Federal Register for April 5, 2000, 65 F.R. 17835)

Advance Pricing Agreements, Issued Pursuant to Pub. L. 106-170, Section 521(b)

Announcement 2000–35

This Announcement is issued pursuant to Section 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. As this is the first report issued under Section 521(b), it includes information about APAs and the APA Program with respect to calendar years 1991 through 1999. Section 521(b)(4) . 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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Advance Pricing
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ANNUAL REPORT CONCERNING ADVANCE PRICING AGREEMENTS

INTRODUCTION

For convenient reference, the subject matter of this report will be organized on the basis of Section 521(b)(2) of Pub. L. 106-170, with each required item or subject reported and captioned by reference to the corresponding statutory provision. First, however, the report provides a general introductory discussion concerning the history, practice, and general approach of the APA Program. This introductory discussion is adapted in part from material contained in Publication 3216, *Report on the Application and Administration of Section 482* (April 21, 1999).

Background

The Advance Pricing Agreement Program is designed to resolve actual or potential transfer pricing disputes in a principled, cooperative manner, as an alternative to the traditional adversarial process. Under the adversarial model, the data gathering, development, and interpretation of a transfer pricing issue is a complex, time-consuming process that often results in an administrative appeal, litigation, or competent authority proceedings under the mutual agreement procedures of our bilateral income tax treaties. A significant transfer pricing issue can typically take eight or more years to resolve. Accordingly, by the time the issue is resolved, the facts in dispute are typically many years old, and considerable uncertainty concerning the proper transfer pricing of current transactions under current conditions can remain.

During the 1980s and prior to the creation of the APA Program, the government as well as taxpayers with transfer pricing issues began to explore some sort of an advance pricing agreement mechanism. A 1985 study by a U.S. professional group on how to improve the large case program recommended advance rulings in the transfer pricing area. In 1986, an agenda topic at a meeting of U.S. and foreign tax officials on how to reduce controversies discussed an advance resolution process for transfer pricing. In 1989, several taxpayers and groups approached the IRS to consider alternative approaches to transfer pricing compliance, viewing the existing means of dealing with transfer pricing issues as being too adversarial as well as unproductive.

The IRS considered new techniques whereby all parties could share the responsibility for enhancing compliance in the transfer pricing area. Derived from the "Compliance 2000" initiatives, this concept of shared responsibility is also consistent with the current mission statement of the IRS to work with taxpayers "to help them understand and meet their tax responsibilities." In April of 1989, the IRS announced at a meeting with the Tax Executives Institute that it was considering an advance ruling procedure for transfer pricing issues. The IRS entered into pilot projects with several taxpayers to negotiate and execute what were initially called Advance Determination Rulings but later became known as Advance Pricing Agreements (APAs). In June of 1990, a draft IRS Revenue Procedure for Advance Determination Rulings was publicly disseminated and the first APA was concluded in January of 1991. With the publication of Rev. Proc. 91–22 (1991–1 C.B. 526), in March of 1991, the IRS formally initiated the APA Program, and by the end of that year, 15 new negotiations had started.

Since then, the APA Program's caseload has steadily grown. The staff has also grown, though not at the same rate as the workload. As of December 31, 1999, the APA Program's staffing included slots for a Director, two Branch Chiefs, four Economists, fourteen Team Leaders, and three clerical support staff. As of December 31, 1999, 231 APAs had been concluded, with another 187 pending. These APAs involve a wide variety of industries. The cross-border transactions involved are also varied, including, for example, manufacturing, sale, and distribution of goods, provision of financial services, and licensing of intellectual property.

The APA Program has also become more "institutionalized" over the years. In 1996, the Service issued internal procedures for processing APA cases. Chief Counsel Directives Manual ("CCDM"), ¶¶ (42)(10)10 – (42)(10)(16)0 (November 15, 1996). Also in 1996, Rev. Proc. 96–53, 1996–2 C.B. 375, was released, updating Rev. Proc. 91–22 in light of the Service's additional experience with administering the APA Program. Together, these releases clarified APA procedures and the respective roles of the various IRS functions involved in the APA process. Rev. Proc. 96–53, in particular, also provides taxpayers a road map of how to apply for an APA and what to expect in the processing of the case.

The APA Program has had a consistent goal of making APAs more practical and affordable, and available to more taxpayers. To this end, in 1997, the IRS instituted an Early Referral program by which, in appropriate cases, District examination teams suggest that taxpayers pursue APAs before substantial time is spent examining transfer pricing issues. To date, however, only three APA requests have been filed pursuant to this procedure. Similarly, in 1998, the IRS published more streamlined procedures for APAs involving Small Business Taxpayers, and also expanded the availability of the lowest APA user fee, in an effort to attract smaller taxpayers who may lack the resources to do the sophisticated studies normally included in APA requests (Notice 98–65, 1998–52 I.R.B. 10). By the end of calendar year 1999, the IRS had concluded 9 small business APAs under these streamlined procedures.

As the United States has become more comfortable with the APA process so has the world. Today, APAs are receiving increased acceptance by many of our treaty partners, including Australia, Mexico, the United Kingdom, Japan, and Canada. In fact, of the 231 closed APAs, 118 involve our treaty partners through the bilateral process (the bilateral process is discussed below). In 1999, the Organization for Economic Cooperation and Development ("OECD") issued as an annex to its Transfer Pricing Guidelines, guidelines for bilateral APAs. OECD, *Guidelines for Conducting Advance Pricing Arrangements Under the Mutual Agreement Procedure ("MAP APAs")* (October 1999). These new OECD guidelines should lead to an even broader acceptance of the APA process by the international community, and it is to be hoped that they will expedite the processing of bilateral APAs by providing for more standardized bilateral APA procedures among OECD members.

The APA Process

The APA process is designed to enable taxpayers and the IRS to agree on the proper treatment of transfer pricing, including cost-sharing arrangements. An APA is a legally enforceable agreement. It need not cover all of a taxpayer's pricing arrangements and instead may be restricted to specified years, specified affiliates, and specified intercompany transactions. APAs are either "unilateral" or "bilateral." A unilateral APA is an agreement between only the taxpayer and the IRS on an appropriate transfer pricing methodology ("TPM") for the transactions at issue. A bilateral APA combines an agreement between the taxpayer and the IRS on a particular TPM with an agreement between the U.S. and foreign taxing authority that the TPM is correct, under authority of the mutual agreement process usually contained in Article 25 of our income tax treaties. 118 of the APAs completed as of the end of 1999 have been bilateral or multilateral, 112 unilateral, and one has involved a U.S. possession. The TPM adopted in both unilateral and bilateral APAs may also be "rolled back" to resolve similar issues for past years under examination.

In practice, an APA is always the result of a voluntary decision by a taxpayer to seek an APA. Before making any commitments or filing the formal application, Taxpayers may through a prefiling conference approach the Service to discuss the Service's preliminary views of their potential APA request, including whether an APA would be appropriate under the facts, what types of information would be necessary to support the request, and whether the taxpayer's proposed TPM would be acceptable. Most taxpayers that come into the APA Program choose to participate in such a prefiling conference. A taxpayer may attend the prefiling conference on an anonymous basis if it wishes. Once the taxpayer decides to apply for an APA, it must prepare and file a submission consistent with the requirements of section 5 of Rev. Proc. 96–53 (1996–2 C.B. 375), accompanied by the appropriate user fee as determined under section 5.14 of Rev. Proc. 96–53.

A multidisciplinary APA Team evaluates the Taxpayer's submission. The APA process focuses on identifying an appropriate TPM, not a desired tax result. The ultimate goal of the APA process is to arrive at an agreement on three basic points: (i) the description of the intercompany transactions to which the APA applies; (ii) the TPM to be applied to those transactions; and (iii) the arm's length range of results that is expected after applying the agreed-upon TPM to the covered transactions. In effect, the IRS APA team conducts "due diligence" to verify the facts and to determine whether the proposed TPM constitutes the "best method" under the Regulations. Typically, one or more meetings between the taxpayer's representatives and the IRS APA team take place. At these meetings, the parties discuss the issues related to the case and attempt to arrive at an agreement concerning the appropriate facts, TPM, and results. In a bilateral case, the APA team will then formulate a negotiating position for use by the United States Competent Authority in negotiations with the relevant foreign government under the mutual agreement article of the applicable treaty. Once a mutual agreement under the treaty is reached, the APA team and the taxpayer will finalize an APA consistent with the terms of the agreement. In unilateral cases, the team will negotiate the terms of the APA with the taxpayer. Both the negotiating position and the APA itself are subject to review and approval by the Associate Chief Counsel (International).

The Arm's-Length Standard

Section 482 of the Internal Revenue Code permits the IRS to allocate items of income, deductions, credits, or allowances between controlled groups or organizations, "to prevent evasion of taxes, or clearly to reflect the income" of any controlled taxpayer, and, in the case of transfers of intangible property, to allocate income with respect to the transfer in a manner that is "commensurate with the income attributable to the intangible."

In determining whether an allocation under Section 482 is necessary clearly to reflect a controlled taxpayer's income, the IRS employs the "arm's length" standard, a principle which is defined in the attendant Treasury regulations. A controlled transaction meets the arm's length standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances. Under current Treasury regulations, the IRS is willing to consider many different approaches to establish the taxpayer's appropriate intercompany transfer pricing methodology or cost sharing practices, provided these approaches satisfy the arm's length principle.

The APA Program evaluates each APA case in terms of developing an arm's-length transfer pricing methodology that is consistent with the Regulations. Because transfer pricing cases typically involve complex facts and difficult issues, there is room for disagreement between reasonable people, acting in good faith, about both the "best method" and the proper application thereof. Therefore, in evaluating and processing an APA case, APA Program Team Leaders are willing to consider taxpayer positions, to engage in negotiations, and to work to reach a mutually acceptable understanding of the appropriate application of the arm's length standard to the taxpayer's facts, in a manner that is consistent with the Regulations.

The arm's length approach is also applied for bilateral and multilateral APAs. In 1995, the Organization for Economic Cooperation and Development ("OECD") published transfer pricing guidelines that adopted the arm's length standard, consistent with our Section 482 Regulations. Similarly, the OECD Model Tax Convention provides:

> where conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

Comparable language outlining the arm's length principle is included – generally in Article 9 – in most income tax treaties to which the United States is a party. Thus, in cases where competent authority negotiations aimed at relieving double taxation under the mutual agreement provisions of our treaties are undertaken, the goal is a mutual agreement consistent with the OECD arm's length standard.

APA OFFICE: STRUCTURE, COMPOSITION, AND OPERATION
(Section 521(b)(2)(A))

Table 1 provides the structure and staffing of the APA Program office as of December 31, 1999:

TABLE 1
APA PROGRAM STRUCTURE AS OF 12/31/99

Director's Office
1 Director (vacant)
1 Secretary to the Director

Branch 1
1 Branch Chief
1 Secretary
7 Team Leaders
2 Economists

Branch 2
1 Branch Chief
1 Secretary
7 Team Leaders
2 Economists

Discussion

Within the IRS, the APA Program is located in the Office of the Associate Chief Counsel (International) ("ACC(I)"), which is part of the Office of Chief Counsel. However, the APA process demands a variety of skills and draws on expertise from other offices within the IRS. The IRS APA team typically includes:

- a "team leader" from the APA Office, who is responsible for leading the IRS team, negotiating with the taxpayer and its representatives, coordinating with the other IRS functions that have a stake in the APA, formulating the U.S. negotiating position in the case of a bilateral APA, and ultimately drafting the APA
- when certain novel or complex issues are presented, an attorney from one of ACC(I)'s technical branches with expertise in such issues
- the revenue agent responsible for the taxpayer's examination with respect to transfer pricing issues, and often that agent's manager and/or the case manager (the manager with overall responsibility for the taxpayer in question)
- an economist from the APA Program or one assigned to assist the examination group
- an attorney from the District Counsel office that provides legal advice to the examination group
- in bilateral cases, an analyst from the Tax Treaty Division, which is part of the Office of the Assistant Commissioner (International).

In addition, in some cases, depending on the circumstances, Field Specialists and personnel from IRS Appeals function participate as members of the APA Team.

MODEL ADVANCE PRICING AGREEMENT
(Section 521(b)(2)(B))

A copy of the model advance pricing agreement currently in use is attached as Appendix A.

APA PROGRAM STATISTICS
(Sections 521(b)(2)(C) and (E))

The statistical information required under Sections 521(b)(2)(C) and (E) is contained in Tables 2 through 6 below:

TABLE 2
APA PROGRAM STATISTICS – APPLICATIONS AND EXECUTED APAs

	91	*92*	*93*	*94*	*95*	*96*	*97*	*98*	*99*	*Total*
Applications Filed[1]	15	21	34	41	58	46	50	67	69	401
APAs executed:										
New APAs executed during calendar year:										
Unilateral		3	7	4	16	11	18[3]	15	17	91
Bilateral	1	6	1	3[2]	5	12	22[4]	22	28	100
Multilateral					1	1			1	3
U.S. Possession						1				1
Renewal APAs executed during calendar year:										
Unilateral					1	3	3	4	8	19
Bilateral					1	1	2	5	4	13
Multilateral									1	1

[1] Applications filed during years 1991 through 1995 are reflected on a September 30 fiscal year-end basis. The number of APA applications filed from 10-1-95 to 12-31-95 were 23, and are included in the total of 58. Applications filed for years 1996 through 1999 are reflected on a calendar year-end basis.
[2] One bilateral APA executed during the 1994 year was inadvertently omitted in prior reports issued by the APA Program.
[3] One unilateral APA was amended during this year but was not counted as an executed APA. Whether an amendment or supplement to an APA is counted as a separate APA depends on the extent and nature of the change.
[4] One bilateral APA revision to a renewal and one supplemental were closed this year but were not counted as executed APAs. See note 3 above.

Revised APAs executed during calendar year:										
Unilateral					2					2
Bilateral										
Multilateral									1	1
Cumulative total:										
Unilateral		3	10	14	33	47	68	87	112	
Bilateral	1	7	8	11	17	30	54	81	113	
Multilateral					1	2	2	2	5	
U.S. Possession						1	1	1	1	
Cumulative Total of Executed APAs	1	10	18	25	51	80	125	171	231	231

TABLE 3
APA PROGRAM STATISTICS – CANCELLATIONS AND WITHDRAWALS

	91	*92*	*93*	*94*	*95*	*96*	*97*	*98*	*99*	*Total*
Number of APAs Revoked or Canceled [5]	0	0	0	0	0	0	0	1	0	1
Number of APA Withdrawals	0	9	4	0	4	3	6	7	13	46

TABLE 4
APA PROGRAM STATISTICS-TIME TO COMPLETE APA

MEDIAN NUMBER OF MONTHS

	1991	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*
Median number of months to complete the following categories of APAs:									
Unilateral-New	-	14.0	11.0	15.5	13.0	17.0	22.5	14.0	20.0
Unilateral-Renewal	-	-	-	-	19.0	9.0	6.0	17.0	10.5
Unilateral-Combined	-	14.0	11.0	15.5	15.0	12.5	18.0	15.0	14.0
Bi/Multilateral-New	22.0	17.5	31.0	30.0	22.0	23.5	20.0	31.0	33.0
Bi/Multilateral-Renewal	-	-	-	-	30.0	28.0	47.5	16.0	31.0
Bi/Multilateral-Combined	22.0	17.5	31.0	30.0	22.0	24.0	20.0	30.0	33.0

AVERAGE NUMBER OF MONTHS

	1991	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*
Average number of months to complete the following categories of APAs:									
Unilateral-New	-	11.7	13.0	14.0	15.8	16.8	21.0	16.1	22.8
Unilateral-Renewal	-	-	-	-	19.0	8.3	6.3	17.0	10.6
Unilateral-Combined	-	11.7	13.0	14.0	15.9	15.0	18.9	16.2	18.9
Bi/Multilateral-New	22.0	19.7	31.0	26.0	19.6	24.6	22.9	34.5	35.4
Bi/Multilateral-Renewal	-	-	-	-	30.0	28.0	47.5	19.0	32.7
Bi/Multilateral-Combined	22.0	19.7	31.0	26.0	20.9	24.9	24.9	31.6	34.9

[5] One APA was canceled during 1998 due to taxpayer changing its way of doing business.

TABLE 5
APA PROGRAM STATISTICS – PENDING REQUESTS

Total Pending requests for APAs:	187
Pending Unilateral Pending Bilateral	51 136
Pending requests for new APAs: Unilateral Bilateral Pending requests for renewal APAs: Unilateral Bilateral	 35 106 16 30

TABLE 6
APA PROGRAM STATISTICS – INDUSTRIES COVERED

Industry	Number of APAs That Involve This Industry[6]
Financial institutions and products	36
Computer hardware, components, and related products, and computer software	32
Chemicals and related products (industrial, pharmaceutical, cosmetics)	27
Transportation equipment	26
Electrical equipment and components (excluding computers and consumer electronics)	25
Food, beverages, and related products	16
Consumer electronics (excluding computers)	16
Engineering, research, consulting, accounting, management, legal, real estate, subscription, and related services	13
Metal and metal products (excluding machinery)	12
Petroleum refining and related industries	8
Textile mill and apparel products	7
Industrial and commercial machinery	6
Jewelry, sporting equipment, and toys	6
Transportation services	5
Lumber, wood, paper, and related products	5
Telecommunications equipment, components, and services	5
General merchandise and food stores	5
Construction services; construction, ground moving, and mining equipment	4
Printing, publishing, and related industries	4
Marketing, customer support, and employee recruiting services	3
Other	10

[6] This and other tables following will not necessarily total to 231, the number of APAs issued; for example, in this table the number of APAs covering the listed industries totals more than 231 because many APAs cover more than one industry.

RELATIONSHIPS BETWEEN RELATED ORGANIZATIONS, TRADES, OR BUSINESSES
(Section 521(b)(2)(D)(i))

The natures of the relationships between the related organizations, trades, or businesses covered by existing APAs are set forth in Table 7 below:

TABLE 7
NATURE OF RELATIONSHIPS BETWEEN RELATED ENTITIES

Relationship	Number of APAs That Involve This Relationship
U.S. parent, foreign subsidiary(ies)	91
Foreign parent, U.S. subsidiary(ies)	90
Sister companies	22
U.S. company and foreign branches	8
Foreign company and U.S. branch	27
Partnership	2
U.S. Parent, U.S. Possessions subsidiary	1

COVERED TRANSACTI0NS
(Section 521(b)(2)(D)(ii))

The controlled transactions covered by existing APAs are set forth in Table 8 below:

TABLE 8
TYPES OF COVERED TRANSACTIONS

Transaction Type	Number of APAs That Involve This Type
Sale of tangible property into the United States	91
Sale of tangible property from the United States	47
Use of intangible property by a U.S. entity	25
Use of intangible property by a foreign entity	39
Performance of services by a U.S. entity	45
Performance of services by a foreign entity	66
R&D cost sharing - U.S. parent	6
R&D cost sharing - foreign parent	8
Financial products - U.S. parent	2
Financial products - foreign parent	5
Financial products - U.S. branch of foreign company	24
Financial products - foreign branch of U.S. company	9
Commodity trading on globally integrated basis	2

BUSINESS FUNCTIONS PERFORMED AND RISKS ASSUMED, INCLUDING CURRENCY RISK

(Sections 521(b)(2)(D)(ii) and (xii))

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 Section 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 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.

In some cases it has been necessary to employ special adjustments that quantify differences in functions, risks, and markets between the tested party or transactions and comparables. The question of whether and how to adjust for currency risk exposure has been an area of particular interest in APAs. Although there are several types of currency risk (e.g., transactional, translation, and economic), economic currency risk has been the area of greatest discussion. Economic currency risk represents the risk that companies incur when their input costs are denominated in a currency that is different than that of their competitors. For example, if a foreign multinational manufactures product in its home country for distribution into the United States then the company's competitive position is eroded (strengthened) if the home country's currency appreciates (depreciates) relative to the U.S. dollar, assuming that the firm's competitors face U.S. dollar based costs.

There are a variety of ways in which this issue has been treated in APAs. In the vast majority of cases no adjustment has been incorporated into the APA agreement. This may be because the comparables experience similar currency exposure, the tested party is assumed not to bear any of the currency risk, the currency fluctuations have not been material, or the taxpayer is able to pass through substantially all of its currency risk to end users. In certain APAs a critical assumption has been inserted that requires the parties to renegotiate the agreement in the event that exchange rate fluctuations exceed certain parameters.

Two types of currency adjustments have been employed in APAs. Both have been employed in conjunction with the comparable profits method ("CPM"). The first type of adjustment specifies that, for a given percentage change in the exchange rate, the tested party's gross margin will be adjusted by a percentage that is less than the percentage change in the exchange rate. The second type of adjustment has provided a band of exchange rate movements for which no adjustment would be made. For exchange rate movements outside of the no adjustment band, the operating margin of the tested party is adjusted based upon the extent of the exchange rate fluctuation. Both of these approaches have generally called for positive or negative adjustments depending on whether a currency appreciates or depreciates against the dollar.

RELATED ORGANIZATIONS, TRADES, OR BUSINESSES WHOSE PRICES OR RESULTS ARE TESTED TODETERMINE COMPLIANCE WITH APA TPMs

(Section 521(b)(2)(D)(iii))

The related organizations, trades, or businesses whose prices or results are tested to determine compliance with TPMs prescribed in existing APAs are set forth in Table 9 below:

TABLE 9
RELATED ORGANIZATIONS, TRADES OR BUSINESSES WHOSE PRICES OR RESULTS ARE TESTED

Type of Organization	Number of APAs That Involve This Type
U.S. distributor	83
Foreign distributor	35
U.S. manufacturer	46
Foreign manufacturer	45
U.S. provider of services	46
Foreign provider of services	50
U.S. participant in cost sharing arrangement	14
Foreign participant in cost sharing arrangement	14
U.S. licensor of intangible property	14
Foreign licensor of intangible property	12
U.S. licensee of intangible property	23
Foreign licensee of intangible property	33
U.S. dealer in financial products	30
Foreign dealer in financial products	22
U.S. dealer in commodities	2
Foreign dealer in commodities	2
Publisher and web site operator	1

With some TPMs, only the results of one party are tested. With the resale price method under Reg. § 1.482–3(c), only the distributor's gross margin is tested. With the cost plus method under Reg. § 1.482–3(d), only the manufacturer's markup on costs is tested. With the comparable profits method under Reg. § 1.482–5, one party's profitability (normally that of the simpler party, with no or fewer pertinent intangible assets) is tested. For provision of services under Reg. § 1.482–2(b), typically only the provider of services is tested. With some TPMs, the prices or results of both parties are tested. For example, with the comparable uncontrolled price method under Reg. § 1.482–3(b), the price charged between the related parties is tested. Similarly, with the comparable uncontrolled transaction method under Reg. § 1.482–4(c), the compensation for intangibles paid between the related parties is tested. With profit split methods under Reg. § 1.482–6, and for financial products cases under Prop. Reg. § 1.482–8, the split of profits between the related parties is tested in light of each party's contributions. With cost sharing under Reg. § 482–7, the parties' sharing of costs is tested in light of the parties' reasonably anticipated benefits.

TPMs AND THE CIRCUMSTANCES LEADING TO THE USE OF THOSE TPMs
(Section 521(b)(2)(D)(iv))

The TPMs used in existing APAs are set forth in Tables 10-14 below:

TABLE 10
TPMs USED FOR TRANSFERS OF TANGIBLE AND INTANGIBLE PROPERTY

TPM	Number of APAs That Involve This TPM
Comparable Uncontrolled Price (CUP) (tangible property only)	7
CUP based on reference to published market data	2
Comparable Uncontrolled Transaction (CUT) (intangible property only)	12
Resale Price (tangible property only)	10
Cost Plus (tangible property only)	10

Comparable Profits Method (CPM): PLI is operating margin	57
Comparable Profits Method (CPM): PLI is gross margin	12
Comparable Profits Method (CPM): PLI is return on assets or capital employed	17
Comparable Profits Method (CPM): PLI is Berry ratio (markup on SG&A)	13
Comparable Profits Method (CPM): PLI is a markup on costs (normally total costs)	15
Commission computed as percentage of sales minus expenses reimbursed by related supplier	1
Operating income point that depends on sales change and on internal management measure of profitability	2
Comparable Profit Split	1
Residual Profit Split	14
For globally integrated commodity trading, profit split by formula based on compensation and commodity positions	2
Other Profit Split	8
Profit set to sum of a certain return on assets and a certain operating margin; this method combined with an other profit split	1
Agreed royalty (fixed rate)	7
Agreed royalty (rate varies with operating margin)	2
Agreed royalty (rate varies with ratio of R&D to sales)	1
Taxpayer's worldwide royalty schedule justified by CPM analysis	1
R&D cost sharing amount plus a percentage of sales	1

TABLE 11
TPMs USED FOR SERVICES

TPM	Number of APAs That Involve This TPM
Charge-out of cost with no markup	17
Charge-out of cost with markup	41
Commission as percentage of sales	2
Markup on costs, but R&D expenses limited to certain percentage of sales	1
Asset-proportionate share of system-wide return on assets, but limited to certain range of markup on costs	1
Profit is the sum of a markup on costs, a percentage of sales of patented products resulting from contract R&D performed by tested party, and other factors	1
For real estate management, fee is percentage of rents plus percentage of total value of new leases, but not less than a certain markup on costs	1
Dollar cap on management fee	1
Profit split using five-factor formula	1
Profit split, subject to a floor on operating margin	1

TABLE 12
TPMs USED FOR FINANCIAL PRODUCTS

TPM	Number of APAs That Involve This TPM
Profit split under Notice 94–40/Prop. Reg. 1.482–8	20
Residual profit split	2
Interbranch allocation (*e.g.*, foreign exchange separate enterprise)	18
Market-based commission	2
Taxpayer's internal allocation system	1

TABLE 13
TPMs USED FOR CONTRIBUTIONS TO COST SHARING ARRANGEMENTS

Cost Allocated By	Number of APAs Using This Allocation
Sales	7
Sales and production costs	2
Sales and profit	2
Profit	2
Raw material costs	1

TABLE 14
TPMs USED FOR COST SHARING BUY-IN PAYMENTS

TPM	Number of APAs That Involve This TPM
Capitalized R&D	2
The sum of two payments, one based on capitalized R&D and the other based on a residual profit split analysis	2
Market capitalization	1
Residual profit split with comparable acquisitions check	1

DISCUSSION

In general, the TPMs set out in Tables 10-14 above track the methods specified in the Regulations. Reg. § 1.482–3(a) provides the following methods to determine income with respect to a transfer of tangible property: the comparable uncontrolled price ("CUP") method (Reg. § 1.482–3(b)); the resale price method (Reg. § 1.482–3(c)); the cost plus method (Reg. § 1.482–3(d)); the comparable profits method ("CPM") (Reg. § 1.482–5); and the profit split method (Reg. § 1.482–6). Reg. § 1.482–4 provides the following methods to determine income with respect to a transfer of intangible property: the comparable uncontrolled transaction ("CUT") method (Reg. § 1.482–4(c)); CPM; and profit split. In addition, with respect to both tangibles and intangibles, methods not specified in these sections may be used if they provide a more reliable result; such methods are referred to as "unspecified methods." In addition to these methods, the Regulations provide for pricing methods applicable to transactions other than the transfer of tangible or intangible property. Reg. § 1.482–2(a) provides rules concerning the proper treatment of loans or advances between controlled taxpayers. Reg. § 1.482–2(b) deals with provision of services, providing that services ordinarily should bear an arm's length charge, and that in certain circumstances an arm's length charge may be deemed to be the cost of providing the services. Finally, 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 from their use of the intangibles assigned to them under the agreement. APAs dealing with such cost sharing agreements deal with both the method of allocating costs among the parties, and the determination of the amount of the "buy-in" payment due in the case of preexisting intangibles transferred as a result of entering into the cost sharing agreement.

Under the Regulations, there is no strict hierarchy of methods, nor is one method exclusively applicable to a given type of transaction, while a different method would be exclusively applicable to a different type of transaction. Instead, the Regulations prescribe a more flexible "best method" approach. The best method is the method that provides the most reliable measure of an arm's length result. Reg. § 1.482–1(c)(1). Usually, data based on results of transactions between unrelated parties provide the most objective basis for determining an arm's length price. Reg. § 1.482–1(c)(2). In such cases, reliability is a function of the degree of comparability between the controlled transactions or taxpayers and the uncontrolled comparable transactions or parties, and the quality of the data and assumptions used in the analysis. Reg. § 1.482–1(c)(2). Factors affecting comparability include the industry involved, the functions performed, the risks assumed, contractual terms, the relevant market and market level, and other considerations. Reg. § 1.482–1(d)(3). See also the discussion of comparables below.

These principles are central to the evaluation of an APA case by the APA Team. Typically, the Team will determine the relevant facts of the case; once the facts are determined, the Team will focus on determining the appropriate TPM by identifying comparable uncontrolled data, determining the degree of comparability of such data, making such adjustments (either to the taxpayer's or tested party's data or to the comparables) as are necessary to make the data more comparable (and thus more reliable), and determining which TPM would be most reliable, and thus the best method, in light of the available data.

This in essence is the function performed by the APA Team. The Team must evaluate each case through an application of the principles of the Regulations. APA cases often tend to be more difficult than a typical transfer pricing case; if the case were easy to resolve, there would be less need to resort to the APA process. Given this fact, and the nature of transfer pricing law and analysis, the APA Team must focus on the particular facts of the case and must have a clear, detailed understanding of the taxpayer's business. The Team then evaluates the taxpayer's functions and risks, the industry involved, market conditions, contractual terms, availability of data, and all the other factors that are relevant under the Regulations. Analysis of the interplay of the facts and transfer pricing principles present in the case, coupled with careful consideration of the taxpayer's views, allows the Team to reach a reasoned, case-specific application of the arm's length principle under Section 482.

Such analysis of real-life cases has proven a valuable way for the Service to learn more about taxpayers' businesses, and their concerns and difficulties in attempting voluntarily to comply with their tax obligations. This can enable the Service to provide better and more timely guidance. At the same time, in the interim, taxpayers can achieve certainty concerning their prospective filing obligations through participation in the APA process. A good example of such synergy between the APA Program and issuance of general guidance is provided by the proposed "global dealing" regulations (63 Fed. Reg. 11177 [REG–208299–90] (March 6, 1998)). The Service's early experience with "global dealing" APAs was described in Notice 94–40, 1994–1 C.B. 351. This Notice described the methodologies that had been used for a particular type of global dealing cases. In these cases, a global financial institution or affiliated group of companies would continuously trade securities and other financial products on a twenty-four hour basis, with responsibility for the "book" of positions passing from location to location in accordance with the passing of normal business hours in a given location. Existing rules created uncertainty regarding the appropriate treatment of such fact patterns. APAs bridged the gap until more general guidance could be issued.

Review of Table 10 reveals that the great majority of APA TPMs applicable to the transfer of tangible or intangible property are specified methods under the Regulations. The CUP method has been used when it has been possible under the facts of the cases submitted to identify uncontrolled transactions with the required degree of comparability between products, contractual terms, and economic conditions. See Reg. § 1.482–3(b)(2)(ii). In many cases data concerning external CUPs was difficult to obtain; unrelated taxpayers dealing in the comparable product would ordinarily also deal in other items as well, and it is sometimes difficult to separate the pricing of the relevant transactions from the other results, based on publicly reported available data. Thus, in the APA Program's experience, there has been a tendency to utilize internal CUPs. In addition, in two cases, where the covered product involved a commodity, publicly available market data provided a comparable price that could be referred to for purposes of establishing a CUP.

For similar reasons, APAs applying the CUT method have tended to rely on internal transactions between the taxpayer and unrelated parties; *i.e.*, it has often been difficult to identify an external CUT. For example, in a case dealing with a royalty for a nonroutine intangible such as a trademark, it can be difficult to identify an unrelated party royalty arrangement that is sufficiently comparable, due to the unique nature of the nonroutine intangibles. To avoid these difficulties, some cases have utilized a "step royalty" arrangement to determine the proper transfer price for use of a unique intangible. For example, taxpayers have argued that an intangible was very valuable and therefore a high royalty rate was appropriate. Because there were no exact or closely similar comparables, it was difficult to demonstrate objectively whether the taxpayer was correct. A sliding scale, or step royalty, in conjunction with a CPM analysis, has been used to resolve such cases. The premise of such APAs was that, if the intangible truly had great value, the taxpayer would earn higher than normal return from its activities utilizing the intangible. Conversely, as the value of the intangible decreased, the taxpayer's pre-royalty results would be in the routine arm's-length range. Therefore, the royalty rate adopted in these APAs increases as the licensee's profitability increases.

Based on the facts and circumstances of the cases evaluated by the APA Program, ten APAs to date have utilized a strict transactional resale price method. Similar considerations concerning comparability and data availability apply to this method.

A transactional cost plus method has been applied in ten cases as well. This method has proved easier to apply than the other transactional methods because the taxpayer's costs are identifiable and it is likely to be easier to identify functionally comparable transactions for purposes of determining an appropriate arm's length markup than it is to identify closely similar products in the case of a CUP. See Reg. § 1.482–3(d)(3)(ii). In other words, for example, a manufacturer might perform similar functions and assume similar risks even though the product manufactured is not identical or nearly identical to the taxpayer's product.

The CPM is frequently applied in APAs. This is because reliable public data on comparable business activities of independent companies can 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. Reg. §§ 1.482–3(c)(3)(iii)(B), 1.482–3(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. Reg. § 1.482–5(c)(2).

As can be seen from Table 10, a variety of profit level indicators ("PLIs") has been used in connection with application of the CPM. The rationale for choosing which PLI to use in a given case turns on all the factors contained in the Regulations, including availability and reliability of information, and the nature of the activities of the tested party. For example, return on assets or return on capital employed ("ROCE") may be most reliable in cases where the level of operating assets has a high correlation to profitability, that is, where the operating assets play a greater role in generating profits – for example, a manufacturer's operating assets such as property, plant, and equipment could have more impact on profitability than a distributor's operating assets, since often the primary value added by a distributor is based on services it provides, which are often less dependent on level of operating assets. Reg. § 1.482–5(b)(4)(i). The reliability of ROCE has also been dependent on the structure of the taxpayer's assets and their similarity to those of the comparables, since different asset categories can have different rates of return.

Other PLIs applied by APAs in conjunction with the CPM are various financial ratios. These include operating margin ("OM"), Berry ratio, markup on costs, and gross margin. OM is defined as the ratio of operating profit to sales. The Berry ratio[7] is defined as the ratio of gross profit to operating expenses. A Berry ratio has in some cases been used when services provided (for example, a low-risk distributor providing marketing and distribution services) are the main source of value added by the tested party, and the expenses incurred for providing those services are classified as operating expenses rather than costs of goods sold. In such cases a Berry ratio is essentially a markup on operating expenses. OM has been used when functions of the tested party are not as closely matched with the available comparables. Markup on costs (normally total costs) has been used when the taxpayer's sales are a controlled transaction, because it relies on an uncontrolled cost figure rather than on the controlled sales figure. This method has also been used where it is common industry practice to set prices by reference to costs, for example, for contract manufacturers. Occasionally, certain costs have not been marked up, such as product-specific taxes reimbursed by the purchaser. In general, gross margin has not been favored as a PLI because the categorization of expenses as operating expenses or cost of goods sold may be subject to manipulation, resulting in understatement of taxable income even where gross margins are within an arm's length range.

The relative utility of each PLI is the subject of much discussion and analysis in each case and depends heavily on the facts and circumstances of the particular case. The APA Team's analysis will often consider several different PLIs; if the results tend to converge, that may provide additional assurance that the result is reliable. If there is a broad divergence between the different PLIs, the Team may derive insight into important functional or structural differences between the tested party and the comparables. For example, such divergence may lead to a discovery that the taxpayer's indicated asset values are not reliable or comparable, such as in the case of a largely depreciated but still valuable asset base.

Profit split methods are used most often when both sides of the controlled transactions own valuable nonroutine intangibles. If all such intangibles were owned by only one side, the other side would usually be the simpler party and therefore, its functional contribution would be more easily valued. Where both sides possess nonroutine intangibles for which there are no good comparables, however, a profit split method can be the most reliable method of establishing an arm's length price. APAs have used both comparable profit splits and residual profit splits, as described in the Regulations. In addition, APAs have used as an unspecified method other types of profit splits; for example, an allocation of profits based on a weighted allocation formula with operating assets and certain operating expenses as factors, allocations based on the relative value of contributions of the parties, or allocations based on compensation and activities similar to the Notice 94–40 (1994–1 C.B. 351), profit split utilized in some financial products cases.

Profit splits have also been used in a number of financial products APAs where the primary income-producing functions are performed in more than one jurisdiction. As described in Notice 94–40, *supra*, these APAs have tended to use a multi-factor formula to represent the contribution of various functions to world-wide profits. Residual profit splits, as provided in Prop. Reg. § 1.482–8(e)(6), have been applied in two cases where routine functions, such as back office functions, were readily valued. The residual profits were allocated on the basis of a case-specific multi-factor formula similar to that discussed in Notice 94–40. In two cases, where all the intangibles were held in one jurisdiction and the other jurisdictions provided routine marketing functions, a market-based transactional commission was used as the most reliable measure of an arm's length return for those routine services. In one case the APA Team determined that the taxpayer's internal profit allocation method provided an arm's length result. In this case, reliability was enhanced because this internal method was used in determining arm's length payments such as compensation and bonuses. Prop. Reg. 1.482–8(e)(5)(iii).

A separate group of financial products cases involves U.S. or foreign branches of a single taxpayer corporation that operate autonomously with respect to the covered transactions, for example the purchase and sale to customers of a financial product such as foreign currency. Pursuant to the business profits articles of the relevant income tax treaties, several APAs determined the appropriate amount of profits attributable to each branch from such activity by reference to the branches' internal accounting methods. The branch results took into account all trades, including interbranch and/or interdesk trades. In order for this method to provide a reliable result, however, it was necessary to ensure that all such controlled trades be priced on the same market basis as uncontrolled trades. To test whether this was so, the branch's controlled trades were matched with that branch's comparable uncontrolled trades made at times close to the controlled trades. A statistical test would then be performed to detect pricing bias, by which the controlled trades might as a whole be priced higher or lower than the uncontrolled trades. See the discussion under "Nature of Ranges and Adjustment Mechanisms" below.

In APA cases involving a cost sharing arrangement ("CSA") under Reg. §

[7] Named after Professor Charles Berry, who used the Berry ratio when serving as an expert witness in *E.I. DuPont de Nemours & Co. v. United States*, 608 F.2d 445 (Ct.Cl. 1979).

1.482–7, the APA Teams have worked with the taxpayers to ensure that the arrangement in question meet the requirements of Reg. § 1.482–7(b). In particular, the Team must determine that the method of determining each participant's share of costs is consistent with the reasonably anticipated benefits that participant is likely to realize from exploitation of the intangible that is the subject matter of the CSA. In cases where the CSA involves transfer of existing technology, the Team must also determine the appropriate "buy-in" under Reg. § 1.482–7(g)(2). Table 13 shows the methods of allocating cost sharing payments adopted in existing APAs, and Table 14 shows the methods of determining the buy-in. These methods have been adopted on a case by case basis, depending on the taxpayer's facts and circumstances.

APAs that have dealt with provision of services have applied Reg. § 1.482–2(b)(3) to determine an arm's length charge for such services; in general, services have been charged out at cost when they were not an integral part of the business activity of either the party rendering the services or the recipient of the services. In cases where the services were integral, or where it was otherwise determined that parties dealing at arm's length would not have charged out the cost of services, the tendency has been to use a cost-plus method to determine an arm's length fee. In six cases, other methods of determining an arm's length fee have been determined to be the best method, as seen in Table 11.

CRITICAL ASSUMPTIONS
(Section 521(b)(2)(D)(v))

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. This type of critical assumption may be defined in terms of a significant variance from budgeted sales volume. 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.

Effects of Critical Assumptions

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 possible Competent Authority activity. Rev. Proc. 96–53, § 11.07. Failure of a critical assumption may also provide an automatic adjustment in the TPM results.

Critical assumption provisions are crucial to the APA because a TPM is premised on certain assumptions that apply to a particular taxpayer, its industry, and the dynamics of the economy. Critical assumptions provide flexibility in an APA by recognizing the reality of change in business cycles and economic circumstances and their effects on varying arm's length returns. Whether critical assumptions change (and/or fail to materialize) is subject to the examination process.

General Critical Assumption

Included in the model APA is the following critical assumption:

The business activities, functions performed, risks assumed, assets employed, and financial [and tax] accounting methods and categories [and estimates] of Taxpayer shall remain materially the same as described in Taxpayer's request for this APA.

Taxpayer-Specific Critical Assumptions

The APAs concluded as of December 31, 1999, include approximately 160 different critical assumptions in addition to the model APA critical assumption noted above. Many of these critical assumptions appear in more than one APA. Most of the critical assumptions reflect specific terms and factors of each taxpayer in an elaboration of the general model APA critical assumption. The critical assumptions can be subdivided into the following categories:

(i) operational,
(ii) legal,
(iii) tax,
(iv) financial,
(v) accounting, or
(vi) economic.

These various categories of critical assumptions are discussed below.

Operational Critical Assumptions

Over 100 of the critical assumptions fall into the operational category. It is not surprising that this is the largest category of critical assumptions. APAs by their nature are factually intensive and reflect the specific operations of each taxpayer and its related parties. In agreeing to a TPM in an APA, the APA Team is basing its position on the facts presented and thus implicitly upon the assumption that those operational facts will remain the same. In addition to the general critical assumption to that effect, many APAs include specific critical assumptions relating to important factual underpinnings of the decision to adopt the TPM.

Over twenty of these operational critical assumptions involve costs or expenses, such as how the taxpayer defines, computes, allocates and apportions costs and expenses. Also included are critical assumptions concerning limits on the amount and manner by which expenses and costs can vary. An example of this type of critical assumption is that a U.S. subsidiary's deductions for restructuring fees shall not exceed a stated maximum dollar amount.

Six operational critical assumptions involve sales. These concern limits on sales mixes, maximum sales amounts, projections of sales and permissible sales trends and variations. An example of this type of critical assumption is that the combined sales of covered products for each APA year must be within 20% of the previous year.

Three operational critical assumption involve new products. They either include or exclude new products from coverage of the APA. They also control how a new product will be treated. An example of this type of critical assumption is that certain new products will not be covered.

Five operational critical assumptions involve permissible variations in items other than sales or expenses. These include how new or disposed of affiliates are treated, to what extent inventories can fluctuate, or to what extent covered purchases can be imported finished products. An example of this type of critical assumption is that the share of covered products that are imported finished goods can vary by X% from the historical baseline share percentage of imported finished goods.

The largest number (over 60) of operational critical assumptions involve limits on change. These critical assumptions state in a specific way that the following items remain substantially the same: customers, products, risks, functions, business methods, assets, pricing policies, absence of catastrophic events, business structure, presence and effect of a cost sharing agreement, functional currency, operating assets, presence or absence of intangible assets, intangible asset ownership, parties to the agreement, licensee agreements, specific personnel, location of specific personnel, presence or absence of commissions, and royalty amounts and percentages. An example of this type of critical assumption is that the location of a particular key executive may not change.

Other operational critical assumptions involve annual review of functions, dates of transfer of property, and maintenance of records. An example of this type of critical assumption is that the gross profit from certain transactions will be recorded in a regularly compiled database.

Legal Critical Assumptions

Fourteen critical assumptions involve legal issues. They include whether a competent authority agreement is conditioned, canceled or has an effect on rollback years (prior years not covered by the APA). An example is that the competent authorities' mutual agreement, which is conditioned on the system profit remaining above a specified minimum level, will remain in effect (*i.e.*, that such condition will continue to be satisfied).

Other critical assumptions of this nature involve liquidations, dissolutions, customs law changes, major regulatory changes, new import or export barriers, and maintenance of a distributor agreement in a specific form. An example of this type of critical assumption is that customs duties on imported covered products shall not increase or decrease by some stated parameter.

Others involve which controlled entity has title to inventory and production equipment, or which controlled entity is required to maintain guarantees, warranties, or product liability. An example of this type of critical assumption is that a parent corporation must maintain existing guarantees for all liabilities of its subsidiary, including its debt and product liability guarantees.

Tax Critical Assumptions

Eleven critical assumptions involve tax issues. These issues include estimated tax liability, period of limitation on assessment, tax effect of specified expenses, sourcing of income, Subpart F income, permanent establishment, foreign tax credit limitation, increasing coverage to other controlled foreign corporations, the ability to change a specified tax election, ability to file for a refund, and a condition of subsequently entering into a closing agreement for roll back years. An example of this type of critical assumption is that the period of limitation on assessments shall be kept open for all APA years until such period expires for the last APA year under U.S. tax law.

Financial Critical Assumptions

Eighteen types of critical assumption are financial in nature. These involve limitations on system loss, intangible profit projections, buy-in payments, lack of currency risk, and valid business reason for debt. Also included in this category are a number of requirements for maintaining various financial ratios such as profit splits, Berry ratios, operating profit margins, and gross profit margins, within prescribed ranges or within limits. An example of this type of critical assumption is that the TPM may not yield a gross margin outside A% to B% for a controlled subsidiary, nor may the combined operating margins be outside C% to D% for the parent and the subsidiary, unless due to valid business reasons or attributable to economic conditions beyond the parent's control.

Accounting Critical Assumptions

Seven critical assumptions involve accounting methods or practices. These include assumptions regarding the use of generally accepted accounting principles, favorable certified opinions, mark to market accounting, consistency of accounting computations for all related parties, methods of accounting for foreign currency gains and losses, and unchanged methods for both financial and tax accounting. An example of this type of critical assumption is that manufacturing costs must be computed in the same manner by U.S. and foreign members of an affiliated group.

Economic Critical Assumptions

Eight critical assumptions involve economic and financial conditions. These include assumptions regarding interest rates and changes in interest rates. They also include assumptions that there will not be significant changes in market conditions, technology, product liability, product design, process design, and market share. An example of this type of critical assumption is that there shall not be an unexpected economic development that materially affects a company's market share or market price of a covered product.

SOURCES OF COMPARABLES, COMPARABLE SELECTION CRITERIA, AND NATURE OF ADJUSTMENTS TO COMPARABLES AND TESTED PARTIES

(Sections 521(b)(2)(D)(v), (vi) and (vii))

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, with the attendant product- or intangible-specific analysis of comparability and reliability. In other cases, comparable business activities of independent companies are utilized in applying the CPM or residual profit split methods. In the APA Program's experience, CUPs and CUTs have been most often derived from internal transactions of the taxpayer. But other cases have utilized third party CUPs or CUTs from external transactions.

For profit-based methods where 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. These steps of identifying potential comparables, selecting comparables from the pool, and adjusting the comparables, are discussed in turn below.

Searching for Comparables

Comparables used in APAs can be U.S. or foreign companies. This depends, of course, 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 which provide data on U.S. publicly-traded companies and on a combination of public and private non-U.S. companies. Table 15 summarizes some of the common databases that have been used for existing APAs.

TABLE 15
COMPARABLES DATABASES USED IN APA ANALYSES

VENDOR	DATABASE*	COVERAGE
Bureau van Dijk	Amadeus Jade Fame	European companies Japanese companies U.K. companies
Disclosure	SEC CanCorp Worldscope	U.S. public companies (primarily) Canadian companies Global companies
Moody's	Domestic International	U.S. public companies Non-U.S. companies
Standard & Poor's	Compustat (Research Insight North America) Global Vantage (Research Insight Global)	U.S. & Canadian public companies (primarily) Non-U.S. companies

* Many vendors now package their data with more than one type of access software. This table shows the major databases without regard to the "front-end" software used to access them. In addition, it does not show other vendors who package existing databases together in products.

Although comparables were most often identified from the databases cited above, in some cases comparables were found from other sources. Chief among this group are comparables derived internally from taxpayer transactions with third parties. In just over 10 percent of all APAs, there were transactions that were evaluated with reference to internal comparable uncontrolled transactions. Also used in a few cases was information available from trade publications in specific industries, and comparables derived from taxpayer information on competitors.

Selecting Comparables

Initial pools of potential comparables have been generally derived from the databases shown in Table 15 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 databases listed above in Table 15 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 even remotely comparable to those of the entity being tested. Therefore, so called "comparables" based solely on SIC or keyword searches are almost never used in APAs.

Rather, pools of initially identified companies are examined closely. This examination consists of a combination of quantitative screens and qualitative evaluations. The application of multiple quantitative screens to select comparables, without also analyzing descriptive information about the companies, has not generally been acceptable APA practice. Rather, companies have been accepted or rejected as comparables based on a combination of screens, business descriptions, and other information found in a company's Annual Report to shareholders and filings with the U.S. Securities and Exchange Commission ("SEC").[8]

In virtually all cases, business activities are required to meet certain basic comparability criteria to be considered comparables. Functions, risks, economic condi-

[8] While the framework is the same for searches for U.S. and non-U.S. comparables, there is generally less descriptive information publicly available for non-U.S. companies. Therefore, selection criteria can be more general for non-U.S. searches.

tions, 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 comparables.

The APA Program has applied a combination of criteria to determine comparability of economic conditions. Specifically, it frequently has combined "same industry" criterion with criteria focusing on the level of market served, the maturity of the company (minimum or maximum number of years of operation) and/or the geographic market served (minimum or maximum percentage of sales in a geographic area and/or percentage of government sales.)

In addition, the APA Program has generally required the potential comparables to have complete financial data available for a specified period of time. Sometimes this has been three years, but it can be 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.

Beyond these criteria and screens which are most often applied, 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, many APA analyses have incorporated some form of 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: operating losses in a given number of years, an unfavorable auditor's opinion, or bankruptcy.

As the transfer pricing regulations state in Reg. § 1.482–1(d)(3)((v), the importance of product comparability depends on the transfer pricing method being used. In using methods that rely on the identification of comparable independent companies, the APA Program has generally required less product comparability than when using methods that rely on comparable uncontrolled prices and licensing transactions. Nonetheless, product comparability, as determined from publicly available corporate information, has been used as a selection criterion when possible.

An additional important class of selection criteria is that which relates to the development and ownership of intangible property. In many 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 in 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. This has been used in circumstances when complete descriptive information about a company's functions was not available.

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." 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 include adjustments for differences in accounts receivable, inventories, and accounts payable. In practice, when data has been available, most APAs have included these adjustments, regardless of whether or not their effect is material. Further, while there is no single standard adjustment mechanism, the different methodologies used have tended to achieve similar results.

The APA Program has 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.

The APA Program has required adjustments for receivables, inventory, and payables based on the principle that holding assets such as receivables and inventory is a cost to the entity holding them and a benefit to customers and/or suppliers (those on either side of a transaction with the entity holding the assets). Such adjustments are based on the assumption that the cost of holding these assets is equal to their carrying cost. Conversely, the holding of accounts payable is considered to be a benefit to the entity holding them, in that they are a source of funds. This benefit has generally been assumed to be equal to the cost of funds.

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 somewhat different formulas have been used in specific APA cases, Appendix B presents one set of formulas used in many APAs.[9] 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 (i/(1+i))[10] rather than a rate (i) should be used in the adjustments for receivables and payables.

Less frequently seen but still potentially 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. In other cases, however, differences in relative levels of PP&E can indicate more of a buy-or-lease difference, variations in the age of assets, or capital-labor choices rather than any functional difference between the companies. In these cases, adjustments similar to those for receivables, inventories, and payables have been made. The PP&E adjustment has, however, been made using a longer term interest rate than the short term rates used for the other balance sheet adjustments.

Additional adjustments, used much more infrequently, include those for differences in other balance sheet items, operating expenses, R&D, or currency risk.[11] In rare or singular cases, there also have been adjustments for start-up costs, cost of capital variations, non-routine intangibles, sales shocks, manufacturing functions, and product liability. These adjustments have been evaluated on a case by case basis and made only when doing so improved the reliability of the results. Finally, 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.

NATURE OF RANGES AND ADJUSTMENT MECHANISMS

(Sections 521(b)(2)(D)(viii) and (ix))

The types of ranges used in existing APAs are set forth in Table 16 below:

TABLE 16
TYPES OF RANGES

Type of Range	Number of APAs That Involve This Type
Full range	5
Interquartile range	41
Interquartile range recomputed after Tukey filter	5
Agreed range	11
Floor (result must be no less than x)	20
Ceiling (result must be no more than x)	4
Specific result	144
Financial products - statistical confidence interval to test for internal CUP	16

DISCUSSION

Reg. § 1.482–1(e)(1) of the transfer pricing regulations 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 Reg. § 1.482–1(e)(2)(i), such a range is normally derived by considering a set of more than one comparable uncontrolled transaction,[12] of similar comparability and reliability. If these comparables are of very high quality, as defined in the Regulations,[13] then under 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 comparables are of lesser quality, then under

[9] The formulas in Appendix B do not represent the formal IRS position on adjustments. Rather, they are examples of adjustment mechanisms that have been used by the APA Program.

[10] This factor may have the holding period incorporated into it.

[11] See above for a discussion of currency risk.

[12] The term "transaction" here can include many transactions by one company, considered on an aggregate basis. See Reg. § 1.482-1(f)(2)(iv) (product lines).

[13] For such comparables, "it is likely that all material differences have been identified" between the uncontrolled comparables and the controlled transaction. Further, each identified difference has "a definite and reasonably ascertainable effect on price or profit, and an adjustment is made to eliminate the effect of each such difference." Reg. § 1.482-1(e)(2)(iii)(A).

Reg. § 1.482–1(e)(2)(iii)(B) "the reliability of the analysis must be increased, where 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. (A precise definition is given in Reg. § 1.482–1(e)(2)(iii)(C).) In the case of bilateral APAs, other methods for setting a range have been agreed upon as a result of compromise negotiations between the Competent Authorities.

A variant on the interquartile range involves a "Tukey filter," as follows. First, the set of comparables is used to derive a standard interquartile range. Then the difference D between the top and bottom of the interquartile range is computed. Next, all comparables whose results are more than a certain multiple of D (often the multiple 1.5 is used) outside the interquartile range are discarded as "outliers." Finally, the reduced set of comparables (without the outliers) is used to compute a second interquartile range, which is then used as the arm's length range. This approach has only occasionally been used for APAs (see Table16). The Tukey filter has been used to eliminate companies that were so anomalous that they arguably should not have been included as comparables in the first place.

Many times, even though a set of comparables could yield a range of results, APAs have specified a single or specific result, also called a "point." This approach was used in some APAs to avoid the possibility of manipulation to produce a result near the bottom of a specified range. For bilateral APAs, each country might be concerned about the potential for such manipulation, making it easier for the two countries to agree on a specific result than on a range. In many APAs, the specific point has been the median point of the set of comparables' results. However, in some APA cases arguments for a different point have been made and accepted.

APAs have often used a point in establishing a royalty rate. A set of comparables may yield a range of possible arm's length royalty rates. However, as a matter of business practice, companies typically fix precise royalty rates in advance. Therefore, APAs often require a specific royalty rate.

APAs also have tended to adopt a point rather than a range when applying profit split methods. In a comparable profit split under Reg. §1.482–6(c)(2), total profit is split in the same ratio as the profit of comparable uncontrolled parties is split. Typically this method produces a specific ratio of profit split, although if more than one set of comparable parties were used it would be possible to derive a range. In a residual profit split under Reg. § 1.482–6(c)(3), each party is first assigned a routine return, and any residual profit or loss is split according to each party's relative contribution to pertinent intangible property. As normally implemented, this method has yielded a specific result for both routine returns and the split of the residual profit, although in some cases it would be possible to derive ranges. Other methods in which a point rather than a range has been used include CUP, resale price, and cost plus. Sometimes only one comparable transaction is used,[14] yielding a specific result rather than a range. However, in some cases APAs have specified a modest range around the specific result, to accommodate changing business practices and conditions.

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. Such an approach has been used, for example, where the TPM is a CPM with OM as the PLI and the comparable transactions reflect certain current business conditions that might improve. The APA required that the tested party's operating margin should always be above the bottom of the interquartile range, but that the operating margin could go above the top of the interquartile range if conditions improved.

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. An example is a financial institution with fairly 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.

Adjustments

Under 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. Where 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 APAs specify that if a tax-

[14] The use of only one comparable transaction is more likely when that transaction is an "internal" comparable uncontrolled transaction, that is, a transaction that involves one of the related parties under evaluation.

payer's results fall outside the applicable point or range, the APA will be canceled or revoked. 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), while guarding against abuse of the adjustment mechanism.

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.

TERM LENGTHS
(Section 521(b)(2)(D)(x))

The various term lengths for existing APAs are set forth in Table 17 below:

TABLE 17
TERMS OF APAs

Term in Years[15]	Number of APAs With This Term
1	2
2	11
3	48
4	48
5	93
6	20
7	6
8	3
9	1
10	2

Section 521(b)(2)(D)(x) requires that the report on term lengths include rollback years (*i.e.*, prior years to which the APA TPM is applied in order to resolve the same or similar transfer pricing issue for those earlier years) . Rollbacks, however, are not under the jurisdiction of the APA Program, but rather of the District Director bearing responsibility for examination of the taxpayer. Accordingly, rollback years are not included in or covered by the APA, and the APA Program office has not systematically tracked rollbacks. In some cases, the APA Program may not be informed whether a rollback of the APA methodology has been applied to back years, as that decision may be made after the APA is executed and closed by the Chief Counsel's office. For the future, the APA Program intends as part of IRS modernization to implement procedures for better coordination of rollbacks with the examination function.

Due to the foregoing, the APA Program is unable to provide complete information about rollbacks in this report. In 1999, however, as part of an unrelated project, the APA Program surveyed the Districts that had participated in APAs in an attempt to determine how and to what extent rollbacks had been applied. The results of that survey are summarized in Table 18 below:

TABLE 18
APA ROLLBACKS

	Number of Cases
Number of APA cases as of August 23, 1999	194
Cases with a rollback and number of rollback years per case:	50
1 year	5
2 years	3
3 years	10
4 years	12
5 years	8
6 years	7
7 years	2
8 years	1
9 years	1
16 years	1
Cases in which the APA process facilitated a settlement of back years, though the methodology was not rolled back	11

NATURE OF DOCUMENTATION REQUIRED
(Section 521(b)(2)(D)(xi))

One significant component of any APA agreement is the requirement that a taxpayer demonstrate compliance with the agreed-upon TPM or, alternatively, that any adjustment required by the TPM is accurately calculated. To accomplish this objective, the APA agreement includes documentation requirements, which are found in Section 5 (Financial Statements and APA Records) and Section 8 (Annual Report) of the model APA.

The APA agreement generally provides in part that "[t]he determination whether a taxpayer has complied with this APA will be based on its United States income tax return; its financial statements as prepared in accordance with generally accepted accounting principles ('GAAP') on a consistent basis (the 'Financial Statements'); the additional records ('APA Records') specified in Appendix B; and all information referenced in section 8 of this APA." The agreement also generally states that a "Taxpayer shall file a timely Annual Report for each APA Year pursuant to the rules of section 11.01 of Rev. Proc. 96–53."

Typically, the APA requires a taxpayer to demonstrate compliance with the agreed-upon TPM by providing the following documents in such an annual report:

1. A statement identifying all material differences between the Taxpayer's business operations, functions performed, risks assumed, and assets employed during the APA Year and the description of the Taxpayer's business operations as contained in Taxpayer's request for this APA or, if there have been no such material differences, a statement to that effect.
2. A statement identifying all relevant and material changes in the Taxpayer's accounting methods and classifications from those described or used in Taxpayer's request for this APA or, if there have been no such material changes, a statement to that effect.
3. The Taxpayer's Financial Statements for the APA Year as prepared in accordance with U.S. GAAP.
4. A financial analysis demonstrating Taxpayer's compliance with the

[15] Partial tax years and short full tax years are both counted as full years.

TPM including a computation of the TPM amount and a reconciliation of the TPM amount to the financial statements.

5. A description of any failure to meet Critical Assumptions or, if there have been no such failures, a statement to that effect.
6. A description of the reason for, and financial analysis of, any Compensating Adjustments with respect to the APA Year, including the means by which any such Compensating Adjustment has been or will be satisfied.
7. A copy of the certified public accountant's opinion described in section 5 of this APA for the APA Year.

The documentation provisions referred to above are necessary to establish whether a taxpayer has complied with the agreed-upon TPM, including whether any adjustment required to bring the taxpayer into compliance with the TPM is accurately calculated. Under the APA, a taxpayer must retain all documents required to be included in the annual report, as well as all work papers, records, or other documents that support the information provided in such documents. Compliance by a taxpayer with the APA documentation provisions also constitutes compliance with the record maintenance requirements of Sections 6038A and 6038C of the Internal Revenue Code with respect to the covered transactions during the APA term.

The documentation provisions generally require a taxpayer to submit audited financial statements for the APA Year prepared in accordance with U.S. GAAP. The IRS relies on audited financial statements – as opposed to unaudited financial statements – because they contain an unqualified opinion by an independent accountant that the Taxpayer's financial condition is fairly presented. Audited financial statements also represent the company's financial condition as it is presented to shareholders and the public. Additionally, audited financial statements prepared in accordance with GAAP ensure that a taxpayer's financial operations are reflected based on known accounting principles.

In addition to the requirements identified above, APA agreements may also require documentation tailored to specific industries. For example, the nature of records kept by taxpayers engaged in the financial products business often differs from that of taxpayers in other industries. Therefore financial products APAs would have record keeping requirements tailored to that industry. For example, such APAs might typically require some or all of the following additional documents:

(1) annual profit & loss statements of the U.S. taxpayer;
(2) summaries of currencies used to account for payments or allocations to parent or head office;
(3) leave order confirmations;
(4) daily revaluation reports;
(5) historical pricing data for currency transactions;
(6) schedule of costs of hedging contracts; and
(7) historical market quotations.

The documents outlined above support transactions that are specific to financial product APAs, such as hedging transactions and the allocation of global trading expenses.

APAs covering cost sharing arrangements may also generate additional documentation requirements, such as requiring a taxpayer to provide:

(1) amendments to cost sharing or technology license agreement;
(2) summaries of each product included in cost sharing agreement;
(3) reconciliations of R&D costs to cost sharing payments, including invoices for cost sharing payments;
(4) lists of affiliates included and excluded in each cost sharing group;
(5) summaries of intangibles that each affiliate brings to the cost sharing agreement; and
(6) internal documents relied upon in calculating the annual cost sharing payment.

These additional requirements are intended to document transactions germane to cost sharing arrangements, including the buy in and buy out payments related to existing and work-in-progress R&D, the expenses comprising the cost pool, as well as the allocation of those expenses to the participating members of the cost sharing arrangement.

Finally, the documentation provisions of an APA can be tailored to address a taxpayer's specific business or specific accounting system. For example, some APAs have required a taxpayer to document sales from specific product lines or to compile sales and expense data for specific factories. In this situation, the information sought might be used to evaluate the financial results or the functions performed by a specific affiliate in a consolidated group. Along the same lines, information regarding a company's worldwide ratio of R&D expenses to sales may shed light on the R&D functions being performed by a domestic subsidiary as compared to a foreign parent.

Alternatively, some annual reports have required information such as third party royalty agreements, which would be used to support a CUT analysis, and U.S. Customs filings, if there is an issue regarding the inconsistent valuation of imported tangible property. Some APAs have also required a taxpayer's business plan or a reconciliation of financial projections with actual financial results to ascertain whether the financial projections that formed the basis for the TPM approximated the actual financial results.

Other types of required documents may include the production of IRS Forms 5471 and 5472 (Information returns outlining transactions between controlled parties) and IRS Form 3115 (Information return outlining changes in accounting methods). Taxpayers may also be required to explain extraordinary transactions with a foreign parent that exceed a certain dollar limitation.

The type of information described above is necessary in evaluating whether there have been changes to a taxpayer's business or accounting methods that could have a material impact on the application of the TPM. Through the APA documentation requirements, the Service can ensure taxpayer compliance with the agreed-upon TPM or, alternatively, the need for an accurate calculation of any adjustment designed to bring a taxpayer into compliance.

EFFORTS TO ENSURE COMPLIANCE WITH APAs

(Section 521(b)(2)(F))

As described above in "Nature of Documentation Required," each APA contains documentation provisions, based on the facts of that case, designed to enable the Service to ensure compliance with the

TPM and other terms of the APA. As part of these provisions, the taxpayer is required to file an annual report demonstrating compliance with the APA for each covered APA year, and putting the Service on notice if critical assumptions have been violated or material facts have changed.

When the annual report is received by the APA Program, it is reviewed by a member of the professional staff. One Team Leader has been assigned the lead role in this review, and is responsible not only for reviewing most of the annual reports received by the APA Program office, but also for maintaining a database that tracks the annual reports required by each APA to ensure that taxpayers are complying with their obligation to file the reports in a timely manner. At times, another member of the APA staff will be responsible for the initial review of a given annual report, for example, the team leader who negotiated the APA in question if the level of complexity makes it more efficient for a person already familiar with the case to review the report; or a request to renew the APA to which the annual report relates might be in process, in which case the team leader assigned the renewal might be assigned the annual report for similar reasons of efficiency.

The APA Program reviews the annual report to make sure that the information required is included in the report, and to determine whether the taxpayer has, on the face of the report, complied with the terms of the APA, including proper application of the TPM. For the most part, the APA Program does not attempt to audit the accuracy of the numbers contained in the report, but will look at issues such as proper classification of expenses. If this review determines that there is a question as to whether the taxpayer is in compliance, the APA Program (in coordination with the relevant District) will contact the taxpayer to discuss the issue and request further information, as necessary. If the APA Program's review does not detect any problems on the face of the annual report, the report is forwarded to the District with examination jurisdiction over the taxpayer – typically, the District that participated in the APA negotiations. The District is responsible for deciding whether or to what extent to audit the underlying data, for example, substantiating expenses or reviewing allocations used by the taxpayer in arriving at the conclusion that it complied with the APA.

To date, this multifunctional review procedure has indicated that taxpayers comply with the requirements of the APA in the great majority of cases. As of December 31, 1999, out of 239 annual reports that had been reviewed, the Service had identified proposed adjustments to taxable income with respect to fifteen APAs. Such adjustments totaled approximately $132 million, though in some cases these amounts have not been agreed to by the taxpayers.

ADVANCE PRICING AGREEMENT
between
TAXPAYER
and

THE INTERNAL REVENUE SERVICE

ADVANCE PRICING AGREEMENT
between
TAXPAYER
and

THE INTERNAL REVENUE SERVICE

THIS ADVANCE PRICING AGREEMENT ("APA") is made by and between Taxpayer and the Internal Revenue Service ("Service"), acting through the Associate Chief Counsel (International).

WHEREAS, Taxpayer and the Service (the "Parties") wish to establish a method for determining whether certain prices used in international transactions involving Taxpayer are in accordance with the principles of section 482 of the Internal Revenue Code of 1986 as amended (the "Code") and attendant Regulations and, to the extent applicable, income tax conventions to which the United States is a party;

NOW, THEREFORE, in consideration of the mutual promises contained herein, the Parties agree as follows:

1. *Identifying information*. Taxpayer's EIN is __________. [Taxpayer is included in the consolidated federal income tax return filed by ________________, EIN ________. All references to Taxpayer's United States income tax return in this APA refer to that consolidated return, and all references in this APA to "Taxpayer" shall refer to the ______________ consolidated return group.]

2. *Covered transactions*. This APA governs the pricing of the transactions specified in Appendix A (the "Covered Transactions").

3. *Legal Effect.*

3.1. Taxpayer agrees to comply with the terms and conditions of this APA, including the transfer pricing methodology ("TPM") that is described in Appendix A. If Taxpayer complies with the terms and conditions of this APA, then the Service will not contest the application of the TPM to the Covered Transactions and will not make or propose any reallocation or adjustment under section 482 of the Code with respect to Taxpayer concerning the transfer prices in Covered Transactions for the years covered by this APA (the "APA Years").

3.2. Regardless of the date on which Taxpayer filed its request for this APA, Taxpayer and the Service agree, unless otherwise specified to the contrary in this APA, that Rev. Proc. 96–53, 1996–2 C.B. 375, and not any predecessor to Rev. Proc. 96–53, governs the interpretation, administration, and legal effect of this APA.

3.3. If, for any APA Year, Taxpayer does not comply with the terms and conditions of this APA, then the Service may:

i. enforce the terms of this APA and propose adjustments to the income, expenses, deductions, credits, or allowances reported on Taxpayer's U.S. federal income tax return in keeping with the terms of this APA;

ii. cancel or revoke this APA pursuant to section 11.05 or 11.06 of Rev. Proc. 96–53; or

iii. revise this APA, upon agreement on revision with Taxpayer.

3.4. [This APA addresses the arm's length nature of prices charged or received in the aggregate between Taxpayer and [name of foreign group], and except as explicitly provided in this APA does not address, and does not bind the Service with respect to, prices charged or received, or the relative amounts of income or loss realized, by particular legal entities that are members of Taxpayer or that are members of [foreign group]. The true taxable income of a member of an affiliated group filing a U.S. consolidated return shall be determined under the regulations governing consolidated returns. *See, e.g.*, Treas. Reg. section 1.1502–12. Similarly, to the extent relevant for United States tax purposes, and except as explicitly provided in this APA, the relative amounts of income of different entities that are members of [foreign group] shall be determined under the arm's length standard of section 482 without reference to this APA.]

3.5. The Parties agree that 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.

4. *Term*. This APA shall apply only to the APA Years, which shall include only ________________.

5. *Financial Statements and APA Records*. The determination whether Taxpayer has complied with this APA will be based on its United States income tax return; its financial statements as prepared in accordance with generally accepted accounting principles ("GAAP") on a consistent basis (the "Financial Statements"); the additional records ("APA Records") specified in Appendix B; and all information specified in section 8 of this APA. Taxpayer will not be in compliance with the TPM unless an independent certified public accountant renders an opinion that the Financial Statements present fairly, in all material respects, the financial position of Taxpayer and the results of its operations, in accordance with GAAP. Taxpayer agrees to maintain the Financial Statements and APA

Records and to make them available within thirty days of a request by the Service in connection with an examination described in section 11.03 of Rev. Proc. 96–53. Compliance with this section 5 of the APA will constitute compliance with the provisions of sections 6038A and 6038C of the Code, with respect to Covered Transactions during the APA Years.

6. *Critical Assumptions*. The Critical Assumptions of this APA, within the meaning of section 5.07 of Rev. Proc. 96–53, are listed in Appendix C.

7. *Tax and Compensating Adjustments*. In the event Taxpayer's actual transactions did not result in compliance with the TPM described in Appendix A, Taxpayer's taxable income must nevertheless be reported in an amount consistent with the TPM and the requirements of the APA, either on a timely filed original return or on an amended return. Taxpayer may make Compensating Adjustments as described in and subject to the rules of section 11.02 of Rev. Proc. 96–53, and subject to any restrictions stated in this APA.

8. *Annual Report*. Taxpayer shall file a timely Annual Report for each APA Year pursuant to the rules of section 11.01 of Rev. Proc. 96–53. The Annual Report shall contain the information described in Appendix D. In connection with an examination described in section 11.03 of Rev. Proc. 96–53, the District Director may request and Taxpayer shall provide additional facts, computations, data or information reasonably necessary to clarify the Annual Report or verify compliance with the APA.

9. *Disclosure*. This APA, and the information, data, and documents related to this APA and Taxpayer's APA request are: (1) considered "return information" pursuant to section 6103(b)(2)(C) of the Code; and (2) not subject to public inspection as a "written determination" pursuant to section 6110(b)(1) of the Code. Pursuant to section 521 of the Tax Relief Extension Act of 1999, however, the Secretary of the Treasury is obligated to prepare a report for public disclosure that would include certain specifically designated information concerning all APAs, including this APA, in such form as not to reveal taxpayers' identities, trade secrets, and proprietary or confidential business or financial information.

10. *Disputes*. Should a dispute arise concerning the interpretation of this APA, the Parties agree to seek resolution of the dispute by the Associate Chief Counsel (International), to the extent reasonably practicable, prior to seeking alternative remedies. Disputes not related to the interpretation of this APA shall be pursued consistent with section 11.03(4) of Rev. Proc. 96–53.

11. *Section Captions*. The section captions contained in this APA are for convenience and reference only and shall not affect in any way the interpretation or application of this APA.

12. *Notice*. Any notices required by this APA or Rev. Proc. 96–53 shall be in writing. Taxpayer shall send notices to the Service at the address and in the manner prescribed in section 5.13(2) of Rev. Proc. 96–53. The Service shall send notices to Taxpayer at ____________________________________.

13. *Effective date*. This APA shall become binding when both Parties have executed the APA [,and the competent authorities of ____________ and the United States have executed a mutual agreement that is consistent with this APA].

14. *Counterparts*. This APA may be executed in counterparts, with each counterpart deemed an original.

IN WITNESS WHEREOF, the Parties have executed this APA on the dates indicated below.

TAXPAYER

By: ____________________________________ Date: ________________

[Name of Signature]

[Title]

INTERNAL REVENUE SERVICE

By: ____________________________________ Date: ________________

[Name of Signature]

[Deputy] Associate Chief Counsel (International)

APPENDIX A
TRANSFER PRICING METHODOLOGY

For each APA Year:

H. ***Covered Transactions.***

The Covered Transactions for this APA consist of ____.

I. ***Transfer Pricing Methodology ("TPM").***

APPENDIX B
APA RECORDS

1. All documents listed in Appendix D 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.]

APPENDIX C
CRITICAL ASSUMPTIONS

1. The business activities, functions performed, risks assumed, assets employed, and financial [and tax] accounting methods and classifications [and methods of estimation] of Taxpayer shall remain materially the same as described or used in Taxpayer's request for this APA.
2. [Insert here other Critical Assumptions.]

APPENDIX D
ANNUAL REPORT

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

1. A statement identifying all material differences between Taxpayer's business operations (including functions performed, risks assumed and assets employed) during the APA Year and the description of the same contained in Taxpayer's request for this APA, or if there have been no such material differences a statement to that effect.
2. A 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 this APA, or if there have been no such material changes a statement to that effect.
3. The Financial Statements.
4. A financial analysis demonstrating Taxpayer's compliance with the TPM.
5. A description of any failure to meet Critical Assumptions, or if there have been no such failures, a statement to that effect.
6. A description of the reason for, and financial analysis of, any Compensating Adjustments with respect to the APA Year, including the means by which any such Compensating Adjustment has been or will be satisfied.
7. A copy of the certified public accountant's opinion, described in section 5 of this APA, for the APA Year.
8. [Insert here other items to be included in Annual Report.]

Appendix B
FORMULAS FOR BALANCE SHEET ADJUSTMENTS

Definitions of Variables:

AP = average accounts payables
AR = average trade receivables, 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

h = average holding period, stated as a fraction of a year (for AP or AR)
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]

[16] Depending on the specific facts, the equations below may use cost of goods sold as shown or total costs, which is defined as (cogs + opex).