

United States: 2023 a great year for APAs in the US

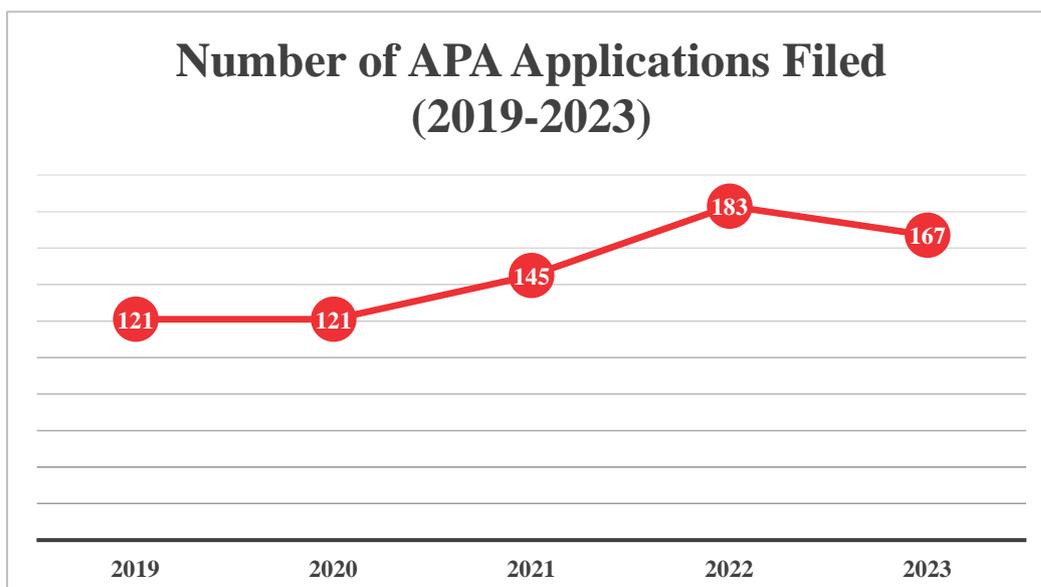
Tax News and Developments

In brief

On 26 March 2024, the IRS Advance Pricing and Mutual Agreement (APMA) Program issued their 25th annual Advance Pricing Agreement (APA) report describing the experience, structure, and activities of the APMA Program during calendar year 2023. The report provides statistical information about the numbers of APA applications received and resolved during the year, including countries involved and transfer pricing methods (TPMs) employed. This article identifies key takeaways based on the data from the report and our experience advising companies during the APA process.

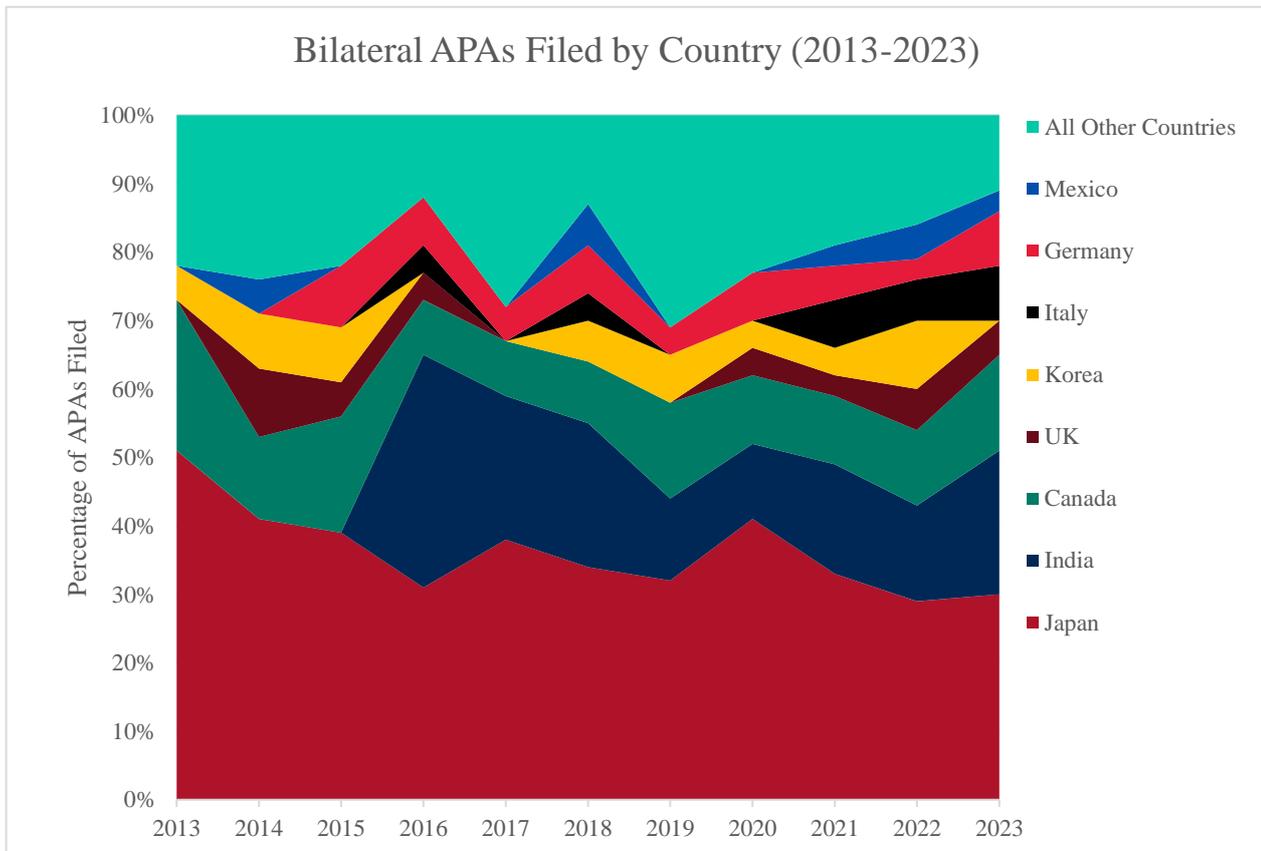
APAs continue to be in demand for US taxpayers

While the number of APA application filings decreased in 2023 compared to 2022, the number of applications filed during 2023 remained above the number of applications filed during each of 2019 through 2021. In particular, APMA received 167 complete APA applications during 2023, as well as 22 user fee filings not yet accompanied by an APA request. While the continual level of interest in APAs makes clear that taxpayers continue to desire the legal certainty (including prospective certainty) and cooperative forum that APAs offer to resolve and prevent potential transfer pricing issues, the decrease in filings from 2022 may be due in part to the IRS's issuance of the [Interim Guidance](#) on the review and acceptance of APAs on 25 April 2023 (see our previous coverage [here](#)). Taxpayers may have been dissuaded from pursuing an APA as a result of such guidance or may have opted to delay filing until the practical effects of such guidance were better understood.



Of the total application pool, the vast majority of the APA applications continued to be made on a bilateral basis (144 of the total 167 applications or 86%), which aligns with APMA's preference to handle APAs on a bilateral (or multilateral) basis. Additionally, the number of unilateral and multilateral requests remained relatively stable compared to prior years, with APMA receiving 17 unilateral and six multilateral applications in 2023, compared to 22 unilateral and seven multilateral applications in 2022.

As with prior years, Japan (30%), India (21%), and Canada (14%) continued to represent the highest number of bilateral APA applications filed. Notably, the number of bilateral APA requests filed with India increased from 14% of APA requests filed in 2022 to 21% of APA requests filed in 2023, likely signifying the filing of renewal APAs related to the first round of India bilateral APAs filed during the 2016-2018 period. The number of bilateral APA requests filed with Italy has also increased in recent years, reaching 8% of total bilateral APAs filed in 2023. The chart below demonstrates the bilateral filing trends by separate countries reported most consistently in the APA annual reports from 2013 through 2023.



APMA's success reflected by increased staffing and highest number of APAs executed

APMA experienced a significant uptick in its staffing during 2023, reflecting the increased IRS resources dedicated to transfer pricing and dispute resolution. This compares to the decrease in staffing during 2022 and represents a return to the APMA staffing levels of 2021. In particular, APMA's staff size increased to 115 total headcount at the end of 2023, compared to 98 at the end of 2022. As of the end of 2023, APMA's staff included 70 team leaders (up from 59 as of 31 December 2022), 29 economists (up from 26 as of 31 December 2022), 12 managers (up from nine as of 31 December 2022), three assistant directors (unchanged from 2021 and 2022), and one acting director.

This increase in staffing enabled APMA to have a very successful year in closing out APAs. As highlighted by John Wall, Acting Director APMA, during a Federal Bar Association panel on 5 March 2024, 2023 was "probably the best year as far as closing APAs ever."¹ We understand that this success was also aided by the role of two senior advisors to the Director, who John Wall noted are also aiding in creating efficiencies and consistencies between teams, as well as helping to ensure best practices throughout the program. In addition, John Wall highlighted that APMA's efforts to spread jurisdiction oversight across the four teams, including three transfer pricing teams and one treaty interpretation ("TAIT") team, helped to create efficiencies and aid in case processing such that each manager and team had fewer countries to manage.

The annual statistics confirm John Wall's statement that 2023 was a very good year for APMA, with the competent authorities finally able to break through the impact of COVID and hold regular in-person meetings with treaty partners. The total number of APAs executed during 2023 was 156, more than double the number of APAs executed during 2022 (77). This included 130 bilateral APAs, 24 unilateral APAs, and two multilateral APAs. Renewal APAs comprised 47% of all APAs executed in 2023, compared to 55% of all APAs executed in 2022. Consistent with the recent history, renewal APAs continue to represent a large part (45%) of the pending APAs as of 31 December 2023. The APA program has been used by many of the same taxpayers for many reasons including the tax certainty it provides. As seen recently in *Coca-Cola Co. & Subs. v Commissioner*, 155 T.C. 145 (2020) and T.C. Memo. 2023-135, taxpayers can put themselves at risk when relying on only a prior settlement agreement with the IRS.

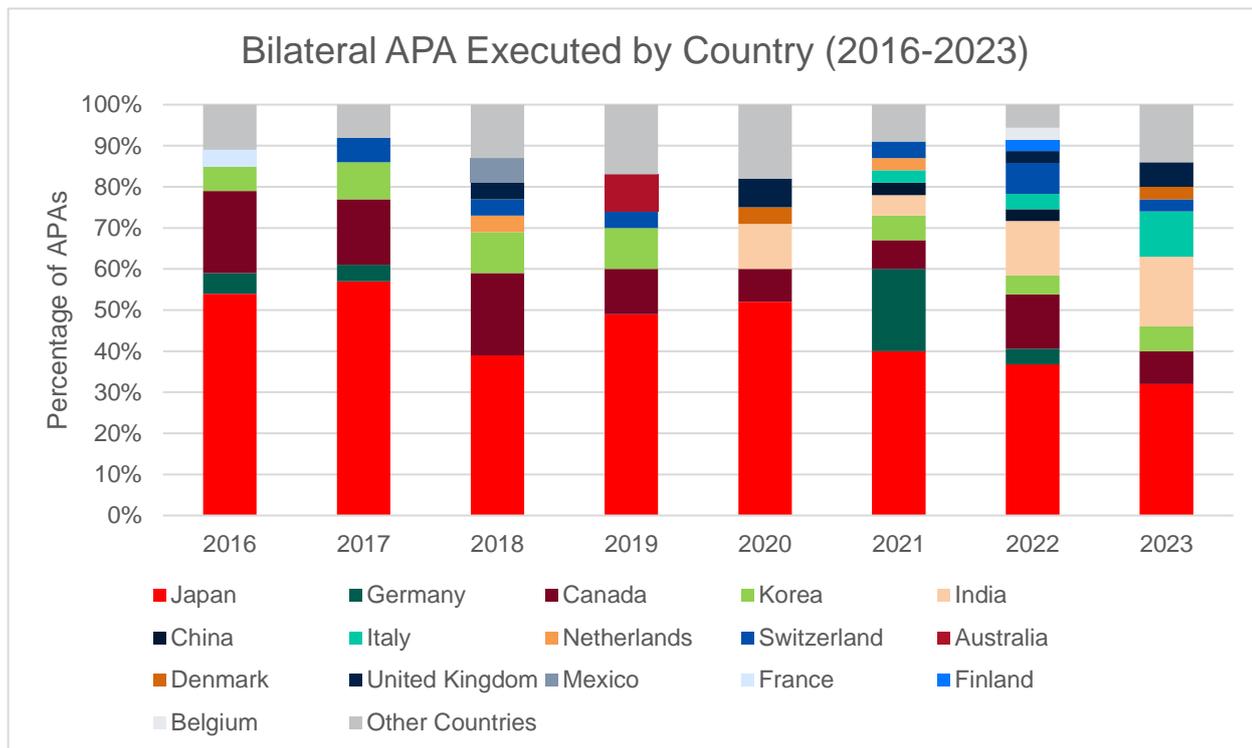
Similar to prior years, the majority (56%) of the APAs executed in 2023 involved transactions between non-US parents and US subsidiaries. As in 2022, no APAs were revoked or cancelled during 2023, though 13 APA requests were withdrawn.

For those APAs that were executed during 2023, the median time required to complete the APA decreased during 2023 to 42.0 months from 43.4 months in 2022, but it continued to be longer than prior years (35.1 months in 2021 and 32.7 months in 2020). These longer time frames likely continued to be due to the delays caused by pandemic-driven scheduling and travel limitations, as well as the brief reduction in APMA's staffing levels during 2022. For new APA requests, the median time to complete a unilateral APA was 34.9 months (average of 45.2 months) and a bilateral APA was 49.9 months (average of 50 months). Compared to 2022, the time to complete a new APA decreased during 2023, from 53 months in 2022 to 49.4 months in 2023. Renewal APAs continued to take less time to negotiate and complete, with the median time to complete a renewal unilateral APA taking 25.2 months (average of 30.2 months), and a bilateral APA taking 33.1 months (average 36.1 months).

These statistics demonstrate that APAs continue to require significant time and investment from taxpayers, though it is clear that APMA's increased staffing levels and efforts to increase efficiency (for example, via use of standardized reference sets for routine transactions and increased transparency) are beginning to result in better case processing times. We expect that these efforts will continue to be reflected in reduced case processing times. However, as noted by John Wall during the March Federal Bar Association panel, a contributing factor for longer case processing times is also delays caused by taxpayers, including not responding to due diligence requests on a timely basis. Thus, taxpayer participation and cooperation with the competent authorities in responding to due diligence requests and ensuring clear responses will likely help in driving these timing rates down. In addition, the OECD has also developed a [Bilateral Advance Pricing Arrangement Manual](#) as a guide for streamlining the bilateral APA process, providing tax administrations and taxpayers with information on the operation of bilateral APAs, and identifying 29 best practices for an effective and streamlined bilateral APA process, with an aim to reduce the average time to complete a new bilateral APA to 24 months for simpler cases and 30 months for more complex cases.

Similar to the trend relating to APA requests filed during 2023, Japan was also the primary bilateral APA treaty partner for the US for APAs executed during 2023, comprising 32% of the concluded APAs, followed by India (17%, up from 8% during 2022), Italy (11%), Canada (8%), and Korea and the United Kingdom (each at 6%).

¹ See, Michael Rapoport, "IRS Says 2023 Was Strong Year for Closing Advance Pricing Deals" Bloomberg, 5 March 2024.



APAs popular across industries, particularly manufacturing and wholesale/retail trade industries

This year's APA statistics exhibit the broad appeal of APAs across industries. Manufacturing and wholesale/retail trade industries continued to make up the majority of APAs executed in 2023, with 31% and 30% of the APAs, respectively. Compared to 2022, other industries comprised a greater percentage of APAs executed during 2023, similar to earlier years, with the services industry representing 17% of executed APAs (up from 12% in 2022), the finance, insurance, and real estate industry representing 12% of executed APAs (up from 4% in 2022), the management industry representing 6% of executed APAs (not separately reported in 2022), and all other industries comprising the remaining 4% of executed APAs.

Of the manufacturing APAs executed in 2023, 31% were related to transportation equipment manufacturing, 19% to chemical manufacturing, 17% to computer and electronic product manufacturing, 6% to machinery, and 17% to all other manufacturing. Of the wholesale/retail trade APAs executed in 2023, the majority continued to be within the merchant wholesales/durable goods industry (53%), followed by merchant wholesales/nondurable goods (21%), and clothing and clothing accessories stores (11%).

The majority of executed APAs covered transactions involving several different functions and risks, including research and development, design and engineering, manufacturing, marketing and distribution, and support functions. The annual report highlights that a significant amount of time in the APA process is dedicated to understanding the allocation of functions and risks among the covered parties. Thus, taxpayers can help to streamline the APA process by clearly detailing the allocation of functions, assets, and risks between the covered parties in the APA request.

The most common covered transactions of APAs executed in 2023 involved either the provision of services (representing 44% of covered transactions) or the sale of tangible property (36% of covered transactions), with the majority of tested parties being US distributors (42%), US manufacturers (13%) or non-US service providers (22%). In October 2023, the IRS announced a transfer pricing initiative targeting the transfer

pricing compliance of large foreign-owned multinational corporations engaging in distribution activities in the US. The announcement implies that many inbound companies operate unfairly in the US by using improper transfer pricing and indicates that the IRS would "crack down on this strategy" via the issuance of compliance alerts. By mid-November 2023, the IRS had sent 180 voluntary compliance letters to foreign-owned distributors (see our recent alert [here](#)). We expect that the IRS will likely expand its examinations on these transactions and recommend taxpayers to consider the APA program as an effective and efficient forum to resolve and prevent potential transfer pricing disputes in this area. In February 2024, the OECD released [additional guidance](#) on Amount B, which was initially introduced as a streamlined approach to provide a fixed return on baseline marketing and distribution activities (See our recent alert [here](#)). However, the latest guidance suggested that Amount B will be entirely optional and will not cover digital goods and services. With the additional uncertainty around whether the US will opt to adopt Amount B, we expect US distributors will continue to be a large part of the APA program.

While the percentage of covered transactions involving intangibles decreased from 2022, the 2023 statistics demonstrate that APAs continue to be an effective tool for addressing intangible property transactions, with 18% of covered transactions involving the use of intangible property. APMA again highlighted that these intangible property transactions tend to be the most challenging in APMA's inventory.

Comparable profits method/transactional net margin method continues to dominate

For 2023, the comparable profits method/transactional net margin method (CPM/TNMM) continued to be the most commonly applied TPM for tangible and intangible property transactions (applied to 80% of such transactions). The operating margin (i.e., the ratio of operating profit to sales) likewise continued to be the most common profit level indicator (PLI) used to benchmark results. The operating margin (defined as operating profit to sales) was used as a PLI in 60% of the executed APAs, while other PLIs, including the Berry Ratio (i.e., the ratio of gross profit to operating expenses) and return on total costs, comprised the remaining 40%.

For services transactions, a majority (86%) of APAs also used the CPM/TNMM as the TPM, with the operating margin and operating profit to operating expense being the most common PLIs (used 48% of the time).

Most covered transactions targeted an interquartile range, a point within the interquartile range, or another targeted arm's length range, whereas both specific royalty rates and ranges were used for transactions involving a royalty payment for the use of intangible property. Similar to prior years, the APAs executed in 2023 included testing periods for a single year, the term of the APA, or the term of the APA plus rollback years.

APA terms maintain a reasonable amount of prospectivity

APA term lengths, including rollback years, continued to average six years in 2023 (consistent with 2020-2022), with the largest number of APAs executed having a five-year term (nearly 45% of the total). Around 88% of the APAs executed in 2023 had terms of five or more years, with total terms ranging from two years to 14 years. Of the APAs executed in 2023, 19% included rollback years.

Conclusion

The 2023 APA statistics reflect a highly successful year for APMA and taxpayers utilizing the APA program in the US. They show that APAs continue to be an effective forum for taxpayers to proactively manage their transfer pricing disputes in a manner that minimizes exposure to potential penalties and double taxation, as

well as to efficiently resolve and prevent disputes with tax authorities in multiple jurisdictions that would likely require significantly more time and resources. We applaud the efforts that APMA has engaged in to increase efficiency, streamline APA processes, strengthen relationships with treaty partners, and create best practices. This has resulted in the highest number of executed APAs and improved case processing times. While the time to process and reach an agreement on an APA continues to be lengthy, we believe that these efforts by APMA will continue to pay off through reduced case processing times going forward, particularly for cooperative taxpayers that both provide robust, thoroughly-developed APA requests that support the method proposed and clearly delineate the functions, assets, and risks of the covered parties, and that respond on a timely basis to inquiries. We understand that the anticipated new APA revenue procedure is currently under review and APMA has carefully analyzed all recommendations received from the public. We hope that by taking into account the comments received and experience over the last nine years, the revised procedures will contain guidance that further streamlines the process and introduces case management tools to further improve case processing.

The 2023 APA statistics demonstrate that the APA process continues to be an excellent forum for preventing and resolving transfer pricing issues for a wide range of transactions and providing certainty to taxpayers across a wide range of industries. It is in the interest of both taxpayers and tax authorities to have a more efficient process with the aim of shorter negotiations and these 2023 statistics reflect APMA's efforts at improving the quality and timeliness of the APA program.

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