Executive summary

The Internal Revenue Service (IRS) Advance Pricing and Mutual Agreement (APMA) program issued the 18th annual Advance Pricing Agreement (APA) report (the Report) on 27 March 2017, in Announcement 2017-03. The Report provides an updated discussion of the APA program, including its activities and structure for calendar year 2016, gives useful insights into the operation of the program and provides some indications of what companies applying for an APA can expect to encounter.

The Report shows that taxpayers filed 98 APA requests in 2016 (similar to the average number of APAs filed in the last 10 years) compared to 183 in 2015. The total number of APAs concluded decreased from 110 to 86 and the median amount of time to finalize an APA has slightly increased from 31.9 months to 32.8 months.

Highlights

- During 2016, 98 APA applications were filed and 86 APAs were completed. The number of APAs completed during 2016 is somewhat lower than each of the preceding four years (2012-2015), in which 100 or more APAs were closed. Despite the overall decrease in applications filed, there has been significant interest in bilateral APAs with India (which represented 34% of bilateral APA filings in 2016), following the recent improvement in relations between the IRS and the Indian tax authorities.
At year end, 398 APA requests were pending, down from 410 pending requests at the end of 2015.

Continuing the practice begun with the 2012 Annual Report, details are provided on the treaty partners to bilateral APAs concluded during the year. APAs with Japan (54%) and Canada (20%) combined comprised 74% of all US bilateral APAs executed in 2016. Interestingly, last year those same two countries comprised 69% of all US bilateral APAs executed.

The median time required to complete an APA slightly increased, from 31.9 months in 2015 to 32.8 months in 2016.

Overall headcount kept fairly constant at 92 professionals as of 31 December 2016.

Unilateral APA requests decreased from 52 in 2015 to 14 in 2016.

The number of applications withdrawn in 2016 significantly increased from 10 in 2015 to 24 in 2016, possibly reflecting uncertainty around tax reform in the US.

Approximately 65% of the APAs executed in 2016 were completed with companies having a foreign parent while 20% were completed with US parent companies.

The Comparable Profits Method/Transactional Net Margin method (CPM/TNMM), using an operating margin as the profit level indicator (PLI), was once again the Transfer Pricing Method (TPM) most commonly applied to APA transactions involving tangible and intangible property (89%).

The CPM/TNMM was applied in 76% of the APAs with intercompany service transactions. The most commonly selected PLI with the CPM/TNMM was the ratio of operating profits to total services cost, “operating margin,” (43%).

The revenue procedure covering APAs has seen many updates and revisions since 1991 when Revenue Procedure 91-22 was issued. The current Revenue Procedure 2015-41 released in August of 2015, supersedes the prior APA Revenue Procedure 2006-09, and became effective for requests filed after 29 December 2015.

The benefits of an APA include:

- Reduction or elimination of the risk of transfer pricing adjustments, penalties and interest, as well as the risk of double taxation
- Reduction of financial statement reserves and administrative costs associated with transfer pricing compliance
- Certainty of prospective tax treatment for APA covered transactions and a consequent increase in tax and management flexibility
- Flexibility in adopting transfer-pricing methods to deal with unique transactions, or a lack of good comparables
- Cost-effective management of multiple past and prospective years compared to the traditional examination process

Revenue Procedure 2015-41 instructs taxpayers to request a term of at least five prospective years, which can be extended through renewal procedures. Similar to Revenue Procedure 2006-09, the new revenue procedure allows taxpayers to request “roll-back” years to be covered by an APA. In 2016, 20% of the completed agreements included roll-back years. Though 52 of the agreements were for terms of five years, the majority of the rest of the cases were for six or more years (including roll-back years).

When competent authority procedures are available in the other countries involved (under an effective tax treaty), the IRS encourages bilateral or even multilateral APAs. These agreements are also binding on the foreign tax authority for the same period and help avoid instances of double taxation.

Background

An APA is an agreement between the IRS and a taxpayer under which the IRS agrees not to seek a transfer pricing adjustment under Internal Revenue Code Section 482 for one or more specific covered transaction(s) if the taxpayer files its tax return for a covered year based on the agreed TPM(s). The APA process is a voluntary program designed to resolve actual or potential transfer pricing disputes in a principled, cooperative manner, as an alternative to the traditional examination process.

Detailed discussion

In 1999, Congress mandated that the APA Program publish an annual report summarizing key information regarding the various APAs filed, pending, and executed during the previous calendar year. This requirement is framed so as to achieve a compromise between providing the public information as to how the IRS resolves transfer pricing issues in the APA process, and protecting the confidential tax information of taxpayers participating in the APA Program.
APA applications, executed APAs and pending APAs

Since the APA program’s inception in 1991 through 31 December 2016, the IRS has received a total of 2,245 APA applications, and executed 1,597 APAs. The table below reports summary statistics about 2016 APA applications, executed APAs, and pending APAs. Data are reported separately for unilateral and bilateral APAs, and completion times for 2016, 2015, and 2014 are compared.

<table>
<thead>
<tr>
<th>Year</th>
<th>Unilateral</th>
<th>Bilateral</th>
<th>Total*</th>
</tr>
</thead>
<tbody>
<tr>
<td>APA applications</td>
<td>14</td>
<td>52</td>
<td>31</td>
</tr>
<tr>
<td>APAs executed</td>
<td>21</td>
<td>30</td>
<td>20</td>
</tr>
<tr>
<td>Renewals executed</td>
<td>17</td>
<td>18</td>
<td>9</td>
</tr>
<tr>
<td>Pending requests for APAs</td>
<td>67</td>
<td>85</td>
<td>62</td>
</tr>
<tr>
<td>Pending requests for new APAs</td>
<td>34</td>
<td>45</td>
<td>34</td>
</tr>
<tr>
<td>Pending requests for renewals</td>
<td>33</td>
<td>40</td>
<td>28</td>
</tr>
<tr>
<td>APAs canceled or revoked</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>APAs withdrawn</td>
<td>9</td>
<td>4</td>
<td>0</td>
</tr>
</tbody>
</table>

* In some cases, the totals include additional multilateral cases

Staffing changes and operating efficiencies

In 2012, there was a concerted hiring effort that focused on adding economist resources. This more than doubled the number of economists available to develop APA positions and therefore enabled the IRS to deploy the appropriate resources to each case while reducing case processing times.

Interestingly, the overall number of employees remains almost the same number from last year, with a similar mix. While the number of economists slightly decreased in 2016 (20) compared to 2015 (21), the number of team leaders (a mix of lawyers and accountants) stayed the same at 62. The number of senior managers managing a group, usually very experienced professionals, has remained constant at 10.

Months to complete APAs

The data reported below indicate that the average time to completion for new bilateral APAs has increased from 40.6 months in 2015 to 50.5 in 2016. The average time to completion for new unilateral APAs has increased from 28.0 months in 2015 to 33.9 months in 2016.

<table>
<thead>
<tr>
<th></th>
<th>Bilateral (New)</th>
<th>Bilateral (Renewal)</th>
<th>Bilateral (Combined)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average months</td>
<td>50.5</td>
<td>40.6</td>
<td>44.2</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Unilateral (New)</th>
<th>Unilateral (Renewal)</th>
<th>Unilateral (Combined)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average months</td>
<td>33.9</td>
<td>28.0</td>
<td>26.7</td>
</tr>
</tbody>
</table>
Treaty partners in bilateral APAs

As shown in the following chart, APAs with Japan represent slightly more than half of all bilateral APAs executed in 2016. This is attributable to the maturity of the APA programs in the United States and Japan and the negotiating experience of the APMA team and the competent authority team representing the National Tax Administration of Japan.

Canada is the second most frequently involved treaty partner, as a result of its role as the United States’ largest trading partner.

In addition, while India did not represent a significant proportion of agreements executed in 2016, there was a substantial number of Indian cases filed as a result of the progress made in the relationship between the IRS and the tax authorities in India during the last couple years. In 2016, India represented 34% of bilateral APAs filed (more than any other country) and 9% of pending bilateral APAs (the third most after Japan and Canada). This constitutes an extremely positive development given the uncertainty and risk of double taxation faced by US multinationals investing in India.

Bilateral APAs filed by Country

![Pie chart showing bilateral APAs filed by country with Japan at 31%, India at 34%, Canada at 8%, Germany at 7%, Italy at 4%, UK at 4%, and all other countries at 12%](image)
Bilateral APAs executed by Country

<table>
<thead>
<tr>
<th>Country</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Japan</td>
<td>54%</td>
</tr>
<tr>
<td>Canada</td>
<td>20%</td>
</tr>
<tr>
<td>Korea</td>
<td>6%</td>
</tr>
<tr>
<td>Germany</td>
<td>5%</td>
</tr>
<tr>
<td>France</td>
<td>4%</td>
</tr>
<tr>
<td>All Other</td>
<td>11%</td>
</tr>
</tbody>
</table>

Industries covered

As shown in the following chart, manufacturing and wholesale/retail trade continue to comprise the largest share of APA cases, representing 85% of all APAs completed in 2016.

Industry Representation

<table>
<thead>
<tr>
<th>Industry</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Manufacturing</td>
<td>47%</td>
</tr>
<tr>
<td>Wholesale/Retail Trade</td>
<td>38%</td>
</tr>
<tr>
<td>Services</td>
<td>7%</td>
</tr>
<tr>
<td>All Other Industries</td>
<td>8%</td>
</tr>
</tbody>
</table>

Slightly less than half of all manufacturing cases involved computer and electronic products, chemicals, and transportation equipment, while the wholesale/retail trade cases were dominated by wholesalers of durable goods.
Manufacturing

- Computer and Electronic Products, 17%
- Chemicals, 15%
- Transportation Equipment, 15%
- Miscellaneous Manufacturing, 23%
- Other Manufacturing, 30%

Wholesale/Retail Trade

- Merchant Wholesalers, Durable Goods, 64%
- Merchant Wholesalers, Nondurable Goods, 27%
- All Other Wholesalers, 9%
Covered transactions and tested parties
The Report describes, in overall terms, the covered transactions and sets out the types of tested parties in each transaction. Note that one APA may cover more than one transaction.

Covered Transactions

- Sale of Tangible Property from the US, 17%
- Use of Intangible Property by a US entity, 14%
- Use of Intangible Property by a non-US entity, 6%
- Performance of Services by a US entity, 20%
- Performance of Services by a non-US entity, 14%
- Sale of Tangible property into the US, 27%
- Other Types of Covered Transactions, 2%

Types of Tested Parties

- US Distributor, 42%
- Non-US Service Provider, 6%
- US Manufacturer, 17%
- Non-US Manufacturer, 6%
- Non-US Distributor, 12%
- All Other Types of Tested Parties, 1%
Transfer pricing methods applied

The CPM/TNMM continues to be the most commonly applied method in cases involving transfers of tangible and intangible property, as well as for services transactions.

Critical assumptions

A critical assumption is a fact on which the taxpayer’s TPM depends. APAs typically list critical assumptions that involve a particular mode of conducting business operations, a particular corporate or business structure, or a range of expected business volume.

The model APA used by the IRS includes a standard critical assumption that there will be no material changes to the taxpayer’s business or to its tax or financial accounting practices during the APA term, and all the APAs executed in 2016 included that standard critical assumption.

A few bilateral cases have included critical assumptions tied to either the taxpayer’s profitability in a certain year or over the term of the APA, or to the amount of non-covered transactions as a percentage of the taxpayer’s revenue.

If a critical assumption has not been met, and the parties cannot agree on how to revise the APA, the APA can be canceled. The IRS did not cancel any APAs in 2016 relating to the failure of a critical assumption (or any other reason).

Implications

Though the number of new APAs filed dropped in 2016, we do not believe this constitutes a long-term trend. With foreign tax authorities increasingly interested in US corporations, multinationals are expected to continue to seek the benefits of the APA program to avoid the risk of double taxation and the commitment of resources involved in audits and litigation.

The highlight of the 2016 report is the large number of bilateral APAs with India. The Tax Authority in India has been particularly focused on transfer pricing in the past years, requiring many multinationals to pursue administrative appeals or litigate. However, neither of these procedural options completely guarantee avoidance of double taxation. Consequently, the fact that multinationals now have the alternative to apply for a bilateral APA with India is a very welcome outcome.

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