FCD Model: A New Tool for APA Submissions

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Taxpayers making advance pricing agreement (“APA”) submissions may be asked to use the new functional cost diagnostic model (“FCD Model”), a taxpayer information data analytics tool. This article describes the FCD Model and explains why the “instruction manual” for using this new tool is unclear and may build taxpayer uncertainty.

The IRS’s Advance Pricing and Mutual Agreement Program (“APMA”) recently introduced the FCD Model, a tool it will use when evaluating certain advance pricing agreement (“APA”) submissions. APMA released an accompanying memo with instructions (the “FCD Memo”), which explains the FCD Model will be used to better understand “the respective contributions each controlled taxpayer makes to exercise control over the economically significant risks surrounding proposed covered transactions.”1

The FCD Memo leaves many questions unanswered that may create undue trepidation for taxpayers.

One unanswered question is whether the FCD Model is required of all taxpayers or whether its use will be determined by APMA on a case by case basis. In a March 1 emailed statement, the IRS clarified that APMA will request that taxpayers complete the model only “in certain cases, typically representing a distinct minority of APMA’s overall APA inventory, in which two of more controlled taxpayers make

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material, non-benchmarkable contributions to their intercompany arrangement."² For certainty and to prevent delays in case processing, taxpayers who believe they may meet these criteria should request a pre-file meeting to ascertain whether the FCD Model will be required for their APA submission.

APMA Director, John Hughes said the model is meant to facilitate discussions with treaty partners when negotiating bilateral APAs: "this is a tool for the resolution of . . . multifaceted cases, especially between treaty partners."³ Therefore, the FCD Memo references the Organisation for Economic Co-operation and Development ("OECD") transfer pricing guidelines (the "OECD Guidelines"), demonstrating that APMA believes the model and accompanying guidance are compatible with the transfer pricing principles applicable to negotiations with other OECD member countries. Importantly, however, nothing in Mr. Hughes’ comments or the FCD Memo forecloses the application of the model in the context of a unilateral APA. Mr. Hughes also confirmed that the FCD Model is "not a tool for exam."⁴

FCD Model: A Cost-Based Residual Profit Split Method ("RPSM")?

The FCD Model is an Excel spreadsheet designed to identify, organize, and analyze the “functional” costs incurred by controlled taxpayers that relate to business operations within the scope of the proposed covered transactions. APMA requires taxpayers to analyze the economic value related to the contributions, and their associated costs, and requests they categorize costs as either routine or as costs that “contribute an economic value lasting beyond a single accounting period.”⁵ For this purpose, costs that contribute an economic value lasting beyond a single accounting period include costs associated with activities that cannot be reliably benchmarked. The FCD Model requires a systematic analysis of the expenses for each function, with a worksheet listing all the cost centers, whether the cost center is identified as cost of goods sold or operating expenses, and whether the activities associated with the costs are benchmarked. For activities with non-benchmarkable costs, taxpayers need to provide the lead time and useful life of these expenses.

The FCD Memo does not opine on what costs should be treated as contributing economic value creation, or what activities and associated costs are readily benchmarkable, and instead directs taxpayers to the OECD Guidelines on profit splits for guidance. The FCD Memo makes broad references to the OECD Guidelines including the general provisions on the arm’s length standard and the intangibles rules. However, the FCD Memo cites with more particularity the revised profit split guidance published by the OECD in June 2018,⁶ indicating APMA’s acknowledgement and acceptance of evolving consensus on the use of profit splits and how they should operate.

The FCD Model benchmarks costs associated with routine activities using a taxpayer’s inputs and selected profit level indicator. Although APMA has developed reference sets of comparables for use in

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² For a link to the emailed statement, see Ryan Finley, APMA Issues Profit-Split Model for ‘Distinct Minority’ of Cases, 93 Tax Notes Int’l 1120 (Mar. 11, 2019).
³ Ryan Finley, Altera Decision May Deter New Regulatory Challenges, 2019 WTD 47-7 (Mar. 11, 2019).
⁴ Id.
⁵ FCD Memo.
⁶ OECD, Revised Guidance on the Application of the Transactional Profit Split Method (June 2018).
certain industries, the FCD Memo does not indicate if these or the taxpayer’s comparable sets will be used for benchmarking returns on costs associated with routine activities.\(^7\) The lack of guidance on comparables and profit level indicators is another reason for taxpayers to have a pre-filing conference with IRS APMA before filing an APA submission.

Costs associated with non-routine activities are aggregated using standard formulas, techniques, and the assumptions entered into the model by the taxpayer to generate relative stocks of contributory assets for a “pro forma split” of residual profits or losses. Objectively, the FCD Model is an attempt by APMA to develop a “standardized” model for costs for the purpose of determining each party’s non-routine contribution to system profit. But with respect to intangible valuation, there may be little that is standard.

Both the OECD Guidelines and the section 482 U.S. Treasury regulations\(^8\) recognize the use of cost as one means of determining the arm’s length value for transactions involving non-routine intangibles, albeit with conditions or caveats.\(^9\) Costs may be objective and easily identifiable, but not all costs associated with non-routine contributions are necessarily equal. This point is noted in the OECD Guidelines, which state that not all R&D expenditures or marketing activities result in the creation or enhancement of an intangible.\(^10\)

Even when activities can be properly categorized, costs alone (even capitalized and amortized) may not be sufficient to account for the different risk profiles associated with a one activity versus another activity, or the time periods over which costs were incurred (early stage vs. late stage) of a particular activity.

**Why the FCD Model?**

The publication of the FCD Model is APMA’s signal to both taxpayers and treaty partners that in certain cases one-sided methods may not be the best transfer pricing method. APMA caveats that requiring a taxpayer to run the FCD Model is not confirmation by APMA that the RPSM is the “most appropriate method”\(^11\) for the covered transactions. Indeed, there may be some circumstances in which the RPSM is the most appropriate method, but the RPSM as applied by the FCD Model nonetheless may not capture an arm’s length result because costs do not always provide a reliable basis for splitting profits. APMA retains the right to determine the most appropriate method based on its due diligence and discussions with the taxpayer about the model, and, interestingly, its application of the OECD Guidelines, and not the U.S. Treasury regulations. Unclear is whether APMA will use the FCD Model as an internal analytical tool to determine whether the RPSM is the best method or “confirmatory” check on

\(^7\) APMA has not yet provided guidance on when the sets are to be used, what functional activities are covered, and most importantly, how the sets were constructed.

\(^8\) Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the “Code”) or the applicable regulations promulgated pursuant to the Code (the “regulations”).


\(^10\) OECD Guidelines ¶ 6.11.

\(^11\) Interestingly APMA uses most appropriate method rather than best method.
a taxpayer’s proposed method. APMA, however, has shared the FCD Model with other taxing authorities, perhaps indicating the tool is more than corroborative in nature. Certainly, the FCD Model demonstrates APMA’s growing interest in profit split methods as a means of analyzing, and perhaps resolving APA cases.

The ambiguity as to whom the FCD Model applies and how APMA will decide to use it does little to quell taxpayer’s concerns, and may actually foster greater uncertainty about what to expect in the APA process. For original APAs, objectively probing and establishing the economic value of the costs contributed by the parties may be reasonable in certain cases, especially if there is obvious complexity with respect to the functions and risks. Transfer pricing policies direct APMA, like other tax authorities, to confirm profits are following the functions, risks, and assets employed. If APMA counters a taxpayer’s one-sided method proposal with a profit split, this may create difficulties and delays for the taxpayer, which necessitates the taxpayer’s determination from the outset APMA’s expectations with respect to a submission.

Taxpayers submitting renewal APAs, with no material changes, may face even more delays and hurdles if APMA switches a previously used one-sided method, such as a comparable profits method using an operating margin, to a residual profit split. The obvious question of the foreign competent authority is, what has happened factually to warrant the method change?

In this base erosion and profit sharing era, the emergence of the FCD Model is the latest, but likely not the last, example of how tax authorities are using data analytics to evaluate taxpayer information.

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