Utilization of Advance Pricing Agreements (APAs) to Resolve Taxpayer/IRS Transfer Pricing Conflicts

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Developed in 1991 as an alternative to the traditional adversarial process, the Advance Pricing Agreement (APA) Program attempts to resolve transfer pricing disputes in a principled and cooperative manner. The APA process is designed to enable taxpayers and the IRS to agree on the proper treatment of transfer pricing including cost sharing arrangements. An APA need not cover all of a taxpayer's pricing arrangements and instead may be restricted to specified years, specified affiliates, and specified intercompany transactions. APAs may be "unilateral" or "bilateral." A unilateral APA is an agreement for a prospective period of time between the taxpayer and the IRS on the appropriate transfer pricing method (TPM) for the transactions at issue. With this approach, there is no guarantee that the foreign country's taxing authority will agree that the TPM is correct. A bilateral APA combines an agreement between the taxpayer and the IRS on a particular TPM with an agreement between the United States and foreign taxing authority regarding the propriety of the TPM.

The APA process focuses on identifying an appropriate TPM, not a desired tax result. The ultimate goal of the APA process is to arrive at an agreement on three basic points: (1) the description of the intercompany transactions to which the APA applies; (2) the TPM to be applied to those transactions; and (3) the arm's length range of results that is expected after applying the agreed-upon TPM to the covered transactions.

The APA process enhances taxpayer compliance by providing an alternative forum to resolve transfer pricing disputes. The success of the APA process is due in part to the coordination and cooperation from all aspects of the APA team including the examination function. The success of the APA program in resolving transfer pricing issues is evidenced by the increasing acceptance of APAs in the international community. Nevertheless, the IRS continues to identify ways to improve the APA process, as evidenced by the recent small business taxpayer initiative discussed above.

Since the enactment in 1994 of the final section 482 regulations as well as the additional disclosure and penalty provisions, the APA Program has enjoyed greater success in identifying important transfer pricing issues while at the same time providing greater uniformity with respect to the treatment of those issues. Notwithstanding this increased uniformity, the APA process remains sufficiently flexible to accommodate the unique circumstances of each taxpayer.

The Program's goals originally enunciated in 1991 - principled negotiations and enhanced tax administration - continue to guide the process. In addition to these goals, the direction that the APA Program will follow in the future can be found in the language of the current IRS Mission Statement - to help taxpayers understand and meet their tax responsibilities by applying transfer pricing concepts with integrity and fairness.