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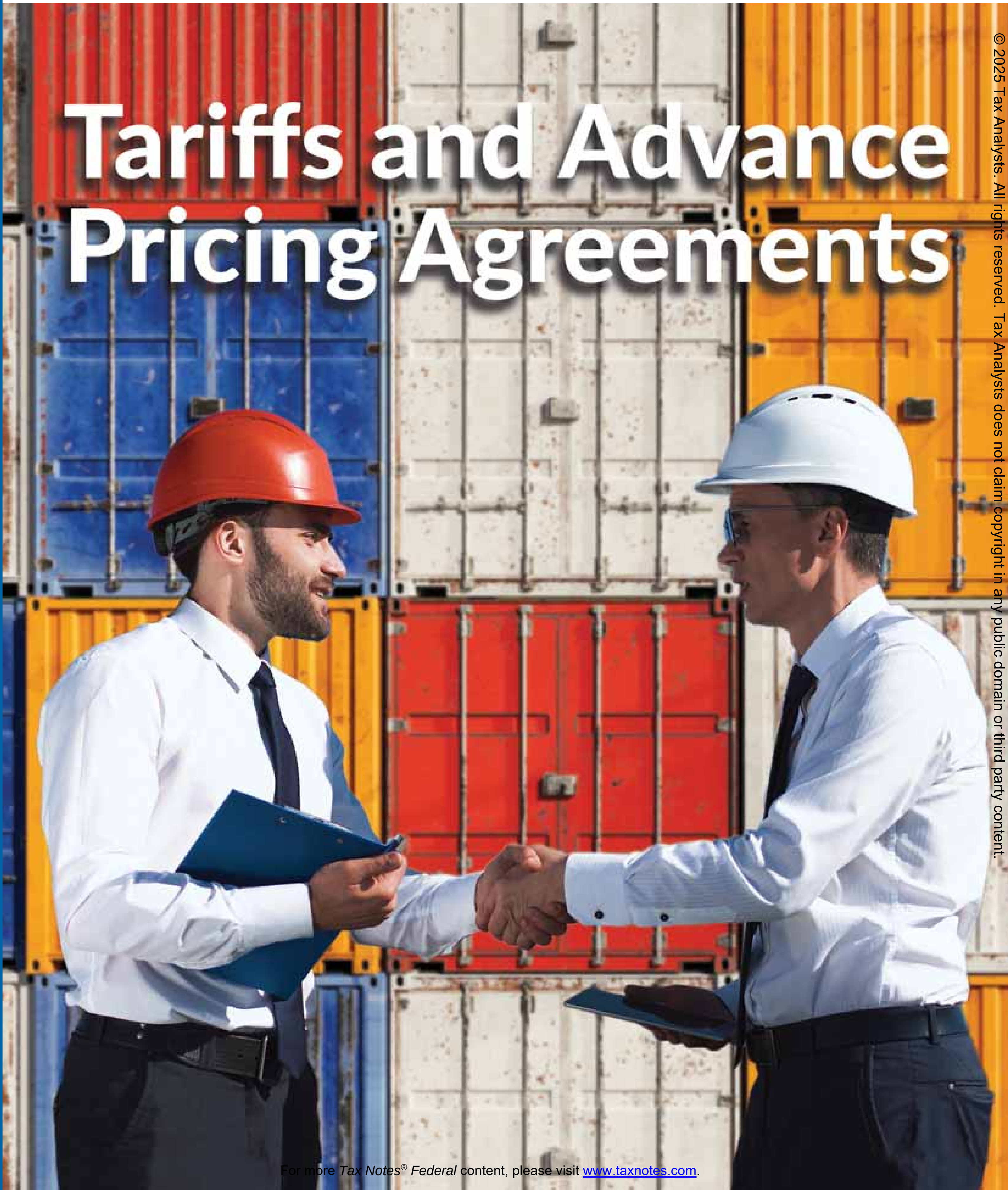

Tariffs and Advance Pricing Agreements

by Mark J. Horowitz, Thomas D. Bettge, Donald C. Hok, and Vesela Grozeva

Mark J. Horowitz

Thomas D. Bettge

Donald C. Hok

Vesela Grozeva

Mark J. Horowitz is a principal in the tax controversy and dispute resolution services group of the Washington National Tax practice of KPMG LLP, Thomas D. Bettge is a managing director in the economic and valuation services group of KPMG's Washington National Tax practice, Donald C. Hok is a managing director in the trade and customs group of KPMG's Washington National Tax practice, and Vesela Grozeva is a senior manager in the economic and valuation services group of KPMG's Washington National Tax practice.

In this installment of Practically Speaking: Tax Controversy, the authors examine the considerations specific to advance pricing agreements that arise when transfer pricing covered by an APA is materially affected by tariffs.

Introduction

The many tariff announcements and implementations by the Trump administration in 2025 have far-reaching implications for transfer pricing. The significant uncertainty about the timing, country-by-country application, and size of the tariffs magnifies the effect on transfer pricing because setting transfer pricing policies is both implicitly prospective and often closely intertwined with the global supply chain. This is especially true in the context of advance pricing agreements, which are intended to be prospective processes that address future periods.

When a large supply shock or another dramatic change upends the economics that underpinned the taxpayer's policy under the APA, it can lead to significant changes in the proposed APA pricing, including sizable potential transfer pricing adjustments, or even a change in whether the methodology is appropriate. Tariffs are a classic example of a development that has the potential to immediately and significantly change the economics of the business and thus the transfer pricing. In this article, we unpack considerations specific to APAs that arise when there are material tariff effects on the transfer pricing covered by the APA.

First things first: Tariffs only directly affect tangible goods pricing (including tangible goods pricing with embedded intangibles or embedded services). While we have confined this discussion to the tangible goods context, please note that there are potentially significant knock-on effects of tariffs on other related party transactions that computationally, economically, or factually interact with a tangible goods transaction. This article examines situations in which tariffs affect APAs, and the potential resolution of this effect based on how competent authorities historically have addressed similar issues.

Effect of Tariffs

For a typical APA with a tangible goods transaction as part of the covered transactions, what is the potential tariff effect? The classic and most-often cited scenario is an APA covering tangible goods distribution with the distributor as the tested party under the comparable profits method/transactional net margin method (CPM/TNMM). Because tariffs are typically included in a distributor's cost of goods sold, increased tariffs on goods imported by the distributor will directly increase costs and decrease profit. If the APA requires the distributor's operating margin to be within a CPM/TNMM arm's-length range, any reduction in profit below the lower end of the agreed APA arm's-length range will require a compensating transfer pricing adjustment under the APA. The tax authority in the country where the seller is resident will not want to subsidize tariffs on tangible goods sales by endorsing an adjustment to provide additional profit to compensate for the tariff effect on the distributor's profitability.

Consider a scenario in which a U.S. distributor (US LRD) purchases products for resale from a foreign supplier (ForCo) and their transfer pricing policy was negotiated through a bilateral APA. Under the APA, the intercompany price for the products is set to ensure US LRD achieves an operating margin within an interquartile range of 3 to 6 percent. At the beginning of 2025, US LRD was expected to import $75 worth of foreign widgets and sell them for $100, expecting to achieve an operating margin of 5 percent.

Table 1. Financial Results Without Tariff Effect

	ForCo	US LRD
Sales	$75	$100
COGS	$40	$75
Operating expenses	$25	$20
Operating profit	$10	$5
Operating margin	13.3%	5%

However, with the imposition of tariffs in 2025, US LRD as the importer of record, had to pay a duty of 40 percent on the value of the imported widgets. This duty cost is included in COGS, although it is shown separately in Table 2 for purposes of illustration. Because of market competition, US LRD was unable to pass the duty costs to the customer. After taking tariffs into account, US LRD realized a loss at year-end, falling below the arm's-length range negotiated by the bilateral APA.

Table 2. Financial Results With Tariff Effect

	ForCo	US LRD
Sales	$75	$100
COGS	$40	$75
Duties	N/A	$30
Operating expenses	$25	$20
Operating profit	$10	-$25
Operating margin	13.3%	-25%

Because the APA requires that US LRD earn an arm's-length operating margin rather than pay a fixed price for widgets, the taxpayer would be required to implement a compensating adjustment under the APA. To achieve a 3 percent operating margin for US LRD (that is, the minimum permissible level under the APA), US LRD and ForCo would have to adjust the intercompany purchase price (in Table 3, ForCo's sales and US LRD's COGS) from $75 to $47.[1] This leaves ForCo with a material loss.

[1] We have not reflected the potential reduction in COGS because of the reduction in customs duties that could result from a change in customs value that corresponds to the change in transfer pricing value.

Table 3. Financial Results Post-Adjustment

	ForCo	US LRD
Sales	$47	$100
COGS	$40	$47
Duties	N/A	$30
Operating expenses	$25	$20
Operating profit	-$18	$3
Operating margin	-38.3%	3%

In the discussion above, we have focused on the effect on CPM/TNMM cases because they are the classic interaction with tariffs. However, other methodologies can also be affected. For example, to the extent that a comparable uncontrolled price methodology relies on historical pricing data or historical contracts, there may be an argument by the tax authorities that they are no longer comparable or that material comparability adjustments need to be made to reflect the effect of tariffs.

In a profit-split case, there is the possibility that tariffs could affect whether there is system profit at all (in the previous example, the tariff costs are twice the pre-tariff system profit), or alternatively, whether there is residual profit to split in a residual profit-split method (RPSM) case. This could lead to difficulty in the application of the methodology, which could cause tax authorities to propose a different methodology.

Moreover, the use of the RPSM for a set of transactions that include but are not limited to tangible goods transactions may cause difficulty in determining the effect on COGS specifically because APAs that use an RPSM for multiple types of transactions often do not specify or allocate an adjustment under the APA methodology to the different transactions (for example, an RPSM that aggregates services, intangibles, and tangible goods). Because an aggregate adjustment does not specify the change only to COGS/tangible goods values, the ability to determine the effect on customs duties may be limited. One approach we have used in broadly similar contexts in the past has been to include operational/transactional transfer pricing in the APA agreement but then use the RPSM, CPM, or another aggregate approach as an overarching method.

Sharing of Tariff Effect

So how does the tariff effect get shared in a CPM/TNMM case, or is it not shared at all? One question in this regard is whether the characterization as a limited or low-risk distributor, or rather as a full-risk distributor or entrepreneur, is relevant to the sharing or allocation of the tariff effect. The answer is arguably yes — a limited-risk distributor should not bear the effect of tariffs and should not incur losses because its risk has been contractually limited and the low-risk distributor does not have the authority to manage the tariff risk by looking for alternative suppliers. On the other hand, limited risk does not mean no risk, so a valid question remains to what extent low-risk distributors should bear the tariff risk, if at all.

On the other side of the tangible goods supply chain, if compensation under the APA is based on a routine return for the manufacturer, similar questions may arise. For example, for a contract or toll manufacturer, tariffs arguably may have no effect on an APA because the CPM/TNMM test does not include tariffs involving the final importation for sale because those are included in the importers' COGS. Likewise, assuming the manufacturer has truly limited risk, then any increased costs included in the CPM/TNMM test arguably should be borne primarily by the principal. Of course, every case is unique, and the specific risk allocation and facts will determine the correct allocation of the economic effects. These questions become more challenging when both parties to the tangible goods transaction are routine entities and the principal sits elsewhere in the value chain.

Historical Lessons Learned

The broad use of tariffs by the current administration as well as retaliation from other countries is, to a great extent, a brave new world. The dramatic effects from the combination of the COVID-19 pandemic economy, the 2017 tariffs, and the supply chain issues that resulted from both are the most similar economic situation in recent memory and can therefore be used to inform how we think about the present. How the

IRS's advance pricing and mutual agreement program and other competent authorities addressed the 2017-2022 economic effects can provide information on how they may react to the current situation. Of course, the 2020-2022 economy was unique in many respects and caution should be taken in gleaning lessons from this period.

There are two potential sets of APAs that can be affected: APAs already concluded and still in effect, and APAs pending negotiation and resolution.

For APAs already concluded, the question is whether there can be any modification to the terms of the APA. The first situation in which there will be discussion of modification is when there has been an APA critical assumption violation. Generally, when addressing cases from the 2017-2022 period, IRS APMA and most other tax authorities were reluctant to agree that an APA critical assumption was violated because of any of the above factors (COVID-19 effects, tariffs, supply chain issues, etc.). While in some cases the IRS's advanced pricing and mutual agreement team was open to additional language or additional critical assumptions, they generally tried to negotiate the standard critical assumption, which in its current form is:

> The business activities, functions performed, risks assumed, assets employed, contractual terms, markets, economic conditions faced, and financial and tax accounting methods and classifications 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.[2]

A layman's reading of the critical assumption would be that tariffs are part of "economic conditions faced" — and thus, one might reason, the imposition of material tariffs should materially alter the relevant economic conditions. Moreover, given that tariffs of the magnitude that are now contemplated are new, it is unlikely — apart from limited risk situations — that the risks of tariffs have been allocated between the parties. Likewise, the decision of whether tariffs or excise taxes will be treated as part of COGS or instead as a tax for transfer pricing and tax purposes that could affect the "financial and tax accounting methods and classifications of Taxpayer." While these arguments are logical, generally competent authorities were reluctant to reopen and renegotiate every APA now in effect that was affected by tariffs, which makes sense from a practical perspective. In practice, a high bar was established for when a critical assumption violation occurred; the mere existence of tariffs, even if material, generally would not suffice.

In contrast, it is more likely that an APA critical assumption violation will have occurred if, because of tariffs, the taxpayer rearranges the relevant controlled transaction. If those changes have or will occur, taxpayers should discuss them internally and with their advisers. Often, it will be advisable to discuss them proactively with the competent authorities to avoid incorrect assumptions and surprises for an APA in effect today.

Of course, it is always possible to request a formal amendment of the APA absent a critical assumption violation, but one competent authority or the other is likely to reject the application for amendment unless there is a strong argument there has been a critical assumption violation. Moreover, amendments in the United States carry an additional user fee of $24,600.

For APAs still under negotiation (or APAs that have been reopened for modification), a range of approaches have been proposed and agreed to by various competent authorities, which are broadly summarized below.

First, there is the instinct to push forward any uncertainty that has arisen and wait to address the associated difficult economic and analytical questions until there is clarity on the issue. This tempting approach has been taken historically, and early experience this year indicates that it will be used by certain competent authorities in the current environment as well. Some competent authorities may want to negotiate shorter APA terms or split terms. For example, since significant tariff effects did not generally arise before 2025,

[2] IRS APMA Advance Pricing Agreement Template (2025).

cutting off the APA term to end in 2024 (or with an early 2025 fiscal year-end) should allow the shortened APA to proceed without considering tariff effects. Then a renewal APA can consider these issues after more time has passed.

Alternatively, we have seen split terms in which one arm's-length range or approach is used for one term (for example, years before 2025) and another is used for 2025 and future years. This approach provides a similar result as shortening the APA term but avoids the burden on the taxpayer of making another submission with all associated costs and delays in resolution. Therefore, for most taxpayers, this multiple-term approach within the same APA will be preferred compared with shortening the APA term and requiring renewal. However, this also means taxpayers may need to wait longer for the resolution of the pre-2025 period.

Historically, many cases proceeded to address the tariff or other similar issues regardless of the uncertainty. Many of those APAs involved some splitting of the tariff's effect between the related parties. For example, some cases involved broad identification of the potential tariff effect and specific splitting of that effect, often using high-level percentages, such as 75 percent/25 percent or 50 percent/50 percent. This was most frequently employed in cases in which the results were already known rather than those cases in which there were many prospective years. There were several similar approaches that had the practical effect of splitting the tariff effect, including the exclusion of certain costs from the cost base as "extraordinary" tariff-related costs.

An approach that was used in some APAs, which involved several prospective years, effectively converted the split percentage into an adjustment to the arm's-length range. For example, if tariffs would likely have an overall 2 percent reduction to operating margin over the APA period, then the competent authorities agreed to reduce the lower quartile and the upper quartile of the arm's-length range by 1 percent. Therefore, the modification of the arm's-length range would generally have the effect of splitting the tariff effect 50 percent/50 percent but has the benefit of sticking with a standard CPM arm's-length range approach with APA adjustments to the edge of the arm's-length range.

The punchline for APAs in cases in which there is not a clear allocation of tariff costs to one party or the other is that there is a range of approaches that may be used by tax authorities to address the effect of tariffs on a particular APA and the allocation of their economic effect among the parties.

We understand that many competent authorities are still very early in their consideration of tariff effects and may be taking a wait-and-see approach. There appears to be a divergence between tax authorities, as we understand that some tax authorities are interested in taking similar approaches to those described above, whereas others are more focused on the use of comparable companies that would (theoretically) take into account tariff effect.

Addressing Tariffs

One comment that we have often heard from both taxpayers and the competent authorities is that these issues should be handled by the comparable companies — the argument being that if there is a high level of comparability, the tariff effect should be seen in the comparable companies. Therefore, there is ultimately no difficult economic or allocation question for negotiations. This certainly has some attractive aspects — ease of analysis, administrative ease in terms of methodology, and minimal need for detailed factual analysis or negotiation for the specific facts of a particular taxpayer's exposure to tariffs. For tax administrations whose APA, mutual agreement procedure, and exam dockets are large, there is a clear benefit and interest in a practical and administratively simple approach. Indeed, the job of a transfer pricing professional would certainly be easier if comparable companies could ride to the rescue here. But unfortunately, as with many things in life, it's not that simple.

The CPM has historically been conceived of as a method more attuned to functional comparability than to product comparability. Typically, differences in products between the tested party and the comparable companies have not been seen as a reason to reject an application of the CPM, except to the extent those differences manifest in more meaningful ways. With material tariffs, these historical assumptions regarding the importance of different comparability factors may be shaken — primarily because tariff rates may differ significantly between product categories and between countries of origin.

Even if an uncontrolled company has materially the same functions, assets, and risks as the tested party, its financials may show a very different tariff effect depending on the breakdown of product mix, inputs of those products, and countries of origin. And even if the analysis needed to adjust for this was not laborious and burdensome (which of course it is), reliable data necessary to perform a granular analysis may not be publicly available.

Developing a set of comparable companies typically involves tradeoffs. A classic example is the choice between routine, limited risk distributors of disparate products in disparate industries and distributors that operate in the same industry with similar products but perform ancillary activities, have additional assets, take on somewhat different risks, or even own intangible assets not possessed by the tested party. In those cases, the lack of perfectly comparable companies should not derail the analysis, but given the dramatically different effect that tariffs have on the profitability of those comparable company sets, the approach taken to compile a set of comparables may become more relevant in both APA and general transfer pricing contexts.

Moreover, even if tariff effects could reliably be determined by a comparable company analysis, there would be significant timing issues that practically affect APAs. APAs rely on previous economic data to predict prospective arm's-length ranges of results. In the context of tariffs, it is entirely possible that their effects do not move through the supply chain and to customers for a year or more. When combined with the time necessary to see the results in public comparable company data, there may be a delay of one, two, or even three or more years before the effect is reliably observable.

And even then, the effects may be intertwined with the effects of the broader economic cycle. This means that a reliable view of the specific effects of tariffs may take several years to become clear — and by that time trade policy will almost certainly have changed, potentially multiple times. The time it takes to obtain reliable data is simply not practical or tenable in an APA context, given the intention to achieve prospective certainty for the taxpayer and the already long timelines for obtaining an APA.

Finally, there is the perennial concern that public company data has an inherent survival bias — only successful companies that stay in business have data available. The current tariffs are (at least partially) designed to change the competitive landscape in the U.S. economy, and it is possible that they could drive some companies out of business and exacerbate the survival bias in the data. Consequently, as the effects of tariffs become more readily observable in companies' financial data, these issues must be carefully considered.

Term Tests and Tariffs

Regardless of methodology, the use of term tests — that is, consideration of the taxpayer's results over a multiyear term rather than testing on an annual basis — in APAs raises an interesting question. There are significant benefits to term tests, both in terms of flexibility and administrative ease for taxpayers. However, how term test adjustments are allocated to COGS for purposes of addressing tariffs is an open question. In the most extreme example, one could see a situation in which an adjustment required by a term test reduces the COGS for a tangible goods transaction between related parties in year 5 of the APA only instead of that adjustment being reported in years 1 through 4. In this example, assume that in year 4 of the APA, either because of a new government or a trade deal, the tariffs imposed by the jurisdiction of the purchasing related party are greatly reduced.

Therefore, if the customs authorities refuse to allocate the COGS reduction to earlier years there would be no corresponding tariff benefit to the term test or telescoped adjustment, as is assumed and discussed below. In most instances, the period for reconciliation or refund of customs duties is relatively short when compared with the typical APA time horizon. Note that the same difficult questions arise in the opposite scenario (significant increase in tangible goods prices) — namely, there is a certain period required for companies to correct their customs valuations. But if those valuations for transfer pricing purposes are not finally determined until years after the importation because they are subject to adjustment under an APA term test, how can the taxpayer fully comply with the customs valuation rules?

How to address both sides of these potential issues could lie in a joint APA-customs process, which has historical precedents. It is also possible that term tests could be converted to single-year or rolling average calculations with telescoped net adjustments into the last year of the APA. This would not provide the flexibility or volatility-reducing benefits of a term test but would continue to provide administrative ease of avoiding amended returns and the complexity of retroactive and annual adjustments.

Adjustments and Tariffs

We have confined this article to the effects of tariffs on APAs rather than the interaction of APAs with customs rulings, joint rulings or processes, tariff reconciliation, refunds, etc. But it is important to note that APAs and transfer pricing planning can complement or support a reduction in customs duties. There will be many APAs in which there are substantial tax adjustments, and there may either be an opportunity to reduce duties or an obligation to report and pay increased duties. We have therefore described how transfer pricing adjustments, such as those required under an APA, could interact with customs duties. While the focus is on U.S. customs valuations and duties, the theory should be generally applicable in other countries with similar rules.

In the case of a price change that reduces COGS for transfer pricing purposes, logically, one would expect that tariffs should be reduced as well. U.S. Customs and Border Protection (CBP), however, is not automatically bound by an APA. Instead, the company is responsible for seeking a refund of duties. An importer that uses the transaction value method to appraise the value of imports can retroactively reduce their customs value, and thus request a refund of duties, if an objective formula is in place before importation, as indicated by the five formulaic factors established by the CBP.[3] The five formulaic factors are as follows:

- a written "intercompany transfer pricing determination policy" is in place before importation, and the policy is prepared taking section 482 into account;
- the U.S. taxpayer uses its transfer pricing policy in filing its income tax return, and any adjustments resulting from the transfer pricing policy are reported or used by the taxpayer in filing that return;
- the company's transfer pricing policy specifies how the transfer price and any adjustments are determined for all products covered by the transfer pricing policy for which the value is to be adjusted;
- the company maintains and provides accounting details from its books and financial statements to support the claimed adjustments in the United States; and
- no other conditions exist that may affect the acceptance of the price by the CBP (for example, the adjusted price must be arm's-length from a U.S. customs perspective).[4]

Taxpayers adjusting the value of imports can apply for a duty refund in two ways: by participating in the CBP's reconciliation program or by filing a post-summary correction. The reconciliation program offers practical advantages for taxpayers expecting frequent adjustments to import values. It allows importers to designate certain customs entries (such as value) as indeterminable data elements to be corrected post-importation. Importers have 21 months from the original customs entry (known as entry summary) to reconcile and report the final value. To make this correction, the importer's underlying intercompany agreements should allow for post-import price adjustments and the adjustment mechanism should exist "at the time of importation." The importer must document how each year-end adjustment is allocated to

[3] The transaction value method generally refers to the first three of six hierarchical methods set by the CBP for appraising the value of imported merchandise.

[4] Intercompany buyers have the additional burden of proving that the transfer price meets the CBP's circumstances of sale test or test values before it can be used as a measure of the imports' value.

individual entry numbers. The CBP can generally audit the reconciliation entry up to five years after liquidation (that is, the CBP's final determination of duties, fees, and taxes owed on an import entry).

The second option is to file a post-summary correction when errors are found in the original customs entries. Post-summary corrections are quick and effective for a small number of entries caught early, but their tight deadline, one-entry-at-a-time format, and audit exposure make them less attractive for large-scale, recurring transfer pricing true-ups. Importers expecting recurring annual adjustments should weigh these downsides against the administrative efficiencies of the reconciliation program.

Meeting these requirements can be challenging for importers without intercompany agreements and clearly stated transfer pricing policies. An APA can help importers demonstrate that they had an objective formula in place that was negotiated and implemented before importation. Further, when the APA explicitly allows year-end true-ups to keep the tested party within a specified operating margin range, the importer can show the CBP that a downward price adjustment was foreseeable — a critical condition for the CBP to accept a post-import value change. With an APA, the adjustment could be characterized as mandated compliance with section 482.

Finally, it should also be noted that the calculation of the duty refund should factor in the feedback effect of the duty refund on the taxpayer's operating profit. For example, if the adjustment to COGS results in a certain operating margin, the duty refund received will further increase that margin. The interplay between the two effects should be considered, especially in those cases in which tariff rates are particularly high, as the duty refund can be sizable.

Conclusion

Tariff-related reductions in profits, and in some cases the generation of losses, put pressure on taxpayers' transfer pricing approaches — and, as a result, on the APAs that provide certainty for those approaches. For taxpayers with existing APAs, it is important to determine whether a critical assumption failure has occurred, taking into account tax administrations' natural reluctance to find that broadly applicable trends require renegotiation of agreements. For taxpayers with pending APA requests, it is important to consider potential alternatives for addressing the tariff effect and identify which would best suit the taxpayer's facts. Whatever approach is taken, adjustments are sometimes inevitable — and when making them, taxpayers must now carefully consider the customs side of the equation. Suffice it to say that if significant tariffs continue to be imposed on imports, taxpayers will need to take into account the role of tariffs when obtaining and complying with current and future APAs. ■