



2015 U.S. APA report shows interest in APAs has never been higher

Global Transfer Pricing Alert 2016-015

The Internal Revenue Service (IRS) on March 31, 2016, released Announcement 2016-12, the advance pricing agreement (APA) annual report covering the activities of the Advance Pricing and Mutual Agreement (APMA) Program during calendar year 2015. The annual report is issued under §521(b) of Pub. L. 106-170, the Ticket to Work and Work Incentives Improvement Act of 1999, which requires the Secretary of the Treasury to report annually to the public on APAs and the APMA Program.

The annual report provides a summary of recent developments in the APMA Program and a statistical snapshot of the program's APA activities during 2015. The 2015 annual report highlighted increased interest in APAs, as evidenced by a record number of APA requests, and an approximately 9 percent increase in the number of APAs executed compared to the prior year. Notably, the IRS reported that it reached its first bilateral APA with Italy.

Transfer pricing enforcement is expected to increase throughout the world as countries adopt the Organisation for Economic Co-operation and Development's (OECD) base erosion and profit shifting (BEPS) final recommendations, including the enactment of country-by-country (CbC) reporting requirements. Consequently, the certainty provided by APAs will play an increasingly important role in transfer pricing risk management.

On August 12, 2015, the IRS released new revenue procedures governing APA and mutual agreement procedure (MAP) applications. Revenue Procedure (Rev. Proc.) 2015-41 provides guidance and instructions on filing APA requests, as well as guidance and information on the administration of APAs. Rev. Proc. 2015-40 provides procedures and guidance on requesting assistance from the U.S. Competent Authority when the taxpayer believes the actions of the United States or a treaty country result or will result in the taxpayer being subject to taxation not in accordance with the applicable U.S. tax treaty.

Statistical highlights of the APA annual report include:

- **Increase in Completed APAs.** During the 2015 calendar year, APMA closed 110 APAs (30 unilateral, 80 bilateral, and no multilateral), compared to 101 APAs in 2014 and 145 APAs in 2013. APA renewals accounted for 66 of the 110 APAs executed, with 18 unilateral and 48 bilateral renewals. As in 2014, renewals represented slightly more than half of all completed APAs. Of APAs executed that were not renewal APAs, slightly more than half included a "rollback" provision, which covered transactions for filed tax years. It is likely that a significant portion of APAs with rollbacks resolved transfer pricing audit activity involving either the IRS or the tax authorities of a treaty partner.
- **Months to Complete APAs.** In 2015, the median time to complete a unilateral APA and bilateral APA was 17.3 months and 38.2 months, respectively. In 2014, the median times to complete unilateral and bilateral APAs were 30.1 months and 35.3 months, respectively. Overall, the median time required to complete the 110 APAs executed in 2015 was 31.9 months, approximately three months less than in 2014.

Processing time for unilateral APAs declined significantly from prior years, while the processing time for bilateral APAs increased slightly. Unlike bilateral APAs, which involve treaty partners, unilateral APAs and their processing time are controlled by APMA. The greatly reduced processing times achieved for unilateral APAs may be indicative of efficiencies achieved by APMA, which may carry over into the processing of bilateral APAs closed in future years.

Taxpayers renewing bilateral APAs benefitted from faster processing times for their APA requests. For bilateral renewal APAs, the median processing time was 35.5 months, compared to the median processing time for bilateral non-renewal (new) APAs of 41.9 months. For unilateral renewal APAs, the median processing time was 14.4 months,

compared to the median processing time for unilateral non-renewal (new) APAs of 23.7 months.

- **Incoming APA Requests.** The IRS received 183 APA applications (52 unilateral, 127 bilateral, and 4 multilateral) in 2015, a significant increase from the 108 APA applications received in 2014 and a historic record for APMA (including its predecessor, the APA Program).
- **Treaty Partners Involved in Bilateral APAs.** While Japan and Canada continue to account for the largest share of new bilateral APA requests, APA requests involving other countries have become a significant part of APMA's inventory. Notably, during 2015, APA requests involving Germany and Korea represented 9 percent and 8 percent of APA requests, respectively; the United Kingdom, Australia, and China had 5 percent, 4 percent, and 4 percent shares, respectively. Other treaty partners with pending or completed APAs with the United States include Denmark, Mexico, the Netherlands, and Switzerland.
- **APA Inventory.** The APMA Program had 410 cases in active inventory at the end of 2015: 85 unilateral APAs, 316 bilateral APAs, and 9 multilateral APAs. In comparison, active inventory was smaller at the end of 2014, with 336 cases. The number of pending APAs rose in 2015 due largely to the record number of APA requests received during the fourth quarter. The fourth quarter surge in applications may be attributable to the BEPS final reports and to taxpayers seeking to file APA requests under prior procedures (Rev. Proc. 2006-9), which were replaced by new procedures (Rev. Proc. 2015-41) effective for requests filed after December 29, 2015.
- **Term Length of APAs.** Of the APAs executed in 2015, 40 cases (36 percent of all APAs executed) had a five-year term, while more than half had terms of six years or longer. The average term length was seven years. In our experience, the APMA Program and foreign competent authorities are willing to extend the standard APA term of five years when additional years are needed to address difficult results during a rollback period and/or completed APA years, or to provide some prospectivity in cases when the APA took a long time to complete. Further, in the context of renewal APAs that were handled expeditiously, the APMA Program has shown a willingness to accept APA terms longer than five years.
- **Staffing.** The APMA Program is currently comprised of 62 team leaders, 21 economists, and 10 senior managers organized into 10 groups (seven team leader groups and three economist groups). Compared to 2014, this represents an increase of three team leaders and a decrease of one economist. In the past, lack of economist resources delayed APA case processing; under the new APMA Program management, economists are taking an increased role in negotiating bilateral APAs with treaty partners. The team leader groups are organized by country, with each group having responsibility for multiple countries.
- **Cancellations, Revocations, and Withdrawals.** No APAs were cancelled or revoked during 2015. Ten APA requests were withdrawn in 2015.
- **APAs Executed by Industry.** In 2015, manufacturing and wholesale/retail trade accounted for 40 percent and 35 percent, respectively, of the total number of executed APAs. Within the wholesale/retail trade industry, merchant wholesalers of durable goods were most common (72 percent of such cases). Meanwhile, the computer and electronic products segment was largest among manufacturers (23 percent of such cases).
- **Covered Transactions and Transfer Pricing Methods.** Thirty-seven percent of the transactions covered in APAs executed in 2015 involved the sale of tangible goods, 38 percent involved the provision of services, and 24 percent involved the use of intangible property. As in recent years, the comparable profits method (CPM) was used to evaluate approximately 79 percent of the transactions involving tangible and intangible property in 2015. Of those property transactions, approximately 62 percent used the operating margin as the profit level indicator (PLI) and 25 percent used the Berry Ratio (i.e., the ratio of gross profits to operating expenses). Compared to recent prior years, this represents a significant decrease in the use of the operating margin (in 2014 and 2013, the operating margin was used in 87 percent and 78 percent of cases applying the CPM, respectively) and a significant increase in the use of the Berry ratio (in 2014 and 2013, the Berry ratio was used in 6 percent and 8 percent of cases applying the CPM, respectively).
For services transactions, the most frequently applied methods were the CPM (85 percent of cases) and the services cost method (11 percent of cases). Of those services transactions applying the CPM, 32 percent used the operating margin as the PLI and 55 percent used a return on total costs.
- **Adjustment Mechanisms.** The majority of the transactions covered in APAs executed in 2015 target an interquartile range. Those APAs include a number of mechanisms for making adjustments to the tested party's results when the results fall outside the range or do not match the point required by the APA. Some examples of the mechanisms included in the 2015 executed APAs include an adjustment bringing the tested party's results to the closest edge of the range applied to the results of a single year, an adjustment to the closest edge of the range applied to the results over the APA term, an adjustment to the specified point or royalty rate, and an adjustment to the median of the range for a single year.
- **Boilerplate and APMA Program Contact Information.** The annual report also includes the latest version of the APMA Program's model APA agreement and a list of primary APMA Program contacts. Because the new APA procedures require the submission of a draft APA based on the model APA, it is surprising that the model APA was not updated to reflect the newly issued procedures. However, APMA has stated that the model APA is currently under review for future changes.

In light of the BEPS final reports, the adoption of CbC reporting requirements by many jurisdictions, and the IRS's recent announcement that it will accept bilateral APA requests involving India, the demand for APAs will undoubtedly continue to be strong. To discuss

whether an APA may be advisable for your organization, please reach out to one of the contacts listed.

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