taxnotes® international

Volume 115, Number 2 ■ July 8, 2024

Record APA Execution Rates Indicate Return to Prepandemic Operations

by Mark R. Martin, Mark J. Horowitz, Thomas D. Bettge, and Caroline Conway

Reprinted from *Tax Notes International*, July 8, 2024, p. 223

tax notes international®

Record APA Execution Rates Indicate Return to Prepandemic Operations

by Mark R. Martin, Mark J. Horowitz, Thomas D. Bettge, and Caroline Conway

Mark R. Martin

Mark J. Horowitz

Thomas D. Bettge

Caroline Conway

Mark R. Martin is principal in charge of the economic and valuation services and tax controversy and dispute resolution groups of the Washington National Tax practice of KPMG LLP. Mark J. Horowitz is a principal in the tax controversy and dispute resolution group of the Washington National Tax practice. Thomas D. Bettge is a senior manager and Caroline Conway is a senior associate in the economic and valuation services group of the Washington National Tax practice.

In this installment of Practically Speaking: Tax Controversy, the authors examine the IRS's annual report on advance pricing agreements and offer insights for taxpayers navigating the changes.

I. The Report: APAs in 2023

The IRS's advance pricing and mutual agreement program released its annual report on advance pricing agreements, "Announcement and Report Concerning Advance Pricing Agreements," on March 29.[1] It outlines the APMA program's activities in negotiating and executing APAs, which offer taxpayers a proactive approach to resolving transfer pricing issues with the IRS.

A. APAs Filed, Executed, Pending, and Withdrawn

2023 saw a record high in APAs executed: a total of 156 — more than double the figure for 2022, surpassing the previous record of 145 set in 2013. While APA filings decreased slightly to 167 in 2023, down from 183 in 2022, they remained higher than any other year since 2018's high water mark. The average processing time for new bilateral and unilateral APAs was about 49.4 months in 2023, which is slightly lower than the 53-month average observed in 2022, but still well above the aspirational 24-month and 30-month timelines envisioned by the OECD's manual on

[1] Announcement 2024-16, 2024-16 IRB 909.

bilateral APAs.[2] In light of the continuing interest in APAs and the high volume of applications, this is not surprising. Withdrawn applications increased from six in 2022 to 13 in 2023, although as in most years, no APAs were revoked or canceled.

Analyzing the APMA statistics on a multiyear basis is crucial to comprehending the factors contributing to the surge in executed APAs in 2023. Somewhat surprisingly, in 2020 and 2021, the APMA statistics did not overtly reflect any notable effect from the COVID-19 pandemic. Rather, there was a slight uptick in the number of executed APAs in 2020 and 2021 compared with 2019 (127 in 2020 and 124 in 2021, as opposed to 120 in 2019) despite the shift to remote work for competent authorities around the world. Both years also saw an increase in APA filings, indicating strong taxpayer interest in the program amid the uncertainties of the pandemic. However, the pandemic's effects finally became apparent in 2022 when only 77 APAs were executed, the lowest number in over a decade.

Based on public comments from competent authority officials, it appears that the accomplishments of 2020 and 2021 can largely be attributed to the collaborative efforts of the IRS and its treaty partners in resolving simpler cases and cases that were already substantively underway before the pandemic. However, newer cases requiring more extensive fact-finding and negotiation did not advance as quickly as they typically would have because of reduced staffing and an inability to meet in person. Thus, considering the time needed to negotiate an APA, with many competent authorities meeting in person twice yearly and many cases requiring at least two meetings to resolve, the significant drop in APAs executed in 2022 is understandable as the reflection of a multiyear inventory management strategy, rather than the result of any occurrence specific to 2022. So it is not that the COVID-19 pandemic did not affect the APA process in 2020 and 2021, but its effect only became visible in the 2022 statistics.

The same multiyear perspective must be taken to understand the increase seen in 2023. It appears that a high number of APAs were substantially resolved around the end of 2022 but not executed until 2023. Indeed, the average number of APAs executed between 2022 and 2023 was about 117, which aligns with the historically high execution rates observed before the pandemic (120 in 2019 and 107 in 2018).

Further, after a dip in staffing in 2022, the APMA team appears to be returning to the high staffing levels achieved during 2021, when it had 80 team leaders (as opposed to only 59 in 2022), as well as 25 economists, nine managers, and three assistant directors. 2023 saw substantial hiring, with the APMA team consisting of 70 team leaders, 29 economists, 12 managers, and three assistant directors as of December 31, 2023, excluding treaty assistance and interpretation team personnel handling non-transfer-pricing cases. The increased number of managers reflects an organizational shift to operate through 12 manager-led teams (four per assistant director), rather than nine, which will hopefully allow the APMA program to devote more attention to relationships with individual treaty partners. The increase in staffing likely helped with the higher number of APAs executed in 2023, although its full effect may not be felt until future years.

Another significant development is the expansion of the APMA program's personnel locations. As of December 2023, the annual report listed offices in the District of Columbia, northern and southern California, Atlanta, Boston, Chicago, Denver, Miami, New York, and Seattle metropolitan areas. Previously, offices were only reported in the District of Columbia, northern and southern California, Chicago, and New York. "Offices" should be understood loosely, since the IRS has offices in all these cities (and many more). Thus a reported office location for the APMA program often simply reflects personnel being formally based in that city, rather than the APMA program having a large presence there. This increase in locations means taxpayers attending APMA conferences have more potential destinations, and the chance of having a team leader and economist in the same location is less than before the pandemic. There is now a material likelihood that taxpayers will have a hybrid meeting, especially as the APMA program has largely returned to its historical practice of

[2] OECD, "Bilateral Advance Pricing Arrangement Manual" (2022).

conducting in-person prefiling conferences for many APA requests (though videoconferencing remains common for more routine cases, such as renewals involving the comparable profits method, as well as for other, more ad hoc meetings).

Lastly, the composition of APAs executed by country may explain the disparity in APAs executed in 2022 compared with 2023. Like 2022, Japan led the pack in bilateral APA executions in 2023, with 32 percent of the total. Japan was followed by India (at 17 percent, up from 8 percent) and Italy (at 11 percent, up from 4 percent).[3] Notably, Canada, contributing only 8 percent of executed bilateral APAs in 2023, fell out of the top three countries for the first time since the release of country-level APMA statistics.[4] Japan also held the largest share of pending bilateral applications, with 25 percent of the total. India and Canada followed, at 23 percent and 13 percent, respectively.

The APMA statistics show a trend of increased concentration of APA applications within a relatively small group of countries. In 2023 Japan, Italy, and India accounted for about 60 percent of all executed APAs. Given this high level of concentration, the timing of a major negotiation session with one of the top three countries, for example, in December 2022 or January 2023, can considerably influence the APMA statistics for a particular year. While this scenario would affect the APMA statistics, it would not have a significant practical effect on taxpayers.

B. Substance of APAs: Industries, Transactions

Manufacturing and wholesale/retail trade remained dominant in 2023, constituting 31 and 30 percent of total APAs executed, trailed by services (17 percent); finance, insurance, and real estate (12 percent); and management (6 percent). All other industries made up the remaining 4 percent. In contrast, in 2022 manufacturing and wholesale/retail trade accounted for 82 percent of all APAs executed. This indicates a shift in the APA process as taxpayers in a growing number of industries seek certainty regarding transfer pricing.

Interestingly, despite the higher number of APAs executed for taxpayers in the finance, insurance, and real estate sector in 2023, the number of APAs executed for intercompany lending did not increase. Specifically, transactions involving the sale of tangible property, use of intangible property, and provision of services accounted for approximately 98 percent of all transactions covered in the APAs executed in 2023. Unless intercompany loans are classified as services in the statistics, which would be unusual given their separate categorization under the section 482 regulations, this type of transaction (together with any others in the catchall bucket) accounted for less than 2 percent of all APAs executed in 2023, the same as in 2022.

The introduction of new guidance from the OECD and heightened scrutiny from global tax authorities have led to an increase in audits and adjustments for financial transactions, particularly intercompany lending transactions.[5] The financial climate in the United States is marked by interest rates that have soared to a 23-year high, a scenario unparalleled in the history of modern transfer pricing enforcement, which began in the 1990s.[6] Issues around intercompany debt are thus likely to continue; however, this increase in audit activity has not yet led to a higher number of APAs focusing on these transactions. This discrepancy represents a missed opportunity for taxpayers.

---

[3]In 2023 the Italian Revenue Agency and the IRS finalized a framework agreement that facilitated the simultaneous resolution of many APA cases. This agreement is likely a driving factor behind the increase in APAs executed between the United States and Italy in 2023 and will hopefully continue to deliver efficiencies.

[4]Country-specific execution statistics were first made available for 2012. Announcement 2013-17, 2013-16 IRB 911.

[5]*See, e.g.*, Mark Martin and Thomas Bettge, "Advance Memorandum Shows IRS Approach to Intercompany Debt Pricing," *Int'l Tax Rev.* (Jan. 8, 2024) (discussing the IRS's position); Christian Engelen, "Stricter Transfer Pricing Rules for German Inbound Financing," *Tax Notes Int'l*, May 13, 2024, p. 989 (discussing Germany's 2024 Wachstumschancengesetz).

[6]The transfer pricing penalty regime was established during the 1990s, and the IRS enacted final regulations under section 482 in 1994 after a multiyear regulatory project to replace the prior regulations from 1968. The recent increase in interest rates means that transfer pricing adjustments regarding interest will carry much more weight than in the past, potentially leading to substantial financial consequences for taxpayers.

II. Other Developments

Recent policy updates could further increase interest in APAs and influence future APMA statistics. Pillar 2, for which model rules were released on December 20, 2021, seeks to ensure that large international businesses pay a 15 percent minimum level of tax in every jurisdiction.[7] This initiative has been adopted by many countries, and certain provisions became effective as of January 1, 2024. Pillar 2 is expected to increase tax planning and compliance complexity and has the potential to lead to double taxation because of asymmetric adjustments. Consequently, the importance of APAs and the tax certainty they provide is only going to increase, especially for taxpayers with low-taxed profits. This is evident in the general trend of increased APA filings after pillar 2's release.

Moreover, on February 19, the OECD/G20 inclusive framework on base erosion and profit shifting released a report on amount B — a simplified and streamlined approach to apply the arm's-length principle to baseline marketing and distribution activities, which in its current incarnation is optional for inclusive framework members.[8] This guidance, effective from January 2025, gives jurisdictions the option to apply the simplified and streamlined approach, either as a taxpayer safe harbor or a mandatory rule, or not to apply it at all. This optionality undermines amount B's goal of delivering improved tax certainty; even for baseline marketing and distribution activities, APAs will, for the foreseeable future, remain the optimal method for achieving binding certainty. Existing APAs will be respected, and bilateral APAs could provide certainty on outcomes that vary from the returns proposed under the simplified and streamlined approach — while transactions that qualify for amount B could potentially use that framework to gain APA certainty more efficiently, which may be especially desirable if one of the counterparty countries has not yet formally adopted amount B. Therefore, amount B could spur an increase in APA filings for distribution transactions.

Considering the increased complexity brought about by the OECD's BEPS project, and increased scrutiny regarding the performance of development, enhancement, maintenance, protection, and exploitation functions, control of risk, and exit taxes, the ability of APAs to deliver certainty is all the more important. These factors have also contributed to a more complicated landscape for mutual agreement procedure cases, further increasing the appeal of APAs. Lastly, the surge in global transfer pricing enforcement has altered the risk calculus, making APAs an increasingly attractive mechanism to manage and mitigate potential tax risks. While novel approaches such as the international compliance assurance program and joint audits have been introduced, these programs have not diminished interest in APAs. However, these approaches could serve as complementary or alternative procedural approaches, offering a broader range of options for taxpayers navigating the evolving global tax landscape.[9] ■

[7] OECD, "Tax Challenges Arising From Digitalisation of the Economy — Global Anti-Base Erosion Model Rules (Pillar Two)" (Dec. 20, 2021).

[8] OECD, "Pillar One — Amount B" (Feb. 19, 2024).

[9] The information in this article is not intended to be "written advice concerning one or more federal tax matters" subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230 because the content is issued for general informational purposes only. The information contained in this article is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser. This article represents the views of the authors only, and does not necessarily represent the views or professional advice of KPMG LLP, the U.S. member firm.