
US 2016 APA report shows greater consistency with prior years after historic number of requests in 2015

April 11, 2017

In brief

The IRS Advance Pricing and Mutual Agreement Program (APMA) on March 27 issued its 18th Annual Statutory Report concerning Advance Pricing Agreements (APAs). The Report reveals that APA applications for 2016 decreased to 98 filed requests, down from a record high of 183 requests filed in 2015. The 2015 surge was driven by the then impending effective date of the new APA procedural requirements and higher user fees announced in Rev. Proc. 2015-41.

While significantly decreased from 2015, the number of filed requests in 2016 is on par with pre-2015 levels, where APA applications in each of the five years preceding 2015 averaged about 100 requests. These numbers indicate that APAs continue to be an attractive option for companies seeking to manage their tax risks and achieve certainty around their intercompany pricing issues.

As in recent years, Japan and Canada dominated the number of executed and pending bilateral APAs. Japan accounted for over half, and Canada less than a quarter, of executed bilateral APAs in 2016. Notably, the IRS began accepting APA requests with India in February 2016. As a result, India has emerged as ranking third in pending bilateral APAs behind Japan and Canada.

IRS productivity, in terms of completed APAs, declined 22 percent from 2015. APMA executed 86 APAs during 2016, down from 110 APAs executed in 2015. The number of completed APAs in 2016 is the lowest number of completed APAs since the formation of the combined APMA office in 2012 (140, 154, 101, and 110 completions in 2012, 2013, 2014, and 2015, respectively).

Bilateral APAs predominated over unilateral APAs, as in prior years, with most completed APAs involving inbound transactions (foreign parent companies with US subsidiaries). In addition, most APAs involved tangible goods or services transactions and companies operating in manufacturing or wholesale or retail trade industries. Use of intangibles comprised 20 percent of all transactions covered in 2016, a slight decrease from 24 percent in 2015. Nevertheless, these numbers continue to indicate an IRS willingness to engage with taxpayers on more complex transactions.

The APA Report discusses APMA's activities and provides key data relating only to APAs. The IRS separately reports mutual agreement procedure data, which it likely will release within the next few weeks.

In detail

India APAs filed for the first time

While APMA began accepting pre-filing conference requests for India bilateral APAs in March 2015, it was not until February 2016 that APMA accepted India bilateral APA requests. Following that announcement, 33 US-India bilateral APA requests were filed in 2016. These India bilateral APA requests accounted for 34 percent of filed APAs, surpassing the number of Japan (31 percent) and Canada (eight percent) bilateral APA request filings in 2016.

Japan and Canada continue to dominate executed and pending cases

Similar to 2015, in 2016 Japan and Canada accounted for nearly three fourths of all executed bilateral APAs. Japan and Canada also continued to dominate the number of pending bilateral APAs, together making up 48 percent of all pending bilateral APA requests (note that pending APAs includes APA requests originally filed in years prior to 2016).

Following Japan and Canada, South Korea executed the next largest number of bilateral APAs, accounting for six percent of completed APAs in 2016, closely followed by Germany (five percent) and France (four percent). All other countries combined accounted for 11 percent.

Decrease in APA applications

Taxpayers filed almost 46 percent fewer APA applications in 2016 compared to 2015, with 98 APA applications filed in 2016, compared to 183 applications filed in 2015.

Observation: The decrease in APA applications is not necessarily due to any decline in the perceived desirability of APAs, when viewed within the context of the record number of requests filed in 2015. In

2015, many taxpayers sought to file APA applications before the 2015 APA Revenue Procedure fully took effect on December 30, 2015. The New Procedure calls for increased user fees and requires substantially more information to be provided with the initial application.

In fact, when compared with 2013 and 2014, the number of APA applications has remained relatively stable in 2016. Many companies are considering APAs as a key strategy for navigating the tax uncertainty arising out of the OECD's Base Erosion and Profit Shifting (BEPS) initiative, which produced draft and final reports in 2014 and 2015 setting forth new transfer pricing principles.

Fewer executed APAs

The number of executed APAs decreased from 110 in 2015 to 86 in 2016, the lowest number of executed APAs in the last five years.

The average time to complete an APA increased in 2016 to 37.9 months from 36.7 months in 2015. Thus, APMA is deviating slightly from its previously stated goal of reducing average APA completion time to approximately 36 months.

The number of APAs withdrawn increased from 10 in 2015 to 24 in 2016. No APAs were revoked or cancelled in 2016.

APMA Program

After increasing headcount in 2011, APMA now employs over 90 professionals, including 20 economists. In general, the APMA staff is organized in groups by country, either with a particular group having responsibility for multiple countries or several groups having responsibility for one country (e.g., Japan and Canada) because of the large volume of cases with those treaty countries.

While APMA headcount has remained consistent from 2015 to 2016, APMA experienced some staff turnover in 2016, including a slight decrease in the number of economists (from 22 in 2014 to 21 in 2015 and 20 in 2016). At the same time, the IRS has experienced significant staff turnover overall, including changes in over half of its leadership positions since 2011. Notably, a new acting Director of APMA took over leadership of the APMA Program in 2016.

Role of bilateral APAs

Of the 98 APA submissions filed in 2016, 84 submissions (approximately 86 percent) requested bilateral APAs and 14 submissions requested unilateral APAs. The high demand for bilateral APAs remained consistent with 2015. Of the 86 APAs that were executed in 2016, 65 involved bilateral APAs (approximately 76 percent).

As in prior years, executed inbound APAs outnumbered executed outbound APAs. In 2016, inbound APAs accounted for approximately 65 percent of executed APAs, compared to 64 percent in 2015 and 55 percent in 2014 and 2013.

The percentage of renewal bilateral APAs out of executed APAs decreased from 44 percent in 2015 to 37 percent in 2016.

Changes in APA inventory

At the end of 2016, there were 398 pending APAs, compared to 410, 336, and 331 pending APAs as of the end of 2015, 2014, and 2013, respectively.

As noted above, the 2015 increase in inventory may be attributable to the sunset period to submit APA applications before the 2015 APA Revenue Procedure came into effect at the end of 2015.

Types of transactions covered in APAs

Consistent with prior years, approximately 44 percent of the transactions covered by completed APAs in 2016 involved the transfer of tangible goods. Sales of tangible goods by non-US entities into the United States accounted for 27 percent, while sales by US entities accounted for 17 percent. Services transactions were covered in 34 percent of executed APAs in 2016. Services by US entities accounted for 20 percent, while the provision of services by non-US entities accounted for 14 percent. Twenty percent of the completed APAs covered the use of intangible property.

Observation: APMA remains dedicated to negotiating APAs for complex transactions involving intangibles, despite the fact that these cases represent less than one quarter of the APA inventory. The intangibles cases represent a lower percentage of the overall inventory primarily because there are a large number of taxpayers (e.g., many Japanese-based companies) that regularly use APAs to obtain certainty on their large volume of inbound tangible goods transactions.

Industries covered in APAs

In 2016, completed APAs covered three general industry segments - manufacturing, wholesale/retail trade, and services - as well as an 'all other industries' category. The manufacturing industry was the largest industry segment, comprising 47 percent of executed APAs; the wholesale/retail trade segment comprised 38 percent and services comprised seven percent. Consistent with previous years, the manufacturing and wholesale/retail trade industries consistently have

accounted for most of the APAs executed by the IRS.

Within the manufacturing industry, the manufacture of computer and electronic products accounted for seven APAs (eight percent of all 2016 executed APAs). Within the wholesale/retail trade industry, the wholesale distribution of durable goods accounted for 21 APAs (24 percent of all 2016 executed APAs).

TPMs and PLIs: CPM and OM lead again

Consistent with the nearly 25-year history of the APA program, the comparable profits method (CPM), with varying profit level indicators (PLIs), dominated transfer pricing methods (TPMs). In 2016, 89 percent of transfers of tangible and intangible property in APAs used the CPM.

For covered transfers of tangible and intangible property that used the CPM, an operating margin (OM, the ratio of operating profit to sales) led as the preferred PLI, benchmarking 67 percent of case results.

Other PLIs - such as the Berry Ratio (the ratio of gross profit to operating expenses) and Return on Assets or Capital Employed - were used in the remaining 33 percent of cases in 2016.

CPM was also the chosen method in 76 percent of cases involving services transactions, a decrease of 10 percent from 2015. The OM was the most frequently applied PLI in 43 percent of the cases.

APA terms

In 2016, the term lengths of APAs executed ranged from two years to 14 years. The majority of APAs had a five-year term (52 APAs). The next most used term lengths were seven years (15 APAs) and six years (eight APAs). Of APAs executed in 2016,

only 20 percent included rollback years. Including rollback years, the average term length for APAs executed in 2016 was six years.

Observation: While down from an average of seven years in 2015, the continued increase in length of APA terms reflects the IRS's willingness to extend terms when slower processing times for APAs have reduced some of the prospective coverage.

Proposed changes to model APA

As in 2015, the 2016 report notes that the model APA, which was last revised significantly in 2009, currently is under review for changes. These are expected to conform to the revised guidance on the process for requesting and obtaining APAs in the new Procedure.

The takeaway

Notwithstanding the drop from the high number of APA applications in 2015, the number of taxpayers seeking an APA in 2016 was relatively consistent with prior years.

The IRS's 18th Annual Statutory Report concerning Advance Pricing Agreements reflects the continued productivity of the IRS since the February 2012 formation of the new APMA Program. Corporate tax personnel and their advisors should evaluate the benefits and opportunities afforded by an APA as a means of proactively resolving potential tax controversies. APAs may have added value in the current environment given the uncertainty around how countries will interpret and apply the new BEPs standards and the heightened scrutiny of transfer pricing expected in the post-BEPS world.

Let's talk

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