

2016 US APA Report shows strong interest in agreements with India, Italy

The Internal Revenue Service on March 27 released Announcement 2017-03, the advance pricing agreement (APA) annual report covering the activities of the Advance Pricing and Mutual Agreement (APMA) Program during calendar year 2016. The annual report is issued under §521(b) of Pub. L. 106-170, the Ticket to Work and Work Incentives Improvement Act of 1999, which requires the Secretary of the Treasury to report annually to the public on APAs and the APMA Program.

The annual report provides a summary of recent APA developments in the APMA Program and a statistical snapshot of the program's APA activities during 2016. While the 2016 annual report reveals a significant decrease in APA applications compared to the record number of APA applications received in 2015, the decrease may be explained by taxpayers accelerating their APA requests to file under procedures that were superseded by new procedures at the very end of 2015.

The IRS began to accept applications for bilateral APAs with India in February 2016, and the 2016 annual report shows substantial taxpayer interest in such APAs during 2016. Additionally, the first bilateral US-Italy APA, concluded in 2015, presaged increased interest during 2016 in bilateral APAs with Italy.

Transfer pricing enforcement is expected to increase throughout the world as countries adopt the Organisation for Economic Co-operation and Development's (OECD) base erosion and profit shifting (BEPS) final recommendations, including the enactment of country-by-country (CbC) reporting requirements. Consequently, the certainty provided by APAs will play an increasingly important role in transfer pricing risk management.

On August 12, 2015, the IRS released new revenue procedures governing APA and mutual agreement procedure (MAP) applications. Effective for all APA requests filed after December 29, 2015, Revenue Procedure (Rev. Proc.) 2015-41 provides guidance and instructions on filing APA requests, as well as guidance and information on the administration of APAs. Effective for all competent authority requests filed on or after October 30, 2015, Rev. Proc. 2015-40 provides procedures and guidance on requesting assistance from the US Competent Authority when the taxpayer believes the actions of the United States or a treaty country result or will result in the taxpayer being subject to taxation not in accordance with the applicable US tax treaty. The IRS is expected to release competent authority statistics separately in the near future.

Statistical highlights of the APA annual report include:

- **Incoming APA requests:** The IRS received 98 APA applications (14 unilateral, 84 bilateral, and 0 multilateral) in 2016, a significant decrease from the 183 APA applications received in 2015, which was a historical record for APMA (including its predecessor, the APA Program). As noted above, the significant decrease is likely the result of taxpayers accelerating filing their APA applications in 2015 under the old procedures – Rev. Proc. 2006-9 – prior to the effective date of Rev. Proc. 2015-41, given the significant additional information required for taxpayers to comply with the new requirements in Rev. Proc. 2015-41.
- **Decrease in completed APAs:** During the 2016 calendar year, APMA closed 86 APAs (21 unilateral, 65 bilateral, and no multilateral), compared to 110 APAs in 2015 and 101 APAs in 2014, while reporting very similar staffing levels in the APMA Program at the end of 2016 compared to the end of 2015. APA renewals accounted for 49 of the 86 APAs executed, with 17 unilateral and 32 bilateral renewals. As in 2015, renewals represented slightly more than half of all completed APAs. Twenty percent of all APAs included rollbacks, and we estimate that approximately 45 percent of new APAs included a rollback. It is likely that a significant portion of APAs with rollbacks resolved transfer pricing audit activity involving either the IRS or the tax authorities of a treaty partner.
- **Months to complete APAs:** In 2016, the median time to complete a unilateral APA and a bilateral APA was 15.4 months and 35.6 months, respectively. In 2015, the median time to complete a unilateral APA and a bilateral APA was 17.3 months and 38.2 months, respectively. Overall, the median time required to complete the 86 APAs executed in 2016 was 32.8 months, approximately one month slower than in 2015.

Processing time for unilateral APAs declined slightly from the prior year. This is an encouraging continuing statistic from 2015, as unlike bilateral APAs, which involve treaty partners, unilateral APAs and their

processing time are more controlled by APMA. Processing time for bilateral APAs also declined slightly from the prior year.

Taxpayers renewing APAs benefitted from faster processing times for their APA requests. For renewal unilateral and bilateral APAs, the median processing time was 23.2 months, compared to the median processing time for new unilateral and bilateral APAs of 46.7 months. The median processing time required to complete new APAs increased significantly from 34.2 months in 2015 to 46.7 months in 2016.

- **Treaty partners involved in bilateral APAs:** While in prior years Japan and Canada typically accounted for the largest share of bilateral APA requests filed, in 2016 India accounted for 34 percent of bilateral APA requests filed, the largest share of any country. This is not particularly surprising, as the IRS only began accepting applications for bilateral APAs with India in February 2016. During 2016, bilateral APA requests filed involving Japan and Canada represented 31 percent and 8 percent, respectively. As noted above, Italy accounted for 4 percent of bilateral APAs filed in 2016; in 2015 the IRS announced that it had reached its first bilateral APA with Italy. Other countries accounting for meaningful percentages of filed, pending, or completed APAs with the United States are China, France, Germany, Korea, and the United Kingdom.

Nearly three quarters of the total number of bilateral APAs executed in 2016 involved bilateral APAs with either Japan or Canada. Based on the filed APA requests during 2016 and the IRS's pending inventory of APAs, the percentage of completed APAs with Japan and Canada is expected to decrease as a percentage of the total as other countries become more active in the APA process.

- **APA inventory:** The APMA Program had 398 cases in active inventory at the end of 2016: 67 unilateral APAs, 322 bilateral APAs, and 9 multilateral APAs. In comparison, active inventory at the end of 2015 was larger, with 410 cases.
- **Term length of APAs:** Of the APAs executed in 2016, 52 cases had a five-year term, while 39 cases had terms of six years or longer. The average term length was six years. In our experience, the APMA Program and foreign competent authorities are willing to extend the standard APA term of five years when additional years are needed to address difficult results during a rollback period and/or completed APA years, or to provide some prospectivity in cases when the APA request took a long time to complete. Further, in the context of renewal APAs that were handled expeditiously, the APMA Program has shown a willingness to accept APA terms longer than five years.
- **Staffing:** As of December 30, 2016, the APMA Program was comprised of 62 team leaders, 20 economists, and 10 senior managers organized into 10 groups (seven team leader groups and three economist groups). Compared to 2015, this represents a decrease of one economist. The team leader groups are organized by country, with each group having responsibility for multiple countries. Because of the large volume of cases with certain treaty partners, some countries are the responsibility of more than one group.
- **Cancellations, revocations, and withdrawals:** No APAs were cancelled or revoked during 2016. Twenty-four APA requests (9 unilateral and 15 bilateral) were withdrawn in 2016, which is significantly higher than the 10 applications withdrawn in 2015.
- **APAs executed by industry:** In 2016, manufacturing and wholesale/retail trade accounted for 47 percent and 38 percent, respectively, of the total number of executed APAs. Within the wholesale/retail trade industry, merchant wholesalers of durable goods were most common (64 percent of such cases).
- **Covered transactions and transfer pricing methods:** Forty-four percent of the transactions covered in APAs executed in 2016 involved the sale of tangible goods, 34 percent involved the provision of services, and 20 percent involved the use of intangible property.

In an increase from recent years, the comparable profits method (CPM) was used to evaluate approximately 89 percent of the transactions involving the transfer of tangible and intangible property in 2016. Of those transactions, 67 percent used the operating margin as the profit level indicator (PLI) and 33 percent used other PLIs, such as the Berry Ratio and Return on Assets or Capital Employed.

For services transactions, the most frequently applied method was also the CPM (76 percent of cases). Of

those services transactions applying the CPM, 43 percent used the operating margin as the PLI. In 2016, the majority of APAs that covered services transactions also included tangible or intangible transactions and were not tested under a separate PLI.

- **Adjustment mechanisms:** The majority of the transactions covered in APAs executed in 2016 target an interquartile range. Those APAs include a number of mechanisms for making adjustments to the tested party's results when the results fall outside the range or do not match the point required by the APA. Some examples of the mechanisms included in the 2016 executed APAs include an adjustment bringing the tested party's results to the closest edge of the range applied to the results of a single year, an adjustment to the closest edge of the range applied to the results over the APA term, an adjustment to the specified point or royalty rate, and an adjustment to the median of the range for a single year.
- **APA boilerplate and APMA Program contact information:** The annual report also includes the latest version of the APMA Program's model APA agreement and a link to the list of primary APMA Program contacts. Because the new APA procedures require the submission of a draft APA based on the model APA, it is surprising that the model APA has not yet been updated to reflect the new procedures. However, APMA has stated that the model APA is currently under review for future changes.

In light of the BEPS final reports and the adoption of CbC reporting requirements by many jurisdictions, the demand for APAs will undoubtedly continue to be strong. To discuss whether an APA may be advisable for your organization, please reach out to one of the contacts listed.

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