

Despite the pandemic, 2020 US APA report shows increase in executed APAs and decreased processing times

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In brief

The IRS Advance Pricing and Mutual Agreement Program (APMA) on March 30 issued its 22nd Annual Statutory Report (the Report) concerning Advance Pricing Agreements (APAs). The Report observes that during calendar year 2020, APMA completed more APAs than in 2019 and completed them somewhat more quickly. A total of 127 APAs were executed in 2020 as compared to 120 APAs executed in 2019. For APAs completed in 2020, the average processing time was 38.5 months, a slight decrease from the prior year's average of 40 months. Further, the data reflects a trend of decreased processing times over the last several years.

Bilateral APAs continue to dominate the APA caseload, comprising approximately 83 percent of APAs executed in 2020. The majority of completed APAs involved Japan (52 percent). APMA also concluded multiple APAs with several other countries, including India (11 percent), Canada (8 percent), and the United Kingdom (7 percent). Although the predominant relationship continues to be with Japan, there has been a steady yearly increase in APAs submitted and executed with India.

The data on the number of APA applications filed indicates a continuing strong taxpayer interest in pursuing APAs. The Report states that APA applications for 2020 remained steady at 121 filed requests, the same number of requests filed in 2019. Given the COVID-19 pandemic in 2020, this number demonstrates that confidence in the APA program was not impacted by the upheaval caused by the virus.

Action item: Corporate tax personnel and their advisors should evaluate the benefits and opportunities that can be afforded by an APA as a means of proactively resolving potential tax controversies, especially in light of the continued uncertainty taxpayers face in the current international tax environment.

In detail

Increase in executed APAs and decreased processing times

The number of executed APAs increased to 127 in 2020, up from 120 in 2019 and 107 in 2018. Of the 127 agreements executed, approximately 41 percent were new APAs (i.e., not renewals of existing APAs).

The overall average time to complete an APA decreased in 2020 to 38.5 months, down from 40.0 months in 2018. The number of withdrawn APAs decreased to seven APAs in 2020 from 12 APAs in 2019.

Observation: The increase in executed APAs and the corresponding decrease in average processing time likely were driven by the commitment of APMA's leadership to finalize APAs as efficiently as possible. Moreover, these positive developments were achieved despite the transition to remote working for APMA personnel given the shutdowns starting in early 2020, due to the COVID-19 pandemic. Initially, the pandemic threatened to slow APMA's work, as the traditional in-person meetings with foreign tax authorities were canceled. However, APMA took advantage of unexpected opportunities for achieving greater efficiencies, such as by moving to video- or tele-conferencing for APA negotiations with foreign tax authorities. Those efficiency gains and increased communications with treaty partners seem likely to continue, even after the pandemic begins to recede. Moreover, although concerns arose during the initial stages of the pandemic that deteriorating economic conditions might lead to a wave of APAs with failures to meet critical assumptions, no APAs were revoked or cancelled in 2020.

APA filings stay at 121; pending inventory decreases slightly

The number of APA applications stayed at 121 in 2020, the same as in 2019.

At the end of 2020, there were 448 pending APAs, compared to 454, 458, and 386 pending APAs at the end of 2019, 2018, and 2017, respectively. APAs with Japan (25 percent), India (20 percent), and Canada (11 percent) continued to account for over half of all pending bilateral APAs. Pending APAs with Germany, Italy, Korea, Mexico, the United Kingdom, and other countries accounted for the remaining pending case inventory.

Changes in APMA staffing

In September 2018, APMA restructured its teams. In 2019, APMA significantly increased its headcount as well (98 professionals). Currently, APMA maintains this general structure and increased headcount. APMA is led by assistant directors and organized in groups by country. As of December 31, 2020, the APMA Program comprised 64 team leaders, 21 economists, nine managers, three assistant directors, and one director. These numbers do not include the Treaty Assistance & Interpretation Team (TAIT), which was moved under the supervision of the APMA director in 2020. TAIT is now a subgroup in APMA, and the director of TAIT is now an assistant director to the APMA director.

Japan continues to dominate executed cases, followed by India and Canada

Similar to 2019, Japan accounted for approximately half of all executed bilateral APAs with the United States in 2020, with a modest increase from 49 percent in 2019 to 52 percent in 2020. Following Japan, India accounted for 11 percent of completed bilateral APAs in 2020, as compared to 2019, when India was not in the top five countries in terms of executed APAs. The percent of executed APAs with Canada fell from 11 percent in 2019 (the second largest) to eight percent in 2020. Next in line were the United Kingdom and Denmark, accounting for seven percent and four percent of the executed APAs, respectively. All other countries combined (including South Korea, France, Germany, and Switzerland, which were in the top six countries in terms of executed APAs in 2019) accounted for 18 percent of the APAs executed in 2020.

The top three countries which dominate executed bilateral APAs also dominate the list of pending bilateral APAs by country. APAs involving Japan account for 25 percent of the pending requests, India accounts for 20 percent, and Canada comes in at 11 percent of the pending inventory. All other countries, including Germany, Italy, Mexico, South Korea, and the United Kingdom, comprise the remaining approximately 44 percent.

Observation: The number of meetings and other regular communication touchpoints between APMA and its counterparts in Japan and Canada have resulted in continuing the steady rate of case closures with these countries. Similarly, the negotiations with India resulted in a noticeable increase in case closures in 2020 compared to 2019.

Role of bilateral APAs

Of the 121 APA submissions filed in 2020, 103 submissions (approximately 85 percent) requested bilateral APAs and 15 submissions (approximately 12 percent) requested unilateral APAs (there also were three multilateral requests). Of the 127 APAs that were executed in 2020, 105 involved bilateral APAs (approximately 83 percent).

As in prior years, more than half of the APAs executed in 2020 (61 percent) involved transactions between non-US parents and US subsidiaries.

Renewal bilateral APAs as a percentage of all executed APAs accounted for 50 percent of APAs in 2020; this is an increase from 40 percent in 2019 and 42 percent in 2018. All renewal APAs (bilateral and unilateral) accounted for 60% of all APAs executed in 2020.

Types of transactions covered in APAs

Approximately 35 percent of the transactions covered by completed APAs in 2020 involved the transfer of tangible goods, including both inbound and outbound sales; this is a decrease from 38 percent in 2019 and 44 percent in 2018.

Approximately 38 percent of the APAs involved services transactions (a decrease from 43 percent in 2019), and 25 percent involved the use of intangible property (an increase from 18 percent in 2019).

Observation: The increase in APAs involving intangible property, which generally involve more complicated issues, indicate a continued willingness by APMA to engage with taxpayers on more complex transactions.

Industries covered in APAs

Completed APAs in 2020 covered five general industry segments — manufacturing (34 percent); wholesale/retail trade (31 percent); services (17 percent); management (seven percent); and finance, insurance, and real estate (nine percent).

TPMs and PLIs: CPM and OM lead again

Consistent with the nearly 29-year history of the APA program, the comparable profits method (CPM), with varying profit level indicators (PLIs), was the primary transfer pricing method (TPM) used. In 2020, 84 percent of APAs involving transfers of tangible and intangible property applied the CPM (compared to 81 percent in 2019). Similarly, 85 percent of APAs involving services transactions relied on the CPM (compared to 82 percent in 2019). The operating margin (OM), defined as the ratio of operating profit to sales, was the most common PLI used in applying the CPM to tangible and intangible transactions, accounting for 69 percent. For APAs that applied the CPM to services transactions, the OM and the markup on total costs accounted for 57 percent of the PLIs employed (a decrease from 65 percent in 2019).

Observation: The 2020 Report does not specify the number of APAs that used the residual profit split method (RPSM). Although the Report does not give visibility as to the TPM used for the remaining 16 percent of tangible or intangible property transactions (and 15 percent for services transactions), the CPM continues to be the dominant method.

Ranges, goals, and adjustment mechanisms

Most transactions covered in APAs target a result that falls within the applicable interquartile range. In transactions involving the payment of royalties for the use of intangibles, both specific royalty rates and ranges were used. Where the covered transaction relied on the use of external agreements, a secondary method testing the post-royalty operating margin or cost-plus markup was used.

For APAs concluded in 2020, several mechanisms were used for making adjustments to the tested party's results when those results fell outside the range or did not match the point required in the APA. The Report provides several examples of the mechanisms used: an adjustment bringing the tested party's results to the closer edge of the range applied to the results of a single year; an adjustment to the closer edge of the range applied to the results over the APA term; an adjustment to the specified point or royalty rate; or an adjustment to the median of the range for a single year.

APA terms

Approximately half of the completed APAs had a five-year term, which is the standard length for an APA term. The longest APA term agreed to in 2020 was 14 years (only one APA had a 14-year term length). Fewer than 10 of the

executed APAs had terms shorter than five years. The overall average number of years for an APA term was six years. Approximately 11 percent of the APAs executed in 2020 included rollback years, a decrease from 25 percent in 2019.

Observation: As in the past, in 2020 APA terms were set, to the extent feasible, to allow for a reasonable amount of prospectivity at the time the APA was executed.

The takeaway

The IRS's 22nd Annual Statutory Report concerning Advance Pricing Agreements reflects positive trends. An increase in the number of executed APAs, coupled with decreased processing time, demonstrates that APMA overcame initial challenges associated with travel restrictions during the pandemic and took advantage of unexpected opportunities to make changes to the process for negotiating with treaty partners, in order to enhance the efficiency of the APA program. Those changes are likely to stay in place and justify continued confidence in using the APA program to avoid transfer pricing disputes. Along those lines, the number of APA requests filed in 2020 demonstrates the steady interest of taxpayers for pursuing APAs to achieve certainty.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

APMA & Transfer Pricing Controversy

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