Announcement and Report Concerning Advance Pricing Agreements

Announcement 2003–19

March 31, 2003

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 covered calendar years 1991 through 1999. Subsequent reports covered calendar years 2000 and 2001. This fourth report describes the experience of the APA Program during calendar year 2002 consistent with the mandate of § 521(b). This document does not provide 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

Internal Revenue Code (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 the largest issues identified by the IRS in its audits of multinational corporations. The 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 (TPM). In year 2002, the IRS and taxpayers executed 85 APAs and amended 9 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 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 (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. 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 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 TPM 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 TPM 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, 2002, the APA program had 17 team leaders. The team leader is responsible for organizing the IRS APA team. The IRS APA team arranges meetings with the taxpayer, secures whatever information is necessary from the taxpayer to analyze the taxpayer's related party transactions and the available facts under the arm's length standard of IRC § 482 and the regulations thereunder (Treas. Reg.), and negotiates with the taxpayer.

The APA team generally includes an economist, an international examiner, LMSB field counsel, and, in a bilateral case, a U.S. Competent Authority analyst who leads the discussions with the treaty partner. The economist may be from the APA Program or the IRS field organization. As of December 31, 2002, the APA Program had 7 economists. The APA team may also include an LMSB International Technical Advisor, other LMSB exam personnel, and an Appeals officer.

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, review, and execution.

(1) *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 is 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 U.S. 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. In all cases, the team leader contacts the Manager, LMSB International Technical Advisors, to determine whether to include a technical advisor on the team. The IRS APA team will generally include a technical advisor if the APA request concerns cost-sharing, intangibles or services. The APA team leader then distributes copies of the APA application to all team members and sets up an opening conference with the taxpayer. The APA office strives to hold this opening conference within 45 days of the assignment of the case to a team leader. At the opening conference, the APA team leader proposes a case plan 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 2002, the median for completing negotiating positions was 12.0 months (average 13.7), and the median for completing unilateral APAs was 15.9 months (average 20.2).

(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. Typically, the taxpayer and the APA team will agree to dates for future meetings during the opening conference. In advance of the opening conference, the APA team leader will submit a list of questions to the taxpayer for discussion. The opening conference may result in a second set of questions. These questions are developed by the APA team and provided to the taxpayer through the APA team leader. It is important to note that this due diligence is not an audit and is focused 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 IRS APA team has completed its due diligence and analysis, it begins negotiations with the taxpayer over the various aspects of the APA including the selection of comparable transactions, asset intensity and other adjustments, the TPM, 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 generally 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 TPM for the covered transaction, taking into account IRC § 482 and the regulations thereunder, 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. negotiating 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 takes the recommended U.S. negotiating position and prepares 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 team leader prepares a summary memorandum for 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.

Model APA at Attachment A

[§ 521(b)(2)(B)]

Attachment A contains the current version of the model APA language. As part of its continuing effort to improve its work product, the APA Program has revised the model language to reflect the program's collective experience with substantive and drafting issues.

The Current APA Office Structure, Composition, and Operation

In 2002, the APA Office consisted of four branches with Branches 1 and 3 staffed with APA team leaders and Branch 2 staffed with economists and a paralegal.[1] Branch 4, the APA West Coast branch, opened an additional office in Laguna Niguel and moved its headquarters there. Its staffing is indicated in the chart below.

[1] Branch 3 includes one team leader with the principal responsibility for annual report review and Branch 2 includes one economist who spends approximately 35% of his time reviewing annual reports.

Overall, the APA staff decreased from 38 to 34 as a result of attrition and transfers to other Chief Counsel functions. The number of APA team leaders decreased from 22 to 17, while the number of economists remained constant at 7. Despite the decrease in the number of APA team leaders, the combination of the APA Program's extensive training and smaller caseloads per APA team leader increased productivity and the currency of the APA inventory.

As of December 31, 2002, the APA staff was as follows:

<table>
<tr><td colspan="4" align="center">Director's Office
1 Acting Director (also Chief, Branch 1)
1 Special Counsel to the Director
1 Secretary to the Director</td></tr>
<tr><td>Branch 1
1 Branch Chief
1 Secretary
8 Team Leaders</td><td>Branch 2
1 Branch Chief
1 Paralegal
7 Economists</td><td>Branch 3
1 Branch Chief
1 Secretary
7 Team Leaders</td><td>Branch 4
1 Branch Chief
(Laguna Niguel)
1 Secretary
(San Francisco)
2 Team Leaders
(San Francisco)</td></tr>
</table>

APA Training

In 2002, the APA Office continued to emphasize training as a high priority, dedicating two half-days each month to full staff training sessions. These training sessions regarded APA-related current developments, new APA office practices and procedures, and international tax law issues. Updated APA New Hire Training materials were published and provided to the APA staff, and to the public through the APA internet site on the IRS Digital Daily (*www.irs.gov*).

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 2002	50	57		107	676
APAs executed					
• Year 2002	27	58[2]		85	434
• 1991–2001	179	163	7	349	
APA renewals executed during year 2002	9	12		21	91
Revised or Amended APAs executed during year 2002 [3]	7	2		9	21
Pending requests for APAs	48	155		203	
Pending requests for new APAs	39	111		150	
Pending requests for renewal APAs	9	44		53	
APAs canceled or revoked [4]	0	0		0	5
APAs withdrawn[5]	7	19		26	80

[2]Approximately half of the 58 bilateral APAs executed in 2002 regarded companies carrying on limited business activities. These APAs were negotiated based on a bilateral competent authority agreement that established streamlined resolution guidelines.
[3] In 2002, the APA Office and taxpayers agreed to amend nine APAs (seven unilateral and two bilateral). In six of these, the taxpayer reorganized its business. In three, the changes reflected technical corrections or modifications to minor aspects of the APA.
[4] In the history of the APA Program, five APAs have been canceled and no APAs have been revoked.
[5] Reasons for withdrawals included jurisdictional issues, inventory corrections, taxpayer reorganizations, and changes in facts and circumstances.

TABLE 2: MONTHS TO COMPLETE APAs

Months to Complete Advance Pricing Agreements in Year 2002	
Combined Unilateral, Bilateral, Multilateral: Average	25.0
Combined Unilateral, Bilateral, Multilateral: Median	23.4

Unilateral New		Unilateral Renewal		Unilateral Combined	
Average	21.0	Average	19.1	Average	20.2
Median	15.9	Median	16.4	Median	15.9

Bilateral/Multilateral New		Bilateral/Multilateral Renewal		Bilateral/Multilateral Combined[6]	
Average	24.6	Average	36.7	Average	27.3
Median	20.6	Median	34.4	Median	25.3

TABLE 3: APA COMPLETION TIME – MONTHS PER APA[7]

Months	Number of APAs	Months	Number of APAs	Months	Number of APAs	Months	Number of APAs
1	1	**21**	4	**41**	0	**61**	0
2	0	**22**	0	**42**	1	**62**	1
3	1	**23**	4	**43**	0	**63**	2
4	2	**24**	0	**44**	0	**64**	0
5	5	**25**	3	**45**	1	**65**	0
6	4	**26**	2	**46**	1	**66**	0
7	5	**27**	1	**47**	1	**67**	0
8	5	**28**	3	**48**	0	**68**	0
9	1	**29**	3	**49**	1	**69**	0
10	3	**30**	0	**50**	1	**70**	0
11	1	**31**	0	**51**	1	**71**	0
12	1	**32**	1	**52**	0	**72**	0
13	0	**33**	0	**53**	0	**73**	1
14	2	**34**	3	**54**	0	**74**	0
15	0	**35**	1	**55**	0	**75**	0
16	2	**36**	2	**56**	3	**76**	0
17	0	**37**	2	**57**	0	**77**	0
18	1	**38**	1	**58**	0	**78**	1
19	0	**39**	1	**59**	0	**79**	0
20	4	**40**	1	**60**	0	**80**	0

TABLE 4: RECOMMENDED NEGOTIATING POSITIONS

Recommended Negotiating Positions Completed in Year 2002	85

[6]The average time required to conclude a bilateral APA has historically been split roughly equally between the APA and U.S. Competent Authority Offices.
[7] Most of the APAs completed in six months or less related to companies carrying on limited business activities. These APAs were negotiated based on a bilateral competent authority agreement that established streamlined resolution guidelines.

TABLE 5: MONTHS TO COMPLETE RECOMMENDED NEGOTIATING POSITIONS

New		Renewal		Combined	
Average	12.3	Average	18.2	Average	13.7
Median	11.5	Median	21.0	Median	12.0

TABLE 6: RECOMMENDED NEGOTIATING POSITIONS COMPLETION TIME – MONTHS PER APA[8]

Months	Number	Months	Number	Months	Number	Months	Number
1	0	**11**	2	**21**	4	**31**	1
2	2	**12**	7	**22**	2	**32**	0
3	2	**13**	4	**23**	2	**33**	0
4	1	**14**	4	**24**	5	**34**	0
5	13	**15**	2	**25**	1	**35**	0
6	3	**16**	0	**26**	0	**36**	0
7	3	**17**	0	**27**	1	**37**	1
8	4	**18**	6	**28**	2	**38**	0
9	5	**19**	4	**29**	0	**39**	0
10	2	**20**	1	**30**	1	**40**	0

TABLE 7: SMALL BUSINESS TAXPAYER APAs[9]

Small Business Taxpayer APAs Completed in Year 2002	**6**
Renewals	3
New	3
Unilateral	5
Bilateral	1

TABLE 8: MONTHS TO COMPLETE SMALL BUSINESS TAXPAYER APAs

New		Renewal		Combined	
Average	12.2	Average	8.1	Average	10.2
Median	8.4	Median	6.5	Median	7.7

[8] A large number of the negotiating positions completed in six months or less related to companies carrying on limited business activities. These negotiating positions were associated with a bilateral competent authority agreement that established streamlined resolution guidelines.
[9] Small Business Taxpayer APAs are processed under the special procedures set forth in Notice 98–65.

TABLE 9: INDUSTRIES COVERED

Industry Involved – NAICS Codes[10]	Number
Computer and electronic product manufacturing – 334	19–21
Electronic equipment, appliance and component manufacturing – 335	16–18
Miscellaneous manufacturing – 339	7–9
Transportation equipment manufacturing – 336	7–9
Apparel manufacturing – 315	4–6
Wholesale trade, durable goods – 421	4–6
Wholesale trade, nondurable goods – 422	4–6
Machinery manufacturing – 333	1–3
Clothing and clothing accessories stores – 448	1–3
Motor vehicle and parts dealers – 441	1–3
Air transportation – 481	1–3
Mining (except oil and gas) – 211	1–3
Food manufacturing – 311	1–3
Beverage and tobacco manufacturing – 312	1–3
Paper manufacturing – 322	1–3
Chemical manufacturing – 325	1–3
Nonmetallic mineral product manufacturing – 327	1–3
Primary metal manufacturing – 331	1–3
Food and beverage stores – 445	1–3
Sporting goods, hobby, book and music stores – 451	1–3
Broadcasting and telecommunications – 513	1–3
Securities, commodity contracts and other intermediary and related activities – 523	1–3
Publishing industries – 511	1–3

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

The nature of the relationships between the related organizations, trades, or businesses covered by APAs executed in Year 2002 is set forth in Table 10 below:

TABLE 10: NATURE OF RELATIONSHIPS BETWEEN RELATED ENTITIES

Relationship	Number of APAs
Foreign Parent – U.S. Subsidiary (-ies)	49
U.S. Parent – Foreign Subsidiary (-ies)	33
Partnership	2
Other	1

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

The controlled transactions covered by APAs executed in Year 2002 are set forth in Table 11 and Table 12 below:

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[10] 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	37
Performance of services by Non-US entity	35
Performance of services by US entity	26
Sale of tangible property from the US	18
Use of intangible property by Non-US entity	11
Use of intangible property by US entity	5
Other	6

TABLE 12: TYPES OF SERVICES INCLUDED IN COVERED TRANSACTIONS

Intercompany Services Involved in the Covered Transactions	Number
Manufacturing services[11]	30
Distribution	13
Technical support services	12
Sales support	10
Logistical support	9
Administrative	9
Marketing	9
Product support	8
Management	7
Research and development	6
Accounting	5
Contract research & development	4
Testing and installation services	4
Warranty services	4
Headquarters costs	4
Assembly	3
Communication service	3
Legal	3
Repair	3
Billing services	2
Purchasing	2

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 2002 are set forth in Tables 13 and 14 below:

[11] Business activities addressed by a bilateral competent authority agreement that established streamlined guidelines for resolution.

TABLE 13: FUNCTIONS PERFORMED BY THE TESTED PARTY

Functions performed	Number
Distribution functions	55
Product assembly and/or packaging	52
Marketing functions	40
Managerial, legal, accounting, finance, personnel, and other support services	37
Manufacturing	35
Product testing and quality control	27
Technical training and tech support for sales staff (including sub-distributors)	26
Purchasing and materials management	24
Transportation and warehousing	23
Research and development	22
Product service (repairs, etc.)	21
Product design and engineering	18
Licensing of intangibles	13
Process engineering	10
Consulting services	10
Customer service	2
Mining and extraction	2

TABLE 14: RISKS ASSUMED BY THE TESTED PARTY

Risks Assumed	Number
Market risks, including fluctuations in costs, demand, pricing, & inventory	63
General business risks (*e.g.*, related to ownership of PP&E)	62
Credit and collection risks	45
Financial risks, including interest rates & currency	38
Product liability risks	19
R&D risks	18

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 its APA submission, the taxpayer must 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 is critical in determining the TPM (including the selection of comparables). Although functional comparability is an essential factor in evaluating the reliability of the TPM (including the selection of comparables), the APA evaluation process also involves consideration of economic conditions such as the economic condition of the particular industry.

In evaluating the functional analysis, the APA program considers contractual terms between the controlled parties and the consistency of the conduct of the parties with respect to the allocation of risk. In accord with the section 482 regulations, the APA program also gives consideration to the ability of controlled parties to fund losses that might be expected to occur as the result of the assumption of 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 section 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 2002 are set forth in Table 15 below:

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

Type of Organization	Number
Non-US provider of services	34
Multiple tested parties[12]	30
US distributor	26
US provider of services	21
US manufacturer	11
Non-US distributor	5
Non-US manufacturer	2
Non-US licensee of intangible property	2
Other	7

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 2002 are set forth in Tables 16–20 below:

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

TPM used	Number[13]
Residual profit split	14
CPM: PLI is operating margin	10
CPM: PLI is Berry Ratio	10
CUT (intangibles only)	8
Resale Price Method (tangibles only)	8
CPM: PLI is markup on total costs	6
Unspecified method	6
CPM: PLI is Gross margin	5
Cost Plus Method (tangibles only)	5
CPM: PLI is other	4
CUP (tangibles only) – based on published market data	3
CUP (tangibles only) – not based on published market data	2
Other	3

[12] "Multiple tested parties" includes covered transactions that utilize profit splits, CUPs, and CUTs.

[13] 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) operating margin (ratio of operating profit to sales); (2) Berry ratio (gross profit to operating expenses); (3) markup on total costs (comparative markup on total costs); and (4) gross margin (ratio of gross profit to sales).

TABLE 17: TRANSFER PRICING METHODS USED FOR SERVICES

TPM used	Number
Cost plus a markup	37
Cost with no markup	9
CPM: PLI is markup on total costs	7
CPM: PLI is other	4
CPM: PLI is Berry Ratio	2
CPM: PLI is operating margin	2
Other	5

Discussion

The TPMs used in APAs completed during Year 2002 were based on the section 482 regulations. Under Treas. Reg. § 1.482–3, the arm's length amount for controlled transfers of tangible property may be determined using the Comparable Uncontrolled Price (CUP) method, the Resale Price Method, the Cost Plus Method, the Comparable Profits Method (CPM), or the Profit Split method. Under Treas. Reg. § 1.482–4, the arm's length amount for controlled transfers of intangible property may be determined using the Comparable Uncontrolled Transaction (CUT) method, CPM, or 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 Treas. Reg. § 1.482–1(c). For transfers involving the provision of services, Treas. Reg. § 1.482–2(b) provides that services performed for the benefit of another member of a controlled group should 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, Treas. Reg. § 1.482–2(a) provides rules concerning the proper treatment of loans or advances, and Treas. Reg. § 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, 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 if sufficiently reliable comparable transactions can be identified. Treas. Reg. § 1.482–3(b)(2)(ii)(A). It was the experience of the APA Program in Year 2002 that in the cases that come into the APA Program, sufficiently reliable CUP transactions are difficult to find. In APAs executed in Year 2002, there were five covered transactions that used the CUP method; three looked to published market data and two used internal data on transactions between the taxpayer and unrelated parties.

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 if sufficiently reliable comparables may be found. Treas. Reg. § 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 2002, there were eight covered transactions that utilized the CUT TPM.

The Cost Plus Method (tangibles only) and Resale Price Method were applied in Year 2002 in five and eight APAs respectively. See Treas. Reg. § 1.482–3(c), (d).

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. Treas. Reg. § 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. Treas. Reg. § 1.482–5(c)(2).

Table 16 reflects 35 uses of the CPM (with varying PLIs) in covered transactions involving tangible or intangible property. The CPM was also used in some APAs concurrently with other methods.

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.

The CPM also was used regularly with services as the covered transactions in APAs executed in Year 2002. There were a total of fifteen 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 2002, there were fourteen APAs involving tangible or intangible property that used the residual profit split, Treas. Reg. § 1.482–6(c)(3). In residual profit split cases, 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.

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

Critical Assumptions used in APAs executed in Year 2002 are described in Table 18 below:

TABLE 18: CRITICAL ASSUMPTIONS

Critical Assumptions involving the following:	Number of APAs
Material changes to the business	84
Material changes to tax and/or financial accounting practices	83
Assets will remain substantially same	31
Consistency requirements, etc., for manufacturing services	30
Catastrophic events	11
Changes in affiliated companies	5
Major regulatory changes	5
Other financial ratio	5
Major contract remains in force	5
Material sales fluctuations	4
Marketing conditions substantially same	3
Currency fluctuations	2
Changes in other duties or tariffs	2
New import/export non-tariff barriers	2
Other	7

Discussion

APAs include critical assumptions upon which their respective TPMs depend. 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 2002 are described in Tables 19 through 21 below. Various formulas for making adjustments to comparables are included as Attachment B.

TABLE 19: SOURCES OF COMPARABLES

Comparable Sources	Number of Times This Source Used
Compustat	81
Disclosure	50
Moody's	12
Trade publication	5
Mergent	2
Bureau Van Dijk's JADE (Japan)	2
Other	9

TABLE 20: COMPARABLE SELECTION CRITERIA

Selection Criteria Considered	Number of Times This Criterion Used
Comparable functions	90
Comparable risks	65
Comparable industry	64
Comparable products	57
Comparable intangables	27
Comparable contractual terms	4

TABLE 21: ADJUSTMENTS TO COMPARABLES OR TESTED PARTIES

Adjustment	Number of Times This Adjustment Used
Balance sheet adjustments	—
Receivables	40
Inventory	38
Payables	38
Property, plant, equipment	12
Non-interest bearing liabilities	2
Other	3
Accounting adjustments	—
LIFO to FIFO inventory accounting[14]	51
Accounting reclassifications (*e.g.*, from COGS to operating expenses)	9
Depreciation	5
Other	2

[14] The majority of these LIFO to FIFO inventory accounting adjustments regard business activities addressed by a bilateral competent authority agreement that established streamlined resolution guidelines.

TABLE 21: ADJUSTMENTS TO COMPARABLES OR TESTED PARTIES—Continued

Adjustment	Number of Times This Adjustment Used
Profit level indicator adjustments (used to "back into" one PLI from another)	—
Operating expense	2
Other	2
Miscellaneous adjustments	—
Goodwill value or amortization	23
Foreign exchange	10
Other	8

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 transactions or business activities of independent companies 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. 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 19 shows the various databases and other sources used in selecting comparables for the APAs executed in Year 2002.

Although comparables were most often identified from the databases cited in Table 19, in some cases comparables were found from other sources, such as comparables derived internally from taxpayer transactions with third parties.

Selecting Comparables

Initial pools of potential comparables generally are derived from the databases using a combination of industry and keyword identifiers. Then, the pool is refined using a variety of selection criteria specific to the transaction or business activity being tested and the TPM being used.

The listed databases allow for searches by industrial classification, 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 industry classification 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 business activities 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 business activities that comprise the set, is highly fact specific and depends on the reliability of the results.

In addition, the APA Program, consistent with the section 482 regulations, generally has looked at the results of comparables 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 comparables in different stages of economic development or use of atypical years of a comparable 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 transaction or business activities being tested. In addition, 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 business activity 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 business activity 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), then 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. 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 industry classification. Similarly, a test involving the ratio of operating expenses to sales has helped to determine whether a company undertakes a significant marketing and distribution function.

Table 22 shows the number of times various screens were used in APAs executed in Year 2002:

TABLE 22: COMPARABILITY SCREENS

Comparability Screen Used	Number of Times Used
Comparability screens used	—
Sales	20
R&D/ sales	18
Foreign sales/ total sales	10
SG&A/ sales	10
Non-startup or start-up	4
PP&E/ sales	4
PP&E/ total assets	3
Operating expenses/ sales	2
Financial distress	—
Losses in one or more years	23
Bankruptcy	22
Unfavorable auditor's opinion	12

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 PLIs, certain "asset intensity" or "balance sheet" adjustments for factors that have generally agreed-upon effects on profits are calculated. In addition, in specific cases, additional adjustments are performed to improve reliability.

The most common balance sheet 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 there is an opportunity cost for holding assets. For these assets it is generally assumed that the cost is a short-term debt interest rate.

To compare the profits of two business activities with different relative levels of receivables, inventory, or payables, the APA Program estimates the carrying costs of each item and adjusts 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 TPM (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 also requires that data be compared on a consistent accounting basis. For example, although financial statements may be prepared on a first-in first-out (FIFO) basis, cross-company comparisons are less meaningful if one or more of the comparables use LIFO inventory accounting methods. This adjustment directly affects costs of goods sold and inventories, and therefore affects both profitability measures and inventory adjustments.

Still important in some cases is the adjustment for differences in relative levels of PP&E between a tested business activity and the comparables. Ideally, comparables and the business activity 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.

Additional adjustments used less frequently 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, are also made when warranted to increase reliability. Often, data is not 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 2002 are reflected in table 21 above.

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

The types of ranges and adjustment mechanisms used in APAs executed in Year 2002 are described in Table 23 and 24 below.

TABLE 23: TYPES OF RANGES

Type of Range	Number[15]
Interquartile range	39
Specific point within CPM range	10
Specific point (royalty)	7
Floor (*i.e.*, result must be no less than x)	4
Specific point (CUP)	2
Other	10

TABLE 24: ADJUSTMENTS WHEN OUTSIDE OF THE RANGE

Adjustment mechanism	Number
Taxpayer makes an adjustment: to closest edge	32
Taxpayer makes an adjustment: to specified point	20
Taxpayer makes an adjustment: to median	10
Other	5

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 Treas. Reg. § 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 Treas. Reg. § 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. If the

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

comparables are of lesser quality, then under Treas. Reg. § 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 Treas. Reg. § 1.482–1(e)(2)(iii)(C). The interquartile range was used 39 times in Year 2002.

Nineteen covered transactions reflected on Table 23 specified a single, specific result, or "point." Ten of these covered transactions involved a CPM in which the taxpayer agreed to a specific result. Some APAs specify not a point or a range, instead using a "floor" that requires the tested party's result be greater than or equal to some particular value. Four APAs executed in Year 2002 used a floor.

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 2002, rolling multi-year averaging was used for twelve covered transactions. Eleven of those used three-year averages, and the other one used a five-year average. Cumulative multi-year averages were used for two covered transactions. Of those two transactions, one used a five-year average, and one used a seven-year average. Additionally, nine covered transactions used term averages.

Adjustments

Under Treas. Reg. § 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. APAs may 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. APAs may permit automatic adjustments unless the result is far outside the range specified in the APA. Thus APAs provide flexibility and efficiency, permitting adjustments when normal business fluctuations and uncertainties push the result somewhat outside the range.

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 Rollback Lengths
[§ 521(b)(2)(D)(x)]

The various term lengths for APAs executed in Year 2002 are set forth in Table 25 below:

TABLE 25: TERMS OF APAs

APA Term in Years	Number of APAs
1	3
2	1
3	5
4	11
5	50
6	7
7	4
8	2
9	1
10	1

Number of rollback years to which an APA TPM was applied in Year 2002 is set forth in Table 26 below:

TABLE 26: NUMBER OF YEARS COVERED BY ROLLBACK OF APA TPM

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

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

APAs executed in Year 2002 required that taxpayers provide various documents with their annual reports. These documents are described in Table 27 below:

TABLE 27: NATURE OF DOCUMENTATION REQUIRED

Documentation	Number of Times This Documentation Required[16]
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	85
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	84
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	84
Financial analysis demonstrating Taxpayer's compliance with TPM	84
Description of any failure to meet Critical Assumptions or, if there have been none, a statement to that effect	84
Financial statements as prepared in accordance with US GAAP	73
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	73
Organizational chart	60
Financial statements as prepared in accordance with a foreign GAAP	30
Various work papers	30
Certified public accountant's opinion that financial statements present fairly financial position of Taxpayer and the results of its operations, in accordance with a foreign GAAP	24
Book to tax reconciliations	10
Certified public accountant's review of financial statements	4
United States income tax return	3
Schedule of costs and expenses (*e.g.*, intercompany allocations)	3
Other	23

[16] The first seven categories of documentation listed in this table were drawn from the standard APA language used in 2002. The facts and circumstances of some APAs may eliminate the need for some standard documentation requirements.

Approaches for Sharing of Currency or Other Risks
[§ 521(b)(2)(D)(xii)]

During Year 2002, there were 38 tested parties that faced financial risks, including interest rate and currency risks. Eleven APAs provide specific approaches for dealing with currency risk, including adjustment mechanisms and critical assumptions.

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.

All reports received by the APA Office are tracked by one designated APA team leader who also has the primary responsibility for annual report review. One of the economists also spends a significant amount of time reviewing annual reports. 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.

The statistics for the review of APA annual reports are reflected in Table 28 below. As of December 31, 2002, there were 101 pending annual reports. In Year 2002, there were 330 reports closed.

TABLE 28: STATISTICS OF ANNUAL REPORTS

Number of APA annual reports pending as of December 31, 2002	101
Number of APA annual reports closed in Year 2002	330[17]
Number of APA annual reports requiring adjustment in Year 2002	5
Number of taxpayers involved in adjustments	2
Number of APA annual reports required to be filed in Year 2002	199
Number of APA annual reports actually filed in Year 2002	189
Number of APA annual report cases over one year old	37

[17] This number differs from previously published figures because of annual reports closed but not yet entered on the system used to compile those statistics.

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, any applicable tax treaties, 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 Revenue Procedure 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 section 11.05 or 11.06 of Revenue Procedure 96–53; 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 Revenue Procedure 96–53. The IRS may request additional information reasonably necessary to clarify or complete the Annual Report. Taxpayer will provide all requested information within 30 days. Additional time may be allowed for good cause.

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 Revenue Procedure 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
Attn: Jane Doe, Sr. Vice President (Taxes)
1000 Any Road
Any City, USA 10000
(phone: __________)

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 ____
Mindy Piatoff
Acting 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)(2) and (3)) 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

The Annual Report will include a cover sheet and a table of contents. The cover sheet will specify:

i. the Parties to the APA

ii. the APA Term (defined in section 3 of this APA)

iii. the APA's effective date (defined in section 14 of this APA)

iv. whether the APA is a renewal, and if so the term of the prior APA

v. whether the APA has been amended, and if so the amendment's effective date

vi. any information needed to distinguish the APA at issue from any other APAs involving the same parties

vii. any changes to the Taxpayer notice information in section 13 of this APA

The table of contents and the Annual Report will be organized as listed below. 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 (including any change that causes an entity to be disregarded for federal income tax purposes) of any Worldwide Group member that is a party to the Covered Transactions or is otherwise relevant to the TPM.

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

f. The amount, reason for, and financial analysis of any compensating adjustments under paragraph 5(f)(2) of this APA for the APA Year, including but not limited to:

i. the amounts paid or received by each affected entity;

ii. the character (such as capital, ordinary, income, expense) and country source of the funds transferred, and the specific affected line item(s) of any affected U.S. Return; and

iii. the date(s) and means by which the payments are or will be made.

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, and any necessary account detail to show compliance with the TPM, with a copy of each independent certified public accountant's opinion required by paragraph 5(d) of this APA.

3. A financial analysis that reflects Taxpayer's TPM calculations for the APA Year. The calculations must reconcile with and reference the Financial Statements in sufficient account 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 are 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): [18]

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 $opex_c$	=	$opex_c - PPEA$

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