United States General Accounting Office

GAO

Report to the Honorable
Byron L. Dorgan, U.S. Senate

August 2000

TAX ADMINISTRATION

IRS' Advance Pricing Agreement Program

Accountability * Integrity * Reliability

GAO/GGD-00-168

United States General Accounting Office
Washington, D.C. 20548

General Government Division

B-283781

August 14, 2000

The Honorable Byron L. Dorgan
United States Senate

Dear Senator Dorgan:

Any company that has a related company with which it transacts business needs to establish transfer prices for its intercompany transactions. The pricing of intercompany transactions affects the distribution of profits among the related companies and, ultimately, the taxable income of the companies. To help curtail complex, lengthy, multimillion-dollar transfer pricing disputes with business taxpayers, the Internal Revenue Service (IRS) developed an advance pricing agreement (APA) program. Under an APA, IRS and taxpayers agree on the methods to determine the prices that related companies charge each other when transferring goods and services over a specified period. Taxpayers also agree to submit annual reports that demonstrate compliance with the terms of the agreements. APAs can be either unilateral—between only IRS and specific taxpayers—or bilateral—involving negotiations with tax authorities in countries that have income tax treaties with the United States.

This is the second report in response to your request that we review various transfer pricing issues.[1] As agreed with your office, the objectives of this report are to determine (1) the extent of APA use by U.S. taxpayers, including those that have had transfer pricing disputes with IRS; (2) the timeliness of IRS' APA processing; and (3) the results of IRS' review of taxpayers' annual reports on compliance with APAs.

To fulfill these objectives, we interviewed IRS officials and other people knowledgeable about IRS' APA program. We also analyzed information from several IRS databases. This report includes information on IRS' APA program from January 1991, when the first APA was approved, through September 30, 1999. We did our review in Washington, D.C., from July 1999 through April 2000 in accordance with generally accepted government auditing standards. (See app. I for a complete discussion of our objectives, scope, and methodology.)

[1]We previously issued Tax Administration: Foreign- and U.S.-Controlled Corporations That Did Not Pay U.S. Income Taxes, 1989-95 (GAO/GGD-99-39, Mar. 23, 1999).

Results in Brief

Based on IRS information, as of September 30, 1999, 244 business taxpayers had either entered into an APA with IRS or had one pending. IRS records also showed that at least 88 other taxpayers were identified as having considered APAs, but for various reasons, they did not complete the process.[2] According to an IRS official, the majority of taxpayers involved in its APA program were large corporations, and they were spread across many industries.

Also, most U.S. taxpayers that had recent transfer pricing disputes with IRS had not participated in the APA program as of September 30, 1999.[3] As of that date, 10 percent of the 1,245 large corporate taxpayers with international related parties had an approved agreement or had one pending, but the 10 percent accounted for 42 percent of the dollar value of the intercompany transactions in our analysis of large taxpayers.[4]

IRS did not consistently meet its timeliness targets for processing unilateral APAs and the first phase of bilateral APAs. Although IRS did not have targets for completing bilateral agreements in their entirety, some were pending for several years, even after their proposed time periods had expired. In particular, IRS did not have targets for completing the part of bilateral agreements involving negotiations with tax authorities in other countries. While IRS has acted to address what its officials said were some of the reasons for the timeliness problems, it is unlikely to resolve them without gathering more information to determine the causes. As a result, we are recommending that IRS gather such information and that IRS test target timeframes for approving bilateral APAs.

According to IRS, only a few problems were found in its reviews of APA annual reports. IRS stated that, of the 211 annual reports reviewed between October 1, 1995, and late September 1999, only 15 reports involving 11 taxpayers caused IRS to adjust or consider adjusting tax returns.

[2]Some taxpayers who considered APAs did not identify themselves to IRS and, thus, are not included in the 88 taxpayers. Taxpayers might use a representative to contact IRS informally about APAs and remain anonymous until they decide to formally pursue an agreement.

[3]This relates to taxpayers involved in IRS' section 482 international examination or appeals cases between Oct. 1, 1994, and Dec. 31, 1998. We used this information because IRS had already compiled and used it in Apr. 1999, shortly before we began our work. (See table 1 and app. I for specific timeframes.)

[4]In this context, a large corporation is one with reported assets in tax year 1994 of $500 million or more for U.S. parent companies of controlled foreign corporations or, in general, total reported receipts of $500 million or more for foreign-controlled domestic corporations.

In commenting on a draft of this report, the Commissioner of Internal Revenue agreed with our recommendations and described several other IRS initiatives to improve the APA program. These initiatives included approximately doubling the APA professional staff over 2 years and changing the annual report review process.

Background

Transfer pricing is governed by section 482 of the Internal Revenue Code and its accompanying regulations. Accurate transfer pricing is important because it affects the distribution of profits among related companies and, thus, their taxable income and may also affect the distribution of tax revenue among countries.

Using APAs, IRS seeks to avoid transfer pricing disputes between it and business taxpayers by reaching prospective agreements with each taxpayer on the (1) appropriate transfer pricing methodologies that are to be applied to intercompany transactions and (2) results that are likely to occur from applying the methodologies. Intercompany transactions include those between U.S. taxpayers and their controlled foreign corporations (CFCs) and between entities abroad and their foreign-controlled corporations (FCCs) in the United States.[5]

Taxpayers who consider APAs do so voluntarily and pay IRS processing fees when they request an APA. APAs cover a specified time, often 3-5 years, and may be renewed or revised if IRS and the taxpayer agree. IRS may cancel or revoke an APA under certain circumstances, such as cases involving a misrepresentation or fraud. In addition, APAs may cover all of a taxpayer's transfer pricing activities or may be restricted to certain related companies or products. IRS' policy provides that the agreed-upon transfer pricing methodology may be applied retroactively to similar unresolved issues identified during previous audits of the taxpayer.

In January 1991, IRS approved its first APA and, shortly after that, issued procedures that implemented its APA program. It also adopted streamlined procedures in December 1998 to encourage small businesses meeting certain total gross income or intercompany transaction thresholds to participate in the program.

Several IRS organizational units are involved in the APA program, principally the APA program office within the Office of Chief Counsel. This

[5]A CFC is a foreign corporation in which U.S. shareholders own more than 50 percent of the value of the outstanding voting stock or all of the value of the outstanding stock. In the context of our report, an FCC is a U.S. company in which a foreign shareholder owns at least 25 percent of the voting power of stock allowed to vote, or 25 percent of the value of all the corporation's stock.

office is to work closely with IRS examiners who audit income tax returns, Appeals representatives who work on appeals of examined cases, and others in developing the proposed agreements with taxpayers.

When the APA program office considers a bilateral agreement, it develops its position on the proposed APA with the taxpayer but leaves the negotiation with the foreign government on such matters as the appropriateness of the transfer pricing methodology to the U.S. Competent Authority. Under U.S. tax treaties, the IRS Assistant Commissioner (International) is the U.S. Competent Authority, a role recently assumed under an IRS reorganization by the IRS Director, International. A tax treaty requires each country to designate a "competent authority" to administer the treaty's operative provisions. The U.S. and foreign competent authorities negotiate APA matters with each other under the applicable treaty's framework. The U.S. Competent Authority uses IRS' Tax Treaty Division as staff.

In administering approved agreements, APA program officials and IRS examiners are to review taxpayers' annual reports on their APAs describing actual operations during the year to ensure that they demonstrate compliance with the terms of the agreements. The annual report for each year of the agreement is to identify all material differences between the taxpayer's actual and expected business operations, all material changes in its methods of estimation, and all failures to meet critical assumptions.

Legislation enacted in December 1999 prohibited disclosure of specific APAs and APA background files but required the Department of the Treasury to report annually to Congress general information on APAs.[6] The first report, which included such information as the number of APA applications filed, the number of APAs revoked or canceled, the number of APAs by industry, and general descriptions about the substance of the APAs, covered January 1, 1991, through December 31, 1999. It was issued on March 30, 2000.[7] Because our APA cutoff date differed from IRS', some statistics in our report also differ from IRS'.

[6]P.L. 106-170, Ticket to Work and Work Incentives Improvement Act of 1999.

[7]Annual Report Concerning Advance Pricing Agreements (IRS, Mar. 30, 2000).

The Extent of APA Use by Taxpayers Varied

Various measures exist on the extent to which taxpayers have used IRS' APA program. For instance,

- 244 taxpayers involved in various industries and countries had approved or pending APAs;
- most taxpayers with recent section 482 international examination findings or appeals determinations did not participate in APAs;[8] and
- a few large taxpayers that participated in APAs accounted for much intercompany trade.

244 Taxpayers Involved in Various Industries and Countries Had Entered Into APAs or Had Them Pending

As of September 30, 1999, 244 taxpayers had entered into an APA, that is, agreed to one that IRS also approved, or had one pending. In addition to these taxpayers, at least 88 others considered APAs but did not complete the process for various reasons, including their voluntary withdrawal of their proposal or IRS' rejection of it.[9] Although a majority of the taxpayers with APAs were large corporations according to an IRS official, eight small business taxpayers had completed agreements under IRS' small business APA program as of September 30, 1999.

Also as of September 30, 1999, IRS reported that of the 400 APAs in its records, 210 had been approved since the program's inception in 1991, and 190 others were in various stages of development. The number of taxpayers involved was less than the number of agreements because some taxpayers had more than one APA.[10] According to IRS data, 247 of the 400 approved and pending APAs were bilateral ones with 15 countries, and most of them involved 4 countries.

The taxpayers in IRS' APA program represented many different industries. As reported by IRS in March 2000, the agreements reached between IRS and taxpayers as of December 31, 1999, were spread over 21 broad industrial categories.[11] However, five industries were predominant among the 21 categories—financial institutions and products; computer items and computer software; chemicals and related products; transportation equipment; and electrical equipment and components.

[8]See table 1 notes for specific time periods.

[9]We could not obtain employer identification numbers for 20 of the 88 taxpayers for which the APA process was discontinued. This means that the tables in this report might not include all taxpayers in the databases we studied that considered obtaining an APA but did not complete the process.

[10]About 19 percent of the 400 agreements were renewals of previous agreements.

[11]IRS' March 2000 APA annual report. The industrial categories were devised by IRS staff who reviewed APA files to develop the APA annual report.

Most Taxpayers With Recent Transfer Pricing Disputes Did Not Participate in APAs

Most taxpayers with recent section 482 international examination proposed adjustments to income or significant section 482 issues subject to appeals determinations did not have approved or pending APAs as of September 30, 1999.

As table 1 shows, taxpayers with approved or pending APAs as of September 30, 1999, accounted for a small proportion of the taxpayers (72, or 6 percent of 1,150) that had section 482 examination disputes with IRS in fiscal years 1996 through 1998. For these 1,150 taxpayers, IRS' international tax return examiners proposed $15.4 billion in section 482 adjustments to income.[12] (See app. II for more information on the extent of APA use by taxpayers with recent section 482 proposed adjustments.)

Table 1: Involvement in APA Program of Taxpayers With Section 482 Disputes

	APA status			
Number of taxpayers with	Approved or pending agreements	Process discontinued	No APA experience	Total
Proposed examination adjustments[a]	72	23	1,055	**1,150**
Nontrial appeals closed[b]	17	11	91	**119**
Appeals open[c]	18	10	76	**104**

Note 1: The information in this table is for the APA program as of Sept. 30, 1999.

Note 2: Because we could not obtain employer identification numbers for 20 taxpayers whose APA process was discontinued, this table might not properly reflect those taxpayers. If any of them had an employer identification number that matched an employer identification number in the examination or appeals database, those taxpayers would have appeared in the "process discontinued" column.

[a]These taxpayers had section 482 international examination cases closed in fiscal years 1996-98.

[b]These taxpayers had section 482 appeals cases closed between Oct. 1, 1994, and Dec. 31, 1998.

[c]These taxpayers had appeals cases open as of Dec. 31, 1998.

Source: GAO analysis of IRS information.

As was the case with section 482 proposed adjustments, taxpayers with approved or pending APAs accounted for a small percentage (14 percent) of section 482 large issue appeals determinations.[13] Of the 119 taxpayers that had $8.1 billion in appeals cases closed between October 1, 1994, and December 31, 1998, without trial, 17 taxpayers had an approved or pending APA as of September 30, 1999. Taxpayers with approved or pending APAs accounted for 18 of the 104 taxpayers involved in open section 482 appeals cases, which had $16.2 billion at issue as of December 31, 1998.

[12]Other taxpayers with approved and pending APAs had section 482 adjustments proposed in examinations closed before fiscal year 1996.

[13]IRS did not track every section 482 issue but focused on significant ones for large corporations.

A Few Large Taxpayers Participating in APAs Accounted for Much Intercompany Trade

Another way to describe the extent of APA use by taxpayers is to discuss the extent to which taxpayers in international intercompany trade participated in the APA process. According to IRS data, a small percentage of the 1,245 large taxpayers with international intercompany transactions participated in IRS' APA program; however, those taxpayers that did participate included some with the largest receipts from, or payments to, related parties. As of September 30, 1999, 10 percent of the large taxpayers had approved or pending APAs. However, these taxpayers accounted for 42 percent of the dollar value of the large corporations' intercompany transactions included in the information we used.[14] These percentages cover both transactions with CFCs and transactions with FCCs and their foreign related parties. (See app. III for information on the extent of APA use by U.S. parent companies of CFCs and app. IV for data on the extent of APA use by FCCs.)

IRS Did Not Consistently Meet Its APA Timeliness Targets

IRS did not consistently meet its timeliness targets for completing APA processing. In some instances, APAs were pending for years. We found many reasons why IRS was unable to complete the processing of APAs as quickly as IRS officials had hoped; some were related to its management of the APA program and some were related to differences in views with its treaty partners. IRS took some actions to improve APA timeliness, but did not go as far as it could have.

The Timeliness of IRS' APA Processing Varied

The timeliness of IRS' APA processing varied. For unilateral APAs, IRS' target was generally 12 months from application, with the target for small businesses being 6 months. For fiscal year 1999 unilateral APAs, the median completion time was 12.5 months—slightly more than the target and the lowest median since 1993. Eleven 1999 unilateral APAs exceeded the target by 2 to 32 months. The median completion time for fiscal year 1998 was 16 months. The median for fiscal years 1998 and 1999 together was 14.5 months, but excluding renewals and small businesses, the median was 24 months.[15] The median times for APA renewals and small businesses for the 2 years were 7.5 and 5 months, respectively, with the small business actual time less than the target. IRS procedures did not specify a separate targeted completion time for approving renewals.

With regard to bilateral APAs, IRS had a target for completing only the first phase of the two-phase process. In the first phase, IRS and the taxpayer

[14]We did not determine if these transactions were actually involved in APAs.

[15]According to APA officials, renewals entail reviewing submitted information and meeting with taxpayers and could involve changed business circumstances or transfer pricing methodologies. The first small business APA was approved in fiscal year 1998.

agree on the transfer pricing methodology, and the IRS APA team then formulates a negotiating position for use by the U.S. Competent Authority in further negotiations with foreign tax authorities. IRS' target for this part of the bilateral APA process was 9 months. However, for the bilateral agreements IRS approved in fiscal year 1999 for which we had information, the APA office used a median time of 18 months to complete the initial phase of bilateral processing. Including competent authority time, for which IRS does not have a target, that year's approved bilateral agreements required a median time of 32 months for approval, the most time since the program began in 1991.[16] Approved bilateral agreements required a range of 10 to 60 months. Forty-two bilateral APAs were pending as of September 30, 1999, even though their applications were filed between calendar years 1993 and 1996. (See app. V for competent authority contributions to APA processing time.)

Despite the intended prospective nature of APAs, IRS was unable to consistently approve all APAs before their proposed terms of coverage ended, so the agreements would have to be applied retroactively. Based on IRS mid-calendar year 1999 data, at least 25 applications for bilateral APAs were still pending even though their proposed terms had passed. While the taxpayers involved might have filed their tax returns knowing IRS' transfer pricing preferences, the "advance" nature of the APAs might have been compromised. Also, completing APAs after relevant tax returns were filed could have kept taxpayers in suspense about their tax treatment and required adjusting their tax returns.

Many IRS Reviews of APA Annual Reports Were Pending for More Than a Year

In many instances, IRS reviews of APA annual reports were pending for a longer amount of time than the period the reports covered. According to an IRS official, IRS did not meet various informal timeliness guidelines relating to its process for reviewing the annual reports. On the basis of IRS statistics, 120 of 240 annual reports pending IRS review as of September 30, 1999, had been pending with IRS for more than a year, and 50 had been pending for more than 2 years. According to an IRS official, APA teams reviewing renewal applications had reviewed some of these annual reports, but this was not reflected in the Chief Counsel's database that contains such information. The IRS official could not say when the annual report review backlog would be eliminated. However, IRS was planning to revamp its procedures for reviewing annual reports to speed up the process.

[16]Seven renewed bilateral APAs and one revision completed between Sept. 30, 1997, and Sept. 30, 1999, took a median of 24.5 months, less than the 31-month median for new bilateral APAs in those 2 years.

APA Timeliness Concerns Existed for Many Reasons

IRS officials and others knowledgeable about IRS' APA program were concerned about how much time it took to complete APAs and offered reasons for APA delays. IRS officials said that they had acted to address some of their concerns and were considering other suggestions.

Reasons Given for APA Delays

In addition to the inherent difficulty of handling contentious cases involving large amounts of tax, IRS officials and others attributed delays within IRS' APA program office to various factors. Both IRS officials and others cited the need for more APA staff and less staff turnover. Individuals outside IRS also mentioned the following: (1) IRS' field staff, with their traditional audit focus, were overly involved in a process that was intended to be cooperative; (2) IRS had difficulty making decisions about proposed APAs; and (3) taxpayers delayed the process by not expeditiously giving IRS requested information.

IRS officials and others agreed that bilateral APA negotiations between it and U.S. tax treaty partners could take a substantial amount of time because, for instance,

- other countries sometimes preferred a different transfer pricing methodology than IRS preferred;
- APA negotiation meetings between IRS and some countries were infrequent;
- the level of some foreign governments' resources devoted to APAs was inadequate; and
- other countries were reluctant to negotiate on APAs because they feared changes in APA confidentiality before the 1999 legislation prohibited disclosing APAs and APA background files.

In addition, individuals knowledgeable about IRS' APA program said that having a single office negotiate with both the taxpayer and the foreign government, a structure that some foreign tax authorities have had, was more efficient than IRS' structure of using two offices to negotiate bilateral agreements. Other knowledgeable individuals, however, saw benefit in having people involved who had experience negotiating with treaty partners. Our work did not address the efficiency of IRS' structure for processing APA applications or those of foreign tax authorities.

IRS Actions to Improve APA Timeliness

IRS has acted over the past few years to address the reasons for its APA timeliness problems. According to IRS officials, the APA program office started requiring a case plan and schedule for each proposed APA, specifying timeframes for completing various negotiation steps with the taxpayer within the APA office. IRS also targeted for completion all APA

cases that were at least 2 years old. In addition, to speed up reviewing APA annual reports, IRS assigned one person to coordinate the reviews, rather than having APA negotiating staff be responsible.

Possibilities for Improving APA Timeliness

Although IRS had taken actions over the past few years to address its APA timeliness concerns, it was not systematically gathering information to determine the reasons for processing delays and, thus, did not have reliable information to make process improvements. For instance, its APA case files did not specifically annotate whether timeframes in its plans and schedules were met, and if they were not met, the reasons why. Nor did IRS make full use of the APA data in its Chief Counsel's Automated Systems Environment (CASE) database. APA officials did not use information from CASE on step-by-step processing times because, among other things, the dates in the database were not always accurate. As a result of these failures to collect and use APA data, IRS lacks information for making improvements to the program.

APA officials were concerned about the extra burden associated with annotating case files. One way to help reduce the burden would be for APA officials to capture this information for approved APAs when recording the data needed to prepare the annual report to Congress on APAs. Another way would be to modify CASE to continually capture information on why problematic APAs were delayed and where the responsibility for delays resided. An APA official said that this was a less costly alternative for capturing information on processing delays than annotating case files.

On a related matter, IRS did not have a timeliness target for completing all processing related to bilateral APAs, including the negotiation with foreign tax authorities. An IRS official told us that at least in recent years, IRS had not focused on having a target. The United Kingdom, however, publicly wrote that it and other affected tax authorities should aim to complete bilateral APAs within 18 months, depending on the applicant's ability to provide information in a timely way.

Also emphasizing the importance of targets, a private firm representing taxpayers advised IRS to include in the impending revisions to its APA procedures the target times it already had for approving unilateral APAs and formulating the negotiating position to use with foreign tax authorities for bilateral agreements. By doing so, the firm said, it would reinforce the idea that timely completion of APAs is both an IRS priority and an element critical to the APA program's future success.

IRS officials were open to the possibility of establishing targets for completing bilateral APAs. However, they were wary of adopting other countries' targets as their own and using them in negotiations with those countries or having different targets for different countries. In addition, one official was concerned that another country's target might be optimistic. Also, according to IRS officials, targets would need to achieve a balance between efficient processing and prudent tax administration, not sacrificing appropriate APA outcomes for the sake of meeting deadlines. These officials described giving taxpayers good customer service and providing a model for relations with other countries as benefits of setting targets. IRS officials told us they wanted APAs approved more quickly than they have been, and having an APA's term elapse before completion was disappointing and frustrating to both them and taxpayers. Taxpayers had no certainty, and IRS had to acknowledge the lengthy process up front when dealing with taxpayers.

IRS' Reviews of APA Annual Reports Found Few Problems

According to IRS, only a few problems were found in the APA annual reports that staff reviewed. Of the 211 annual reports staff reviewed between October 1, 1995, and late September 1999, IRS staff found circumstances in 15 reports affecting 11 taxpayers that appeared to be problematic. For these taxpayers, adjustments to their income tax returns had been made or were still being considered when we completed our review. Adjustments were needed because IRS believed the taxpayers did not fully comply with the terms of the APA. Problems included inappropriate costs being charged and certain income not being reported. An IRS official estimated these adjustments to taxpayers' income would total at least $132 million, with additional amounts still being developed.

Conclusions

Delays in APA processing could adversely affect business taxpayers, leading, for instance, to retroactive adjustments to tax returns and preventing taxpayers from getting the advance certainty about their tax situations that they seek. Delays that discourage participation in the APA program could also lead to more disputes that are costly to both the taxpayer and the government.

With better information on the reasons for APA delays, IRS would have more of a basis for making improvements to the APA program. Also, although IRS officials were wary of setting targets for completing the processing of bilateral APAs, such targets might establish expectations for more timely bilateral APA negotiations on the part of both American taxpayers and other countries.

Recommendations to the Commissioner of Internal Revenue

We recommend that the Commissioner of Internal Revenue take steps to cost-effectively collect data on APA processing suitable for analyzing the causes of delays and developing options for improvement. Such steps might include documenting deviations from plans or schedules and the reasons why in case files or modifying CASE to systematically capture such data.

We also recommend that the Commissioner test the use of written timeliness targets for processing bilateral APAs to determine the feasibility of using them for all bilateral APAs.

Agency Comments

In commenting on a draft of our report, the Commissioner of Internal Revenue said it was fair and informative. He agreed with our recommendations and also described other initiatives to improve the APA program. He shared our concerns about the time taken to process APAs and found our recommendations helpful.

In agreeing to collect more data on APA processing, the Commissioner said that, by September 1, 2000, the APA program would create codes within CASE to capture data on the causes of APA case-processing delays. According to the Commissioner, the change will allow IRS to monitor the causes for delays and address and correct structural and case-specific problems identified.

The Commissioner also mentioned three other measures to improve APA processing times. First, because it believed resource constraints were the main cause of APA cases taking a long time, IRS expected to approximately double the size of the APA professional staff over 2 years. Second, the Commissioner for Large and Mid-size Business within IRS indicated that, as part of his initiative to promote IRS-taxpayer cooperation before tax returns are filed, he was preparing a staffing initiative to help the processing of bilateral APAs. Finally, agreeing that the backlog in reviewing annual reports should be reduced, IRS was planning to change the review process. Although the APA program office has made marked progress in reviewing annual reports, starting September 1, 2000, IRS' operating divisions, with their larger resources, and not the APA program office, are to do the first and primary review of annual reports.

Agreeing with our recommendation that IRS test the use of written timeliness targets for processing bilateral APAs, the Commissioner said IRS will immediately approach several treaty partners to pursue such targets bilaterally. It will do so in the context of not jeopardizing the timely resolution of non-APA cases. Also, it will do so keeping in mind that

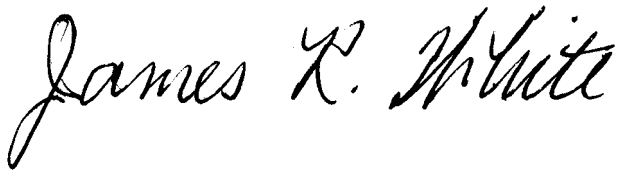
general timeliness targets should not be misunderstood. That is, the time to process specific cases may vary substantially depending on their complexity.

The full text of the Commissioner's comments is reprinted in appendix VI.

As agreed with your office, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from the date of this letter. At that time, we will send copies to Senator William V. Roth, Jr., Chairman, and Senator Daniel Patrick Moynihan, Ranking Minority Member, Senate Committee on Finance; Representative Bill Archer, Chairman, and Representative Charles B. Rangel, Ranking Minority Member, House Committee on Ways and Means; the Honorable Charles O. Rossotti, Commissioner of Internal Revenue; and other interested parties. Copies will be made available to others upon request.

If you or your staff have any questions about this report, please contact Charlie Daniel or me on (202) 512-9110. Key contributors to this report are acknowledged in appendix VII.

Sincerely yours,



James R. White
Director, Tax Policy
and Administration Issues

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Abbreviations

APA	advance pricing agreement
CASE	Chief Counsel's Automated Systems Environment
CFC	controlled foreign corporation
FCC	foreign-controlled corporation
IRS	Internal Revenue Service
USCC	U.S.-controlled corporation

Objectives, Scope, and Methodology

The objectives of this report were to determine (1) the extent of advance pricing agreement (APA) use by U.S. taxpayers, including those that have had transfer pricing disputes with IRS; (2) the timeliness of APA processing; and (3) the results of IRS' review of taxpayers' annual reports on compliance with APAs.

In determining the extent of APA use, we took two approaches. First, by analyzing databases containing APA information, we ascertained the number of taxpayers involved in the APA program and gathered from the databases descriptive information about each taxpayer, such as the employer identification number. Second, by matching these databases with others, we determined the extent to which taxpayers with contentious transfer pricing histories or international intercompany transactions became part of the APA process.

The information we are reporting, such as the number of taxpayers with approved or pending APAs and the number of taxpayers with histories of transfer pricing disputes with IRS, was not an assessment of the effectiveness of the APA program. Such an assessment would require a more substantive, in-depth analysis than our work intended. However, some of our analysis could be used to draw inferences that could lead to improving the program. In addition, recognizing that APAs are voluntary agreements by taxpayers is important because taxpayers might have legitimate reasons for not participating in IRS' APA program. For example, some taxpayers might not want to pay the fee involved with the APA process, which could be up to $25,000.

For our study, we obtained certain types of information, such as the identity of taxpayers that did identify themselves to IRS before filing APA applications, from the Chief Counsel's Automated Systems Environment (CASE). This system was designed to, among other things, track various Chief Counsel cases. We also used IRS' APA program office databases of APA cases that included information on those that were approved or pending.

We compared the information from these databases on the taxpayers that had been involved in the APA program as of September 30, 1999, with information on taxpayers in two of IRS' Statistics of Income Division databases. Our purpose was to determine the extent to which large taxpayers with international intercompany transactions were involved in the APA program. We used the Statistics of Income Division's tax year 1994 databases on foreign corporations controlled by large U.S. multinational corporations and on large foreign-owned domestic

corporations, which we call foreign-controlled corporations (FCCs). These databases were the most recent available when we began our work.

As IRS wrote in an article resulting from the use of the FCC database, it could not locate all the needed corporate income tax returns in time to be included in its population of FCCs.[1] Thus, some of the returns it did have were given a sampling weight of more than one to compensate for those missing. Because of some imprecision owing to sampling variability, we used IRS' sampling weights to calculate confidence intervals for the FCC estimates used in this report. Unless otherwise noted, we are 95-percent confident that actual population values are within plus or minus 5 percent of the estimates we report.

To determine the extent to which taxpayers with section 482 examination findings appeared in IRS' APA databases, we compared information for examinations completed in fiscal years 1996 through 1998 from IRS' International Case Management System with information from the APA databases. The International Case Management System contains the results of IRS examinations of the international features of tax returns. We used information from fiscal years 1996 through 1998 because IRS had already segregated this information for its April 1999 report to Congress on section 482.[2]

Further, we matched the taxpayers in IRS' APA databases as of September 30, 1999, with taxpayers that had appeals cases with section 482 issues. Our purpose in doing this was to obtain general information on the extent to which taxpayers involved in IRS' appeals process were also involved with APAs. We used an IRS database that tracks appeals cases covering large corporations and major appeals issues. Our focus was on cases that had closed between October 1, 1994, and December 31, 1998, or were still open as of December 31, 1998. Like the examination findings data, the appeals data on closed section 482 cases had already been used by IRS in its 1999 report to Congress on section 482.

Although we did not audit to determine the accuracy and reliability of the information in any of these databases, we checked the reasonableness of the results we obtained against other information we acquired from IRS. Such checking was necessary because we determined from our discussions with IRS officials with knowledge about the different

[1]"Transactions Between Large Foreign-Owned Domestic Corporations and Related Foreign Persons, 1994," IRS, SOI Bulletin (Winter 1997–1998).

[2]Report on the Application and Administration of Section 482 (IRS, Apr. 1999).

databases that there were varying degrees of control over the quality of the input. If our checks showed that information was not reliable, we did not use it, or we qualified our use of it. For instance, in trying to determine the number of APAs that foreign-controlled business taxpayers entered into or had pending, we noticed that the information in CASE was internally inconsistent and also inconsistent with other information we obtained. Therefore, we decided not to use these specific data.

Throughout our analysis, in comparing information across the different databases, we used the employer identification number IRS assigned to each taxpayer. In circumstances where the employer identification numbers were not used in certain databases or seemed to be in error, we worked with IRS to resolve any discrepancies.

In matching the databases, we were interested in determining the extent to which the taxpayers that had section 482 examination or appeals issues with IRS were also involved in IRS' APA program. However, we could not determine whether the APAs dealt with the same transfer pricing issues that were the subject of IRS' previous compliance findings.

Also, in matching the databases, we used information from different time periods. This was because we were analyzing the APA experience of taxpayers that were at least of a certain size for a specified time period or had section 482 examination or appeals issues and enough time had elapsed since those issues arose for them to become involved with the APA program.

To determine the timeliness of APA processing, we analyzed information on processing times contained in IRS' databases. This information included data on specific taxpayers with approved or pending APAs as of September 30, 1999, and on a few taxpayers that started the process of securing an APA but discontinued it. We also used this information to determine how much time IRS used to renew APAs and to review APA annual reports.

To determine the results of IRS' reviews of APA annual reports, we discussed the review process with IRS officials and analyzed relevant documentation.

In addressing all three objectives, we interviewed people knowledgeable about the APA program both inside IRS, such as officials in the APA program, and outside IRS, such as taxpayer representatives. We also

reviewed IRS surveys, reports, and other documents relating to the APA program.

The Extent of APA Use by Taxpayers With Section 482 Proposed Adjustments

This appendix provides descriptive information on APA use by business taxpayers whose tax returns were reviewed by IRS international examiners who proposed section 482 adjustments to income. This information is based on the data in table 1 in this report, which shows that 1,150 taxpayers had international examination cases closed with section 482 proposed adjustments in fiscal years 1996 through 1998 and that 1,055 of them had no experience with IRS' APA program. This information is also derived from the other sources we used in our work. In general, the data show that taxpayers with approved or pending APAs comprised small percentages of various subgroups of the 1,150 taxpayers with closed examinations. The information follows:

- IRS' international examination database identified 760 of the 1,150 taxpayers as foreign-controlled corporations (FCCs) and 269 as U.S.-controlled corporations (USCCs) but did not have information for the remaining 121.[1] About 6 percent of these FCCs and 9 percent of the USCCs were taxpayers that had entered into an APA with IRS or had one pending.
- According to IRS information, 366 of the 1,150 taxpayers had assets of $250 million or more, and about 12 percent of the 366 had entered into an APA with IRS or had one pending.
- Of the 100 taxpayers with the largest section 482 proposed adjustments, 21 had approved or pending APAs.
- In 13 industries, 448 taxpayers accounted for 39 percent of the 1,150 taxpayers with section 482 proposed adjustments for the years covered by our analysis. These same taxpayers accounted for 62 percent of the $15.4 billion in proposed adjustments.[2] Taxpayers with approved or pending APAs existed in all of the 13 industries except one, but accounted for only 7 percent of the 448 taxpayers.

IRS had section 482 examination issues with taxpayers of different sizes. However, according to an APA official, the taxpayers with APA experience were less diverse.

- About 67 percent of the 1,150 taxpayers for which IRS had section 482 proposed adjustments to income for fiscal years 1996-98 reported that they had no balance sheet or less than $250 million in assets. However, an APA

[1]USCCs are domestic corporations that are not foreign controlled, although certain entities such as subchapter S corporations, which are corporations that are treated for federal income tax purposes like partnerships, are not included in either category.

[2]We chose the 13 industries to give us reasonably broad coverage of both the number of taxpayers with section 482 proposed adjustments and the amount of adjustments associated with the taxpayers.

official told us that most of the taxpayers in the APA program were among the largest corporations in the country.[3]

- About 32 percent of the taxpayers with section 482 proposed adjustments were taxpayers with $250 million or more in assets. However, of the taxpayers with both section 482 findings and approved or pending APAs, 60 percent were taxpayers reporting assets in this range.

After we began our review, IRS collected information on the extent to which the 129 taxpayers that had entered into APAs as of August 23, 1999, had been the subject of previous section 482 findings. IRS found that about half, or 65, of the 129 taxpayers had previous transfer pricing examination issues or disputes related to their APAs for which the IRS examiners had proposed increases to income of $3.2 billion. Additionally, IRS and the taxpayers agreed to retroactively apply the APA transfer pricing methodology to cover open transfer pricing issues for adjustments totaling about $920 million. This means that, at most, about 29 percent of the original proposed adjustments for these taxpayers were covered through retroactive applications. In addition, IRS reported that, even without retroactively applying the transfer pricing methodology, the APA process helped it settle another $630 million in proposed adjustments to income applicable to previous years. These settlements included almost $300 million for situations in which IRS and the taxpayer agreed that no adjustment was needed.

[3]We did not verify this assertion because the indicator in the Chief Counsel's Automated Systems Environment database noting whether a taxpayer was in IRS' Coordinated Examination Program—the program containing the nation's largest corporations—did not provide information that was consistent within CASE or with other information we had.

The Extent of APA Use by Large U.S. Parent Companies of Controlled Foreign Corporations

This appendix provides data on the extent of APA use by large U.S. parent companies of controlled foreign corporations (CFCs). In this context, a large U.S. parent company is one with reported assets in tax year 1994 of $500 million or more. Information in table III.1 shows the following:

- Sixty-six large parent companies of CFCs had approved or pending APAs as of September 30, 1999. This was about 8 percent of the 801 largest taxpayers that reported having CFCs in tax year 1994, the year covered by the database underlying IRS' most recently published information on CFCs at the time we began our work.[1]
- Another 28 large parent companies of CFCs, or 4 percent, were identified as having considered obtaining an APA but not completing the process.
- More of the large U.S. parent companies that had approved or pending APAs, and more of their 7,500 largest CFCs, were in the manufacturing industry compared to the other industry groups.

Table III.1: Participation of Large CFC Parent Companies and Their CFCs in IRS' APA Program

	APA status				
Industry group	**Approved**	**Pending**	**Process discontinued**	**No APA experience**	**Total**
CFC parent companies					
Manufacturing	33	11	17	415	**476**
Other	17	5	11	292	**325**
Total	**50**	**16**	**28**	**707**	**801**
CFCs[a]					
Manufacturing	345	118	146	2,236	**2,845**
Other[b]	620	121	361	3,553	**4,655**
Total	**965**	**239**	**507**	**5,789**	**7,500**

Note 1: Because we could not obtain employer identification numbers for 20 taxpayers whose APA process was discontinued, this table might not properly reflect those taxpayers. If any of them had an employer identification number that matched an employer identification number in the CFC database, those taxpayers would have appeared in the "process discontinued" column.

Note 2: Industry groups in the "other" category include agriculture, forestry, and fishing; mining; construction; transportation and public utilities; wholesale and retail trade; finance, insurance, and real estate; and services.

[a]The numbers in this section of the table refer to the number of CFCs whose parent companies were or were not involved with APAs. The same parent could have more than one CFC.

[b]The largest industry group within this category was finance, insurance, and real estate, which had 418 CFCs whose parent companies had approved or pending APAs, less than the 463 manufacturing CFCs whose parent companies had approved or pending APAs.

Source: GAO analysis of IRS information on APA participation as of Sept. 30, 1999.

The few large taxpayers that had CFCs and also approved or pending APAs represented proportionately larger shares of CFC transactions.

[11]"Controlled Foreign Corporations, 1994," IRS, SOI Bulletin (Summer 1998).

Specifically, the 66 large taxpayers (8 percent of the 801 taxpayers) with CFCs and approved or pending APAs accounted for almost half the related-party payments by all the large taxpayers' CFCs (see table III.2).

Table III.2: Payments by CFCs Whose Parent Companies Were or Were Not Involved in APAs

Dollars in billions for 1994 tax returns

	Approved or pending APAs	APA process discontinued or no APA experience	Total
Payments by CFCs	$228	$269	**$497**

Note 1: For U.S. taxpayers involved or not involved in IRS' APA program as of Sept. 30, 1999.

Note 2: Because we could not obtain employer identification numbers for 20 taxpayers whose APA process was discontinued, this table might not properly reflect those taxpayers. If any of them had an employer identification number that matched an employer identification number in the CFC database, those taxpayers would be included in the "process discontinued" category.

Source: GAO analysis of IRS information.

Although about 8 percent of large taxpayers with CFCs had approved or pending APAs, this percentage was higher for taxpayers with CFCs that had large amounts of receipts or payments. Of the 73 large taxpayers whose CFCs reported related-party receipts or payments of at least $1 billion, 19 of them, or 26 percent, had completed an agreement or had one pending.

Our analysis of related-party payments and receipts by industry showed that 12 industries each accounted for more than $10 billion of receipts or payments. Taxpayers had different experiences in these industries as noted in the following:

- Taxpayers whose CFCs accounted for most of the dollars in some of those industries had approved or pending APAs, and taxpayers accounting for most of the dollars in other industries did not.
- In some industries, IRS had approved or pending APAs with the few large taxpayers that had most of those industries' related-party receipts and payments by large taxpayers' CFCs.
- In other industries, IRS had approved or pending APAs with few of the large number of large taxpayers involved, and those taxpayers represented a small percentage of those industries' related-party receipts or payments by large taxpayers' CFCs.

The Extent of APA Use by Large Foreign-Controlled Corporations

This appendix provides data on the extent of APA use by large foreign-controlled corporations (FCCs). In this context, a large FCC is one that had, in general, total reported receipts of $500 million or more. Table IV.1 shows that, of the 444 large FCCs that IRS identified from 1994 tax returns,[1] 53, or 12 percent, had an approved or pending APA as of September 30, 1999.

Table IV.1: Largest FCCs' Involvement in IRS' APA Program

FCCs	Approved or pending APAs	APA process discontinued or no APA experience	Total
Selected countries[a]	40[b]	156	**196**
All other countries	13	235	**248**
Total	**53[b]**	**391**	**444**
Payments to foreign related parties[c]	$85	$135	**$220**

Note: Because we could not obtain employer identification numbers for 20 taxpayers whose APA process was discontinued, this table might not properly reflect those taxpayers. If any of them had an employer identification number that matched an employer identification number in the FCC database, those taxpayers would have been included in the "process discontinued" category.

[a]For each of these countries, at least 16 percent of the large FCCs with a parent company in the country had an approved or pending APA.

[b]The 95-percent confidence interval--plus or minus 3--surrounding this number exceeds plus or minus 5 percent.

[c]Dollars in billions from 1994 tax returns.

Source: GAO analysis of IRS information on APA participation as of Sept. 30, 1999.

Table IV.1 summarizes information on large FCCs that were involved in IRS' APA program by two country groupings. Country names are omitted to avoid disclosing taxpayer data. We make the following observations:

- For an aggregation of certain selected countries, 40 of 196 large FCCs had approved or pending APAs, a ratio of about 1 in 5.
- The corresponding ratio for the other countries and for the 13 FCCs with no country identified in IRS' database was about 1 in 19.

The following observations were also derived from information in table IV.1:

- Although 12 percent of the large FCCs had approved or pending APAs, they had 39 percent ($85 billion of $220 billion) of the total payments made to foreign related parties from all large FCCs.

[1]"Transactions Between Large Foreign-Owned Domestic Corporations and Related Foreign Persons, 1994," IRS, SOI Bulletin (Winter 1997–1998).

- Of the 49 large FCCs that reported foreign related-party receipts or payments of at least $1 billion, 16, or about a third, had an approved or pending APA.

In addition to analyzing the FCC information by country and size of receipts and payments, we also examined it by industry. We found the following:

- Like most of the large FCCs, most of the 53 large FCCs with approved or pending APAs were in the manufacturing and wholesale and retail trade industrial sectors.
- Some industries had at least seven large FCCs but none in IRS' APA program.
- For the four largest wholesale trade industries in terms of intercompany payments made by large FCCs, about 63 percent of the payments were made by large FCCs that had approved or pending APAs.

Competent Authority Contributions to APA Processing Times

The time an APA spent in the competent authority part of the APA process was often a significant, albeit not the only, contributor to the overall time to complete APA processing, as follows:

- Median competent authority times for cases closed in fiscal years 1997 through 1999 and resulting in an APA varied by country involved in the process. For the 3-year period taken as a whole, the median competent authority times ranged between 12 and 19 months for different countries, with one country having a much lower median time.
- The median total times spent on these cases over the 3-year period, with the same exception for a shorter time, ranged from 20 to 44 months, depending on the country.
- In 23 of the 60 cases closed in this period, the time spent in IRS' competent authority process, as recorded by the competent authority office, was more than half the entire time reported by the APA office.
- The amount of time spent by competent authority on individual cases ranged from 2 to 51 months.
- IRS' competent authority staff did not have a goal for how long the competent authority part of the APA process should take, but they said that timely resolution was critical.

Comments From the Internal Revenue Service

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

COMMISSIONER

July 27, 2000

Mr. James R. White
Director, Tax Policy
and Administration Issues
U.S. General Accounting Office
441 G Street, N.W.
Washington, D.C. 20548

Dear Mr. White:

Thank you for the opportunity to comment on your draft report entitled "Tax Administration: IRS' Advance Pricing Agreement (APA) Program," dated June 26, 2000.

The APA Program is one of our most visible and successful customer service compliance initiatives, and timely processing of APA requests is crucial to the Program's continued success. As a result, we share your concerns about the time it takes to process APAs, and we find your recommendations helpful. As you suggest, we are developing a system that will allow us to monitor the causes for delays, and address and correct both structural and case-specific problems. In addition, we will work with our treaty partners who have significant APA inventories to develop mutually agreed measures to promote the timeliness of APA processing.

The main reason APA cases take longer than the ideal to process is resource constraints. In this way, the APA Program has been a victim of its own success. As the Program's reputation for reaching principled, even-handed, practical solutions to some of the most difficult cases facing the IRS and taxpayers has grown, demand for APAs has also grown. Even though we are processing APAs at a record pace, this demand has outstripped the Program's resources.

Thanks to the dedication and skills of APA Program and Competent Authority personnel, productivity has grown steadily. Although APA Program and Competent Authority professional staff levels have remained constant over the past several years, output has risen. The APA Program completed 31 APAs in FY 1996 and 46 in FY 1999. Although the APA Program has continually processed individual APAs more efficiently, the increasing number of taxpayers seeking APAs has led to increasing inventory and case loads. Year-end inventory grew from 144 in FY 1996 to 190 in

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FY 1999. For more detailed information on the APA Program, see the recently released first *Annual Report Concerning Advance Pricing Agreements*, Announcement 2000-35, 2000-16 I.R.B. 922.

While we continue to look for ways to improve our productivity, we believe increases in processing speed and reducing our backlog can best be accomplished by dedicating additional resources to processing APAs. Therefore, the IRS Chief Counsel has recently adopted a two-year staffing initiative for the APA Program. Under this initiative, the Chief Counsel has authorized the APA Program to increase its professional staff from 17 to 25 this fiscal year. The Chief Counsel also intends to hire additional APA staff next fiscal year. At the end of this two-year initiative, the APA Program professional staff is expected to approximately double in size.

The Commissioner for Large and Mid-size Business ("LMSB"), as part of his initiative to promote pre-filing efforts, also is preparing a staffing initiative to assist the processing of bilateral APAs. The LMSB organization has only recently come into existence and program staffing levels are now under review. The LMSB Commissioner said that pre-filing initiatives, including APAs, will be a priority in the new organization, and that additional resources will be made available for this purpose.

COMMENTS ON DRAFT REPORT

We find the GAO's draft report fair and informative. We are quite pleased with your finding that large taxpayers involved in the APA Program account for 42 percent of the dollar value of the large corporations' intercompany transactions included in the information you used. This illustrates the impact and importance of the APA Program to tax administration and our goal of promoting voluntary compliance. We are less pleased with the findings that relatively small percentages of large taxpayers and taxpayers with pending transfer pricing issues are involved in the APA Program. Because we want to increase the level of taxpayer participation in the APA Program (among other pre-filing initiatives), we have adopted streamlined small business procedures, an early referral program, and the initiative for increased staffing described above. We will also continue to explore other ways to make the Program more accessible and attractive to taxpayers.

We have already discussed the need to speed up processing of APA cases and are optimistic that our staffing initiative, along with the new CASE procedure for tracking the reasons for processing delays (described below under recommendations), will help us make significant improvements in this area.

We agree we need to reduce the backlog associated with our review of Annual Reports. APAs require taxpayers to furnish an Annual Report containing specified information and demonstrating compliance with the Transfer Pricing Methodology (TPM) prescribed in the APA. Taxpayers send these reports to the APA Program Office in Washington for an initial review to ensure the taxpayer has complied with the terms and conditions

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of the APA. If the initial reviewer decides the Annual Report does not contain the required information or does not, on its face, indicate the taxpayer has complied with the TPM, the initial reviewer contacts the taxpayer or representative, usually in writing, requesting additional information or clarification. Generally, either the taxpayer's response resolves the issue raised, or the taxpayer agrees to make an adjustment to comply with the terms of the APA.

Once the APA Program Office has reviewed the Annual Report, it forwards a copy of the Report and all correspondence to the Operating Division with responsibility for the taxpayer for a secondary review. The secondary reviewer has 90 days to complete its review and is mainly concerned with tying the numbers from the Annual Report to the books and records of the taxpayer. Any follow-up issues raised by the secondary reviewer related to the interpretation of the Transfer Pricing Methodology that affect the validity or applicability of the APA are coordinated with the APA Program Office.

By September 1998, the APA Program Office had received over 300 Annual Reports, 200 of which had not yet been initially reviewed. To combat this backlog, the APA Program hired a program analyst to manage the APA Annual Report program. The analyst created an Annual Report inventory database to ensure that all filings were received and accounted for and began to reduce the backlog. Since the hiring of the program analyst in 1998, the APA Program Office has received an additional 400 Annual Reports, more than all the reports filed from the time the Program began in 1991 until 1998. In 1998, only about one-third of all filed Annual Reports had been reviewed. Today, approximately 60% of all filed Annual Reports have been reviewed. We have made significant progress in this area; however, as noted by the GAO, a significant backlog of unreviewed Reports remains.

In response to this backlog, the APA Program Office is planning to modify the Annual Report review process. Beginning September 1, 2000, incoming Annual Reports will first be sent to and reviewed by the IRS Operating Divisions. Historical data has shown that approximately 80% of the Annual Reports are accepted as filed with no additional inquiry. If this trend continues, then approximately 80% of the incoming Annual Reports will require a less stringent review by the APA Program Office as secondary reviewer. This change will allow the relatively small APA Program Office to call upon the larger resources of the Operating Divisions to help the APA Program Office close Annual Reports more rapidly. For the 20% of the Annual Reports that may require additional information or clarification, the Operating Divisions will continue to coordinate with the APA program analyst's office.

We have several comments about your recommendation that we test the use of written timeliness targets for processing bilateral APAs. First, we must ensure we apply the principle of reciprocity to tax treaty administration. This principle is demonstrated in the processing of bilateral APAs, which must reflect the consent of the treaty partner as well as that of the United States. We believe that, while timeliness targets serve as important management tools, they are more likely to succeed in the APA setting if they

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are endorsed in advance by the treaty partner. We propose to test this by approaching on a bilateral basis several treaty partners to pursue agreement on these targets.

Bilateral APAs are only part of the inventory of bilateral cases handled by the United States. The countries with which the IRS has bilateral APA cases are also countries with which we have notable numbers of bilateral post-audit transfer pricing cases (double-tax cases), as well as non-transfer pricing cases. We must carefully manage our efforts to reach bilateral agreements on APAs so that we do not jeopardize the timely resolution of these other cases. This is particularly true because a treaty partner ordinarily has a finite amount of staff time available to work its entire Mutual Agreement Program (MAP) inventory, of which APA cases are only a part.

We also must ensure timeliness targets established within this program are not misunderstood or misconstrued. The time required to process an individual MAP case (whether APA, double-tax, or a non-transfer pricing issue) may vary substantially depending on the complexity of the particular case. Some cases take longer to process than others, because there are several treaty partners to negotiate with, several taxpayers involved in a joint venture, or several product line transactions with different methodologies to analyze. On the other hand, we believe a commitment to timely processing is important to both taxpayers and the government. A number of years ago, the IRS asked for input from international tax practitioners; they supported a two-year target for the overall MAP as a reasonable amount of time for the process. Over the ensuing years, the IRS steadily improved processing to meet this two-year objective. We believe it is appropriate to seek further improvements to the processing of our entire MAP program, including APAs.

Accordingly, we support establishing time guidelines for the processing of bilateral APAs, and will implement the recommendation within the parameters described above.

The following is our response to the two recommendations in your report.

RECOMMENDATION:

The Commissioner should take steps to cost effectively collect data on APA processing suitable for analyzing the causes of delays and developing options for improvement. Such steps might include documenting deviations from plans or schedules and the reasons why in case files or modifying CASE to systematically capture data.

RESPONSE:

We agree. The APA Program will create codes for the CASE system to capture data on the causes of delay in APA case processing. For all APA cases, this system will require the APA Team Leaders to categorize their cases into two classes: those that are processing normally and those that are delayed. For those cases delayed, the APA Program has developed CASE codes to further categorize the source of the delay

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including: Team Leader workload, economist not available, difficulty scheduling meetings, and delay in receiving requested information. The APA Team Leaders will review weekly the classification of their cases under the coding scheme and update the coding as appropriate. These codes will be available for review and analysis by APA management through the CASE report system. This CASE based coding scheme for collecting data on APA case processing delays has been discussed with GAO.

RESPONSIBLE OFFICIAL:

Associate Chief Counsel (International)

EFFECTIVE DATE:

September 1, 2000.

RECOMMENDATION:

The Commissioner should test the use of written timeliness targets for processing bilateral APAs to determine the feasibility of using them for all bilateral APAs.

RESPONSE

We agree. The IRS will work with our treaty partners who have significant APA inventories to develop mutually agreed measures to promote the timeliness of APA processing.

RESPONSIBLE OFFICIAL

Director, International

EFFECTIVE DATE

Immediately

We appreciate the work of the GAO in preparing this report on the APA Program and for providing us with the opportunity to comment on the report's findings. If you have any questions or comments regarding this letter, please call Floyd Williams, National Director for Legislative Affairs, at (202) 622-3720.

Sincerely,

Charles Rossotti

Charles O. Rossotti

GAO Contacts and Staff Acknowledgments

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Acknowledgments

In addition to those named above, Lawrence Korb, John Lesser, and John Mingus made key contributions to this report.

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