KPMG

KPMG LLP
Suite 2000
355 South Grand Avenue
Los Angeles, CA 90071-1568

Telephone 213 972 4000
Fax 213 622 1217
Internet www.us.kpmg.com

March 7, 2005

Mr. Donald Korb, Chief Counsel
Mr. Hal Hicks, Associate Chief Counsel (International)
Mr. Matthew Frank, Director APA Program
Internal Revenue Service
799 9th Street, NW
Washington, DC 20001

Re: KPMG's Written Comments from APA Hearing on February 22, 2005

Dear Messrs. Korb, Hicks, and Frank:

Thank you again for giving us the opportunity to provide comments on the APA Program. It was a tremendous experience for both of us. We hope that our feedback will be useful as you move forward with the intended changes to the APA Program.

As promised, we have developed a written summary of our presentation and added additional specific suggestions for improvement.

We would be pleased to discuss any of our comments with you and invite you to call on the two of us, or any other of KPMG's transfer pricing Partners, if we can be of assistance. We are all strong supporters of your efforts and look forward to a continued bright future for the APA Program.

You can reach Patricia and Bernhard at 404-221-2361 and 213-593-6794, respectively.

Best regards,

Patricia A. Fouts, Ph.D.
Principal
KPMG LLP

Bernhard von Thaden
Principal
KPMG LLP

KPMG LLP, a U.S. limited liability partnership, is the U.S. member firm of KPMG International, a Swiss cooperative.

KPMG

KPMG Comments – Public Hearing on the APA Program
Washington, D.C. on February 22, 2005

The following document summarizes the comments made by Patricia Fouts and Bernhard von Thaden, both Principals with KPMG's Economic and Valuation Services practice, during the hearing and provides a list of recommendations aimed at increasing the efficiency and effectiveness of the APA Program.

KPMG chose to illustrate the positive qualities as well as some of the structural flaws of the APA Program with two case studies. After an introduction, Dr. Fouts presented the first case study:[1]

> The case I am presenting is a success story, and Bernhard is going to discuss a contrasting experience. We will then close our remarks by sharing some "best practice" ideas.
>
> The Taxpayer in my case was a European manufacturer looking to establish operations in the United States by setting up a related distributor for its European-manufactured products. The Taxpayer's favorable impression of the APA Program and in particular the certainty offered by having an APA as well as the elimination of the burden of preparing annual documentation, led it to seek an APA prospectively in its first year of U.S. operations.
>
> I will add that the Taxpayer's confidence in the integrity of the APA Program and its desire to express full commitment to its openness in this process led it to seek a named Prefiling.
>
> It became clear to the Taxpayer early on that the APA Office shared its commitment to open communication in a professional and collaborative environment. The Taxpayer felt in this process that the APA Office recognized and respected its desire to progress as far as possible with the negotiations during its first year of U.S. operations, so that it could get its transfer pricing correct from the start.
>
> The APA Office provided detailed questions, information requests, and follow-ups to the Taxpayer promptly and with sufficient time before scheduled meetings for the Taxpayer to prepare its responses in all instances. Similarly, every inquiry by the Taxpayer to the APA Office for information, status updates, and meetings met with a prompt response.

[1] Certain modifications were made to the oral presentation to adapt to the written format.

The APA team carefully reviewed the Taxpayer's analysis and also performed its own detailed analysis independent of the Taxpayer's analysis. Although both parties did not agree on certain points, each offered constructive solutions, collaborating to reach a mutually acceptable conclusion that is consistent with the §482 regulations, appropriate for the issues involved and fair to the IRS and the Taxpayer.

As a result of going through the APA process, the Taxpayer now weighs the impact of all of its proposed business decisions on the administration of the APA. Further, the Taxpayer has firmly integrated its business operations with the tax compliance aspects of the APA.

In summary, this case experience demonstrates several strengths of the APA program:

- Without exception, the individuals encountered in this case brought strong technical and legal capabilities to the case and applied these skills throughout the process, performing careful due diligence in their fact gathering and analysis throughout;
- The government individuals involved in this case had significant industry knowledge and successfully applied it in understanding the facts and circumstances in the real-life business environment faced by the Taxpayer;
- The APA Team fostered a professional, candid environment throughout the process that facilitated productive two-way discussion; and
- The APA Team demonstrated timeliness, responsiveness, and commitment to reaching a collaborative resolution.

This concluded Dr. Fouts' first part of her testimony. Mr. von Thaden proceeded to present the second case study:

Before I launch into my part of the testimony, I would like to go on record that I am a huge fan of the APA Program based on the many positive experiences with other APA cases. It is a very accessible, and in this sense unique, government program that generally leads to fair and equitable results for the taxpayer. The annual statistics show the continued popularity and success of the program. Nevertheless, I am presenting today this rather frustrating case study because it perfectly illustrates some of the organizational and structural flaws of the APA Program.

The case is a recent bilateral APA case between the U.S. and a European country. The Taxpayer is a manufacturer with valuable intangibles on both sides of the Atlantic and is seeking to globally consolidate the ownership of its intangibles in one location. For this purpose a very significant and valuable bundle of intangible property ("IP") – including

product technology, process technology, customer lists – will be transferred from the U.S. to a European country. Even though the IPs are closely connected and really inseparable from a business perspective, the Taxpayer decided to transfer one of the IPs during the fiscal year right before the APA term. The remainder of the IP was transferred during year 1 and year 2 of the APA term.

The Taxpayer's goals were fairly typical. Achieving certainty with respect to this very large and complex transaction as well as the reduced compliance burden, were the main motives for pursuing a bilateral APA. In addition, the Company had a very favorable impression of effectiveness of the U.S. APA program. What was holding the Taxpayer back initially was the worry about the preparedness of the European tax authority to handle a bilateral APA of this size and complexity. This concern was overcome, however, through a Prefiling conference.

Initially this APA was managed very efficiently and evolved consistent with the case plan: Submission approximately four months after the Prefiling Conference; Opening Conference about one month after the Submission; a series of Economic Subgroup Meetings for a period of six months following the Opening Conference; after which the European tax authority finalized its Position Paper and signaled that they were ready to negotiate in Competent Authority. At this point, it was the Taxpayer's and our impression that the APA Office was also very far along in its analysis and in developing its position paper. It is important to note that this was just eleven months after the Prefiling Conference and six months since the Opening Conference! This was a great achievement for the APA team, especially for such a complex case.

What happened then, I believe, is exemplary for some of the procedural and organizational flaws of the APA Program. The Field team, who had attended all relevant meetings and had access to all relevant information since the Prefiling Conference, but had so far asked no questions neither related to the pre-APA transaction under its jurisdiction nor to the more general methodologies and assumptions proposed by the Taxpayer, started challenging the valuation methodologies proposed by the Taxpayer and KPMG for the valuation of the IP under its jurisdiction. This triggered almost 14 months (!) of internal negotiations between the Field and the APA Office until the U.S. Negotiating Position could finally be concluded. This delay was completely unnecessary and could have been avoided if some of the proposed changes had been made. It took the repeated personal intervention of Hal Hicks, Associate Chief Counsel (International), and Matt Frank, APA Program Director, to unlock the case and hand the case over to Competent Authority. Thank you, Hal and Matt, for your assistance in this case.

In a historical context this is certainly not the worst case, but this does not take away from the fact that this is a good case study to illustrate our proposed procedural and organizational changes. Specifically, we are proposing:

(1) Upgrade the role of the APA Team and the Team Leader in particular:

In the case presented, there was no process available to facilitate and accelerate resolution of the internal disagreements within the IRS. It took 14 months to resolve an impasse that could have been avoided if the APA Office would not have to secure complete agreement of all Field team members over the valuation methodologies and assumptions applied to the rollback period. This is even more troubling, as the Field and the APA Office ultimately are on the same team. It absolutely needs to be assumed that the APA Office will act in the best interest of the U.S. government the same way the Field generally does. Our suggestion is therefore to shift jurisdiction over rollback years to the APA Office if the Taxpayer requests to do so. Only transactions closely related to the ones discussed and negotiated in the APA context would move under the APA Office's jurisdiction. Other issues, especially non-transfer pricing issues, would stay under the jurisdiction of the Field.

(2) Consistently set and tightly manage the Case Plan:

In the case study above, the Case Plan became obsolete during the extended phase of internal negotiations, leading to a frustrating waiting period. There was no attempt to establish a new or revised case plan, let alone to set and enforce deadlines for completion of documents and reviews. Our suggestion is therefore that a case plan always be established and tightly managed towards agreed upon milestones. If reaching certain milestones is delayed by a certain amount of time, the case will automatically be elevated to the Branch Chief. If there is further delay, it will move up to the Program Director. Milestones will be set both for the APA Office and for the Taxpayer. If the Taxpayer misses a certain deadline, the Case Plan will automatically be adjusted by the length of the delay. It will be a living working document, continuously adjusted by the Team Leader.

(3) Increase transparency of internal IRS discussions:

In the case presented, access to both the Field and the APA Office during the 14 months of internal negotiations process was very limited. The Taxpayer had no certain indication of where the discussion stood and what the controversial issues were. While this is somewhat understandable for a certain period of time – within the time frame established by the Case Plan - the process could have been accelerated significantly if the Field, the APA Team Leader and Economist, the Taxpayer and KPMG had had the opportunity for a joint meeting early on in the process. Most of

> the issues and misunderstandings around some of the very technical issues could have been resolved at that meeting. Our suggestion is therefore to give the Taxpayer better access to both the Field and the APA Office if the internal negotiation process causes a significant delay in the case plan
> What constitutes a significant delay, would need to be defined and may vary by APA case.

With that, Mr. von Thaden concluded this part of the testimony and referred back to Dr. Fouts.

> "In addition to the three suggestions above, we would like to present four additional suggestions for some best practices to be introduced by the APA Program:

(4) Joint onsite visits with Canadian Authorities. We have heard from several speakers regarding the APA Office's small travel budgets resulting in lack of site visits. My first comment pertains to site visits – not by the APA Office but rather by the U.S. Competent Authority. We understand that the CA's current position is not to participate in CRA-requested site visits in general. We have encountered this issue in two cases and the Taxpayers felt that the U.S. CA not participating in the site visit requested by CRA put it at a disadvantage in the negotiations because both governments did not have the same set of information. The issue here was not excessive travel costs – in fact, the site visit was within the DC metro area. We suggest that the CA revisit this position to ensure that both governments have the same set of information to work from in negotiating.

(5) Our next suggestion echoes a remark made earlier today by another speaker. The APA Office's current practice is to develop its own position before meeting with the foreign tax authority in a bilateral case. We recommend that before developing a position, the two governments discuss informally (it can be by telephone) whether they agree that the Taxpayer has proposed the correct TPM and communicate with the Taxpayer on this issue. This would help to move bilateral cases forward more quickly than each government waiting for the receipt of the other's formal position paper to begin negotiations and eliminate the Taxpayer needing to come up with a position for each government after each has already issued their positions. We also suggest imposing a time line on this discussion, such as a set number of days following the APA Submission.

(6) Our sixth suggestion is that the date of the APA Submission should serve as a "marker" in that the IRS should treat the Submission Date as the date that any amended return is filed for a historical year during the requested rollback period for which the first contact has not been made for purposes of establishing a qualified amended return under Reg. § 1.6664-2(c)(3). This is similar to Canada's Voluntary Disclosure program, and we believe it would

encourage taxpayers that want to come forward voluntarily and use the APA Program to resolve historical years' transfer pricing issues.

(7) Finally our seventh suggestion arises from the CA practice that a Taxpayer will not face a more burdensome position as a result of seeking assistance from the CA. The suggestion is that this principle should apply to the APA space as well. Specifically, a Taxpayer should be protected from an APA request suddenly triggering an audit of its transfer pricing unexpectedly. We suggest that a Taxpayer that files an APA request and suddenly receives a notice of a transfer pricing audit should have the right to appeal to the LMSB Industry Director to determine that the audit was not triggered as a consequence of filing the APA request.

That concludes our formal remarks today. Thank you again for providing us with the opportunity to present remarks on behalf of KPMG, and we are prepared to answer any of your questions.

With these suggestions Dr. Fouts concluded her testimony.