

Global Transfer Pricing

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2014 U.S. APA Report Shows Program Holding Steady

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The Internal Revenue Service on March 30, 2015, released Announcement 2015-11, the advance pricing agreement (APA) annual report covering the activities of the Advance Pricing and Mutual Agreement (APMA) Program during calendar year 2014. 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 brief summary of recent developments in the APMA Program and a statistical snapshot of the program's activities during 2014.

Unlike the 2013 annual report, which highlighted improved efficiencies, the 2014 annual report suggests the APMA Program was generally able to hold onto efficiencies from the prior year but was unable to make further improvements. During 2014, there were significant changes in the management of the IRS LB&I transfer pricing leadership, which may have hindered further efficiency improvements.

As countries adopt and companies seek to comply with recent Organization for Economic Cooperation and Development (OECD) Base Erosion and Profit Shifting (BEPS) initiatives, including country-by-country reporting, as early as 2016, APAs are expected to play an important role in transfer pricing risk management. The IRS is also expected to release an update to the APA Rev. Proc. 2006-9 this year.

Statistical highlights of the APA annual report include:

- **Decrease in Completed APAs.** During the 2014 calendar year, APMA closed 101 APAs (20 unilateral, 81 bilateral, and no multilateral), compared to a record 145 APAs in 2013 and 140 APAs in 2012. Renewal APAs represented 48 of the 101 APAs executed, with 9 unilateral and 39 bilateral renewals. As in the prior year, renewals represented about half of all completed APAs.
- **Months to Complete APAs.** In 2014, the median time to complete a unilateral APA was 30 months, and 35 months for a bilateral APA. In 2013, the median times to complete unilateral and bilateral APAs were 28 months and 37 months, respectively. Overall, the median time required to complete the 101 APAs executed in 2014 was 35 months, approximately two months longer than in 2013, indicating that APMA was able to maintain efficiency gains from the past two years but unable to further improve on those gains. Taxpayers renewing bilateral APAs benefitted from faster processing times for their APA requests – a median of 33.9 months-- compared to the median processing time for new bilateral APA requests – 45.1 months. Inexplicably, renewals of unilateral APAs took 15 months longer than new unilateral APA applications (40.9 months compared to 26 months, based on median processing times).

- **New Cases.** The IRS received 108 APA applications (31 unilateral, 74 bilateral, and 3 multilateral) in 2014, a slight decrease from the 111 APA applications received in 2013. While Japan and Canada continue to account for the largest share of bilateral APA requests, APA requests involving other countries have become a significant part of APMA's inventory. Notably, APAs involving the United Kingdom and Korea represented 10 percent and 8 percent of APA requests, respectively; Denmark, Mexico, and the Netherlands each had a 5 percent share. The IRS announced recently that it would start accepting prefiling conferences for APA requests involving India, which the IRS had previously refused to do as a result of the large number of unresolved double tax cases with India. Accordingly, bilateral U.S.-India APA requests are expected to be a significant source of new APA requests in 2015.
- **APA Inventory.** The APMA Program had 336 cases in active inventory at the end of 2014: 62 unilateral APAs, 268 bilateral APAs, and 6 multilateral APAs. In comparison, active inventory was about the same at the end of 2013, with 331 cases. Thus, the APMA Program in 2014 was closing cases about as fast as new requests were coming in. APMA and the taxpayer community had hoped further efficiencies would be realized from the streamlining of the APMA Program's internal processes to reduce the number of pending APA requests. APMA's efficiencies in completing cases may also likely reflect that less complex cases are being processed in a timely manner with more complex cases remaining in the active inventory for a longer period.
- **Term Length of APAs.** Of the APAs executed in 2014, 41 cases had a five-year term, while more than half had terms of six years or longer. 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 59 team leaders, 22 economists, and 10 senior managers organized into 10 groups (seven team leader groups and three economist groups). Compared to the prior year, this represents an increase of four team leaders and a decrease of four economists. The reduction in the number of economists may be a cause for concern. 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 2014. One APAs request was withdrawn in 2014.
- **Inbound v Outbound.** As in 2013, inbound cases continued to account for the majority of the APMA Program's caseload in 2014, with 55 percent of the APAs executed involving foreign multinationals with U.S. subsidiaries. Significantly, APAs involving U.S. multinationals and their non-U.S. branches, likely financial institutions for the most part, constituted 8 percent of APAs executed.
- **APAs Executed by Industry.** In 2014, manufacturing and wholesale/retail trade accounted for 48 percent and 22 percent, respectively, of the total number of executed APAs. Within the wholesale/retail trade industry, merchant wholesalers of durable goods were most common (64 percent of such cases). Meanwhile, the computer and electronic products segment was largest among manufacturers (27 percent of such cases).
- **Covered Transactions and Transfer Pricing Methods.** Thirty-six percent of the transactions covered in APAs executed in 2013 involved the sale of tangible goods, and 40 percent involved the provision of services. As in 2013, the comparable profits method (CPM) was used to evaluate approximately 78 percent of the transactions involving tangible and intangible property in 2014. Of those property transactions, approximately 88 percent used the operating margin as the profit level indicator (PLI). For services transactions, the most frequently applied methods were the CPM (77 percent of cases) and the services cost method (17 percent of cases). Of those services transactions applying the CPM, 47 percent used operating margin as the PLI and 45 percent used return on total costs.

- **Sources of Comparables.** The IRS expanded the breadth of databases used to identify comparables, particularly comparable license agreements and financial transactions. Newly identified sources include RoyaltyStat, RoyaltySource, ktMINE, LoanConnector, Bloomberg, and Recap.
- **Adjustment Mechanisms.** The majority of the transactions covered in APAs executed in 2014 target an interquartile range. Those APAs include a number of mechanisms for making adjustments to tested-party 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 2014 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 boilerplate APA agreement (the Model APA) and a list of primary APMA Program contacts. Efforts are currently underway to revise the Model APA for the first time since 2009.

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