Announcement and Report Concerning Advance Pricing Agreements

Announcement 2002–40

March 29, 2002

This Announcement is issued pursuant to § 521(b) of Pub. L. 106–170, the Ticket to Work and Work Incentives Improvement Act of 1999, requiring that the Secretary of the Treasury annually report to the public concerning Advance Pricing Agreements (APAs) and the APA Program. The first report, in Announcement 2000–35 (2000–1 C.B. 922), covered calendar years 1991 through 1999. The second report, in Announcement 2001–32 (2001–17 I.R.B. 1113), described the experience of the APA Program during calendar year 2000. This third report describes the experience of the APA Program during calendar year 2001 consistent with the mandate of § 521(b). This document does not provide general guidance regarding the application of the arm's length standard; rather, it reports on the structure and activities of the APA program.

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Background

IRC § 482 provides that the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among two or more commonly controlled businesses if necessary to reflect clearly the income of such businesses. Under the regulations, the standard to be applied in determining the true taxable income of a controlled business is that of a business dealing at arm's length with an unrelated business. The arm's length standard also has been adopted by the international community and is incorporated into the transfer pricing guidelines issued by the Organization for Economic Cooperation and Development (OECD). OECD, TRANSFER PRICING GUIDELINES FOR MULTINATIONAL ENTERPRISES AND TAX ADMINISTRATORS (1995). Transfer pricing issues by their nature are highly factual and have traditionally been one of largest issues identified by the IRS in its audits of multinational corporations. The Advance Pricing Agreement (APA) Program is designed to resolve actual or potential transfer pricing disputes in a principled, cooperative manner, as an alternative to the traditional examination process. An APA is a binding contract between the IRS and a taxpayer by which the IRS agrees not to seek a transfer pricing adjustment under IRC § 482 for a covered transaction if the taxpayer files its tax return for a covered year consistent with the agreed transfer pricing method. In year 2001, the IRS and taxpayers executed 55 APAs and amended 7 APAs.

Since 1991, with the issuance of Rev. Proc. 91–22 (1991–1 C.B. 526), the IRS has offered taxpayers through the APA Program the opportunity to reach an agreement in advance of filing a tax return on the appropriate transfer pricing methodology (TPM) to be applied to related party transactions. In 1996, the IRS issued internal procedures for processing APA requests. Chief Counsel Directives Manual (CCDM), ¶¶(42)(10)10–(42)(10)(16)0 (November 15, 1996). Also in 1996, the IRS updated Rev. Proc. 91–22 with the release of Rev. Proc. 96–53 (1996–2 C.B. 375). The APA Program continues to operate under the provisions of Rev. Proc. 96–53, which provides taxpayers with instructions of how to apply for an APA, and what to expect in the processing of the case.[1] In addition, in 1998, the IRS published Notice 98–65 (1998–2 C.B. 803), which set forth streamlined APA procedures for Small Business Taxpayers (SBTs). That Notice also expanded the availability of the lowest APA user fee in an effort to attract taxpayers who may not have the resources to do the sophisticated economic studies normally required in APA submissions.

Advance Pricing Agreements

An APA generally combines an agreement between a taxpayer and the IRS on an appropriate transfer pricing methodology (TPM) for the transactions at issue (Covered Transactions) with an agreement between the U.S. and one or more foreign tax authorities (under the authority of the mutual agreement process of our income tax treaties) that the TPM is correct. With such a “bilateral” APA, the taxpayer ordinarily is assured that the income associated with the Covered Transactions will not be subject to double taxation by the IRS and the foreign tax authority. It is the policy of the United States, as reflected in § 7 of Rev. Proc. 96–53 to encourage taxpayers that enter the APA program to seek bilateral or multilateral APAs when competent authority procedures are available with respect to the foreign country or countries involved. However, the IRS may execute an APA with a taxpayer without reaching a competent authority agreement (a “unilateral” APA).

A unilateral APA is an agreement between a taxpayer and the IRS establishing an approved transfer pricing methodology for U.S. tax purposes. A unilateral APA binds the taxpayer and the IRS, but obviously does not prevent foreign tax administrations from taking different positions on the appropriate transfer pricing methodology for a transaction. As stated in Rev. Proc. 96–53, should a transaction covered by a unilateral APA be subject to double taxation as the result of an adjustment by a foreign tax administration, the taxpayer may seek relief by requesting that the U.S. competent authority consider initiating a mutual agreement proceeding, provided there is an applicable income tax treaty in force with the other country.

When a unilateral APA involves taxpayers operating in a country that is a treaty partner, information relevant to the APA (including a copy of the APA and APA annual reports) may be provided to the treaty partner under normal rules and principles governing the exchange of information under income tax treaties.

The APA Program

APAs are negotiated with the taxpayer by an IRS team headed by an APA team leader. As of December 31, 2001, the APA program had 22 team leaders, of whom 21 were attorneys and 1 was a former international examiner. The team leader is responsible for organizing the IRS APA team, arranging meetings with the taxpayer, securing whatever information is necessary from the taxpayer to analyze the taxpayer’s related party transactions, analyzing the available facts under the arm’s length standard of § 482 and the regulations, and negotiating with the taxpayer.

The APA team generally includes an economist, an international examiner and, in a bilateral case, a competent authority analyst who leads the discussions with the treaty partner. The economist may be from the APA Program or from the IRS field organization. The APA team may include LMSB field counsel, other LMSB exam personnel, and an appeals officer.

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[1] In an effort to encourage taxpayers to utilize the APA process, in 1997 the IRS instituted an Early Referral Program by which, in appropriate cases, field examination teams may suggest to taxpayers that APAs be pursued before substantial time is spent examining transfer pricing issues. Since the reorganization of the IRS in 2000 into separate business units, the Large & Midsize Business (LMSB) Division has encouraged taxpayers to resolve their issues through a variety of pre-filing programs, including APAs. As a result, the IRS is no longer separately tracking APA cases under the 1997 Early Referral Program.

The APA Process

The APA process is voluntary. Taxpayers submit an application for an APA, together with a user fee as set forth in Rev. Proc. 96–53. The APA process can be broken into five phases: (1) application; (2) due diligence; (3) analysis; (4) discussion and agreement; and (5) drafting and execution.

(1) *The APA Application*

In many APA cases, the taxpayer's application is preceded by a pre-file conference with the APA staff in which the taxpayer can solicit the informal views of the APA Program. Pre-file conferences can occur on an anonymous basis, although a taxpayer must disclose its identity when it applies for an APA. Taxpayers must file the appropriate user fee on or before the due date of the tax return for the first taxable year that the taxpayer proposes to be covered by the APA. Many taxpayers file a user fee first and then follow up with a full application later. The procedures for pre-file conferences, user fees, and delayed applications can be found in Rev. Proc. 96–53.

The APA application can be a relatively modest document for a small business taxpayer. Notice 98–65 describes the special APA procedures for small businesses. For most taxpayers, however, the APA application is a substantial document filling several binders. The APA Program makes every effort to reach agreement on the basis of the information provided in the taxpayer's application.

The application is assigned to an APA team leader who will be responsible for the case. The APA team leader's first responsibility is to organize the APA team. This involves contacting the appropriate LMSB International Territory Manager to secure the assignment of an international examiner to the APA case and the LMSB Counsel's office to secure a field counsel lawyer. In a bilateral case, the U.S. Competent Authority will assign a competent authority analyst to the team. In a large APA case, the international examiner may invite his or her manager and other LMSB personnel familiar with the taxpayer to join the team. When the APA may affect taxable years in Appeals, the appropriate appellate conferee will be invited to join the team. The APA team leader will then distribute copies of the APA application to all team members and will set up an opening conference with the taxpayer. The APA office strives to hold this opening conference within 45 days of the receipt of the complete application. At the opening conference, the APA team leader will propose a schedule designed to complete the recommended U.S. negotiating position for a bilateral APA within 9 months from the date the full application was filed and to complete a unilateral APA within 12 months from the application date. In 2001, the median for completing negotiating positions was 22.9 months (average 25.6), and the median for completing unilateral APAs was 16.0 months (average 16.8).

(2) *Due Diligence*

The APA team must satisfy itself that the relevant facts submitted by the taxpayer are complete and accurate. This due diligence aspect of the APA is vital to the process. It is because of this due diligence that the IRS can reach advance agreements with taxpayers in the highly factual setting of transfer pricing. Due diligence can proceed in a number of ways, but in a large case the taxpayer and the APA team typically will agree to a meeting, or more often to a series of meetings on dates, established in the opening conference. In advance of the meeting, the APA team leader will submit a list of questions to the taxpayer for discussion at the meeting. The meeting may result in a second set of questions. These questions from the IRS are developed jointly by the APA team leader and the IRS field. It is important to note that this due diligence is not an audit and is focused only on the transfer pricing issues associated with the transactions in the taxpayer's application, or such other transactions that the taxpayer and the IRS may agree to add.

(3) *Analysis*

A significant part of the analytical work associated with an APA is done typically by the APA or IRS field economist assigned to the case. The analysis may result in the need for additional information. Once the APA team has completed its due diligence and analysis, the APA team leader will begin negotiations with the taxpayer over the various aspects of the APA including the selection of comparable transactions, asset intensity and other adjustments, the transfer pricing methodology, which transactions to cover, the appropriate critical assumptions, the APA term, and other key issues. The APA team leader will discuss particularly difficult issues with his or her managers, but in the main the APA team leader is empowered to negotiate the APA.

(4) *Discussion and Agreement*

This phase differs for bilateral and unilateral cases. In a bilateral case, the discussions proceed in two parts and involve two IRS offices — the APA Program and the U.S. Competent Authority. In the first part, the APA team will attempt to reach a consensus with the taxpayer regarding the recommended position that the U.S. Competent Authority should take in negotiations with its treaty partner. This recommended U.S. negotiating position is a paper drafted by the APA team leader and signed by the APA Director that provides the APA Program's view of the best transfer pricing methodology for the covered transaction, taking into account the IRC, the Treasury regulations, the relevant tax treaty, and the U.S. Competent Authority's experience with the treaty partner.

The experience of the APA office and the U.S. Competent Authority is that APA negotiations are likely to proceed more rapidly with a foreign competent authority if the taxpayer fully supports the U.S. negotiating position. Consequently, the APA Office works together with the taxpayer in developing the recommended U.S. position. On occasion, the APA team will agree to disagree with a taxpayer. In these cases, the APA office will send a recommended U.S. negotiating position to the U.S. Competent Authority that includes elements with which the taxpayer does not agree. This disagreement is noted in the paper. The APA team leader also solicits the views of the field members of the APA team, and, in the vast majority of APA cases, the international examiner, LMSB field counsel, and other IRS field team members concur in the position prepared by the APA team leader.

Once the APA Program completes the recommended U.S. negotiating position, the APA process shifts from the APA Program to the U.S. Competent Authority. The U.S. Competent Authority analyst assigned to the APA will take the recommended U.S. negotiating position and prepare the final U.S. negotiating position, which is then transmitted to the foreign competent authority. The negotiations with the foreign competent authority are conducted by the U.S. Competent Authority analyst, most often in face-to-face negotiating sessions conducted periodically throughout the year. At the request of the U.S. Competent Authority analyst, the APA team leader may continue to assist the negotiations.

In unilateral APA cases, the discussions proceed solely between the APA Program and the taxpayer. In a unilateral case, the taxpayer and the APA Program must reach agreement to conclude an APA. Like the bilateral cases, the APA team leader almost always will achieve a consensus with the IRS field personnel assigned to the APA team regarding the final APA. The APA Program has a procedure in which the IRS field personnel are solicited formally for their concurrence in the final APA. This concurrence, or any items in disagreement, is noted in a cover memorandum prepared by the APA team leader that accompanies the final APA sent forward for review and execution.

(5) *Drafting, Review, and Execution*

Once the IRS and the taxpayer reach agreement, the drafting of the final APA generally takes little time because the APA Program has developed standard language that is incorporated into every APA. The current version of this language is found in Attachment A. APAs are reviewed by the Branch Chief and the APA Director. In addition, the substance of each APA is briefed to the Associate Chief Counsel (International) (ACC(I)). On March 1, 2001, the ACC(I) delegated to the APA Director the authority to execute APAs on behalf of the IRS. *See* Chief Counsel Notice CC–2001–016. The APA is executed for the taxpayer by an appropriate corporate officer.

The Current APA Office Structure, Composition, and Operation

In 2001, the APA Office was restructured into four branches. Branches 1 and 3 are staffed with APA team leaders. Branch 2 is a new economist branch and also includes the team leader with the principle responsibility for annual report review. Branch 4 is the new APA West Coast office, located in San Francisco and staffed with a mix of APA team leaders and an economist. Also new in 2000 is a Special Counsel to the Director. As of December 31, 2001, the APA staff was as follows:

Director's Office 1 Director 1 Special Counsel to the Director 1 Secretary to the Director			
Branch 1 1 Branch Chief 1 Secretary 9 Team Leaders	*Branch 2* 1 Branch Chief 1 Team Leader 6 Economists	*Branch 3* 1 Branch Chief 1 Secretary 9 Team Leaders	*Branch 4* 1 Branch Chief 3 Team Leaders 1 Economist

The APA staffing grew dramatically in 2001, rising from 25 persons at the end of 2000 to 38 as of December 31, 2001. The APA Office also continued to experience relatively high turnover in the past year, although lower than the turnover experienced in 2000. Of the 25 people on the APA staff at the end of 2000, 6 were no longer on the staff at the end of 2001. The hiring and turnover combined to create a significant training challenge in 2001. As of December 31, 2001, 10 of the 22 team leaders and 5 of the 7 economists had been with the program less than a year. In addition, 3 of the 4 branch chiefs were new.

The number of team leaders grew from 16 to 22, while the number of economists increased from 3 to 7. Thus the relative number of economists increased substantially, from a ratio of 5 team leaders per economist, to almost 3 team leaders per economist. This increase in the relative number of APA economists is expected to have a salutary affect on APA case processing time. Historically, APA team leaders have reported that lack of economist support is one of the major impediments to timely case processing. Average caseloads fell from 13 APAs per team leader as of December 31, 2000, to 10 per team leader as of December 31, 2001. This should also help in case timeliness as relatively high case loads in prior years had made it difficult for APA team leaders to give adequate attention to all pending cases. As set forth in Table 1 below, new APA filings declined by 15% to 77 as compared to 91 in the prior year.

APA New Hire Training

In 2001, the APA Office greatly increased the size of its professional staff. To ensure the most immediate benefits from its new staff, provide the highest quality service to the program's customers, and increase the program's efficient use of its new resources, the APA Program worked with the Training and Communications Division of the Office of Associated Chief Counsel (Finance & Management) to develop an APA New Hire Training Program. The APA managers, senior Team Leaders and APA Economists participated in the training by developing a list of topics, preparing and reviewing course materials, and serving as class presenters.

The APA New Hire Training consisted of 19 three to four hour sessions presented throughout June, July, August, and September. The session topics included the history of the APA Program, general administrative matters, APA case management procedures, and substantive transfer pricing/APA topics.

The APA Office has released the written course materials to the public. These training materials and other APA related documents can be found at the IRS website, *www.irs.gov*, under an APA hyperlink under the Business/Corporate webpage. The APA Office will periodically update these training materials as appropriate.

APA West Coast Branch

In September 2001, the APA Program opened its new Branch 4 in California, implementing its plan to be more easily accessible to taxpayers located west of the Mississippi. Approximately 25% of APA caseload comes from such taxpayers, with the majority of these in California, divided almost evenly between Northern and Southern California. The APA Program determined that having Western cases serviced from California would benefit both taxpayers and APA staff by reductions in travel time, costs, and time zone complications, and by closer relations with Western taxpayers and taxpayer organizations.

The first of Branch 4's two planned offices is located in San Francisco and is already fully functional, staffed with a branch manager, three team leaders, and an economist. Numerous taxpayer representatives have contacted the office from its first days of operation; after six months, Branch 4 is handling a significant inventory of APA submissions and pre-filing conferences for Western cases. Plans for the second Branch 4 office are in the final stages. The office is expected to open during the first half of 2002 in Laguna Niguel in Orange County, about one hour south of Los Angeles. After hiring is complete, this office, like the San Francisco office, will have three team leaders and an economist. In addition, the branch chief of Branch 4 will be resident at the Southern California office, while continuing to manage the San Francisco office. The APA Program expects that its office in Southern California will meet with the same positive reaction among Western taxpayers, taxpayer organizations and their representatives that Branch 4's Northern California office is enjoying.

Model APA at Attachment A
[§ 521(b)(2)(B)]

Once the IRS and the Taxpayer reach agreement, the drafting of the final APA generally takes little time because the APA Program has developed model language. Attachment A contains the current version of this language. As part of its continuing effort to improve its work products, the APA Program has revised the model language to reflect the program's collective experience with substantive and drafting issues.

APA Program Statistical Data
[§ 521(b)(2)(C) and (E)]

The statistical information required under § 521(b)(2)(C) is contained in Tables 1 and 9 below; the information required under § 521(b)(2)(E) is contained in Tables 2 and 3 below:

TABLE 1: APA APPLICATIONS, EXECUTED APAs, and PENDING APAs

	Unilateral	Bilateral	Multilateral	Year Total	Cumulative Total
APA applications filed during year 2001	31	46		77	569
APAs executed					
•Year 2001	36	19		55	349
•1991–2000	143	144 [2]	7	294	
APA renewals executed during year 2001	14	2		16	70
Revised or Amended APAs executed during year 2001 [3]	6	1		7	12
Pending requests for APAs	40	177		217	
Pending requests for new APAs	34	132		166	
Pending requests for renewal APAs	6	45		51	
APAs canceled [4]	3	1		4	5
APAs withdrawn	1	4		5	54

TABLE 2: MONTHS TO COMPLETE APAs

Months to Complete Advance Pricing Agreements in Year 2001	
Combined Unilateral, Bilateral, Multilateral: Average	23.3
Combined Unilateral, Bilateral, Multilateral: Median	18.0

Unilateral New		Unilateral Renewal		Unilateral Combined	
Average	16.0	Average	18.1	Average	16.8
Median	15.5	Median	17.0	Median	16.0

Bilateral/Multilateral New		Bilateral/Multilateral Renewal		Bilateral/Multilateral Combined[5]	
Average	37.2	Average	21.0	Average	35.5
Median	42.0	Median	21.0	Median	42.0

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[2] One 1996 APA involving a US Possession is counted as a bilateral APA.

[3] In 2001, the APA Office and taxpayers agreed to amend 7 APAs (*i.e.*, six unilateral and one bilateral). Generally, the APA Office and taxpayers amended APAs to clarify the agreement. For example, five APA amendments related to: conforming the language of the APA to reflect the parties' agreement; conforming the language of the APA to the language of the mutual agreement letter; clarifying the definition of a term; clarifying non-covered transactions; and clarifying the length of the APA term. Failure to meet a critical assumption precipitated the amendment of two other APAs. In one of the APAs, the taxpayer failed to have minimum annual gross sales. In the other APA, the taxpayer reorganized its business.

[4] In the history of the APA Program, no APAs have been revoked. In 2001, the APA Office and taxpayers agreed to cancel 4 APAs (*i.e.*, three unilateral and one bilateral). The circumstances of these cancellations were the sale of the taxpayer's covered business operations, the failure of the taxpayer to have minimum covered transaction-related revenue, and the taxpayer's inability to operate due to equipment failure, and the takeover of the taxpayer resulting in a material change of its accounting systems.

[5] The average time required to conclude a bilateral APA has historically been split roughly equally between the APA and Competent Authority Offices.

TABLE 3: APA COMPLETION TIME – MONTHS PER APA

Months	Number of APAs	Months	Number of APAs	Months	Number of APAs	Months	Number of APAs
1	2	**16**	4	**31**	0	**46**	3
2	0	**17**	2	**32**	2	**47**	2
3	1	**18**	3	**33**	0	**48**	1
4	0	**19**	0	**34**	0	**49**	0
5	0	**20**	1	**35**	0	**50**	0
6	2	**21**	0	**36**	0	**51**	0
7	1	**22**	0	**37**	0	**52**	0
8	3	**23**	4	**38**	0	**53**	0
9	3	**24**	2	**39**	0	**54**	0
10	1	**25**	0	**40**	0	**55**	0
11	2	**26**	0	**41**	0	**56**	2
12	1	**27**	2	**42**	5	**57**	0
13	2	**28**	0	**43**	0	**58**	0
14	1	**29**	1	**44**	1	**59**	0
15	1	**30**	0	**45**	0	**60**	0

TABLE 4: RECOMMENDED NEGOTIATING POSITIONS

Recommended Negotiating Positions Completed in Year 2001	43

TABLE 5: MONTHS TO COMPLETE RECOMMENDED NEGOTIATING POSITIONS

Combined		New		Renewal	
Average	25.6	Average	22.2	Average	30.0
Median	22.9	Median	17.8	Median	23.3

TABLE 6: RECOMMENDED NEGOTIATING POSITIONS COMPLETION TIME – MONTHS PER APA

Months	Number	Months	Number	Months	Number	Months	Number
1	0	**26**	0	**51**	0	**76**	0
2	0	**27**	2	**52**	1	**77**	0
3	0	**28**	0	**53**	0	**78**	0
4	2	**29**	0	**54**	0	**79**	0
5	0	**30**	0	**55**	0	**80**	0
6	0	**31**	0	**56**	0	**81**	0
7	0	**32**	0	**57**	0	**82**	0
8	0	**33**	1	**58**	0	**83**	0
9	1	**34**	1	**59**	0	**84**	0
10	1	**35**	0	**60**	1	**85**	0
11	2	**36**	0	**61**	0	**86**	0
12	1	**37**	1	**62**	0	**87**	0
13	1	**38**	0	**63**	0	**88**	0
14	7	**39**	1	**64**	0	**89**	0
15	2	**40**	0	**65**	0	**90**	0
16	0	**41**	0	**66**	0	**91**	0
17	0	**42**	0	**67**	0	**92**	0
18	1	**43**	1	**68**	0	**93**	1
19	0	**44**	1	**69**	0	**94**	0
20	1	**45**	0	**70**	0	**95**	0
21	0	**46**	0	**71**	0	**96**	0
22	4	**47**	1	**72**	0	**97**	0
23	4	**48**	1	**73**	0	**98**	0
24	1	**49**	0	**74**	0	**99**	0
25	2	**50**	0	**75**	0	**100**	0

TABLE 7: SMALL BUSINESS TAXPAYER APAs[6]

Small Business Taxpayer APAs Completed in Year 2001	11
Renewals	1
New	10
Unilateral	10
Bilateral	1

TABLE 8: MONTHS TO COMPLETE SMALL BUSINESS TAXPAYER APAs

Months to Complete Small Business Taxpayer APAs in Year 2001					
New		**Renewal**		**Combined**	
Average	15.4	Average	9.0	Average	14.8
Median	17.0	Median	9.0	Median	17.0

[6] A "small business taxpayer" is a U.S. taxpayer with a total gross income of $200 million or less, and the APA is processed under the special procedures set forth in Notice 98–65.

TABLE 9: INDUSTRIES COVERED

Industry Involved — NAICS Codes[7]	Number
Computer and electronic product manufacturing – 334	13–15
Machinery manufacturing – 333	4–6
Electrical equipment, appliance and component manufacturing – 335	4–6
Transportation equipment manufacturing – 336	4–6
Chemical manufacturing – 325	4–6
Wholesale trade, durable goods – 421	1–3
Securities, commodity contracts and other intermediary and related activities – 523	1–3
Apparel manufacturing – 315	1–3
Motor vehicle and parts dealers – 441	1–3
Air transportation – 481	1–3
Publishing industries – 511	1–3
Information service and data processing services – 514	1–3
Beverage and tobacco manufacturing – 312	1–3
Furniture and related products manufacturing – 337	1–3
Miscellaneous manufacturing – 339	1–3
Wholesale trade, nondurable goods – 422	1–3
Health and personal care stores – 446	1–3
Broadcasting and telecommunications – 513	1–3
Professional, scientific and technical services – 541	1–3

Trades or Businesses
[§ 521(b)(2)(D)(i)]

The nature of the relationship between the related organizations, trades, or businesses covered by APAs executed in Year 2001 are set forth in Table 10 below:

TABLE 10: NATURE OF RELATIONSHIPS BETWEEN RELATED ENTITIES

Relationship	Number of APAs
Foreign Parent – U.S. Subsidiary (-ies)	34
U.S. Parent – Foreign Subsidiary (-ies)	12
Foreign company and U.S. Branch (-es)	6
U.S. Company and Non-U.S. Branch (-es)	2
Partnership	1

Covered Transactions
[§ 521(b)(2)(D)(ii)]

The controlled transactions covered by APAs executed in Year 2001 are set forth in Table 11 and Table 12 below:

[7] The categories in this table are drawn from the North American Industry Classification System (NAICS), which has replaced the U.S. Standard Industrial Classification (SIC) system. NAICS was developed jointly by the U.S., Canada, and Mexico to provide new comparability in statistics about business activity across North America.

TABLE 11: TYPES OF COVERED TRANSACTIONS

Transaction Type	Number
Sale of tangible property into the US	29
Performance of services by US entity	19
Performance of services by Non-US entity	11
Sale of tangible property from the US	10
Use of intangible property by US entity	8
Use of intangible property by Non-US entity	7
Financial products — US branch of foreign company	3
R&D cost sharing — Non-US parent	2
Other	4

TABLE 12: TYPES OF COVERED TRANSACTIONS – SERVICES

Intercompany Services Involved in the Covered Transactions	Number
Distribution	16
Marketing	9
Headquarters costs	8
Assembly	7
Product support	7
Sales support	6
Warranty services	6
Accounting	5
Administrative	5
Research and development	5
Technical support services	5
Billing services	3
Contract research & development	3
Purchasing	3
Testing and installation services	3
Communication service	2
Legal	2
Management	2
Logistical support	1
Other	4

Business Functions Performed and Risks Assumed

[§ 521(b)(2)(D)(ii)]

The general descriptions of the business functions performed and risks assumed by the organizations, trades, or businesses whose results are tested in the covered transactions in the APAs executed in Year 2001 are set forth in Tables 13 and 14 below:

TABLE 13: FUNCTIONS PERFORMED BY THE TESTED PARTY

Functions Performed	Number
Marketing and distribution functions	49
Manufacturing	20
Product assembly and/or packaging	14
Research and development	12
Transportation and warehousing	12
Product service (repairs, etc.)	12
Product design and engineering	10
Managerial, legal, accounting, finance, personnel, and other support services	10
Technical training and tech support for sales staff (including sub-distributors)	9
Process engineering	8
Product testing and quality control	7
Purchasing and materials management	6
Engineering and construction related services	3
Licensing of intangibles	2
Trading and risk management of financial products	2
Consulting services	1
Telecom services	1
Other	3

TABLE 14: RISKS ASSUMED BY THE TESTED PARTY

Risks Assumed	Number
Market risks, including fluctuations in costs, demand, pricing, & inventory	43
General business risks (*e.g.*, related to ownership of PP&E)	36
Credit and collection risks	29
Financial risks, including interest rates & currency	27
R&D risks	7
Product liability risks	7
Warranty replacement risk	1

Discussion

The vast majority of APAs have covered transactions that involve numerous business functions and risks. For instance, with respect to functions, companies that manufacture products have typically conducted research and development, engaged in product design and engineering, manufactured the product, marketed and distributed the product, and performed support functions such as legal, finance, and human resources services. Regarding risks, companies have been subject to market risks, R&D risks, financial risks, credit and collection risks, product liability risks, and general business risks. In the APA evaluation process a significant amount of time and effort is devoted to understanding how the functions and risks are allocated amongst the controlled group of companies that are party to the covered transactions.

In their APA proposals taxpayers are required to provide a functional analysis. The functional analysis identifies the economic activities performed, the assets employed, the economic costs incurred, and the risks assumed by each of the controlled parties. The importance of the functional analysis derives from the fact that economic theory posits that there is a positive relationship between risk and expected return and that different functions provide different value and have different opportunity costs associated with them. It is important that the functional analysis go beyond simply categorizing the tested party as, say, a distributor. It should provide more specific information since, in the example of distributors, not all distributors undertake similar functions and risks.

Thus, the functional analysis has been critical in determining the TPM (including the selection of comparables). Although functional comparability has been an essential factor in evaluating the reliability of the TPM (including the selection of comparables), the APA evaluation process has also involved consideration of economic conditions such as the economic condition of the particular industry.

In evaluating the functional analysis, the APA program has considered contractual terms between the controlled parties and the consistency of the conduct of the parties with respect to the allocation of risk. Per the § 482 regulations, the APA program also has given consideration to the ability of controlled parties to fund losses that might be expected to occur as the result of the assumption of a risk. Another relevant factor considered in evaluating the functional analysis is the extent to which each controlled party exercises managerial or operational control over the business activities that directly influence the amount of income or loss realized. The § 482 Regulations posit that parties at arm's length will ordinarily bear a greater share of those risks over which they have relatively more control.

Related Organizations, Trades, or Businesses Whose Prices or Results are Tested to Determine Compliance with APA Transfer Pricing Methods

[§ 521(b)(2)(D)(iii)]

The related organizations, trades, or businesses whose prices or results are tested to determine compliance with TPMs prescribed in APAs executed in Year 2001 are set forth in Table 15 below:

TABLE 15: RELATED ORGANIZATIONS, TRADES, OR BUSINESSES WHOSE PRICES OR RESULTS ARE TESTED

Type of Organization	Number[8]
US distributor	31
US provider of services	11
Non-US distributor	9
Non-US manufacturer	6
Non-US provider of services	6
US licensee of intangible property	6
US manufacturer	5
Non-US licensee of intangible property	5
US licensor of intangible property	4
US dealer in financial products	2
US participant in cost sharing agreement	2
Non-US participant in cost sharing agreement	2
Non-US licensor of intangible property	1
Non-US dealer in financial products	1

Transfer Pricing Methods and the Circumstances Leading to the Use of Those Methods

[§ 521(b)(2)(D)(iv)]

The TPMs used in APAs executed in Year 2001 are set forth in Tables 16–20 below:

[8] For purposes of this report, both sides are counted as tested parties for certain transactions, such as those involving the use of the Comparable Uncontrollod Price, Comparable Uncontrolled Transaction, profit split methods, as well as cost sharing agreements.

TABLE 16: TRANSFER PRICING METHODS USED FOR TRANSFERS OF TANGIBLE AND INTANGIBLE PROPERTY

TPM used	Number[9]
Comparable Profits Method (CPM): PLI is operating margin	22
Comparable Profits Method (CPM): PLI is Berry ratio	7
CUT (intangibles only)	6
Comparable Profits Method (CPM): PLI is markup on total costs	6
Transactional Cost Plus Method (tangibles only)	5
Royalty implementing a CUT TPM	5
Royalty implementing a residual profit split TPM	5
Transactional Resale Price Method (tangibles only)	4
Royalty implementing a profit split TPM	3
Comparable Profits Method (CPM): PLI is Other	3
Unspecified method (except unspecified profit split)	2
Residual profit split	2
CUP (tangibles only) not based on published market data	1
Other profit split	1
Comparable Profits Method (CPM): PLI is return on assets or capital employed	1
Comparable Profits Method (CPM): PLI is gross margin	1
Comparable Profits Method (CPM): PLI is markup on other costs	1

TABLE 17: TRANSFER PRICING METHODS USED FOR SERVICES

TPM used	Number[10]
Cost plus a markup	13
CPM: PLI is operating margin	5
CPM: PLI is markup on total costs	4
Cost with no markup	4

TABLE 18: TRANSFER PRICING METHODS USED FOR FINANCIAL PRODUCTS

TPM used	Number
Interbranch allocation (*e.g.*, foreign exchange separate enterprise with statistical test of interbranch trades)	3

TABLE 19: TRANSFER PRICING METHODS USED FOR CONTRIBUTIONS TO COST SHARING ARRANGEMENTS

TPM used	Number
Costs allocated based on units produced, used, or sold	1
Cost allocated based on cost of raw materials	1

[9] Profit Level Indicators ("PLIs") used with the Comparable Profit Method of Treas. Reg. § 1.482–5, and as used in these TPM tables, are as follows: (1) rate of return on assets or capital employed is the ratio of operating profit to operating assets, (2) operating margin is the ratio of operating profit to sales, (3) gross margin is the ratio of gross profit to sales, (4) Berry ratio is the ratio of gross profit to operating expenses, and (5) markup on total costs is generally a comparative markup on total costs involved.

[10] Some of the service transactions were covered by the transfer pricing methods used in tangible/intangible property transactions.

TABLE 20: TRANSFER PRICING METHODS USED FOR COST SHARING BUY-IN PAYMENTS

TPM used	Number
Buy-in based on residual profit split	1
Buy-in based on capitalized R&D	1

Discussion

The transfer pricing methods used in APAs completed during Year 2001 were based on those in the § 482 Treasury Regulations. Under § 1.482–3, the arm's length amount for controlled transfers of tangible property are determined using the Comparable Uncontrolled Price (CUP) method, the Resale Price Method, the Cost Plus Method, the Comparable Profits Method (CPM), and the Profit Split method. Under § 1.482–4, the arm's length amount for controlled transfers of intangible property are determined using the Comparable Uncontrolled Transaction (CUT) method, CPM, and the Profit Split Method. An "Unspecified Method" may be used for both tangible and intangible property if it provides a more reliable result than the enumerated methods under the best method rule of § 1.482–1(c). For transfers involving the provision of services, § 1.482–2(b) provides that services performed for the benefit of another member of a controlled group should ordinarily bear an arm's length charge, either deemed to be equal to the cost of providing the services (when non-integral) or which should be an amount that would have been charged between independent parties.

In addition, § 1.482–2(a) provides rules concerning the proper treatment of loans or advances, and § 1.482–7 provides rules for qualified cost sharing arrangements under which the parties agree to share the costs of development of intangibles in proportion to their shares of reasonably anticipated benefits. APAs involving cost sharing arrangements generally address both the method of allocating costs among the parties as well as determining the appropriate amount of the "buy-in" payment due for the transfer of intangibles to the controlled participants.

In reviewing the TPMs applicable to transfers of tangible and intangible property reflected in Table 16, it is clear that the majority of the APAs followed the specified methods. However, there are several distinguishing points that should be made. The Regulations note that for transfers of tangible property, the Comparable Uncontrolled Price (CUP) method will generally be the most direct and reliable measure of an arm's length price for the controlled transaction when sufficiently reliable comparable transactions can be identified. § 1.482–3(b)(2)(ii)(A). It was the experience of the APA Program in Year 2001 that in the cases that come into the APA Program, sufficiently reliable CUP transactions are difficult to find. In APAs executed in Year 2001, there was only one APA that used the CUP method; it did not look to published market data in setting the arm's length price.

Similar to the CUP method, for transfers of intangible property, the CUT method will generally provide the most reliable measure of an arm's length result when sufficiently reliable comparables may be found. § 1.482–4(c)(2)(ii). It has generally been difficult to identify external comparables, and APAs using the CUT method tend to rely on internal transactions between the taxpayer and unrelated parties. In Year 2001, there were six APAs that utilized the CUT method, and four of those also used one or more other methods for different covered transactions by the same taxpayer in the same APA.

The transactional Cost Plus Method (tangibles only) and Resale Price Method were applied in Year 2001 in five and four APAs respectively. See § 1.482–3(c), (d). The transactional nature of these methods distinguishes them from the CPM method using either a gross margin PLI (as compared to the Resale Price Method) or a markup on total costs PLI (as compared to the Cost Plus Method). A strict transactional method focuses on prices for individual or narrow groups of transactions, while a CPM looks at profits from broader groups of transactions or all of a company's transactions. In Year 2001, only two of the Cost Plus Method APAs used that method alone. The other three APAs using this method were supplemented by a CPM. In Year 2001, only two of the Resale Price Method APAs used that method alone. The other two APAs using this method were supplemented by a CPM.

The CPM is frequently applied in APAs. This is because reliable public data on comparable business activities of independent companies may be more readily available than potential CUP data, and comparability of resources employed, functions, risks, and other relevant considerations is more likely to exist than comparability of product. The CPM also tends to be less sensitive than other methods to differences in accounting practices between the tested party and comparable companies, *e.g.* classification of expenses as cost of goods sold or operating expenses. § 1.482–3(c)(3)(iii)(B), and –3(d)(3)(iii)(B). In addition, the degree of functional comparability required to obtain a reliable result under the CPM is generally less than required under the resale price or cost plus methods, because differences in functions performed often are reflected in operating expenses, and thus taxpayers performing different functions may have very different gross profit margins but earn similar levels of operating profit. § 1.482–5(c)(2).

There were 39 covered transactions involving tangible or intangible property that used some form of the CPM (with varying PLIs). The CPM was also used in some APAs concurrently with other methods. For example, the CPM was used with two out of the four APAs that used the resale price method.

The CPM has proven to be versatile in part because of the various PLIs that can be used in connection with the method. Reaching agreement on the appropriate PLI has been the subject of much discussion in many of the cases, and it depends heavily on the facts and circumstances. Some APAs have called for different PLIs to apply to different parts of the covered transactions or with one PLI used as a check against the primary PLI. In two covered transactions, an operating margin PLI was used in conjunction with another PLI, the markup on total costs.

The CPM also was used regularly with services as the covered transactions in APAs executed in Year 2001. There were a total of nine services covered transactions using the CPM method with various PLIs according to the specific facts of the taxpayers involved. Table 17 reflects the methods used to determine the arm's length results for APAs involving services transactions.

In Year 2001, there were two APAs involving tangible or intangible property that used some form of a profit split. Both APAs used the Residual Profit Split, § 1.482–6(c)(3), in which routine contributions by the controlled parties are allocated routine market returns, and the residual income is allocated among the controlled taxpayers based upon the relative value of their contributions of intangible property to the relevant business activity. One of those APAs also used a second type of profit split. Profit splits are generally considered in cases in which the parties to the controlled transaction own valuable, non-routine, intangible property.

There were three financial product APAs involving interbranch allocations. These involve a single taxpayer with branches that act autonomously with respect to the covered transactions, generally involving foreign currency exchanges. These particular APAs determine the appropriate amount of profits attributable to each branch from the activity by reference to the branches' internal accounting methods. The results take into account all trades, and test the arms length results using statistical tests to verify that controlled trades are priced the same as uncontrolled trades.

There were two cost sharing APAs during Year 2001. Cost sharing APAs under § 1.482–7 generally address the methods used for determining each participant's share of costs (consistent with the reasonably anticipated benefits) for the development of intangibles. When there is also the transfer of existing intangibles, the APA will also generally address the appropriate buy-in amount. Tables 19 and 20 reflect the methods applied in cost sharing APAs executed in Year 2001.

Critical Assumptions
[§ 521(b)(2)(D)(v)]

Critical Assumptions used in APAs executed in Year 2001 are described in Table 21 below:

TABLE 21: CRITICAL ASSUMPTIONS

Critical Assumptions involving the following:	Number of APAs
Material changes to the business	55
Material changes to tax and/or financial accounting practices	55
Assets will remain substantially same	17
Changes in affiliated companies	14
Catastrophic events	5
Major regulatory changes	4
Use of Mark-to-Market method	3
Minimum sales volume	3
Changes in market shares	3
Major contract remains in force	3
Other financial ratio	3
Changes in sharing of risks of currency fluctuations	2
Interest rate changes	2
Material sales fluctuations	2
Marketing conditions substantially same	2
New import/ export non-tariff barriers	2
Ratio of R&D to sales	2
Currency fluctuations	1
Sales territories substantially same	1
Changes involving anti-dumping/ countervailing duties	1
Changes in other duties or tariffs	1
Major technological changes	1
Licensing agreements remain in effect	1
Other	11

Discussion

APAs include critical assumptions upon which their respective TPMs depend. Critical assumptions are objective business and economic criteria that form the basis of a taxpayer's proposed TPM. A critical assumption is any fact (whether or not within the control of the taxpayer) related to the taxpayer, a third party, an industry, or business and economic conditions, the continued existence of which is material to the taxpayer's proposed TPM. Critical assumptions might include, for example, a particular mode of conducting business operations, a particular corporate or business structure, or a range of expected business volume. Rev. Proc. 96–53, § 5.07. Failure to meet a critical assumption may render an APA inappropriate or unworkable.

A critical assumption may change (and/or fail to materialize) due to uncontrollable changes in economic circumstances, such as a fundamental and dramatic change in the economic conditions of a particular industry. In addition, a critical assumption may change (and/or fail to materialize) due to a taxpayer's actions that are initiated for good faith business reasons, such as a change in business strategy, mode of conducting operations, or the cessation or transfer of a business segment or entity covered by the APA.

If a critical assumption has not been met, the APA may be revised by agreement of the parties. If such agreement cannot be achieved, the APA may be canceled. If a critical assumption has not been met, it requires taxpayer's notice to and discussion with the Service, and, in the case of a bilateral APA, Competent Authority consideration. Rev. Proc. 96–53, § 11.07.

Sources of Comparables, Selection Criteria, and the Nature of Adjustments to Comparables and Tested Parties

[§ 521(b)(2)(D)(v), (vi), and (vii)]

The sources of comparables, selection criteria, and rationale used in determining the selection criteria for APAs executed in Year 2001 are described in Tables 22 through 24 below. Various formulas for making adjustments to comparables are included as Attachment B.

TABLE 22: SOURCES OF COMPARABLES

Comparable Sources	Number of Times This Source Used [11]
Compustat	39
Disclosure	13
Moody's	2
Japan Company Handbook	1
Global Vantage	1
Taxpayer's information on competition	1
Other	9

TABLE 23: COMPARABLE SELECTION CRITERIA

Selection Criteria Considered	Number of Times This Criterion Used
Comparable functions	46
Comparable industry	36
Comparable risks	31
Comparable products	27
Comparable geographic market	13
Comparable intangibles	11
Contractual terms	3
Other	4

TABLE 24: ADJUSTMENTS TO COMPARABLES OR TESTED PARTIES

Adjustment	Number of Times This Adjustment Used
Asset intensity adjustments	34
Receivables	34
Inventory	33
Payables	33
Property, plant, equipment	6
Other	2
Accounting adjustments	8
LIFO to FIFO inventory accounting	7
Accounting reclassifications (*e.g.*, from COGS to operating expenses)	2
Other	1
Profit level indicator adjustments (used to "back into" one PLI from another)	7
Operating expense	5
Other	2
Miscellaneous adjustments	3
Advertising	1
Other	2

[11] Although still guided by the arm's length standard, some APAs do not use comparables, for example, when there is a residual profit or in the case of certain financial products.

Discussion

At the core of most APAs are comparables. The APA program works closely with taxpayers to find the best and most reliable comparables for each covered transaction. In some cases, CUPs or CUTs can be identified. In other cases, comparable business activities of independent companies are utilized in applying the CPM or residual profit split methods. Generally, in the APA Program's experience since 1991, CUPs and CUTs have been most often derived from the internal transactions of the taxpayer.

For profit-based methods in which comparable business activities or functions of independent companies are sought, the APA Program typically has applied a three-part process. First, a pool of potential comparables has been identified through broad searches. From this pool, companies having transactions that are clearly not comparable to those of the tested party have been eliminated through the use of quantitative and qualitative analyses, *i.e.*, quantitative screens and business descriptions. Then, based on a review of available descriptive and financial data, a set of comparable companies or transactions has been finalized. The comparability of the finalized set has then been enhanced through the application of adjustments.

Sources of Comparables

Comparables used in APAs can be U.S. or foreign companies. This depends on the relevant market, the type of transaction being evaluated, and the results of the functional and risk analyses. In general, comparables have been located by searching a variety of databases that provide data on U.S. publicly traded companies and on a combination of public and private non-U.S. companies. Table 22 shows the various databases and other sources used in selecting comparables for the APAs executed in Year 2001.

Although comparables were most often identified from the databases cited in Table 22, in some cases comparables were found from other sources, such as comparables derived internally from taxpayer transactions with third parties and comparables derived from taxpayer information on competitors.

Selecting Comparables

Initial pools of potential comparables generally have been derived from the databases using a combination of industry and keyword identifiers. Then, the pool has been refined using a variety of selection criteria specific to the transaction or entity being tested and the transfer pricing method being used.

The listed databases allow for searches by industrial classification (generally, U.S. Standard Industrial Classification (SIC)), by keywords, or by both. These searches can yield a number of companies whose business activities may or may not be comparable to those of the entity being tested. Therefore, comparables based solely on SIC or keyword searches are rarely used in APAs. Instead, the pool of comparables is examined closely, and companies are selected based on a combination of screens, business descriptions, and other information found in the companies' Annual Reports to shareholders and filings with the U.S. Securities and Exchange Commission (SEC).

Business activities are required to meet certain basic comparability criteria to be considered comparables. Functions, risks, economic conditions, and the property (product or intangible) and services associated with the transaction must be comparable. Determining comparability can be difficult — the goal has been to use comparability criteria restrictive enough to eliminate companies that are not comparable, but yet not so restrictive as to have no comparables remaining. The APA Program normally has begun with relatively strict comparability criteria and then has relaxed them slightly if necessary to derive a pool of reliable comparables. A determination on the appropriate size of the comparables set, as well as the companies that comprise the set, is highly fact specific and depends on the reliability of the results.

In addition, the APA Program, consistent with the regulations, generally has looked at the results of comparable companies over a multi-year period. Sometimes this has been three years, but it has been more or less, depending on the circumstances of the controlled transaction. Using a shorter period might result in the inclusion of companies in different stages of economic development or use of atypical years of a company subject to cyclical fluctuations in business conditions.

Many covered transactions have been tested with comparables that have been chosen using additional criteria and/or screens. These include sales level criteria and tests for financial distress and product comparability. These common selection criteria and screens have been used to increase the overall comparability of a group of companies and as a basis for further research. The sales level screen, for example, has been used to remove companies that, due to their size, might face fundamentally different economic conditions from those of the entity or transaction being tested. In addition, some APA analyses have incorporated selection criteria related to removing companies experiencing "financial distress" due to concerns that companies in financial distress often have experienced unusual circumstances that would render them not comparable to the entity being tested. These criteria include: an unfavorable auditor's opinion, bankruptcy, and in certain circumstances, operating losses in a given number of years.

An additional important class of selection criteria is the development and ownership of intangible property. In some cases in which the entity being tested is a manufacturer, several criteria have been used to ensure, for example, that if the controlled entity does not own significant manufacturing intangibles or conduct research and development (R&D), neither will the comparables. These selection criteria have included determining the importance of patents to a company or screening for R&D expenditures as a percentage of sales or costs. Another criterion used in some cases has been a comparison of the book and market values of a company; this can be another indicator of intangible value. Again, quantitative screens related to identifying comparables with significant intangible property generally have been used in conjunction with an understanding of the comparable derived from publicly available business information.

Selection criteria relating to asset comparability and operating expense comparability have also been used at times. A screen of property, plant, and equipment (PP&E) as a percentage of sales or assets, combined with a reading of a company's SEC filings, has been used to help ensure that distributors (generally lower PP&E) were not compared with manufacturers (generally higher PP&E), regardless of their SIC classification. Similarly, a test involving the ratio of operating expenses to sales or total costs has helped to determine whether a company undertakes a significant marketing and distribution function.

Table 25 shows the number of times various screens were used in APAs executed in Year 2001:

TABLE 25: COMPARABILITY SCREENS

Comparability Screen Used	Number of Times Used
Comparability screens used	—
Sales	18
Operating expenses/ sales	12
Non-startup or start-up	12
R&D/ sales	8
Foreign sales/ total sales	3
Financial distress	—
Bankruptcy	15
SG&A/ sales	7
Unfavorable auditor's opinion	7
Losses in Three Years	5
Losses in Two Years	3
PP&E/ sales	1

Adjusting Comparables

After the comparables have been selected, the regulations require that "[i]f there are material differences between the controlled and uncontrolled transactions, adjustments must be made if the effect of such differences on prices or profits can be ascertained with sufficient accuracy to improve the reliability of the results." Treas. Reg. § 1.482–1(d)(2). In almost all cases involving income-statement-based profit level indicators (PLIs), certain "asset intensity" or "balance sheet" adjustments for factors that have generally agreed-upon effects on profits have been carried out. In addition, in specific cases, additional adjustments have been performed to improve reliability.

The most common asset intensity adjustments used in APAs are adjustments for differences in accounts receivable, inventories, and accounts payable. The APA Program generally has required adjustments for receivables, inventory, and payables based on the principle that holding assets such as receivables benefits customers in a way that increases the entity's operating profit. Such adjustments are based on the assumption that the increase in operating profit is equal to the carrying cost of the assets. Conversely, the holding of accounts payable is considered to burden suppliers in a way that decreases the entity's profit. The decrease in operating profit has generally been assumed to be equal to the cost of funds implicitly borrowed from suppliers.

To compare the profits of two entities with different relative levels of receivables, inventory, or payables, the APA Program has estimated the carrying costs of each item and adjusted profits accordingly. Although different formulas have been used in specific APA cases, Attachment B presents one set of formulas used in many APAs. Underlying these formulas are the notions that (1) balance sheet items should be expressed as mid-year averages, (2) formulas should try to avoid using data items that are being tested by the transfer pricing method (for example, if sales are controlled, then the denominator of the balance sheet ratio should not be sales), (3) a short term interest rate should be used, and (4) an interest factor should recognize the average holding period of the relevant asset.

The APA Program has also required that data must be compared on a first-in first-out (FIFO) accounting basis. Although financial statements may be prepared on a last-in first-out (LIFO) basis, cross-company comparisons are less meaningful when one or more companies use LIFO inventory accounting methods. This adjustment directly affects costs of goods sold and inventories, and therefore affects both profitability measures and inventory adjustments.

Less commonly used but still important in some cases is the adjustment for differences in relative levels of PP&E between a tested entity and the comparables. Ideally, comparables and the entity being tested will have fairly similar relative levels of PP&E, since major differences can be a sign of fundamentally different functions and risks. Typically, the PP&E adjustment is made using a medium term interest rate, while short-term interest rates are used for receivables, inventories, and payables.

Additional adjustments used less infrequently include those for differences in other balance sheet items, operating expenses, R&D, or currency risk. Accounting adjustments, such as reclassifying items from cost of goods sold to operating expenses, for example, have also been made when warranted to increase reliability. Often, data has not been available for both the controlled and uncontrolled transactions in sufficient detail to allow for these types of adjustments.

The adjustments made to comparables or tested parties in APAs executed in Year 2001 are reflected in table 24 above.

Nature of Ranges and Adjustment Mechanisms
[§ 521(b)(2)(D)(viii)–(ix)]

The types of ranges used in APAs executed in Year 2001 are described in Tables 26 and 27 below.

TABLE 26: TYPES OF RANGES

Type of Range	Number [12]
Interquartile range	23
Floor (*i.e.*, result must be no less than x)	8
Specific point within CPM range	7
Specific point (royalty)	6
Financial products – statistical confidence interval to test against internal cups	3
Ceiling (*i.e.*, result must be no more than x)	3
Full range	1
Specific point (CUP)	1
Other	1

TABLE 27: ADJUSTMENTS WHEN OUTSIDE OF THE RANGE

Adjustment Mechanism	Number
Taxpayer makes an adjustment: to closest edge	15
Taxpayer makes an adjustment: to specified point	14
Competent Authority process invoked if results are outside the range	5
Taxpayer makes an adjustment: to median	4
Other	7

[12] Numbers do not include TPMs with cost or cost-plus methodologies.

Discussion

Treas. Reg. § 1.482–1(e)(1) states that sometimes a pricing method will yield "a single result that is the most reliable measure of an arm's length result." Sometimes, however, a method may yield "a range of reliable results," called the "arm's length range." A taxpayer whose results fall within the arm's length range will not be subject to adjustment.

Under § 1.482–1(e)(2)(i), such a range is normally derived by considering a set of more than one comparable uncontrolled transaction of similar comparability and reliability. If these comparables are of very high quality, as defined in the Regulations, then under § 1.482–1(e)(2)(iii)(A), the arm's length range includes the results of all of the comparables (from the least to the greatest). However, the APA Program has only rarely identified cases meeting the requirements for the full range. There was one APA executed in Year 2001 that used a full range. If the comparables are of lesser quality, then under § 1.482–1(e)(2)(iii)(B), "the reliability of the analysis must be increased, when it is possible to do so, by adjusting the range through application of a valid statistical method to the results of all of the uncontrolled comparables." One such method, the "interquartile range," is "ordinarily . . . acceptable," although a different statistical method "may be applied if it provides a more reliable measure." The "interquartile range" is defined as, roughly, the range from the 25th to the 75th percentile of the comparables' results. See § 1.482–1(e)(2)(iii)(C). The interquartile range was used 23 times in Year 2001.

In fourteen APAs executed in Year 2001, the APA specified a single, specific result, or "point." Seven of these APAs involved a CPM in which the taxpayer agreed to a specific result. Some APAs specify not a point or a range, but a "floor" or a "ceiling". When a floor is used, the tested party's result must be greater than or equal to some particular value. When a ceiling is used, the tested party's result must be less than or equal to some particular value. Eight APAs executed in Year 2001 used a floor and three used a ceiling.

Some APAs involving financial products have employed a statistical confidence interval to compare pricing of a large set of controlled transactions with a comparable set of uncontrolled transactions. A statistical confidence interval is typically applied to a financial institution with autonomous branches in several countries. Pursuant to the business profits article of the applicable income tax treaties and Prop. Reg. § 1.482–8(b), APAs have been executed allowing the taxpayer to allocate profits between branches with reference to the branches' internal accounting methods, taking into account all trades, including interbranch and/or interdesk trades. In order for this method to provide a reliable result, however, it is necessary to ensure that all such controlled trades be priced on the same market basis as uncontrolled trades. To test whether this is so, a branch's controlled trades are matched with that branch's comparable uncontrolled trades made at times close to the controlled trades. A statistical test is performed to detect pricing bias, by which the controlled trades might as a whole be priced higher or lower than the uncontrolled trades. This has been accomplished by construction of a statistical confidence interval (typically 95%), with the tested hypothesis being that controlled trades are priced on the same basis as uncontrolled trades. An adjustment is necessary if the results of the controlled trades fall outside of this confidence interval. During Year 2001, there were three APAs executed that employed the statistical confidence interval.

Some APAs look to a tested party's results over a period of years (multi-year averaging) to determine whether a taxpayer has complied with the APA. In 2001, rolling multi-year averaging was used for 11 covered transactions. Three of those used two-year averages, and the other eight used three-year averages. Cumulative multi-year averages were used for 18 covered transactions. Of those 18 transactions, four used two-year averages, three used three-year averages,[13] two used four-year averages, four used five-year averages, one used a six-year average, one used a seven-year average, two used nine-year averages, and one used a ten-year average.

Adjustments

Under § 1.482–1(e)(3), if a taxpayer's results fall outside the arm's length range, the Service may adjust the result "to any point within the arm's length range." Accordingly, an APA may permit or require a taxpayer and its related parties to make an adjustment after the year's end to put the year's results within the range, or at the point, specified by the APA. Similarly, to enforce the terms of an APA, the Service may make such an adjustment. When the APA specifies a range, the adjustment is sometimes to the closest edge of the range, and sometimes to another point such as the median of the interquartile range. Depending on the facts of each case, such automatic adjustments are not always permitted. Some bilateral APAs specify that in such a case there will be a negotiation between the Competent Authorities involved to determine whether and to what extent an adjustment should be made. Some APAs permit automatic adjustments unless the result is far outside the range specified in the APA. Thus they provide flexibility and efficiency (permitting adjustments when normal business fluctuations and uncertainties push the result somewhat outside the range).

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[13] One of the three-year cumulative averages applied a three-year cumulative average twice, once at the end of year three and once at the end of year six. A second covered transaction that used a three-year cumulative average also used a five-year cumulative average at the end of five years. To avoid double counting, that covered transaction is not included in the count of covered transactions using five-year averages.

In order to conform the taxpayer's books to these tax adjustments, the APA usually permits a "compensating adjustment" as long as certain requirements are met. Such compensating adjustments may be paid between the related parties with no interest, and the amount transferred will not be considered for purposes of penalties for failure to pay estimated tax. See § 11.02, Rev. Proc. 96–53.

APA Term and Rollback Lengths
[§ 521(b)(2)(D)(x)]

The various term lengths for APAs executed in Year 2001 are set forth in Table 28 below:

TABLE 28: TERMS OF APAs

APA Term in Years	Number of APAs
1	1
2	1
3	5
4	7
5	30
6	5
7	0
8	2
9	3
10	1

Number of rollback years to which an APA TPM was applied in Year 2001 are set forth in Table 29 below:

TABLE 29: NUMBER OF YEARS COVERED BY ROLLBACK OF APA TPM

Number of Rollback Years	Number of APAs
1	2
2	7
3	3
4	1
5 or more	2

Nature of Documentation Required
[§ 521(b)(2)(D)(xi)]

APAs executed in Year 2001 required that various documents be provided with the Annual Reports filed by the taxpayers. These documents are described in Table 30 below:

TABLE 30: NATURE OF DOCUMENTATION REQUIRED

Documentation	Number of Times This Documentation Required [14]
Statement identifying all material differences between Taxpayer's business operations during APA Year and description of Taxpayer's business operations contained in Taxpayer's request for APA, or if there have been no such material differences, a statement to that effect	55
Statement identifying all material changes in Taxpayer's accounting methods and classifications, and methods of estimation, from those described or used in Taxpayer's request for APA, or if there have been none, statement to that effect	55
Financial analysis demonstrating Taxpayer's compliance with TPM	55
Description of any failure to meet Critical Assumptions or, if there have been none, a statement to that effect	55
Description of, reason for, and financial analysis of, any Compensating Adjustments with respect to APA Year, including means by which any Compensating Adjustment has been or will be satisfied	53
Financial statements as prepared in accordance with US GAAP	47
Certified public accountant's opinion that financial statements present fairly financial position of Taxpayer and the results of its operations, in accordance with US GAAP	47
United States income tax return	14
Financial statements as prepared in accordance with foreign GAAP	8
Certified public accountant's opinion that financial statements present fairly financial position of Taxpayer and the results of its perations, in accordance with foreign GAAP	8
Profit & Loss statement	8
Schedule of costs and expenses (*e.g.*, intercompany allocations)	8
Various workpapers	6
Certified public accountant's review of financial statements	6
Book to tax reconciliations	6
Form 5471 or 5472	4
Organizational chart	4
Description of any matters economically or substantively related to the covered transactions, but that are not subject to the APA	4
Cash Flow statement	3
Pertinent intercompany agreements	2
Narrative description of taxpayer's business	1
Other	17

Approaches for Sharing of Currency or Other Risks

[§ 521(b)(2)(D)(xii)]

During Year 2001, there were 27 tested parties that faced financial risks, including interest rate and currency risks. One case that explicitly addressed currency risk adjusted a resale price interquartile range by a currency adjustment factor.

Efforts to Ensure Compliance with APAs

[§ 521(b)(2)(F)]

As described in Rev. Proc. 96–53, section 11, APA taxpayers are required to file annual reports to demonstrate compliance with the terms and conditions of the APA. The filing and review of annual reports is a critical part of the APA process. Through annual report review, the APA program monitors taxpayer compliance with the APA on a contemporaneous basis. Annual report review provides current information on the success or problems associated with the various TPMs adopted in the APA process.

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[14] The first seven categories of documentation listed in this table were drawn from the standard APA language used in 2001. In some financial product APAs, the taxpayer agrees to maintain certain records, but the compliance with the TPM is determined by a later audit under an agreed statistical methodology. In these cases, some of the standard documentation requirements may not be appropriate.

All reports received by the APA Office are tracked by one designated APA team leader who also has the prime responsibility for annual report review. Other APA team leaders also assist in this review, especially when the team leader who negotiated the case is available, since that person will already be familiar with the relevant facts and terms of the agreement. Once received by the APA Office, the annual report is sent out to the district personnel with exam jurisdiction over the taxpayer. This process changed in November 2001; previously reports were held until reviewed by an APA team leader. This change has facilitated simultaneous review of the reports and allowed the APA office to eliminate much of the backlog of annual reports.

The statistics for the review of APA annual reports are reflected in Table 31 below. As of December 31, 2001, there were 187 pending annual reports. In Year 2001, there were 320 reports closed.

TABLE 31: STATISTICS OF ANNUAL REPORTS

Number of APA annual reports pending as of December 31, 2001	187
Number of APA annual reports closed in Year 2001	320
Number of APA annual reports requiring adjustment in Year 2001	7
Number of taxpayers involved in adjustments	3
Number of APA annual reports required to be filed in Year 2001	252
Number of APA annual reports actually filed in Year 2001	207 [15]
Number of APA annual report cases over one year old	84

[15] Many of the reports that were due in Year 2001, but not received by Dec. 31, 2001, were timely filed but held up as a result of the new screening procedures of the mail.

ATTACHMENT A

ADVANCE PRICING AGREEMENT
between
[***Insert Taxpayer's Name***]
and
THE INTERNAL REVENUE SERVICE

PARTIES

The Parties to this Advance Pricing Agreement (APA) are the Internal Revenue Service (IRS) and [*Insert Taxpayer's Name*], EIN __________ (Taxpayer).

RECITALS

Taxpayer's principal place of business is [*City, State*]. [*Insert general description of taxpayer and other relevant parties.*]

This APA contains the Parties' agreement on the best method for determining arm's-length prices of the Covered Transactions under I.R.C. section 482 and the Treasury Regulations.

Unless otherwise specified, terms in the plural include the singular and vice versa. Appendix D contains definitions for capitalized terms not elsewhere defined in this APA.

{*If renewal, add*} [Taxpayer and IRS previously entered into an APA covering taxable years ending _______ to _______, executed on __________.]

AGREEMENT

The Parties agree as follows:

1. *Covered Transactions*. This APA applies to the Covered Transactions, as defined in Appendix A.

2. *Transfer Pricing Method*. Appendix A sets forth the Transfer Pricing Method (TPM) for the Covered Transactions.

3. *Term*. This APA applies to Taxpayer's taxable years ending ___________ through ________(APA Term).

4. *Operation*.

a. Revenue Procedure 96–53 governs the interpretation, legal effect, and administration of this APA.

b. Nonfactual oral and written representations, within the meaning of sections 10.04 and 10.05 of Rev. Proc. 96–53 (including any proposals to use particular TPMs), made in conjunction with this request constitute statements made in compromise negotiations within the meaning of Rule 408 of the Federal Rules of Evidence.

5. *Compliance*.

a. For each taxable year covered by this APA (APA Year), if Taxpayer complies with the terms and conditions of this APA, then the IRS will not make or propose any allocation or adjustment under I.R.C. section 482 to the Covered Transactions.

b. If Taxpayer does not comply, then the IRS may:

i. enforce the terms and conditions of this APA and make or propose allocations or adjustments under I.R.C. section 482 consistent with this APA;
ii. cancel or revoke this APA under Revenue Procedure 96–53, section 11.05 or 11.06; or
iii. revise this APA, if the Parties agree.

c. Taxpayer must timely file an Annual Report for each APA Year in accordance with Appendix C and section 11.01 of Rev. Proc. 96–53. The IRS may request additional information reasonably necessary to clarify the Annual Report or verify compliance with the APA. Taxpayer will provide all requested information within a reasonable time.

d. The IRS will determine whether Taxpayer has complied with this APA based on Taxpayer's U.S. Returns, Financial Statements, and other APA Records, for the APA Term and any other year necessary to verify compliance. For Taxpayer to comply with this APA, an independent certified public accountant must *{use the following or an alternative}* render an opinion that the Taxpayer's Financial Statements present fairly, in all material respects, Taxpayer's financial position under U.S. GAAP.

e. In accordance with section 11.04 of Rev. Proc. 96–53, Taxpayer will (1) maintain its APA Records, and (2) make them available to IRS in connection with an examination under section 11.03. Compliance with this subparagraph constitutes compliance with the record-maintenance provisions of I.R.C. sections 6038A and 6038C for the Covered Transactions for any taxable year during the APA Term.

f. If Taxpayer's actual transactions do not result in compliance with the TPM, Taxpayer:

i. Must report its taxable income in an amount that is consistent with the TPM and all other requirements of this APA on its timely filed U.S. Return. However, for any APA Year, if Taxpayer's timely filed U.S. Return is filed no later than 60 days after the effective date of this APA, then Taxpayer may instead report its taxable income in an amount that is consistent with the TPM and all other requirements of this APA on an amended U.S. Return filed no later than 120 days after the effective date of this APA.

ii. May make compensating adjustments under Revenue Procedure 96–53, section 11.02, subject to any modifications or restrictions in Appendix A or elsewhere in this APA.

g. *{Insert when U.S. Group or Foreign Group contains more than one member.}* [This APA addresses the arm's-length nature of prices charged or received in the aggregate between Taxpayer[s] and Foreign Participants. Except as explicitly provided, this APA does not address and does not bind the IRS with respect to prices charged or received, or the relative amounts of income or loss realized, by particular legal entities that are members of U.S. Group or that are members of Foreign Group.]

h. The True Taxable Income within the meaning of Treasury Regulations section 1.482–1(a)(1) of a member of an affiliated group filing a U.S. consolidated return will be determined under the I.R.C. section 1502 Treasury Regulations.

i. *{Optional for US Parent Signatories}* To the extent that Taxpayer's compliance with this APA depends on certain acts of Foreign Group members, Taxpayer will ensure that each Foreign Group member will perform such acts.

6. *Critical Assumptions*. This APA's critical assumptions, within the meaning of Revenue Procedure 96–53, section 5.07, appear in Appendix B. Revenue Procedure 96–53, section 11.07, governs if any critical assumption has not been met.

7. *Disclosure*. This APA, and any background information related to this APA or the APA Request, are: (1) considered "return information" under I.R.C. section 6103(b)(2)(C); and (2) not subject to public inspection as a "written determination" under I.R.C. section 6110(b)(1). Section 521(b) of Pub. L. 106–170 provides that the Secretary of the Treasury must prepare a report for public disclosure that includes certain specifically designated information concerning all APAs, including this APA, in a form that does not reveal taxpayers' identities, trade secrets, and proprietary or confidential business or financial information.

8. *Disputes*. If a dispute arises concerning the interpretation of this APA, the Parties will seek a resolution by the IRS Associate Chief Counsel (International), to the extent reasonably practicable, before seeking alternative remedies. If any dispute arises that is not related to interpreting this APA, the Parties will seek to resolve the dispute in a manner consistent with Revenue Procedure 96–53, section 11.03(4).

9. *Materiality*. In this APA the terms "material" and "materially" will be interpreted consistently with the definition of "material facts" in Revenue Procedure 96–53, section 11.05(1).

10. *Section Captions*. This APA's section captions, which appear in *italics*, are for convenience and reference only. The captions do not affect in any way the interpretation or application of this APA.

11. *Entire Agreement and Severability*. This APA is the complete statement of the Parties' agreement. The Parties will sever, delete, or reform any invalid or unenforceable provision in this APA to approximate the Parties' intent as nearly as possible.

12. *Successor in Interest*. This contract binds, and inures to the benefit of, any successor in interest to Taxpayer.

13. *Notice*. Any notices required by this APA or Revenue Procedure 96–53 must be in writing. Taxpayer will send notices to the IRS at the address and in the manner set forth in Revenue Procedure 96–53, section 5.13(2). The IRS will send notices to:

Taxpayer Corporation
1000 Road
Any City, USA 10000
Attn: Jane Doe,
Sr. Vice President (Taxes)

14. *Effective date and Counterparts*. This APA is effective starting on the date, or later date of the dates, upon which all Parties execute this APA. The Parties may execute this APA in counterparts, with each counterpart constituting an original.

WITNESS,

The Parties have executed this APA on the dates below.

[**Taxpayer Name in all caps**]

By: ___________________________________ Date: __________, 20 _____

Jane Doe
Sr. Vice President (Taxes)

IRS

By: ___________________________________ Date: __________, 20 _____

Sean F. Foley
Director, Advance Pricing Agreement Program

APPENDIX A

COVERED TRANSACTIONS AND TRANSFER PRICING METHOD (TPM)

1. **Covered Transactions**.

[*Define the Covered Transactions.*]

2. **TPM**.

{Note: If appropriate, adapt language from the following examples.}

- **CUP Method**

The TPM is the comparable uncontrolled price (CUP) method. The price charged for ____________ must equal between __________ and _______________ (the Arm's Length Range). Taxpayer must realize, recognize, and report results on its U.S. Returns that clearly reflect such pricing.

- **Resale Price Method (RPM)**

The TPM is the resale price method (RPM). Taxpayer must realize, recognize, and report results on its U.S. Returns that clearly reflect a gross margin (defined as gross profit divided by sales revenue as those terms are defined in Treasury Regulations sections 1.482–5(d)(1) and (2)) of between _____% and _____% (the Arm's Length Range) for the Covered Transactions.

- **Cost Plus Method**

The TPM is the cost plus method. Taxpayer must realize, recognize, and report results on its U.S. Returns that clearly reflect a ratio of gross profit to production costs (within the meaning of Treasury Regulations sections 1.482–3(d)(1) and (2)) of between _____% and _____% (the Arm's Length Range) for the Covered Transactions.

- **CPM with Berry Ratio PLI**

The TPM is the comparable profits method (CPM). Taxpayer must realize, recognize, and report results on its U.S. Returns that clearly reflect a gross profit to operating expenses ratio (as those terms are defined in Treasury Regulations sections 1.482–5(d)(1) and (2)) of between _______ and _____ (the Arm's Length Range) for the Covered Transactions.

- **CPM using an Operating Margin PLI**

The TPM is the comparable profits method (CPM). The profit level indicator is an operating margin. Taxpayer's reported operating profit (within the meaning of Treasury Regulations sections 1.482–5(d)(5)) must clearly reflect an operating margin (defined as the ratio of operating profit to sales revenue as those terms are defined in Treasury Regulations section 1.482–5(d)(1) and (4)) of between __________% and _______% (the Arm's Length Range) for the Covered Transactions.

- **CPM using a Three-year Rolling Average Operating Margin PLI**

The TPM is the comparable profits method (CPM). The profit level indicator is an operating margin. Taxpayer's Three-Year Rolling Average operating margin is defined as follows for any APA Year: the sum of Taxpayer's reported operating profit (within the meaning of Treasury Regulations section 1.482–5(d)(5)) for that APA Year and the two preceding years, divided by the sum of Taxpayer's sales revenue (within the meaning of Treasury Regulations section 1.482–5(d)(1)) for that APA Year and the two preceding years. Taxpayer's Three-Year Rolling Average operating margin must be between _______% and _____ (the Arm's Length Range).

- **Residual Profit Split Method**

The TPM is the residual profit split method. Taxpayer must realize, recognize, and report results on its U.S. Returns that clearly reflect the following: [*insert description of profit-split mechanism*].

[*Insert additional provisions as needed.*]

3. **Adjustments**

{For use with a CPM}

For each APA Year, if Taxpayer's year-end [Three-Year Rolling Average] *{specify PLI used}* for the Covered Transactions is not in compliance with the TPM, Taxpayer will make an adjustment that brings its [Three-Year Rolling Average] *{specify PLI used}* to *{if the TPM specifies a point value, use that; if the TPM specifies an Arm's Length Range, use the nearest edge of the Arm's Length Range or a point such as the median within the Arm's Length Range}*.

[*Insert additional provisions as needed.*]

APPENDIX B

CRITICAL ASSUMPTIONS

This APA's critical assumptions are:

1. The business activities, functions performed, risks assumed, assets employed, and financial and tax accounting methods and classifications [and methods of estimation] of Taxpayer in relation to the Covered Transactions will remain materially the same as described or used in Taxpayer's APA Request. A mere change in business results will not be a material change.

[*Insert additional provisions as needed.*]

APPENDIX C

APA RECORDS AND ANNUAL REPORT

APA RECORDS

The APA Records will consist of:

1. All documents listed below for inclusion in the Annual Report, as well as all documents, notes, work papers, records, or other writings that support the information provided in such documents.

2. [Insert here other records as required.]

ANNUAL REPORT

Taxpayer must include the following items in its Annual Report for each APA Year:

1. Statements that fully identify, describe, analyze, and explain:

a. All material differences between any of Taxpayer's business operations (including functions, risks, markets, contractual terms, economic conditions, property or services, and assets employed) during the APA Year and the description of the business operations contained in the APA Request. If there have been no material differences, the Annual Report will include a statement to that effect.

b. All material changes in Taxpayer's accounting methods and classifications, and methods of estimation, from those described or used in Taxpayer's request for this APA. If there have been no such material changes, the Annual Report will include a statement to that effect.

c. Any failure to meet any critical assumption. If there have been no failures, the Annual Report will include a statement to that effect.

d. Any change to any entity classification for federal income tax purposes of any Worldwide Group member that is a party to the Covered Transactions or otherwise relevant to the TPM.

e. Any changes to Taxpayer's financial accounting methods that were made to conform to GAAP changes and that affect the Covered Transactions.

f. The amount, reason for, and financial analysis of any compensating adjustments under paragraph 5(e)(2) of this APA for the APA Year, including the means by which any such compensating adjustment has been or will be satisfied.

g. The amounts, description, reason for, and financial analysis of any book-tax differences relevant to the TPM for the APA Year, as reflected on Schedule M–1 of the U.S. Return for the APA Year.

2. The Financial Statements with a copy of each independent certified public accountant's opinion required by paragraph 5(c) of this APA.

3. A financial analysis that reflects Taxpayer's TPM calculations for the APA Year in sufficient detail to allow the IRS to determine whether Taxpayer has complied with the TPM.

4. An organizational chart for the Worldwide Group, revised annually to reflect all ownership or structural changes of entities that are parties to the Covered Transactions or otherwise relevant to the TPM.

APPENDIX D

DEFINITIONS

The following definitions control for all purposes of this APA. The definitions appear alphabetically below:

Term	Definition
Annual Report	A report within the meaning of Revenue Procedure 96–53, section 11.
APA	This Advance Pricing Agreement, which is an “advance pricing agreement” within the meaning of Revenue Procedure 96–53, section 1.
APA Records	The records specified in Appendix C.
APA Request	Taxpayer’s request for this APA dated ___/___/___, including any amendments or supplemental or additional information thereto.
Covered Transaction	This term is defined in Appendix A.
Financial Statements	The financial statements prepared in accordance with U.S. GAAP and stated in U.S. dollars.
Foreign Group	Worldwide Group members that are not U.S. persons.
Foreign Participants	[Name the foreign entities involved in Covered Transactions.]
I.R.C.	The Internal Revenue Code of 1986, 26 U.S.C., as amended.
Pub. L. 106–170	The Ticket to Work and Work Incentives Improvement Act of 1999.
Revenue Procedure 96–53	Rev. Proc. 96–53 (1996–2 C.B. 375).
Transfer Pricing Method (TPM)	A transfer pricing method within the meaning of Treasury Regulations section 1.482–1(b) and Revenue Procedure 96–53, section 3.02.
U.S. GAAP	U.S. generally-accepted accounting principles.
U.S. Group	Worldwide Group members that are U.S. persons.
U.S. Return	For each taxable year, the “returns with respect to income taxes under subtitle A” that Taxpayer must “make” in accordance with I.R.C. section 6012. {*Or substitute for partnership:* For each taxable year, the “return” that Taxpayer must “make” in accordance with I.R.C. section 6031.}
Worldwide Group	Taxpayer and all organizations, trades, businesses, entities, or branches (whether or not incorporated, organized in the United States, or affiliated) owned or controlled directly or indirectly by the same interests.

ATTACHMENT B

FORMULAS FOR BALANCE SHEET ADJUSTMENTS

Definitions of Variables:

AP	=	average accounts payable
AR	=	average trade accounts receivable, net of allowance for bad debt
cogs	=	cost of goods sold
INV	=	average inventory, stated on FIFO basis
opex	=	operating expenses (general, sales, administrative, and depreciation expenses)
PPE	=	property, plant, and equipment, net of accumulated depreciation
sales	=	net sales
tc	=	total cost (cogs + opex, as defined above)
h	=	average accounts payable or trade accounts receivable holding period, stated as a fraction of a year
i	=	interest rate
t	=	entity being tested
c	=	comparable

Equations:

If Cost of Goods Sold is controlled (generally, sales in denominator of PLI):

Receivables Adjustment ("RA"):	$RA = \{[AR_t / sales_t) \times sales_c] - AR_c\} \times \{i/[1+(i \times h_c)]\}$
Payables Adjustment ("PA"):	$PA = \{[AP_t / sales_t) \times sales_c] - AP_c\} \times \{i/[1+(i \times h_c)]\}$
Inventory Adjustment ("IA"):	$IA = \{[(INV_t / sales_t) \times sales_c\} - INV_c\} \times i$
PP&E Adjustment ("PPEA"):	$PPEA = \{[(PPE_t / sales_t) \times sales_c] - PPE_c\} \times i$

If Sales are controlled (generally, costs in the denominator of PLI):[16]

Receivables Adjustment ("RA"):	$RA = \{[(AR_t / tc_t) \times tc_c] - AR_c\} \times \{i/[1+(i \times h_c)]\}$
Payables Adjustment ("PA"):	$PA = \{[(AP_t / tc_t) \times tc_c] - AP_c\} \times \{i/[1+(i \times h_c)]\}$
Inventory Adjustment ("IA"):	$IA = \{[(INV_t / tc_t) \times tc_c] - INV_c\} \times i$
PP&E Adjustment ("PPEA"):	$PPEA = \{[(PPE_t / tc_t) \times tc_c] - PPE_c] \times i$

Then Adjust Comparables as Follows:

adjusted $sales_c$	=	$sales_c + RA$
adjusted $cogs_c$	=	$cogs_c + PA - IA$
adjusted $opex_c$	=	$opex_c - PPEA$

[16] Depending on the specific facts, the equations below may use total costs ("tc") or cost of goods sold ("cogs").