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by Sean Foley, Matthew Frank, François Vincent,
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Sean Foley is a principal in the economic valuation services (EVS) group of KPMG LLP's Washington National Tax practice; Matthew Frank is a principal in KPMG's EVS group in New York; François Vincent is an EVS principal in Chicago; Theresa Kolish is an EVS managing director in San Francisco; Mark R. Martin is an EVS principal in the Washington National Tax practice; and Luca Bonardi is an EVS principal in New Jersey.

In this article, the authors explain how recent changes to the U.S. advance pricing agreement model confirm the potential to amend existing APAs and highlight the value of the APA process to address extraordinary economic disruption through tailored long-term solutions.

An advance pricing arrangement¹ is essentially a long-term contract between a tax authority and a taxpayer, the key feature of which is agreement that the tax authority will not disturb the taxpayer's transfer prices as long as the taxpayer follows an agreed method for setting those prices. Since the advent of the OECD's base erosion and profit-shifting project, many taxpayers have turned to APAs to manage the uncertainty of the evolving international tax landscape. In 2018 and 2019 combined, the IRS advance pricing and mutual agreement program received 324 APA requests and completed 227 APAs. The U.S. program is more popular than ever, a phenomenon that extends to

¹The OECD defines an advance pricing arrangement (known in the United States as an advance pricing agreement) as "an arrangement that determines, in advance of controlled transactions, an appropriate set of criteria (e.g. method, comparables and appropriate adjustments thereto, critical assumptions as to future events) for the determination of the transfer pricing for those transactions over a fixed period." OECD, "OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations," para. 4.134.

APA programs in many countries around the world.

The length of an APA contract can vary. In the United States the average length of APA contracts concluded in 2018 and 2019 was 6.4 years, but APAs covering periods of seven, eight, or 10 years are common.²

For many APAs in effect or under negotiation, a tension exists between achieving long-term transfer pricing certainty and the need to accommodate unexpected economic disruptions such as the conditions many companies are now facing from the impact of COVID-19.

A long APA term can help taxpayers manage transfer pricing risk but can pose a problem if attached to an APA that has static pricing targets without a mechanism to adjust those targets in the event of a change to taxpayer-specific or macroeconomic conditions.

This article considers how the APMA program and well-advised taxpayers may respond to APA challenges resulting from COVID-19. The discussion considers separately the issues pertaining to signed APAs that are still in effect and APA requests that are in negotiation. Let's begin with signed APAs still in effect.

Prospect of COVID-19 Critical Assumption Breach

The key question for U.S. APAs in effect is whether the standard critical assumption in the APA contract will allow taxpayers (or the IRS) to force reopening of an APA to make adjustments to account for the extraordinary global economic disruption that is occurring because of COVID-19. The IRS is taking a wait-and-see approach

²In the United States, 83 (36 percent) of the 227 APAs completed in 2018-2019 had terms of seven years or longer; 58 (26 percent) had terms of eight years or longer; 27 (12 percent) had terms of 10 years or longer.

regarding whether the COVID-19 disruption is severe enough to trigger a critical assumption breach because, as of this writing, we are only two and a half months into the crisis, and its future course is uncertain. If the economic disruption lasts as long and is as bad as people fear, however, it seems likely that the standard critical assumption in a U.S. APA will allow taxpayers and the IRS to reopen already executed APAs for discussion and possible revision.

We reach this conclusion even though the IRS has been reluctant historically to reopen APAs on account of taxpayer hardship. The IRS has surmised that reopening APAs is almost always a one-way street, to the benefit of the taxpayer, not to the benefit of the United States. The IRS is skeptical of taxpayers seeking a nonreciprocal accommodation, asking to reopen an APA to allow them to report less income in the United States because their economic fortunes have deteriorated.

The IRS's unwillingness to renegotiate APAs to accommodate taxpayer hardship is the reason for the language in every APA that says an APA will not be renegotiated because of "a mere change in [the taxpayer's] business results."³ This language has appeared in the APA model for nearly 20 years, since the APA model released in March 2002.⁴

The U.S. APMA program draws a distinction, however, between bad business results for the taxpayer on one hand and a material change in economic conditions on the other. This distinction is made clear by a recent amendment to the APA standard critical assumption. The new language introduced in March 2019 reaffirms that an APA will not be renegotiated because of "a mere change in business results," but it provides expressly for renegotiation when there is a material change in

"markets and economic conditions faced in relation to the Covered Issue(s)."⁵

Most APAs currently in effect have the old critical assumption language that does not refer to changes in "economic conditions." This is true even for many APAs completed in 2019 and the start of 2020.

In the age of COVID-19, the key question for taxpayers with the old APA critical assumption language is whether the new language referring to a material change in economic conditions represents a change in meaning, adding a new basis for a critical assumption breach that wasn't there before, or is merely an elaboration of the original critical assumption language, giving fuller articulation to a concept that was implicit in the original text. In other words, has "a material change in economic conditions" always been part of the standard U.S. critical assumption?

Our view, supported by discussions with IRS APMA management, is that a material change in economic conditions is regarded by the IRS as implicit in the original critical assumption language. Thus, a material change in economic conditions will allow a taxpayer to assert that a critical assumption has been breached under both the original and current versions of the Appendix B critical assumption language. Consequently, if the economic disruption visited by COVID-19 persists and results in a material change in economic conditions relevant to the taxpayer's covered issues, the APA is subject to revision or, failing agreement, cancellation.⁶

In support of this conclusion, we note that the standard language in Appendix C of all APAs (old and new) calls on taxpayers to identify and explain annually "all material differences . . . [in] economic

³This language appears in the standard Appendix B critical assumption that outlines the essential underpinnings of the APA contract — facts regarding the taxpayer's operations on which the agreement is based and which, if they cease to be so, will cause the APA to terminate unless the parties agree on an appropriate revision. The pre-March 2019 IRS standard APA critical assumption reads as follows: "The Covered Entities' business activities, functions performed, risks assumed, assets employed and financial and tax accounting method and classifications [and methods of estimation] of Taxpayer will remain materially the same as described in the APA Request. For this purpose, a mere change in business results will not be a material change."

⁴See APA program annual statutory report for 2001, Appendix B, at 41 (Mar. 29, 2002).

⁵See APA program annual statutory report for 2018, Appendix 2 (model APA based on Rev. Proc. 2015-41, 2015-35 IRB 263), Appendix B, at 64 (Mar. 22, 2019). The revised language reads as follows: "The Covered Entities' business activities, functions performed, risks assumed, assets employed, contractual terms, markets and economic conditions faced in relation to the Covered Issue(s) will remain materially the same as described in the APA Request. For this purpose, a mere change in business results will not be a material change."

⁶See Rev. Proc. 2015-41, section 7.06(3) and (7) (if a critical assumption is breached, the IRS will cancel the APA unless the parties agree on an amendment; the cancellation "generally is effective as of the beginning of the taxable year in which the critical assumption failed").

conditions . . . during the APA Year from [those] . . . described in the APA Request.”⁷ The requirement that taxpayers report annually whether there have been material changes in economic conditions is consistent with the view that economic conditions are relevant to evaluating compliance with, and the continued applicability of, the APA. Also consistent with this conclusion, and obviously very helpful, is confirmation received from IRS personnel that APMA management views the current critical assumption language as a clarification of the former language, not as effecting a change in meaning.

The practical question becomes whether at some point in the current crisis “economic conditions faced in relation to the [taxpayer’s] Covered Issue(s)” will have changed to the degree that those conditions can no longer be said to have “remain[ed] materially the same as described in the [taxpayer’s] APA Request.”

That question must be carefully considered and the materiality threshold must be evaluated on the facts of each case. An APA taxpayer should not expect the IRS to accept it back to the negotiating table without a particularized showing of the taxpayer’s eligibility based on its facts. Temporary hardship is unlikely to suffice.

But in these extraordinary times, with a few more weeks or months of experience behind us, there will likely be many cases in which the answer is clear. This means that for many APA taxpayers, there will be a breach of a critical assumption. (Our discussion is framed in terms of the taxpayer asserting the breach because that has been the most common scenario in the past. The IRS is equally entitled to assert a breach under the APA contract and might do so in an appropriate case.)

If a critical assumption is breached, the APA revenue procedure (Rev. Proc. 2015-41, 2015-35 IRB 263), which is incorporated by reference into every APA contract, provides that the parties will confer and seek to reach agreement on an appropriate revision to the APA to take account of the new facts. The revision may take any form. If the parties are unable to reach agreement,

however, the APA shall be canceled effective as of the beginning of the tax year in which the critical assumption failed.

For most APAs, the consequences of a cancellation should be straightforward; the APA period before cancellation survives and stands on its own. For other APAs, such as those involving a term test extending past the period of cancellation, the consequences can be more complex. In our experience, the APMA program works constructively to reach sensible resolutions so even the complex issues should be resolved satisfactorily, in a spirit true to the APA process.

For most cases in which critical assumptions are breached, the result is not cancellation of the APA but an agreed revision to it. In unilateral APAs, this requires agreement between the IRS and the taxpayer only. In bilateral or multilateral APAs, it requires concurrence by the foreign treaty partners as well. In connection with potential revisions of bilateral APAs, it is worth noting that APMA announced May 11 that it is “actively discussing various substantive and procedural issues with treaty partners, including such technical issues as the application of transfer pricing methods in periods of economic distress and the impacts of current economic conditions on specific industries, types of taxpayer, regions, etc.” Also, APMA is inviting interested parties to reach out to discuss these issues.⁸

The discussion of how to revise an APA to account for COVID-19 in a case involving a critical assumption breach shares many features with the discussion of how to handle COVID-19 for an APA still under negotiation. Our discussion below will address both cases.

(Re)Negotiating an APA in the Age of COVID-19

Every feature of an APA has implications for its suitability or adaptability in difficult times: the choice of the transfer pricing method, the selection of the profit level indicator, the length of the APA term, the use of an arm’s-length range versus a point, the use of an annual test versus a multiyear average or term test, and of course any adjustment mechanism that may be built into the

⁷Cf. Para. 4.146 of the 2017 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the APA discussions in chapter IV) (stating that an APA should provide for the possible revision or cancellation of the APA if uncontrolled economic circumstances critically affect the reliability of the method in a manner that independent enterprises would consider significant).

⁸See IRS, “Competent Authority Filing Modifications and APMA APA Consultations” (May 11, 2020).

agreement — for example, recalibration of a pricing target based on sales performance. We will not catalog all possible features here.

There is a similarly broad variety of ways to define the critical assumptions that may trigger cancellation or revision of an APA. Taxpayers aren't constrained by the standard critical assumption. Many APAs have additional language, forcing the parties back to the table in the event that the taxpayer loses a major customer, experiences a sales decline greater than X percent, suffers a large increase in input costs, or upon the occurrence of any other defined trigger. Again, we will not catalog all the possible refinements to the critical assumption language.

We will limit this discussion to what we think are the three approaches that combine broad relevance and utility to most taxpayers and likely acceptance by the IRS. The right solution for a taxpayer may be a combination of these points and others, or may lie elsewhere altogether. That is a discussion for the taxpayer and an experienced adviser.

The first approach to ensuring the adaptability of an APA and its ability to weather unexpected market conditions is to test the arm's-length nature of taxpayer results not annually but on a multiyear basis, extending ideally to the full APA term, and to extend the APA term to capture a full business cycle or longer.

For a signed APA or for one in negotiation, this might mean amending the APA to add years to the term, combined with adding an APA term test if it was not already a part of the APA. In either case, the effect would be to spread the COVID-19 downturn over several years.

Adding a couple of years to an APA to accommodate the COVID-19 crisis should be doable. As noted at the outset of this article, the average length of APAs signed in 2018 and 2019 was 6.4 years, but APAs covering periods of seven, eight, or 10 years are common. Designing a testing mechanism that evaluates results over several years, up to the full APA term, should be doable as long as the tax authority is confident that the taxpayer won't manipulate results by timing the receipt of income in a way that is unrelated to market conditions. In the current environment, the case for a multiyear testing mechanism is self-evident; it shouldn't be difficult

to make that case to the IRS. Combining these two features — a long-term and a multiyear testing mechanism — allows a taxpayer to absorb tough economic conditions while satisfying APA requirements.⁹

A second approach, which is relevant to taxpayers that have signed APAs or pending APAs nearing the end of the actual or proposed term (for example, terms ending in 2020, 2021, or 2022), is to propose terminating the APA at the end of the year before the COVID-19 crisis — for example, the fiscal year ended December 31, 2019, for a calendar-year taxpayer — and immediately entering into negotiation for a renewal APA. This approach would, in effect, separate the COVID-19 affected years from an existing APA and address those years in a separate forward-looking APA renewal. The difference between an APA extension and an APA renewal may be mostly semantic; in practice, it may come down to the number of years involved and the IRS's choice of forum, which may be driven by precedent and practical considerations — for example, user fees. The advantage with this approach is that it may be desirable to achieve certainty for the past years right away (not to leave those years pending) and to tackle the COVID-19 issues in a longer forward-looking agreement designed specifically for that purpose.

A third approach is to add to the APA a dynamic element to address proactively what happens if the market changes (specifically, collapses) — for example, if sales decline by X percent, if there is a system loss on a three-year aggregate basis, or if some other cataclysm occurs. The result may be that the minimum return is reduced to break even, that the tested party results are measured against a full range rather than an interquartile range, or that there is a ceiling on the percentage of system profit the tested party may earn on a single- or multiyear basis.

There are innumerable ways to design this type of adjustment mechanism. If the trigger is

⁹ Tax authorities may be inclined to wait a few months before agreeing to a term extension or to a different testing mechanism, hoping to know better whether the COVID-19 shock will give rise to a V-shaped or U-shaped recovery, or will drag economies into a prolonged recession. Tax authorities will seek some assurance that the APA accommodation is both appropriate and adequate to ensure taxpayer compliance. Both of these will depend on the taxpayer's specific facts.

limited to truly extraordinary (100-year-flood-type) events and the relief is limited to addressing the impact of those extraordinary events, the IRS is likely to be more willing to entertain such an accommodation without the level of scrutiny and required support that would attach to the general transfer pricing method (that is, the method that would apply in the other 99 years). For an existing APA, this would mean amending the transfer pricing method to take into account the events of 2020, as well as the expectations for the next few years. For an APA under negotiation, this would mean building in this adjustment mechanism in the agreed APA.

Regardless of the approach, we know from experience that solutions are available. Two of this article's authors are former directors of the APA program, a third was an APMA team leader until recently, another was the architect of the APA program in Canada, and all of us have a long history working with the APMA (formerly APA) program. In our experience, renegotiation of an APA, or revision to an APA under negotiation, to account for market-driven forces is usually pretty straightforward. The sometimes lengthy initial APA negotiation has often laid the foundation for a relatively rapid agreement on an amendment or revision. Failure to reach agreement is rare.¹⁰

Entering Into an APA in the Age of COVID-19

Taxpayers shouldn't hesitate to begin an APA negotiation now despite the economic uncertainty caused by the pandemic.

The IRS APMA program is proceeding in a "business as usual" manner. Many of the APMA team leaders and economists have worked from home routinely for years. The COVID-19 situation has not slowed them down or the progression of most of their cases. Its greatest effect is on the scheduling of competent authority negotiations with some countries, and pausing some cases nearing completion when the COVID-19 disruption is requiring last-minute rethinking or retooling. It is not affecting case intake

¹⁰ The APMA program has demonstrated a willingness to work with taxpayers. During the 2008-2010 economic downturn, the IRS amended 29 APAs, an average of 10 a year, versus an average of four a year over the prior five-year period (2003-2007).

procedures, the scheduling of prefilling or opening conferences, or the due diligence process.

The early and middle stages of the APA process, which typically take 15 to 18 months to complete, are unaffected. Taxpayers can therefore begin an APA dialogue and work on their APA fact development and foundational principles to develop a solution that will carry them through the current crisis and extend transfer pricing protection for seven, eight, or 10 years. The final touches can be added later when the current situation has passed or at least come into clearer focus.

Starting the process now ensures that the taxpayer can cover the current year as an APA year in the United States to avail itself of the flexibility, the transfer pricing security, and the double tax protection historically afforded by the APA process.

Conclusion

APAs have been an important part of the transfer pricing landscape since the mid-1990s and, until the COVID-19 crisis, have operated in a relatively stable world economy, with some bumps in the road including the 2008-2009 downturn. During this time taxpayers have found APAs to be practical solutions to difficult transfer pricing issues.

The economic events resulting from COVID-19 are highlighting the value of the APA process — the mechanisms it makes available to address extraordinary economic disruption through tailored long-term solutions.

While there is no "one size fits all" to deal with the APA issues raised by COVID-19, there are many options to address the disruption. The key is for taxpayers to figure out how the COVID-19 virus has or will affect them, to present this information persuasively, to propose constructive solutions for how to deal with the effects, and to work with the APMA program to reach agreement. We are optimistic that it can be done.¹¹ ■

¹¹ The information in this article is not intended to be written advice concerning one or more federal tax matters subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230 because the content is issued for general informational purposes only. The information in this article is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser. This article represents the views of the authors only and does not necessarily represent the views or professional advice of KPMG.