ANNOUNCEMENT AND REPORT CONCERNING ADVANCE PRICING AGREEMENTS

March 29, 2011

This Announcement is issued pursuant to § 521(b) of Pub. L. 106-170, the Ticket to Work and Work Incentives Improvement Act of 1999, which requires the Secretary of the Treasury to report annually to the public concerning Advance Pricing Agreements (APAs) and the APA Program. The first report covered calendar years 1991 through 1999. Subsequent reports covered separately each calendar year 2000 through 2009. This twelfth report describes the experience, structure, and activities of the APA Program during calendar year 2010. It does not provide guidance regarding the application of the arm's length standard.

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Background

Internal Revenue Code (IRC) § 482 provides that the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among two or more commonly controlled businesses if necessary to reflect clearly the income of such businesses. Under the § 482 regulations, the standard to be applied in determining the true taxable income of a controlled business is that of a business dealing at arm's length with an unrelated business. The arm's length standard has also been adopted by the international community and is incorporated into the transfer pricing guidelines issued by the Organization for Economic Cooperation and Development (OECD). OECD, TRANSFER PRICING GUIDELINES FOR MULTINATIONAL ENTERPRISES AND TAX ADMINISTRATIONS (2010). Transfer pricing issues by their nature are highly factual and have traditionally been one of the largest issues identified by the IRS in its audits of multinational corporations. The APA Program is designed to resolve actual or potential transfer pricing disputes in a principled, cooperative manner, as an alternative to the traditional examination process. An APA is a binding contract between the IRS and a taxpayer by which the IRS agrees not to seek a transfer pricing adjustment under IRC § 482 for a covered transaction if the taxpayer files its tax return for a covered year consistent with the agreed transfer pricing method (TPM). In 2010, the IRS and taxpayers executed 69 APAs and 9 amended APAs.

Since 1991, with the issuance of Rev. Proc. 91-22, 1991-1 C.B. 526, the IRS has offered taxpayers, through the APA Program, the opportunity to reach an agreement in advance of filing a tax return on the appropriate TPM to be applied to related party transactions. In 1996, the IRS issued internal procedures for processing APA requests. Chief Counsel Directives Manual

(CCDM), ¶¶ 42.10.10 – 42.10.16 (November 15, 1996).[1] Also in 1996, the IRS updated Rev. Proc. 91-22 with the release of Rev. Proc. 96-53, 1996-2 C.B. 375.[2] In 1998, the IRS published Notice 98-65, 1998-2 C.B. 803,[3] which set forth streamlined APA procedures for small business taxpayers. Then on July 1, 2004, the IRS updated and superseded both Rev. Proc. 96-53 and Notice 98-65 by issuing Rev. Proc. 2004-40, 2004-2 I.R.B. 50,[4] effective for all APA requests filed on or after August 19, 2004.

On December 19, 2005, the IRS again updated the procedural rules for processing and administering APAs with the release of Rev. Proc. 2006-09, 2006-1 C.B. 278.[5] Rev. Proc. 2006-09 supersedes Rev. Proc. 2004-40 and is effective for all APA requests filed on or after February 1, 2006. On May 21, 2008, the IRS released Rev. Proc. 2008-31, 2008-23 IR.B. 1133, which revised Rev. Proc. 2006-09 to describe further the types of issues that may be resolved in the APA process.[6] Specifically, Rev. Proc. 2008-31 added a new sentence to Section 2.01 of Rev. Proc. 2006-09, to advise that the APA process may be used to resolve any issue for which transfer pricing principles may be relevant, such as attribution of profit to a permanent establishment under certain U.S. income tax treaties, the amount of income effectively connected with the conduct of a U.S. trade or business, and the amount of income derived from sources partly within and partly without the United States.

Advance Pricing Agreements

An APA generally combines an agreement between a taxpayer and the IRS with an agreement between the United States and one or more foreign tax authorities (under the authority of the mutual agreement process of our income tax treaties) on an appropriate TPM for the transactions at issue (Covered Transactions). With such "bilateral" APAs, the taxpayer ordinarily is assured that the income associated with the Covered Transactions will not be subject to double taxation by the combination of the United States and the foreign jurisdictions. The policy of the United States, as reflected in §§ 2.08 and 7 of Rev. Proc. 2006-09, is to encourage taxpayers that enter the APA Program to seek bilateral or multilateral APAs when competent authority procedures are available with respect to the foreign country or countries involved. However, the IRS may execute an APA with a taxpayer without reaching a competent authority agreement (a unilateral APA).

A unilateral APA is an agreement between a taxpayer and the IRS establishing an approved TPM for U.S. tax purposes. A unilateral APA binds the taxpayer and the IRS, but does not prevent a foreign tax administration from taking a different position on the appropriate TPM for a

[1] Current CCDM provisions regarding APA procedures are available at http://www.irs.gov/irm/part32/ch04s01.html.

[2] Available at http://www.irs.gov/pub/irs-irbs/irb96-49.pdf.

[3] Available at http://www.irs.gov/pub/irs-irbs/irb98-52.pdf.

[4] Available at http://www.irs.gov/pub/irs-irbs/irb04-29.pdf.

[5] Available at http://www.irs.gov/irb/2006-02_IRB/ar12.html.

[6] Available at http://www.irs.gov/pub/irs-irbs/irb08-31.pdf.

transaction. As stated in § 7.07 of Rev. Proc. 2006-09, should a transaction covered by a unilateral APA be subject to double taxation as the result of an adjustment by a foreign tax administration, the taxpayer may seek relief by requesting that the U.S. Competent Authority (USCA) consider initiating a mutual agreement proceeding pursuant to an applicable income tax treaty (if any).

The policy generally preferring bilateral (or multilateral) over unilateral APAs is grounded in the APA Program's goal to achieve certainty and the avoidance of double taxation through an early dispute resolution process that is most efficient from both taxpayer and government perspectives. Consistent with that policy, the IRS is reviewing both initial and renewal submissions for factors weighing in favor of bilateral or multilateral APAs (e.g., potentially large amounts of income; complex issues; a high risk of adjustment in a foreign country; or other indications in the interests of efficient tax administration) or unilateral APAs (e.g., small amounts at stake relative to the additional transaction costs of a bilateral or multilateral APA; a multiplicity of smaller foreign situs operations covered by unilateral APAs while bilateral or multilateral APAs cover major intercompany transaction flows; or other indications in the interests of efficient tax administration). To date no request for a unilateral APA has been rejected on the sole basis that the submission sought a unilateral rather than a bilateral or multilateral process

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

The APA Program

An IRS team headed by an APA team leader is responsible for the consideration of each APA. As of the last statutory report (for the period ending December 31, 2009), the APA Program had nineteen team leaders; by December 31, 2010, that number declined to sixteen. The team leader is responsible for organizing the IRS APA team. The IRS APA team leader arranges meetings with the taxpayer, secures necessary information from the taxpayer to analyze the taxpayer's Covered Transactions and the available facts under the arm's length standard of IRC § 482 and the regulations thereunder, and leads the discussions with the taxpayer.

The APA team generally includes an economist, an IRS Large Busines and International Division (LB&I) international examiner, LB&I field counsel, and, in a bilateral case or multilateral APA case, a USCA analyst. The economist may be from the APA Program or the IRS field organization. As in the last statutory report, as of December 31, 2010, the APA Program had seven economists on staff, plus one economist manager. The APA team may also include an LB&I International Technical Advisor, other LB&I exam personnel, and an Appeals Officer.

The APA Process

The APA process is voluntary. Taxpayers submit an application for an APA, together with a user fee as set forth in Rev. Proc. 2006-09, § 4.12. The APA process can be broken into five phases: (1) application; (2) due diligence; (3) analysis; (4) discussion and agreement; and (5) drafting, review, and execution.

(1) Application

In many APA cases, the taxpayer's application is preceded by a pre-file conference (PFC) with the APA staff in which the taxpayer can solicit the informal views of the APA Program. Pre-file conferences can occur on an anonymous basis, although a taxpayer must disclose its identity when it applies for an APA. The APA Program has been requiring taxpayers interested in an APA under Rev. Proc. 2008-31 to schedule a PFC before submitting a formal APA application.

Even outside the expanded jurisdiction conferred in Rev. Proc. 2008-31, PFCs are useful tools for the early exchange of ideas and expectations on complex, novel, and potentially contentious issues that will be present in an APA submission. The APA Program believes that discussions with the IRS in PFCs, when followed in an APA submission, has the potential to shorten the period of time required to complete an APA by identifying issues that will require specific development and providing preliminary views on acceptable methodologies and analytical concepts. The APA Program has recently revised its internal practices concerning PFCs to improve efficiency, including better tracking of PFCs and, most notably, assigning some of the PFCs presenting the most complex or novel issues to senior staff.

As part of a taxpayer's APA application, the taxpayer must file the appropriate user fee on or before the due date, including extensions, of the tax return for the first taxable year that the taxpayer proposes to be covered by the APA. (If the taxpayer receives an extension to file its tax return, it must file its user fee no later than the actual filing date of the return.) Many taxpayers file a user fee first and then follow up with a full application later -- a "dollar file" in APA parlance. The procedures for PFCs, user fees, and applications can be found in §§ 3 and 4 of Rev. Proc. 2006-09.

The APA application can be a relatively modest document for small businesses. Section 9 of Rev. Proc. 2006-09 describes the special APA procedures for small business taxpayers. For most taxpayers, however, the APA application is a substantial document filling several binders. APA applications must be accompanied by a declaration, signed by an authorized corporate officer, attesting to the accuracy and completeness of the information presented.

The application is assigned to an APA team leader who is responsible for the case. The APA team leader's first responsibility is to organize the APA team. This involves contacting the appropriate LB&I International Territory Manager to secure the assignment of an international examiner to the APA case and the LB&I Counsel's office to secure a field counsel lawyer. In a bilateral or multilateral case, the USCA will assign a USCA analyst to the team. In a large APA case, the international examiner may invite his or her manager and other LB&I personnel familiar with the taxpayer to join the team. If the APA may affect taxable years in Appeals, the appropriate appellate conferee will be invited to join the team. In cases involving cost-sharing arrangements, other complex intangibles and services transactions, or novel issues, the APA team leader contacts the Manager, LB&I International Technical Advisors, to determine whether or not to include a technical advisor on the team. The multi-functional nature of APA teams combines the APA Program's transfer pricing expertise and APA experience with other elements of the IRS that possess complementary or supplementary knowledge about the taxpayer, the taxpayer's industry, related or ancillary tax issues, the foreign competent authority, and other relevant issues. By bringing all relevant parties to the table in a single proceeding, the APA process is able to resolve transfer pricing issues early on in a more principled, efficient, consistent, and comprehensive manner than the standard administrative process (i.e., audit, appeals, litigation).

The APA team leader distributes copies of the APA application to all team members, makes initial contact with the taxpayer to confirm the APA Program's receipt of the taxpayer's application, and sets up an opening conference with the taxpayer. Under past APA case management procedures, the APA office strived to (i) make initial contact with the taxpayer within 21 days of its receipt of the APA application and (ii) hold the opening conference within 45 days from the date that the APA team expects to begin actively working the case – the "Start Date" under the revised case management procedures. However, limited Program resources have led to delays, so, for example, opening conferences are now frequently held six months or more after a completed application is received.

On or about the opening conference, the APA team leader proposes a case plan appropriate for the case. Case plans are generally targeted to complete a unilateral APA or, in the case of a bilateral APA, the U.S. recommended negotiating position (RNP) within 12 months from the date of the opening conference. The targeted completion date in a particular case, however, may vary from the 12-month benchmark, depending on the complexity of the case, APA team workloads, taxpayer schedules, and other factors. Case plans are signed by both an APA manager and an authorized official of the taxpayer and are intended to be adhered to except in unforeseen or exceptional circumstances. Implementation and adherence to case plans has been uneven, at best. The rapidly increasing workloads have resulted in the actual median and average times for completing unilateral and bilateral APAs, recommended negotiating positions for bilateral APAs, and APAs for small business taxpayers to increase significantly. These APA inventory and case completion times are described in greater detail below in Tables 2 through 11. The APA Program is taking steps to increase its tracking of and adherence to case plans and, as discussed below, is endeavoring to increase efficiencies and augment resources through a pooling with USCA.

<u>Due Diligence</u>

The APA team must satisfy itself that the relevant facts submitted by the taxpayer are complete and accurate. This due diligence aspect of the APA is vital to the process. It is because of this due diligence that the IRS can reach advance agreements with taxpayers in the highly factual setting of transfer pricing. Due diligence can proceed in a number of ways. Typically, the APA team leader will submit in advance of the opening conference a list of questions to the taxpayer for discussion at the conference. The opening conference may result in additional questions and an agreement to meet one or more times in the future. These questions and meetings are not an audit and are focused on the transfer pricing issues associated with the transactions in the taxpayer's application, or other transactions that the taxpayer and the IRS may agree to add.

(3) Analysis

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

(4) Discussion and Agreement

The discussion and agreement phase differs for bilateral and unilateral cases. In a bilateral case, the discussions have typically proceeded in two parts and involve two IRS offices -- the APA Program and the USCA. In the first part, the APA team attempted to reach a consensus with the taxpayer regarding the RNP that the USCA should take in negotiations with its treaty partner. This U.S. RNP was a paper drafted by the APA team leader, reviewed by APA management, and signed by the APA Director that provides the APA Program's view of the best TPM for the Covered Transactions, taking into account IRC § 482 and the regulations thereunder, the relevant tax treaty, and the USCA's experience with the treaty partner.

The experience of the APA office and the USCA has been that APA negotiations are likely to proceed more rapidly with a foreign competent authority if the U.S. negotiating position is fully supported by the taxpayer. Consequently, the APA office has worked with the taxpayer in developing the U.S. RNP. Often, however, the taxpayer has disagreed with part or all of the RNP. In these cases, the APA office will send an RNP to the USCA that identifies and explains the elements of the RNP with which the taxpayer disagrees. The APA team leader also solicited the views of the other members of the APA team, and, in the vast majority of APA cases, the other members of the APA team concur in the position prepared by the APA team leader. If there was any disagreement that cannot be resolved, it is noted in the RNP.

After the APA Program completed the recommended U.S. negotiating position, the APA process shifted from the APA Program to the USCA – the "hand-off." The USCA analyst assigned to the APA took the U.S. RNP and prepared the final U.S. negotiating position, which was then transmitted to the foreign competent authority. The negotiations with the foreign competent authority were conducted by the USCA analyst, most often in face-to-face negotiating sessions conducted periodically throughout the year. At the request of the USCA, APA Program staff members have assisted in the negotiations.

Both in response to the inherent inefficiencies of the "hand-off" and because of resource constraints, the APA Program and USCA have commenced efforts towards a pooling of resources and better managing their shared bilateral caseload as a single inventory. These efforts are still at the initial stage. Practices that are under consideration include the possible assignment of a single APA team leader, or USCA analyst, from either the APA Program or the USCA to work a bilateral case through both offices from inception through to conclusion, consistent with the applicable revenue procedures. By the end of 2010, a few cases were identified for carrying forward under the pooling approach.

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

(5) Drafting, Review, and Execution

Once the IRS, competent authorities, and the taxpayer reach agreement, the final APA is drafted. The APA Program has developed standard language that is incorporated into every APA. The current version of this language is found in Attachment A. APAs are reviewed by the APA Branch Chief and the APA Director. In addition, the team leader prepares a summary memorandum for approval by the Associate Chief Counsel (International) (ACC(I)). On March 1, 2001, the ACC(I) delegated to the APA Director the authority to execute APAs on behalf of the IRS. See Chief Counsel Notice CC-2001-016. The APA is executed for the taxpayer by an appropriate corporate officer. It is anticipated that under the pooling practice between the APA Program and USCA, RNPs and final APAs would continue to be reviewed and approved by the APA Director and ACC(I), while the mutual agreement reached between competent authorities would continue to be reviewed and approved by the USCA.

Model APA at Attachment A

[§ 521(b)(2)(B)]

Attachment A contains the current version of the model APA language.

The Current APA Office Structure, Composition, and Operation

In 2010, the APA office consisted of four branches, with Branches 1 and 3 staffed with APA team leaders and Branch 2 staffed with economists based in Washington, D.C. Branch 4, the APA West Coast branch, is headquartered in San Francisco, California, with an additional office in Laguna Niguel, California, and is staffed with both team leaders and economists.

APA full-time staffing decreased during 2010, starting at 39 at the end of 2009, falling to 35 by the end of the year. As of December 31, 2010, the APA staff was as follows:

Craig Sharon, Director
John Hinding, Deputy Director
Richard Osborne, Special Counsel
Brenda Robinson, Secretary
Katina Cooper, Paralegal
Frank McFeeters, Paralegal

Branch One

Patrica Lacey, Branch Chief
Senita Smith, Secretary
Team Leaders:
- **Stephen J. Hawes**
- **Rebecca Kalmus**
- **Nancy Kim**
- **Lisa Robinson**

Branch Two

Russell Kwiat, Branch Chief
Economists:
- **Walter Bottiny**
- **Donna McComber**
- **Kimberly Rogers**
- **Behzad Touhidi-Baghini**

Branch Three

Judith Cohen, Branch Chief
Kimberly Clay, Secretary
Team Leaders:
- **Robert Weissler**
- **Thomas Herring**
- **Helen Hong-George**
- **Vijay Rajan**

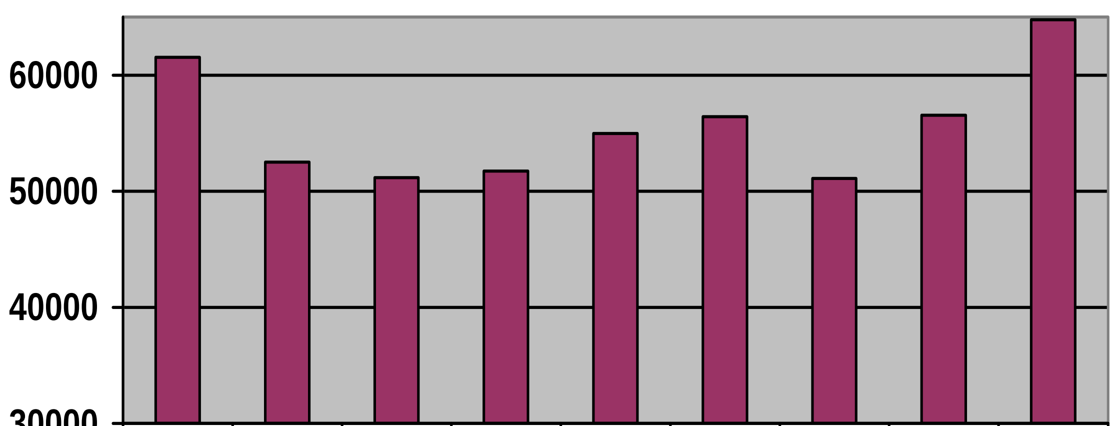
Branch Four

Peter Rock, Branch Chief
Loretha White, Secretary
Economists:
- **David Broomhall**
- **Mike Aarstol**
- **Ho Jin Lee**

Team Leaders:
- **David Chamberlain**
- **Mark Dunshee**
- **Johan Deprez**
- **Theresa Kolish**
- **Matthew Kramer**
- **Spencer Stowe**
- **Victor Thayer**
- **Mina Tyagi**

Total hours spent by APA professional staff increased in 2010 by roughly 14.5% over the previous year. The decrease in the staff near the end of 2010 is yet to be reflected in staff hours due to the timing of the departures. The change in APA hours spent over the last nine years is reflected in the table below.

Hours of APA attorneys, economists, and paralegal staff by year (excluding holiday and leave):



	2002	2003	2004	2005	2006	2007	2008	2009	2010
APA staff hours	61528	52495	51170	51744	54970	56410	51077	56549	64763

APA Issue/Industry Coordination Teams

In May 2005, the IRS Chief Counsel announced a series of initiatives to improve APA Program performance. One initiative was to increase specialization within the office by creating teams of select individuals to handle all cases of a particular type. The purpose was to increase efficiency, quality, and consistency.

The APA Program selected five categories of cases for specialization – cases involving cost sharing arrangements, financial products, the semiconductor industry, the automotive industry, and the pharmaceutical industry. These categories were selected because they each had a sufficient number of cases and commonality of issues to warrant their assignment to teams. Cases falling within these five categories have historically accounted for about 40 percent of the APA Program's case load and about half of its total case time. At the end of 2010, cases within these five categories accounted for 86 of the 243 cases pending in the office that were either unilateral APAs or bilateral APAs that had not yet been forwarded to the USCA.

Staffing of the coordination teams at the end of 2010 is indicated below:

Auto & Auto Parts

Peter Rock, Reviewer

Tom Herring, Team Leader
Vijay Rajan, Team Leader
Johan Deprez, Team Leader
Victor Thayer, Team Leader
Walt Bottiny, Principal Economist

Pharmaceuticals & Medical Devices

Victor Thayer, Reviewer

David Chamberlain, Team Leader
Tom Herring, Team Leader
Helen Hong-George, Team Leader
Mark Dunshee, Team Leader
Jamie Hawes, Team Leader
Richard Sciacca, Principal Economist

Cost Sharing

Judith Cohen, Reviewer

David Chamberlain, Team Leader
Matthew Kramer, Team Leader
Robert Weissler, Team Leader
David Broomhall, Principal Economist

Financial Products

Richard Osborne, Reviewer

Rebecca Kalmus, Team Leader
Lisa Robinson, Team Leader
Robert Weissler, Team Leader
Donna McComber, Principal Economist

Semiconductors

Peter Rock, Reviewer

Matthew Kramer, Team Leader
Vijay Rajan, Team Leader
Behzad Touhidi-Baghini, Principal Economist

The APA Program is mindful that the purpose of the coordination effort is not to impose the same transfer pricing method on all taxpayers in an industry. The appropriate transfer pricing method remains a case-by-case determination, influenced by numerous factors that are not common to all companies operating in a particular industry. While the coordination effort may result in the APA Program promoting a common approach on some issues where appropriate, the Program expects that the greater industry familiarity developed through the coordination effort will also allow it to develop a more sophisticated understanding of issues that will permit more tailored approaches, thereby promoting more (appropriately) varied results than might otherwise be the case.

APA Training

In 2010, the APA office continued its training activities. Training sessions addressed APA-related current developments, the application of Rev. Proc. 2008-31, regulatory developments, new APA office practices and procedures, OECD study on restructuring, review of novel or unique APAs or RNPs, and international tax law issues. The training materials used for new hires are available to the public through the APA internet site at http://www.irs.gov/businesses/corporations/article/0,,id=96221,00.html. The APA's new-hire materials, which were originally prepared in 2003 and have not been updated, do not constitute guidance on the application of the arm's length standard and are not to be relied upon or cited as precedent. Also available to the public is a spreadsheet model that performs calculations in a Comparable Profits Method (CPM) analysis, which APA economists developed in 2007 and which is now routinely used by the APA office when performing APA analyses. An electronic version of the model may be obtained by contacting the APA office in Washington, D.C. at (202) 435-5220 (not a toll-free number).

APA Program Statistical Data

[§ 521(b)(2)(C) and (E)]

The statistical information required under § 521(b)(2)(C) is contained in Tables 1 and 10 below; the information required under § 521(b)(2)(E) is contained in Tables 2 and 3 below. The 144 APA applications during 2010 represented a new one-year high for the Program, following record-breaking years in 2008 (123) and 2009 (127).[7] From 2000-2007, the APA Program averaged 91 applications per year, and it had never received more than 110 applications in a single year. The APA Program expects APA applications to continue in 2011 at the same high levels as in 2008-2010.

[7] Of the 127 new APA applications in 2009 -- the first full year in which Rev. Proc. 2008-31 was in effect -- approximately ten submissions invoked APA jurisdiction under Rev. Proc. 2008-31. In 2010, the APA Program completed three or fewer APAs falling within APA jurisdiction because of Rev. Proc. 2008-31.

TABLE 1: APA APPLICATIONS, EXECUTED APAS, AND PENDING APAS

	Unilateral	Bilateral	Multilateral	Year Total	Cumulative Total
APA applications filed during 2010	46	98		144	1523
All APAs executed[8]					
Year 2010	20	49	0	69	973
1991–2010	385	506	13	904	
APA renewals executed during 2010	14	18		32	293
APAs revised or amended during 2010	5	4		9	70
Pending requests for APAs	85	315		400	
Pending requests for new APAs	38	186		224	
Pending requests for renewal APAs	47	129		176	
APAs canceled or revoked	0	0		0	9
APAs withdrawn	8	11		19	165

TABLE 2: MONTHS TO COMPLETE APAS

Months to Complete Advance Pricing Agreements in 2010					
All New		**All Renewals**		**All Combined**	
Average	40.7	Average	33.1	Average	37.2
Median	37.3	Median	31.0	Median	33.2
Unilateral New		**Unilateral Renewals**		**Unilateral Combined**	
Average	26	Average	23.3	Average	24.1
Median	26.9	Median	24.2	Median	24.4
Bilateral/Multilateral New		**Bilateral/Multilateral Renewals**		**Bilateral/Multilateral Combined**	
Average	43.6	Average	40.7	Average	42.5
Median	39.2	Median	34.1	Median	37.3

[8] "All APAs executed" includes APA renewals, but not APAs revised or amended.

TABLE 3: APA COMPLETION TIME – MONTHS PER APA

Months	Number of APAs	Months	Number of APAs	Months	Number of APAs
1		**26**	3	**51**	1
2		**27**	2	**52**	1
3		**28**	2	**53**	
4		**29**	1	**54**	
5	1	**30**	5	**55**	1
6		**31**	2	**56**	
7		**32**	3	**57**	1
8	1	**33**	2	**58**	
9		**34**	2	**59**	1
10		**35**	2	**60**	1
11		**36**	2	**61**	1
12	1	**37**	3	**62**	
13		**38**	1	**63**	
14		**39**	1	**64**	
15	1	**40**	1	**65**	
16		**41**	1	**66**	1
17	1	**42**		**67**	
18	3	**43**	1	**68**	
19		**44**		**69**	1
20		**45**	2	**70**	1
21	2	**46**		**71-80**	
22		**47**	1	**81**	1
23	1	**48**	1	**82-118**	
24	4	**49**	2	**119**	1
25	1	**50**	1		

TABLE 4: RECOMMENDED NEGOTIATING POSITIONS

Recommended Negotiating Positions Completed in 2010	58

Table 5: MONTHS TO COMPLETE RECOMMENDED NEGOTIATING POSITIONS

New		Renewal		Combined	
Average	25.4	Average	22.9	Average	24.4
Median	25.8	Median	24.8	Median	25.4

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

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

TABLES 7 AND 8 BELOW SHOW HOW LONG EACH APA REQUEST PENDING AT THE END OF 2010 HAS BEEN IN THE SYSTEM AS MEASURED FROM THE FILING DATE OF THE APA SUBMISSION. THE NUMBERS FOR PENDING UNILATERAL AND BILATERAL CASES DIFFER FROM THE NUMBERS IN TABLE 1 BECAUSE TABLES 7 AND 8 REFLECT ONLY CASES FOR WHICH SUBMISSIONS HAVE BEEN RECEIVED, WHILE TABLE 1 INCLUDES ANY CASE FOR WHICH A USER FEE HAS BEEN PAID.

TABLE 7: UNILATERAL APAS – TIME IN INVENTORY – MONTHS PER APA

Months	Number of APAs	Months	Number of APAs	Months	Number of APAs	Months	Number of APAs
1	5	**10**	2	**19**	3	**28**	1
2	6	**11**	4	**20**	0	**30**	2
3	5	**12**	5	**21**	0	**31**	1
4	2	**13**	4	**22**	1	**32**	1
5	3	**14**	0	**23**	1	**33**	1
6	6	**15**	3	**24**	0	**35**	1
7	1	**16**	2	**25**	1	**36**	2
8	3	**17**	3	**26**	1	**37**	1
9	4	**18**	0	**27**	0	**44**	1

TABLE 8: BILATERAL APAS – TIME IN INVENTORY – MONTHS PER APA

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

Of the 350 cases in the APA Program's inventory shown in Tables 7 and 8, 107 cases (all of which are reflected in Table 8) are bilateral cases that have been forwarded to the USCA office for discussion with a treaty partner. This leaves 243 cases in the APA Program's active inventory at the end of 2010 that are either unilateral APAs (76 cases) or bilateral APAs for which the APA Program has not yet completed a recommended negotiating position (167 cases). Of the 243 active APA cases, 36 involve small business taxpayer (SBT) cases, as defined in Rev. Proc. 2006-9, § 4.12(5).

The table below shows the average age (in months) of the 243 active cases in inventory at the end of 2010, along with a comparison of the number of active cases and their average age at year-end for each year back to 2004. The table also shows the same information for cases that were at least 6-months old or 1-year old (the latter being a subset of the former) at the end of each year to allow comparison without potential distortions caused by year-to-year variations in the number of cases received in the latter half or during the course of the year. The build-up in inventory during 2010 primarily reflects the delays caused by the significant fluctuations in APA personnel in 2009 combined with the record number of new APA applications during the past three years. The increases in APA applications and inventory levels have, in fact, masked improvements in recent years in APA productivity, as measured by the number of completed APA items (e.g., APAs, APA amendments, and recommended US negotiating positions) divided by total APA staff hours during a year.

TABLE 9: NUMBER AND AVERAGE AGE OF ACTIVE CASES IN INVENTORY AT YEAR-END

	2004	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**
Active cases	130	133	110	105	161	222	243
Average age (months)	15.2	13.2	10.6	9.1	10.2	12.9	15.4
Active cases 6+ months	106	87	81	66	110	176	196
Average age (months)	17.8	18.5	13.0	13.0	13.5	15.6	18.3
Active cases 1+ year	60	55	32	27	51	116	138
Average age (months)	24.2	23.3	19.4	18.5	18.7	19.5	22.1

TABLE 10: SMALL BUSINESS TAXPAYER APAS

Small Business Taxpayer APAs Completed in 2010	**7**
New	4
Renewals	3
Unilateral	3
Bilateral	4

TABLE 11: MONTHS TO COMPLETE SMALL BUSINESS TAXPAYER APAS

Months to Complete Small Business Taxpayer APAs in 2010					
New		**Renewal**		**Combined**	
Average	37.9	Average	30.0	Average	34.5
Median	37.3	Median	24	Median	29

Although the APA Program strives to complete SBT cases on an expedited basis, our experience is that such cases require nearly the same level of resources and the same commitment of time as non-SBT cases. This phenomenon may be explained by a number of factors, including the fact that the complexity or novelty of transfer pricing issues do not necessarily depend on the dollar volume of the related-party transactions, the lesser transfer pricing experience and/or resources of many SBTs, and the importance to both SBTs and non-SBTs of obtaining APA outcomes that reflect each taxpayer's particular facts and circumstances (as opposed to an analysis based on streamlined factual development and general transfer pricing principles). The Program completed four SBT RNPs during 2010 with average and median lengths of 20.1 and 21.1 months, respectively.

TABLE 12: INDUSTRIES COVERED[9]

Industry Involved - NAICS Codes	Number
Wholesale trade, durable goods - 421	16-18
Computer and electronic product manufacturing - 334	7-9
Professional, scientific and technical services - 545	4-6
Wholesale trade, nondurable goods - 422	1-3
Transportation equipment manufacturing - 336	1-3
Motor vehicle and parts dealers - 441	1-3
Chemical manufacturing - 325	1-3
Electronic equipment, appliance and component manufacturing - 335	1-3
Machinery manufacturing - 333	1-3
Oil and gas extraction - 212	1-3
Publishing industries - 511	1-3
Miscellaneous manufacturing - 339	1-3
Information service and data processing services - 514	1-3
Beverage and tobacco manufacturing - 312	1-3
Air transportation - 481	1-3
Plastics and rubber products manufacturing - 326	1-3
Securities, commodity contracts and other intermediary and related activities - 523	1-3
Clothing and clothing accessories stores - 448	1-3
Food manufacturing - 311	1-3
Sporting goods, hobby, book and music stores - 451	1-3
Broadcasting and telecommunications - 513	1-3
Insurance carriers and related activities - 524	1-3
Paper manufacturing - 322	1-3
Nonmetallic mineral product manufacturing - 327	1-3
Water transportation - 483	1-3
Electronic and appliance stores - 443	1-3
Data Processing, Hosting, and Related Services - 518	1-3

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

Trades or Businesses

[§ 521(b)(2)(D)(i)]

The nature of the relationships between the related organizations, trades, or businesses covered by APAs executed in 2010 set forth in Table 13 below:

TABLE 13: NATURE OF RELATIONSHIPS BETWEEN RELATED ENTITIES

Relationship	Number of APAs
Foreign Parent - U.S. Subsidiary (-ies)	44
Unilateral	*14*
Bilateral	*30*
U.S. Parent - Foreign Subsidiary (-ies)	20
Unilateral	*4*
Bilateral	*16*
Foreign Company and U.S. branch(es)	≤3
Unilateral	*0*
Bilateral	≤3
U.S. Company and non-U.S. branch(es)	≤3
Unilateral	*0*
Bilateral	≤3
Partnership	≤3
Unilateral	≤3
Bilateral	≤3

Covered Transactions

[§ 521(b)(2)(D)(ii)]

The controlled transactions covered by APAs executed in 2010 are set forth in Tables 14 and 15 below:

TABLE 14: TYPES OF COVERED TRANSACTIONS

Transaction Type	Number
Sale of tangible property into the United States	40
Performance of services by U.S. entity	28
Performance of services by non-U.S. entity	21
Use of intangible property by U.S. entity	19
Use of intangible property by non-U.S. entity	11
Sale of tangible property from the United States	11
Cost Sharing – U.S. parent/foreign subsidiary	≤3
Cost Sharing –non U.S. parent/domestic subsidiary	≤3
Other	≤3

TABLE 15: TYPES OF SERVICES INCLUDED IN COVERED TRANSACTIONS

Intercompany Services Involved in the Covered Transactions	Number
Marketing	29
Distribution	26
Logistical support	19
Technical support services	18
Sales support	15
IT	11
Management	10
Headquarters costs	9
Product support	9
Legal	7
Health, safety, environmental, and regulatory affairs	6
Purchasing	6
Research and development	6
Corporate and public relations	5
Treasury activities	5
Tax compliance activities/services	5
Warranty services	≤3
Assembly	≤3
Accounting and auditing	≤3
Benefits	≤3
Staffing and recruiting	≤3
Accounts receivable	≤3
Accounts payable	≤3
Payroll	≤3

Budgeting	≤3
Contract manufacturing	≤3
Others	≤3

Business Functions Performed and Risks Assumed

[§ 521(b)(2)(D)(ii)]

The general descriptions of the business functions performed and risks assumed by the organizations, trades, or businesses whose results are tested in the Covered Transactions in the APAs executed in 2010 are set forth in Tables 16 and 17 below:

TABLE 16: FUNCTIONS PERFORMED BY THE TESTED PARTY

Functions Performed	Number
Distribution	78
Product service	62
Marketing functions	47
Manufacturing	41
Managerial, legal, accounting, finance, personnel, and other support services	29
Transportation and warehousing	28
Purchasing and materials management	18
Licensing of intangibles	17
Research and development	15
Product design and engineering	14
Product assembly or packaging	13
Technical training and technical support	12
Consulting Services	8
Trading and risk management of financial products	7
Process engineering	≤3
Engineering and construction related services	≤3
Mining and extraction	≤3
Telecom Services	≤3

TABLE 17: RISKS ASSUMED BY THE TESTED PARTY

Risks Assumed	Number
Market risks, including fluctuations in costs, demand, pricing, and inventory	104
General business risks (e.g., related to ownership of PP&E)	62
Credit and collection risks	84
Product liability risks	35
Financial risks, including interest rates and currency	47
Research and development risks	18

Discussion

The majority of APAs have Covered Transactions that involve numerous business functions and risks. For instance, with respect to functions, multinational groups that manufacture products typically conduct research and development (R&D), engage in product design and engineering, manufacture the product, market and distribute the product, and perform support functions such as legal, finance, and human resources services. Regarding risks, these groups are 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 among the controlled group of companies that are party to the Covered Transactions.

In its APA submission, the taxpayer must provide a functional analysis. The functional analysis identifies the economic activities performed, the assets employed, the economic costs incurred, and the risks assumed by each of the controlled parties. The importance of the functional analysis derives from the economic theory positing 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 because, in the example of distributors, not all distributors undertake similar functions and risks.

The functional analysis is critical in determining the appropriate TPM (including the selection of comparables, tested party, and profit level indicator (PLI)). In conjunction with evaluating the functional analysis, the APA Program considers contractual terms between the controlled parties, the allocation of risk between the parties, the relevant economic conditions, and the type of property or services at issue. In assessing contractual terms and risk allocations, the APA Program considers not only written agreements between the parties, but also the economic substance of the transactions as indicated by the conduct of the parties over time, the financial capacity of each party to fund losses arising from risks, and the managerial or operational control each party exercises over activities giving rise to risk. Relevant economic conditions reviewed often include the geographic market and the level of the market in which the functions are performed, and the business cycle or general economic condition of the industry under review.

During 2010, the APA Program received numerous inquiries about the potential effect of the economic downturn on existing and pending APAs. On existing APAs, the APA Program, in consultation with the USCA, has adopted a general policy not to re-open closed cases absent a special Critical Assumption on point.[10] The APA Program has dealt with pending APA applications (whether pending with the USCA or the APA Program) on a case-by-case basis. Whether or not a special "down-economy adjustment" might be appropriate depends on a variety of factors, including whether or not the tested party and the comparables have been similarly affected by the downturn, the tested party's historic risk profile and performance, and a taxpayer's willingness to accept a symmetrical adjustment (e.g., in a renewal APA) when the economy improves. Approaches to the down economy that have been considered include changing the APA term, waiting for more current financial data, using a different set of comparables, and/or applying a longer testing period.

The APA Program's evaluation of the functional analysis also considers the assets or other resources employed by each controlled party. In this evaluation, each party's ownership or investment in valuable intangible assets is often an important consideration.

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

[§ 521(b)(2)(D)(iii)]

The related organizations, trades, or businesses whose prices or results are tested to determine compliance with TPMs prescribed in APAs executed in 2010 are set forth in Table 18 below:

TABLE 18: RELATED ORGANIZATIONS, TRADES, OR BUSINESSES WHOSE PRICES OR RESULTS ARE TESTED[11]

Type of Organization	Number
U.S. distributor	46
Non-U.S. provider of services	21
U.S. provider of services	20
Non-U.S. distributor	12
U.S. manufacturer	9
Non-U.S. manufacturer	9
U.S. licensor of intangible property	≤3
Non-U.S. licensor of intangible property	≤3

[10] See Table 21 and accompanying text.
[11] "Multiple tested parties" includes covered transactions that utilize profit splits, CUPs, and CUTs.

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

[§ 521(b)(2)(D)(iv)]

The TPMs used in APAs executed in 2010 are set forth in Tables 19 and 20 below:

TABLE 19: TRANSFER PRICING METHODS USED FOR TRANSFERS OF TANGIBLE AND INTANGIBLE PROPERTY[12]

TPM Used	Number
CPM: PLI is operating margin	55
Unspecified method	21
CUT (intangibles only)	6
CPM: PLI is Berry ratio	5
Residual profit split	5
CPM: PLI is other PLI	5
CPM: PLI is markup on total costs	≤3
Other profit split	≤3

TABLE 20: TRANSFER PRICING METHODS USED FOR SERVICES

TPM Used	Number
CPM: PLI is operating profit-to-total services cost ratio	46
Comparable Uncontrolled Services Price Method	16
Gross Services Margin Method	9
Services Cost Method: Specified Covered Services	7
CPM: PLI is return on assets or capital involved	5
Services Cost Method: Low Margin Covered Services	≤3
CPM: PLI is Berry ratio	≤3
Other profit split	≤3
Unspecified method	≤3

Discussion

The TPMs used in APAs completed during 2010 were based on the section 482 regulations. Under Treas. Reg. § 1.482-3, the arm's length amount for controlled transfers of tangible property may be determined using the Comparable Uncontrolled Price (CUP) Method, the Resale Price Method, the Cost Plus Method, the Comparable Profits Method (CPM), or the Profit

[12] PLIs used with the Comparable Profit Method of Treas. Reg. § 1.482-5, and as used in these TPM tables, are as follows: (1) operating margin (ratio of operating profit to sales); (2) Berry ratio (ratio of gross profit to operating expenses); (3) gross margin (ratio of gross profit to sales); (4) markup on total costs (percentage markup on total costs); and (5) rate of return on assets or capital employed (ratio of operating profit to operating assets).

Split Method. Under Treas. Reg. § 1.482-4, the arm's length amount for controlled transfers of intangible property may be determined using the Comparable Uncontrolled Transaction (CUT) Method, the CPM, or the Profit Split Method. An "Unspecified Method" may be used for transfers of either tangible or intangible property if it provides a more reliable result than the enumerated methods under the best method rule of Treas. Reg. § 1.482-1(c).

For transfers involving the provision of services, Treas. Reg. § 1.482-9(a) provides that the arm's length amount charged must be determined under one of six specified methods or an unspecified method. The six specified methods are the Services Cost Method, the Comparable Uncontrolled Services Price (CUSP) Method, the Gross Services Margin Method, the Cost of Services Plus Method, the CPM, and the Profit Split Method. Treasury Reg. § 1.482-2(a) provides rules concerning the proper treatment of loans or advances.

On January 5, 2009, the IRS issued new temporary regulations, Treas. Reg. § 1.482-7T, which provide rules for qualified cost sharing arrangements under which the parties agree to share the costs of developing intangibles in proportion to their shares of reasonably anticipated benefits. APAs involving cost sharing arrangements generally address both the method of allocating costs among the parties as well as determining the appropriate amount of the payment for "platform contribution transactions" (PCTs) due for the transfer of pre-existing intangibles, and the commitment of services with embedded intangibles, among the controlled participants (known as "buy ins" in the previous cost-sharing regulations). As in 2009, in 2010 the APA Program completed its recommendations on three or fewer bilateral cost sharing/PCT cases and sent those on to the USCA. In addition, the APA Program is currently working on roughly 10 cases involving cost-sharing/PCTs, split almost evenly between bilateral and unilateral. The PCT cases include both initial and subsequent buy-in/buy-out transactions. The methods used in the completed and pending PCT cases include valuations based on the income method, including cases involving a split of the discounted present value of platform contributions made by two or more parties, and other types of analyses.

In reviewing the TPMs applicable to transfers of tangible and intangible property reflected in Table 19, the majority of the APAs followed the specified methods. However, several points should be made. The section 482 regulations note that for transfers of tangible property, the CUP Method will generally be the most direct and reliable measure of an arm's length price for the controlled transaction if an uncontrolled transaction has no differences with the controlled transaction that would affect the price, or if there are only minor differences that have a definite and reasonably ascertainable effect on price and for which appropriate adjustments are made. Treas. Reg. § 1.482-3(b)(2)(ii)(A). As in earlier years, it was the experience of the APA Program in 2010 that CUP transactions meeting these criteria were difficult to find.

Similar to the CUP Method, for transfers of intangible property the CUT Method will generally provide the most direct and reliable measure of an arm's length result if an uncontrolled transaction involves the transfer of the same intangible under the same, or substantially the same, circumstances as the controlled transaction. Treas. Reg. § 1.482-4(c)(2)(ii). Under the regulation, circumstances between the controlled and uncontrolled transaction will be considered substantially the same if there are at most only minor differences that have a definite and reasonably ascertainable effect on the amount charged and for which appropriate adjustments are made. *Id*. It has generally been difficult to identify external comparables, and APAs using the

CUT Method tend to rely on internal transactions (those between the taxpayer and uncontrolled parties). In 2010, six Covered Transactions utilized the CUT TPM.

The Resale Price Method was not applied in 2010. See Treas. Reg. § 1.482-3(c), (d).

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

Table 19 reflects at least 65 uses of the CPM (with varying PLIs) in Covered Transactions involving tangible or intangible property. In some APAs, the CPM was also used concurrently with other methods.

The CPM has proven to be versatile in part because of the various PLIs that can be used in connection with the method. Reaching agreement on the appropriate PLI has been the subject of much discussion in many of the cases, and it depends heavily on the facts and circumstances. Some APAs have called for different PLIs to apply to different parts of the Covered Transactions or applied a secondary PLI as a check against the primary PLI.

The CPM was also used regularly with services as the Covered Transactions in APAs executed in 2010. There were at least fifty-one services Covered Transactions using the CPM Method with various PLIs according to the specific facts of the taxpayers involved. At least seven services-related APAs completed in 2010 applied the new Services Cost Method under the § 1.482-9 regulations. Table 20 reflects the methods used to determine the arm's length results for APAs involving services transactions.

In 2010, five APAs involving tangible or intangible property used the Residual Profit Split Method. Treas. Reg. § 1.482-6(c)(3). In residual profit split cases, routine contributions by the controlled parties are allocated routine market returns, and the residual income is allocated among the controlled taxpayers based upon the relative value of their contributions of non-routine intangible property to the relevant business activity.

Profit splits have also been used in a number of financial product APAs in which the primary income-producing functions are performed in more than one jurisdiction.

Critical Assumptions

[§ 521(b)(2)(D)(v)]

Critical Assumptions used in APAs executed in 2010 are described in Table 21 below:

TABLE 21: CRITICAL ASSUMPTIONS

Critical Assumptions involving the following:	Number of APAs
Material changes to tax and/or financial accounting practices	69
Material changes to the business	69
Assets will remain substantially same	7
Other	7
Other financial ratios	6
Changes in affiliated companies	≤3

<u>Discussion</u>

APAs include critical assumptions upon which their respective TPMs depend. A critical assumption is any fact (whether or not within the control of the taxpayer) related to the taxpayer, a third party, an industry, or business and economic conditions, the continued existence of which is material to the taxpayer's proposed TPM. Critical assumptions might include, for example, a particular mode of conducting business operations, a particular corporate or business structure, or a range of expected business volume. Rev. Proc. 2006-09, § 4.05. Failure to meet a critical assumption may render an APA inappropriate or unworkable. Most APAs contain only the standard critical assumption language set forth in Appendix B of the Model APA (Attachment A to this Announcement and Report). Where appropriate, additional critical assumption language may be added, but the APA Program generally seeks to limit additional critical assumption language to objective, measurable benchmarks.

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

If a critical assumption has not been met, the APA may be revised by agreement of the parties. If such an agreement cannot be achieved, the APA is canceled. If a critical assumption has not been met, the taxpayer must notify and discuss the APA terms with the Service, and, in the case of a bilateral APA, competent authority consideration is initiated. Rev. Proc. 2006-09, §§ 11.05, 11.06.

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

[§ 521(b)(2)(D)(v), (vi), and (vii)]

The sources of comparables, selection criteria, and rationale used in determining the selection criteria for APAs executed in 2010 are described in Tables 22 through 24 below. Various formulas for making adjustments to comparables are included as Attachment B.

TABLE 22: SOURCES OF COMPARABLES

Comparable Sources	Number of Times This Source Used
Compustat	73
No Comparables used	37
Disclosure	21
Mergent	15
Other	10
Worldscope	7
Amadeus	5
Moody's	5
Austrailian Business Who's Who	4
Capital IO	≤3
Global Vantage	≤3
SEC	≤3
Osiris	≤3
Japan Accounts and Data on Enterprises (JADE)	≤3

TABLE 23: COMPARABLES SELECTION CRITERIA

Selection Criteria Considered	Number of Times This Criterion Used
Comparable functions	85
Comparable risks	72
Comparable industry	50
Comparable intangibles	37
Comparable products	41
Comparable terms	17

TABLE 24: ADJUSTMENTS TO COMPARABLES OR TESTED PARTIES

Adjustment	Number of Times Used
Balance sheet adjustments	
Payables	52
Receivables	51
Inventory	52
Property, plant, equipment	8
Other	≤3
Accounting adjustments	
LIFO to FIFO inventory accounting	37
Other	24
Accounting reclassifications (e.g., from COGS to operating expenses)	≤3
Profit level indicator adjustments (used to "back into" one PLI from another PLI)	
Miscellaneous adjustments	
Goodwill value or amortization	22
Stock-based compensation	19
Research and development Other	≤3 ≤3

Discussion

At the core of most APAs are comparables. The APA Program works closely with taxpayers to find the best and most reliable comparables for each Covered Transaction. In some cases, CUPs or CUTs can be identified. In other cases, profit data on comparable business activities of independent companies are used in applying the CPM or a Profit Split Method. Generally, in the APA Program's experience since 1991, CUPs and CUTs have been most often derived from the internal transactions of the taxpayer.

For profit-based methods in which comparable business activities or functions of independent companies are sought, the APA Program typically has selected them using a three-part process. First, a pool of companies with potentially comparable business activities has been identified through broad searches. From this pool, companies performing business activities 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 review of business descriptions. Then, based on a review of available descriptive and financial data, a set of comparable independent companies has been finalized. The comparability of the final set has then been enhanced by adjusting their financial data.

Sources of Comparables

Comparables used in APAs can be from the United States or foreign countries, depending on the relevant market, the type of transaction being evaluated, the availability of relevant data, and the results of the functional and risk analyses. In general, comparables have been located by searching a variety of databases that provide data on U.S. publicly traded companies and on a combination of public and private non-U.S. companies. Table 22 shows the various databases and other sources used in selecting comparables for the APAs executed in 2010.

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

Selecting Comparables

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

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

Business activities of independent companies generally must meet certain basic comparability criteria to be considered comparable. The independent company's functions, risks, and economic conditions, and the property (product or intangible) and services associated with the company's business activities, must be comparable to those involved in the Covered Transaction. Determining comparability requires judgment – the goal has been to use comparability criteria restrictive enough to eliminate business activities that are not comparable, but yet not so restrictive as to leave no comparables remaining. The APA Program normally has begun with relatively strict comparability criteria and then has relaxed them slightly if necessary to derive a pool of reliable comparables. A determination on the appropriate size of the comparables set, as well as the business activities that comprise the set, is highly fact-specific and depends on the reliability of the results.

In addition, the APA Program, consistent with the section 482 regulations, generally has looked at the results of comparables over a multi-year period (the analysis window). Often this has been a three-year or a five-year period, but other periods are sometimes used depending on the circumstances of the controlled transaction. Using a shorter period might result in the inclusion of comparables in different stages of economic development or use of atypical years of a comparable due to cyclical fluctuations in business conditions. The economic downturn has focused particular attention on the appropriate analysis window for APAs with terms that include 2008 and 2009, and to a lesser extent 2010, given the different economic conditions that may have confronted the comparables during the years comprising the analysis window, which typically lags behind the years covered by an APA (e.g., the comparables results for 2004-08 may be used to test the taxpayer's results under the APA from 2008-2012). As noted in the discussion following Table 17, the APA Program has been dealing with the economic downturn in various ways, including waiting for more current comparables' financial data to develop a more contemporaneous analysis window.

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 smaller size, might face fundamentally different economic conditions from those of the transaction or business activities being tested. In addition, APA analyses have incorporated selection criteria designed to identify and remove companies experiencing "financial distress" because of concerns that companies in financial distress face unusual circumstances and operational constraints that render them not comparable to the business activity being tested. These "financial distress" criteria may include an unfavorable auditor's opinion, bankruptcy, failure to comply with financial obligations (e.g., debt covenants), and, in certain circumstances, operating losses in a given number of years.

An additional important class of selection criteria is the development and ownership of intangible property. Most often, comparables are sought to test the results of a business activity that does not employ significant intangible assets or engage in intangible development. Thus, for example, in some cases in which the tested business activity is manufacturing conducted by a controlled entity that does not own significant manufacturing intangibles or conduct R&D, several criteria have been used to ensure that the comparables similarly do not own significant intangibles or conduct R&D. These selection criteria have included determining the importance of patents to a company or screening for R&D expenditures as a percentage of sales. Similar selection criteria may be applied to ensure, where appropriate, that the comparables do not own or develop significant marketing intangibles such as valuable trademarks. Again, quantitative screens related to identifying comparables with significant intangible property generally have been used in conjunction with an understanding of the comparable derived from publicly available business information.

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

Table 25 shows the number of times various screens were used in APAs executed in 2010:

TABLE 25: COMPARABILITY AND FINANCIAL DISTRESS SCREENS

Comparability/Financial Distress Screen	Times Used
Comparability screens used	
R&D/sales	37
Sales	33
Foreign sales/total sales	18
Other	14
Related party transactions	12
Insufficient detail	9
PP&E/sales	9
SG&A/sales	8
Non-routine intangibles	7
Inventory/sales	5
Non-startup or start-up	4
Government sales	≤3
Employees	≤3
PP&E total assets	≤3
Operating expense/sales	≤3
Advertising/sales	≤3
Geographic market	≤3
Financial distress	
Bankruptcy	62
Unfavorable auditor's opinion	32
Losses in one or more years	14
Other	11
Stopped filing public documents	4

Adjusting Comparables

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

The most common balance sheet adjustments used in APAs are adjustments for differences in accounts receivable, inventories, and accounts payable. The APA Program generally has required adjustments for receivables, inventory, and payables based on the principle that there is an opportunity cost for holding assets. For these assets, it is generally assumed that the cost is appropriately measured by the interest rate on short-term debt.

To compare the profits of two business activities with different relative levels of receivables, inventory, or payables, the APA Program estimates the carrying costs of each item and adjusts profits accordingly. Although different formulas have been used in specific APA cases, Attachment B presents one set of formulas used in many APAs. Underlying these formulas are the notions that (1) balance sheet items normally should be expressed as mid-year averages, (2) formulas should try to avoid using data items that are being tested by the TPM (for example, if sales are controlled, then the denominator of the balance sheet ratio should not be sales), (3) a short term interest rate should be used, and (4) an interest factor should recognize the average holding period of the relevant asset. As it has since 2007, during the course of 2010, the APA Program used an interest rate equal to LIBOR (3 months) plus 200 basis points for purposes of calculating adjustments for accounts receivable and accounts payable for U.S. companies in many cases. In addition, the APA Program often used an interest rate equal to the Corporate Bonds (Moody's) Baa rate for purposes of calculating inventory adjustments for U.S. companies. However, the facts and circumstances surrounding a given case will ultimately determine the reliability of making balance sheet adjustments and the selection of the most reliable interest rate.

The APA Program also requires that financial data be compared on a consistent accounting basis. For example, although financial statements may be prepared on a first-in first-out (FIFO) basis, cross-company comparisons are less meaningful if one or more of the comparables use last-in first-out (LIFO) inventory accounting methods. This adjustment directly affects costs of goods sold and inventories, and therefore affects both profitability measures and inventory adjustments.

In some cases, the APA Program has made an adjustment to account for differences in relative levels of PP&E between a tested business activity and the comparables. Ideally, comparables and the business activity being tested will have fairly similar relative levels of PP&E, since major differences can be a sign of fundamentally different functions and risks. Typically, the PP&E adjustment is made using a medium-term interest rate. During the course of 2010, the APA Program often used the Corporate Bonds (Moody's) Baa rate as the interest rate for purposes of calculating adjustments for inventory and PP&E for U.S. companies. Again, however, the facts and circumstances surrounding a given case will ultimately determine the reliability of making balance sheet adjustments and the selection of the most reliable interest rate.

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

The adjustments made to comparables or tested parties in APAs executed in 2010 are reflected in Table 24 above.

Ranges, Targets, and Adjustment Mechanisms

[§ 521(b)(2)(D)(viii)–(ix)]

The types of ranges, targets, and adjustment mechanisms used in APAs executed in 2010 are described in Tables 26 and 27 below.

TABLE 26: RANGES AND TARGETS[13]

Type of Range	Number
Interquartile range	71
Other	13
Cost-only services	11
Specific point within CPM range (not floor or ceiling)	8
Floor (i.e., result must be less than x)	8
Ceiling (i.e., result must be no more than x)	7
Specific point (royalty)	5
Financial products statistical confidence interval to test against internal CUPs	≤3

TABLE 27: ADJUSTMENTS WHEN OUTSIDE THE RANGE

Adjustment mechanism	Number
Taxpayer makes an adjustment: to specified point or royalty rate	58
Taxpayer makes an adjustment: to closest edge of multi-year average	41
Taxpayer makes an adjustment: to closest edge of single year	13
Taxpayer makes an adjustment: to median of current year	≤3
Taxpayer makes an adjustment: to median of multi-year average	≤3
Taxpayer makes an adjustment: to a specific dollar amount	≤3

<u>Discussion</u>

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

Under Treas. Reg. § 1.482-1(e)(2)(i), such a range is normally derived by considering a set of more than one comparable uncontrolled transaction of similar comparability and reliability. If these comparables are of very high quality, as defined in the section 482 regulations, then under Treas. Reg. § 1.482-1(e)(2)(iii)(A), the arm's length range includes the results of all of the comparables (from the least to the greatest). However, the APA Program has only rarely identified cases meeting the requirements for the full range. If the comparables are of lesser

[13] The numbers do not include TPMs with cost or cost-plus methodologies.

quality, then under Treas. Reg. § 1.482-1(e)(2)(iii)(B), "the reliability of the analysis must be increased, when it is possible to do so, by adjusting the range through application of a valid statistical method to the results of all of the uncontrolled comparables." One such method, the "interquartile range," is ordinarily acceptable, although a different statistical method "may be applied if it provides a more reliable measure." The interquartile range is defined as, roughly, the range from the 25th to the 75th percentile of the comparables' results. See Treas. Reg. § 1.482-1(e)(2)(iii)(C). The interquartile range was used seventy-one times in 2010.

Eight Covered Transactions reflected on Table 26 were tested against a single, specific result. Some APAs – deliberately infrequent – 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. Fifteen APAs executed in 2010 used a floor or a ceiling.

Some APAs look to a tested party's results over a period of years (multi-year averaging) to determine whether a taxpayer has complied with the APA. In 2010, rolling multi-year averaging was used for seven Covered Transactions. All seven of these Covered Transactions used rolling averages from three to five years. Seven Covered Transactions used cumulative multi-year averaging, while twenty-seven Covered Transactions used term averages.

<u>Adjustments</u>

Where a taxpayer's actual transactions do not produce results that conform to the TPM, a taxpayer must nonetheless report its taxable income in an amount consistent with the TPM (an APA primary adjustment), as further discussed in § 11.02 of Rev. Proc. 2006-09. When the TPM specifies an arm's length range, an APA primary adjustment is necessary only if the taxpayer's actual transactional result falls outside the specified range.

Under Treas. Reg. § 1.482-1(e)(3), if a taxpayer's results fall outside the arm's length range, the IRS may adjust the result "to any point within the arm's length range." Accordingly, an APA may permit or require a taxpayer 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 IRS may make such an adjustment. When the APA specifies a range, the adjustment is sometimes to the closest edge of the range, and sometimes to another point such as the median of the interquartile range. Depending on the facts of each case, automatic adjustments are not always permitted. APAs may specify that in such a case there will be a negotiation between the competent authorities involved to determine whether and to what extent an adjustment should be made. APAs may permit automatic adjustments unless the result is far outside the range specified in the APA. Thus, APAs provide flexibility and efficiency, permitting adjustments when normal business fluctuations and uncertainties push the result somewhat outside the range.

APA Term and Rollback Lengths

[§ 521(b)(2)(D)(x)]

The various term lengths for APAs executed in 2010 are set forth in Table 28 below:

TABLE 28: TERMS OF APAS

APA Term in Years	Number of APAs
2	≤3
3	≤3
4	≤3
5	30
6	10
7	14
8	5
9	≤3
10 or more	≤3

The number of rollback years to which an APA TPM was applied in 2010 is set forth in Table 29 below:

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

Number of Rollback Years	Number of APAs
1	≤3
2	9
3	≤3
4	≤3
5 or more	5

Together, Tables 28 and 29 indicate that the 69 APAs completed in 2010 covered more than 427 taxable years, and potentially more than 500 taxable years. In terms of dollar value, 38 of the 69 completed APAs involved Covered Transactions exceeding $100 million per year, with 21 APAs covering transactions exceeding $250 million per year. Combining the total covered years and the total dollar-value of Covered Transactions represents one measure of the effectiveness of the APA Program.

Nature of Documentation Required

[§ 521(b)(2)(D)(xi)]

APAs executed in 2010 required that taxpayers provide various documents with their annual reports. These documents are described in Table 30 below:

TABLE 30: NATURE OF DOCUMENTATION REQUIRED

Documentation	Number
Statement identifying all material differences between Taxpayer's business operations during APA Year and description of Taxpayer's business operations contained in Taxpayer's request for APA, or if there have been no such material differences, a statement to that effect.	69
Statement of all material changes in the Taxpayer's accounting methods and classifications, and methods of estimation, from those described or used in Taxpayer's request for the APA. If there has been no material change in accountings methods and classifications or methods of estimation, a statement to that effect.	69
Description of any failure to meet Critical Assumptions or, if there have been none, a statement to that effect.	69
Copy of the APA	69
Financial analysis demonstrating Taxpayer's compliance with TPM.	69
Organizational chart	69
Any change to the taxpayer notice information in section 14 of the APA.	69
The amount, reason for, and financial analysis of any compensating adjustment under Paragraph 4 of Appendix A and Rev. Proc. 2006-9, § 11.02(3), for the APA year, including but not limited to: the amounts paid or received by each affected entity; the character (such as capital or ordinary expense) and country source of the funds transferred, and the specific line item(s) of any affected U.S. tax return; and any change to any entity classification for federal income tax purposes of any member of the Taxpayer's group that is relevant to the APA.	69
The amounts, description, reason for, and financial analysis of any book-tax difference relevant to the TPM for the APA Year, as reflected on Schedule M-1 or Schedule M-3 of the U.S. return for the APA Year.	69
Financial Statements and any necessary account detail to show compliance with the TPM, with a copy of the opinion from an independent CPA required by paragraph 5(f) of the APA.	63
Certified public accountant's opinion that financial statements present fairly the financial position of Taxpayer and the results of its operations, in accordance with a foreign GAAP.	8
CPA review of Taxpayer's financial statements	5
Various work papers	4
Schedule of costs and expenses (e.g. intercompany allocations)	≤3
Profit and loss statement	≤3
Foreign tax return	≤3
Pertinent intercompany agreements	≤3

Approaches for Sharing of Currency or Other Risks

[§ 521(b)(2)(D)(xii)]

During 2010, there were forty-seven tested parties that faced financial risks, including interest rate and currency risks. In appropriate cases, APAs may provide specific approaches for dealing with currency risk, such as adjustment mechanisms and/or critical assumptions.

Efforts to Ensure Compliance with APAs

[§ 521(b)(2)(F)]

As described in Rev. Proc. 2006-09, § 11.01, APA taxpayers are required to file annual reports to demonstrate compliance with the terms and conditions of the APA. The filing and review of annual reports is a critical part of the APA process. Through annual report review, the APA Program monitors taxpayer compliance with the APA on a contemporaneous basis. Annual report review provides current information on the success or problems associated with the various TPMs adopted in the APA process.

All reports received by the APA Program are assigned to a designated APA team leader. Whenever possible, annual report reviews are assigned to the team leader who negotiated the case, since that person will already be familiar with the relevant facts and terms of the agreement. Other team leaders and economists may assist the assigned team leader as well. Once received by the APA Program, the annual report is also sent to the field personnel with exam jurisdiction over the taxpayer.

The statistics for the review of APA annual reports are reflected in Table 31 below. As of December 31, 2010, there were 245 pending annual reports. In 2010, 336 annual reports were closed.

TABLE 31: STATISTICS OF ANNUAL REPORTS

Number of APA annual reports pending as of December 31, 2010	245
Number of APA annual reports closed in 2010	336
Number of APA annual reports requiring adjustment in 2010	3
Number of taxpayers involved in adjustments	3
Number of APA annual report cases over one-year old	126

Attachment A
Model APA - Based on Revenue Procedure 2006-9

ADVANCE PRICING AGREEMENT

between

[*Insert Taxpayer's Name*]

and

THE INTERNAL REVENUE SERVICE

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

PARTIES

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

RECITALS

[*Insert Taxpayer Name*] is the common parent of an affiliated group filing consolidated U.S. tax returns (collectively referred to as "Taxpayer"), and is entering into this APA on behalf of itself and other members of its consolidated group.

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

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

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

AGREEMENT

The Parties agree as follows:

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

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

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

4. *Operation.*

a. Revenue Procedure 2006-9 governs the interpretation, legal effect, and administration of this APA.

b. Nonfactual oral and written representations, within the meaning of sections 10.04 and 10.05 of Revenue Procedure 2006-9 (including any proposals to use particular TPMs), made in conjunction with the APA Request constitute statements made in compromise negotiations within the meaning of Rule 408 of the Federal Rules of Evidence.

5. *Compliance.*

a. Taxpayer must report its taxable income in an amount that is consistent with Appendix A and all other requirements of this APA on its timely filed U.S. Return. However, if Taxpayer's timely filed U.S. Return for an APA Year is filed prior to, or no later than 60 days after, the effective date of this APA, then Taxpayer must report its taxable income for that APA Year in an amount that is consistent with Appendix A and all other requirements of this APA either on the original U.S. Return or on an amended U.S. Return filed no later than 120 days after the effective date of this APA, or through such other means as may be specified herein.

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

c. For each taxable year covered by this APA (APA Year), if Taxpayer complies with the terms and conditions of this APA, then the IRS will not make or propose any allocation or adjustment under I.R.C. section 482 to the amounts charged in the aggregate between Taxpayer and Foreign Participant[s] with respect to the Covered Transactions.

d. If Taxpayer does not comply with the terms and conditions of this APA, then the IRS may:

i. enforce the terms and conditions of this APA and make or propose allocations or adjustments under I.R.C. section 482 consistent with this APA;

ii. cancel or revoke this APA under section 11.06 of Revenue Procedure 2006-9; or

iii. revise this APA, if the Parties agree.

e. Taxpayer must timely file an Annual Report (an original and four copies) for each APA Year in accordance with Appendix C and section 11.01 of Revenue Procedure 2006-9. Taxpayer must file the Annual Report for all APA Years through the APA Year ending [insert year] by [insert date]. Taxpayer must file the Annual Report for each subsequent APA Year by [insert month and day] immediately following the close of that APA Year. (If any date falls on a weekend or holiday, the Annual Report shall be due on the next date that is not a weekend or holiday.) The IRS may request additional information reasonably necessary to clarify or complete the Annual Report. Taxpayer will provide such requested information within 30 days. Additional time may be allowed for good cause.

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

g. In accordance with section 11.04 of Revenue Procedure 2006-9, Taxpayer will (1) maintain its APA Records, and (2) make them available to the IRS in connection with an examination under section 11.03. Compliance with this subparagraph constitutes compliance with the record-maintenance provisions of I.R.C. sections 6038A and 6038C for the Covered Transactions for any taxable year during the APA Term.

h. The True Taxable Income within the meaning of Treasury Regulations sections 1.482-1(a)(1) and (i)(9) of a member of an affiliated group filing a U.S. consolidated return will be determined under the I.R.C. section 1502 Treasury Regulations.

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

6. *Critical Assumptions.* This APA's critical assumptions, within the meaning of Revenue Procedure 2006-9, section 4.05, appear in Appendix B. If any critical assumption has not been met, then Revenue Procedure 2006-9, section 11.06, governs.

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

8. *Disputes.* If a dispute arises concerning the interpretation of this APA, the Parties will seek a resolution by the IRS Associate Chief Counsel (International) to the extent reasonably practicable, before seeking alternative remedies.

9. *Materiality.* In this APA the terms "material" and "materially" will be interpreted consistently with the definition of "material facts" in Revenue Procedure 2006-9, section 11.06(4).

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

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

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

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

14. *Notice.* Any notices required by this APA or Revenue Procedure 2006-9 must be in writing. Taxpayer will send notices to the IRS at the address and in the manner set forth in Revenue Procedure 2006-9, section 4.11. The IRS will send notices to:

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

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

WITNESS,

The Parties have executed this APA on the dates below.

[Taxpayer Name in all caps]

By: ______________________________ Date: ________________, 20___
Jane Doe
Sr. Vice President (Taxes)

IRS

By: ______________________________ Date: ________________, 20___
John E. Hinding
Director, Advance Pricing Agreement Program

APPENDIX A

COVERED TRANSACTIONS AND TRANSFER PRICING METHOD (TPM)

---

1. Covered Transactions.

[*Define the Covered Transactions.*]

2. TPM.

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

[The Tested Party is __________.]

- **CUP Method**

The TPM is the comparable uncontrolled price (CUP) method. The Arm's Length Range of the price charged for _________ is between _______ and ___________ per unit.

- **CUT Method**

The TPM is the CUT Method. The Arm's Length Range of the royalty charged for the license of ______is between ____% and ___ % of [Taxpayer's, Foreign Participants', or other specified party's] Net Sales Revenue. [Insert definition of net sales revenue or other royalty base.]

- **Resale Price Method (RPM)**

The TPM is the resale price method (RPM). The Tested Party's Gross Margin for any APA Year is defined as follows: the Tested Party's gross profit divided by its sales revenue (as those terms are defined in Treasury Regulations section 1.482-5(d)(1) and (2)) for that APA Year. The Arm's Length Range is between ____% and ___ %, and the Median of the Arm's Length Range is ___%.

- **Cost Plus Method**

The TPM is the cost plus method. The Tested Party's Cost Plus Markup is defined as follows for any APA Year: the Tested Party's ratio of gross profit to production costs (as those terms are defined in Treasury Regulations section 1.482-3(d)(1) and (2)) for that APA Year. The Arm's Length Range is between ___% and ___%, and the Median of the Arm's Length Range is ___%.

- **CPM with Berry Ratio PLI**

The TPM is the comparable profits method (CPM). The profit level indicator is a Berry Ratio. The Tested Party's Berry Ratio is defined as follows for any APA Year: the Tested Party's gross profit divided by its operating expenses (as those terms are defined in Treasury Regulations section 1.482-5(d)(2) and (3)) for that APA Year. The Arm's Length Range is between ____ and ___, and the Median of the Arm's Length Range is ___.

- **CPM using an Operating Margin PLI**

The TPM is the comparable profits method (CPM). The profit level indicator is an operating margin. The Tested Party's Operating Margin is defined as follows for any APA Year: the Tested Party's operating profit divided by its sales revenue (as those terms are defined in Treasury Regulations section 1.482-5(d)(1) and (4)) for that APA Year. The Arm's Length Range is between ____% and ___ %, and the Median of the Arm's Length Range is ___%.

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

The TPM is the comparable profits method (CPM). The profit level indicator is an operating margin. The Tested Party's Three-Year Rolling Average operating margin is defined as follows for any APA Year: the sum of the Tested Party's operating profit (within the meaning of Treasury Regulations section 1.482-5(d)(4) for that APA Year and the two preceding years, divided by the sum of its sales revenue (within the meaning of Treasury Regulations section 1.482-5(d)(1)) for that APA Year and the two preceding years. The Arm's Length Range is between ____% and ____%, and the Median of the Arm's Length Range is ___%.

- **Residual Profit Split Method**

The TPM is the residual profit split method. [I*nsert description of routine profit level determinations and residual profit-split mechanism*].

[*Insert additional provisions as needed.*]

3. Application of TPM.

For any APA Year, if the results of Taxpayer's actual transactions produce a [price per unit, royalty rate for the Covered Transactions] [or] [Gross Margin, Cost Plus Markup, Berry Ratio, Operating Margin, Three-Year Rolling Average Operating Margin for the Tested Party] within the Arm's Length Range, then the amounts reported on Taxpayer's U.S. Return must clearly reflect such results.

For any APA year, if the results of Taxpayer's actual transactions produce a [price per unit, royalty rate] [or] [Gross Margin, Cost Plus Markup, Berry Ratio, Operating Margin, Three-Year Rolling Average Operating Margin for the Tested Party] outside the Arm's Length Range, then amounts reported on Taxpayer's U.S. Return must clearly reflect an adjustment that brings the [price per unit, royalty rate] [or] [Tested Party's Gross Margin, Cost Plus Markup, Berry Ratio, Operating Margin, Three-Year Rolling Average Operating Margin] to the Median.

For purposes of this Appendix A, the "results of Taxpayer's actual transactions" means the results reflected in Taxpayer's and Tested Party's books and records as computed under U.S. GAAP [*insert another relevant accounting standard if applicable*], with the following adjustments:

(a) [The fair value of stock-based compensation as disclosed in the Tested Party's audited financial statements shall be treated as an operating expense]; and

(b) To the extent that the results in any prior APA Year are relevant (for example, to compute a multi-year average), such results shall be adjusted to reflect the amount of any adjustment made for that prior APA Year under this Appendix A.

4. APA Revenue Procedure Treatment

If Taxpayer makes a primary adjustment under the terms of this Appendix A, Taxpayer may elect APA Revenue Procedure Treatment in accordance with section 11.02(3) of Revenue Procedure 2006-9.

[*Insert additional provisions as needed.*]

APPENDIX B

CRITICAL ASSUMPTIONS

This APA's critical assumptions are:

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

[*Insert additional provisions as needed.*]

APPENDIX C

APA RECORDS AND ANNUAL REPORT

APA RECORDS

The APA Records will consist of:

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

ANNUAL REPORT

The Annual Report will include two copies of a properly completed APA Annual Report Summary in the form of Exhibit E to this APA, one copy of the form bound with, and one copy bound separately from, the rest of the Annual Report. In addition, the Annual Report will include a table of contents and the information and exhibits identified below, organized as follows.

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

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

b. All material changes in the U.S. Entities' accounting methods and classifications, and methods of estimation, from those described or used in Taxpayer's request for this APA. If any such change was made to conform to changes in U.S. GAAP (or other relevant accounting standards), Taxpayer will specifically identify such change. If there has been no material change in accounting methods and classifications or methods of estimation, the Annual Report will include a statement to that effect.

c. Any change to the Taxpayer notice information in section 14 of this APA.

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

e. Any change to any entity classification for federal income tax purposes (including any change that causes an entity to be disregarded for federal income tax purposes) of any

Worldwide Group member that is a party to the Covered Transactions or is otherwise relevant to the TPM.

f. The amount, reason for, and financial analysis of any compensating adjustments under paragraph 4 of Appendix A and Revenue Procedure 2006-9, section 11.02(3), for the APA Year, including but not limited to:

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

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

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

g. The amounts, description, reason for, and financial analysis of any book-tax difference relevant to the TPM for the APA Year, as reflected on Schedule M-1 or Schedule M-3 of the U.S. Return for the APA Year.

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

3. A financial analysis that reflects Taxpayer’s TPM calculations for the APA Year. The calculations must reconcile with and reference the Financial Statements in sufficient account detail to allow the IRS to determine whether Taxpayer has complied with the TPM.

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

5. A copy of the APA.

APPENDIX D

DEFINITIONS

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

Term	Definition
Annual Report	A report within the meaning of Revenue Procedure 2006-9, section 11.01.
APA	This Advance Pricing Agreement, which is an "advance pricing agreement" within the meaning of Revenue Procedure 2006-9, section 2.04.
APA Records	The records specified in Appendix C.
APA Request	Taxpayer's request for this APA dated _________, including any amendments or supplemental or additional information thereto.
Covered Transaction(s)	This term is defined in Appendix A.
Financial Statements	Financial statements prepared in accordance with U.S. GAAP and stated in U.S. dollars.
Foreign Group	Worldwide Group members that are not U.S. persons.
Foreign Participants	[name the foreign entities involved in Covered Transactions].
I.R.C.	The Internal Revenue Code of 1986, 26 U.S.C., as amended.
Pub. L. 106-170	The Ticket to Work and Work Incentives Improvement Act of 1999.
Revenue Procedure 2006-9	Rev. Proc. 2006-9, 2006-1 C.B. 278.
Transfer Pricing Method (TPM)	A transfer pricing method within the meaning of Treasury Regulations section 1.482-1(b) and Revenue Procedure 2006-9, section 2.04.
U.S. GAAP	U.S. generally-accepted accounting principles.
U.S. Group	Worldwide Group members that are U.S. persons.

Term	Definition
U.S. Return	For each taxable year, the "returns with respect to income taxes under subtitle A" that Taxpayer must "make" in accordance with I.R.C. section 6012. {*Or substitute for partnership:* For each taxable year, the "return" that Taxpayer must "make" in accordance with I.R.C. section 6031.}
Worldwide Group	Taxpayer and all organizations, trades, businesses, entities, or branches (whether or not incorporated, organized in the United States, or affiliated) owned or controlled directly or indirectly by the same interests.

APPENDIX E

APA ANNUAL REPORT SUMMARY FORM

The APA Annual Report Summary on the next page is a required APA Record. The APA Team Leader has supplied some of the information requested on the form. Taxpayer is to supply the remaining information requested by the form and submit the form as part of its Annual Report.

APA Annual Report SUMMARY	**Department of the Treasury--Internal Revenue Service** **Office of Associate Chief Counsel (International)** **Advance Pricing Agreement Program**	APA no. _______________ Team Leader ____________________________ Economist _______________________________ Intl Examiner ____________________________ CA Analyst ______________________________

APA Information

Taxpayer Name: ____
Taxpayer EIN:_________________ NAICS:___________________
APA Term: Taxable years ending ________ to ____________.
Original APA [ ] Renewal APA [ ]
Annual Report due dates:
_________________, 200__ for all APA Years through APA Year ending in 200__; for each APA Year thereafter on _________________ [month and day] immediately following the close of the APA Year.
Principal foreign country(ies) involved in covered transaction(s): _______________________________________
Type of APA: [ ] unilateral [ ] bilateral with ________________
Tested party is [ ] US [ ] foreign [ ] both
Approximate dollar volume of covered transactions (on an annual basis) involving tangible goods and services:
[ ] N/A [ ] <$50 million [ ] $50-100 million [ ] $100-250 million [ ] $250-500 million [ ] >$500 million

APA tests on (check all that apply):
[ ] annual basis [ ] multi-year basis [ ] term basis

APA provides (check all that apply) a:
[ ] range [ ] point [ ] floor only [ ] ceiling only [ ] other_____________

APA provides for adjustment (check all that apply) to:
[ ] nearest edge [ ] median [ ] other point

APA Annual Report Information
(to be completed by the Taxpayer)

APA date executed: ______________, 200__
This APA Annual Report Summary is for APA Year(s) ending in 200__ and was filed on _____________, 200__
Check here [ ] if Annual Report was filed after original due date but in accordance with extension.
Has this APA been amended or changed? [ ] yes [ ] no Effective Date: ______________________
Has Taxpayer complied with all APA terms and conditions? [ ] yes [ ] no
Were all the critical assumptions met? [ ] yes [ ] no
Has a Primary Compensating Adjustment been made in any APA Year covered by this Annual Report?
[ ] yes [ ] no If yes, which year(s): 200___
Have any necessary Secondary Compensating Adjustments been made? [ ] yes [ ] no
Did Taxpayer elect APA Revenue Procedure treatment? [ ] yes [ ] no
Any change to the entity classification of a party to the APA? [ ] yes [ ] no
Taxpayer notice information contained in the APA remains unchanged? [ ] yes [ ] no
Taxpayer's current US principal place of business: (City, State) _____________________________________

APA Annual Report Checklist of Key Contents
(to be completed by the Taxpayer)

Financial analysis reflecting TPM calculations	[ ] yes [ ] no
Financial statements showing compliance with TPM(s)	[ ] yes [ ] no
Schedule M-1 or M-3 book-tax differences	[ ] yes [ ] no
Current organizational chart of relevant portion of world-wide group	[ ] yes [ ] no
Attach copy of APA	[ ] yes [ ] no

Other APA records and documents included:
[The information required in the following section should be tailored to the particular case]

____________________	[ ] yes [ ] no
____________________	[ ] yes [ ] no
____________________	[ ] yes [ ] no
____________________	[ ] yes [ ] no
____________________	[ ] yes [ ] no

Contact Information

Authorized Representative	Phone Number	Affiliation and Address

ATTACHMENT B

EXAMPLE FORMULAS FOR BALANCE SHEET ADJUSTMENTS

The formulas below provide examples of the balance sheet adjustment formulas used in the APA Program's CPM spreadsheet model.[14] The formulas below are applicable to the operating margin profit level indicator. The APA Program's calculations measure balance sheet intensity by reference to the denominator of the profit level indicator (e.g., for the Berry ratio, the denominator used is operating expenses). Therefore, the formulas vary for each profit level indicator.

Definitions of Variables:

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

Equations:

Example Assuming Profit Level Indicator is Operating Margin:

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"): $PPEA = \{[(PPE_t / sales_t) \times sales_c] - PPE_c\} \times i$

Then Adjust Comparables as Follows:
adjusted $sales_c = sales_c + RA$
adjusted $cogs_c = cogs_c + PA - IA$
adjusted $opex_c = opex_c - PPEA$

[14] Copies of the APA Program's CPM spreadsheet model are available from the APA Program by calling (202) 435-5220 (not a toll-free number) or by writing to the Office of Associate Chief Counsel (International), Advance Pricing Agreement Program, Attn: CC:INTL:APA, MA2-266, 1111 Constitution Ave. NW, Washington DC, 20224.