

US APA report for 2021 shows steady overall results and increased interest in APA program

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In brief

The IRS Advance Pricing and Mutual Agreement Program (APMA) on March 22 issued its 23rd Annual Statutory Report (the Report) concerning Advance Pricing Agreements (APAs). The Report observes that during calendar year 2021, APMA completed almost the same number of APAs as those completed in 2020, without significant increase in processing times. A total of 124 APAs were executed in 2021 as compared to 127 APAs executed in 2020. For APAs completed in 2021, the average processing time was 39.2 months, a slight increase from the prior year's average of 38.5 months.

Bilateral APAs continue to dominate the APA caseload, comprising approximately 79 percent of APAs executed in 2021. Interestingly, Japan cases no longer were the majority of completed APAs. The percentage of completed Japan APAs decreased from 52 percent to 40 percent. APMA also concluded multiple APAs with several other countries, including Germany (20 percent), Canada (7 percent), South Korea (6 percent), and India (5 percent). Although the relationship with Japan continues to be strong, APAs executed with Canada, Germany, India, and Italy are also notable for 2021.

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 2021 increased to 145 filed requests as compared to 121 requests filed in 2020. The significant increase in APA applications in 2021 demonstrates the growing relevance of the APA program in the current landscape.

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 business and international tax environment.

In detail

Decrease in executed APAs and increased processing times

The number of executed APAs decreased in 2021 to 124, down from 127 in 2020, but still up from 120 in 2019 and 107 in 2018. Of the 124 agreements executed, approximately 37 percent were new APAs (i.e., not renewals of existing APAs).

The overall average time to complete an APA increased in 2021 to 39.2 months, up from 38.5 months in 2020, but still down from 40.0 months in 2018. The number of withdrawn APAs decreased to six APAs as compared to seven APAs in 2020.

Observation: The slight decrease in executed APAs and the corresponding increase in average processing time reflects the commitment of APMA's leadership to finalize APAs as efficiently as possible despite the ongoing challenges due to the COVID-19 pandemic. APMA continued to take advantage of opportunities for achieving greater efficiencies, such as by moving to video- or tele-conferencing for APA negotiations with foreign tax authorities.

APA filings increased significantly in 2021 to 145; pending inventory increased slightly

The number of APA applications increased to 145 in 2021, up from 121 in 2020 and 2019.

At the end of 2021, there were 461 pending APAs, compared to 448, 454, and 458 pending APAs at the end of 2020, 2019, and 2018, respectively. APAs with Japan (25 percent), India (22 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, Switzerland, and other countries accounted for the remaining pending case inventory.

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

In 2021, Japan accounted for approximately 40 percent of all executed bilateral APAs with the United States. The percentage of bilateral APAs executed with Japan has declined from 52 percent in 2020 and 49 percent in 2019.

Following Japan, Germany accounted for 20 percent of completed bilateral APAs in 2021, as compared to 2020 when Germany was not in the top five countries in terms of executed APAs. The percentage of executed APAs with Canada also continued to fall to seven percent in 2021, as compared to 11 percent in 2019 (the second largest) and eight percent in 2020. Next in line were South Korea and India, accounting for six percent and five percent of the executed APAs, respectively. This represents a significant drop for India, which constituted 11 percent of the 2020 total. All other countries combined (including China, Italy, Netherlands, and Switzerland) accounted for 22 percent of the APAs executed in 2021.

Japan also dominated the list of pending bilateral APAs by country, followed by India and Canada. APAs involving Japan account for 25 percent of the pending requests, India accounts for 22 percent, and Canada comes in at 11 percent of the pending inventory. All other countries, including Germany, Italy, Mexico, South Korea, Switzerland, and the United Kingdom, comprise the remaining approximately 42 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 resolutions with these countries. Similarly, the negotiations with Germany resulted in a noticeable increase in case closures in 2021 compared to 2020 and prior years.

Role of bilateral APAs

Of the 145 APA submissions filed in 2021, 121 submissions (approximately 83 percent) requested bilateral APAs, and 16 submissions (approximately 11 percent) requested unilateral APAs. There also were eight multilateral requests. Of the 124 APAs that were executed in 2021, 98 involved bilateral APAs (approximately 79 percent).

As in prior years, more than half of the APAs executed in 2021 (61 percent) involved transactions between non-US parents and US subsidiaries.

Renewal bilateral APAs as a percentage of all executed APAs accounted for 47 percent of APAs in 2021; this is a slight decrease from 50 percent in 2020 but still more than 40 percent in 2019 and 42 percent in 2018. All renewal APAs (bilateral and unilateral) accounted for approximately 63 percent of all APAs executed in 2021.

Types of transactions covered in APAs

Approximately 45 percent of the transactions covered by completed APAs in 2021 involved the transfer of tangible goods, including both inbound and outbound sales; this is an increase from 35 percent in 2020. Approximately 38 percent of the APAs involved services transactions (the same percentage as in 2020), and 16 percent involved the use of intangible property (a decrease from 25 percent in 2020).

Industries covered in APAs

Completed APAs in 2021 covered five general industry segments — manufacturing (37 percent); wholesale/retail trade (38 percent); services (14 percent); management (six percent); and finance, insurance, and real estate (three percent).

TPMs and PLIs: CPM and OM lead again

Consistent with the approximately 30-year history of the APA program, the comparable profits method (CPM) transactional net margin method (TNMM), with varying profit level indicators (PLIs), was the primary transfer pricing method (TPM) used. In 2021, 85 percent of APAs involving transfers of tangible and intangible property applied the CPM/TNMM (compared to 84 percent in 2020). Similarly, 90 percent of APAs involving services transactions relied on the CPM/TNMM (compared to 85 percent in 2020).

The operating margin (OM), defined as the ratio of operating profit to sales, was the most common PLI used in applying the CPM/TNMM to tangible and intangible transactions, accounting for 65 percent of these cases. For APAs that applied the CPM/TNMM to services transactions, the OM and operating profit to operating expense was the most common PLI and accounted for 56 percent of the PLIs employed (similar to 57 percent in 2020).

Observation: The 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 15 percent of tangible or intangible property transactions (and 10 percent for services transactions), the CPM/TNMM 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 2021, 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

More than half of the completed APAs in 2021 had a five-year term, which is the standard length for an APA term. The longest APA term agreed to in 2021 was 15 years (only one APA had a 15-year term length). Eleven of the executed APAs had terms shorter than five years. The overall average number of years for an APA term was six years. Approximately 22 percent of the APAs executed in 2021 included rollback years, an increase from 11 percent in 2020.

Observation: As in the past, in 2021 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 23rd Annual Statutory Report concerning Advance Pricing Agreements reflects positive trends and overall consistency in the performance of the APA program. The number of executed APAs decreased slightly in 2021, along with a slight increase in the number of processing times. These numbers, however, are still better as compared to the pre-pandemic period in 2019. This is consistent with the view that APMA was effective in making timely changes to the process for negotiating with treaty partners to overcome initial challenges associated with travel restrictions during the pandemic in order to enhance the efficiency of the APA program. The number of APA requests in 2021 increased significantly in 2021, demonstrating growing interest of taxpayers for pursuing APAs as well as continued confidence in using the APA program to manage transfer pricing risks.

Let's talk

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

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