ANNOUNCEMENT AND REPORT CONCERNING ADVANCE PRICING AGREEMENTS

April 2, 2012

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 2010. This thirteenth report describes the experience, structure, and activities of the APA Program during calendar year 2011. It does not provide guidance regarding the application of the arm's length standard.

As described in greater detail below, in the first quarter of calendar year 2012, the APA Program merged with that portion of the Office of the U.S. Competent Authority (USCA) that resolves transfer pricing cases under the mutual agreement procedures of the United States' bilateral income tax conventions. As the successor to the APA Program, the new Advance Pricing and Mutual Agreement (APMA) office has prepared and finalized this report.

Throughout the period covered by this report, and most particularly following the announcement of the new combined APMA Office, the APA Program and the USCA engaged in extensive efforts to ensure a smooth transition and successful realignment. In addition to addressing personnel transfer, systems management, and other logistical issues, during the fall of 2011, the USCA hired additional managers and staff for the APMA Office, representing a 50-percent increase in total headcount. These new employees are receiving extensive training and mentoring from existing staff and management.

In part because of these transitional issues, during 2011, case closures fell short of normal expectations and average cycle times increased. APA, with some assistance from USCA, completed 43 APAs (including one amended APA) and 47 recommended negotiating positions (RNPs), down from totals of 69 APAs and 58 RNPs in 2010. The average time to complete an APA increased from 37.2 months in 2010 to 40.7 months in 2011.

Additional contributing factors to these results were the decrease in APA personnel for most of 2011 and the record number of new APA applications filed during the past four years. It is anticipated that when the transition to the APMA Office is complete, the number of completed APAs will increase and the average cycle time will decrease. Despite a decrease in 2011, over the last several years the APA program experienced increasing 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.

In view of the existing backlog of APA submissions, the hiring of new personnel, an expected growth in requests in coming years, and the expanding role of APMA in examinations and other matters involving treaty jurisdictions, it is difficult to predict APMA's future resource needs with confidence. With the recently augmented staff, however, management anticipates steady growth in the productivity of the new APMA Office in the years to come.

Samuel M. Maruca
Director, Office of Transfer Pricing Operations

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 agreement 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) and otherwise complies with the APA.

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.

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[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.

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.

With the formation of the APMA Office, the IRS anticipates that it will amend Rev. Proc. 2006-9 and 2008-31, as well as 2006-54 (the revenue procedure governing Competent Authority processes) in 2012.

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 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).

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[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.

The policy generally preferring bilateral (or multilateral) over unilateral APAs is grounded in the goal of achieving certainty and avoiding double taxation through an early dispute resolution process that is most efficient from both taxpayer and government perspectives. Consistent with that policy, the IRS reviews 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., the lack of a tax treaty with the country or countries involved with the major transaction flows; the lack of an APA program in a treaty partner country involved with the major transaction flows; 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).

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

The following discussion explains the APA Program as it was organized through the end of December, 2011. As described above, prior to the publication of this report, the APA Program merged with that portion of the Office of the U.S. Competent Authority (USCA) that resolves transfer pricing cases under the mutual agreement procedures of the United States' bilateral income tax conventions. It is currently anticipated that the APA process described below will remain substantially the same in the new APMA Office, although it is also anticipated that an updated Revenue Procedure will be issued that will include modifications to the specific procedures described below.

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.

Before the formation of APMA, the APA team generally included, in addition to the team leader an economist, an IRS Large Business 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 could be from the APA Program or the IRS field organization. In the last statutory report, as of December 31, 2010, the APA Program had seven economists on staff, plus one economist manager. As of December 31, 2011, the APA Program had ten economists on staff, plus one economist manager. The APA team sometimes included an LB&I International Technical Advisor, other LB&I exam personnel, field counsel 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. The APA process as described below remained essentially the same throughout 2011; any changes resulting from the efforts of the APA Program and the USCA to pool resources before the decision to create the APMA Office are noted where relevant below.

(1) Application

In many APA cases, the taxpayer's application is preceded by a pre-file conference (PFC) with the IRS staff in which the taxpayer can solicit the informal views of the APMA Office. 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 required 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 by 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 APMA Office believes that having the taxpayer discuss the case with the IRS before making a submission has the potential of shortening the period of time required to complete an APA by identifying issues that will require specific development and providing preliminary views on acceptable methodologies. In 2010-2011 the APA Program revised its internal practices concerning PFCs to improve efficiency, including better tracking of PFCs and, most notably, assigning some PFCs presenting complex or novel issues to the most experienced 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.

For most taxpayers, 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.[7]

The application is assigned to a 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 for assignment of an international examiner to the APA case and the LB&I Counsel's office for assignment of a field counsel lawyer. Before

[7] Section 9 of Rev. Proc. 2006-09 describes the special APA procedures for small business taxpayers.

the formation of the APMA Office, in a bilateral or multilateral case the USCA would 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 transfer pricing expertise of APA personnel with the expertise of other IRS personnel 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 can resolve transfer pricing issues early in a principled, efficient, consistent, and comprehensive manner.

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 Program 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 led to significant delays, so, for example, opening conferences have been held six months or more after a completed application was received. During the period since the prior statutory report the pooling of resources noted above has reduced the number of cases for which opening conferences were delayed. A priority for the APMA Office is to meet the case processing goals listed in the Rev. Proc. and case management guidelines.

At the time of the opening conference, the APA team leader would propose a case plan appropriate for the case. Case plans were 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, could and often did vary from the 12-month benchmark, depending on the complexity of the case, team workloads, taxpayer response times, and other factors. Case plans are signed by both an office manager and an authorized official of the taxpayer and are intended to control the process except in unforeseen or exceptional circumstances. Implementation and adherence to case plans has been uneven. Rapidly increasing workloads have resulted in the actual median and average times for completion to increase significantly. These APA inventory and case completion times are described in greater detail below in Tables 2 through 11. During the period since the last statutory report the APA Program took steps to increase its tracking of and adherence to case plans and, as discussed above, expects to further improve timeliness as the new APMA Office becomes fully operational.

(2) <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 submitted a list of questions to the taxpayer before the opening conference for discussion at the conference. The opening conference often resulted in additional questions and an agreement to meet one or more times in the future. These questions and meetings focus 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. The APA due diligence process thus differs from standard audit procedures.

(3) Analysis

Much of the economic analysis associated with an APA is typically conducted by an economist assigned to the case. The analysis may result in the need for additional information. Once the APA team has completed its due diligence and analysis, 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 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 (and for a majority of the cases in 2011) proceeded in two parts and involved 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 present 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 Associate Chief Counsel (International) (ACC(I)) and the APA Director. The RNP provided 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. It is anticipated that the new APMA Office will streamline these procedures once it is fully functional.

The experience of the APA Program and the USCA has been that APA negotiations are likely to proceed more rapidly with a foreign competent authority if the taxpayer fully supports the U.S. negotiating position. Consequently, the IRS 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 Program 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 were any disagreement that could not be resolved, it was 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 – in a so-called "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 occasionally assisted in the negotiations.

Both in response to the inherent inefficiencies of a "hand-off" of an APA from one team to another, and because of resource constraints, during 2011 the APA Program and USCA commenced efforts towards a pooling of resources and better managing their shared bilateral caseload as a single inventory. This pooling effort ultimately led to the merger, as noted above. Following the merger, the goal is to eliminate hand-offs, so only a single team leader and economist will be involved in all phases of the APA process – application, due diligence, analysis, discussion, agreement and negotiation with the foreign competent authority.

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

(5) <u>Drafting, Review, and Execution</u>

Once the IRS, competent authorities, and the taxpayer reach agreement, the APA team drafts the final APA. The IRS has developed standard language that is incorporated into every APA. The current version of this language appears in Attachment A. The relevant APA Branch Chief and the APA Director review final APAs. In addition, for the period covered by this statutory report, the team leader prepared a summary memorandum for approval by the ACC(I). On March 1, 2001, the ACC(I) delegated to the APA Director the authority to execute APAs on behalf of the IRS. <u>See</u> Chief Counsel Notice CC-2001-016. An authorized corporate officer executes the APA on behalf of the taxpayer. In light of the formation of the APMA Office, it is anticipated that there will be modifications to the process of executing APAs with taxpayers.

Model APA at Attachment A

[§ 521(b)(2)(B)]

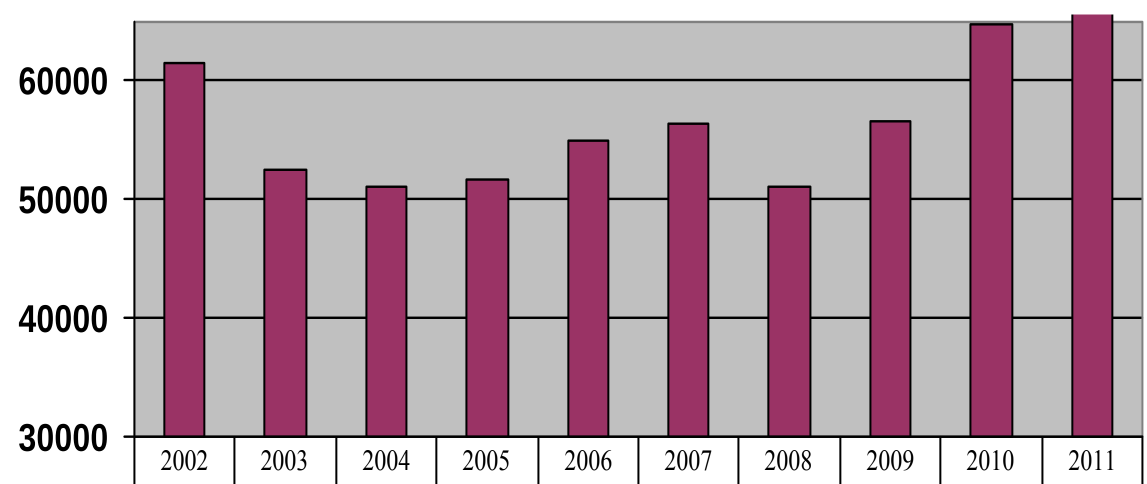
Attachment A contains the current version of the model APA language.

The APA Office Structure, Composition, and Operation

In 2011, the APA Program 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, was headquartered in San Francisco, California, with an additional office in Laguna Niguel, California staffed with both team leaders and economists.

APA full-time staffing fluctuated during 2011, starting at 35 at the end of 2010, decreasing early in the year and returning to 35 by the end of the year. Total hours spent by APA professional staff increased slightly in 2011 over the previous year. 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	2011
APA staff hours	61528	52495	51170	51744	54970	56410	51077	56549	64763	69850

As of January 25, 2012, for the resolution of allocation cases the U.S. Competent Authority employed seven managers, fifty-seven analysts, five economists, and five support staff, which were combined with the APA Program to form the APMA Office.

<u>APA Issue/Industry Coordination Teams</u>

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 2011, 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.

The new APMA Office 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 IRS promoting a common approach on some issues where appropriate, the APMA Office expects that 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. The IRS is considering whether to continue formal industry groups in APMA, and if so, in what form.

APA Training

In 2011 the APA Program continued its training activities. Training sessions addressed APA-related current developments, regulatory developments, new APA Program practices and procedures, OECD guidelines on business restructuring, review of novel or unique APAs or RNPs, and international tax law issues. In addition, a joint training session with the USCA office covered negotiation skills and techniques. 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 APMA Office when performing APA analyses. An electronic version of the model may be obtained by contacting the APMA 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 96 APA applications during 2011 represented a decrease from the all-time high of 144 in 2010 and previous record-breaking years in 2008 (123) and 2009 (127).[8] From 2000-2007, the APA Program averaged 91 applications per year, and it had never received more than 110 applications in a single year. With the additional resources and added efficiencies from its recent restructuring, APMA expects APA applications to continue to be attractive to taxpayers and trend upwards in 2012, possibly reaching the same high levels as in 2008-2010.

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

	Unilateral	Bilateral	Multilateral	Year Total	Cumulative Total
APA applications filed during 2011	20	76		96	1619
All APAs executed[9]					
Year 2011	8	34	0	42	1015
1991–2010	405	555	13	973	
APA renewals executed during 2011	2	13		15	308
APAs revised or amended during 2011	1	0		1	71
Pending requests for APAs	93	352		445	
Pending requests for new APAs	44	214		258	
Pending requests for renewal APAs	49	138		187	
APAs canceled or revoked	2	0		2	11
APA applications withdrawn	4	5		9	174

[8] 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. In 2011, there were no APAs completed that fell within APA jurisdiction because of Rev. Proc. 2008-31.

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

TABLE 2: MONTHS TO COMPLETE APAS

Months to Complete Advance Pricing Agreements in 2011					
All New		**All Renewals**		**All Combined**	
Average	40.9	Average	40.3	Average	40.7
Median	39.5	Median	38.9	Median	36.5
Unilateral New		**Unilateral Renewals**		**Unilateral Combined**	
Average	31.2	Average	14.2	Average	27.0
Median	28.6	Median	14.2	Median	26.8
Bilateral/Multilateral New		**Bilateral/Multilateral Renewals**		**Bilateral/Multilateral Combined**	
Average	43.9	Average	44.1	Average	44.0
Median	42.8	Median	42.4	Median	42.4

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TABLE 3: APA COMPLETION TIME – MONTHS PER APA

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

TABLE 4: RECOMMENDED NEGOTIATING POSITIONS

Recommended Negotiating Positions Completed in 2011	47

Table 5: MONTHS TO COMPLETE RECOMMENDED NEGOTIATING POSITIONS

New		Renewal		Combined	
Average	29.5	Average	23.7	Average	27.1
Median	32.9	Median	24.4	Median	29.0

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

Months	Number	Months	Number	Months	Number	Months	Number
1		**12**		**23**		**34**	2
2	1	**13**		**24**		**35**	2
3		**14**	4	**25**	2	**36**	3
4	1	**15**		**26**	2	**37**	1
5		**16**	1	**27**	2	**38**	
6		**17**	2	**28**	1	**39**	1
7		**18**	1	**29**	1	**40**	
8		**19**	2	**30**	4	**41**	2
9		**20**		**31**		**42**	
10		**21**	2	**32**	1	**43**	2
11		**22**		**33**	5	**44**	
						45	1
						46	1

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TABLES 7 AND 8 BELOW SHOW HOW LONG EACH APA REQUEST PENDING AT THE END OF 2011 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
1	1	**17**	2	**33-35**	
2	1	**18**	5	**36**	1
3	1	**19**	3	**37**	
4		**20**	4	**38**	1
5	2	**21**	3	**39**	1
6	2	**22**	1	**40**	
7	2	**23**	3	**41**	1
8		**24**	5	**42**	
9	1	**25**	5	**43**	2
10	1	**26**	1	**44**	1
11	2	**27**		**45**	1
12	4	**28**	3	**46**	1
13	3	**29**	2	**47**	
14	1	**30**	2	**48**	1
15	6	**31**		**49**	1
16	5	**32**	2	**50**	1

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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	**26**	3	**51**	2	**81**	1
2	7	**27**	2	**52**	0	**82-83**	0
3	1	**28**	6	**53**	2	**84**	1
4	8	**29**	7	**54**	1	**85-86**	0
5	8	**30**	12	**55**	1	**87**	1
6	4	**31**	5	**56**	1	**88-91**	0
7	7	**32**	11	**57**	1	**92**	1
8	6	**33**	0	**58**	0	**93-106**	0
9	7	**34**	6	**59**	3	**107**	1
10	14	**35**	6	**60**	0	**108**	0
11	4	**36**	11	**61**	3	**109**	1
12	17	**37**	6	**62-23**	0		
13	2	**38**	3	**64**	3		
14	7	**39**	3	**65-67**	0		
15	4	**40**	9	**68**	1		
16	2	**41**	4	**69-70**	0		
17	3	**42**	3	**71**	1		
18	9	**43**	5	**72**	2		
19	6	**44**	2	**73**	1		
20	4	**45**	4	**74**	0		
21	12	**46**	5	**75**	2		
22	7	**47**	8	**76**	0		
23	3	**48**	5	**77**	1		
24	10	**49**	8	**78-79**	0		
25	4	**50**	2	**80**	1		

Of the 350 cases in the APA Program's inventory shown in Tables 7 and 8, 45 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 305 cases in the APA Program's active inventory at the end of 2011 that are either unilateral APAs (76 cases) or bilateral APAs for which the APA Program has not yet completed a recommended negotiating position (229 cases). Of the 305 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 305 active cases in inventory at the end of 2011, 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.

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

	2004	2005	2006	2007	2008	2009	2010	2011
Active cases	130	133	110	105	161	222	243	305
Average age (months)	15.2	13.2	10.6	9.1	10.2	12.9	15.4	17.4
Active cases 6+ months	106	87	81	66	110	176	196	248
Average age (months)	17.8	18.5	13.0	13.0	13.5	15.6	18.3	21.2
Active cases 1+ year	60	55	32	27	51	116	138	185
Average age (months)	24.2	23.3	19.4	18.5	18.7	19.5	22.1	24.9

TABLE 10: SMALL BUSINESS TAXPAYER APAS

Small Business Taxpayer APAs Completed in 2011	**3**
New	1
Renewals	2
Unilateral	1
Bilateral	2

TABLE 11: MONTHS TO COMPLETE SMALL BUSINESS TAXPAYER APAS

Months to Complete Small Business Taxpayer APAs in 2011					
New		**Renewal**		**Combined**	
Average	31.8	Average	17.2	Average	22.1
Median	31.8	Median	17.2	Median	19.2

Although the APA Program strives to complete SBT cases on an expedited basis, our experience is that such cases require nearly the same commitment of resources 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 achieving 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 three SBT RNPs during 2011 with average and median lengths of 21.2 and 22.1 months, respectively.

TABLE 12: INDUSTRIES COVERED[10]

Industry Involved - NAICS Codes	Number
Computer and electronic manufacturing- 334	7-9
Wholesale trade, durable goods - 421	4-6
Miscellaneous manufacturing - 339	4-6
Professional scientific and technical services- 545	4-6
Motor Vehicle and parts dealers- 441	1-3
Wholesale Trade, non-durable goods- 422	1-3
Transportation equipment manufacturing - 336	1-3
Electronic equipment, appliance and component manufacturing - 335	1-3
Chemical manufacturing- 325	1-3
Machinery manufacturing - 333	1-3
Publishing industries - 511	1-3
Information service and data processing services - 514	1-3
Fabricated metal manufacturing- 332	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
Sporting goods, hobby, book and music stores - 451	1-3
Broadcasting and telecommunications - 513	1-3
Broadcasting and telecommunications - 513	1-3
Heavy Construction- 234	1-3
Paper manufacturing - 322	1-3
Electronic and appliance stores - 443	1-3

Trades or Businesses

[§ 521(b)(2)(D)(i)]

The nature of the relationships between the related organizations, trades, or businesses covered by APAs executed in 2011 set forth in Table 13 below:

TABLE 13: NATURE OF RELATIONSHIPS BETWEEN RELATED ENTITIES

Relationship	Number of APAs

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

Foreign Parent - U.S. Subsidiary (-ies)	26
Unilateral	7
Bilateral	19
U.S. Parent - Foreign Subsidiary (-ies)	16
Unilateral	≤3
Bilateral	15
Foreign Company and U.S. branch(es)	0

Covered Transactions

[§ 521(b)(2)(D)(ii)]

The controlled transactions covered by APAs executed in 2011 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	22
Sale of tangible property from the United States	15
Performance of services by U.S. entity	15
Use of services by U.S. entity	9
Use of intangible property by non-U.S. entity	8
Use of intangible property by U.S. entity	5
Commodity trading on globally integrated basis	≤3
Financial Products- non US parent/US Sub	≤3
Financial Products-US branch of foreign company	≤3
Other	≤3

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TABLE 15: TYPES OF SERVICES INCLUDED IN COVERED TRANSACTIONS

Intercompany Services Involved in the Covered Transactions	Number
Distribution	14
Technical support services	12
Marketing	9
Administrative	7
IT	7
Accounting and auditing	7
Legal	6
Management	6
Sales support	5
Tax	5
Statistical assistance	5
Payroll	4
Contract research& development	4
Headquarters costs	≤3
Warranty services	≤3
Product support	≤3
Logistical support	≤3
Treasury activities	≤3
Benefits	≤3
Purchasing	≤3
Corporate and public relations	≤3
Health, Safety, Environment and regulatory affairs	≤3
Staffing and recruiting	≤3
Accounts receivable	≤3
Budgeting	≤3
Accounts payable	≤3
Maquiladora Manufacturing	≤3
Insurance claims Management	≤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 2011 are set forth in Tables 16 and 17 below:

TABLE 16: FUNCTIONS PERFORMED BY THE TESTED PARTY

Functions Performed	Number
Distribution	46
Product support services	26
Marketing functions	15
Manufacturing	15
Research and development	10
Product design and engineering	9
Licensing of intangibles	7
Product assembly or packaging	6
Transportation and warehousing	5
Product testing and quality control	5
Managerial, legal, accounting, finance, personnel, and other support services	5
Trading and risk management of financial products	5
Purchasing and materials management	≤3
Technical training and technical support	≤3
Telecom Services	≤3
Mining and extraction	≤3

TABLE 17: RISKS ASSUMED BY THE TESTED PARTY

Risks Assumed	Number
Market risks, including fluctuations in costs, demand, pricing, and inventory	60
Credit and collection risks	46
General business risks (e.g., related to ownership of PP&E)	37
Financial risks, including interest rates and currency	24
Product liability risks	22
Research and development risks	8

<u>Discussion</u>

The majority of APAs involve Covered Transactions featuring 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. 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, the APA team devotes a significant amount of time and effort to understanding the allocation of functions and risks among the entities 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 economic theory, which posits that returns vary in proportion to risk, and that different economic functions contribute different value and have different opportunity costs associated with them. It is important that the functional analysis be specific – simply categorizing a tested party as, say, a distributor, is not sufficient. 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, the level of the market in which the functions are performed, and the business cycle or general economic condition of the industry.

During 2010 and 2011, the APA Program received numerous inquiries about the potential effect on existing and pending APAs of the economic downturn and the major earthquake and tsunami that struck Japan in 2011. With respect to existing APAs, the APA Program, in consultation with the USCA, has adopted a general policy not to re-open closed cases in the absence of a Critical Assumption on point.[11] 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,

[11] See Table 21 and accompanying text.

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 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 2011 are set forth in Table 18 below:

TABLE 18: RELATED ORGANIZATIONS, TRADES, OR BUSINESSES WHOSE PRICES OR RESULTS ARE TESTED[12]

Type of Organization	Number
U.S. distributor	25
U.S. manufacturer	20
U.S. provider of services	11
Non-U.S. provider of services	7
Non-U.S. distributor	6
U.S. licensor of intangible property	≤3
U.S. Licensee of intangible property	≤3
Non- U.S. manufacturer	≤3

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[12] "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 2011 are set forth in Tables 19 and 20 below:

TABLE 19: TRANSFER PRICING METHODS USED FOR TRANSFERS OF TANGIBLE AND INTANGIBLE PROPERTY[13]

TPM Used	Number
CPM: PLI is operating margin	30
Unspecified method	12
CPM: PLI is markup on total costs	7
CUT (intangibles only)	≤3
Residual profit split	≤3
Cost Plus Method (tangibles only)	≤3
CUP (tangibiles only)- not based on market data	≤3
CPM: PLI is other PLI	≤3
CPM: PLI is Berry ratio	≤3
CPM: PLI is return on assets or capital employed	≤3
CPM:PLI is gross margin	≤3

TABLE 20: TRANSFER PRICING METHODS USED FOR SERVICES

TPM Used	Number
CPM: PLI is operating profit-to-total services cost ratio	8
Cost of Services plus method	≤3
Services Cost Method: Specified Covered Services	≤3
CPM: PLI is Berry ratio	≤3
Residual Profit Split Method	≤3

Discussion

The TPMs used in APAs completed during 2011 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

[13] 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.

Treas. Reg. § 1.482-7 provides rules for 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) (known as "buy ins" under the previous cost-sharing regulations). In 2011 the APA Program completed its recommendations on three or fewer bilateral cost sharing/PCT cases and sent those 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 noted. The section 482 regulations provide 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 there are no differences between an uncontrolled transaction and 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 may be made. Treas. Reg. § 1.482-3(b)(2)(ii)(A). As in earlier years, it was the experience of the APA Program in 2011 that qualifying CUP transactions were rare.

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 may be made. *Id*. It has generally been difficult to identify external comparables, and APAs using the CUT Method tend to rely on internal uncontrolled transactions (i.e., those between the taxpayer and uncontrolled parties). In 2011, three Covered Transactions utilized the CUT TPM.

The APA team did not apply the Resale Price Method in 2011. See Treas. Reg. § 1.482-3(c), (d).

Both taxpayers and the IRS frequently apply the CPM in APAs because reliable public data on comparable business activities of independent companies may be more readily available than potential CUP data, and comparability of resources employed, functions, risks, and other relevant considerations is more likely to exist than comparability of product. The CPM also tends to be less sensitive than other methods to differences in accounting practices between the tested party and comparable companies, e.g., classification of expenses as cost of goods sold or operating expenses. Treas. Reg. § 1.482-3(c)(3)(iii)(B) and (d)(3)(iii)(B). In addition, the CPM generally requires a lesser degree of functional comparability to obtain a reliable result than that required under the Resale Price Method or the Cost Plus Method. This difference in degree of functional comparability reflects differences in functions performed, which often are reflected in operating expenses. 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 45 uses of the CPM (with varying PLIs) in Covered Transactions involving tangible or intangible property. Some APAs used the CPM concurrently with other methods.

The CPM has proven to be versatile in part because of its various PLIs . The discussions in many cases involve identifying the appropriate PLI, which in turn depends heavily on the facts and circumstances of the particular case. Some APAs have applied different PLIs 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 2011. At least twenty-four services Covered Transactions used the CPM Method, with various PLIs according to the specific facts of the taxpayers involved. Three or fewer services-related APAs completed in 2011 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 2011, three or fewer 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 2011 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	42
Material changes to the business	42
Assets will remain substantially same	10
Other	7
Other financial ratios	≤3
Changes in affiliated companies	≤3
Catastrophic events	≤3
Currency fluctuations	≤3

Discussion

APAs include critical assumptions underlying the application of the TPM. A critical assumption is any fact (whether or not within the control of the taxpayer) related to the taxpayer, a third party, an industry, or business and economic conditions, the continued existence of which is material to the taxpayer's proposed TPM. Critical assumptions might include, for example, a particular mode of conducting business operations, a particular corporate or business structure, or a range of expected business volume. Rev. Proc. 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 parties may agree to revise the APA. 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 2011 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	54
Disclosure	21
Mergent	15
No comparables used	12
Moody's	5
Amadeus	4
Japan Accounts and Data on Enterprises (JADE)	4
Damodaran	4
Sources of comparables unidentified or unknown	≤3
Taxpayer's information on competition	≤3
Global Vantage	≤3
Osiris	≤3
SEC	≤3
Thompson financial	≤3
Japan Company Handbook	≤3
Other	≤3

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TABLE 23: COMPARABLES SELECTION CRITERIA

Selection Criteria Considered	Number of Times This Criterion Used
Comparable functions	65
Comparable risks	51
Comparable industry	32
Comparable intangibles	20
Comparable products	23
Comparable terms	17

TABLE 24: ADJUSTMENTS TO COMPARABLES OR TESTED PARTIES

Adjustment	Number of Times Used
Balance sheet adjustments	
Payables	49
Receivables	47
Inventory	46
Property, plant, equipment	12
Other	≤3
Accounting adjustments	
LIFO to FIFO inventory accounting	40
Other	25
Accounting reclassifications (e.g., from COGS to operating expenses)	≤3
Profit level indicator adjustments (used to "back into" one PLI from another PLI)	
Operating expense	≤3
Other	≤3
Miscellaneous adjustments	
Goodwill value or amortization	8
Stock-based compensation	7
Research and development	≤3
Other	4

<u>Discussion</u>

Comparables are at the core of most transfer pricing analysis. The APA Program works closely with taxpayers to find the best and most reliable comparables for each Covered Transaction. In some cases, the taxpayer and IRS can identify CUPs or CUTs. In other cases, the APA team uses profit data on comparable business activities of independent companies to apply 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 selects them using a three-part process. First, the team identifies a pool of companies with potentially comparable business activities through broad searches. From this pool, the team eliminates companies performing business activities that are clearly not comparable to those of the tested party through the use of quantitative and qualitative analyses, i.e., quantitative screens and review of business descriptions. Then, the team finalizes a set of comparable independent companies based on a review of available descriptive and financial data. The team then enhances the comparability of the final set by adjusting its 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 2011.

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 tested party. 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 and the major earthquake and tsunami that hit Japan in 2011 have focused particular attention on the appropriate analysis window for APAs with terms that include 2008 and 2009, and to a lesser extent 2010 and 2011, 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 2005-09 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 are 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 are 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 tested party. In addition, APA analyses have incorporated selection criteria designed to identify and remove companies experiencing "financial distress" because of concerns that such companies face unusual circumstances and operational constraints that limit comparability 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. In many cases the tested party does not employ unique intangible assets or engage in intangible development. In such cases the APA team has used several criteria to increase the chances 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 unique marketing intangibles such as distinctive trademarks. The APA team uses quantitative screens related to identifying comparables with significant intangible property together with publicly available business information.

APA teams sometimes use selection criteria relating to asset and/or operating expense comparability. For example, 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, may help distinguish distributors (generally lower PP&E) from manufacturers (generally higher PP&E), regardless of their industry. 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 such screens were used in APAs executed in 2011:

TABLE 25: COMPARABILITY AND FINANCIAL DISTRESS SCREENS

Comparability/Financial Distress Screen	Times Used
Comparability screen	
R&D/sales	37
Sales	24
Other	21
Foreign sales/total sales	19
PP&E/sales	7
PP&E total assets	6
Operating expenses/sales	6
Non-startup or start-up	≤3
SG&A/sales	≤3
Sales to a specific customer type	≤3
Financial distress	
Bankruptcy	31
Unfavorable auditor's opinion	15
Losses in one or more years	10
Other	6

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, the analyst calculates certain "asset intensity" or "balance sheet" adjustments for factors that affect prices or profits. 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 differences in these items may affect prices or profits. For these items, it is generally assumed that the most reliable measure of the difference is 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 2011, 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 balance sheet adjustments and the selection of the most appropriate 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, 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 2011, 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, and 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 2011 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 2011 are described in Tables 26 and 27 below.

TABLE 26: RANGES AND TARGETS[14]

Type of Range	Number
Interquartile range	30
Other	18
Specific point (cost-plus specific mark up)	7
Specific point within CPM range (not floor or ceiling)	5
Full range	5
Cost (no mark up-services	5
Specific point (royalty)	≤3
Specific point (CUP)	≤3
Ceiling (i.e., result must be no more than x)	≤3
Financial products statistical confidence interval to test against internal CUPs	≤3

[Remainder of page intentionally blank]

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

TABLE 27: ADJUSTMENTS WHEN OUTSIDE THE RANGE

Adjustment mechanism	Number
Taxpayer makes an adjustment: to specified point or royalty rate	24
Taxpayer makes an adjustment: to closest edge of single year	23
Taxpayer makes an adjustment: to closest edge of multi-year average	22
Competent Authority negotiation	6
Taxpayer makes an adjustment: to median of current year	≤3
Cost plus mark up	≤3
Taxpayer makes an adjustment: to median of multi-year average	≤3
Taxpayer makes an adjustment: to a specific dollar amount	≤3
Covered Transaction no longer covered but APA not cancelled	≤3

Discussion

Treas. Reg. § 1.482-1(e)(*1*) states that sometimes a pricing method will yield "a single result that is the most reliable measure of an arm's length result." Sometimes, however, a method may yield "a range of reliable results," referred to as 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 lowest to the highest). However, the APA Program has only rarely identified cases meeting the requirements for using the full range. If the comparables are of lesser quality, then under Treas. Reg. § 1.482-1(e)(2)(iii)(B), "the reliability of the analysis must be increased, when it is possible to do so, by adjusting the range through application of a valid statistical method to the results of all of the uncontrolled comparables." One such method, the "interquartile range," is ordinarily acceptable, although a different statistical method "may be applied if it provides a more reliable measure." The interquartile range is defined as, roughly, the range from the 25th to the 75th percentile of the comparables' results. See Treas. Reg. § 1.482-1(e)(2)(iii)(C). The interquartile range was used thirty times in 2011.

Twelve 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. Three or fewer APAs executed in 2011 used a ceiling; no APAs executed in 2011 used a floor.

Some APAs examine a tested party's results over a period of years (multi-year averaging) to determine whether a taxpayer has complied with the APA. In 2011, rolling multi-year averaging was not used for any Covered Transactions.

Adjustments

Where a taxpayer's actual transactions do not produce results that conform to the TPM, the 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 2011 are set forth in Table 28 below:

TABLE 28: TERMS OF APAS

APA Term in Years	Number of APAs
3	≤3
4	≤3
5	20
6	8
7	6
8	≤3
9	≤3

The number of rollback years to which an APA TPM was applied in 2011 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	4
3	6
5 or more	≤3

Together, Tables 28 and 29 indicate that the 43 APAs (including one amended APA) completed in 2011 covered more than 270 taxable years, and potentially more than 300 taxable years. In terms of dollar value, 26 of the 43 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 2011 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.	42
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.	42
Description of any failure to meet Critical Assumptions or, if there have been none, a statement to that effect.	42
Copy of the APA	42
Financial analysis demonstrating Taxpayer's compliance with TPM.	42
Organizational chart	42
Any change to the taxpayer notice information in section 14 of the APA.	42
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	42

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.	
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.	42
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.	42
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.	≤3
Financial statements as prepared in accordance with a foreign GAAP	≤3
Various work papers	≤3
Certified public account's review of financial statements	≤3

Approaches for Sharing of Currency or Other Risks

[§ 521(b)(2)(D)(xii)]

During 2011, twenty-four tested parties 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, who is 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, 2011, there were 251 pending annual reports. In 2011, 349 annual reports were closed.

TABLE 31: STATISTICS OF ANNUAL REPORTS

Number of APA annual reports pending as of December 31, 2011	251
Number of APA annual reports closed in 2011	349
Number of APA annual reports requiring adjustment in 2011	0
Number of taxpayers involved in adjustments	0
Number of APA annual report cases over one-year old	142

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.[15] 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 $opex_c = opex_c - PPEA$

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[15] 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.