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Global Tax Alert

News from Transfer Pricing

US Advance Pricing and Mutual Agreement Program releases Functional Cost Diagnostic Model to be used in certain APAs

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On 26 February 2019, the United States (US) Advance Pricing and Mutual Agreement Program (APMA) released an excel-based financial model that the Program intends to use when reviewing certain Advance Pricing Agreement (APA) requests. The stated purpose of the model is to allow the Internal Revenue Service (IRS) "to better understand the controlled taxpayers' contributions to the proposed covered transactions, including the respective contributions each controlled taxpayer makes to the exercise of control over the economically significant risks surrounding the proposed covered transactions."¹ To that end, the Functional Cost Diagnostic Model (FCD Model) collects, identifies, organizes and analyzes the costs incurred by each controlled taxpayer related to the covered transactions. It then computes a pro forma profit (loss) split. APMA will compare the pro forma profit split results to the results achieved under the transfer pricing method proposed in a taxpayer's APA request. APMA assures taxpayers that it will use the FCD Model in limited circumstances, only for diagnostic purposes, and its application does not imply that the residual profit split is necessarily the "most appropriate method" under the Organisation for Economic Co-operation and Development (OECD) Guidelines for the covered transactions.

Background

The APA Program provides a voluntary process designed to resolve actual or potential transfer pricing disputes in a principled, cooperative manner, as an alternative to the traditional examination process. Revenue Procedure 2015-41 requires an APA submission to include significant financial information, to facilitate APMA's analysis of the arm's-length nature of the consideration paid or received. The requirements include the following: (i) estimated dollar value of the covered transactions in the proposed APA years; (ii) summary of the covered methods (per transaction), including interquartile range proposed, income statement and balance sheet of the comparables; (iii) demonstration of proposed transfer pricing method to the covered transactions; and (iv) application of the APA financial model (income statement and balance sheet) to the tested party, etc.

The FCD Model is not a requirement of Revenue Procedure 2015-41, and therefore is not something a taxpayer needs to include in its submission. Rather, it is now a post-submission requirement that the IRS may ask a taxpayer to complete.

Detailed analysis - What's in the FCD Model?

The FCD Model contains four sets of tabs: setup tabs, benchmark tabs, functional costs tabs, and financial tabs. Whereas the first two sets of tabs do not represent significant additional work for taxpayers, the costs and financial tabs will require taxpayers to devote significant time and resources to provide the required information.

The setup tabs include the opening tab, where a taxpayer fills in information such as the number of parties and functions involved, the start and end dates of the APA, and the number of years of historical costs that are relevant to properly apply the model.

The benchmark tabs list the covered parties and the routine functions they perform as well as the suggested returns for each of these functions. This information should have already been submitted to the APMA team as part of the APA request.

The functional costs tabs require taxpayers to fill in one tab per party and per function (party 1, function 1; party 1 function 2; party 2, function 1, etc.), referred to as "functional worksheets," and collect all the associated costs (i.e., routine costs and contributions, as explained later).

Each of the functional worksheets require a listing of the cost centers and the associated cost of goods sold (COGS) or sales, general, and administrative expenses (SGNA). COGS and SGNA should further be categorized as "benchmarked" (under the premise of constituting routine costs) or "not benchmarked" (non-routine). For non-benchmarked expenses, taxpayer needs to provide the lead time (more commonly referred to as gestation lag) and useful life in years.² The costs subject to a benchmark are deemed to be performed by comparable companies and provided a routine return. The rest of the costs are capitalized and amortized and accumulated as capitalized contributions. These capital contributions could then be plugged in as profit split factors in a residual profit split model.

The financial tabs require taxpayers to fill in one financial data tab per party per function as well as one last tab with the combined financials of the covered parties. The taxpayer should construct financial statements for each function by allocating revenues, costs and balance sheet items to each function. This information is not always readily available, and taxpayers may have to work with their advisors to explain these complexities (sometimes the impossibility) of complying with the FCD Model data requests.

Implications

APMA has stated it intends to use the FCD Model in a manner consistent with the revised OECD Guidelines for both inbound and outbound cases, stressing concepts such as important functions and control, but it is not clear how this relates to concepts and principles already embedded in the Internal Revenue Codes Section 482 regulations, such as respecting contractual arrangements (including allocation of risks) that have substance, and the appropriate return to risky financing of investments.

The FCD Model approach is another example of pressures on transfer pricing policies in which risks are separated from functions. If a taxpayer's covered transactions involve more than routine functions and risks, the IRS will ask the taxpayer to complete this model to see if RPSM or another method is more appropriate than the taxpayer's proposed method to provide arm's-length results. This will involve more due diligence on the part of taxpayers, including a viewpoint toward system-wide profit that may not be readily available. While the results of the FCD Model could substantially agree with the results with the taxpayer's original method results, the analysis will have to be completed to make that determination.

Endnotes

1. *Functional Cost Diagnostic Model Documentation, Advance Pricing and Mutual Agreement Program*, page 1.
2. There is no indication whether decay can be incorporated into the analysis.

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