

1 April 2019

Global Tax Alert

News from Transfer Pricing

US IRS issues annual APA report for 2018

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Executive summary

The United States (US) Internal Revenue Service (IRS) Advance Pricing and Mutual Agreement (APMA) program issued the 19th annual Advance Pricing Agreement (APA) report (the Report) on 22 March 2019, in [Announcement 2019-03](#). The Report provides an updated discussion of the APA program, including its activities and structure for calendar year 2018, gives useful insights into the operation of the program and provides some indications of what companies applying for an APA can expect to encounter.

The Report shows that interest in APAs remains strong, with taxpayers filing 203 APA requests in 2018 compared to 101 in 2017. The total number of APAs concluded decreased from 116 to 107 and the median amount of time to finalize an APA slightly increased from 33.8 months to 40.2 months.

Highlights

- ▶ During 2018, 203 APA applications were filed and 107 APAs were completed. The number of APAs completed during 2018 represents a significant number. Additionally, there has been a continued interest in bilateral APAs with India over the past two years (which both represented 21% of bilateral APA filings in 2018 and 2017 respectively), following the recent improvement in relations between the IRS and the Indian tax authority.

- ▶ At year end, 458 APA requests were pending (387 bilateral, 13 multilateral and 58 unilateral), up from 386 and 398 pending requests at the end of 2017 and 2016 respectively.
- ▶ Details are provided on the treaty partners to bilateral APAs concluded during the year. APAs with Japan (39%) and Canada (20%) combined comprised 59% of all US bilateral APAs executed in 2018. Interestingly, the percentage of US-Japan bilateral APAs has declined significantly.
- ▶ The median time required to complete an APA increased, from 33.8 months in 2017 to 40.2 months in 2018.
- ▶ Overall, APMA headcount has been slowly decreasing over the last year and stood at 77 professionals as of 22 December 2018.
- ▶ Unilateral APA requests increased from 14 in both 2016 and 2017 to 35 in 2018.
- ▶ The number of applications withdrawn in 2018 significantly increased from 8 in 2017 to 21 in 2018.
- ▶ Approximately 52% of the APAs executed in 2018 were completed with companies having a foreign parent while 22% were completed with US parent companies.²
- ▶ Among the transfers of tangible or intangible property that used the Comparable Profits Method/Transactional Net Margin Method (CPM/TNMM), the operating margin was once again the profit level indicator (PLI) most commonly applied in APAs (68%).
- ▶ The CPM/TNMM was applied in 86% of the APAs with intercompany service transactions. The most commonly selected PLI with the CPM/TNMM was the operating margin (76%).

Detailed discussion

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 revenue procedure covering APAs has seen many updates and revisions since 1991, when Revenue Procedure 91-22 was issued. The current Revenue Procedure 2015-41, released in August of 2015, supersedes the prior APA Revenue Procedure 2006-09, and became effective for requests filed after 29 December 2015.

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. Similar to Revenue Procedure 2006-09, the new revenue procedure allows taxpayers to request “roll-back” years to be covered by an APA. In 2018, 20% of the completed agreements included roll-back years. Though 36 of the agreements were for terms of five years, the majority of the rest 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 effective 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.

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 2018, the IRS has received a total of 2,549 APA applications, and executed 1,820 APAs. The following table reports summary statistics about 2018 APA applications, executed APAs and pending APAs. Data are reported separately for unilateral and bilateral APAs,* and completion times for 2018, 2017 and 2016 are compared.

Year	Unilateral			Bilateral			Total*		
	2018	2017	2016	2018	2017	2016	2018	2017	2016
APA applications	35	14	14	161	86	84	203	101	98
APAs executed	24	30	21	81	85	65	107	116	86
Renewals executed	15	22	17	45	48	32	62	70	49
Pending requests for APAs	58	57	67	387	321	322	458	386	398
Pending requests for new APAs	22	28	34	229	188	191	210	222	232
Pending requests for renewals	36	29	33	158	133	131	195	164	166
APAs canceled or revoked	0	0	0	0	0	0	0	0	0
APAs withdrawn	7	1	9	14	6	15	21	8	24

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

IRS staffing changes and operating efficiencies

In 2012, the IRS made a concerted hiring effort to add more economists. Consequently, the number of economists available to develop APA positions more than doubled, allowing the IRS to deploy the appropriate resources to each case while reducing case-processing times.

However, since 2012, the total number of APMA employees has decreased. The number of economists decreased in 2018 (12) compared to 2017 (17) and 2016 (20), the number of team leaders (a mix of lawyers and accountants) increased from 55 in 2017 to 56 in 2018. There were six managers and three assistant directors in 2018. Each assistant director supervised two managers who lead teams comprised of both team leaders and economists.

Months to complete APAs

The following data indicate that the average time to completion for new bilateral APAs increased to 47.8 months in 2018 from 46.9 months in 2017. The average time to completion for new unilateral APAs decreased from 40.4 months in 2017 to 35.4 months in 2018.

	Bilateral (New)			Bilateral (Renewal)			Bilateral (Combined)		
	2018	2017	2016	2018	2017	2016	2018	2017	2016
Average months	47.8	46.9	50.5	43.9	37.3	34.2	45.6	41.5	42.4

	Unilateral (New)			Unilateral (Renewal)			Unilateral (Combined)		
	2018	2017	2016	2018	2017	2016	2018	2017	2016
Average months	35.4	40.4	33.9	32.4	28.7	21.8	33.4	32.6	24.1

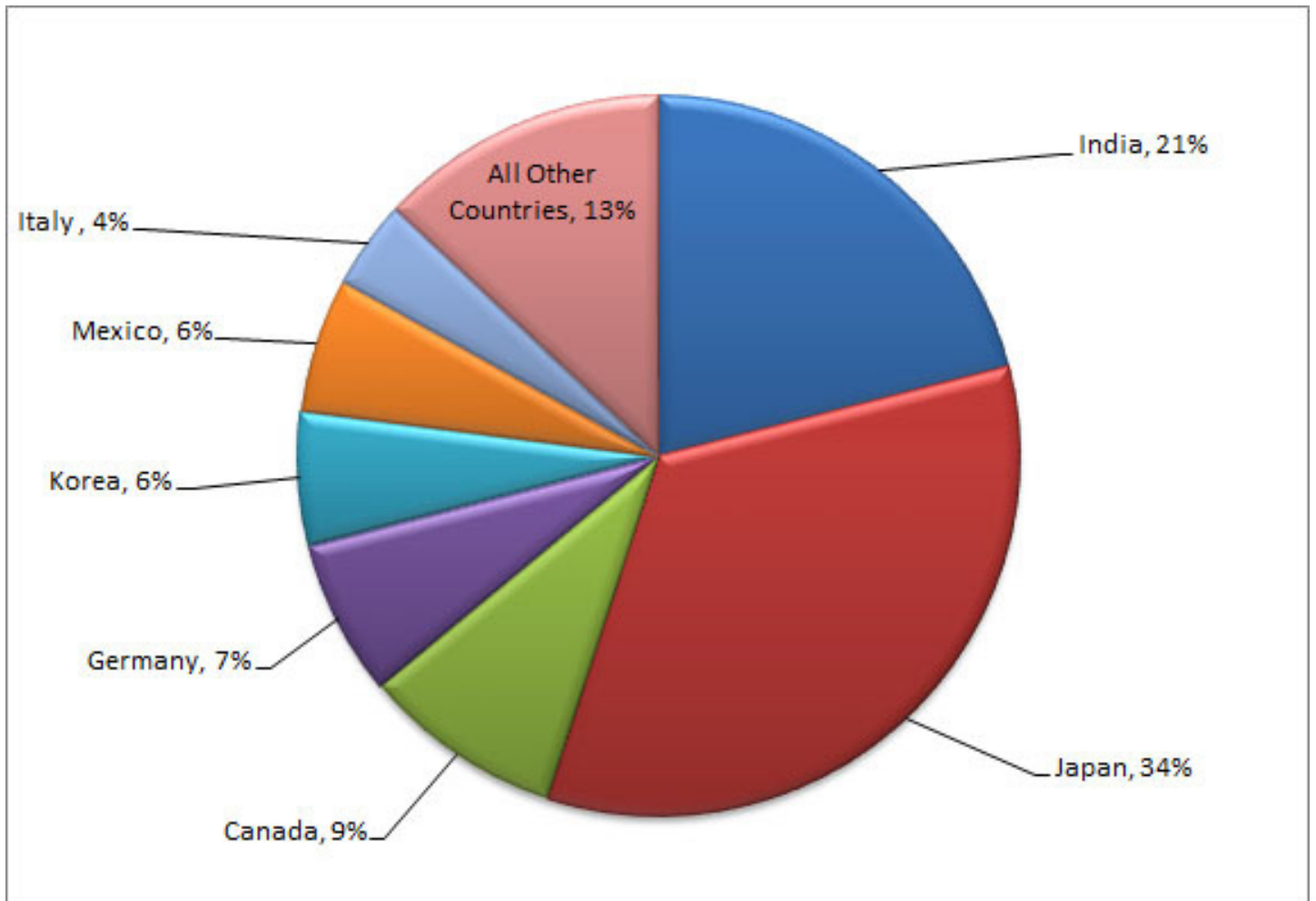
Treaty partners in bilateral APAs

As shown in the following chart, APAs with Japan represent more than any other one country at 39% of bilateral APAs executed in 2018. 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.

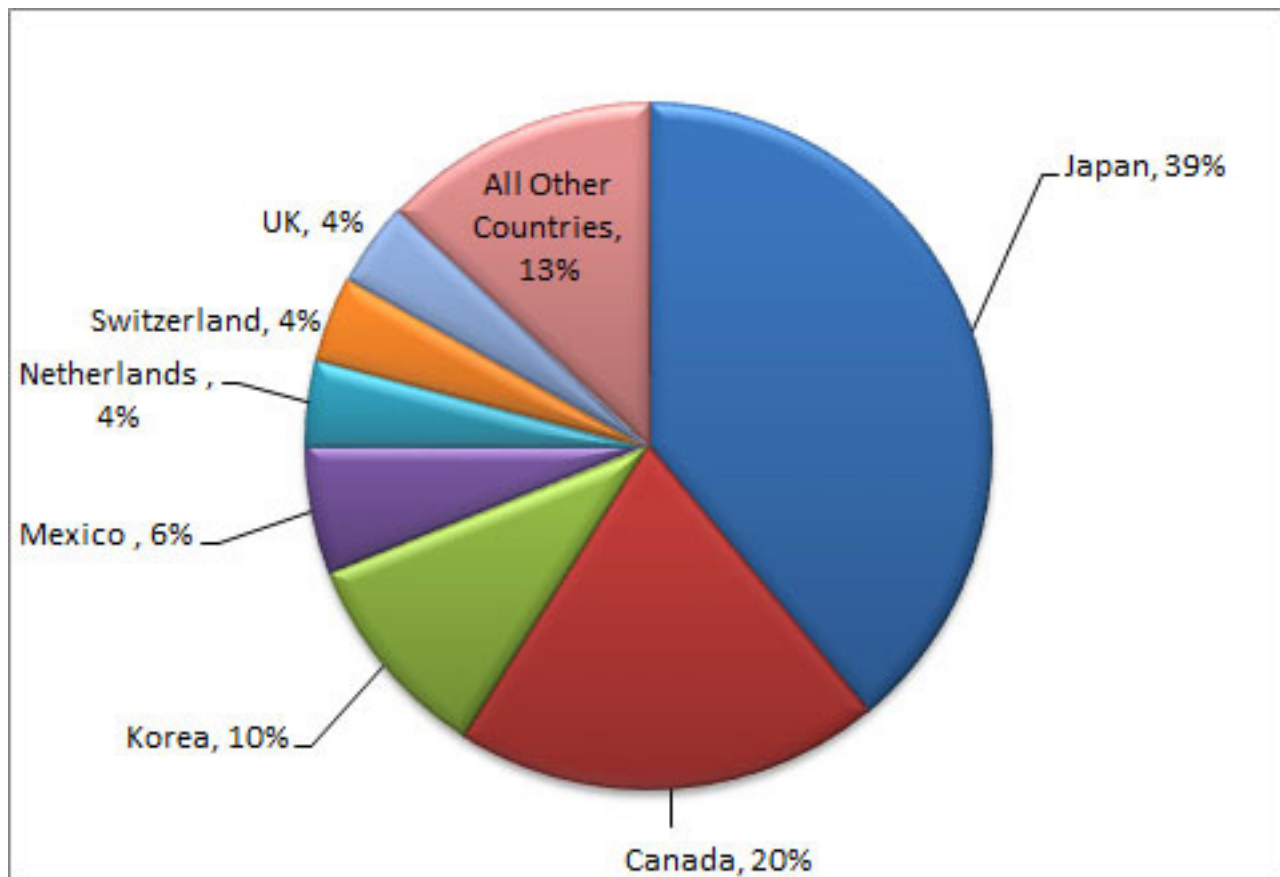
Canada is the second most frequently involved treaty partner in executed APAs in 2018, as a result of its role as the second largest trading partner with the US (following China, which was the largest US trading partner for 2018) and the fact that it has been a US tax treaty partner for over 35 years.

In addition, while India did not represent a significant proportion of agreements executed in 2018, a substantial number of India cases was filed as a result of the progress made in the relation between the IRS and India's tax authorities during the last few years. In 2018, India represented 21% of bilateral APAs filed (more than any other country except for Japan) and 20% of pending bilateral APAs (the second most after Japan). This constitutes an extremely positive outcome given the uncertainty and severe risk of double taxation faced by multinationals investing in India.

Bilateral APAs filed by country



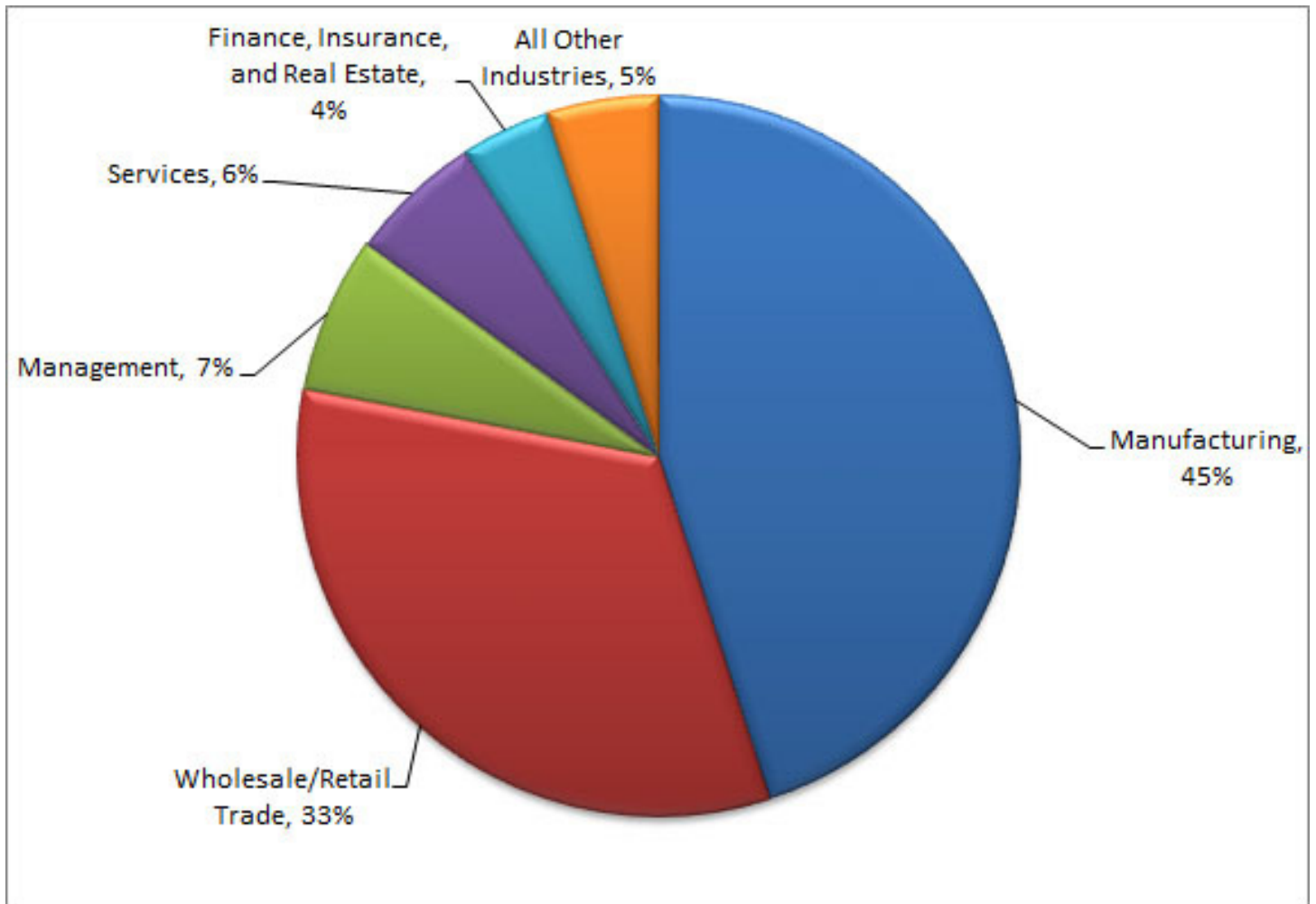
Bilateral APAs executed by country³



Industries covered

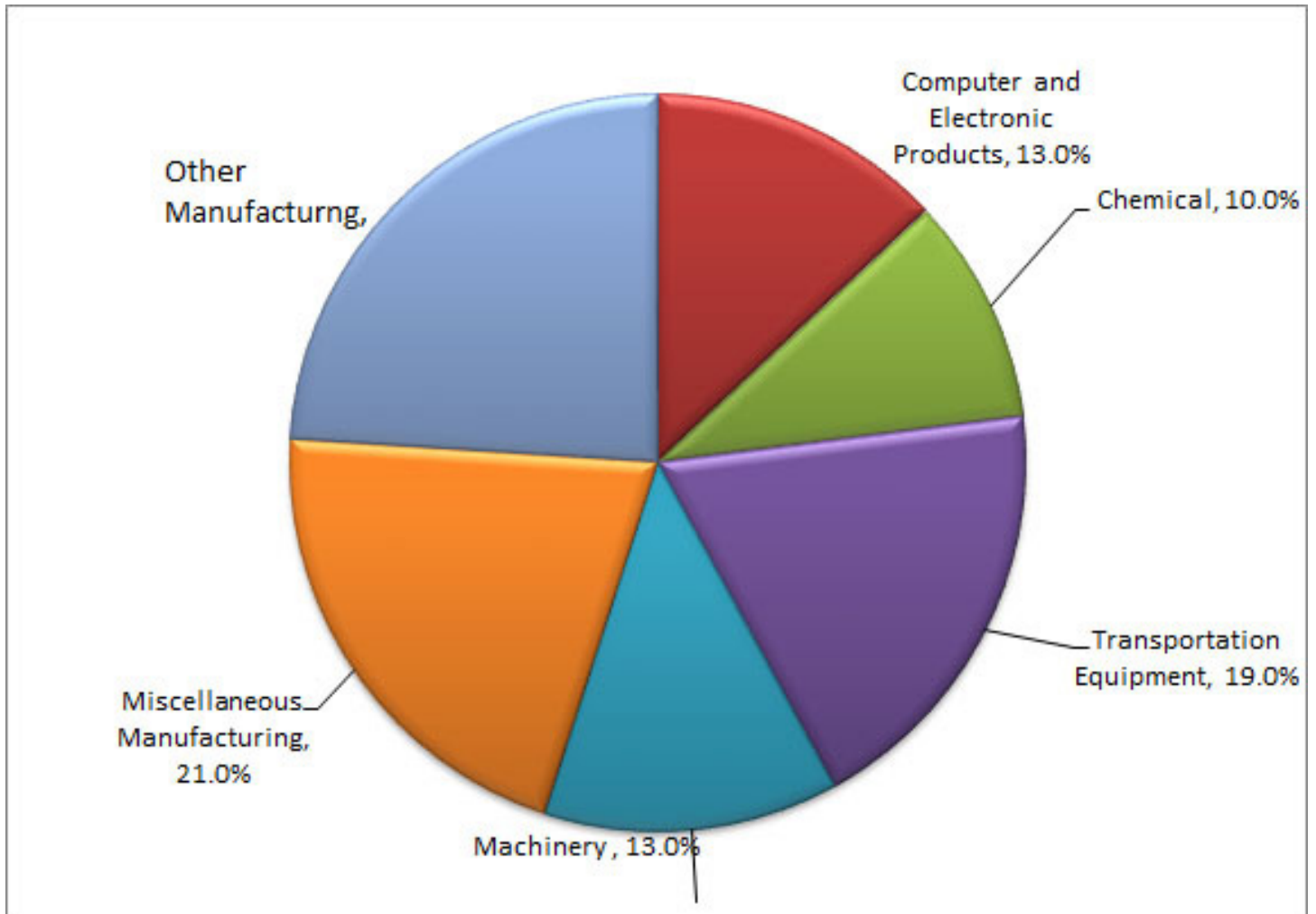
As shown in the following chart, manufacturing and wholesale/retail trade continue to comprise the largest share of APA cases, representing 83% of all APAs completed in 2017.

Industry Representation

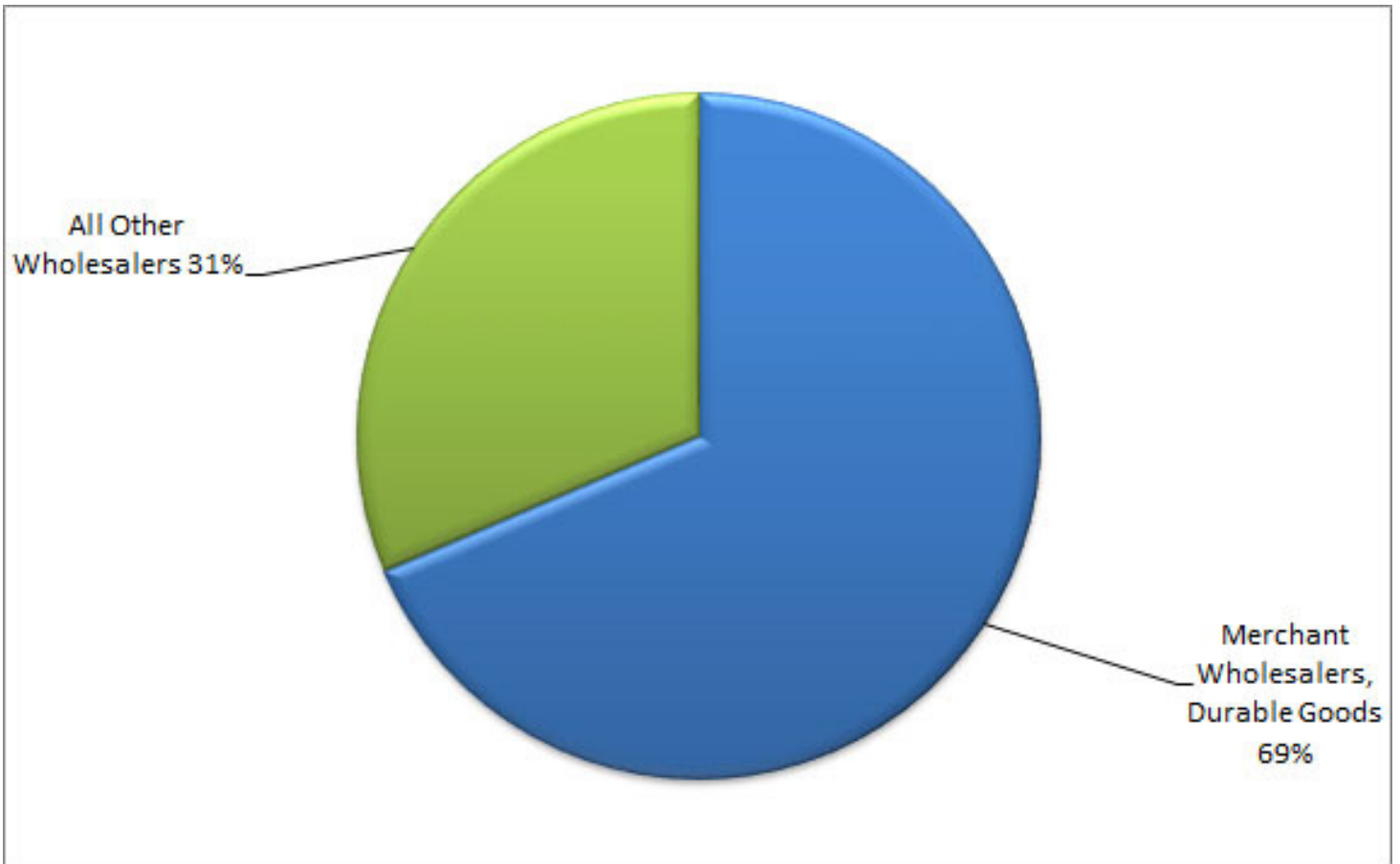


Approximately 42% of manufacturing cases involved computer and electronic products, chemicals, and transportation equipment, while the wholesale/retail trade cases were dominated by wholesalers of durable goods.

Manufacturing



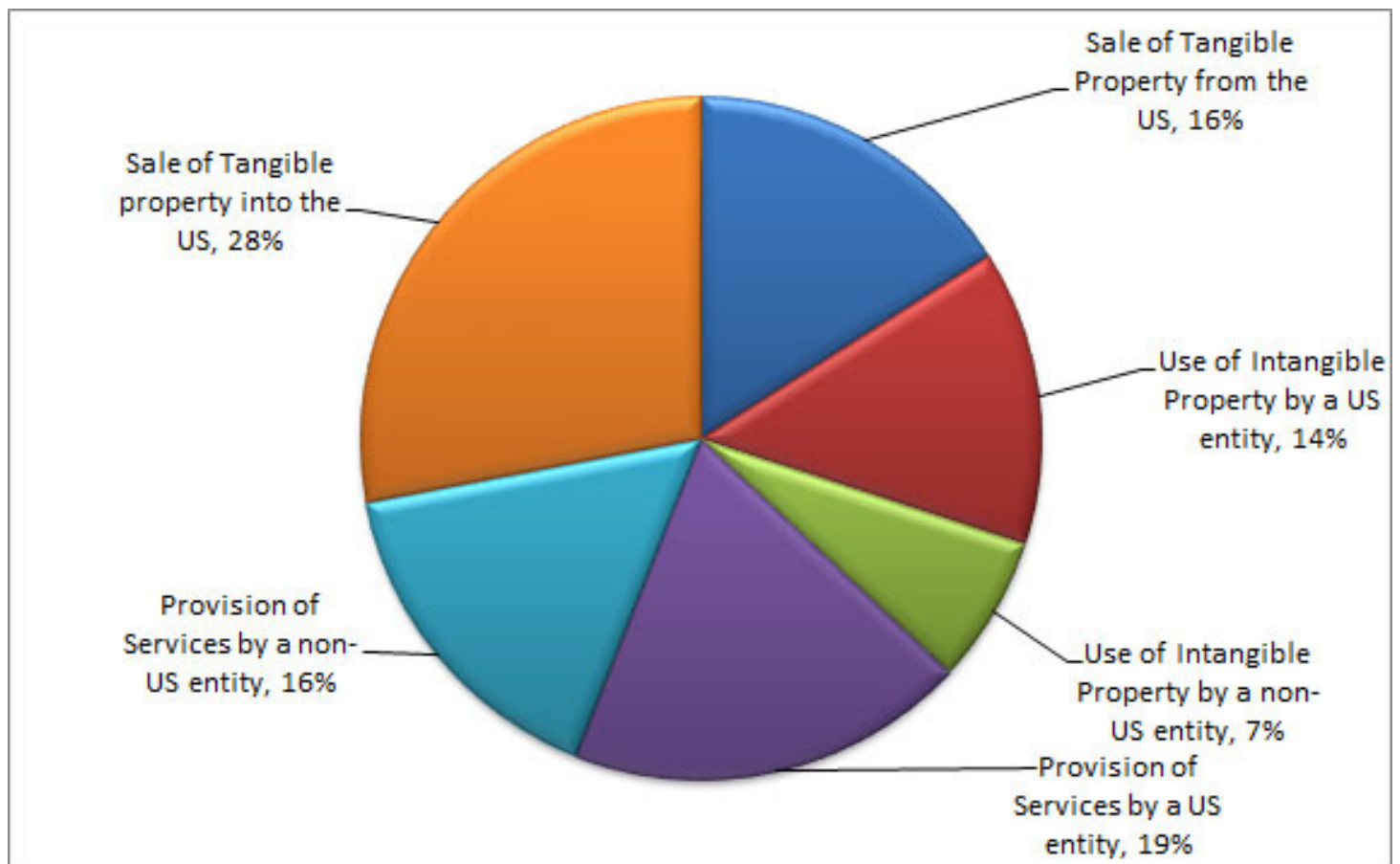
Wholesale/retail trade



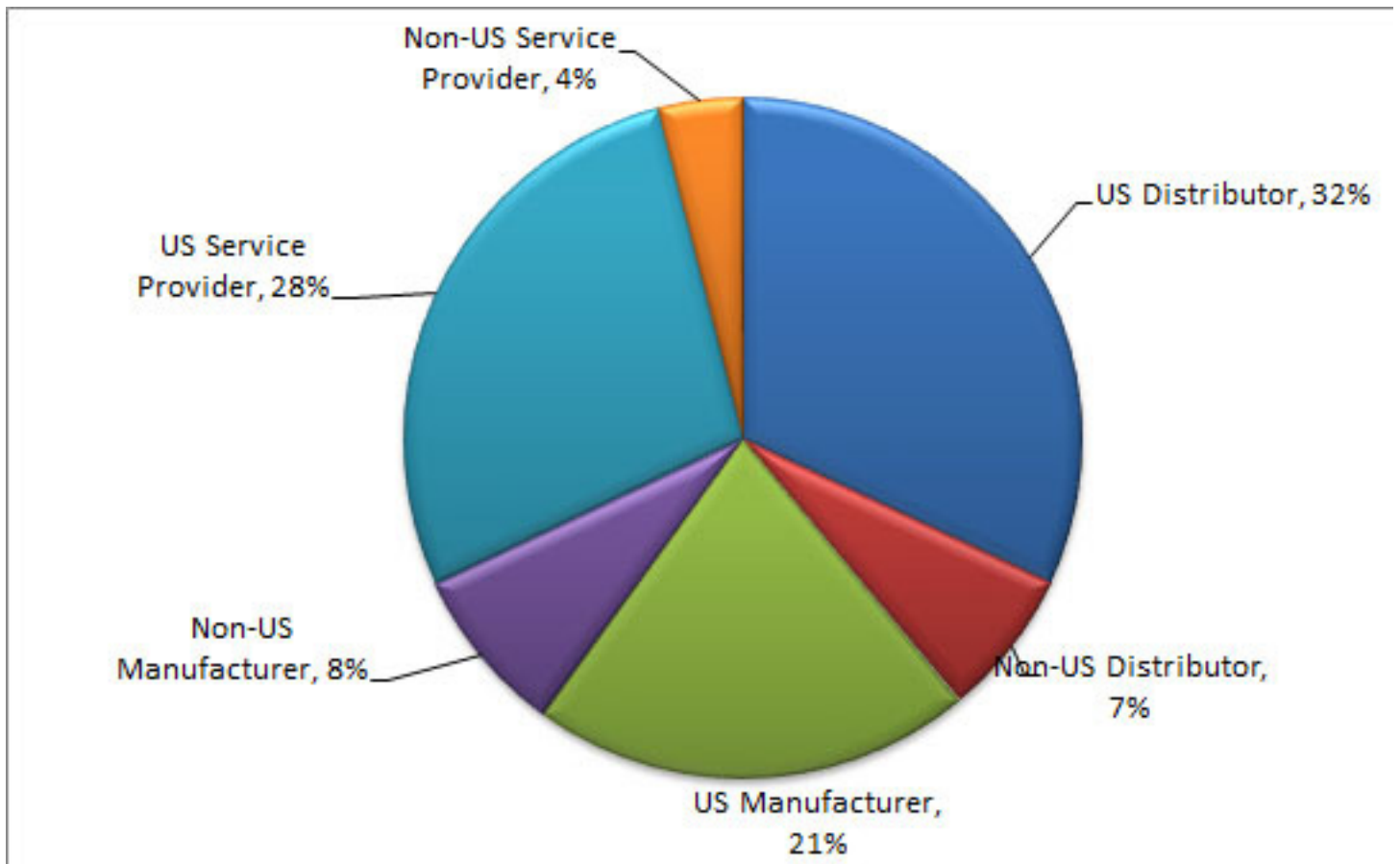
Covered transactions and tested parties

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 2018 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 term of the APA, 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 2018 relating to the failure of a critical assumption (or any other reason).

Implications

During 2018, APMA substantially increased APA user fees in stages. The last of those increases took effect for APAs filed after 31 December 2018. Thus, it is not surprising that the number of new APAs filed before the end of 2018 increased significantly as companies tried to beat the increase in the user fees. The increased number of new APA requests, along with the decrease in economist resources, suggests that processing times may increase.

The new provisions introduced as part of US tax reform have some implications for most multinationals – whether US or foreign-based. In many cases multinationals are rethinking

their supply chains. 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 2018 Report (continuing the trend) is the large number of pending bilateral APAs with India. The tax authority in India has been particularly focused on transfer pricing in the past years, forcing many multinationals to pursue administrative appeals or litigation. However, neither of these procedural options completely guarantee avoidance of double taxation. Consequently, the fact that multinationals now have the alternative to apply for a bilateral APA with India is a very welcome outcome.

Endnotes

1. EY is handling approximately 35% of total number of bilateral APAs with India and completed the first US - India bilateral APA in January of 2018.
2. The rest consists of sister companies (24%) and all other relationships (2%).
3. Where any table in Announcement 2019-03 differs from the figures in the pie graph, the figures in the pie graph were used.

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EYG no. 001065-19Gbl

1508-1600216 NY
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