



TRANSFER PRICING

**REPORT**

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Former APA Director Sees Long-Term, Strategic Revamp Needed to Integrate Program with Competent Authority

Craig Sharon, who left the Internal Revenue Service's Advance Pricing Agreement Program in February, discusses the program's achievements and challenges during his nearly three years as its director. In a Feb. 24 interview with BNA Tax Management, Sharon, who joined the firm Bingham McCutchen Feb. 7, shared insights about the challenges of integrating the APA Program's handling of applications and pooling of resources with the Competent Authority. The former official also revealed his thinking about likely practical issues if the APA Program or its function moves.

Expansion of APA Program to PE Cases

BNA TAX MANAGEMENT: In June of 2008, not long after you became Director of the APA Program, the revenue procedure on APAs was expanded to cover permanent establishment cases. Can you talk about the APA Program's work in those cases? Have there been enough of them to justify a specialized team?

SHARON: Since the APA Program issued Rev. Proc. 2008-31¹ in early 2008, the program has received a healthy number of inquiries and held enough pre-filing conferences to appreciate the novelties and complexities raised by the different kinds of cases that fall under the revenue procedure. However, the program has re-

ceived only a small number of actual submissions attributable to the amended revenue procedure, and of those cases, only a few have dealt with the attribution of profits to a PE. I'm excluding the PE attribution cases involving financial products and global dealing, which the program has long handled.

Many of the inquiries dealing with PE attribution outside the financial products area have involved older U.S. income tax treaties, which, in contrast to our newer treaties (for example, with the United Kingdom, Japan, Germany, and Canada), do not incorporate the arm's-length standard in attributing profit to PEs under Article 7. Because Rev. Proc. 2008-31 applies only when transfer pricing principles are 'relevant,' the APA Program generally lacks the authority to accept PE attribution cases under older treaties.

In a number of inquiries, taxpayers have challenged the existence of the PE, but asked the APA Program to resolve the profit attribution question in the event a PE was deemed to exist. Keeping in mind that the APA Pro-

¹ Rev. Proc. 2008-31, 2008-23 I.R.B. 1133, expanded the APA Program's scope to allow it to cover the attribution of profit to a PE and other issues "for which transfer pricing principles may be relevant" (17 *Transfer Pricing Report* 50, 5/22/08).

gram does not have the authority under Rev. Proc. 2008-31 to determine the existence of a PE—because the issue is not based on transfer pricing principles—we have not accepted these cases, consistent with our broader policy not to consider speculative transactions. If a taxpayer wants an advance determination on the PE question, it can request a pre-filing agreement from the Large Business and International division, and, if a PE is determined to exist, then request an APA on the attribution question.

One other point is worth emphasizing. Since Rev. Proc. 2008-31 was issued, the APA Program has required taxpayers to come in for pre-filing conferences before filing APA requests dealing with the issues outlined in the procedure. That policy remains in effect whether the case involves PE attribution under a treaty or application of an Internal Revenue Code provision where transfer pricing principles may be relevant (for example, certain sourcing rules or determinations of effectively connected U.S. income). Given that we're plowing new ground in this area, pre-filing conferences are an essential part of the process for both the IRS and taxpayers.

We considered creating a special coordination group for Rev. Proc. 2008-31 cases, but have held off, given the small number of cases and the substantial overlap with the financial products group, in favor of a more informal approach. That could change, but I don't see it having much of an impact.

Economic Downturn

BNA TAX MANAGEMENT: You said in early 2009 that the IRS was fielding requests from taxpayers who wanted to reopen their APAs in light of the economic downturn (17 *Transfer Pricing Report* 762, 2/19/09).

How did most of the issues related to the downturn end up being resolved?

SHARON: In the months immediately following the economic downturn in 2008, a few foreign competent authorities and a small number of taxpayers asked to reopen APAs already in effect on the grounds that the downturn triggered the standard APA critical assumption dealing with material changes in a taxpayer's business. At the same time, and continuing well into 2010, the APA Program and the U.S. Competent Authority received numerous requests for special 'economic downturn' adjustments in cases then pending in one office or the other. In response to these requests, the APA Program formed an ad hoc committee to coordinate the handling of the requests, and we began to consult closely with the Competent Authority to develop both general 'downturn' policies and specific positions in individual cases.

Specifically, we categorized the cases into three classes:

- completed APAs;
- older pending APAs where 2008 and 2009 were later years in the APA term; and
- newer pending APAs where 2008 and 2009 were earlier years in the APA term.

For each of the categories, the ad hoc committee developed a basic position, and then we took into account the specific facts and circumstances of each request before deciding how to resolve the issue in a particular case.

The APA Program and Competent Authority adopted a general policy not to reopen completed APAs absent a special critical assumption dealing with a specific con-

tingency triggered by the downturn (for example, a material drop in sales or the closing of a major plant). We did not view the downturn, on its own, as violating the standard critical assumption, given the proviso in the standard critical assumption that a 'mere change in results' would not trigger the critical assumption. Given that no taxpayer had ever proposed to reopen a case because its results were better than expected, we took the position that a 'deal was a deal' even if to the taxpayer's detriment.

On older, pending APAs—whether pending with the APA Program or the Competent Authority—the program has been willing to consider special accounting or methodological adjustments, depending on a variety of factors, including:

- whether the taxpayer and the comparables had been similarly affected by the downturn;
- the tested party's historic risk profile and performance; and
- a taxpayer's willingness to accept a symmetrical adjustment when the economy improved.

From mid-2008 through mid-2010, this occurred most often when a taxpayer could show that, because of the economic downturn, the historic financial data for the proposed comparables set should not be used to test the taxpayer's results during the APA years affected by the downturn. In these circumstances, we had a choice—either put the case on hold until the comparables' 2008, 2009, and possibly 2010 financial data became available, or go ahead and complete the case by agreeing to a transfer pricing method that factored in the effects of the downturn. To avoid further delays—of uncertain duration at the time, I might add—and knowing that the issue could be revisited in a renewal, most taxpayers with older pending APAs elected to proceed with special accounting or method adjustments.

Approaches that have been applied or considered include:

- shortening or lengthening the APA term;
- using a different set (or a subset) of comparables for the downturn years;
- using an analysis window for the comparables that included the 2001-2002 recession;
- creating special ranges for downturn years;
- changing the testing method (for example, moving from a single-year test to a longer multi-year or rolling-average test); and
- applying a longer testing period to smooth out a taxpayer's results.

On newer, pending APAs, where 2008 and 2009 are earlier years in the APA term, we generally waited for the updated financial data to become available. That approach has made particular sense given the APA Program's current resource constraints, which have significantly delayed the start date of new APA requests. Regardless, the 2008 and 2009 financial data is now fully available and seems to have solved the data lag problem, judging by the paucity of recent down-economy inquiries. The improving economy has also seemed to limit the issue to mostly a two-year period.

We'll have to see how the down economy affects upcoming 2008-09 audits of non-APA taxpayers, but the issue may be less contentious than expected given that, unlike in an APA setting, all the relevant financial data will be available at the start of the exam. Still, the issue is likely to engender transfer pricing controversies between taxpayers and the IRS field and between compe-

tent authorities, particularly when the operating losses of previously profitable taxpayers are large or persistent.

Pooling of Resources

BNA TAX MANAGEMENT: You said early in your tenure as APA director that you intended to strengthen the role of both the field and Competent Authority in APAs (17 *Transfer Pricing Report* 119, 6/19/08).

Was eliminating the hand-off and having analysts from Competent Authority work cases from the beginning, as announced by IRS Deputy Commissioner (International) Michael Danilack, what you had in mind?

SHARON: You are correct that two of my major goals when I became APA director were to improve the APA Program's relations with the IRS field and to improve coordination between the APA Program and the Competent Authority. My third major goal was to recruit and retain the highest-quality APA staff. The overriding principle was to improve the efficiency and effectiveness of APA teams in order to improve both the APA process (that is, smoother, faster case processing) and the substantive results (that is, more consistent, principled outcomes).

Actually, I think we made considerable progress on all three goals during my time as director. On competent authority coordination specifically, the APA office and the Tax Treaty office have begun to work together in unprecedented fashion—for example, holding joint managers' meetings, coordinating APA case plans and competent authority agendas, requiring earlier and more active teamwork between APA and Competent Authority staff, and executing closing documents more quickly.

In another change, along with a few other APA managers, I became personally involved in the negotiation of some particularly novel or complex bilateral APAs, traveling to and attending competent authority meetings to provide background information and technical explanation in support of the U.S. position. These initiatives were encouraged and strongly backed by current and former executives from the IRS and the Office of Associate Chief Counsel (International), and they have led to a much closer working relationship between the two offices.

Unfortunately, our progress in advancing these goals has been obscured by the record-high number of new APA applications in the past three years—from an average of about 90 applications from 2000 through 2007 to 123 in 2008, 127 in 2009, and more than 140 in 2010. This avalanche of new cases, combined with continuing constraints on APA resources, has hampered APA's performance as measured in terms of reduced completions, increased case processing times, and accumulating inventories.

These results in turn—and notwithstanding the record-high applications—have tarnished the program's reputation and its attractiveness to taxpayers. No doubt, from both IRS and taxpayer perspectives—and I have heard this now in virtually every taxpayer meeting that I've been in since leaving the program—the number one challenge facing the program is the length of time that it takes to complete an APA. In 2009, this was about 24 months in the case of a unilateral APA and about 45 months in the case of a bilateral APA.

The proposal to eliminate the hand-off between the APA Program and the Competent Authority by allowing

a single APA team leader or Competent Authority analyst to handle a bilateral case from beginning to end is a partial response to the foregoing challenges and perceptions. I can't say that I anticipated elimination of the hand-off, but I also wouldn't say that the change represents either a radical idea, given the acknowledged inefficiencies in the current two-step process, or a dramatic change in practice, given the current high level of coordination.

Suffice it to say that a confluence of factors affecting transfer pricing compliance and enforcement has led the IRS to revisit a number of old ideas and consider a few new ones, including eliminating the hand-off in bilateral APAs and pooling APA and Competent Authority resources.

'Stop-Gap' Measure

BNA TAX MANAGEMENT: Can you say more about how the pooling of APA and Competent Authority resources is evolving, and how you expect it to evolve?

SHARON: The proposed pooling of APA and Competent Authority resources can work if properly implemented, but even then, in my view, it should only be viewed as a short-term, stop-gap measure to augment APA's resources until broader questions about the program's future can be answered, presumably at the highest levels within the IRS and Chief Counsel. Such questions include:

- What is the role of the APA Program within the overall IRS enforcement strategy for transfer pricing?
- What is the appropriate balance between public guidance versus taxpayer-specific case resolution, including APAs?
- How should resources be allocated between the IRS and Chief Counsel, among the different Chief Counsel Associate offices, and within ACC(I) between the technical branches and the APA Program?
- Should the APA Program remain part of Chief Counsel or be moved to the IRS?

I thought these questions were being addressed—either explicitly or by implication—in the restructuring of the Large and Mid-Size Business division that created LB&I, but as has been widely reported, the APA Program was left out of the new LB&I, with its future to be decided at a later date. Since August 2010, the program has been waiting for a final answer, uncertain if, when, and how the decision will be made. In the meantime, the program has begun implementing a series of ad hoc efficiency measures, while being told not to limit its intake of new cases and not to expect additional resources from within Chief Counsel, which is dealing with Counsel-wide budget restrictions and competing priorities.

Recent case processing changes include:

- risk-assessing new cases up front with the expectation that easier cases (for example, small business cases, simple renewals) should be processed more quickly;
- rethinking the program's handling of pre-filing conferences in order to identify issues earlier, improve the focus of APA submissions, and narrow the potential areas of disagreement;
- increasing utilization of case plans and enforcing them more strictly;
- as already discussed, experimenting with the elimination of the hand-off on bilateral cases; and

- curtailing APA participation in the so-called transfer pricing pilot, which will stand up shortly as the new LB&I transfer pricing practice.

As helpful as these efficiency improvements may be, at best, they will only marginally improve case processing times. This fact, in combination with the absence of additional resources from within Chief Counsel and a limited ability to restrict the acceptance of new cases, has left the APA Program with a dilemma: either allow case processing times to further increase or look for outside resources to meet the surging demand for APAs.

Additional Resources from LB&I

Because no one wants the former result, the focus over the past year or so has been on identifying additional resources from outside Chief Counsel. Fortunately, LB&I has been willing and able to help. First, LB&I has made additional field economists available to the APA Program to help overcome the current shortage of APA economists. This solution may be short-lived, however, because LB&I may begin to experience its own resource constraints once the transfer pricing practice stands up. I should also note that Associate Chief Counsel (International) Steve Musher recently allocated two ACC(I) professional positions to APA to replace two recently departed APA economists. Both of these steps are critical to helping relieve the current APA economist bottleneck, which is delaying the start of new cases by six months or more.

Second, and of potentially greater consequence—and to get back to your original question—the APA Program has begun to pool resources with the Competent Authority, which has doubled in size over the past 18 months and still has the authority to hire additional staff. At the moment, the two programs are experimenting with the arrangement in a few cases, typically where there has been a recent turnover in personnel. At the same time, APA and Competent Authority managers have been meeting to work out the logistics of a more comprehensive arrangement. Until then, the concept will continue to evolve, probably even after it becomes operational in a month or two. The current federal budget environment could also affect how the arrangement plays out.

At the moment, the most that I can say about the pooling arrangement—and assuming nothing has changed since I left the IRS a few weeks ago—is that the APA Program and the Competent Authority staff assigned to APAs will operate on an integrated basis. That is, as one program, with one director, with a combined staff, with one pool of inventory, pursuant to the current APA and Competent Authority revenue procedures, and subject to the same delegations of authority as currently exist. There will not be separate or parallel programs, nor will there be any change in the competent authority process, other than the elimination of the hand-off in bilateral APAs.

The good news is that the management of both offices, including Deputy Commissioner (International) Mike Danilack and Associate Chief Counsel (International) Steve Musher, is committed to making the arrangement work for as long as necessary.

Practical Issues

BNA TAX MANAGEMENT: You and other officials have mentioned some of the processes that will need to be worked out under the new system, such as which office manages what part of the APA process. Can you expand on that? What questions, specifically, arise at various stages of the process?

SHARON: Having decided on an integrated model, as just described, there remains a host of practical issues to work out, such as:

- structuring the Competent Authority APA function (that is, dedicated APA branches or branches that mix Competent Authority and APA functions);
- deciding on the right balance of team leaders and economists within Competent Authority, taking into account the current APA economist shortage;
- deciding on the criteria, if any, for assigning cases to one office or the other (for example, unilateral versus bilateral, routine versus complex issues, industry coordination cases versus other cases);
- matching the different skills and experience levels in assigning team leaders or analysts and economists to specific cases;
- shifting supervisory review when a case moves to the bilateral negotiation stage or having a single manager take the case through the entire process;
- when making case assignments, balancing the benefits of case- and industry-specific knowledge versus the need for continuity in the tax treaty relationship;
- coordinating travel;
- managing separate travel and other budgets;
- providing promotion and other career-advancement opportunities for employees and managers alike;
- providing for hiring authority to replace departing employees, especially within Chief Counsel;
- coordinating recruiting; and
- reconciling the different compensation policies and labor rules applicable to IRS and Chief Counsel employees.

A big unknown in resolving these issues is the duration of the arrangement. The longer or more permanent the arrangement, the more care and time is required to get it right. In the short run, as I said earlier, the arrangement can work, but it does not seem sustainable over time, especially if Chief Counsel is unable to allocate sufficient resources to the ACC(I) side of the program. In that event, the APA Program will shrink over time, become a less desirable place to work, and become a de facto part of LB&I, even if the program's legal authority remains within ACC(I). For many reasons, this does not sound like a responsible plan or a desirable result.

Revenue Procedure Changes Unlikely

BNA TAX MANAGEMENT: Will the new system require changes to the APA revenue procedure?

SHARON: The APA Program started to update its revenue procedure in 2009, in coordination with an update of the Competent Authority revenue procedure, but the APA project has been put on hold given the current uncertainty surrounding the program and the need to economize on resources as much as possible. I don't think that any change in the APA revenue procedure is required to implement the pooling arrangement, but

certainly some changes would be advisable, and other changes may be required as the concept evolves. If the APA Program moves to LB&I, the revenue procedure will certainly need to be revised.

BNA TAX MANAGEMENT: Given the issues involved in running one program from two offices, would it be easier to just move the APA Program to the enforcement side, as has been discussed several times over the years? What issues would arise in that scenario?

SHARON: Yes, it would be easier to move the APA Program to the enforcement side, but I don't think the placement of the APA Program should be based on convenience. Nor do I think that it should be resolved with a short-term perspective or in the absence of a coherent plan. The APA Program is too important as an enforcement process and as a learning tool not to think about it on a long-term, strategic basis.

As a threshold matter, the 'big picture' questions that I mentioned earlier need to be considered. Specifically, what is the appropriate role for the APA Program in the new LB&I structure and transfer pricing practice? And what resources does it need to fulfill that role? In an ideal world, the answers to these questions would not affect APA's placement since, under any scenario, the program will remain part of the larger IRS organization. In reality, however, location does matter, since it would or could affect the program's funding, authority, jurisdiction, reporting relationships, recruiting, compensation policies, working conditions, and other issues.

If the program moved, a few of the more important issues that would need to be addressed, in no particular order, include:

- Should the APA Program move to Competent Authority or to the transfer pricing practice?
- If the APA Program is moved to the transfer pricing practice, should double-tax allocation cases also be moved there?
- To what extent will the APA Program be involved with the transfer pricing practice's audit functions?
- Should the APA Program remain intact as a separate, specialized unit or be mixed with other LB&I functions?
- What would happen if a current APA employee preferred to stay with Chief Counsel?
- Would Chief Counsel/ACC(I) retain any of the staff positions now filled by APA staff or would all such positions move with the program?

At this point, I am agnostic on the APA placement issue—whether or not a move should happen and, if it does, to which office within LB&I. That's a significant change from my predecessors, who more or less strongly opposed moving the program out of Chief Counsel.

The current circumstances are materially different from the circumstances in previous debates, with the program, for the first time, potentially benefiting in significant ways from a move, in the form of additional resources and a potentially 'starring role' in the new IRS transfer pricing regime. It's also comforting to know that current LB&I and ACC(I) management strongly support the program.

Still, if a move does occur, I have long-term concerns about whether the program will be able to maintain its independence and culture, as IRS personnel changes and institutional memory fades.

On the other hand, if the APA Program stays in Chief Counsel, unless additional resources are provided, APA management will need to be given flexibility to balance the demand for APAs with the available resources. If not, the program's performance and therefore its attractiveness to taxpayers and its ultimate effectiveness will continue to decline.

Transfer Pricing Practice Director

BNA TAX MANAGEMENT: What type of involvement do you expect the IRS transfer pricing practice director, when he or she is hired, to have in APAs?

SHARON: It's too early to say, but it will depend on the person hired and the ultimate placement of the APA Program. The transfer pricing practice director's involvement with the APA Program could range from direct oversight if the program is moved into the practice to informal consulting if the Program remains in Chief Counsel. Ideally, the transfer pricing practice director will be involved in the decision, which is why I'm not expecting a final answer on APA's placement until after the director is announced. Hopefully, that announcement will come in the next month.

BNA TAX MANAGEMENT: What will be your focus in the private sector?

SHARON: My job at Bingham McCutchen will be to help build out the international tax controversy practice with a special focus on transfer pricing. To date, the firm's transfer pricing practice has centered on complex, high-stakes litigation, such as the *Glaxo Tax Court case*.² That will continue to be a focus of the practice, but we also hope to get involved earlier in cases to help assess risk, advise on procedural options—including APAs and the competent authority process—and resolve disputes short of litigation, if possible.

A second part of my job will be to help recruit great new tax lawyers. On that front, I'm especially happy that Clark Armitage, my former deputy director at the APA Program, has decided to join me at Bingham. After eight years with the APA Program, Clark brings a wealth of transfer pricing knowledge and experience, including a long-time, proven working relationship with me.

BNA TAX MANAGEMENT: What advice do you have for your successor, John Hinding?

SHARON: John hardly needs to hear my advice, given his significant public- and private-sector experience, including his many years at ACC(I) Branch 6, which is primarily responsible for transfer pricing and informally serves as the APA Program's legal adviser. John has also spent most of the past eight months working closely with me, effectively functioning as APA co-director.

John's immediate priority has to be to manage the program's resource challenge. That will necessarily involve finalizing the structure and implementation of the pooling arrangement with Competent Authority. In the meantime, he'll have to keep the program running as

² The case, *GlaxoSmithKline Holdings (Americas) Inc. v. Comr., T.C.*, Nos. 5750-04 and 6959-05 1989-2005, concerned the pricing of pharmaceuticals between the U.S. firm and its U.K. parent and was resolved with the company's payment of \$3.4 billion to the IRS (15 *Transfer Pricing Report* 335, 9/13/06).

smoothly as possible. Fortunately, John knows that he has Steve Musher's full support, that he has a great group of APA managers to help out, and that he can rely on APA staff to continue doing their jobs as good professionals.

Big picture, John is inheriting the program at an exciting time, with the emergence of a new international tax enforcement concept based primarily on APA principles, such as specialization, teamwork, cooperation, transparency, interaction, early resolution, and cer-

tainty. Given the program's expertise and experience, it will surely be at the forefront of this paradigm shift, dealing with the standup of the transfer pricing practice, the continued overseas focus on transfer pricing, the expanding collaboration between tax authorities, and the increasing need for multilateral solutions.

My best advice to John would be to engage as much as possible in the shift to the new enforcement strategy. The concept is great, but implementation will be a bear.