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INSIGHT: Advance Pricing Arrangement Series: Americas



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Bilateral Advance Pricing Agreements (APAs) began as two pilot projects between the U.S. and, respectively, Canada, and Australia in the early 1990's. While the programs have much evolved since then, the value and importance of APAs in the prevention of double taxation and the avoidance of often difficult transfer pricing audits has been undeniable.

In the years following the Organization for Economic Cooperation and Development (OECD) action plan against Base Erosion and Profit Shifting (BEPS), KPMG is expecting a significant increase in transfer pricing controversy. This rise of transfer pricing controversy is fueled by an increase in exchange of information between tax authorities, the number and qualification of tax auditors, tax authority aggressiveness, tax authorities' use of technology to identify transfer pricing risks and inconsistencies, developing tax laws and regulations, and public pressure on governments to increase revenues generated from corporate income taxes. Thus, KPMG has seen an increase of APA applications across the Americas. This article focuses on the APA programs in Canada, Mexico, Peru, and the U.S.

HISTORICAL OVERVIEW

Canada

APAs are the Canada Revenue Agency's (CRA) method of choice to resolve transfer pricing issues. Given the efficiency and experience of the CRA on these matters, taxpayer interest in APAs continues to surpass CRA resources, resulting in the CRA's restrict-

ing access to the APA program to only the most suitable taxpayer candidates.

Since its inception in 1993, the APA program has become a key compliance tool for the CRA. The intent of the program is to foster a collaborative and cooperative relationship between the taxpayer and the CRA in order to reach a reasonable conclusion for both parties. Over the course of its almost 30-year existence, the APA program has shown that communication, transparency, and compromise result in mutually agreeable resolutions to various transfer pricing issues on a proactive and, in some cases, retroactive, basis.

Mexico

APAs were introduced in Mexico during the 1990's, as a result of Mexico's adoption of the OECD's transfer pricing approach. Within the Large Taxpayers Unit at the Mexican Tax Administration (SAT), there is a team specialized in solving APAs, whose members are not involved on any audit procedures.

On the international field, Mexico has signed tax treaties with more than 60 countries. In the majority of these treaties, bilateral APA procedures are contemplated.

APAs in Mexico mainly involve Maquiladora companies, which are enterprises operating in Mexico under a contract manufacture structure, with the particularity that the inventories and assets used in their business operations are owned by their related parties abroad, and all the finished goods they produce are exported. APAs are used because entities operating under this regime are required by the law to price their intercompany transactions based either on a safe-harbor or on an APA in order to fulfill their transfer pricing requirements.

Peru

APAs were first introduced in the Peruvian Income Tax Law in August 2001, which became effective in 2002. At the time, the rules contemplated only the possibility of executing APAs for international controlled transactions. However, the APA program could not become effective at that time since more detailed rules were required in order to define what the exact procedures would be for applying for an APA in practice.

It took many years for the regulators to finally draft such detailed rules, which were published in 2012 and 2013. These new rules opened up a couple of doors. First, APAs may now be executed for local controlled transactions, which are also an important part of the universe of transactions covered by local transfer pricing rules. Second, bilateral APAs may be executed between the Peruvian tax authority and foreign tax authorities with which Peru has Double Taxation Agreements. The new rules defined the characteristics and scope of APAs in Peru, the procedures needed for sending an APA proposal, the desired content of the APA proposals, as well as the rules applicable for the tax authorities to approve or disregard the APA proposals. The APA rules are not only very clear, detailed, and complete but they also rely on OECD recommendations.

Aside from minor modifications, the APA program remains unchanged since its adoption.

United States

The APA program began in 1991 as an alternative dispute resolution program in response to Internal Revenue Service and taxpayer dissatisfaction with the traditional mechanisms for handling transfer pricing cases—characterized as “trench warfare” by the then IRS Commissioner Fred Goldberg in his testimony before the Subcommittee on Oversight, Committee on Ways and Means, U.S. House of Representatives. Subsequently, then IRS Commissioner Charles Rossotti explained the program is “to some extent about improved service to taxpayers and to some extent about improved compliance.” It is an entirely voluntary program, premised on the notion that, according to then Assistant Treasury Secretary (Tax Policy) John Samuels, “Both sides win in an APA: The taxpayer obtains certainty, and the IRS . . . can devote fewer resources to subsequent audits of the taxpayer’s business.”

The program has been successful and has served as a model for programs in other countries.

Many of the features of the U.S. APA program have been consistent throughout its life. The bilateral APA inventory has been dominated by cases with Japan and Canada, which in many years account for 60% or more of all U.S. bilateral cases.

Foreign-parented companies are, and always have been, disproportionately represented in the U.S. program. Of the first 100 applications filed in the early and mid-1990s, 60% were filed by foreign-parented companies. This percentage has remained largely the same throughout the program’s history, continuing to the present. Over the last five years (2014-2018), approximately 70% of the 420 executed APAs for which information is available have involved foreign-parented companies.

CURRENT STATISTICS

Canada

According to the most recent data, over the 2013–2017 period, the CRA received, on average, 24 pre-file meeting requests per year. Indeed, in 2017 there were exactly 24 pre-file meeting requests, of which 16 were accepted by the CRA. Over the 2015–2017 period, the CRA has done an impressive job of reducing its inventory of APAs: at the end of 2015 its inventory of in-process APAs was 107, yet by the end of 2017 it had reduced that number to 67. This is likely reflective of the increasing resources the CRA has put towards its APA program, and a commitment by the CRA (to taxpayers and tax authorities alike) to reduce the completion time for an APA. For example, in 2013 the median time to complete a bilateral APA (which comprises 90% of the current APA inventory) was almost 57 months, whereas by 2017 the CRA had reduced that to less than 48 months (a modest improvement, but there are signs that indicate that this trend is expected to continue).

Since Dec. 15, 2010, bilateral APAs with the U.S. are subject to the mandatory binding arbitration feature of the U.S.-Canada tax treaty, with one important distinction: the two-year timeline for mandatory arbitration under the mutual agreement procedure is generally extended to four years for an APA. Obviously, with the average time to complete an APA around 48 months from official acceptance to completion, staying within the four-year mark of the mandatory arbitration can be challenging.

The applicable foreign tax authority with which APAs are negotiated generally reflects the trade characteristics of the Canadian economy: over the course of the APA program, 72% of all bilateral/multilateral APAs were with/involved the U.S. At the end of 2017, this figure had decreased to 53%. This decrease reflects the broadening scope of the Canadian economy, and the desire of the CRA to undertake APAs with a variety of other countries. The other jurisdictions with which Canada has been involved in APAs include: Austria, Australia, Chile, China, Denmark, France, Germany, Hong Kong, India, Ireland, Italy, Japan, the Netherlands, New Zealand, Portugal, Singapore, South Korea, Sweden, Switzerland, and the U.K.

Mexico

To date, the SAT does not publish any official statistics on APAs. However, it is understood that APAs are generally resolved between 18 and 36 months.

Even though there are no official data available, SAT officers have publicly stated that using an approach such as the methodology negotiated between the IRS and SAT known as the Qualified Maquila Approach (QMA) has been extremely efficient, since more than 600 APAs have been solved unilaterally, with no double taxation effects for the counterparties in the U.S.

Peru

Even though there are no publicly available statistics on the APA program in Peru, it is well known that no APA has actually been signed in Peru to date.

After the launch of the complete rules in 2012-2013, some companies showed interest in applying for the APA program and a few of them initiated the process of pre-filing meetings with the tax authorities.

However, the companies that initiated these processes dropped their intention to continue with their APA applications due to difficulties during the process. Specifically, the companies felt that the amount of information they needed to gather to continue with the process was not worth the effort, especially considering that the transactions that were originally selected for the first APA attempts were usually low-to-medium risk transactions.

United States

The U.S. APA program continues to be popular and to perform well. It received 203 APA requests in 2018, an all-time high and more than double the number filed in either 2017 or 2016 (101 and 98 requests, respectively). It executed 107 APAs in 2018, which is an average number in recent years.

Seventy-eight percent of the APAs executed in 2018 were bilateral or multilateral. Of the bilateral APAs, 39% were with Japan, 20% were with Canada, 10% with Korea, and 6% with Mexico.

The program ended 2018 with an inventory of 458 cases, 87% bilateral, including approximately 120 cases with Japan and 75 to 80 cases with India.

The APA program continues to be challenged by timeliness issues. The average time to complete a bilateral APA in 2018 was 46 months, slightly longer than in 2016 and 2017 (42 months each) and longer than the prior 10-year average (also 42 months). Unilateral APAs took less time (33 months on average). These timeliness issues have been a feature of the program for decades and are likely to remain.

Other notable trends include the lengthening of APA terms. The average term of an APA executed during the first 10 years of the program was just 4.5 years. In 2018 and over the 3-year period 2016-2018, the average term of an APA has been extended to 6.8 years. It is now not unusual for an APA term to be 10 years or more—and this was a feature of 17 of the 107 APAs executed in 2018.

The final trend to note is the dramatic shift towards bilateral APAs versus unilateral APAs. Over the first 10 years of the program, bilateral APAs accounted for 51% of the APAs executed. That percentage has grown steadily and in 2018 and over the last three years (2016-2018), that figure is 78% and 76%, respectively. The increase in the bilateral inventory is due to increasing availability of the bilateral process as foreign tax authorities bring their APA programs online, including countries such as India, China, Switzerland, and Italy. A second reason for the trend to bilateral APAs is a shift in the role played in many cases by the U.S. APA program. In the early days, many taxpayers were driven to the U.S. APA program to seek an alternative to an IRS field examination, where they may have had, or feared, a bad experience. In more recent years, they enter the U.S. APA program seeking to enlist the U.S. as a counterweight to challenges they face or anticipate with tax authorities abroad. The ever-increasing aggressiveness of foreign tax authorities has prompted taxpayers to initiate the bilateral APA process to give the IRS a seat at

the table and to enlist its support to achieve tax certainty on a reasonable basis.

RECENT DEVELOPMENTS

Canada Given the significant taxpayer interest in APAs, it is no surprise that the CRA restricts access to the APA program by admitting only those taxpayers that they believe are suitable candidates. This is in contrast to some other tax authorities where access is not as restricted. Indeed, the CRA stated in its annual report that its vetting process “will help ensure that only taxpayers who are willing to openly work with the CRA will be permitted access to the APA program.” We expect this trend to continue.

Further to the above, given the success of the APA program in Canada, taxpayer demand for APA renewals is also high. Prior to 2019, the CRA typically conducted in-person APA site visits for APA renewals. However, in 2019 this policy was changed such that in-person APA site visits for renewals will only be undertaken when a change in the applicable facts deems it necessary (e.g. a significant change in the operations of the taxpayer). Otherwise, APA site visits for renewals are expected to be conducted via conference or video calls.

Mexico

From 2014 to 2016, the SAT received around 750 unilateral APA requests from maquiladora entities in Mexico, where almost 90% of them were handling intercompany transactions with their related parties in the U.S. Given the volume of APA requests, and in order to optimize the resolution process, in October 2016 the IRS and the SAT concluded the negotiation of a transfer pricing methodology to benchmark the maquila services transaction related to the APA requests, which was named QMA. Afterwards, the SAT solved more than 600 maquila APAs unilaterally between 2017 and 2018, contemplating the avoidance of any possible double-taxation effects for the parent entities in the U.S., since the QMA was agreed to between both competent authorities.

The QMA brought significant advantages for the taxpayers, as well as both competent authorities, including:

- *Unilateral solution:* Taxpayers did not need to file bilateral requests in order to avoid any double-taxation effects related to the unilateral APA filed to the Mexican authorities.

- *Transfer pricing audit avoidance:* Since the methodology was agreed to bilaterally, there is no need for the authorities involved to invest any time on auditing the arm’s length consistency of the intercompany transaction.

- *Rapid resolution:* Once the framework was finished, more than 600 APAs were solved systematically in almost two years, meaning on average the SAT issued 25 rulings per month.

- *Certainty:* A bilateral agreement like this reflects a collaborative environment between the competent authorities of both countries, which gives taxpayers certainty in the way they conduct their intercompany transactions with regard to the taxes to report in each

jurisdiction.

In 2016, the SAT published broader guidance on APA filing requirements, increasing the amount of data and documents to be filed with APA request.

The countries that Mexico usually conducts APA negotiations with include the U.S., Germany, Switzerland, Japan, and Canada.

Peru

The Peruvian Tax Authorities have recently stated their decision to re-launch the APA program and make it more attractive to companies.

This intention is accompanied by an increase in transfer pricing audits, which is likely to create new interest in APAs. The Peruvian Tax Authorities performed approximately 50 transfer pricing audits in 2018, with a result of transfer pricing adjustments for approximately US\$ 270 million. The number of transfer pricing audits is expected to show a 60% increase, reaching 80 cases in 2019. In order to administer the audits, the tax authority has significantly grown its transfer pricing team, recruiting several professionals from the private sector. The main focus of these audits will be intragroup services, financial transactions, and commodities, in addition to the usual focus on low risk distributors seen in previous years. This audit activity is likely to generate an increased interest in the APA program.

United States

Effective Jan. 1, 2019, the IRS user fee for most taxpayers filing an APA request was increased to \$113,500 for a new APA and to \$62,000 for a renewal APA, nearly doubling the fees that had been put in place at the end of 2015. The size of the user fee makes it imperative for taxpayers contemplating multiple APAs to take advantage of the provision allowing for multiple APA requests to be filed for a single user-fee (or for a greatly reduced user-fee) so long as the requests are filed within a single 60-day period.

In February 2019, the IRS's Advance Pricing and Mutual Agreement Program (APMA) released a Functional Cost Diagnostic Model (FCDM) that it will use when evaluating certain APA requests. The model asks for certain data to facilitate a high-level residual profit-split method (RPSM) analysis. An APMA spokesperson advises that the FCDM does not signal that APMA will necessarily make greater use of the RPSM approach. Whether a taxpayer will be expected to complete the FCDM is a matter that should be discussed with the APMA program when considering an APA submission.

Finally, the U.S. continues to expand the practical reach of its bilateral APA network. It has approximately a dozen APA cases pending with China, where progress has been reported, and has established strong APA relationships with Switzerland, the Netherlands, Italy, India, and other countries that historically had few, if any, cases with the U.S.

KEY TAKEAWAYS

Canada

The CRA's APA program is a successful and efficient program, and this has resulted in increased demand by

taxpayers for access to the APA program. Taxpayers wanting to be admitted into the APA program should be prepared to work with the CRA in a non-adversarial manner where the ultimate goal is to reach an agreement that reflects the arm's-length principle. Taxpayers that are unwilling to do so are not likely to be admitted into the APA program.

Mexico

While pre-filing meetings are not mandatory, they are encouraged in order to start the APA process off smoothly with a high level of communication.

Because of the joint development of a the transfer pricing methodology by the SAT and IRS, there is now a high level of certainty provided to the maquiladora industry, since transfer pricing double-taxation risks related were significantly minimized.

Peru

The main takeaway from the Peruvian experience, which probably applies to most countries in the region (except for Mexico), is that it is not enough to have best-in-class APA rules in place in order for an APA program to launch effectively and be attractive to taxpayers. It is also necessary to work on the practical aspects of the program in order for it to be successful.

In addition, the Peruvian tax authority is one of the most enthusiastic institutions in Peru's effort to formally join the OECD by 2021, and having a successful APA program is a credential that the country would certainly like to show during this process. Therefore, it is expected that they will work on improving the APA program so that this mechanism becomes more attractive to companies.

United States

The APMA program's record number of APA requests in 2018 (more than 200!) is a testament to its popularity and success. Its record inventory (more than 450) is a challenge to its timeliness goals.

The APMA program has a deserved reputation for handling cases in a smart, responsible manner. It takes principled positions and works effectively with treaty partners to reach agreement in the vast majority of cases. Major treaty partners such as Japan, Canada, Korea, and Mexico still account for most of the bilateral inventory, but there are now fully functioning bilateral APA opportunities with China, Switzerland, The Netherlands, India, and other countries.

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