inefficient audit. If a taxpayer submits a prefiling memorandum or APA request and is not accepted into the APA program, it creates a disincentive for a taxpayer to consider an APA in the first place particularly if the rejection materializes after the taxpayer has expended significant resources in preparing and submitting an APA request.

A joint audit of transfer pricing issues will typically involve simultaneous audits by two tax authorities of transactions between related parties in the relevant jurisdictions. Cooperation between the two tax authorities may be limited to information sharing, joint discussion, and reconciliation of relevant facts, or it could involve a more comprehensive process in which a bilateral resolution is reached between the tax authorities on the appropriate transfer pricing. If a taxpayer is subject to audits in two jurisdictions on the same issues at the same time, then a joint audit has the potential to streamline the process for resolving the dispute, but this could lead to inefficiencies if timelines do not align. Joint audits may also result in more information being shared than would have occurred under independent, domestic audits.

The Interim Guidance appears to place a heavy emphasis on ICAP as an alternative to APAs. ICAP is a new voluntary program launched by the OECD in 2018, and is seen as complementary to other measures (APA, MAP, tax audits). Currently, 22 jurisdictions participate in ICAP, and ICAP provides an opportunity to engage with countries that the US does not have a treaty with (e.g., Argentina, Chile, Colombia and Singapore). In general, the IRS intends to consider for ICAP review all transfer pricing transactions in which the US is a counterparty, except those covered by bilateral APAs. ICAP can also cover other international tax issues (e.g., permanent establishment, withholding taxes, etc.). Under ICAP, tax authorities usually consider one or two of a taxpayer's most recent periods plus two roll-forward periods. For the ICAP process, at least three jurisdictions are required to participate. According to the OECD, the optimal number of countries is between four to eight in one ICAP review. As compared to APAs, ICAP review is supposed to have a significantly shorter timeline, targeted to be between 24-28 weeks, but that can vary based on the complexity of the issues. There are no user fees for participating in this program.

The main difference between ICAP and other measures is the level of certainty for the taxpayer. ICAP does not provide legal certainty in the form of a binding agreement like an APA. Through ICAP, a taxpayer may only obtain “comfort” from a participating tax administration that it “does not anticipate that compliance resources will be dedicated to a further review of covered risks for a defined period.” The letter may also contain qualifications and is not binding for the tax administration. As part of the ICAP review, a tax administration may also refuse to provide such comfort and instead recommend an APA and/or follow with a tax audit.

### **Unintended Consequences of the Interim Guidance**

The IRS identified quality and timeliness as the goals of the Interim Guidance. According to the memorandum accompanying the Interim Guidance, the new procedures aim to “align LB&I processes for APAs to be consistent with our strategy and maximize the probability of successful, timely, and comprehensive resolution of transfer pricing issues for both taxpayers and the IRS.” We understand that this guidance is also intended to formalize and standardize practices and ensure that there is a consistent application of review steps across all teams within and outside APMA. In pursuing timelier and better-quality outcomes, the memorandum notes that the guidance is not necessarily intended to limit or reduce the number of APA submissions accepted by APMA, but instead provide “an early mechanism for identifying potential roadblocks to successfully concluding a proposed APA and opportunities for other paths to certainty.”

Although not explicitly stated, it is possible that the change in process was informed or motivated by challenges that APMA has faced with a lack of resources and the increased lag time between acceptance and conclusion of APAs. Based on APMA’s most recent annual APA report issued on March 29, 2023, the median completion time for all APAs increased in 2022 to 43.4 months (up from 35.1 months in 2021 and 32.7 months in 2020). Likewise, for the second year in a row, APMA received more APAs than it concluded. Specifically, during 2022, APMA received 183 APA applications, while only 77 APAs were executed, thus increasing the inventory of pending APAs.

It is possible that the increased IRS budget mandated by the Inflation Reduction Act (roughly \$80 billion over 10 years based on legislation enacted last August) will ultimately relieve some of APMA’s resource constraints. That said, it is unclear whether this funding would increase APMA’s funds to hire additional resources. In addition, the recent deal that was reached between the White House and Congress to raise the debt ceiling limit calls for roughly \$21.4 billion of IRS budget cuts, slashing part of the nearly \$80 billion in agency funding. As such, the lack of resources will likely remain an issue for APMA, at least in the near term.

Further, while TTPO's stated purpose for implementing these rules is to improve quality and timeliness, the procedures may well have the opposite effect, leading to potential inefficiencies and reduced tax certainty. For example, as depicted in the diagrams above, the Interim Guidance introduces several additional steps during the APA inquiry and submission process, leading to increased burden on both taxpayers and the IRS. This additional burden may discourage taxpayers from seeking an APA for issues and transactions that would otherwise be appropriate for resolution through the APA process. Taxpayers may also stay away if they believe submission of an APA request or prefiling memorandum may increase the likelihood of a transfer pricing audit, particularly considering the requirement in the Revenue Procedure that taxpayers submit with the APA request a signed extension of the period of limitations for the proposed APA years.

Assuming that taxpayers are willing to engage in the new APA process, it is not certain that diverting taxpayers to ICAP (on a voluntary basis) or to a US transfer pricing audit (on a non-voluntary basis) will ultimately increase efficiency or reduce burdens on APMA. While such a diversion may temporarily relieve APMA's workload, it may lead to an increase in audits both in the US and abroad that require significant investments from taxpayers and tax authorities alike, and ultimately need to be resolved through the MAP process. There are undoubtedly matters involving certain treaty countries that cannot productively be resolved through APAs and are better candidates for MAP resolutions. However, the approach set forth in the Interim Guidance may well divert to audit, and subsequently MAP, cases that could have been more efficiently resolved through an APA.

Through its focus on ICAP, the Interim Guidance appears to suggest that the IRS may start encouraging taxpayers to address their transfer pricing issues through ICAP. For example, routine transactions involving several ICAP participant jurisdictions may be viewed as potentially better suited for ICAP, as ICAP requires fewer resources, would likely take less time, and can cover multiple jurisdictions. However, the fact remains that ICAP does not provide the taxpayer with legal certainty and obtaining a letter of "comfort" may not comfort a taxpayer seeking legal certainty.

Given these constraints, it is unlikely that a material percentage of taxpayers who are considering an APA will voluntarily decide to engage in ICAP. While joint audit may offer an efficient avenue for resolution in some cases, it is challenging because of the close coordination and timing alignment required between the examination teams of the respective tax authorities. This means that the majority of transfer pricing cases that are not accepted into the APA program will simply be left unresolved until they are audited by either the IRS or the foreign tax authority and ultimately resolved unilaterally or through the MAP process.

On the bright side, we are pleased to hear that the IRS will monitor the process of this new guidance and its outcomes and adjust as needed before the Interim Guidance is formally incorporated into the IRM. In our view, it would be very helpful if the IRS could clarify several procedural points before the Interim Guidance is incorporated into the IRM or before additional guidance is issued under a new revenue procedure.



## Recommendations for Clarification

*Timing for Applying Interim Guidance.* Any retroactive application of the Interim Guidance should be curtailed. We recommend that the Interim Guidance not be applied to prefiling memoranda and / or APA requests filed before May 1, 2023, as taxpayers who filed their prefiling memoranda or APA request before such date were unaware of the “procedural change” introduced in the Interim Guidance.

*Anonymous Prefiling Discussions.* We recommend clarifications on how the Interim Guidance takes into account the option for taxpayers to engage in anonymous prefiling discussions per the Revenue Procedure.

*Interaction between Prefiling Memorandum Review and APA Request Review Stages.* We recommend clarifying the interaction and ensuring consistency between the prefiling memorandum review procedures and the APA request review procedures in the Interim Guidance. As currently drafted, APMA could recommend at the conclusion of the prefiling memorandum review process that the taxpayer may file an APA request but then APMA has the discretion to reject the APA request after the taxpayer has committed significant resources to preparing and filing the request. This risk of rejection may be unfairly heightened under the Interim Guidance due to the use of a different set of reviewers during the two stages of review. Further, it is not clear why certain factors that are to be considered during the APA request review stage are not also to be considered in the prefiling review stage – for example, APMA's experience with the proposed treaty partner and whether APMA has had more success in MAPs as compared to APAs with that treaty partner. If these factors are relevant to the APA request acceptance review, they should be identified and discussed during the prefiling stage review.

*Weighting of Factors.* More clarity should be provided on the types of cases that are best suited for APAs. We recommend that APMA consider providing additional detail or instruction regarding how each of the factors are to be considered and weighed in determining whether an APA or ICAP/joint audit or other process is most appropriate for a given taxpayer. For example, during the prefiling review, one of the factors to be considered is whether the “covered transactions rise to a level of significance that justifies the use of resources necessary to engage in and complete an APA.” We would recommend clarifying how this is analyzed and measured For example, is significance based on the dollar amount at issue? The complexity of the transaction? The history of or risk of audit in the United States or the other Treaty jurisdiction?

*Renewal Requests.* We would recommend that any new or amended guidance clarify whether (and perhaps why) additional conditions are to be considered in the case of a renewal request. Based on the Interim Guidance, it appears that APA renewal requests are subject to greater acceptance requirements than new APA requests. It seems inefficient to apply additional factors to determining whether to accept a renewal request as compared to a new case, given that renewals generally represent a more streamlined process and take significantly less time to negotiate based on APMA's annual reports (28.3 months to complete a renewal APA compared to 53.0 months to complete a new APA based on the 2022 Annual APA Report).



*TPRA and TPP Involvement.* As part of the APA submission review, the Interim Guidance explains that the TPRA team will provide a risk assessment for the Submission Review Team's consideration. It would be helpful to clarify the purpose of this risk assessment for determining whether an APA is an appropriate path for resolution. We recommend that any amended or new guidance address the specific factors the TPRA team will consider in this risk assessment so that taxpayers may take this into consideration in analyzing whether to pursue an APA.

*Taxpayer Protections and Assurances.* Since the Interim Guidance "is not intended to limit or decrease the number of APA requests accepted by APMA," we recommend providing additional taxpayer protections so that taxpayers can continue using the APA program to effectively and efficiently resolve transfer pricing issues. For example, when a taxpayer goes through the prefiling review process with APMA and is invited to submit an APA request at that stage, we recommend that it be clear the APA request will not be rejected during the APA request review stage absent some material misrepresentation or misstatement of fact, given the substantial time, effort, and resources required for taxpayers to prepare an APA request that satisfies all of the substantive and formal requirements set forth in the Revenue Procedure. This is a patently reasonable approach and is supported by the Interim Guidance itself, which provides: "[A] successful outcome for achieving transfer pricing certainty is based not only on reaching agreement but also doing so with an appropriately commensurate commitment of financial and human resources for *both* the taxpayer and the tax administrations involved."

Additionally, given that the new guidance appears to create additional hurdles to acceptance, we would recommend that, if a taxpayer pays an APA user fee and the APA request is rejected, then the guidance clarify that APMA will refund the taxpayer's user fee under Section 4.02(2) of the Revenue Procedure, particularly where a taxpayer has engaged in the prefiling process and obtained a recommendation to move forward with filing of an APA request. In the alternative, we would recommend that the payment of the user fee be postponed until after the APA request has been accepted given APMA's due diligence and analysis phase will begin in earnest after acceptance.

We would also suggest that TTPO consider allowing taxpayers to postpone extending the period of limitations pursuant to the requirements of the Revenue Procedure for the proposed APA years until after the APA request has been accepted, or in the alternative, make clear in writing that they will not execute the extension submitted with the request until the APA request has been accepted.

*Engagement with Treaty Partners.* Since most of the APA requests filed with APMA are bilateral (approximately 84% based on the 2022 Annual APA Report), it would also be important to clarify how the Interim Guidance would promote cooperation with treaty partners. While the Submission Review Team may, at its discretion, seek the views of the treaty partner(s) in a bilateral or multilateral APA, it does not need to do so, and it is not clear how those views would weigh into the determination of whether to accept an APA request, particularly where the treaty partner's views may diverge from APMA's views. We think it is important that the Submission Review Team consider the treaty partner's view on the materiality and complexity of the proposed covered issues in the APA request, and we recommend that IRS guidance clarify that APMA intends to take these views into account as appropriate. For example, what may be viewed as a routine or not "complex" transaction or issue from APMA's perspective may not align with the view of the treaty partner. These routine issues can often give rise to significant controversy in foreign jurisdictions that may disagree with the routine characterization of the transaction and entity, or with the method applied. In those cases, the APA program is the optimal venue to resolve potential disputes over characterization and ensures the treaty partners are reaching a resolution that resolves potential double taxation in a prospective, transparent and cooperative manner. We also recommend that the guidance clarify whether the Submission Review Team will take into account the treaty partner's experience with joint audit or ICAP in considering whether an APA is the best avenue for resolution.

## **Conclusion**

APAs are a valuable tool for both taxpayers and tax authorities to efficiently address potential transfer pricing disputes, particularly those that are complex or contentious. It is in the interest of both taxpayers and tax authorities to have a more efficient process with the aim of shorter negotiations and earlier certainty. The stated intent of this guidance (i.e., "to improve the quality and timeliness of APMA's APA program") is laudable but as this article has noted, the guidance is at times ambiguous and could produce results that are contrary to the IRS's stated intent.

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