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In this article, the authors discuss the mutual agreement procedure, focusing on the workings between the U.S. competent authority and its counterparts in China.

Ever since the League of Nations' work on a model bilateral income tax convention, tax authorities have been trying to eliminate double taxation via tax treaties. Those efforts have historically been twofold: adopting a common set of rules or standards to prevent double taxation, and adopting a mechanism to resolve instances of double taxation (or taxation not in accordance

with the relevant treaty) — namely, the mutual agreement procedure.[1] Thus, the common standards were meant to avoid double taxation, while MAP was meant to resolve it, generally via adjustments proposed by tax authorities.

As the number of bilateral tax treaties has grown, so has the availability of MAP to resolve double taxation. Since the early 1990s, many tax authorities have focused more resources on tackling perceived abuses in international transfer pricing both by refining their rules and by dedicating more resources to the administration and audit of transfer pricing transactions.[2] That in turn has led to a substantial increase in transfer pricing adjustments and a correlative increase in MAP requests by multinational enterprises.

The 1990s also saw the introduction, in parallel with traditional MAP cases, of extensions to the MAP process such as advance pricing agreements and the accelerated competent authority procedure. While the accelerated procedure was meant to complement MAP by extending its application and making it more efficient for addressing recurring problems, the APA program was meant to proactively handle potential double tax problems by providing a form of ruling for future transfer pricing transactions.

With the publication of MAP statistics by various tax authorities in the early 2000s, it became apparent that MAP programs were experiencing a strain on resources as inventories grew and the average time to complete cases increased.

In 2012 the G-20 tasked the OECD with revising the established standards of international taxation as part of the base erosion and profit-shifting initiative, and the first BEPS recommendations published in September 2014 and October 2015 indicated that MAP requests by MNEs could increase significantly.

The MAP process has long been presented as a sort of black box whereby MNEs make their requests to competent authorities and then wait in the dark for the process to unfold, sometimes with little or no understanding of the procedure and rationale underlying the ultimate conclusion — regardless of whether the double taxation was fully resolved.

This series of articles is intended to explain MAP and its procedures with emphasis on the workings between the U.S. competent authority, now part of the IRS advance pricing and mutual agreement team, and its foreign counterparts — in this case, China.

MAP success can depend on understanding why a particular question might cause a problem between competing competent authorities, both currently and historically, and finding the appropriate approach and presenting it at the right moment and to the right interlocutor.

The first part of this article addresses MAP per se (including the accelerated competent authority procedure), and the second part covers APAs as extensions of MAP.

I. The Beginning of MAP Provisions

A. The United States

The first U.S. income tax convention was the Convention and Protocol Between the United States of America and France, signed April 27, 1932. While it contained a version of the associated enterprise article applying a variation of the arm's-length standard, it did not contain a MAP provision. The first U.S. income tax convention to contain a MAP article was the Convention and Protocol With Sweden Respecting Double Taxation, signed March 23, 1939.

At the time of this publication, the United States had expanded its network of tax treaties to cover 68 countries, including China.[3]

[1] One of the early examples of that kind of provision mentioned by the League of Nations reads:

> If the measures taken by the financial authorities of the contracting States have resulted in double taxation, the taxpayer affected may forward a protest to the State of which he is a subject; if the protest is admitted to be justified, the supreme financial authority of such State shall be authorised to arrange with the supreme financial authority of the other State to find a just remedy for the double taxation.

[2] That is illustrated by the 1994 U.S. adoption of the final section 482 regulations, as well as the 1995 OECD publication of its Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations.

[3] For a list of U.S. tax treaties, see IRS, "United States Income Tax Treaties — A to Z" (no date).

B. The People's Republic of China

China began building its extensive tax treaty network on September 6, 1983, when it and Japan signed the Agreement for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income. Article 9 of the treaty implements the arm's-length principle. That article mirrors article 9 of the 1977 OECD Model Double Taxation Convention on Income and on Capital. However, the China-Japan tax treaty does not contain the second paragraph of model article 9 (known as the "corresponding adjustment paragraph"), which specifies that when a contracting state has correctly revised profits upward to comply with article 9, and those profits have already been taxed by the other contracting state, the other state must make an appropriate adjustment to relieve double taxation.[4] OECD model article 9(2) also provides that if necessary, the competent authorities must consult with one another on that matter.

Even though article 9 of the China-Japan treaty excludes the reference to double taxation relief and competent authority consultation, article 25 addressing MAP is largely in line with the OECD model convention. The commentary to article 25 of the OECD model provides that when a bilateral convention does not contain rules similar to those of article 9(2),[5] inserting article 9 language, as limited to the text of paragraph 1, indicates that the contracting states intended for the convention to cover economic double taxation. Brazil and India are the only nonmember countries to have expressed disagreement with that interpretation.[6]

II. Collaboration Between the U.S. and China

The Joint Communiqué of the United States of America and the People's Republic of China, commonly known as the Shanghai Communiqué, was the first step toward diplomatic relations between China and the United States.[7] At the invitation of Premier Zhou Enlai, President Nixon visited China in February 1972. Although no formal agreement was concluded, a "serious and frank exchange" occurred regarding opening diplomatic relations.[8] The Joint Communiqué on the Establishment of Diplomatic Relations, signed January 1, 1979, marked the formal establishment of relations between the United States and China.

The first step toward competent authority collaboration between China and the United States was the Agreement With Respect to Mutual Exemption From Taxation of Transportation Income of Shipping and Air Transport Enterprises, signed March 5, 1982. It provides mutual tax exemption for shipping and air transport enterprises. While the agreement does not provide for the exchange of tax information by the competent authorities, it allows them to resolve "any difficulties or doubts arising from the interpretation or application of the convention."

In April 1984 President Reagan visited Beijing to meet with President Li Xiannian.[9] Referring to the visit, Reagan stated, "Let us hope that, as contacts grow between the Chinese and American people, each of us will continue to learn about the other, and this important new friendship of ours will mature and prosper."[10] On April 30, 1984, after two years of negotiations, Reagan signed the Agreement for the Avoidance of Double Taxation and the Prevention of Tax Evasion With Respect to the Taxes on Income, the first protocol, and letters of agreement.[11] A second protocol concerning the interpretation of paragraph 7 was signed May 10, 1986. The treaty entered into force November 21, 1986, and became effective January 1, 1987.

The MAP provision of the China-U.S. tax treaty is article 24. Unlike the China-Japan tax treaty, the China-U.S. treaty contains the

[4] *See* OECD commentary on model article 9.

[5] As is usually the case for conventions signed before 1977.

[6] OECD, "Positions on Non-Member Countries" (2008), at para. 5.

[7] Richard M. Nixon, *Richard Nixon: 1972: Containing the Public Messages, Speeches, and Statements of the President* 376-379 (2005). *See also Foreign Relations of the United States, 1969-1976*, Vol. XVII, Document 203.

[8] *Id.*

[9] "April 26, 1984 — President Reagan Visits China," History.com (Nov. 16, 2009).

[10] Steven R. Weisman, "Pacts With China Signed as Reagan Ends Peking Visit," *The New York Times*, Apr. 30, 1984.

[11] Robert E. Cox, "The United States — People's Republic of China Double Taxation Treaty," 5 *Int'l Tax & Bus. Law.* 111 (1987).

corresponding adjustment paragraph in article 9(2). China's domestic law makes clear that MAP may be initiated in China when the corresponding adjustment is to be made in the other contracting state.[12]

After the China-U.S. tax treaty was submitted to the U.S. Senate for ratification, the U.S. Treasury Department published a technical explanation reflecting the "policies behind particular provisions as well as understandings reached with respect to interpretation and application of the Agreement." For example, article 24(2) of the explanation provides:

> The competent authority to which the case is presented, if it considers the objection to be justified and if it is not itself able to arrive at a solution, shall endeavor to resolve the case through consultation with the competent authority of the other Contracting State. Any agreement reached shall be implemented without regard to any statutory time limits of the Contracting States. Thus, if a Contracting State agrees that its tax was overstated, a refund of the excess tax paid will be made, even though the statute of limitations under domestic law may have expired. The waiver of the statute of limitations applies only for refunds and not for the imposition of additional taxes.

Senate hearings on the China-U.S. tax treaty began July 30, 1985. Then-Sen. Jesse Helms attempted to block ratification, citing disapproval of the treaty-shopping language.[13] The objections prompted the Senate Foreign Relations Committee to seek more detailed explanations on treaty shopping, the foreign tax credit, and sourcing rules.[14] Then-Treasury Secretary James A. Baker III negotiated the necessary clarifications, and the second protocol was signed in Beijing on May 10, 1986. The U.S. Senate ratified the treaty July 24, 1986.[15]

III. MAP Programs

A. The United States

In 1970 the IRS published its first MAP-related revenue procedure. Rev. Proc. 70-18, 1970-2 C.B. 493, set forth the procedural rules for taxpayers to invoke competent authority assistance. Its guidance applied to cases involving the allocation of income and deductions between related persons,[16] and the procedures it outlined and information it required were similar to current IRS requirements.

1. Creation of the APMA Program

In early 2012 the APA program merged with the portion of the office of the U.S. competent authority responsible for transfer pricing cases under the MAPs of U.S. bilateral income tax conventions to form the APMA program, which is intended to resolve actual or potential transfer pricing disputes in a timely, principled, and cooperative manner.

The APA program moved from the IRS Office of Chief Counsel (International) to the Office of Transfer Pricing Operations in the IRS Large Business & International Division to improve efficiency and increase resources. Specifically, the move eliminated the handoff between the APA program, which developed the recommended negotiating position for APAs, and the U.S. competent authority, which was then responsible for negotiating with the treaty partner. Moreover, LB&I had greater ability to hire additional team leaders and economists. As discussed below, the formation of APMA resulted in increased APA completions.[17]

2. Rev. Proc. 2015-40

Rev. Proc. 2015-40, 2015-35 IRB 236, updated guidance on requesting and obtaining assistance under U.S. tax treaties from the U.S. competent authority, acting through the APMA program and the LB&I treaty assistance and interpretation team. Rev. Proc. 2015-40 was issued alongside

[12] *See* Section III.B.1, *infra*.

[13] Eric Schmitt, "Helms on a New Target: Tax Treaty With China," *The New York Times*, Mar. 17, 1986.

[14] Cox, *supra* note 11. *See also* Senate Committee on Foreign Relations, Report on the Income Tax Agreement (and Protocol) With the Government of the People's Republic of China, S. Rep. 7 (1985).

[15] Cox, *supra* note 11.

[16] In 1977 the IRS issued Rev. Proc. 77-16, 1977-1 C.B. 57, which provided the procedures to request competent authority in non-reallocation cases, such as double taxation for individuals.

[17] *See* Section V.A.1, *infra*.

Rev. Proc. 2015-41, 2015-35 IRB 263, which provides guidance on APAs.[18]

a. Expanded Issues

The APMA function now considers issues and cases that were not generally accepted before. One important change: Matters arising as a result of taxpayer-initiated adjustments — that is, those that directly or indirectly result in double taxation — may be permitted into the competent authority process. Rev. Proc. 2015-40 provides that mandatory prefiling procedures apply to issues involving taxpayer-initiated positions so that APMA can decide whether to accept the matter.

Rev. Proc. 2015-40 also specifies that taxpayers may request assistance with specific ancillary issues, such as penalties, fines, and interest, as well as repatriation payment matters. Although many U.S. income tax treaties contain language about the IRS and its treaty partners being able to consult to resolve those types of issues, Rev. Proc. 2015-40 says those ancillary issues are part of the competent authority process and assistance with them can — and should — be requested by taxpayers in their submissions.

Further, APMA will be available for informal consultations (on an anonymous or named basis) on general matters concerning competent authority questions, including foreign tax matters and other matters that are related to but not themselves competent authority issues. Any advice given, however, is informal and not binding on the IRS.

b. Improving Access

To ensure that taxpayers have broad access to competent authority to resolve disputes under the applicable income tax treaties, Rev. Proc. 2015-40 clarifies that taxpayers will not be required to expand the scope of a competent authority case to include interrelated issues or additional years (or a coupled APA) to obtain competent authority assistance.

The draft revenue procedures would have allowed the U.S. competent authority to condition acceptance of a competent authority matter on taxpayers agreeing to extend the number of years involved or issues covered (including, in some instances, requiring an APA submission or initiating its own competent authority matter on behalf of a taxpayer). Those draft provisions were criticized as potentially creating an environment in which taxpayers could be hesitant to approach the U.S. competent authority out of concern that the scope of their matters would expand well beyond the assistance they required.

Under Rev. Proc. 2015-40, taxpayers may be required to provide information on interrelated issues — but competent authority assistance is not conditioned on their coverage or on expanding the scope of a competent authority matter to include additional years or an APA. That change from the draft revenue procedures will continue to allow taxpayers to have control over the scope of their issues and years when requesting competent authority assistance.

In sharp contrast, however, Rev. Proc. 2015-41 continues to allow the U.S. competent authority to condition acceptance of an APA request on taxpayer extension of years covered or issues covered. Specifically, it clarifies that the APMA function may require, as a condition of continuing with the APA process, that the taxpayer expand the proposed scope of its APA request to cover interrelated matters (interrelated issues in the same years, covered or interrelated issues in other years, and covered or interrelated issues in the same or other years as applied to other countries). The APMA function will impose those requirements with due regard for principled, effective, and efficient tax administration and only after considering the views of the taxpayer and the applicable foreign competent authority. That distinction in treatment might reflect the IRS's commitment to the BEPS action 14 goal to make dispute resolution procedures more effective, while managing resources to create efficiencies in the APA process.

Rev. Proc. 2015-40 also reflects changes from Rev. Proc. 2006-54, 2006-49 IRB 1035, and the draft revenue procedure in terms of the bases for denying competent authority assistance. Taxpayers must be aware of those changes because they could be traps for the unwary. One significant change involves the level and type of agreement that taxpayers may enter into with foreign governments to resolve their tax disputes. Rev. Proc. 2006-54 provides that the U.S. competent authority may deny assistance if:

[18] *Id.*

> the taxpayer was found to have acquiesced in a foreign initiated adjustment that involved significant legal or factual issues that otherwise would be properly handled through the competent authority process and then unilaterally made a corresponding correlative adjustment or claimed an increased foreign tax credit, without initially seeking U.S. competent authority assistance.

Accordingly, the U.S. taxpayer had to make a corresponding correlative adjustment or claim an increased FTC for a foreign adjustment (related to major legal or factual issues) to which they had acquiesced for the assistance to be potentially subsequently denied.

The draft revenue procedure, however, provided that the U.S. competent authority may deny assistance if "the taxpayer agreed to or acquiesced in a foreign-initiated adjustment involving significant legal or factual issues without previously having consulted" the U.S. competent authority. That provision was troubling because it is often the case that foreign taxpayers, like U.S. taxpayers, must conclude a foreign audit and agree to an adjustment just to be able to move the case to another forum such as the competent authority for ultimate resolution. In that way, taxpayers can conclude protracted, expensive exam audits that show little or no sign of satisfactory resolution or, for example, eliminate additional interest or withholding tax exposures. Having to consult with the APMA function as a prerequisite to reaching any kind of agreement with a foreign government would have often resulted in difficult, and sometimes draconian, decisions.

Rev. Proc. 2015-40 creates less of a barrier to competent authority assistance than the draft procedures, although it leaves some ambiguity. It provides that the U.S. competent authority may deny competent authority assistance if the taxpayer's conduct before or after filing its request "has undermined or been prejudicial to" the competent authority process. An example is a taxpayer's agreeing to or acquiescing in a foreign-initiated adjustment that involves "significant legal or factual issues in a manner that impeded the U.S. competent authority from engaging in full and fair consultations with the foreign competent authority on the competent authority issues."

The potential requirement of consulting with the U.S. competent authority before reaching an agreement to protect taxpayer access to the competent authority has been removed. Clearly, though, it remains important for taxpayers to avoid entering into binding arrangements with foreign tax authorities that could preclude those authorities from being willing or able to discuss and negotiate the underlying facts and issues.

c. Protective Claims/Treaty Notifications

Another potential trap for the unwary lies with the requirements to file protective claims and treaty notifications. Rev. Proc. 2015-40 addresses both. The two requirements, although similar, do not serve the same purpose; making the appropriate filing for one does not result in compliance with the other.

Protective claims must generally be made to protect a right to a potential refund or credit following a MAP resolution and to retain rights to remedies outside MAP. The protective claim should be made as soon as a taxpayer has reason to believe that a tax authority's action is likely to result in a competent authority issue. The claim must fully advise the IRS of the grounds on which the credit or refund is claimed, contain sufficient facts to apprise the IRS of the claim's basis, describe and identify the contingencies affecting the claim, state the year for which the claim is made, be verified by written declaration made under penalties of perjury, and be filed before the expiration of the applicable limitations period.

A protective claim can be made within a MAP request. If a claim is made in a separate letter, the subject of the letter should be "Protective Claim Pursuant to Section 11 of Rev. Proc. 2015-40." Until a MAP request has been made, taxpayers must provide annual notification to the U.S. competent authority of their intent to file a MAP request for the tax year for which the protective claim was filed.

On the other hand, treaty notifications serve to advise the relieving competent authority within a specified time frame of potential or actual adjustments that may require competent authority assistance. Failure to properly file treaty notifications exposes taxpayers to the risk of not being able to access MAP.

In the United States, treaty notifications are also subject to an annual notification requirement until a complete MAP request has been filed. The subject of the letter containing an annual notification should be "Treaty Notification Annual Update Under Section 12 of Rev. Proc. 2015-40."

Failure to abide by either the protective claims or the treaty notifications requirements can result in loss of a right to a potential refund or credit, loss of access to MAP, or both. Consolidating the annual protective claim and treaty notification in a single letter is permissible.

d. Prefiling Conferences

Prefiling conferences were previously not required, but Rev. Proc. 2015-40 introduced a narrow scope of issues for which they are required. While Rev. Proc. 2015-40 makes clear that APMA welcomes requests from taxpayers for prefiling meetings (on a named or anonymous basis) as part of its effort to be of more assistance to taxpayers navigating the competent authority process, the prefiling procedures are mandatory only for cases involving taxpayer-initiated adjustments.

Prefiling procedures are recommended but not required in some instances — for example, for a foreign-initiated adjustment in which the total adjustments exceed $50 million for all years combined; for an intangible development arrangement, a business restructuring, or a global trading arrangement; or if the taxpayer believes double tax has arisen outside the context of an examination (such as in withholding tax cases).

Rev. Proc. 2015-40 clarifies the taxpayer's proactive role in the competent authority process. For example, it provides that taxpayers should remain in contact with the U.S. competent authority team leader throughout the process, particularly when a tentative competent authority resolution has been reached. The taxpayer must also ensure that the relevant tax authorities receive complete, accurate, and timely information on the underlying factual and legal issues, and that they are permitted to offer constructive and principled proposals for resolving their cases. Also, taxpayers can request the opportunity to make joint presentations before the relevant tax authorities to clarify some issues or facts.

When a tentative — as opposed to final — agreement has been reached, Rev. Proc. 2015-40 provides that the taxpayer will be apprised orally or in writing, depending on case size and complexity. That is an important change; under the prior procedures, taxpayers were often advised only of the formal outcome. However, Rev. Proc. 2015-40 also clarifies that the purpose of informing the taxpayer is not to cause the renegotiation of the underlying intergovernmental agreement but rather to address any implementation concerns (for example, computational concerns).

Previously, a taxpayer was presumed to accept the U.S. competent authority resolution if it was silent. Now, it must tell the U.S. competent authority that it accepts the resolution, and the U.S. competent authority may deem it to have rejected the tentative resolution if the taxpayer does not timely accept it. (The new procedures do not specify that the acceptance or rejection be in writing, but that would likely be prudent to memorialize the taxpayer's decision and demonstrate that it was conveyed to APMA.)

e. Structure of MAP Request Letter

There is a revised listing of the standard specifications for the content and format of a request for competent authority assistance. The additional information has generally previously been requested by APMA as part of its due diligence for competent authority cases. That information will now be provided earlier in the competent authority process so that APMA can perform its initial evaluation more effectively. Further, more copies of the request must be filed (printed as well as electronic versions). Rev. Proc. 2015-40 makes clear that failure to provide complete requests in the format specified at best will delay the processing of the request and at worst could result in the denial of its acceptance into the APMA program.

The importance of respecting the table of contents of the request for APMA and its ordering under Rev. Proc. 2015-40 cannot be stressed enough; failing to follow procedure can result in the request being rejected by APMA with all the potential consequences an invalid filing would entail.

B. China

In the 1980s, after China established diplomatic relations with the United States and other countries, trade and investment skyrocketed. In China, the collective concept of a foreign-invested enterprise encompasses three types of enterprises: equity joint ventures, contractual joint ventures, and wholly foreign-owned enterprises. Each type is governed by specific laws and regulations.[19] Foreign-invested enterprises were flocking to the country and experiencing rapid development, but more than half were reporting losses.[20]

According to one study, transfer pricing manipulations were the primary way to avoid taxation.[21] The tax avoidance accomplished through those manipulations distorted the Chinese economy and resulted in public support for lawmakers to address them.[22]

In 1991 China passed its first piece of transfer pricing legislation, the Income Tax Law of the People's Republic of China for Enterprises With Foreign Investment and Foreign Enterprises.

In 1998 the State Administration of Taxation (SAT) issued transfer pricing regulations and tax administration rules and procedures for transactions between related parties.[23] Those regulations represented an effort to standardize both transaction reporting and audit procedures.

1. Development of MAP Guidance

Despite the implementation of transfer pricing laws in the 1990s, in 2005 over half of foreign companies with investment in China continued to report operating losses, which Chinese tax auditors asserted were the result of indifference to transfer pricing rules.[24] As a result, enforcement was enhanced and 40 percent of audited MNEs were subject to transfer pricing adjustments.[25]

The mid-2000s also ushered in an era of increased outbound investment, raising the importance the SAT placed on implementing MAP in China.[26] Over 20 years after MAP was first mentioned in the China-Japan tax treaty, China implemented formal MAP guidance.

Before that guidance was issued, the SAT concluded dozens of non-transfer-pricing MAP cases with treaty partners in accordance with those treaties. In July 2005 it released Circular 115,[27] which specifies that a Chinese resident or national may apply for MAP when:

- taxes on adjustments made to profits as a result of transactions between related parties may result in, or have resulted in, double taxation by different tax authorities;
- the resident objects to the tax collection or applicable rate for dividends, interest, or royalties;
- the nondiscrimination provisions of the income tax treaties have been violated or discrimination has occurred;
- the resident objects to the determination of a permanent establishment or residence, the attribution of profits to a PE, or the deductibility of expenses; or
- there is a dispute on the interpretation or implementation of the income tax treaty, and in other matters that cannot be resolved by the resident.[28]

Circular 115 provides the taxpayer with the information necessary to submit a proper MAP request. For example, the application must describe the opinions of the competent authority, the taxpayer, and the other contracting state. One commentator has suggested that the taxpayer's position will be strengthened if he can prove that

[19] Yuan Anyuan, "Perspective: Foreign Direct Investments in China — Practical Problems of Complying With China's Company Law and Laws for Foreign-Invested Enterprises," 20 *Nw. J. Int'l L. & Bus.* 475, 478 (1999-2000).

[20] Tizhong Liao, *Transfer Pricing Tax System and Its Development in China* (2001); and Jessica L. Ho, "How to Train a Toothless Dragon: Finding Room for Improvement in China's Transfer Pricing Regulations," 54 *Va. J. Int'l L.* 437 (2013-2014).

[21] Hung Chan and Lynne Chow, "An Empirical Study of Tax Audits in China on International Transfer Pricing," 23 *J. Acct. & Econ.* 83, 87 (1997).

[22] Liao, *supra* note 20.

[23] Guo Shui Fa [1998] No. 59.

[24] Ho, *supra* note 20.

[25] Guo Shui Fa [2005] No. 239. *See also* Jian Il and Alan Paisey, *Transfer Pricing Audits in China* (2007).

[26] Dave Lewis et al., "China Portfolios Competent Authority Functions and Procedures in China, the Mutual Agreement Procedure for Taxpayer Cases," Bloomberg BNA.

[27] Provisional Measures for Applications by Chinese Residents for Launching Mutual Agreement, Guo Shui Fa [2005] No. 115.

[28] Lewis et al., *supra* note 26.

the transfer pricing policy is in line with OECD standards.[29]

The written application must be submitted within three years of the date of the transfer pricing adjustment. Under Circular 115, to induce harmonization between provinces and the SAT, the provincial authorities must report the case to the SAT within 15 days.[30] If the SAT deems the case sufficiently merited, it contacts the competent authority of the other contracting state. The guidance ensures that the SAT will provide the taxpayer with notice of the outcome in writing.

In 2008 the Corporate Income Tax Law replaced the Foreign Enterprise Income Tax Law and the Domestic Enterprise Income Tax Law. The goal of the tax reform was to standardize rules that diverged based on whether a company was domestic or foreign. The 2008 regime replaced preferential rates for foreign companies with a 25 percent corporate tax rate and added a preferential rate of 15 percent for "new high technology" companies.[31]

Included in the 2008 reform was Circular 114, which updated the reporting standards for related-party transactions.[32] It also restructured the SAT to create the Large Enterprise Tax Administration Department, which left the International Taxation Department to build specialization in transfer pricing policy, bilateral APAs, and MAP.

In 2009 the SAT released Circular 2,[33] which included regulations covering contemporaneous documentation, controlled foreign corporations, APAs, and cost-sharing agreements. Regarding MAP, Circular 2 stated that if one party to a transaction was subject to a transfer pricing adjustment, the counterparty should be allowed to make a corresponding adjustment to avoid double taxation. However, it clarified that situations involving taxes paid for "overseas related-party interest, rent, or royalty payments involved in a transfer pricing adjustment" would not be eligible for a corresponding adjustment.

The SAT initiated MAP for transfer pricing cases when the corresponding adjustment should be made in the other contracting state.[34] Circular 2 explained that if the adjustment involved a country that has a tax treaty with China, the SAT would negotiate with the treaty partner. However, to initiate negotiations, the taxpayer must have first submitted an application for initiating MAP to both the SAT and the in-charge tax authority.[35] The taxpayer must also have provided additional documents, including copies of the transfer pricing adjustment notice. Circular 2 said the SAT would negotiate according to the relevant procedures as defined in the tax treaty with the other contracting state.

In 2013 the SAT released Circular 56, which includes final guidelines on MAP procedures.[36] However, those guidelines exclude transfer pricing corresponding adjustments — unlike Circular 2, which, as mentioned, included transfer pricing corresponding adjustments but excluded other taxes.

On October 18, 2016, Announcement on the Enhancement of Administration of Advance Pricing Arrangement (Announcement 64) was released. It superseded the APA administrative rules in chapter 6 of Circular 2 as of December 1, 2016.

On March 28, 2017, the SAT released Announcement on Special Tax Investigations, Adjustments and Mutual Agreement Procedures (Announcement 6), which replaced the MAP provision in chapter 11 of Circular 2 as of May 1, 2017. In contrast to Circular 2, Announcement 6 says a MAP request must be made directly to the SAT, with the in-charge tax authority responsible for delivering notices to the applicants and monitoring and implementing the collection or

[29] James Morgan, "New Developments in the Resolution of International Tax Disputes," *Tax Notes Int'l*, July 3, 2006, p. 77.

[30] For MAP cases involving transfer pricing matters, the taxpayer must submit an application to both the provincial authority and the SAT.

[31] KPMG China, "People's Republic of China Tax Profile" (Aug. 2014).

[32] *Id.*

[33] Circular of the State Administration of Taxation on the Issuance of the Implementation Measures of Special Tax Adjustments (Provisional), Guo Shui Fa [2009] No. 2.

[34] Committee of Experts on International Cooperation in Tax Matters, 12th Session, China Country Practice, Geneva (Oct. 11-14, 2016) (MAP can be applied to taxation resulting from transfer pricing adjustments that might require corresponding adjustments from the other contracting state or used to negotiate bilateral and multilateral APAs).

[35] The in-charge tax authority may be either provincial (in most cases) or local. Under Circular 115, the application was submitted only to the local authority.

[36] Announcement on Implementation Measures of Tax Treaty Mutual Agreement Procedures, Guo Shui Fa [2013] No. 56.

refund of the relevant taxes following the conclusion of MAP negotiations. Announcement 6 was released to comply with BEPS actions 8-10 and 14 and is expected to increase clarity and transparency in Chinese transfer pricing investigations.[37]

Announcement 6 clarifies that it controls MAPs for special tax adjustment matters but that Circular 56 is still in force for non-transfer-pricing MAP cases. Announcement 6 is in line with Circular 2, indicating that a Chinese tax resident may not seek MAP assistance for a special tax adjustment unless it has actually been double taxed. Circular 2 provided that applications must be made within three years of receiving a transfer pricing adjustment notice, but Announcement 6 defines limitations on MAP applications by making general references to China's tax treaties. Announcement 6 also does not indicate the amount of time the SAT will endeavor to resolve MAP cases, despite OECD efforts to improve the effectiveness of dispute resolution.

LB&I Commissioner Douglas O'Donnell recently discussed the cooperation between the IRS and SAT regarding MAP cases, describing the inventory of cases as "surprisingly few . . . given the amount of cross-border investment."[38]

Despite the small inventory, the two countries hope for improvement. O'Donnell said that during a May 2016 meeting in Beijing, the countries resolved several transfer pricing disputes. Further, the SAT has hired more MAP personnel, which O'Donnell said the IRS expects will lead to more frequent meetings.[39] He also hinted that China and the United States may soon release more detailed information regarding their shared MAP inventory.

In other improvements in Chinese MAP, Christian Kaeser, vice president and global head of tax at Siemens AG, recently disclosed that the company has initiated its first competent authority case in China.[40] Kaeser said the German company had not previously requested MAPs in China out of fear that more double taxation would be imposed, given the lack of mandatory arbitration in China's treaties.

There is no provision in Chinese tax law clearly specifying the relationship between MAP and domestic remedies.[41] In other words, it is unclear whether taxpayers may request MAP assistance when they have sought, or plan to seek, domestic remedies. However, taxpayers must decide quickly between seeking domestic remedies and requesting MAP, because judicial review of an administrative decision must be requested within 15 days. In theory, once a judicial review is initiated, MAP terminates and cannot be reinstated.[42] Therefore, taxpayers have a small window of opportunity to decide which path to take.

C. MAP Statistics

1. United States

It has been reported that between 1995 and 2000, the U.S. competent authority received 583 allocation cases (which address transfer pricing matters and attribution of profits to PEs) and disposed of 557 cases.[43] U.S.-initiated cases constituted the majority, ranging from 52 to 77 percent. That ratio changed sharply by 2001, with U.S.-initiated cases falling below one-third of the intake. The average time to complete MAP cases ranged from 21 to 33 months with no specific trend between U.S.- and foreign-initiated cases.

Some general observations for the 2001-2012 period can be made from the official MAP statistics published by the IRS. For instance, the U.S. competent authority received 1,454 allocation cases and disposed of 1,254 cases, for an ending inventory of 403 cases on December 31, 2012. The number of cases it received annually hovered around 100 between 2001 and 2006, then began

[37] Reuven S. Avi-Yonah and Haiyan Xu, "China and the Future of the International Tax Regime," Law & Economics Working Papers 140 (2017).

[38] Kevin A. Bell, "U.S., China Settle Competent Authority Cases," Bloomberg BNA (Sept. 20, 2016).

[39] *Id.*

[40] Bell, "Siemens Has 11 Double-Tax Cases; Some Involve India, China," *International Tax News* (Sept. 27, 2016).

[41] OECD, "China Dispute Resolution Profile" (last updated Jan. 2019).

[42] Morgan, *supra* note 29.

[43] Zvi Daniel Altman, "Dispute Resolution Under Tax Treaties," IBFD Doctoral Series Vol. 11 (2005), at 115-116. Between 1971 and 1980, the U.S. competent authority received 344 allocation cases and disposed of 217. The data do not distinguish between U.S.- and foreign-initiated cases. The data available do not distinguish between allocation and non-allocation cases and are thus of limited use in evaluating time to resolve transfer pricing MAP negotiations.

Table 1. U.S. Mutual Agreement Procedure Statistics (2001-2012)

	Correlative Adjustment	Adjustment Withdrawn	Partial Relief	No Relief
2001	31.5%	59.7%	3.1%	5.7%
2002	40.7%	29.2%	29.1%	1.0%
2003	36.6%	55.3%	5.7%	2.4%
2004	28.7%	64.4%	2.3%	4.7%
2005	50.6%	37.6%	9.6%	2.2%
2006	53.8%	28.6%	4.4%	13.2%
2007	35.6%	60.1%	0.2%	4.0%
2008	56.5%	32.8%	3.3%	7.4%
2009	34.8%	60.8%	3.4%	1.0%
2010	33.0%	63.6%	1.8%	1.6%
2011	22.1%	55.7%	0.8%	21.5%
2012	32.4%	63.6%	1.8%	2.2%

increasing to reach 166 in 2011 and 181 in 2012. Received U.S.-initiated cases jumped from 35 in 2001 to 51 in 2012, and received foreign-initiated cases jumped from 78 in 2001 to 130 in 2012. U.S.-initiated cases disposed of under MAP outpaced received U.S.-initiated cases (383 to 356), but the opposite was true for foreign-initiated cases (871 disposed, 1098 received).

For disposed cases, the IRS provides information about the relief provided as a percentage of the total dollar adjustment for a given year. Table 1 provides breakdowns from 2001 to 2012.

The United States was the relieving competent authority in most MAP cases: Foreign-initiated adjustments represented on average 76 percent of MAP cases received and 69 percent of those disposed. The overall average time to dispose of a MAP case in the United States was relatively stable, averaging 23.8 months, with U.S.-initiated cases averaging 19.3 months and foreign-initiated cases averaging 28.3 months.

Between 2013 and 2015, the U.S. competent authority received 789 MAP cases. The annual number of cases received was between 237 and 286, more than doubling the caseload in previous years.

Received U.S.-initiated cases outweighed those disposed (184-110), as was true of foreign-initiated cases (605-375), for an ending inventory of 707 cases on October 31, 2015. The average time to dispose of a MAP case was 22 months for U.S.-initiated cases and 28 months for foreign-initiated cases. Unresolved cases over the period resulted in an ending inventory of 755 cases as of December 31, 2015.

As in the prior period, the United States was consistently the relieving competent authority for most MAP cases from 2013-2015, with foreign-initiated adjustments representing on average 76 percent of received MAP cases and 77 percent of disposed MAP cases.

In 2016 the OECD began publishing more detailed MAP statistics as part of its peer review process, and the United States now reports MAP statistics in a manner more closely aligned with the OECD format. According to the OECD's 2017 U.S. MAP statistics, the average time to dispose of a transfer pricing MAP case started before January 1, 2016, was 35.53 months.

The OECD statistics also show the outcomes of all MAP cases started before and as of January 1, 2016. Table 2 provides the outcomes for cases involving transfer pricing.

Table 2. 2017 U.S. Mutual Agreement Procedure Statistics

	Transfer Pricing Cases (All)	Transfer Pricing Cases Started Before January 1, 2016	Transfer Pricing Cases Started as From January 1, 2016
Denied MAP access	2	0	2
Objection is not justified	0	0	0
Withdrawn by taxpayer	9	5	4
Unilateral relief granted	90	45	45
Resolved via domestic remedy	3	0	3
Agreement fully eliminating double taxation/fully resolving taxation not in accordance with tax treaty	111	87	24
Agreement partially eliminating double taxation/partially resolving taxation not in accordance with tax treaty	6	6	0
Agreement that there is no taxation not in accordance with tax treaty	0	0	0
No agreement including agreement to disagree	2	2	0
Any other outcome	5	0	5
Total	228	145	83

2. China

In 2013, as a partner economy to the OECD, China began reporting transfer pricing and non-transfer-pricing MAP data. Hareesh Dhawale, then-director of the IRS APMA program, said the cases the IRS received involving transactions with China in 2013 and 2014 were in the single digits and that the agency did not have "a large number of either China initiated, or U.S. initiated, MAP cases."[44] The cases initiated by China in those years involved $55 million in proposed adjustments; to put that number in perspective, the total adjustments for Indian-initiated cases the IRS received over the same period totaled $2.1 billion.[45]

The number of China-U.S. MAP cases remains small. Despite that small caseload, China's backlog of MAP cases has increased. At the end of 2015, China had concluded 44 MAP agreements with seven countries, with 99 cases remaining open. That was a significant increase from 2014, when only 55 cases were in inventory. Like many other countries, China's backlog is growing exponentially — it receives approximately 25 new cases per year and resolves approximately nine.[46]

The backlog has not yet affected the average cycle time. In 2013 the average for cases completed, closed, or withdrawn during the reporting period was 29.7 months for MAP cases between China and OECD countries and 31 months for cases between China and non-OECD countries. In 2014 China reported an average cycle time of 19.1 months for OECD countries and 23.5 months for non-OECD countries. In 2015 those numbers were 33 months for OECD countries and 4.5 months for non-OECD countries.[47]

[44] Bell, "U.S. Receives 61 Indian MAP Cases, in 2015, Adjustments of $1.25 Billion," *International Tax News* (June 16, 2015).

[45] *Id.*

[46] *See* OECD, Mutual Agreement Procedure Statistics 2006-2015.

[47] *Id.*

Table 3. 2017 China Mutual Agreement Procedure Statistics

	Transfer Pricing Cases (All)	Transfer Pricing Cases Started Before January 1, 2016	Transfer Pricing Cases Started as From January 1, 2016
Denied MAP access	0	0	0
Objection is not justified	0	0	0
Withdrawn by taxpayer	1	1	0
Unilateral relief granted	4	2	2
Resolved via domestic remedy	0	0	0
Agreement fully eliminating double taxation/fully resolving taxation not in accordance with tax treaty	7	7	0
Agreement partially eliminating double taxation/ partially resolving taxation not in accordance with tax treaty	3	3	0
Agreement that there is no taxation not in accordance with tax treaty	0	0	0
No agreement including agreement to disagree	1	1	0
Any other outcome	0	0	0
Total	16	14	2

China reports its MAP statistics in a manner similar to the OECD reporting format. According to the OECD's 2017 Chinese MAP statistics, the overall average time to dispose of a pre-2016 transfer pricing MAP case in China was 31.86 months. Table 3 shows the outcomes for MAP cases involving transfer pricing.

D. Recommendations

For a successful and timely MAP request involving the United States and China, taxpayers should establish and maintain contact with the competent authority analysts in both countries. They should file MAP requests as soon as they receive the first notification of the action resulting in taxation not in accordance with the provisions of the China-U.S. tax treaty and ensure that the request follows the required form in the appendix to Rev. Proc. 2015-40 and application to initiate MAP. If a taxpayer thinks the proposed or actual adjustments should be withdrawn, it should contact the adjusting competent authority to discuss unilateral resolution. Taxpayers should also schedule a prefiling conference with the relieving competent authority, which will let the authority get up to speed more rapidly and should allow the case to be ready for negotiation sooner; provide updated and new information promptly and simultaneously to both competent authorities; and file protective claims and treaty notifications annually in the United States. On receiving the communication of the competent authorities' negotiated settlement, taxpayers should immediately determine whether it is acceptable, then communicate their responses to both competent authorities in 30 days.

IV. APA Programs

As mentioned, APAs are essentially extensions of MAP. From the start, bilateral APAs involved the implication of competent authorities acting via MAP. However, APAs are generally not based on actual double taxation but instead on potential double taxation, so some countries have argued that they are part of the obligations of competent authorities under MAP.

A. United States

The first U.S. APA test case involved Australia-U.S. transactions of Apple Inc. It began

in late 1989 and was successfully concluded in March 1991.[48]

The United States increased its transfer pricing enforcement efforts in the late 1980s. In anticipation of a corresponding increase in transfer pricing disputes with taxpayers, the IRS developed the APA program and on March 1, 1991, issued its first revenue procedure to govern the process (Rev. Proc. 91-22, 1991-1 C.B. 526). The procedures remained largely unchanged until the formation of the APMA program, then changed substantially.

1. Staffing and Statistics

The APA program was founded in the Office of Associate Chief Counsel (International), whereas the competent authority function resided in the enforcement side of the IRS. That separation was intentional, because it made the voluntary program more appealing to taxpayers who saw chief counsel as an impartial office that provided a technical analysis of tax law.[49]

As noted, one consequence of the separation of the APA and competent authority functions was the handing off of every bilateral case.[50] APA teams were responsible for meeting with the taxpayer, assessing the case, conducting initial taxpayer negotiations, and preparing the recommended negotiating position. The APA team then provided that position to the competent authority, which was responsible for negotiating with the U.S. treaty partner.

As the program developed, that handoff became a major impediment to efficient case resolution. As a part of the Office of Chief Counsel, the APA team had to provide a technical analysis of each case using U.S. law. It was unable to consider factors such as the relevant treaty, OECD guidelines, or common practices between the countries' competent authorities.[51] As a result, some of its recommended negotiating positions were unrealistic in the context of bilateral negotiations, forcing the competent authority to discard those positions and develop its own. That led to frustrations for taxpayers who found themselves obliged to educate a second team on the facts and circumstances of their cases and essentially renegotiate with the IRS.

On April 5, 2000, the IRS published its first annual report of APA statistics in response to a push for the public disclosure of APAs.[52] The statistics covered from 1991, the program's year of inception, through 1999, the previous calendar year. During that time, the IRS executed 231 APAs, 112 of which were unilateral, 113 bilateral, five multilateral, and one involving a U.S. possession. The number of unilateral APAs concluded reflects the APA program's focus on serving as an alternative dispute resolution program within the IRS.

The median completion time was 14 months for unilateral APAs and 33 months for bilateral APAs. The most represented industry was financial institutions and products (which would decline in subsequent years), followed by computer hardware, components, products, and software; and chemicals and related products (industrial, pharmaceutical, cosmetics). While the statistics were not broken down by country involved, 91 APAs involved a U.S. parent and a foreign subsidiary, and 90 involved a foreign parent and a U.S. subsidiary.

The APA program was historically plagued by low staffing. It was not unusual for overwhelmed team leaders to indicate that a taxpayer's submission would not be reviewed for six months or more because of inventory overloads. As of December 31, 1999, the APA office was staffed with one director, two branch chiefs, 14 team

[48] Philip Bergquist, "Experience Concerning Advance Pricing Agreements," 20(6-7) *Intertax* 387 (1992).

[49] "Founders of U.S. APA Program Examine Its 20-Year History," 19 *Tax Mgmt. Transfer Pricing Rep.* 1261 (Apr. 7, 2011).

[50] *See* Section III.A.1, *supra*.

[51] Alison Bennett, "Audits: Taxpayers Offering to Participate in LMSB Transfer Pricing Initiative, Danilack Says," 19 *Tax Mgmt. Transfer Pricing Rep.* 690 (May 20, 2010).

[52] That report also enumerated the policy rationale behind the program: to resolve actual or potential transfer pricing disputes in a principled, cooperative manner as an alternative to the traditional adversarial process. Before the APA program was established, taxpayers and the IRS often resolved transfer pricing disputes through protracted, costly litigation. Under the adversarial model, the data gathering, development, and interpretation involved in a transfer pricing dispute is complex, time consuming, and often results in administrative appeal, litigation, or competent authority proceedings under U.S. tax treaty MAPs. From audit through litigation, a major transfer pricing dispute can take eight years or more to resolve. Accordingly, by the time of resolution, the facts in dispute are old, and there can be considerable uncertainty regarding the proper transfer pricing of transactions under current conditions. APAs are intended to supplement those traditional administrative, judicial, and treaty mechanisms for resolving transfer pricing disputes.

leaders, and four economists. To address resource constraints, the number of APA branches increased from two to four in 2000, and plans were made to service APAs arising west of the Mississippi River via a new branch in California. That branch opened in September 2001 in San Francisco; between 2000 and 2001, APA staff increased from 25 to 38. In 2002 a second office of the West Coast branch was opened in Laguna Niguel, California.

Between 2000 and 2004, the IRS concluded 142 new and 49 renewal unilateral APAs, 181 new and 46 renewal bilateral APAs, and three new multilateral APAs with one renewal. The average time to conclude new unilateral APAs hovered at just under 21 months, and the average time to conclude bilateral and multilateral APAs remained at just under 40 months. Renewals were slightly faster, with unilateral APAs coming at 16 months and bilateral and multilateral APAs at around 34 months.

In 2005 the Office of Chief Counsel held public hearings to obtain suggestions to improve the APA program, which led to several initiatives, such as new case management procedures to improve timelines and industry and issue coordination to promote efficiency. The second initiative resulted in five categories of specialization representing approximately 40 percent of APA cases — cost-sharing arrangements; financial products; and the semiconductor, automotive, and pharmaceutical industries.

In 2006 the IRS published Rev. Proc. 2006-9, 2006-2 IRB 278, to update the process and incorporate several innovations developed through 16 years of experience. In 2008 it issued Rev. Proc. 2008-31, 2008-23 IRB 1133, which extended the APA program to cover issues for which transfer pricing principles may be relevant, including attributing profits to a PE under an income tax treaty, determining income effectively connected with a U.S. trade or business, and determining income derived from sources partly within and partly without the United States, as well as related subsidiary issues.

In 2006 the APA program had a staff of 40. However, by 2008, that number was down to 33 people, only to bounce up to 39 by the end of 2009. The 2010-2011 period was difficult for the program. The number of APAs executed did not exceed the applications filed in those years, and there were only 35 APA professionals at the end of 2011.

In 2010 the IRS acknowledged the failure of the handoff process, referring to it as "terribly inefficient" and a problem that needed to be addressed.[53] It said APA teams and competent authority analysts would be responsible for negotiating cases from start to finish.[54] On July 27, 2011, it announced that the APA program would be relocated to LB&I and combined with the competent authority function to create the APMA program.[55] The IRS indicated that the move was expected to improve its ability to resolve bilateral matters more efficiently.

In 2012 the IRS appointed Richard McAlonan the first APMA director, responsible for planning, developing, directing, and implementing the tax treaty administration program and providing executive leadership and direction to the APMA program. In March 2013 it announced that combining APA and MAP and adding personnel had brought APMA staffing to approximately 104 employees at the end of 2012, mostly divided into teams that handle different countries or regions under the supervision of three assistant directors.[56] Many new hires brought transfer pricing experience from other IRS offices and the private sector. Processing efficiencies were incorporated and produced results: APMA saw a threefold increase in APA closures in 2012 (from 42 to 140) and closed 145 APAs in 2013.

APMA completed 101 APAs in 2014, consisting of 20 unilateral APAs and 81 bilateral APAs. The program received 108 applications during 2014, nearly matching the APA case closures for the year. APMA executed 110 APAs during 2015, consisting of 30 unilateral APAs and 80 bilateral APAs; of the 110 APAs executed, 66 were renewal applications. APMA received a record 183 APA applications in 2015, largely because taxpayers decided to file their applications before the changes in Rev. Proc. 2015-41 — especially for fees — took effect.

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[53] "Danilack Sees Less Bureaucracy Under LB&I Structure, Announces International Business Compliance Director Position," 19 *Tax Mgmt. Transfer Pricing Rep.* 552 (Sept. 9, 2010).

[54] Molly Moses, "United States: U.S. APA Director Says His Staff Also to Negotiate Cases From Start to Finish," 19 *Tax Mgmt. Transfer Pricing Rep.* 739 (Nov. 4, 2010).

[55] That change became effective February 27, 2012.

[56] For more detail on APMA roles, *see* Section IV.A.2.f, *infra*.

Table 4. U.S. APA Filing Fees (in U.S. dollars)

	User Fee Structure (Prior to June 30, 2018)	User Fee Structure (Between July 1 and December 31, 2018)	User Fee Structure (After December 31, 2018)
Regular APA request	**60,000**	**86,750**	**113,500**
Renewal of APA request (routine/non-routine)	**35,000 / 60,000**	**48,500**	**62,000**
Small case APA request	**30,000**	**42,000**	**54,000**
Renewal of small case APA (routine/non-routine) request	**30,000**	**42,000**	**54,000**
Amending APA request or a completed APA	**12,500**	**17,750**	**23,000**

Source: Rev. Proc. 2015-41, appendix section 3.03.

Note: According to the IRS, taxpayers must pay their APA user fees electronically via http://www.pay.gov.

Beginning in 2012, APMA began publishing the number of APAs executed with its respective treaty partners. At the end of 2017, the number of pending APA applications with China was 4 percent of the total bilateral APA inventory.[57] (See Figure 1.) In 2018 pending APA requests with China were not represented, implying the number was less than 4 percent of the total bilateral APA inventory.[58]

2. Rev. Proc. 2015-41

a. Prefiling Conferences

The first step in pursuing an APA in the United States is to determine whether a prefiling conference is needed. Rev. Proc. 2015-41 provides for mandatory and optional conferences. A prefiling conference is mandatory when:

- the taxpayer seeks a unilateral APA to cover an issue that could be covered under a bilateral or multilateral APA;
- the taxpayer wants permission to file an abbreviated APA request; or
- the proposed covered issues will, or could reasonably be expected to, involve license or other transfer of intangibles in connection with development of intangibles under an intangibles development arrangement; a global trading arrangement, business restructuring, or use of intangibles whose ownership changed as a result of a business restructuring; or unincorporated branches, passthrough entities, hybrid entities, or entities disregarded for U.S. tax purposes.

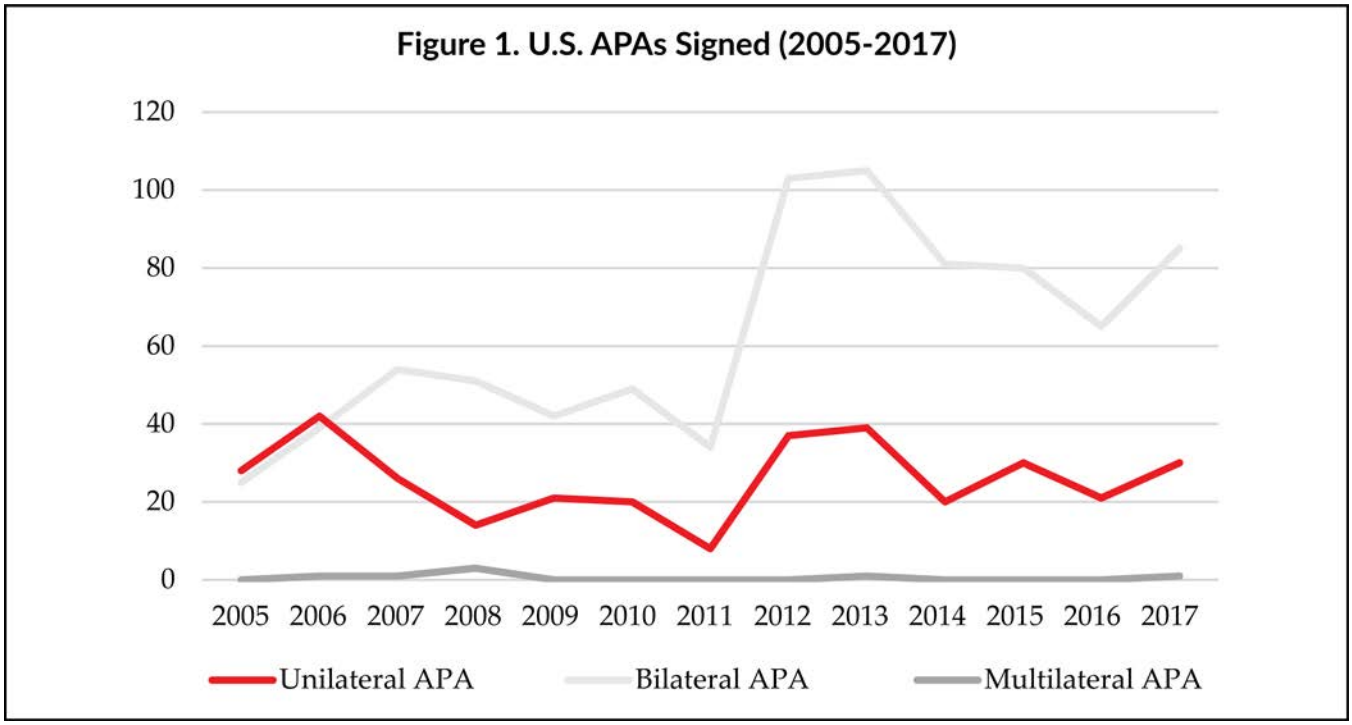
If a prefiling conference is mandatory, the taxpayer must submit a prefiling memorandum. Whether mandatory or optional, a prefiling memorandum must provide specific information detailed in section 3 of Rev. Proc. 2015-41.

Some taxpayers may be hesitant to discuss a potential APA out of concern that failure to pursue it could trigger an examination. To accommodate those taxpayers, the IRS permits prefiling conferences to be held with the taxpayer's representatives anonymously. If the taxpayer has been or is involved in a difficult transfer pricing examination, there may be some tactical advantage to pursuing the prefiling conference anonymously because no representative of the district examination office will attend. Thus, the taxpayer can discuss the issues without reference to the earlier relationship with the examination team.

In the prefiling conference, the taxpayer or its representative is expected to provide an explanation of the relevant facts, covered transactions, and proposed transfer pricing method. Typically, taxpayers use the prefiling conference submission as an agenda for the prefiling conference. The taxpayer explains its industry, organization, functions and risks, proposed covered transactions, proposed transfer

[57] IRS Announcement 2018-08, 2018-16 IRB 552.

[58] China Advance Pricing Arrangement Annual Report (2017).



pricing method (and the previous method, if different), comparable selection criteria, and proposed data adjustments. Based on that presentation, the taxpayer requests the APMA program's response to the proposed APA and recordkeeping requirements and any concerns or questions.

APMA personnel read the prefiling conference submission and the taxpayer's presentation before the conference to become familiar with the taxpayer's facts and proposed APA. Based on their experience, APMA personnel can then respond to the acceptability of the transfer pricing method, comparable search criteria, data adjustments, recordkeeping requirements, competent authority issues, level of requisite additional information, and other concerns.

While the IRS's comments during a prefiling conference are often specific, the APMA program will reserve its right to change its views and positions based on its review of the taxpayer's complete APA request.

b. Expanding to Interrelated Issues

To continue the APA process, the APMA function may require the taxpayer to expand the proposed scope of its APA request to cover interrelated matters. That includes additional interrelated issues; additional tax years, including potential rollback years; and additional treaty countries. Rev. Proc. 2015-41 includes several other examples of interrelated matters, such as global trading arrangements or transactions involving hybrid or disregarded entities.

APMA will consider the views of the taxpayer and the applicable foreign competent authority and communicate to the taxpayer any concerns about interrelated matters and potential scope expansion at the earliest time possible.

c. Filing Deadline

If the prefiling conference is successful, the taxpayer should have a good understanding of the IRS's initial reaction and areas of concern. Based on that information, the taxpayer may begin drafting its formal APA request, which it must file within the statutory time for filing its federal income tax return for the first year of the proposed APA term. If the taxpayer receives an extension to file that tax return, it must file its APA request no later than the actual filing date of the return.

The APA will be considered filed on the date the required user fee is paid, provided that a substantially complete APA request is filed with the APMA program within 120 days of the date the user fee was paid for the first proposed APA

year.[59] The APMA director will consider extending that deadline only in unusual circumstances. Further, the director may consider the request to have been filed after its actual filing if the APMA program's evaluation of a request is delayed by the taxpayer's lack of responsiveness or timeliness.

An additional filing deadline applies for bilateral and multilateral APA requests. To better coordinate the timing of discussions on bilateral and multilateral APAs with foreign competent authorities, the taxpayer should file a complete bilateral or multilateral APA request (or be considered to have filed a complete request under section 3.03(3)) no later than 60 days after a corresponding bilateral or multilateral request proposing to cover substantially the same coverable issues and APA years has been filed with a foreign competent authority.

That new deadline was put into effect because some countries require that an APA request be filed before the beginning of the first year of the APA term. In that circumstance, some taxpayers would not file the U.S. APA request until the U.S. deadline, which could be as much as 18 months after the foreign APA request was filed.

d. General Content of APA Request

Rev. Proc. 2015-41 specifies the required contents of an APA request, which are more prescriptive than under the prior revenue procedure. Requests must be structured according to the table of contents in section 1 of the appendix to Rev. Proc. 2015-41.

There are several new items to keep in mind. For instance, taxpayers should provide a detailed explanation of the proposed APA terms and conditions as reflected in the draft APA submitted with the APA request, noting in particular any proposed APA terms and conditions that differ from those in the model APA. They should also submit an estimated dollar value of issues in the proposed APA years. Further, as part of the APA request, the taxpayer must provide a general consent to extend the statute of limitations for specific years; as part of the APA process, the taxpayer and the IRS will execute consent agreements as necessary to extend the limitations period for assessing tax for each proposed APA year (including both proposed prospective and rollback years). Taxpayers should also include diagrams, charts, or similar representations depicting the required information as it relates to the proposed covered issues and any interrelated matters that APMA might reasonably consider in analyzing the proposed covered issues.[60]

e. Evaluation and Negotiation

Once a substantially complete APA request is filed, the IRS will designate a team leader to oversee the APMA team's processing of the request. If the taxpayer participated in a prefiling conference, the IRS will generally select the team leader who presided over that conference. The APMA team leader will contact the taxpayer once APMA has determined that the APA request is complete and that the process should continue.

In almost all cases, the next step is to hold an opening conference. Generally, the APMA team will forgo an opening conference only if it has no substantial disagreement with what the APA request proposes (which is rare). In the usual case in which the APMA team decides to hold an opening conference, the team leader will work with the taxpayer to set a date for the conference.

The APMA team may request that the taxpayer provide responses to its specific questions about the APA request before or at the opening conference. The team leader may set or agree to a due date for those responses before the opening conference and postpone the conference if the responses are not provided by that date.

Once the APMA team receives the additional information from the taxpayer, it evaluates the information, focusing on determining the appropriate transfer pricing method and an acceptable range of results. The parties then attempt to reach an informal agreement on the taxpayer's request, followed by a formal agreement. The evaluation of the request will not

[59] For example, a taxpayer's calendar year 2013 could be covered by paying the user fee before September 15, 2014 (or the date on which the 2013 return was actually filed, if an extension was granted), if a comprehensive APA request is submitted within 120 days of the user-fee payment.

[60] Those must be presented in a manner similar to and with a degree of detail no less than that presented in the diagrams accompanying the case studies "Alpha" through "Foxtrot" in Joint Committee on Taxation, "Present Law and Background Related to Possible Income Shifting and Transfer Pricing," JCX-37-10 (July 20, 2010).

constitute an examination or inspection of the taxpayer's books and records under section 7605(b) or other code provisions.

The APMA function schedules the evaluation and negotiation with the goal of completing a unilateral APA or completing the position paper within 12 months of the date the full request was filed.

f. APMA Team

For a bilateral or multilateral APA, the APMA team is supposed to develop, in consultation with the taxpayer and consistent with sound tax administration, a competent authority negotiating position it can recommend for approval. For a unilateral APA, the team is meant to make best efforts, consistent with sound tax administration, to develop an APA that it can recommend for approval by the APMA director.

Each team member performs specific functions. The APMA team leader coordinates the IRS negotiating efforts and sets their tone. Team leaders are usually attorneys or accountants who have extensive transfer pricing experience and training in interest-based negotiating methods. They work to coordinate the activities of the other team members and focus on resolving the issues necessary to reach an agreement, applying best methods and a principled negotiation approach. For a bilateral APA, the team leader is also responsible for negotiating the APA with the foreign competent authority, which is a noteworthy change that resulted from the movement of the APA program from the Office of Chief Counsel to LB&I. Before, the team included a separate competent authority analyst that advised the team and negotiated with the foreign competent authority.

Ten senior managers assist the APMA director and assistant directors in managing the APA caseload. They are charged with reviewing the cases in their respective branches to ensure that section 482 is applied consistently and with monitoring scheduling to ensure that cases are timely processed. Senior managers also assist in resolving any differences of opinion among the APMA team leaders, economists, and field representatives. The senior managers who manage economists are responsible for reviewing the economic analysis.

APMA economists are responsible for reviewing and critiquing the taxpayer's functional and risk analyses, the comparables selection and adjustments, and the proposed transfer pricing method. They typically suggest modifications to the selection and adjustments of the taxpayer's proposed comparables. Occasionally, they will suggest changes in the transfer pricing method; however, that can generally be avoided if the prefiling conference is thorough and candid. Because of heavy caseloads, some cases will include an IRS transfer pricing economist from outside the APMA program.

The APMA team also generally includes an LB&I international examiner and LB&I field counsel from the IRS division that would otherwise examine the taxpayer. If the taxpayer is undergoing a transfer pricing examination, the international examiner comes from the team conducting that exam. Further, when the taxpayer is subject to a transfer pricing exam, the IRS field team may include the IRS examination team coordinator and others from the examination team with knowledge of the taxpayer and its operations and related-party transactions. The IRS field team helps other IRS team members understand the taxpayer's operations, activities, functions, and risks and evaluate the potential effect of rolling back the APA transfer pricing method on the years under examination. The group will generally be allowed to review and comment on the U.S. position paper for bilateral or multilateral APAs, and the proposed APA for unilateral APAs.

g. APA Case Plan

The APMA program adopted the APA case plan to ensure that APA cases proceed in a timely fashion. With or without a case plan, the APA team will try to move through the APA process efficiently, given the scope and complexity of the proposed APA and the due diligence and analysis the team must undertake.

In preparing a case plan, the APA team and the taxpayer will discuss milestones, which will depend on the nature of the covered issues, the quality of the APA request and any taxpayer responses, and further due diligence and analysis required. The time estimates for those milestones are subject to revision. The time required to achieve milestones can be affected by various

factors, including the quality and timeliness of information provided by the taxpayer; the need to consider interrelated matters; the emergence of unanticipated issues (for example, because of a change in the facts); the ease with which an agreement can be reached with the taxpayer for unilateral APA requests or with the foreign competent authorities for bilateral and multilateral APA requests; and for bilateral or multilateral APA requests, when the foreign competent authorities are prepared to discuss the case.

As a practical matter, taxpayers seldom fail to meet the case deadlines and they appreciate the ability to encourage the IRS to reach closure on preliminary issues.

Formal imposition of the case plan differs from team leader to team leader. From the authors' experience, the use of case plans has significantly declined recently.

h. Critical Assumptions

To support the APA, the taxpayer must propose critical assumptions, which are facts outside the control of the taxpayer or the IRS whose continued existence is material to the outcome of the transfer pricing method.[61] Critical assumptions might include, for example, a particular mode of conducting business operations, a particular corporate or business structure, a range of expected business volume, or the relative value of foreign currencies. One standard critical assumption is included in almost all APAs:

> The business activities, functions performed, risks assumed, assets employed, and financial and tax accounting methods and classifications [and methods of estimation] of Taxpayer in relation to the Covered Transactions will remain materially the same as described or used in Taxpayer's APA Request. A mere change in business results will not be a material change.[62]

Most taxpayers think critical assumptions protect the IRS, but they can also protect the taxpayer if unforeseen events cause the taxpayer to report a lower profitability. For example, if the IRS were concerned that large currency fluctuations could affect the taxpayer's results, and the taxpayer did not believe that large fluctuations would occur, the taxpayer could agree to a critical assumption that currency values remain within a particular range. On the other hand, a taxpayer concerned about the effect of a down economy could request a critical assumption that would allow him to revise downward the profit expectations if specific down-economy triggering events occur.

Although taxpayers must include proposed critical assumptions in their APA requests, most assumptions are actually drafted during final APA negotiations when the parties, who may have differing factual expectations, are attempting to reach agreement. Critical assumptions used in APAs include that assets will remain substantially the same, or that there will be material changes to the business or to tax and financial accounting practices.

Public statements by APMA staff indicate that the IRS is taking a formal legal approach to determine whether an APA should be amended or canceled when a critical assumption is triggered. That has caused taxpayers to carefully consider the critical assumptions included in their APAs.

i. Bilateral Negotiations

Although they are generally consulted by the APMA function before formal negotiations with the other treaty partner begin, taxpayers do not always agree with the team's recommended negotiating position.

Even so, the next stage of a bilateral APA involves negotiations between treaty partners. At this point, the APMA team will convey the substance of its views to the taxpayer, generally in a memorandum of length, content, and format appropriate to the scope and duration of the APA process and to the size and complexity of the proposed covered issues and methods and other relevant facts and circumstances.[63] In some cases, the APMA team may present the memo to the taxpayer for comment before it formally presents

[61] Rev. Proc. 2006-9.

[62] Rev. Proc. 2015-41.

[63] *Id.*

its views to the foreign competent authorities. In other cases, the team may issue the memo simultaneously to the taxpayer and foreign competent authorities. The taxpayer would then be invited to provide its comments to both the APMA team and the foreign competent authorities for discussion and consideration in reaching a competent authority resolution.

B. China

In China, the APA was first introduced as one of the transfer pricing methods in Guo Shui Fa [1998] No. 59.[64] Although Chinese tax treaties began referencing APAs with the 1983 China-Japan treaty, the first unilateral APA was not finalized until 1998 by the Xiamen State Tax Bureau.[65] Chinese APA legislation remained vague at the provincial level and nonexistent at a countrywide level until 2002, when the APA program was formally introduced.[66] In 2004 the SAT released APA implementation rules for related-party transactions, which provided guidance on APA negotiation and conclusion procedures, requirements, follow-up, execution, and monitoring.[67] The SAT also required local tax authorities to report all unilateral APAs before execution, thereby giving the agency the information necessary to further standardize China's APA administration.[68]

As noted, China's first step toward concrete APA guidance occurred in 2002. With that new guidance in place, the Chinese competent authority was able to execute its first bilateral APA in 2005, with Toshiba Copying Machine (Shenzhen) Co. Ltd., a Japanese electronics manufacturer.[69]

Chapter 6 of Circular 2 provided a detailed description of the entire APA process, including administrative instructions and a list of items that should be included in a draft APA.[70] While Circular 2 was a groundbreaking step in the development of APA regulations, Announcement 64 replaced Chapter 6 in October 2016 and became effective December 1, 2016.

1. Administration and Statistics

The Chinese tax system has developed under a decentralized environment, with the provincial authorities managing most tax matters, promulgating contradictory procedures and even applying differing rates. Because of that format, the SAT had a long road to standardize processes and implement legislation in an international context. To centralize processes, the SAT hired 16 people in 2016 and expects to hire 26 more in the next two years, with the goal of establishing a 50-person department dedicated to transfer pricing centrally located at SAT headquarters.[71]

Under Announcement 64, the SAT has made clear that it will be involved in more APA negotiations. For example, it will coordinate the APA process when it involves tax authorities in two or more Chinese regions or involves both provincial and local tax departments.[72] Even if a taxpayer applies for a unilateral APA, if it involves multiple regions or departments, the taxpayer should still submit the APA application to both the SAT and the tax authorities designated by the SAT. Only when a unilateral APA involves two or more local tax authorities in a single region, involving either the provincial or local tax department, will the APA be coordinated by the local or provincial tax authority.[73] The wording of the provision may be conducive to the conclusion that even district tax authorities may be entitled to handle the APA (as potential in-charge tax authorities). However, given that most provinces have centralized the special tax adjustment competence, provincial tax bureaus will be primarily engaged in the coordination roles.

In 2009 the SAT released its first report on APA statistics. In addition to reporting the status

[64] *See supra* note 23 and accompanying text.

[65] Hiuyan Qiu, "Emerging APA Legislation and Practice in China," *Tax Notes Int'l*, Mar. 26, 2007, p. 1245.

[66] Implementation Rules of Tax Collection and Administration Law of the People's Republic of China, Guo Wu Yuan Ling [2002] No. 362.

[67] Implementation Rules on Advance Pricing Arrangements for Transactions Between Related Parties (Trial Version), Guo Shui Fa [2004] No. 118.

[68] SAT, "China Advance Pricing Arrangement Annual Report (2014)."

[69] *Id.*

[70] *Id.*

[71] Chi Cheng et al., "China Transfer Pricing – First Mover on BEPS," *China — Looking Ahead* (Dec. 2016).

[72] The term "region" is intended to include provinces, autonomous regions, municipalities, and cities. *See* SAT Bulletin on Issues to Improve Administration of Advance Pricing Arrangements (English translation) (2016).

[73] *Id.*

of APA cases, "China Advance Pricing Agreement Annual Report (2009)" described how the APA mechanism had become an integral component of China's antiavoidance administration. It reiterated China's goal of continued integration with the world economy. The SAT described how it had created a "three-in-one" antiavoidance system that integrates administration, services, and investigation. According to the report, the APA mechanism was meant to improve the services available to taxpayers as part of the three-in-one system. The SAT wanted to increase certainty, avoid international double taxation, and implement an administrative philosophy of improved tax compliance with an emphasis on prevention of tax avoidance.

According to the SAT's 2018 APA annual report, from 2005 to 2018, the SAT concluded and signed 89 unilateral APAs and 67 bilateral APAs. Of the concluded APAs, 65.07 percent represented a purchase or sale of tangible assets, 14.83 percent represented a transfer or use of intangible assets, 20.1 percent represented the provision of services, and 0 percent represented financing arrangements. As of 2018, China had signed 44 bilateral APAs with Asian countries, 16 with European countries, and seven with North American countries.

Action 14 of the BEPS project has listed the implementation of bilateral APAs as important for improving MAP effectiveness and efficiency. Although China has historically focused on unilateral APAs, the SAT has been placing increased importance on bilateral APAs in an effort to become BEPS compliant. Figure 2, from China's 2018 APA annual report shows number and type of APAs the SAT signed between 2005 and 2018. In 2018 alone, the conclusion of bilateral transfer pricing APAs resulted in an elimination of double taxation of approximately CNY 3.6 billion ($523 million) for taxpayers.[74]

2. Qualifying for an APA Submission

To qualify for a Chinese APA submission under Announcement 64, a taxpayer must meet three criteria. First, the annual amount of the related-party transactions must exceed CNY 40 million during each of the three previous years.[75] Those transactions include purchase, sale, transfer, and use of tangible assets; transfer or use of intangible assets; financing transactions; or the provision of services. Second, the enterprise must

[74] SAT, "China Advance Pricing Arrangement Annual Report (2018)."

[75] Under Circular 2, that threshold had to be met only in the preceding year.

comply with Chinese related-party disclosure requirements. The taxpayer should submit the annual reporting forms for related-party dealings of Chinese enterprises with its annual corporate income tax return to the tax authority within five months of the year following the year of related-party transactions. Finally, the enterprise must prepare, maintain, and provide contemporaneous documentation (which includes organizational structure, business operations, related-party transactions, comparability analysis, and selection and application of the transfer pricing method) in accordance with applicable regulations.[76]

No filing fee must be submitted with an APA application. However, the Chinese tax authorities prioritize applications when:

- the enterprise submits full information disclosures, comprehensive filings of related-party transactions, and contemporaneous transfer pricing documentation;
- the enterprise has a tax compliance rating of A;[77]
- tax authorities audited the enterprise for special tax adjustments and have concluded their case;
- the enterprise applies for renewal of the APA after the execution period, and the facts and operating environment in that APA have not changed significantly;
- the enterprise submits full and comprehensive materials as required by the APA application, with a clear and complete analysis of the value or supply chain, taking into consideration any location-specific factors, such as market premium and cost savings, and the proposed transfer pricing principle and calculation methods are reasonable;
- the enterprise proactively cooperates with the tax authorities to conduct the APA application procedure;
- for a bilateral or multilateral APA, the competent authorities in other countries are eager to negotiate and conclude the APA and consider the application of high importance; and
- other factors facilitate the conclusion of the APA.[78]

Some commentators have noted that the SAT wants to expand its expertise to new and exciting types of related-party transactions[79] and to countries where it has not previously conducted APA negotiations.[80] The 2018 APA annual report states that 84.62 percent of APAs signed between 2005 and 2018 involved the manufacturing industry and 65.07 percent involved the purchase and sale of tangible assets. Therefore, an APA may be more appealing to the SAT if it involves issues falling outside the realm of tangible property or involving a unique industry.

Table 5 provides a full breakdown of concluded APAs by industry involved, as reported by the SAT.

3. APA Process

According to Guo Shui Fa [1998] No. 59, the APA application and administration process involves several stages, discussed below.

a. Prefiling Meeting

Before a formal application may be submitted, the taxpayer must first request a prefiling meeting from the tax authority and include the following information: applicable years, the related parties and transactions involved, the enterprise and group's organizational structure, business operations, contemporaneous documentation, parties' functions and risks, market conditions, location-specific advantages, whether a rollback is involved, and any other items requiring explanation.[81]

[76] SAT APA bulletin, *supra* note 72.

[77] Tax ratings are divided into A, B, C, and D. The SAT implements procedures based on principles of rewarding integrity and punishing dishonesty. It classifies taxpayers based on tax risks and tax revenue concentration. KPMG, "SAT to Classify & Grade Taxpayers (Shui Zong FA [2016] No. 99," 33 *China Tax Weekly Update* (Aug. 2016).

[78] SAT APA bulletin, *supra* note 72.

[79] "With about 50 companies waiting to get accepted into the Chinese APA program, a key to getting to the front of the queue is presenting the APA as being simple and exciting." Julie Martin, "International Panelists Explore Pros and Cons of Securing APAs," *Tax Notes Int'l*, Mar. 26, 2012, p. 982.

[80] Tracy Zhang et al., "China Tax — Big Data and Beyond," *China – Looking Ahead* (Dec. 2016).

[81] KPMG, "State Administration of Taxation (SAT) Issued Announcement on the Enhancement of Administration of Advance Pricing Arrangement (APA)," *China Tax Alert* (Oct. 2016, Issue 28).

Table 5. Breakdown of APAs Signed by Industry (2005-2018)

Industry Involved	Concluded APAs	
Manufacturing	132	84.6%
Leasing and Commercial Services	5	3.2%
Wholesale Trade and Retail	9	5.8%
Transportation, Warehousing, and Postal Services	4	2.6%
Scientific and Technical Services	2	1.3%
Information Transmission, Software and Information Technology Services	2	1.3%
Electricity, Thermo, Gas and Water Generation and Supply	1	0.6%
Construction	1	0.6%
Total	156	100.0%
Source: SAT, "China Advance Pricing Arrangement Annual Report (2017)."		

If applying for a bilateral APA, the enterprise should include a description of the status of any application filed in the other contracting state. Also, the bilateral APA application and the APA application to the tax authorities in the other jurisdiction should include an overview of related-party business operations and transactions during the most recent three to five years and a statement of international double taxation.[82]

Under Circular 2, applications could be submitted anonymously, but Announcement 64 eliminated that option.[83] The lack of anonymity prompts taxpayers to be more precise in submitting their applications.

b. Intention

After the prefiling meeting is concluded and the tax authority issues a notice on tax matters, the taxpayer may submit the APA letter of intention and application draft. In addition to the requirements involved in the prefiling meeting stage, the APA application draft should contain information regarding functions and risks, comparable information, related-party transaction data, proposed transfer pricing principles and calculation method, analyses of value chains and location-specific advantages, transaction price or profit, and critical assumptions.[84]

Announcement 64 highlights the importance of analyzing the value chain and location-specific advantages, but the SAT has not provided guidance on how a taxpayer should conduct those analyses. However, China contributed to the discussion of location-specific advantages in the U.N. Practical Manual on Transfer Pricing for Developing Countries.[85]

The draft China chapter released in October 2016 puts a greater focus on location-specific advantages and market premiums and brings new industry-specific examples. It is part of the new U.N. manual, released in April 2017, and describes the SAT's four-step approach in analyzing location-specific advantages: identifying those advantages, determining whether they generate additional profit for an MNE, measuring additional profits, and determining the profit allocation method. SAT officials have said that both an industry analysis and a qualitative analysis are critical in the first two steps. The SAT has also noted that in China, location-specific advantages are typically found

[82] *Id.*

[83] *Id.*

[84] SAT APA bulletin, *supra* note 72.

[85] The contributing authors were Tizhong Liao, SAT deputy director of the International Taxation Department, and Wang Xiaoyue, SAT director of the antiavoidance division of the International Taxation Department.

in saving on items such as raw materials, labor, rent, transportation, and infrastructure.[86]

The intention stage has been a notorious bottleneck in the APA process, so it is important to consider why the SAT might reject a request at this point. Those reasons may include:

- the tax authorities have already initiated a special tax-adjustment investigation or other tax investigation on the enterprise and the relevant tax investigation has not been closed;
- the enterprise failed to submit the annual related-party transactions disclosure forms according to relevant regulations;
- the enterprise failed to prepare, preserve, and submit transfer pricing documentation according to relevant regulations; or
- the tax authorities and the enterprise failed to reach consensus during the prefiling meeting phase.[87]

c. Analysis and Appraisal

Under Circular 2, the analysis and appraisal stage was called "Examination and Evaluation" and followed the formal application stage. Announcement 64 attempts to improve the efficiency of the formal application stage by moving analysis and appraisal up in the process.

During this stage, the tax authority will engage with the taxpayer regarding the APA application draft. The competent authority may even conduct on-site functional and risk interviews. If it finds that the APA is inconsistent with the arm's-length standard, the taxpayer may continue negotiations. Once it is determined that the APA application draft is aligned with the arm's-length standard, the taxpayer will receive a notice on tax matters, which allows it to submit the formal application.[88]

d. Formal Application

During this stage, the taxpayer may submit the formal APA application. If the taxpayer is requesting a bilateral APA, it should also submit an application for initiating MAP.[89]

Announcement 64 provides examples of situations in which the SAT will reject the APA application at this stage, such as:

- proposed pricing principles and calculation methods in the draft APA report are unreasonable and the enterprise refuses to negotiate and make adjustments;
- the enterprise refuses to provide relevant information requested by the tax authorities, or refuses to provide additional or corrected information if the information originally provided does not meet the requirements of the tax authorities;
- the enterprise refuses to cooperate with tax authorities when conducting field visits, or refuses inquiries to understand functions performed and risks assumed by the enterprise and related parties; or
- other situations in which an APA is inappropriate.

e. Negotiation and Signing

If a taxpayer is pursuing a unilateral APA, an agreement may be signed after the competent authority reaches consensus with the taxpayer.[90] If a bilateral APA is pursued, the SAT will negotiate with the foreign competent authority. Announcement 64 summarizes the contents of a typical bilateral APA.[91] After an agreement is reached, the APA is formally signed.

Table 6 shows APA inventory as of December 31, 2018.

f. Supervision of Implementation

Announcement 64 requires the taxpayer to submit to the competent authority an annual report that includes a description of the business operations, the status of the APA, and any need to review or terminate the APA. The taxpayer should also notify the competent authority within

[86] SAT APA bulletin, *supra* note 72.

[87] *Id.*

[88] *Id.*

[89] *See* Section III.B.1, *supra*.

[90] SAT APA bulletin, *supra* note 72.

[91] Typically, basic information on the enterprise and its related parties; related-party transactions and years covered by the APA; selected pricing principles and calculation methods in the APA, as well as comparable prices or profit levels; definition of terms regarding the application of the transfer pricing method and calculation basis; assumptions and obligations for notification when there are changes to the assumptions; the enterprise's annual reporting obligations; binding power of the APA; renewal of the APA; effectiveness, revision, and termination of the APA; dispute resolution; confidentiality of the documents and materials; information exchange for unilateral APAs; and relevant appendices.

Table 6. Breakdown of APA Inventory by Phase (2005-2018)

Stage	Unilateral	Bilateral	Total
Intent	7	32	39
Application	9	56	65
Signing	89	67	156

30 days of any substantial changes affecting the APA.

The annual inspection addresses issues such as whether the taxpayer complies with the provisions and requirements of the APA, whether the annual report reflects the actual operations of the enterprise, and whether the critical assumptions are still valid.

During the APA implementation period, if the enterprise's actual operating results are outside the agreed range of prices or profits, the tax authorities have the right to make adjustments to the actual operating profits, targeting the median of the agreed range.[92] After the execution period, if the weighted-average operating results fall below the median and are not adjusted to the median, the SAT will no longer accept an application for renewal.[93]

Each year the SAT provides taxpayers with a visual roadmap outlining the steps expected in the MAP process in the China APA annual report (see Figure 3).

4. Rollback Policy

Circular 2 was silent regarding the rollback policy, drawing into question whether an APA may be applied retroactively. Although the rollback policy was informally accepted in prior years,[94] Announcement 64 formalizes that if specified throughout the APA application process and accepted by the SAT, an APA may be applied to the evaluation of a related-party transaction in the year of application or any prior year up to 10 years. That policy is consistent with the minimum standard of BEPS action 14. Interestingly, Announcement 64 specifically references the possibility of obtaining a tax refund, which is a groundbreaking change because the SAT has rarely provided a chance to receive refunds under an APA.[95]

5. Timing

Circular 2 provided taxpayers with time frames for completing each stage; Announcement 64 removed them. Despite the lack of expectations regarding the timing of each stage, the SAT has stated that its goal is to complete unilateral APAs in one year and bilateral APAs in two years.

Table 7 shows the time frame the SAT reported for APAs concluded between 2005 and 2018.

6. Peer Review

One important aspect of the minimum standards of BEPS action 14 is the peer review process, under which jurisdictions assess the effectiveness of other jurisdictions' MAP and APA processes.[96] In anticipation of being subjected to the peer review requirement, the SAT added an antiavoidance division to its international tax department.[97]

7. Exchange of Information

To ease compliance with BEPS action 5, Announcement 64 provides taxpayers with notice that the SAT has the right to carry out information exchange with other countries' competent authorities for unilateral APAs signed after April 1, 2016. Further, Announcement 42, issued June 29, 2016, requires enterprises to provide a list and brief description of the group's existing APAs as part of the master file.[98] However, the taxpayer is not required to prepare a local file or special documentation for related-party transactions covered by an APA. Also, the amounts covered by an APA are not included in the calculation for determining whether a company meets the threshold to prepare the local file.

[92] KPMG, *supra* note 81.

[93] *Id.*

[94] SAT, "China Advance Pricing Arrangement Annual Report (2017)."

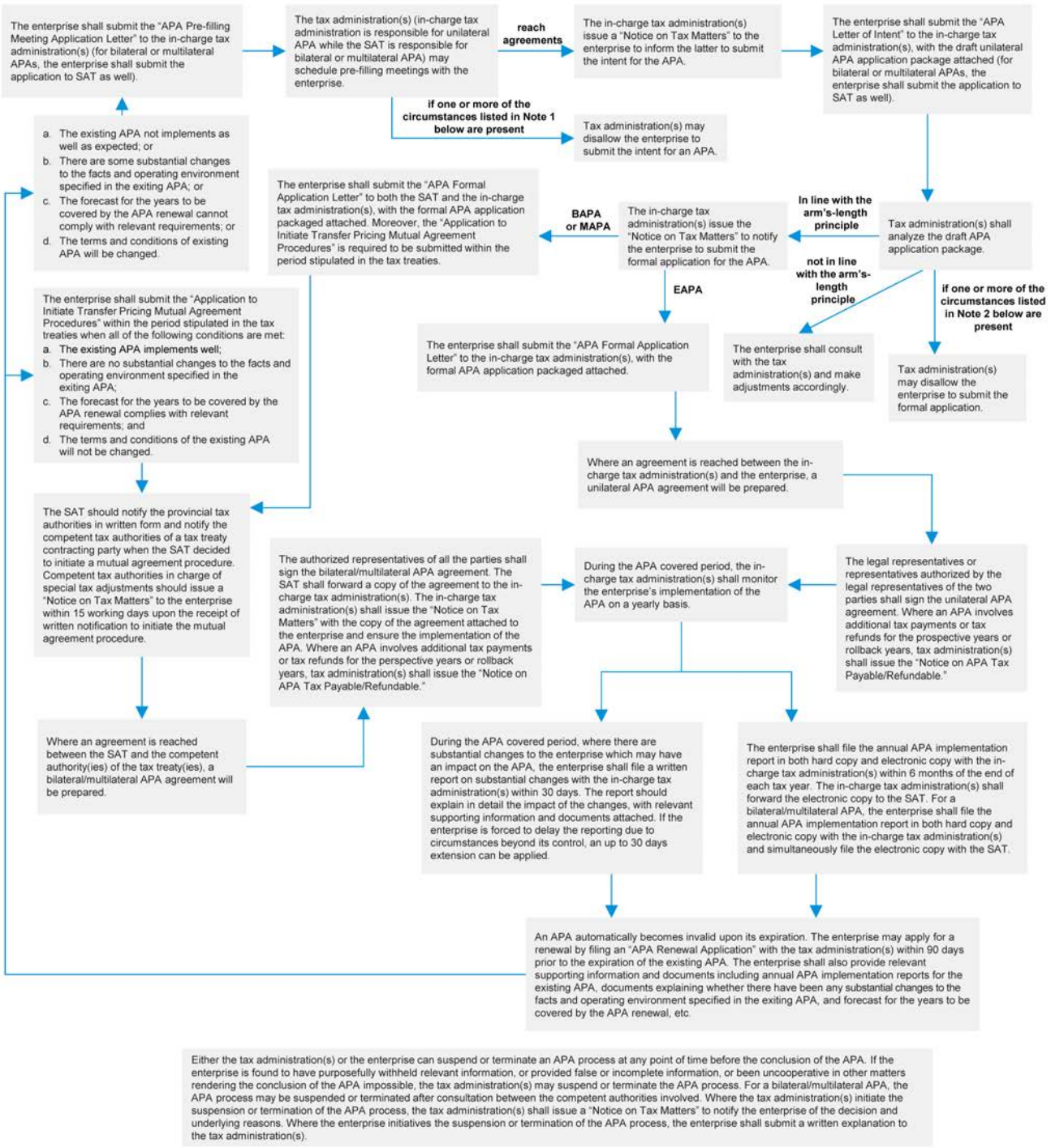
[95] Shanwu Yuan, Jason Wen, and Ning Liu, "China Issues New Rules on APA Administration," *Tax Planning Int'l Asia-Pacific Focus* (Oct. 31, 2016).

[96] *See* OECD, "BEPS Action 14 on More Effective Dispute Resolution Mechanisms: Peer Review Documents" (Oct. 2016).

[97] *See* KPMG, *supra* note 81.

[98] SAT Announcement on the Enhancement of the Reporting of Related Party Transactions and Administration of Contemporaneous Documentation [2016] No. 42.

Figure 3. China-U.S. APA Flow Chart



Note 1: If one or more of the following are present:
a) a special tax adjustment investigation or other tax investigations are underway;
b) failure to file the annual reporting forms for related-party transactions;
c) failure to provide contemporaneous transfer pricing documentation; or
d) no agreement is reached during the prefiling meeting stage.

Note 2: If one or more of the following are present:
a) the proposed pricing methodologies and calculation are found to be inappropriate and the enterprise refuses to consult or make adjustments;
b) failure to provide relevant information or provide additional and/or correct information upon further request by the tax administration;
c) failure to cooperate with request to conduct on-site interviews; or
d) any other circumstances warranting the discontinuance of the APA process.

Table 7. Time to Reach a Conclusion for APAs Signed in 2018

Type	<1 Year	1-2 Years	2-3 Years	>3 Years	Total
Unilateral	51	33	4	1	89
Bilateral	31	9	10	17	67

C. The First Bilateral China-U.S. APA

On January 12, 2007, the IRS announced (IR-2007-9) the execution of the first bilateral APA between the United States and China, involving Wal-Mart Stores Inc.

In an article discussing its APA experience, Wal-Mart indicated that in 2004 it was made aware of China's APA regulations. It said it did not consider pursuing an APA at the time because of uncertainty regarding the use and protection of taxpayer information, the dichotomy of China's local and national tax rules, and the expected timeline for completing an APA between the United States and China.[99]

Years later, when Wal-Mart began to seriously consider an APA, it began informal conversations with the Shenzhen Local Tax Bureau before the prefiling meeting. During that meeting in Shenzhen, the Chinese tax authorities commented on Wal-Mart's presentation, indicating that they would review the company's supply of intellectual property and services to Wal-Mart China, and explaining the contents of a formal request, their expectation that Chinese comparables be used[100] and that the transfer pricing method consider market differences, and their desire to complete the APA quickly.

To address Wal-Mart's concern regarding the split between provincial and federal rules, Wal-Mart, the Shenzhen Local Tax Bureau, and the SAT together developed a method for evaluating the combined results of the Chinese entities in various provincial regions. Without that combined method, the APA administration would have been more complicated. The parties also decided that the SAT would direct the APA process on the Chinese side, with the assistance of the Shenzhen Local Tax Bureau.

The APA negotiations, led by then-APA Director Matthew Frank, took only six months.[101] SAT officials attributed that speed to "the preparedness of the parties, the professionalism shown during APA negotiations and the determination on the part of the competent authority officials to reach a result that was in accordance with the letter and spirit of the United States-China Income Tax Treaty."[102]

D. Recommendations

The success of APA programs very much relies on the importance that tax authorities put on proactively solving transfer pricing issues, which generally translates into the philosophy adopted by an APA team and the resources dedicated to the program. The other key ingredients are the individuals involved in running the program. The ultimate leader of the APA program bears a crucial role in defining the general philosophy of the program during his tenure (for example, is the program expanding or contracting, and is the intent to tackle more — and more complex — issues, or to limit the number of entrants and issues?). Over the years there have been noticeable changes in the acceptance and administration of APAs as different individuals took office. That said, the APA analysts and their managers also play pivotal roles — based on their personalities and confidence levels with various situations, they can facilitate a smooth process from acceptance to completion or make it difficult or even impossible.

And while APA is an extension of MAP, it is not the same. Establishing a relationship of trust

[99] Burton Mader and Todd Ludeke, "The Bilateral APA in China: Wal-Mart's Experience," 16 *Transfer Pricing Rep.* 273 (Aug. 9, 2007).

[100] That was an initial requirement, but the SAT eventually agreed to accept U.S. comparables after Wal-Mart demonstrated the unreliability of Chinese comparables.

[101] Martin, *supra* note 79. Frank is now a principal at KPMG, based in the New York office.

[102] Steven Tseng, "Implications of the First Bilateral APA Between the United States and China," KPMG Tax News Flash No. 2007-03. *See also* Qiu, *supra* note 65.

with the government APA teams is key to an efficient and successful process. The importance of communication cannot be overstated. Taxpayers pursuing bilateral APAs between the United States and China should keep several things in mind.

Be ready to discuss all aspects and history of covered transactions and of ancillary transactions and issues and include all cross-border transactions if the tax authorities so request.

Be proactively transparent. Failing to disclose or mention a material fact will affect your credibility and the tax authorities' comfort in believing your representations, which will lead to difficulties in proceeding with an APA.

Prepare a complete prefiling memorandum or package containing the information in Announcement 64 and Rev. Proc. 2015-41, and prepare a complete APA submission by following the structure of Rev. Proc. 2015-41 and inserting the information required under Circular 2 and Announcement 64.

If the same transactions covered by your APA request were undertaken under the same or similar circumstances in prior tax years, consider requesting an APA rollback as part of your request.

Establish and maintain close contact with the APA analysts in both countries. Reach out to each APA analyst at least every month to give or receive an update. Also think strategically about which tax authority with which to first line up an APA prefiling conference or meeting. Provide all responses to queries for updated and new information promptly and simultaneously to both APA teams.

For a U.S. APA filing, pay the user fee via pay.gov a few days ahead of the deadline to leave enough time in the event that troubleshooting is needed.

Once you have received communication of the competent authorities' negotiated APA, review it and decide immediately whether it is acceptable, then communicate your response to both competent authorities within 30 days.

Take the time to carefully review each domestic APA. Mistakes do happen. Pay particular attention to the description of the agreed transfer pricing method, the generally accepted accounting principles to be used, whether audited financial statements are required (or prepared) for the tested party, the critical assumptions, and the annual APA reporting requirements (including the filing date for the first annual APA report and the subsequent annual APA reports). ■