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# Global Tax Alert

News from Transfer Pricing

## US IRS issues annual APA report for 2019

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### Executive summary

The United States (US) Internal Revenue Service (IRS) Advance Pricing and Mutual Agreement (APMA) Program issued the 21st annual Advance Pricing Agreement (APA) report (the Report) on 25 March 2020, in Announcement 2020-2. The Report provides a discussion of the APMA Program, including its activities and structure for calendar year 2019, and gives useful insights into its operation.

The number of APA filings decreased, with taxpayers filing 121 APA requests in 2019 compared to 203 in 2018. This decrease is not surprising given that APMA substantially increased the user fees charged to companies applying for an APA starting after 2018. The total number of APAs concluded increased from 107 to 120 and the median amount of time to finalize an APA slightly decreased from 40.2 months to 38.8 months.

### Highlights

- ▶ During 2019, 121 APA applications were filed and 120 APAs were completed. The number of APAs completed during 2019 is generally consistent with the number of APAs completed during the last several years. Additionally, there has been a continued interest in bilateral APAs, with Japan (32%), India (12%), and Canada (14%) representing 58% of all US bilateral APAs filed.

- ▶ At year end, 454 APA requests were pending (386 bilateral, 22 multilateral and 46 unilateral), down from 458 in 2018.
- ▶ Details are provided on the treaty partners to bilateral APAs concluded during the year. APAs with Japan (49%) and Canada (11%) comprised approximately 60% of all US bilateral APAs executed in 2019. The percentage of US-Japan bilateral APAs increased by 10% in 2019 compared to 2018.
- ▶ The median time required to complete an APA decreased, from 40.2 months in 2018 to 38.8 months in 2019.
- ▶ Overall APMA headcount remained the same at 77 professionals as of 31 December 2019.
- ▶ Unilateral APA requests significantly decreased from 35 in 2018 to 17 in 2019.
- ▶ The number of applications withdrawn in 2019 significantly decreased from 21 in 2018 to 12 in 2019.
- ▶ Approximately 62% of the APAs executed in 2019 were completed for transactions between foreign parented companies and their US subsidiaries, while 16% were completed for transactions between US parent companies and their foreign subsidiaries.
- ▶ Among the transfers of tangible or intangible property that used the Comparable Profits Method/Transactional Net Margin Method (CPM/TNMM), the operating margin (OM) was once again the profit level indicator (PLI) most commonly applied, being used in 64% of cases.
- ▶ The CPM/TNMM was applied in 82% of the APAs with intercompany service transactions. The most commonly selected PLI with the CPM/TNMM was the operating margin (65%).

## Background

An APA is an agreement between the IRS and a taxpayer under which the IRS agrees not to seek a transfer pricing adjustment under Internal Revenue Code Section 482 for one or more specific covered transaction(s) if the taxpayer files its tax return for a covered year based on the agreed TPM(s). The APA process is a voluntary program designed to resolve actual or potential transfer pricing disputes in a principled, cooperative manner, as an alternative to the traditional examination process.

The benefits of an APA include:

- ▶ Reduction or elimination of the risk of transfer-pricing adjustments, penalties and interest, as well as the risk of double taxation
- ▶ Potential reduction of financial statement reserves and administrative costs associated with transfer-pricing compliance
- ▶ Certainty of prospective tax treatment for APA-covered transactions and a consequent increase in tax and management flexibility
- ▶ Flexibility in adopting transfer-pricing methods to deal with unique transactions, or a lack of good comparables
- ▶ Cost-effective management of multiple past and prospective years compared to the traditional examination process

Revenue Procedure 2015-41 instructs taxpayers to request a term of at least five prospective years, which can be extended through renewal procedures. The revenue procedure allows taxpayers to request “roll-back” years to be covered by an APA. In 2019, 25% of the completed agreements included roll-back years. Although 53 of the agreements were for terms of five years, 50 of the cases were for six or more years (including roll-back years).

When competent authority procedures are available in the other countries involved (under an applicable tax treaty), the IRS encourages bilateral or even multilateral APAs. These agreements are also binding on the foreign tax authority for the same period and help avoid instances of double taxation.

## Detailed discussion

In 1999, Congress mandated that the APA Program publish an annual report summarizing key information regarding the various APAs filed, pending and executed during the previous calendar year. This requirement is framed so as to achieve a compromise between providing the public information as to how the IRS resolves transfer-pricing issues in the APA process, and protecting the confidential tax information of taxpayers participating in the APA Program.

## APA applications, executed APAs and pending APAs

Since the APA Program's inception in 1991 through 31 December 2019, the IRS has received a total of 2,670 APA applications, and executed 1,940 APAs. The following table reports summary statistics about 2019 APA applications, executed APAs and pending APAs. Data are reported separately for unilateral and bilateral APAs,\* and completion times for 2019, 2018 and 2017 are compared.

Year	Unilateral			Bilateral			Total*		
	2019	2018	2017	2019	2018	2017	2019	2018	2017
APA applications	17	35	14	96	161	86	121	203	101
APAs executed	29	24	30	91	81	85	120	107	116
Renewals executed	20	15	22	48	45	48	68	62	70
Pending requests for APAs	46	58	57	386	387	321	454	458	386
Pending requests for new APAs	18	22	28	228	229	188	268	210	222
Pending requests for renewals	28	36	29	158	158	133	186	195	164
APAs canceled or revoked	0	0	0	0	0	0	0	0	0
APAs withdrawn	1	7	1	11	14	6	12	21	8

\* In some cases, the totals include additional multilateral cases

## IRS staffing changes and operating efficiencies

The total number of APMA employees has remained fairly constant over the past several years, although the mix of economists and team leaders occasionally changes. The number of economists increased in 2019 (16) compared to 2018 (12), the number of team leaders (a mix of lawyers and accountants) decreased from 56 in 2018 to 52 in 2019. There were 6 managers and 3 assistant directors in 2019. Each assistant director supervised 2 managers who led teams comprised of both team leaders and economists.

## Months to complete APAs

The following data indicate that the average time to complete new bilateral APAs slightly decreased from 47.8 months in 2018 to 47.2 months in 2019. The average time to complete new unilateral APAs decreased from 35.4 months in 2018 to 33.8 months in 2019.

	Bilateral (New)			Bilateral (Renewal)			Bilateral (Combined)		
	2019	2018	2017	2019	2018	2017	2019	2018	2017
Average months	47.2	47.8	46.9	38.5	43.9	37.3	42.5	45.6	41.5

	Unilateral (New)			Unilateral (Renewal)			Unilateral (Combined)		
	2019	2018	2017	2019	2018	2017	2019	2018	2017
Average months	33.8	35.4	40.4	31.7	32.4	28.7	32.2	33.4	32.6

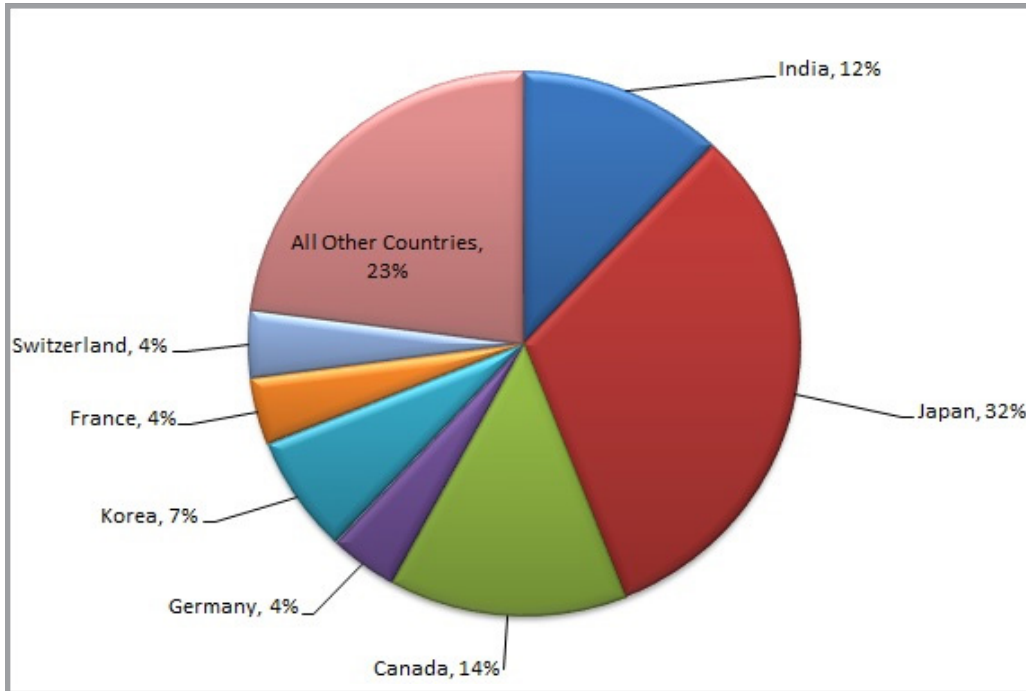
## Treaty partners in bilateral APAs

As shown in the following chart, APAs with Japan has 49% of bilateral APAs executed in 2019, more than any other country. This is attributable to the maturity of the APA Programs in the United States and Japan, and the negotiating experience of the APMA team and the competent authority team representing the National Tax Administration of Japan.

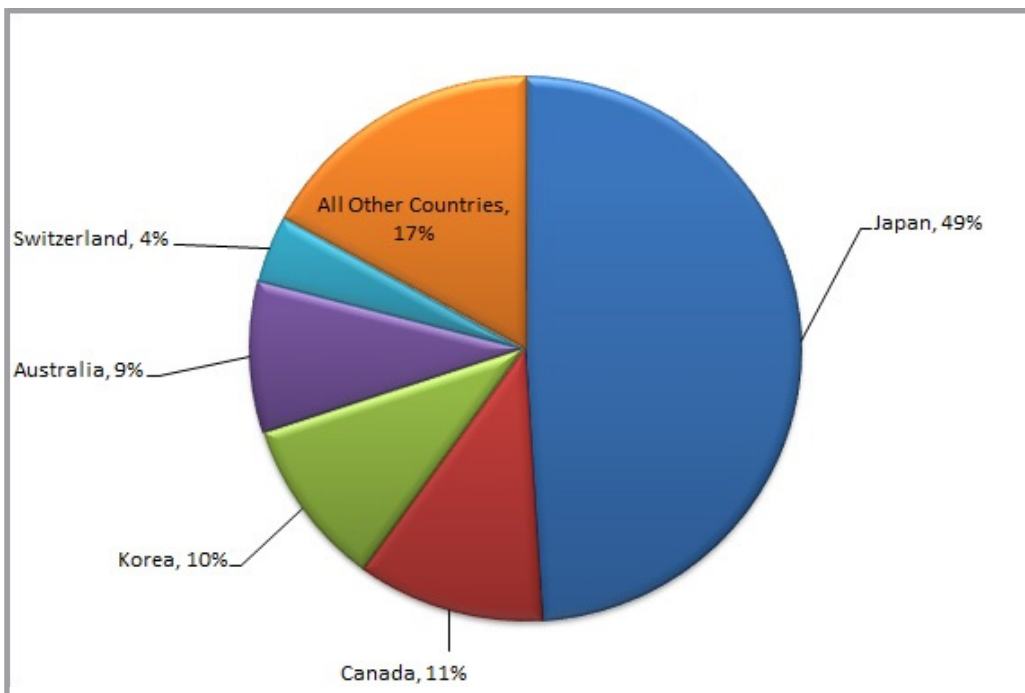
Canada is the second most frequently involved treaty partner, with 11% of executed APAs in 2019, as a result of its role as the second largest trading partner with the US (following China, which was the largest US trading partner for 2019) and the fact that it has been a US tax treaty partner for over 35 years.

While India did not represent a significant proportion of agreements executed in 2019, proportionately more India cases were filed as a result of the progress made in the relationship between the IRS and India's tax authorities during the last few years. In 2019, India represented 12% of bilateral APAs filed (more than any other country except for Japan) and 21% of pending bilateral APAs (again, the second most after Japan). This is an extremely positive outcome given the uncertainty and severe risk of double taxation faced by multinationals investing in India.

## Bilateral APAs filed by country



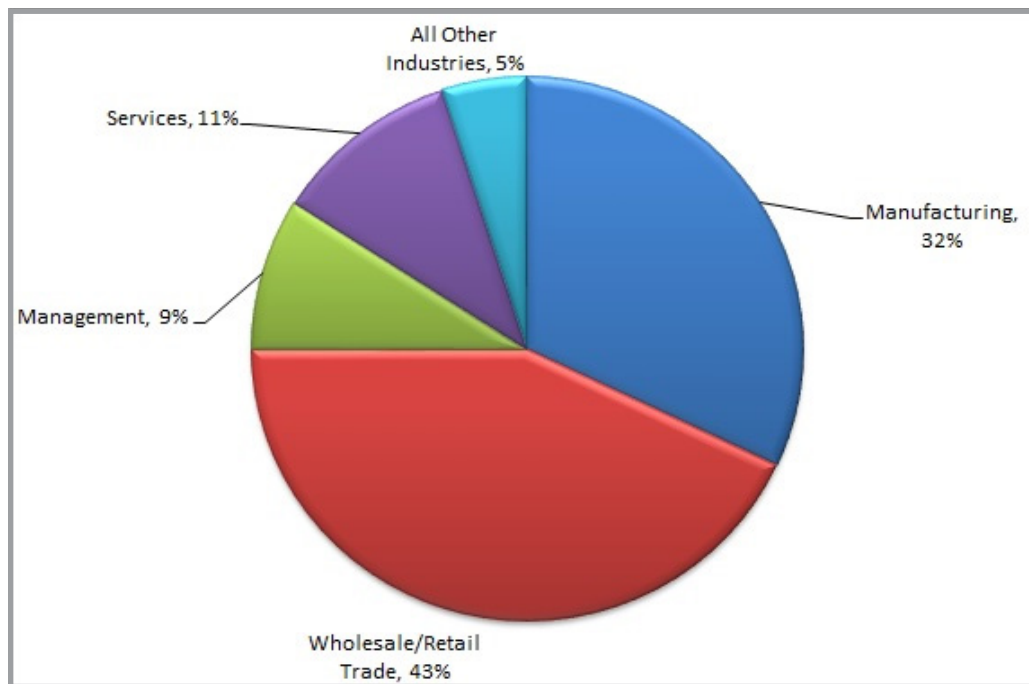
## Bilateral APAs executed by country



### Industries covered

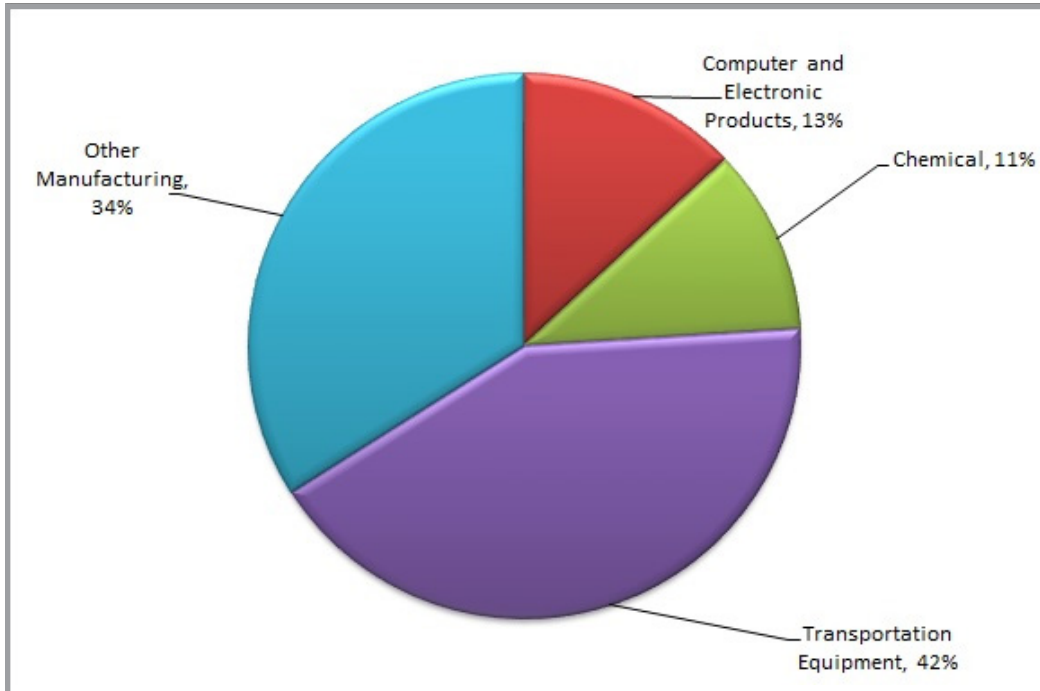
As shown in the following chart, manufacturing and wholesale/retail trade continue to comprise the largest share of APA cases, representing 75% of all APAs completed in 2019.

### Industry Representation

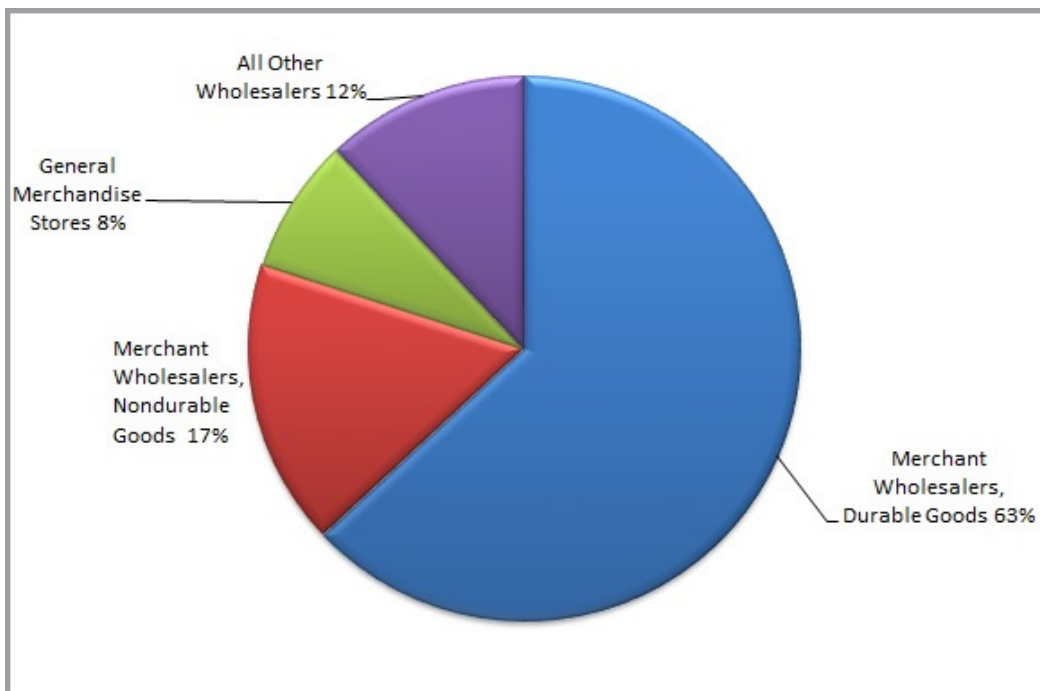


Approximately 66% of manufacturing cases involved computer and electronic products, chemicals and transportation equipment, while the wholesale/retail trade cases were dominated by wholesalers of durable goods.

## Manufacturing



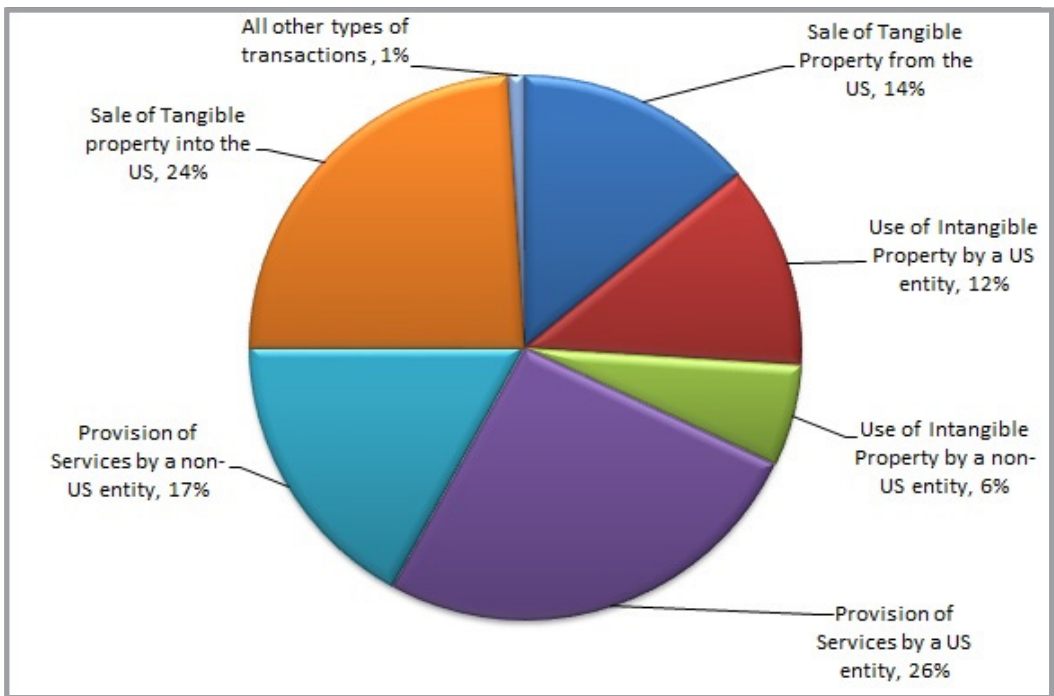
## Wholesale/retail trade



### Covered transactions and tested parties

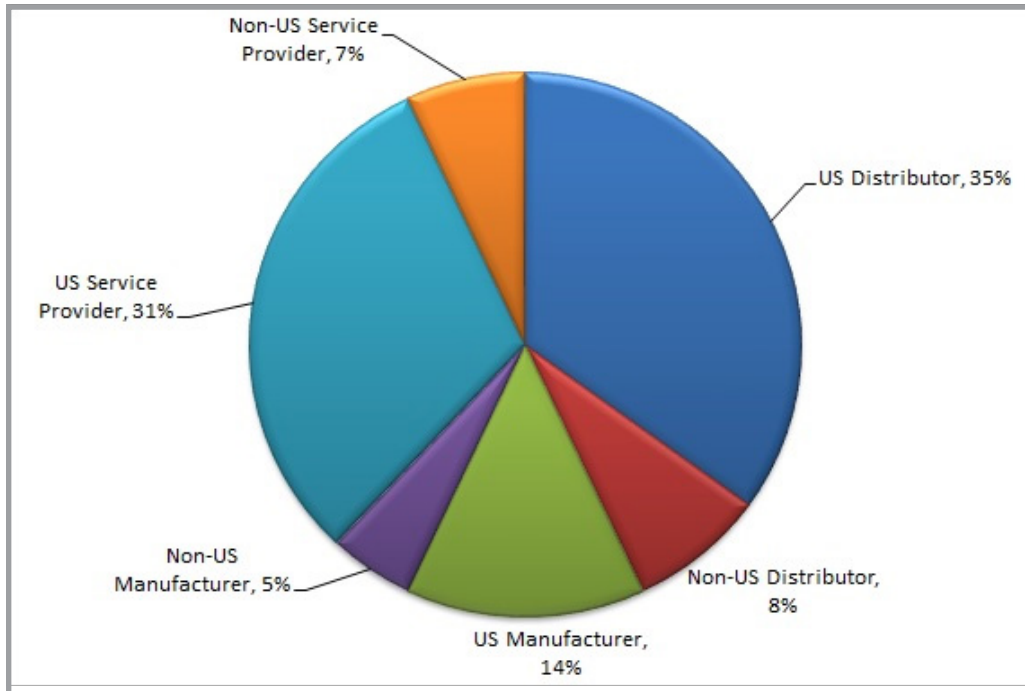
The Report describes, in overall terms, the covered transactions and sets out the types of tested parties in each transaction. Note that one APA may cover more than one transaction.

#### Covered transactions





## Types of tested parties



## Transfer pricing methods applied

The CPM/TNMM continues to be the most commonly applied method in cases involving transfers of tangible and intangible property, as well as for services transactions.

## Critical assumptions

A critical assumption is a fact on which the taxpayer's TPM depends. APAs typically list critical assumptions that involve a particular mode of conducting business operations, a particular corporate or business structure, or a range of expected business volume.

The model APA used by the IRS includes a standard critical assumption that there will be no material changes to the taxpayer's business or to its tax or financial accounting practices during the APA term, and all the APAs executed in 2019 included that standard critical assumption.

A few bilateral cases have included critical assumptions tied to either the taxpayer's profitability in a certain year or over the APA's term, or to the amount of non-covered transactions as a percentage of the taxpayer's revenue.

If a critical assumption has not been met, and the parties cannot agree on how to revise the APA, the APA can be canceled. The IRS did not cancel any APAs in 2019 relating to the failure of a critical assumption (or any other reason).

## Implications

The average time to complete new bilateral APAs and new unilateral APAs decreased slightly in 2019 from 2018. This is likely due to the increase in the number of economists.

As a result of the COVID-19 pandemic and the current state of the economy, many multinationals are rethinking their supply chains and transfer pricing frameworks. As a result, multinationals are likely to continue seeking the benefits of an APA to avoid the risk of double taxation and the commitment of resources involved in audits and litigation.

The highlight of the 2019 Report is the large number of pending bilateral APAs with Japan and India. As of 31 December 2019, approximately half of the pending bilateral APA requests involved either Japan or India. The tax authorities in Japan and India are particularly focused on transfer pricing, requiring many multinationals to pursue administrative appeals or litigation. Neither of these procedural options, however, completely guarantees avoidance of double taxation. Consequently, the fact that multinationals can apply for a bilateral APA in Japan and India is an attractive option.

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## Endnotes

1. The rest consists of transactions between subsidiaries of US- and foreign-parented groups, i.e. sister companies (20%) and all other relationships (2%).

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