Executive summary

The US Internal Revenue Service (IRS) Advance Pricing and Mutual Agreement (APMA) program issued the 17th annual Advance Pricing Agreement (APA) report (the Report) on 31 March 2016 in Announcement 2016-12. The Report provides an updated discussion of the APA program, including its activities and structure for calendar year 2015, 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 have increased their interest in APAs by filing a significantly greater number of requests, 183 in 2015 compared to the 108 filed in 2014. The total number of APAs concluded has increased by 10% and the median amount of time to finalize an APA has slightly decreased from 35.3 months to 31.9 months. The Report mirrors the streamlined structure first unveiled in 2012, and continues to include information on program trends not discussed prior to 2012, which can be useful for taxpayers considering an APA.

Highlights

- During 2015, 183 APA applications were filed and 110 APAs were completed. Though lower than the number of APAs completed during 2012 and 2013, it still represents the fourth consecutive year in which 100 or more APAs were closed.
At year end, 410 APA requests were pending, up from 336 pending requests at the end of 2014.

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 (46%) and Canada (23%) combined comprised 69% of all US bilateral APAs executed in 2015. Interestingly, last year those same two countries comprised 62% of all US bilateral APAs executed.

The median time required to complete an APA slightly decreased, from 35.3 months in 2014 to 31.9 months in 2015.

Overall headcount kept fairly constant at 93 professionals as of 31 December 2015.

Unilateral APA requests increased from 31 in 2014 to 52 in 2015.

The number of applications withdrawn in 2015 significantly increased from just 1 in 2014 to 10 in 2015.

Approximately 64% of the APAs executed in 2015 were completed with companies having a foreign parent while 18% were completed with US parent companies. The remaining 18% involved transactions that included a partnership, a branch or other form of relationship.

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 (79%).

The CPM/TNMM was applied in 85% of the APAs with intercompany service transactions. The Services Cost Method (SCM), which was the most commonly used method in 2013, was applied in 11% 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” (55%).


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.

Rev. Proc. 2015-41 instructs taxpayers to request a term of at least five prospective years, which can be extended through renewal procedures. Similar to Rev. Proc. 2006-09, the new revenue procedure allows taxpayers to request “roll-back” years to be covered by an APA. In 2015, 22% of the completed agreements included roll-back years. Though around 36% of the agreements were for terms of five years, 56% of all 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 of time and help avoid instances of double taxation.

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 2015, the IRS has received a total of 2,147 APA applications, and executed 1,511 APAs. The table below reports summary statistics about 2015 APA applications, executed APAs, and pending APAs. Data are reported separately for unilateral and bilateral APAs, and completion times for 2015, 2014, and 2013 are compared.

<table>
<thead>
<tr>
<th></th>
<th>Unilateral</th>
<th>Bilateral</th>
<th>Total*</th>
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<tr>
<td>APA applications</td>
<td>52</td>
<td>31</td>
<td>20</td>
</tr>
<tr>
<td>APAs executed</td>
<td>30</td>
<td>20</td>
<td>39</td>
</tr>
<tr>
<td>Renewals executed</td>
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<td>9</td>
<td>27</td>
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<td>Pending requests for APAs</td>
<td>85</td>
<td>62</td>
<td>51</td>
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<td>34</td>
<td>31</td>
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<tr>
<td>Pending requests for renewals</td>
<td>40</td>
<td>28</td>
<td>20</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>4</td>
<td>0</td>
<td>3</td>
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</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 2015 (21) with respect to 2014 (22), the number of team leaders (mostly lawyers), slightly increased from 59 to 62. The number of senior managers who manage a group, usually very experienced professionals, has remained constant at 10. In addition, as a result of the progress made in the relation between the IRS and the Tax Authorities in India during the last year, APMA now has three groups focused on India APAs. An interesting outcome of the improved relations between the tax authorities is that the number of pending APAs will significantly change in 2016 with the addition of India cases.

Months to complete APAs

The data reported below indicate that the average time to completion for new bilateral APAs has slightly decreased from 44.2 months in 2014 to 40.6 in 2015. The average time to completion for new unilateral APAs has slightly increased from 26.7 months in 2014 to 28.0 months in 2014.
**Treaty partners in bilateral APAs**

As shown in the chart below, APAs with Japan represent slightly less than half of all bilateral APAs executed in 2015. 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.

**Bilateral APAs by Country**

![Pie chart showing APAs by country with Japan at 46%, Canada at 23%, Korea at 4%, Denmark at 5%, and All Other Countries at 22%]

**Industries covered**

As shown in the chart below, manufacturing and wholesale/retail trade continue to comprise the largest share of APA cases, representing three of every four APAs completed in 2015.

**Industry Representation**

![Pie chart showing industry representation with Manufacturing at 40%, Wholesale/Retail Trade at 35%, Services at 11%, Management at 6%, Finance, Insurance and Real Estate at 4%, and All Other Industries at 4%]
More than half of all manufacturing cases involved computer and electronic products, chemical, and transportation equipment, while the wholesale/retail trade cases were dominated by wholesalers of durable goods.

Manufacturing

Wholesale/Retail Trade
Covered transactions and tested parties
The Report describes, in overall terms, the covered transactions and sets out the functions performed by the related entities, as well as the tested party in each transaction. Note that one APA may cover more than one transaction.

Covered Transactions

Tested Parties
Transfer pricing methods applied
The CPM/TNMM continues to be the most commonly applied method in cases involving transfers of tangible and intangible property.

Tangible and Intangible Property TPM

![Tangible and Intangible Property TPM chart]

Services TPM

![Services TPM chart]
Critical assumptions

A critical assumption is a fact on which the taxpayer’s TPM is dependent. 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 2015 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 2015 relating to the failure of a critical assumption (or any other reason).

Implications

The increased interest by taxpayers seeking the certainty of APAs in 2015 (a jump from 108 in 2014 to 183 requests in 2015 - a 69% increase) is likely attributable to two primary reasons: (1) the increased uncertainty around transfer pricing and increase in transfer pricing audits by tax authorities around the globe, especially in light of the Organisation for Economic Co-operation and Development’s Base Erosion and Profit Shifting (BEPS) initiative, and (2) taxpayers seeking APAs under the prior APA Rev. Proc. 2006-09 deadline of 29 December 2015 to avoid being subject to the new APA Rev. Proc. 2015-41, which places more requirements on taxpayers requesting APAs.

Taxpayers should view APMA’s continued trend of a triple digit annual closure rate as an indication that the IRS is serious about improving the APA process. The APMA Program recognizes that taxpayers are voluntarily approaching the IRS for prospective resolution (at an all-time record number), and that optimizing the program provides for a more efficient deployment of resources for both the IRS and the taxpayer. APMA’s continued focus on resolving cases is expected to lead more taxpayers to consider pursuing APAs as a way to proactively resolve their transfer pricing issues. This may be especially true within the context of the BEPS environment of increased focus on transparency and impending country by country reporting.

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