CAP Updates Bring Transfer Pricing Issues to the Fore

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In this article, the authors examine two changes to the IRS's compliance assurance process program that involve transfer pricing: Taxpayers applying for CAP must complete a template of material intercompany transactions; and for some issues, an advance pricing agreement may be required for the taxpayer to remain in CAP.

Introduction

In 2018 the IRS announced that its compliance assurance process program would continue with some important changes. Two of those changes relate to transfer pricing: Taxpayers applying for CAP must now complete a template of material intercompany transactions, and for some issues an advance pricing agreement may be required for the taxpayer to remain in CAP.

The CAP program, which is under the jurisdiction of the IRS Large Business and International Division, allows a select group of taxpayers to receive a real-time audit of disclosed positions, with the goal of reaching agreement on positions before the filing of a return. When CAP began in 2005, it had 17 participants; as of 2018, it had 169.

On August 27, 2018, LB&I announced changes to CAP, effective for the 2019 application period.[1] While these changes affect various facets of CAP, two pertain specifically to transfer pricing: First, taxpayers are required to provide "specified transfer pricing issue information," if applicable.[2] Second, LB&I noted that "certain transfer pricing issues may be required to be resolved via the Advance Pricing Agreement program."[3] On December 13, 2018, LB&I provided additional clarification related to these CAP transfer pricing matters via a list of frequently asked questions on its website.[4]

[1] IR-2018-174, published as "IRS Announces Changes to Compliance Assurance Process Program."

[2] *Id.*

[3] *Id.*

[4] LB&I, "Compliance Assurance Process (CAP) Frequently Asked Questions (FAQ) as of December 13, 2018" (FAQ).

On June 14, 2019, LB&I announced that it will begin considering new CAP applicants for the 2020 CAP year.[5] The program had previously not accepted any new applicants since 2015. While the admission of new taxpayers remains contingent on the availability of LB&I resources, those interested in applying are requested to submit a statement of interest by July 26, 2019, as a precursor to a formal application. This statement of interest must include a description of the applicant's transfer pricing activity.

The MITT

The requirement to provide transfer pricing issue information was developed with the IRS's publication of the Material Intercompany Transactions Template (MITT), which must be submitted as part of a CAP application.[6] The MITT requires taxpayers to report information on related-party transactions from forms 5471, 5472, 8865, and 8858 (the relevant tax forms) as well as section 6662 documentation based on the taxpayer's last filed tax return before the commencement of the CAP year. For purposes of the MITT, materiality is determined on a taxpayer-by-taxpayer basis; the FAQ states that "a 'material' intercompany transaction is any new or recurring intercompany transaction for which the amount reported [on the MITT] is greater than the last agreed upon permanent materiality threshold." The taxpayer and the IRS agree on the materiality thresholds in CAP:

> The IRS and the taxpayer will jointly determine the scope of the CAP review, including materiality thresholds. Materiality thresholds are used as a guide by both parties in determining the scope of transactions to disclose and review. The parties will openly discuss situations where exceptions to the materiality threshold may be warranted. Materiality thresholds are used in CAP for the taxpayer to know which completed business transactions should be disclosed. . . . Further, materiality thresholds may be reconsidered during the CAP. The materiality thresholds will be documented in the CAP Plan and apply only to the relevant CAP year. The CAP Plan will be discussed with and provided to the taxpayer.[7]

When negotiating materiality thresholds for a given year with the IRS, taxpayers should be cognizant of the need to fill out the MITT for any intercompany transactions that exceed the pertinent threshold.

Transactions may be aggregated for MITT reporting purposes only if they used the same transfer pricing policy and were tested using the same transfer pricing method. Further, unless required under the taxpayer's documented transfer pricing method, aggregate reporting is impermissible if the tested parties' functions, assets, and risks are materially different.[8] Discrepancies between information reported on the relevant tax forms and the taxpayer's transfer pricing documentation must be noted, and the correct amounts must be reported on the MITT. If the taxpayer is accepted into CAP, it must explain how the discrepancies arose, and the CAP team may suggest changes to the taxpayer's internal controls over transfer pricing matters.

Taxpayers must update the MITT to reflect material changes. Here, again, materiality should be understood within the broader framework of CAP's agreed materiality thresholds. The instructions provide that new transactions should be listed on a revised MITT "as soon as possible in the CAP cycle." Data reported based on estimates, rather than actual amounts, must be noted. Once the CAP process is complete and a tax return is filed, the CAP team will review a final MITT.

Most of the data required by the MITT is routine. Taxpayers must list basic information about the transaction, such as its amount, a description, the countries involved, data on the benchmarking and method used in the taxpayer's

[5] IR-2019-113; Statement of Interest for New CAP Applicants.

[6] The MITT is available online. Instructions are provided at "CAP Material Intercompany Transaction Template (MITT)."

[7] Internal Revenue Manual section 4.51.8.5(11).

[8] The MITT instructions state: "Do not aggregate transactions where the related party performs different functions, employs different assets or assumes different risks unless the taxpayer's method as discussed in the Transfer Pricing Documentation requires such aggregation." We believe that "the related party" should be understood as referring to the tested parties in the transactions potentially subject to aggregation.

section 6662 documentation, and the actual results of the transaction. The MITT also requires that the taxpayer tie this data to the forms, lines, and columns in which it was reported (when applicable), and provide specific references to the sections or pages of the transfer pricing documentation that analyze the transaction.

Other information required by the MITT is less routine but helpful to an assessment of the risk posed by the transactions. The taxpayer must indicate whether payments are subject to the base erosion and antiabuse minimum tax under section 59A, as well as whether a U.S. tax treaty may apply to the transaction.[9] Any changes in policy or method must be noted as well as the inception or discontinuance of a transaction.

Lastly, the MITT requires some information that is not routine, and may not be pertinent outside of general risk assessment. If a foreign related party had any income that required a subpart F computation, this must be stated — regardless of whether that income is related to the transaction being reported on the MITT. Likewise, the operating margin (OM) for the tested party must be given at the entity level, regardless of whether the OM was used as the profit level indicator for the transaction being reported, and regardless of whether this transaction made up only a small fraction of the tested party's business (in which case an OM based on segmented data would provide more reliable insight).

In addition to the information reported on the MITT itself, taxpayers with cost sharing arrangements or platform contribution transactions must provide an explanation of them. Taxpayers may also supplement the MITT with additional information on the listed transactions.

The purpose of the MITT is risk assessment. LB&I has released a memorandum of understanding template for 2019,[10] which explains: "The MITT and the Worldwide Tax Organization Chart will be used by a Transfer Pricing Risk Team to help the CAP team determine the most appropriate treatment of Transfer Pricing issues for the Taxpayer."[11] Specifically, according to the MITT instructions, it will be used for "risk analysis in the selection or de-selection of transfer pricing issues," and will inform the review of issues that are selected. Importantly, the MITT cuts both ways: It is not only a tool for selecting issues to audit, but also a way to "deselect" issues that do not require attention.

APAs and CAP

As noted, LB&I stated in August 2018 that some transfer pricing issues "may be required to be resolved" through an APA effective for the 2019 CAP year. The December 2018 FAQ drew back from this statement:

> For the CAP 2019 transition year, entering into an APA is not mandatory but will be strongly encouraged for transfer pricing issues that cannot be resolved in pre-filing and may result in the Taxpayer having multiple open years going forward. For the 2020 CAP year and subsequent years, the requirement to apply for an APA, when requested by the CAP team and the taxpayer fails to comply, may affect suitability for remaining in CAP going forward and could also lead to termination from CAP during that year.[12]

Taxpayers concerned that the changes to CAP may result in burdensome or unnecessary APA application proceedings thus have a reprieve for 2019, though for some taxpayers, agreeing to pursue an APA may become a prerequisite for remaining in CAP in 2020.

While APAs provide desirable certainty of tax treatment, taxpayers might not desire an APA for several reasons. Some taxpayers, particularly those in volatile industries, may be loath to lock themselves into a specific method or set of benchmarks with an APA. Others may not wish to raise issues that previously have not attracted

[9] On February 19 LB&I released "Interim Guidance on Mandatory Issue Team Consultations With APMA for Examination of Transfer Pricing Issues Involving Treaty Countries." The new procedure, which is motivated by concerns of efficiency and effective use of specialized resources, applies to examinations of LB&I taxpayers in which a potential transfer pricing adjustment would involve a U.S. treaty partner, regardless of whether APMA has an effective mutual agreement procedure relationship with the country in question.

[10] IRS, "CAP Memorandum of Understanding" (CAP MOU).

[11] *Id.*

[12] FAQ, Question 1.

attention in the foreign counterparty's country, which would gain significant insight into the taxpayer's transfer pricing and operations when negotiating an APA, possibly resulting in a less favorable overall result. Still others may simply find the APA process expensive: The user fee for an application is $113,500 for a new APA,[13] and the cost of outside advisers will generally be substantially more. For issues that a taxpayer believes to be low risk, the expense and time required for an APA will generally not be justified.

However, cost-based concerns are less likely to apply when the CAP team would be inclined to insist that the taxpayer get an APA. If the updated CAP program functions as it should, the MITT will be used as a tool for selecting and deselecting transfer pricing issues for CAP consideration based on risk. Only high-risk issues should be selected for CAP consideration and thus potentially subject to the requirement that an APA be executed. Thus, cost should be less of a concern: An APA should only ever be required for transfer pricing issues identified as high risk by the CAP team, and so certainty should be desirable, especially when the alternative appears to be expulsion from CAP followed by a possible transfer pricing audit, which could easily be more costly and time consuming than the APA process.

The reasoning behind the APA requirement appears to lie in historical difficulties LB&I experienced with addressing transfer pricing issues in CAP and in the 90-day goal for resolving CAP issues, which was announced in August 2018. Complex transfer pricing issues likely cannot be resolved within that time frame — indeed, new APAs take on average 42.8 months to execute.[14] LB&I personnel announced in 2011 that transfer pricing issues were posing difficulties for CAP,[15] and in 2014 LB&I singled out the issue of transfer pricing issues that linger on post-filing, with then-LB&I Deputy Commissioner (International) Michael Danilack stating that "there's also perhaps a question as to whether a taxpayer who's got myriad transfer pricing issues should be in CAP at all."[16]

The APA requirement seems poised to resolve the issue of "hangover" transfer pricing issues that linger beyond the end of the normal CAP period. The FAQ explains that an APA "is an effective resolution tool and can provide CAP taxpayers with certainty for several tax years once completed rather than having the local CAP team resources deployed on a year-by-year basis. In addition, the covered years are not counted against the CAP taxpayer while the APA is in process and the years are in APMA's jurisdiction."[17] The intent seems to be to have two parallel processes: the CAP process for issues that can be resolved effectively within the contemplated 90-day timeframe, and an APA process for long-term resolution of larger and more complex transfer pricing issues.

The MOU also addresses the use of APAs. If, based on a review of the MITT, "it is deemed that the most appropriate treatment is an Advance Pricing Agreement (APA), the [Account Coordinator (AC)] will schedule a meeting between the Taxpayer and the Advance Pricing and Mutual Agreement (APMA) Team to discuss the benefits of entering into an APA."[18] The language here is gentler than in the FAQ, and no mention is made of removing taxpayers unwilling to pursue an APA from CAP. While taxpayers should nonetheless expect, on the basis of the FAQ, that APAs will in some cases be mandatory for those who wish to remain in CAP starting in 2020, the MOU language points to a more collaborative process of discussion. Presumably, while APMA will be available to "discuss the benefits of entering into an APA," the taxpayer will likewise have a chance to make a case for why an APA would not be necessary or appropriate. While the CAP team will ultimately make the decision, it doesn't seem that all taxpayers for whom APAs are suggested will be facing an ultimatum.

[13] IRS, "IRS Announces Fee Increases for Advance Pricing Agreements" (Feb. 6, 2018).

[14] Announcement 2019-3, 2019-15 IRB 1.

[15] Shamik Trivedi, "IRS Acknowledging Transfer Pricing Problems in CAP," *Tax Notes Int'l*, Aug. 8, 2011, p. 439.

[16] Dolores W. Gregory and Lydia Beyoud, "Budget Woes, Mounting Demands Force IRS to Think Strategically, Focus on Training," *Tax Mgmt. Transfer Pricing Report*, Mar. 20, 2014.

[17] FAQ, Question 19.

[18] CAP MOU, *supra* note 10.

The MOU paints a picture of coordination of the APA and CAP programs that extends beyond the recommendation or requirement that a taxpayer seek an APA:

> Taxpayers in the CAP Program that have already submitted a request for an APA under Revenue Procedure 2015-41 (or successor thereto) and/or a request for assistance from the U.S. Competent Authority under Revenue Procedure 2015-40 (or successor thereto) should notify their AC of the existence of such requests. The AC will then contact the appropriate APMA Team or the Treaty Assistance and Interpretation Team (TAIT) lead or analyst to ensure ongoing coordination between the CAP and APMA/TAIT Programs.

How this coordination will play out in practice remains to be seen. It is unclear to the authors how APMA will deploy its already-constrained resources to address a potential influx of APAs from CAP taxpayers. Still, the CAP program's willingness to coordinate with the APA program indicates that LB&I has come a long way from the days when serious transfer pricing issues were considered to render a taxpayer potentially unfit for CAP.

Conclusion

The MITT is not simply a matrix of information to be filled out, but a summary document that is meant to be supplemented and explained by additional material: "Taxpayers are encouraged to attach additional explanations and documentation as necessary to support related party transactions."[19] This provides a valuable opportunity for taxpayers. At best, the summary information on the MITT lacks important context; at worst, it may be positively misleading. Taxpayers who participate in or are thinking about participating in CAP should proactively fill out the MITT and consider how their transactions appear based on the data it presents. Doing so will give them insight into how CAP teams will assess transfer pricing risk when selecting issues and will provide an opportunity to appropriately supplement the MITT with information that can reduce the risk rating for transactions, possibly resulting in their deselection as low risk.

The IRS will inevitably view some transactions as high risk. In other cases, however, the selective nature of the information presented on the MITT may result in false positives. For instance, the low profitability of a tested party because of market conditions in one year could result in a benign transaction being flagged as high risk since it is necessary to report the entity's overall operating margin, regardless of whether it is significantly affected by transfer pricing.

In those cases, effectively presenting and supplementing the MITT should also decrease the likelihood that the CAP team will require the taxpayer to request an APA, because such requests should be confined to high-risk transactions. For those taxpayers whose CAP teams do broach the possibility of an APA, there should again be an opportunity for the taxpayer to present its case and, in keeping with the collaborative nature of the CAP program, explain why an APA would or would not be desirable. While the CAP team will make the final decision, this is an area in which proactive consideration and the presentation of a well-thought-out case may sway the course of the CAP audit.[20] ■

[19] Instructions, *supra* note 6.

[20] 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 contained 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 LLP.