

US APA report shows increase in executed APAs and decreased processing times in 2019

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In brief

On March 25, the IRS Advance Pricing and Mutual Agreement Program (APMA) issued its 21st Annual Statutory Report (the Report) concerning Advance Pricing Agreements (APAs). The Report reveals that, as compared to the prior year, APMA completed more APAs and completed them somewhat more quickly. A total of 120 APAs were executed in 2019 as compared to 107 APAs executed in 2018. For APAs completed in 2019, the average processing time was 40 months, a slight decrease from the prior year's average of 43 months.

Bilateral APAs continue to dominate the APA case load, comprising approximately 76 percent of APAs executed in 2019. More than half of the completed APAs involved Japan (49 percent) and Canada (11 percent). APMA also concluded multiple APAs with several other countries, including South Korea, Australia, and Switzerland.

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 2019 fell to 121 filed requests from 203 requests filed in 2018 — a 40 percent decrease. This decrease primarily may be attributable to the spike in APA applications in 2018 caused by taxpayers accelerating their APA submissions to avoid the increase in APA user fees that went into effect in 2019. To account for this factor, a better gauge of taxpayer interest in pursuing APAs may be the average number of APA filings over 2018 and 2019. The annual average number of APA applications filed over 2018 and 2019 was 162, which is significantly higher than the number of applications filed in 2017 (101 requests) and 2016 (98 requests).

In detail

Increase in executed APAs and decreased processing times

The number of executed APAs increased to 120 in 2019, up from 107 in 2018 and 116 in 2017. Of the 120 agreements executed, approximately 43 percent were new APAs (i.e., not renewals of existing APAs).

The average time to complete an APA decreased in 2019 to 40.0 months, down from 42.8 months in 2018. The number of withdrawn APAs decreased to 12 APAs in 2019 from 21 APAs in 2018.

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 and by increased communication with treaty partners during 2019. Moreover, these positive developments were achieved despite 2019 having fewer working days for APMA personnel given the government shutdown in early 2019.

APA filings fall to 121; pending inventory decreases slightly

The number of APA applications fell sharply to 121 in 2019, from 203 in 2018, reflecting a 40-percent decline.

At the end of 2019, there were 454 pending APAs, compared to 458, 386, and 398 pending APAs at the end of 2018, 2017, and 2016, respectively. APAs with Japan, India, and Canada continued to account for over half of all pending bilateral APAs.

Observation: APA filings decreased substantially in 2019 relative to 2018. This difference primarily may be attributable to taxpayers accelerating the filing of their APA requests to avoid heftier user fees beginning in 2019. When comparing the number of applications filed prior to the post-2018 fee increases, 2019 demonstrates an increase in the number of filings — 121 requests in 2019 as compared to 2017 (101 requests) and 2016 (98 requests). To remove the effect of accelerated APA filings in 2018 that otherwise would have been filed in 2019, the 2018-2019 average number of filings might be viewed as a better gauge of the volume of APA requests filed. This average is 162, a significant increase over prior years. Thus, the 2019 data actually indicates a trend of continued growth in APA filings.

Changes in APMA staffing

In September 2018, APMA restructured its teams. In general, the APMA staff still is organized in groups by country, with each of three assistant directors overseeing two managers who lead teams comprised of both team leaders and economists. Previously, economists generally were housed in separate teams.

In 2019, APMA retained its 2018 headcount of 77 professionals. However, the composition of these individuals varied slightly. In 2018, APMA employed 56 team leaders, 12 economists, six managers, and three assistant directors. In 2019, APMA reallocated its staffing to include 52 team leaders (a four-person decrease from 2018), 16 economists (a four-person increase from 2018), six managers, and three assistant directors. In addition, APMA recently announced its intent to hire 15 new team leaders.

Japan and Canada continue to dominate executed cases

Similar to prior years, Japan and Canada accounted for over half of all executed bilateral APAs with the United States in 2019. Following Japan and Canada, South Korea executed the next largest number of bilateral APAs, accounting for 10 percent of completed APAs in 2019, followed closely by Australia (nine percent). Switzerland accounted for four percent of executed APAs in 2019. All other countries combined, including India, accounted for 17 percent of the APAs executed in 2019.

Interestingly, in terms of pending APA requests, Japan and Canada, combined, are less than 40 percent of the inventory. APAs involving India account for 21 percent of the pending requests. All other countries, including Germany, South Korea, Mexico, UK, and Italy, comprise the remaining approximately 40 percent.

Observation: The number of meetings and other regular communication touchpoints that APMA has with its counterparts in Japan and Canada clearly is driving the number of case closures with these countries.

Role of bilateral APAs

Of the 121 APA submissions filed in 2019, 96 submissions (approximately 79 percent) requested bilateral APAs and 17 submissions (approximately 14 percent) requested unilateral APAs (there also were eight multilateral requests). Of the 120 APAs that were executed in 2019, 91 involved bilateral APAs (approximately 76 percent).

As in prior years, more than half of the APAs executed in 2019 (62 percent) involved transactions between non-U.S. parents and U.S. subsidiaries.

Renewal bilateral APAs as a percentage of executed APAs accounted for 40 percent of APAs in 2019; this is consistent with the 42 percent in 2018 and 41 percent in 2017.

Types of transactions covered in APAs

Approximately 38 percent of the transactions covered by completed APAs in 2019 involved the transfer of tangible goods, including both inbound and outbound sales; this contrasts to the 44 percent seen in 2018. A large percentage of APAs (43 percent) involved services transactions.

A significant number of completed APAs covered intangible transactions, which generally involve more complicated issues. Use of intangibles comprised 18 percent of all transactions covered in 2019, relative to 21 percent in 2018. These numbers indicate a continued willingness by APMA to engage with taxpayers on more complex transactions.

Industries covered in APAs

Completed APAs in 2019 covered five general industry segments — wholesale/retail trade, management, services, manufacturing, and an “all other industries” category. The wholesale/retail trade segment was the largest industry segment, comprising 43 percent of executed APAs, followed by the manufacturing segment (32 percent of executed APAs).

TPMs and PLIs: CPM and OM lead again

Consistent with the nearly 28-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 2019, 81 percent of APAs involving transfers of tangible and intangible property applied the CPM. Similarly, 82 percent of APAs involving services transactions relied on the CPM. 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 64 percent. For APAs that applied the CPM to services transactions, the OM and the markup on total costs PLIs accounted for 65 percent of the PLIs employed.

Observation: The 2019 Report does not specify the number of APAs that used the residual profit split method (RPSM). The introduction of APMA’s Functional Cost Diagnostic (FCD) workbook in February 2019 to facilitate APMA’s due diligence reviews employs a functional cost analysis to test whether taxpayers are making significant value-added contributions and, accordingly, whether some form of profit split method should be considered. Taxpayers will be watching to see if the FCD workbook leads to a greater use of the RPSM in future APAs.

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 2019, 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

Almost 45 percent of the completed APAs had a five-year term, which is the standard length for an APA term. The longest APA term in 2019 was 15 years (only one APA had a 15-year term length). Fewer than 15 percent of the executed APAs had terms shorter than five years. Approximately 25 percent of the APAs executed in 2019 included rollback years. The overall average number of years for an APA term was six years. As in the past, in 2019, 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 21st Annual Statutory Report concerning Advance Pricing Agreements reflects positive trends regarding APAs. An increase in the number of executed APAs, coupled with decreasing processing time, demonstrates that APMA continues to make efforts to enhance the efficiency of the APA program. Also, the number of filed APA requests shows a continuing increase in taxpayer interest in pursuing APAs, particularly when considered in conjunction with the high volume of APA requests filed in 2018.

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, especially in light of the continued uncertainty taxpayers face in the current international tax environment.

Let's talk

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

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