

HIGHLIGHTS OF THIS ISSUE

These synopses are intended only as aids to the reader in identifying the subject matter covered. They may not be relied upon as authoritative interpretations.

SPECIAL ANNOUNCEMENT

Announcement 2005-27, page 918.

This document contains the annual report to the public concerning Advance Pricing Agreements (APAs) and the experience of the APA program during calendar year 2004. This document does not provide guidance regarding the application of the arm's length standard; rather, it reports on the structure and activities of the APA program.

INCOME TAX

Rev. Rul. 2005-24, page 892.

Health reimbursement arrangements. This ruling addresses the income tax treatment under section 105 of the Code of amounts received by employees from employer-provided reimbursement plans. Notice 2002-45 amplified.

REG-125443-01, page 912.

Proposed regulations under section 1441 of the Code would implement certain changes announced in Notice 2001-4, 2001-1 C.B. 267; Notice 2001-11, 2001-1 C.B. 464; and Notice 2001-43, 2001-2 C.B. 72. In addition, these regulations would provide guidance under section 411 of the American Jobs Creation Act of 2004. A public hearing is scheduled for July 20, 2005.

Notice 2005-32, page 895.

This notice provides interim procedures for partnerships and their partners to comply with the mandatory basis adjustment provisions of sections 734 and 743 of the Code. This notice also provides interim procedures for electing investment part-

nerships and their partners to comply with sections 743(e) and 6031(f).

Rev. Proc. 2005-21, page 899.

This procedure provides general rules and specifications from the Service for paper and computer-generated substitutes of the extensively revised January 2005 versions of Form 941, *Employer's Quarterly Federal Tax Return*, and Schedule B (Form 941), *Report of Tax Liability for Semiweekly Schedule Depositors*. Rev. Proc. 2005-21 will be reproduced as Publication 4436, *General Rules and Specifications for Substitute Form 941 and Schedule B (Form 941)*.

Rev. Proc. 2005-24, page 909.

This procedure provides a safe harbor procedure under which the Service will disregard a spousal right of election for purposes of determining whether the CRAT or CRUT meets the requirements of section 664(d)(1)(B) or (d)(2)(B) of the Code continuously since its creation if the spouse irrevocably waives the right of election in the manner prescribed.

ESTATE TAX

Rev. Proc. 2005-24, page 909.

This procedure provides a safe harbor procedure under which the Service will disregard a spousal right of election for purposes of determining whether the CRAT or CRUT meets the requirements of section 664(d)(1)(B) or (d)(2)(B) of the Code continuously since its creation if the spouse irrevocably waives the right of election in the manner prescribed.

(Continued on the next page)

Finding Lists begin on page ii.



GIFT TAX

Rev. Proc. 2005–24, page 909.

This procedure provides a safe harbor procedure under which the Service will disregard a spousal right of election for purposes of determining whether the CRAT or CRUT meets the requirements of section 664(d)(1)(B) or (d)(2)(B) of the Code continuously since its creation if the spouse irrevocably waives the right of election in the manner prescribed.

EMPLOYMENT TAX

Rev. Proc. 2005–21, page 899.

This procedure provides general rules and specifications from the Service for paper and computer-generated substitutes of the extensively revised January 2005 versions of Form 941, *Employer's Quarterly Federal Tax Return*, and Schedule B (Form 941), *Report of Tax Liability for Semiweekly Schedule Depositors*. Rev. Proc. 2005–21 will be reproduced as Publication 4436, *General Rules and Specifications for Substitute Form 941 and Schedule B (Form 941)*.

The IRS Mission

Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by

applying the tax law with integrity and fairness to all.

Introduction

The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest. It is published weekly and may be obtained from the Superintendent of Documents on a subscription basis. Bulletin contents are compiled semiannually into Cumulative Bulletins, which are sold on a single-copy basis.

It is the policy of the Service to publish in the Bulletin all substantive rulings necessary to promote a uniform application of the tax laws, including all rulings that supersede, revoke, modify, or amend any of those previously published in the Bulletin. All published rulings apply retroactively unless otherwise indicated. Procedures relating solely to matters of internal management are not published; however, statements of internal practices and procedures that affect the rights and duties of taxpayers are published.

Revenue rulings represent the conclusions of the Service on the application of the law to the pivotal facts stated in the revenue ruling. In those based on positions taken in rulings to taxpayers or technical advice to Service field offices, identifying details and information of a confidential nature are deleted to prevent unwarranted invasions of privacy and to comply with statutory requirements.

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations,

court decisions, rulings, and procedures must be considered, and Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

The Bulletin is divided into four parts as follows:

Part I.—1986 Code.

This part includes rulings and decisions based on provisions of the Internal Revenue Code of 1986.

Part II.—Treaties and Tax Legislation.

This part is divided into two subparts as follows: Subpart A, Tax Conventions and Other Related Items, and Subpart B, Legislation and Related Committee Reports.

Part III.—Administrative, Procedural, and Miscellaneous.

To the extent practicable, pertinent cross references to these subjects are contained in the other Parts and Subparts. Also included in this part are Bank Secrecy Act Administrative Rulings. Bank Secrecy Act Administrative Rulings are issued by the Department of the Treasury's Office of the Assistant Secretary (Enforcement).

Part IV.—Items of General Interest.

This part includes notices of proposed rulemakings, disbarment and suspension lists, and announcements.

The last Bulletin for each month includes a cumulative index for the matters published during the preceding months. These monthly indexes are cumulated on a semiannual basis, and are published in the last Bulletin of each semiannual period.

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Part I. Rulings and Decisions Under the Internal Revenue Code of 1986

Section 105.—Amounts Received Under Accident and Health Plans

(Also Section 106.)

Health reimbursement arrangements. This ruling addresses the income tax treatment under section 105 of the Code of amounts received by employees from employer-provided reimbursement plans. Notice 2002-45 amplified.

Rev. Rul. 2005-24

ISSUE

Are amounts paid to an employee under a reimbursement plan that provides for the payment of unused reimbursement amounts in cash or other benefits excludable from gross income under § 105(b) of the Internal Revenue Code (the Code)?

FACTS

Situation 1

Employer sponsors a reimbursement plan (the Plan) that reimburses an employee solely for medical care expenses (as defined in § 213(d)) that are substantiated before the reimbursements are made. The Plan reimburses the medical care expenses of both current and former employees (including retired employees), their spouses and dependents (as defined in § 152, determined without regard to § 152(b)(1), (b)(2), and (d)(1)(B)). The Plan also reimburses the medical care expenses of the surviving spouse and dependents of a deceased employee. No other person may receive reimbursements from the Plan. Upon the death of the deceased employee's surviving spouse and last dependent, or upon the death of the employee if there is no surviving spouse or dependents, any unused reimbursement amount is forfeited.

The Plan is paid for solely by Employer and is not provided pursuant to a salary-reduction election or otherwise under a § 125 cafeteria plan. The Plan provides reimbursements up to an annual maximum dollar amount for the coverage period, which

is the plan year. The Plan reimburses medical care expenses only to the extent that the employee or the employee's spouse or dependents have not been reimbursed for the expense from any other plan.

Under the Plan, a portion of each employee's reimbursement amount available at the end of each plan year is forfeited if not used to reimburse medical expenses. The remaining unused reimbursement amount is carried forward for use in subsequent plan years. Neither the employee nor any other person has the right, currently or for any future year, to receive cash or any taxable or nontaxable benefit other than the reimbursement of medical care expenses incurred by the employee and his or her spouse and dependents.

When an employee retires, Employer automatically and on a mandatory basis (as determined under the Plan) contributes an amount to the reimbursement plan equal to the value of all or a portion of the retired employee's accumulated unused vacation and sick leave. Under no circumstances may the retired employee or the retired employee's spouse or dependents receive any of the designated amount in cash or other benefits.

The Plan satisfies the nondiscrimination requirements of § 105(h) for a self-insured medical expense reimbursement plan.

Situation 2

Same facts as in *Situation 1*, except the Plan provides that the employee will receive a cash payment equal to all or a portion of the unused reimbursement amount available to that employee at the end of the plan year or upon termination of employment, if earlier. Employer treats the cash payment as taxable compensation to the employee.

Situation 3

Same facts as in *Situation 1*, except the Plan provides that upon the death of an employee all or a portion of the unused reimbursement amount is paid in cash to a beneficiary or beneficiaries designated by the employee, and if no beneficiary is designated, to the deceased employee's estate.

Situation 4

Same facts as in *Situation 1*, except the Employer has an "option plan" which purports to be separate and apart from the reimbursement plan. Under the "option plan," an employee elects, prior to the beginning of the plan year, to participate in the "option plan." If an employee elects to participate in the "option plan," any unused reimbursement amount available at the end of the plan year is "forfeited." However, the "option plan" provides that the employee may elect to transfer all or a portion of the "forfeited" amount to one of several retirement plans or to receive the amount as a cash payment. If an employee does not elect to participate in the "option plan," any reimbursement amount unused at the end of the plan year is carried forward for use in future plan years.

LAW AND ANALYSIS

Section 61(a)(1) provides that, except as otherwise provided in Subtitle A, gross income includes compensation for services, including fees, commissions, fringe benefits, and similar items. Section 1.61-21(a)(3) and (4) of the Income Tax Regulations state that a fringe benefit provided in connection with the performance of services shall be considered to have been provided as compensation to the person performing such services.

Section 106 provides that the gross income of an employee does not include employer-provided coverage under an accident or health plan. Section 1.106-1 of the regulations provides that the gross income of an employee does not include contributions which the employee's employer makes to an accident or health plan for compensation (through insurance or otherwise) for personal injuries or sickness to the employee or the employee's spouse or dependents.

Section 105(a) provides that, except as otherwise provided in § 105, amounts received by an employee through accident or health insurance for personal injuries or sickness shall be included in gross income to the extent such amounts (1) are attributable to contributions by the employer which were not includible in the gross in-

come of the employee, or (2) are paid by the employer.

Section 105(e) states that amounts received under an accident or health plan for employees are treated as amounts received through accident or health insurance for purposes of § 105. Section 1.105-5(a) of the regulations states that an accident or health plan is an arrangement for the payment of amounts to employees in the event of personal injuries or sickness.

Section 105(b) states that except in the case of amounts attributable to (and not in excess of) deductions allowed under § 213 (relating to medical expenses) for any prior taxable year, gross income does not include amounts referred to in § 105(a) if such amounts are paid, directly or indirectly, to the taxpayer to reimburse the taxpayer for expenses incurred by the taxpayer for the medical care (as defined in § 213(d)) of the taxpayer or the taxpayer's spouse or dependents (as defined in § 152, determined without regard to § 152(b)(1), (b)(2), and (d)(1)(B)).

Section 1.105-2 of the regulations provides that only amounts that are paid specifically to reimburse the taxpayer for expenses incurred by the taxpayer for the prescribed medical care are excludable from gross income. Section 105(b) does not apply to amounts that the taxpayer would be entitled to receive irrespective of whether or not the taxpayer incurs expenses for medical care. Accordingly, if an employee is not paid specifically to reimburse medical care expenses but is entitled to receive the payment irrespective of whether any medical expenses have been incurred, none of the payments are excludable from gross income under § 105(b) whether or not the employee has incurred medical expenses during the year.

Part I of Notice 2002-45, 2002-2 C.B. 93, describes the tax treatment of health reimbursement arrangements (HRAs). The notice explains that a tax-favored HRA is an arrangement that is paid for solely by the employer and not pursuant to a salary reduction election or otherwise under a § 125 cafeteria plan, reimburses the employee for medical care expenses (as defined in § 213(d)) incurred by the employee and by the employee's spouse and dependents, and provides reimbursements up to a maximum dollar amount with any unused portion of that amount at the end

of the coverage period carried forward to subsequent coverage periods.

Part II of Notice 2002-45 states that to qualify for the exclusion from gross income, an HRA may only provide benefits that reimburse expenses for medical care as defined in § 213(d). An HRA does not qualify for the exclusion under § 105(b) if any person has the right to receive cash or any other taxable or non-taxable benefit under the arrangement other than the reimbursement of medical care expenses. If any person has such a right, currently or for any future year, all distributions to all persons made from the arrangement in the current year are included in gross income, even amounts paid to reimburse medical care expenses. The notice specifically states that arrangements providing for the payment of a death benefit, a bonus, or a separation payment without regard to medical care expenses do not qualify for tax-favored treatment.

Notice 2002-45 notes that arrangements formally outside the HRA that provide for the adjustment of an employee's compensation or an employee's receipt of any other benefit will be considered in determining whether the arrangement is an HRA and whether the benefits are eligible for the exclusion from gross income.

Rev. Rul. 75-539, 1975-2 C.B. 45, describes two labor contracts. Contract A provides that upon retirement, an employee will receive a portion of accumulated unused sick leave credits as a cash payment or, at the election of the employee, the payment may be applied to continue the employee's participation in the employer's health plan. Contract B provides that the value of a portion of the accumulated unused sick leave credits will be used to pay for continued participation in the employer's health plan. Under no circumstances under Contract B may the retired employee, the retired employee's spouse or dependents receive this payment in cash.

Rev. Rul. 75-539 holds that, under Contract A, the value of unused accumulated sick leave credits used to continue health coverage is constructively received by the retired employee under § 451, and therefore is includible in the retired employee's gross income. Under Contract A, the amount of premium payments is considered an employee contribution out of salary and not a contribution by the

employer under § 106. However, under Contract B, the value of the unused accumulated sick leave credits, which may not be received in cash, is not constructively received by the retired employee, but is a contribution by the employer to the employer's health plan that is excludable from the retired employee's gross income under § 106.

The reimbursement plan described in *Situation 1* is an HRA that meets the requirements for tax-favored treatment under §§ 106 and 105(b). The Plan in *Situation 1* is an employer-provided accident or health plan under § 106 and payments are limited solely to reimbursements of previously substantiated medical care expenses incurred by current and former employees and their spouses and dependents. No person has the right, currently or in the future, to receive cash or any other taxable or non-taxable benefit under the Plan other than the reimbursement of substantiated medical care expenses as required by § 105(b).

On the other hand, the reimbursement plans described in *Situations 2* through *4* do not meet the requirements for tax-favored treatment. The Plan in *Situation 2* provides for a cash payment equal to all or a portion of the unused reimbursement amount available at the end of the plan year or upon termination of employment, if earlier. The Plan in *Situation 3* provides for a death benefit upon the death of the employee of all or a portion of the unused reimbursement amount without regard to medical care expenses. The Plan in *Situation 4* permits conversion of unused reimbursement amounts to cash or other benefits regardless of whether or not medical expenses have been incurred. Although the "option plan" in *Situation 4* purports to be formally outside the reimbursement arrangement, the option plan and the reimbursement arrangement constitute one plan. Accordingly, because the Plans in *Situations 2* through *4* pay amounts "irrespective" of whether medical care expenses have been incurred, no amount paid under the Plans to any person is excludable from gross income under § 105(b). See also Rev. Rul. 2002-80, 2002-2 C.B. 925, and Rev. Rul. 2003-43, 2003-1 C.B. 935.

HOLDINGS

Amounts paid to an employee under a reimbursement plan that provides for

the payment of unused reimbursement amounts in cash or other benefits are not excludable from gross income under § 105(b). Thus, amounts paid from plans as described in *Situations 2 through 4* are not excludable from gross income under § 105(b). In *Situations 2 through 4*, none of the payments made from the arrangements during the plan year to any person, including amounts paid to reimburse medical expenses, are excluded from gross income. On the other hand, contributions to and amounts paid from a plan as described in *Situation 1* are excludable from the gross income of an employee under §§ 106 and 105(b).

This ruling applies to any purported employer-provided medical reimbursement arrangement, regardless of how the arrangement is characterized, that provides for the receipt by the employee or any other person of cash or any other taxable or nontaxable benefit or any combination of such benefits (including, but not limited to the benefits described in *Situations 2 through 4*) other than the reimbursement of medical care expenses of employees and their spouses and dependents. Moreover, this ruling applies to employer-provided reimbursement arrangements that are lim-

ited only to retired employees, as well as to employer-provided arrangements that cover active employees or both active employees and retirees.

SCOPE

This revenue ruling addresses only reimbursement arrangements paid for solely by an employer under the specific Code sections mentioned and not pursuant to salary reduction or otherwise under a § 125 cafeteria plan. No inference is intended as to §§ 401, 403, 408, 409A, and 457 of the Internal Revenue Code.

EFFECT ON OTHER DOCUMENTS

Notice 2002-45, 2002-2 C.B. 93, is amplified.

EFFECTIVE DATE

For reimbursement arrangements within the SCOPE of this revenue ruling, the ruling is effective for plan years beginning after December 31, 2005.

DRAFTING INFORMATION

The principal author of this revenue ruling is Barbara E. Pie of the Office of

Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). For further information regarding this revenue ruling, contact Ms. Pie at (202) 622-6080 (not a toll-free call).

Section 106.—Contributions by Employer to Accident and Health Plans

Are amounts paid to an employee under a reimbursement plan that provides for the payment of unused reimbursement amounts in cash or other benefits excludable from gross income under § 105(b) of the Internal Revenue Code (the Code)? See Rev. Rul. 2005-24, page 892.

Section 664.—Charitable Remainder Trusts

26 CFR 1.664-1: Charitable remainder trusts.

Does a trust qualify under section 664 if a spouse's right of election under applicable state law includes the assets of a CRAT or CRUT? See Rev. Proc. 2005-24, page 909.

Part III. Administrative, Procedural, and Miscellaneous

Interim Rules and Procedures for Partnerships Under Section 833 of the American Jobs Creation Act of 2004

Notice 2005-32

Section 1. PURPOSE

The American Jobs Creation Act of 2004, P.L. 108-357, 118 Stat. 1418 (the Act), was enacted on October 22, 2004. The Treasury Department and the Internal Revenue Service intend to issue regulations implementing §§ 833 and 834 of the Act, which amended §§ 704, 734, 743, and 6031 of the Internal Revenue Code. This notice provides interim procedures for partnerships and their partners to comply with the mandatory basis provisions of §§ 734 and 743, as amended by the Act. This notice also provides interim procedures for electing investment partnerships (EIPs) and their partners to comply with §§ 743(e) and 6031(f), as provided in § 833(b) of the Act.

Section 2. BACKGROUND

Section 833(c) of the Act requires basis adjustments to be made following certain distributions from partnerships for which no § 754 election is in effect. As amended by § 833(c) of the Act, § 734(a) and (b) requires a partnership to reduce its basis in partnership property upon a distribution of partnership property after October 22, 2004, if there is a “substantial basis reduction.” Under § 734(d), there is a substantial basis reduction if a downward adjustment of more than \$250,000 would be made to the basis of partnership assets if a section 754 election were in effect at the time of the distribution. EIPs, like other partnerships, are required to make any basis adjustments that are required under § 734 upon the distribution of partnership property.

Section 833(b) of the Act requires basis adjustments to be made following certain transfers of interests in partnerships for which no § 754 election is in effect. As amended by § 833(b) of the Act, § 743(a) and (b) requires a partnership to reduce the basis of partnership property upon a

transfer after October 22, 2004, of an interest in the partnership by sale or exchange or upon the death of a partner, if, at the time of the relevant transfer, the partnership has a “substantial built-in loss.” Section 743(d)(1) provides that, for purposes of § 743, a partnership has a substantial built-in loss with respect to a transfer of a partnership interest if the partnership’s adjusted basis in the partnership’s property exceeds by more than \$250,000 the fair market value of the property.

Section 833(b) of the Act also provides that an EIP is not treated as having a substantial built-in loss, and thus is not required to make basis adjustments to partnership property, with respect to any transfer of a partnership interest occurring while an election to be treated as an EIP is in effect. In lieu of the partnership basis adjustments otherwise required under § 743, a partner-level loss disallowance rule applies. Section 743(e)(2) provides that, in the case of a transfer of an interest in an EIP, the transferee partner’s distributive share of the losses, without regard to gains, from the sale or exchange of partnership property is not allowed, except to the extent that it is established that the losses exceed the loss recognized on the transfer of the partnership interest by the transferor partner (or by a prior transferor to the extent not fully offset by a prior disallowance under § 743(e)(2)). Under § 743(e)(3), losses disallowed under this rule do not decrease the transferee partner’s basis in its partnership interest. Section 743(e) is to be applied without regard to any termination of the partnership under § 708(b)(1)(B). In the case of a basis reduction to property distributed to the transferee partner in a nonliquidating distribution, § 743(e)(5) provides that the amount of the transferor’s recognized loss taken into account under § 743(e)(2) is reduced by the amount of the basis reduction under § 732(a)(2).

Section 743(e)(6), as added by the Act, provides that an EIP means any partnership if (A) the partnership makes an election to have § 743(e) apply, (B) the partnership would be an investment company under section 3(a)(1)(A) of the Investment Company Act of 1940 but for an exemption under paragraph (1) or

(7) of section 3(c) of such Act, (C) the partnership has never been engaged in a trade or business, (D) substantially all of the assets of the partnership are held for investment, (E) at least 95 percent of the assets contributed to the partnership consist of money, (F) no assets contributed to the partnership had an adjusted basis in excess of fair market value at the time of contribution, (G) all partnership interests of the partnership are issued by the partnership pursuant to a private offering before the date which is 24 months after the date of the first capital contribution to the partnership, (H) the partnership agreement of the partnership has substantive restrictions on each partner’s ability to cause a redemption of the partner’s interest, and (I) the partnership agreement of the partnership provides for a term that is not in excess of 15 years. However, in the case of an EIP which is in existence on June 4, 2004, § 743(e)(6)(H) does not apply to the partnership, and § 743(e)(6)(I) is applied by substituting “20 years” for “15 years”.

Section 743(e)(7) provides that the Secretary shall prescribe regulations as may be appropriate to carry out the purposes of § 743(e), including regulations for applying § 743(e) to tiered partnerships.

Section 6031(f) provides that in the case of any EIP, the information required under § 6031(b) to be furnished to any partner to whom § 743(e)(2) applies shall include information as is necessary to enable the partner to compute the amount of losses disallowed under § 743(e).

Section 3. INTERIM PROCEDURES RELATING TO BASIS ADJUSTMENTS REQUIRED UNDER § 833 OF THE ACT

Sections 1.734-1(d) and 1.743-1(k) of the Income Tax Regulations require partnerships and partners to provide certain statements following distributions with respect to partnership interests, and transfers of partnership interests, in partnerships for which an election under § 754 is in effect. The Treasury Department and the Service intend to amend the regulations under §§ 734 and 743 to require partnerships and partners to provide statements, similar to those contained in §§ 1.734-1(d)

and 1.743-1(k), following any distributions and transfers that trigger basis adjustments under § 833(b) or (c) of the Act.

Until further guidance is provided, partnerships that are required to reduce the bases of partnership properties under § 833(c) of the Act must comply with § 1.734-1(d) as if an election under § 754 were in effect at the time of the relevant distribution. Partnerships that are required to reduce the bases of partnership properties under § 833(b) of the Act must comply with § 1.743-1(k)(1) as if an election under § 754 were in effect at the time of the relevant transfer. The transferee of an interest in a partnership that is required to reduce the bases of partnership properties under § 833(b) of the Act must comply with § 1.743-1(k)(2), within the time prescribed under § 1.743-1(k)(2) (or, if later, by May 19, 2005), as if an election under § 754 were in effect at the time of the relevant transfer. In addition, partnerships that are required to reduce the bases of partnership properties under § 833(b) of the Act may rely on, and must comply with, § 1.743-1(k)(3), (4), and (5) as if an election under § 754 were in effect at the time of the relevant transfer.

Section 4. INTERIM PROCEDURES FOR EIP ELECTION

Until further guidance is provided, a partnership must make the election to be treated as an EIP by attaching a written statement to an original or amended partnership return for the taxable year for which the election is effective. The statement must (i) set forth the name, address, and tax identification number of the partnership making the election, (ii) contain a representation that the partnership is eligible to make the election under § 743(e)(6)(A), and (iii) contain a declaration that the partnership elects under § 743(e) to be treated as an EIP. If a partnership has filed a return with respect to a taxable year that includes October 22, 2004, and desires to elect to be treated as an EIP for transfers after October 22, 2004, but did not attach a statement satisfying the requirements of this paragraph, then the partnership must file an amended return with a statement satisfying those requirements.

For the election to be valid, the original or amended return must be filed not

later than six months after the time prescribed by § 1.6031(a)-1(e) of the Procedure and Administration Regulations (excluding extensions thereof) for filing the return for the taxable year for which the election is effective. Once an election is made, it is effective for all succeeding taxable years, unless terminated or revoked, as described below. In the case of an election filed for the partnership's taxable year that includes October 22, 2004, the election is effective for all transfers occurring after October 22, 2004. In all other cases, the election is effective for all transfers during the partnership's taxable year for which the election is effective. A partnership that has an election under § 754 in effect is ineligible to make an election to be treated as an EIP. If the partnership is not otherwise required to file a partnership return, the election to be an EIP shall be made in accordance with the rules of § 1.6031(a)-1(b)(5).

The election to be treated as an EIP shall terminate if the partnership fails to meet the definition of an EIP. In this case, the partnership will become subject to the mandatory basis adjustment rules with respect to the first transfer of a partnership interest that occurs after the partnership ceases to meet the definition of an EIP and to each subsequent transfer. An EIP also may terminate its election to be treated as an EIP without the consent of the Commissioner by filing an election under § 754. In this case, the partnership will become subject to the mandatory basis adjustment rules with respect to the first transfer of a partnership interest that occurs after the effective date of the election under § 754. In all other cases, except as provided in future guidance, a partnership having an election in effect to be treated as an EIP may revoke the election only with the consent of the Commissioner. The application for consent to revoke the election must be submitted to the Service in the form of a letter ruling request. If an election to be treated as an EIP is terminated, any losses that are subsequently allocated to a partner to whom a partnership interest was transferred while the EIP election was in effect shall remain subject to disallowance under § 743(e)(2).

Section 5. INTERIM REPORTING REQUIREMENTS

A. Transferor Partner Required to Provide Information to Transferee Partner and Partnership

Until further guidance is provided, if a partnership interest in an EIP is transferred in a sale or exchange or upon the death of a partner, the transferor (or, in the case of a partner who dies, the partner's executor, personal representative, or other successor in interest) must notify the transferee and the EIP in writing. The notice must be provided within 30 days after the date on which the transferor partner (or the executor, personal representative or other successor in interest) receives Schedule K-1 from the EIP for the partnership's taxable year in which the transfer occurred (or, if later, by May 19, 2005). The notice must be signed under penalties of perjury and must include (i) the name, address, and tax identification number of the transferor, (ii) the name, address, and tax identification number of the transferee (if ascertainable), (iii) the name of the partnership, (iv) the date of the transfer (and, in the case of the death of a partner, the date of the death of the partner), (v) the amount of loss, if any, recognized by the transferor on the transfer of the interest, together with the computation of the loss, (vi) the amount of losses, if any, recognized by any prior transferors to the extent the losses were subject to disallowance under § 743(e)(2) in the hands of a prior transferee and have not been offset by prior loss disallowances under § 743(e)(2), and (vii) any other information necessary for the transferee to compute the amount of loss disallowed under § 743(e)(2). If the transferor is a nominee (within the meaning of § 1.6031(c)-1T), then the nominee, and not the beneficial owner of the transferred interest, must supply the information to the transferee of the interest and to the EIP.

The transferee and the EIP shall retain the notice described in this Section 5.A as long as the contents thereof may become material in the administration of any internal revenue law.

B. Distributive Shares of Partnership Items of EIP

Because the amount of losses disallowed under § 743(e) is determined with-

out regard to gains, an EIP is required to separately state on Schedule K and K-1 of the partnership's return (Form 1065) all allocations of losses to all of its partners under § 1.702-1(a)(8)(ii), including losses that, in the absence of § 743(e), could be netted against gains at the partnership level. If a partnership has filed a return with respect to a taxable year that includes October 22, 2004, in which gain and losses were not separately stated, the EIP must, prior to the expiration of the period for making an EIP election for that year, file an amended return in which gains and losses are separately stated. If a partnership's election to be treated as an EIP is terminated, the partnership must continue to state such gains and losses separately in future returns relating to any period during which the partnership has one or more transferee partners that are subject to § 743(e)(2). If an EIP is not required to file a partnership return, the transferee of a partnership interest in the EIP may be required to provide to the Service similar information regarding the partner's distributive share of gross gains and losses of the EIP under § 1.6031(a)-1(b)(4).

C. Partnership Required to Provide Annual Statements to Partners

Until further guidance is provided, an EIP must provide the following statement to all of its partners. The statement shall be attached to every statement provided to a partner or nominee under § 6031(b) that is issued with respect to any taxable year for which an election to be treated as an EIP is in effect (whether or not the election is in effect for the entire taxable year). If an EIP has provided statements under § 6031(b) with respect to a taxable year that includes October 22, 2004, and elects to be treated as an EIP for that year, but did not include the statements required by this section 5.C., then the EIP must provide amended statements under § 6031(b), prior to the expiration of the period for making an EIP election for that year, which do include the required statements.

Notice of Election. This partnership has elected to be treated as an electing investment partnership under section 743(e) of the Internal Revenue Code.

Information for Transferors. If you transfer an interest in this part-

nership to another person, Notice 2005-32, 2005-16 I.R.B. 895, provides that you must, within 30 days after receiving a Schedule K-1 from this partnership for the taxable year that includes the date of the transfer, provide the transferee with certain information, including the amount, if any, of loss that you recognized on the transfer of the partnership interest, and the amount of losses, if any, recognized by prior transferors with respect to the same interest. See Notice 2005-32 for more information.

Information for Transferees. If an interest in this partnership is transferred to you, section 743(e)(2) requires that you reduce your distributive share of losses from this partnership, determined without regard to gains from this partnership, to the extent of any losses recognized by the transferor partner when that partner transferred the partnership interest to you (and to the extent of other losses recognized on prior transfers of the same partnership interest that have not been offset by prior loss disallowances). Each year, you must reduce your share of losses as reported to you by this partnership by the amount of any loss recognized by the transferor partner (or any prior transferor to the extent not already offset by prior loss disallowances) until you have reduced your share of partnership losses by the total amount of losses required to be disallowed. If the transferor partner, or its legal representative in the case of a transfer by death, fails to provide you with the required statement, you must treat all losses allocated from the EIP as disallowed under § 743(e)(2) unless you obtain, from the EIP or otherwise, the information necessary to determine the proper amount of losses disallowed under § 743(e)(2). See Notice 2005-32 for more information.

D. Effects of Failure to Notify Transferee Partner

If the transferor partner, or its legal representative in the case of a transfer by death, fails to provide the transferee part-

ner with the statement required by Section 5.A of this notice with respect to a transfer of an interest in the EIP, the transferee partner must treat all losses allocated from the EIP as disallowed under § 743(e)(2) unless the transferee partner obtains, from the EIP or otherwise, the information necessary to determine the proper amount of losses disallowed under § 743(e)(2). If the transferee does not have the information necessary to determine the proper amount of losses disallowed under § 743(e)(2), but does have information sufficient to determine the maximum amount of losses that could be disallowed, then the transferee may treat the amount of losses disallowed under § 743(e)(2) as being equal to that maximum amount. For example, if the transferee is able to ascertain the adjusted basis that a prior transferor had in its partnership interest, but is not able to ascertain the amount realized by that transferor, the transferee may assume, for purposes of calculating the amount of losses disallowed under § 743(e)(2), that the sales price when the prior transferor sold its interest was zero. If, following the filing of a return pursuant to the previous sentence, the transferor partner or the EIP provides the required information to the transferee partner, the transferee partner should make appropriate adjustments in an amended return for the year of the loss allocation from the EIP in accordance with § 6511 or other applicable rules.

Section 6. CHARACTER OF LOSSES DISALLOWED UNDER § 743(e)(2)

Until further guidance is issued, if an EIP allocates losses with a different character from the sale or exchange of property to the transferee (such as ordinary or § 1231 losses and capital losses) and the losses allocated to that partner are limited by § 743(e)(2), then a proportionate amount of the losses disallowed under § 743(e)(2) shall consist of each loss of a separate character that is allocated to the transferee partner.

Section 7. TRADES OR BUSINESSES OF LOWER-TIER PARTNERSHIPS

As noted above, a partnership that is engaged in a trade or business, or that has previously engaged in a trade or business, is not eligible to elect to be treated as an

EIP. The Treasury Department and the Service are studying the conditions under which a partnership (“upper-tier partnership”) that holds interests in one or more partnerships (“lower-tier partnerships”) that are engaged in a trade or business should be treated as engaged in a trade or business.

Until further guidance is issued, an upper-tier partnership will not be treated as engaged in the trade or business of a lower-tier partnership if, at all times during the period in which the upper-tier partnership owns an interest in the lower-tier partnership, the adjusted basis of its interest in the lower-tier partnership is less than 25 percent of the total capital that is required to be contributed to the upper-tier partnership by its partners during the entire term of the upper-tier partnership. This notice does not address the situation in which the upper-tier partnership’s adjusted basis in its lower-tier partnership interest is, at any time, 25 percent or more of the total capital that is required to be contributed to the upper-tier partnership by its partners during the entire term of the upper-tier partnership.

The Treasury Department and the Service specifically request comments on rules that may be appropriate for future guidance. Factors that may be relevant in future guidance in determining whether an upper-tier partnership is treated as engaged in a trade or business that is conducted by a lower-tier partnership include (i) the relative amount of the upper-tier partnership’s investment in the lower-tier partnership as compared to the total capital that is required to be contributed to the upper-tier partnership by its partners during the entire term of the upper-tier partnership, (ii) the degree to which the upper-tier partnership participates in the management of the lower-tier partnership’s activities, and (iii) the motivations for the formation of the upper-tier partnership in making the investments in the lower-tier partnership.

The Treasury Department and the Service may adopt rules in future guidance that are more restrictive than the safe harbor provided for above. If a partnership that qualifies as an EIP under the safe harbor does not qualify as an EIP under future guidance, the partnership’s election to be treated as an EIP will terminate for transfers occurring on or after the date on which such future guidance becomes effective.

Section 8. EXAMPLES

A. Transfer of Partnership Interest

PRS is a partnership which does not have an election under § 754 in effect. *PRS* has no liabilities. The fair market value of *PRS*’s assets is \$4 million and the adjusted basis of *PRS*’s assets is \$4.3 million. Under § 743(d), *PRS* has a substantial built-in loss because the adjusted basis of the partnership property exceeds the fair market value of the partnership property by more than \$250,000. *A*, a partner of *PRS*, sells a 25 percent partnership interest in *PRS* to *B* for its fair market value of \$1 million. Under § 743(b), an adjustment is required to the adjusted basis of *PRS*’s assets with respect to *B*. Under Section 3 of this notice, *B* must provide the written notice described in § 1.743-1(k)(2) to *PRS* within 30 days after the sale, and *PRS* must attach the statement described in § 1.743-1(k)(1) to the partnership return for the year of the transfer.

B. Distribution of Partnership Property

A and *B* each contribute \$2.5 million and *C* contributes \$5 million to a newly formed partnership, *PRS*, which does not have an election under § 754 in effect. *PRS* has no liabilities. *PRS* purchases *LMN* stock for \$3 million and *XYZ* stock for \$7 million. The value of each stock declines to \$1 million. *PRS* distributes *LMN* stock to *C* in complete liquidation of *C*’s interest in *PRS*. Under § 732(b), the basis of *LMN* stock in *C*’s hands is \$5 million and *C* would recognize a loss of \$4 million if the *LMN* stock were sold for \$1 million. There is a substantial basis reduction within the meaning of § 734(d), because the \$2 million increase in the adjusted basis of *LMN* stock (described in § 734(b)(2)(B)) is greater than \$250,000. Under § 734(b), *PRS* is required to decrease the basis of *XYZ* stock by \$2 million (the amount by which the basis of *LMN* stock was increased), leaving a basis of \$5 million remaining in the *XYZ* stock. Under Section 3 of this notice, *PRS* must attach the statement described in § 1.734-1(d) to the partnership return for the year of the distribution.

C. EIP

(i) *PRS* is a domestic partnership with a calendar year taxable year that desires to elect to be treated as an EIP for 2004 and all succeeding taxable years. *PRS* and all of its partners have a calendar year taxable year. *PRS* has no liabilities. Other than the making of the election, *PRS* meets all other requirements to be an EIP under § 743(e)(6). *PRS* elects to be treated as an EIP by attaching a statement to its income tax return for 2004 in accordance with Section 4 of this notice.

(ii) Between October 22 and December 31, 2004, the only transfer of a partnership interest in *PRS* occurred on November 30, 2004, when *A* transferred a 10 percent partnership interest to *C*. The purchase price for the 10 percent partnership interest was \$3,000,000. *A*’s adjusted basis in *A*’s partnership interest on December 31, 2003, was \$3,000,000. In 2004, the partnership’s only items of income, gain, loss, and deduction are \$3 million of long-term capital gain and \$2 million of long-term capital loss. Because *PRS* has elected to be treated as an EIP, *PRS* must separately state this gain and loss on its return in accordance with Section 5.B of this notice.

(iii) If *A* had remained a partner for the entire year, *A*’s distributive share of the partnership’s items would have been \$300,000 of long-term capital gain

and \$200,000 of long-term capital loss. Assume that under § 706, *A*’s distributive share of these items are properly determined to be 334/365 of each of these amounts, or \$274,521 of long-term capital gain and \$183,014 of long-term capital loss, and that *C*’s distributive shares of these items are properly determined to be 31/365 of each of these amounts, or \$25,479 of long-term capital gain and \$16,986 of long-term capital loss.

(iv) *PRS* must provide a statement to all of its partners in accordance with Section 5.C of this notice. The statement must be attached to each partner’s Schedule K-1 for *PRS*’s taxable year ending December 31, 2004. Assume that *A* receives *A*’s Schedule K-1 on March 12, 2005. Within 30 days after receiving this Schedule K-1, *A* must provide statements to *C* and EIP as described in Section 5.A of this notice.

(v) The adjusted basis in *A*’s partnership interest on November 30, 2004, \$3,091,507, equals *A*’s adjusted basis on December 31, 2003, \$3,000,000, plus *A*’s distributive share of partnership gain in 2004, \$274,521, less *A*’s distributive share of partnership loss in 2004, \$183,014. The amount of loss recognized by *A* on the sale of *A*’s partnership interest is \$91,507, which equals the adjusted basis in *A*’s partnership interest on the date of the sale, \$3,091,507, less the amount realized by *A*, \$3,000,000. Thus, the first \$91,507 of gross loss allocated to *C* is disallowed under § 743(e)(2). The entire amount of *C*’s long-term capital loss in 2004, \$16,986, is disallowed under § 743(e)(2). The first \$74,521 of any gross loss allocated to *C* in future years will also be disallowed under § 743(e)(2), regardless of whether *PRS* is an EIP in those future years.

(vi) *C*’s adjusted basis as of December 31, 2004, is \$3,025,479, the sum of *C*’s purchase price paid for *A*’s interest, \$3,000,000, plus the distributive share of gain allocated to *C*, \$25,479. Under § 743(e)(3), the \$16,986 loss allocated to *C*, but disallowed under § 743(e)(2), does not reduce the basis of *C*’s partnership interest.

Section 9. REQUEST FOR COMMENTS

The Treasury Department and the Service intend to issue further guidance implementing §§ 833 and 834 of the Act, including guidance addressing the application of these provisions to tiered partnership structures. Comments are requested concerning the scope and content of this guidance. In particular, comments are requested concerning the application of these provisions to tiered partnerships and the reporting obligations that should be imposed on tiered partnerships and their partners. As stated earlier, comments are also requested on the rules provided in Section 7 of this notice. Comments should be submitted in writing on or before July 19, 2005, and should include a reference to Notice 2005-32. Comments may be submitted to CC:PA:LPD:PR (Notice 2005-32), Room 5226, Internal Revenue Service, PO Box 7604, Ben Franklin

Station, Washington, DC 20044. Alternatively, comments may be submitted electronically via the following e-mail address: *Notice.Comments@irscounsel.treas.gov*. Please include “Notice 2005–32” in the subject line of any electronic communications.

Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to CC:PA:LPD:PR (Notice 2005–32), Courier’s Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC 20224.

PAPERWORK REDUCTION ACT

The collections of information contained in this notice have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–1939.

An agency may not conduct or sponsor, and a person is not required to respond

to, a collection of information unless the collection of information displays a valid OMB control number.

The collections of information in this notice are in Sections 3, 4, and 5. This information is required, and will be used, to assure compliance with the new provisions of the American Jobs Creation Act of 2004. The collections of information are required to obtain a benefit or are mandatory. The likely respondents are individuals and businesses or other for-profit institutions.

The estimated total annual reporting burden and/or recordkeeping burden is 552,100 hours.

The estimated annual average burden per respondent/recordkeeper varies from is 0.05 hours to 3 hours, depending on individual circumstances, with an estimated average of 2.07 hours.

The estimated number of respondents and/or recordkeepers is 266,400.

The estimated annual frequency of responses (used for reporting requirements only) is various.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

DRAFTING INFORMATION

The principal author of this notice is Sean I. Kahng of the Office of Associate Chief Counsel (Passthroughs & Special Industries). However, other personnel from the Treasury Department and the Service participated in its development. For further information regarding this notice, contact Mr. Kahng at (202) 622–3050 (not a toll-free call).

NOTE: This revenue procedure will be reproduced as IRS Publication 4436, *General Rules and Specifications for Substitute Form 941 and Schedule B (Form 941)*.

Rev. Proc. 2005–21

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Section 1 – Purpose

.01 The purpose of this publication is to provide general rules and specifications from the Internal Revenue Service (IRS) for paper and computer-generated substitutes for the newly revised January 2005 version of Form 941, Employer’s Quarterly Federal Tax Return, and Schedule B (Form 941), Report of Tax Liability for Semiweekly Schedule Depositors.

.02 This publication provides measurements and printing specifications for substitute Form 941 and Schedule B (Form 941). If you need more in-depth information on who must complete the forms and how to complete them, see the Instructions for Form 941 and Publication 15 (Circular E), Employer’s Tax Guide, or visit the IRS website at www.irs.gov.

.03 Forms should not be submitted to the IRS for specific approval. If you are uncertain of any specification and want it clarified, you may submit a letter citing the specification and your understanding of the specification, and enclose an example of the form (if appropriate) to:

Internal Revenue Service
Attn: Substitute Forms Program
SE:W:CAR:MP:T:T:SP, IR-6406
1111 Constitution Avenue, NW
Washington, DC 20024

Note. Allow at least 30 days for the IRS to respond.

.04 However, software developers and form producers should send a blank copy of their substitute Form 941 and Schedule B (Form 941) in pdf format to Victor.V.Martin@irs.gov. The purpose is not specifically for approval but to assist the IRS in preparing to scan these forms. Submitters will only receive comments if a significant problem is discovered through this process. Submitters are not expected to delay marketing their forms in order to receive feedback. In no case should submitters include “live” taxpayer data.

Section 2 – What’s New

.01 We extensively revised Form 941 and Schedule B (Form 941) to enable the IRS to scan the forms and to make them easier to complete. Optical scanning of tax returns enables the IRS to capture data more accurately and efficiently. This will reduce our need to contact filers because of an error in recording amounts reported on their returns.

.02 Because scanning requires conformity, we are publishing this revenue procedure to provide specifications for producing substitutes for the new revisions of Form 941 and Schedule B (Form 941). It is acceptable to produce substitutes of Form 941 and Schedule B (Form 941) using the official IRS form as posted on the IRS website or to produce substitutes based on the format developed by the software industry, which uses a 6x10 grid. Either format must be precisely followed.

.03 We now require filers to check a box at the top of Form 941 to indicate the tax period. We also require that line 1 (“number of employees”) be completed for each quarter. We combined income and social security tax adjustments into a single line (line 7) and no longer require a supporting statement for tips or group-term life insurance adjustments. Because Form 941 is now two pages, filers must enter their name, Employer Identification Number (EIN), and signature on page 2.

.04 There is a new form for reporting discrepancies between Forms 941 and Forms W-2. We recently developed Schedule D (Form 941), Report of Discrepancies Caused by Acquisitions, Statutory Mergers, or Consolidations. You may use Schedule D (Form 941) to explain the discrepancies between what an employer reported to the Social Security Administration on Form W-2 and what the employer reported to the IRS on Form 941, if the discrepancies are caused by acquisitions, statutory mergers, or consolidations. Areas where discrepancies may occur include social security wages, social security tips, Medicare wages and tips, federal income tax withheld, and advanced earned income payments. We did not include specifications for Schedule D (Form 941) in the exhibits (Section 7) because scanning of Schedule D (Form 941) is not available at this time. However, any substitute paper or computer-generated paper forms should generally follow the specifications for Form 941.

Section 3 – General Requirements for Reproducing IRS Official Form 941 and Schedule B (Form 941)

.01 Do not submit substitute Form 941 and Schedule B (Form 941) to the IRS for approval. Substitute Form 941 and Schedule B (Form 941) that **completely conform** to the specifications contained in this revenue procedure do not require prior approval from the IRS. Substitute forms filed with the IRS that do not conform may be returned.

.02 Print the form on paper that is 8.5 inches wide by 11 inches deep.

.03 Use white paper that meets generally-accepted weight, color, and quality standards (minimum 20lb. white bond paper).

Note. Reclaimed fiber in any percentage is permitted provided that the requirements of this standard are met.

.04 The IRS prefers printing Form 941 on both sides of a single sheet of paper, but it is acceptable to print on one side of each of two separate sheets of paper.

.05 Make substitute paper forms as identical to the official IRS-printed forms as possible.

.06 Print using nonreflective black inks.

.07 Use typefaces that are substantially identical in size and shape to the official forms and use rules and shading that are substantially identical to those on the official forms.

.08 Print the form ID codes in the upper right-hand corner of each form using nonreflective black, carbon-based, 12-point (minimum 10-point required) OCR-A font. Use the official paper over-the-counter IRS forms to develop your substitute paper forms. Print “9501” on page 1 of Form 941, “9502” on page 2 of Form 941, and “9503” on Schedule B (Form 941). See Section 4 for form ID codes for software-generated forms.

.09 Print the OMB number in the same location as on the official forms.

.10 Print all entry boxes and checkboxes exactly as shown on the official forms.

.11 Print your IRS-issued three-letter substitute form printer source code in the middle at the bottom of page 1 of Form 941.

.12 Print “For Privacy Act and Paperwork Reduction Act Notice, see the back of the Payment Voucher” at the bottom of page 1 of Form 941.

.13 Print “For Paperwork Reduction Act Notice, see separate instructions” at the bottom of Schedule B (Form 941).

.14 Do not print the form catalog number (“Cat. No.”) at the bottom of the forms or instructions.

.15 Do not print the Government Printing Office (GPO) symbol at the bottom of the forms or instructions.

.16 See Exhibits A and B in Section 7.

Section 4 – Reproducing Form 941 and Schedule B (Form 941) for Software-Generated Paper Forms

.01 You may use the 6x10 grid exhibits (C and D) at the end of this document to develop a software version of Form 941 and Schedule B (Form 941). Please follow the specifications exactly to develop the fields.

.02 If you are developing software that is designed using the 6x10 grid in the exhibits, you may make the following modifications. See Exhibits C and D in Section 7.

- Use “9701” for page 1 of Form 941, “9702” for page 2 of Form 941, and “9703” for Schedule B (Form 941) as the form ID codes.
- Place all boxes and entry spaces in the same fields as indicated in the 6x10 grid exhibits.
- Use single lines for “Employer Identification Number” (EIN) and other entry areas in the entity section of page 1 of Form 941.
- You do not need to use reverse type as shown on the IRS official form.
- You do not need to pre-print decimal points in the data boxes. However, all amounts should be printed with decimal points and place holders for cents.
- Use a single box for “state abbreviation” in line 14 of Form 941.
- Delete the pre-printed formatting in the “date” box for line 16 and in Parts 5 and 6 of Form 941.
- Delete the pre-printed formatting in the “Phone” box for Parts 4, 5, and 6.
- Use a single box for “Personal Identification Number (PIN)” in Part 4 of Form 941.
- You may delete all shading when using the 6x10 grid format.

.03 If producing both the form and the data or the form only, print your 3-letter IRS-issued form printer source code in Row 63, Columns 49–51 on page 1 of Form 941.

.04 If producing only the data on the form, print your 4-digit software industry form code in Row 4, Columns 58–61 on page 1 of Form 941. See the National Association of Computerized Tax Processors (NACTP) website at www.nactp.org for information on these codes.

.05 Print “For Privacy Act and Paperwork Reduction Act Notice, see the Payment Voucher” at the bottom of page 1 of Form 941.

.06 Print “For Paperwork Reduction Act Notice, see separate instructions” at the bottom of Schedule B (Form 941).

.07 Do not print the form catalog number (“Cat. No.”) at the bottom of the forms or instructions.

.08 Do not print the Government Printing Office (GPO) symbol at the bottom of the forms or instructions.

.09 To enable accurate scanning and processing, enter data on Form 941 and Schedule B (Form 941) as follows:

- Use 12-point (minimum 10-point) Courier font (if possible).
- Omit dollar signs, but use commas to show amounts.
- Except for line 10, leave blank any data field with a value of zero.
- Enter negative amounts in parentheses or with a minus sign.
- Show name and EIN on all pages and attachments.

Section 5 – OMB Requirements for Substitute Forms

.01 The Paperwork Reduction Act (the Act) of 1995 (Public Law 104-13) requires that:

- The OMB approves all IRS tax forms that are subject to the Act.

- Each IRS form contains the OMB approval number, if required. (The official OMB numbers may be found on the official IRS printed forms and are also shown in the exhibits.)
- Each IRS form (or its instructions) states:
 - (1) Why the IRS needs the information,
 - (2) How it will be used, and
 - (3) Whether or not the information is required to be furnished to the IRS.

.02 This information must be provided to any users of official or substitute IRS forms or instructions.

.03 The OMB requirements for substitute IRS forms are:

- Any substitute form or substitute statement to a recipient must show the OMB number as it appears on the official IRS form.
- For Form 941 and Schedule B (Form 941), the OMB number must appear exactly as shown on the official IRS form.
- For any form, the OMB number must use one of the following formats.
 - (1) OMB No. XXXX-XXXX (preferred) or
 - (2) OMB# XXXX-XXXX (acceptable).

.04 If no instructions are provided to users on your forms, you must furnish to them the exact text of the Privacy Act and Paperwork Reduction Act Notice.

Section 6 – Reproducible Copies of Forms

.01 You can order official IRS forms and information copies of federal tax materials by calling the IRS National Distribution Center at 1-800-829-3676. Other ways to get federal tax material include:

- The Internet at www.irs.gov.
- GPO Superintendent of Documents Bookstores.
- CD-ROM.

.02 The IRS also offers an alternative to downloading electronic files and provides current and prior year access to tax forms and instructions through its Federal Tax Forms CD-ROM. Order Publication 1796, IRS Federal Tax Products CD-ROM, by using the IRS website at www.irs.gov/cdorders or by calling 1-877-CDFORMS (1-877-233-6767).

Section 7 – Exhibits

.01 Please follow the specifications indicated in the following exhibits to produce substitute Form 941 and Schedule B (Form 941).

.02 These forms are subject to review and possible change as required. Therefore, employers are cautioned against overstocking supplies of privately-printed substitutes.

.03 **Do not** submit substitute Form 941 and Schedule B (Form 941) to the IRS for approval. Substitute Form 941 and Schedule B (Form 941) that **completely conform** to the specifications contained in this revenue procedure may be privately printed without prior approval from the IRS. Substitute forms filed with the IRS that do not conform may be returned. See Section 3 of this publication.

Exhibit A, Form 941 (Official Version)

Form **941 for 2005: Employer's Quarterly Federal Tax Return**
(Rev. January 2005)
 Department of the Treasury — Internal Revenue Service

9501
OMB No. 1545-0029

Employer identification number -

Name (not your trade name)

Trade name (if any)

Address

Number Street Suite or room number

City State ZIP code

Report for this Quarter ...
(Check one.)

1: January, February, March

2: April, May, June

3: July, August, September

4: October, November, December

Read the separate instructions before you fill out this form. Please type or print within the boxes.

Part 1: Answer these questions for this quarter.

1 Number of employees who received wages, tips, or other compensation for the pay period including: Mar. 12 (Quarter 1), June 12 (Quarter 2), Sept. 12 (Quarter 3), Dec. 12 (Quarter 4) **1**

2 Wages, tips, and other compensation **2**

3 Total income tax withheld from wages, tips, and other compensation **3**

4 If no wages, tips, and other compensation are subject to social security or Medicare tax Check and go to line 6.

5 Taxable social security and Medicare wages and tips:

Column 1	Column 2
5a Taxable social security wages <input style="width: 50%;" type="text"/> × .124 = <input style="width: 50%;" type="text"/>	1.45"
5b Taxable social security tips <input style="width: 50%;" type="text"/> × .124 = <input style="width: 50%;" type="text"/>	
5c Taxable Medicare wages & tips <input style="width: 50%;" type="text"/> × .029 = <input style="width: 50%;" type="text"/>	
5d Total social security and Medicare taxes (Column 2, lines 5a + 5b + 5c = line 5d) 5d <input style="width: 100%;" type="text"/>	

6 Total taxes before adjustments (lines 3 + 5d = line 6) **6**

7 Tax adjustments (If your answer is a negative number, write it in brackets.):

7a Current quarter's fractions of cents <input style="width: 50%;" type="text"/>	2.2"
7b Current quarter's sick pay <input style="width: 50%;" type="text"/>	
7c Current quarter's adjustments for tips and group-term life insurance <input style="width: 50%;" type="text"/>	
7d Current year's income tax withholding (Attach Form 941c) <input style="width: 50%;" type="text"/>	
7e Prior quarters' social security and Medicare taxes (Attach Form 941c) <input style="width: 50%;" type="text"/>	
7f Special additions to federal income tax (reserved use) <input style="width: 50%;" type="text"/>	
7g Special additions to social security and Medicare (reserved use) <input style="width: 50%;" type="text"/>	
7h Total adjustments (Combine all amounts: lines 7a through 7g.) 7h <input style="width: 100%;" type="text"/>	

8 Total taxes after adjustments (Combine lines 6 and 7h.) **8**

9 Advance earned income credit (EIC) payments made to employees **9**

10 Total taxes after adjustment for advance EIC (lines 8 - 9 = line 10) **10**

11 Total deposits for this quarter, including overpayment applied from a prior quarter **11**

12 Balance due (lines 10 - 11 = line 12) Make checks payable to the United States Treasury **12**

13 Overpayment (If line 11 is more than line 10, write the difference here.) **13** Apply to next return.
 Send a refund.

Next →

For Privacy Act and Paperwork Reduction Act Notice, see the back of the Payment Voucher. Form **941** (Rev. 1-2005)

Exhibit A, Form 941 (Official Version) (continued)

9502

Name (not your trade name) _____ Employer identification number _____

Part 2: Tell us about your deposit schedule for this quarter.

If you are unsure about whether you are a monthly schedule depositor or a semiweekly schedule depositor, see *Pub. 15 (Circular E)*, section 11.

14 Write the state abbreviation for the state where you made your deposits OR write "MU" if you made your deposits in *multiple* states. ← .5" →

15 Check one: Line 10 is less than \$2,500. Go to Part 3.
 You were a monthly schedule depositor for the entire quarter. Fill out your tax liability for each month. Then go to Part 3.

Tax liability: Month 1 .25" ↕ .25" ↕
Month 2 1.8" ← 1.8" →
Month 3
Total Total must equal line 10.

You were a semiweekly schedule depositor for any part of this quarter. Fill out Schedule B (Form 941): Report of Tax Liability for Semiweekly Schedule Depositors, and attach it to this form.

Part 3: Tell us about your business. If a question does NOT apply to your business, leave it blank.

16 If your business has closed and you do not have to file returns in the future Check here, and enter the final date you paid wages / / 1.1" ← 1.1" →

17 If you are a seasonal employer and you do not have to file a return for every quarter of the year . . . Check here.

Part 4: May we contact your third-party designee?

Do you want to allow an employee, a paid tax preparer, or another person to discuss this return with the IRS? See the instructions for details.

Yes. Designee's name 5.5" ← 5.5" →

Phone) - 2.0" ← 2.0" → Personal Identification Number (PIN) - - 1.4" ← 1.4" →

No.

Part 5: Sign here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete.

Sign your name here 5.9" ← 5.9" →

Print name and title

Date / / 1.1" ← 1.1" → Phone () - - 2.0" ← 2.0" →

Part 6: For paid preparers only (optional)

Preparer's signature

Firm's name

Address EIN 1.75" ← 1.75" →

Date / / 3.6" ← 3.6" → ZIP code

Phone () - - SSN/PTIN

Check if you are self-employed.

Page 2 Form 941 (Rev. 1-2005)

Exhibit B, Schedule B (Form 941) (Official Version)

Schedule B (Form 941): Report of Tax Liability for Semiweekly Schedule Depositors

(Rev. January 2005) Department of the Treasury — Internal Revenue Service

9503
OMB No. 1545-0029

Employer identification number -
 Name (not your trade name)

Report for this Quarter ...
(Check one.)

1: January, February, March
 2: April, May, June
 3: July, August, September
 4: October, November, December

Use this schedule to show your tax liability for the quarter; DO NOT use it to show your deposits. You must fill out this form and attach it to Form 941 (or Form 941-SS) if you are a semiweekly schedule depositor or became one because your accumulated tax liability on any day was \$100,000 or more. Write your daily tax liability on the numbered space that corresponds to the date wages were paid. See Section 11 in *Pub. 15 (Circular E), Employer's Tax Guide*, for details.

Month 1

1		9		17		25		Tax liability for Month 1
2		10		18		26		
3	.25"	11		19		27		
4		12		20		28		
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Month 2

1		9		17		25		Tax liability for Month 2
2		10		18		26		.6"
3		11		19		27		
4		12		20		28		
5		13		21		29		
6		14		22		30		
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Month 3

1		9		17		25		Tax liability for Month 3
2		10		18		26		
3		11		19		27		
4		12		20		28		
5		13		21		29		
6		14		22		30		
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Total liability for the quarter
Total must equal line 10 on Form 941 (or line 8 on Form 941-SS).

Exhibit C, Form 941 (6 x 10 Grid Version)

1	2	3	4	5	6	7	8	9	0	1	2	3	4	5	6	7	8	9	0	1	2	3	4	5	6	7	8	9	0	1	2	3	4	5
1	Form 941 for 2005: Employer's Quarterly Federal Tax Return 9701																											1						
2	(Rev. January 2005) Department of the Treasury -- Internal Revenue Service OMB No. 1545-0029																											2						
3	Employer identification number																											3						
4	Name (not your trade name)																											4						
5	Trade name (if any)																											5						
6	Address																											6						
7	Part 1: Answer these questions for this quarter.																											7						
8	1 Number of employees who received wages, tips, or other compensation for the pay period including: Mar. 12 (Quarter 1), June 12 (Quarter 2), Sept. 12 (Quarter 3), Dec. 12 (Quarter 4) 1																											8						
9	2 Wages, tips, and other compensation 2																											9						
10	3 Total income tax withheld from wages, tips, and other compensation 3																											10						
11	4 If no wages, tips, and other compensation are subject to social security or Medicare tax <input type="checkbox"/> Check and go to line 6.																											11						
12	5 Taxable social security and Medicare wages and tips:																											12						
13	5a Taxable social security wages													Column 1	5a Taxable social security wages													Column 2	13					
14	5b Taxable social security tips														5b Taxable social security tips														14					
15	5c Taxable Medicare wages & tips														5c Taxable Medicare wages & tips														15					
16	5d Total social security and Medicare taxes (Column 2, lines 5a + 5b + 5c = line 5d) 5d																											16						
17	6 Total taxes before adjustments (lines 5 + 5d = line 6) 6																											17						
18	7 Tax adjustments (If your answer is a negative number, enter it in brackets.):																											18						
19	7a Current quarter's fractions of cents																											19						
20	7b Current quarter's sick pay																											20						
21	7c Current quarter's adjustments for tips and group-term life insurance																											21						
22	7d Current year's income tax withholding (Attach Form 941c)																											22						
23	7e Prior quarters' social security and Medicare taxes (Attach Form 941c)																											23						
24	7f Special additions to federal income tax (reserved use)																											24						
25	7g Special additions to social security and Medicare (reserved use)																											25						
26	7h Total adjustments (Combine all amounts: lines 7a through 7g.) 7h																											26						
27	8 Total taxes after adjustments (Combine lines 6 and 7h.) 8																											27						
28	9 Advance earned income credit (EIC) payments made to employees 9																											28						
29	10 Total taxes after adjustment for advance EIC (lines 8 - 9 = line 10) 10																											29						
30	11 Total deposits for this quarter, including overpayment applied from a prior quarter 11																											30						
31	12 Balance due (lines 10 - 11 = line 12) Make checks payable to the United States Treasury 12																											31						
32	13 Overpayment (If line 11 is more than line 10, enter the difference here.) <input type="checkbox"/> Check one <input type="checkbox"/> Apply to next return. <input type="checkbox"/> Send a refund.																											32						
33	For Privacy Act and Paperwork Reduction Act Notice, see the Payment Voucher. Form 941 (Rev. 1-2005)																											33						

Exhibit C, Form 941 (6 x 10 Grid Version) (continued)

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9702

Form 941 (Rev. 1-2005) Page 2

Name (not your trade name) Employer identification number

Part 2: Tell us about your deposit schedule for this quarter.

If you are unsure about whether you are a monthly schedule depositor or a semiweekly schedule depositor, see Pub. 15 (Circular E), section 11.

14 Enter the state abbreviation for the state where you made your deposits OR enter "MU" if you made your deposits in multiple states.

15 Check one: Line 10 is less than \$2,500. Go to Part 3.

You were a monthly schedule depositor for the entire quarter. Fill out your tax liability for each month. Then go to Part 3.

Tax liability:

Month 1

Month 2

Month 3

Total Total must equal line 10.

You were a semiweekly schedule depositor for any part of this quarter. Fill out Schedule B (Form 941): Report of Tax Liability for Semiweekly Schedule Depositors, and attach it to this form.

Part 3: Tell us about your business. If a question does NOT apply to your business, leave it blank.

16 If your business has closed and you do not have to file returns in the future. Check here, and

enter the final date you paid wages .

17 If you are a seasonal employer and you do not have to file a return for every quarter of the year Check here.

Part 4: May we contact your third-party designee?

Do you want to allow an employee, a paid tax preparer, or another person to discuss this return with the IRS? See instructions for details.

Yes. Designee's name

Phone Personal Identification Number (PIN)

No.

Part 5: Sign here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete.

► Sign your name here

Print name and title

Date Phone

Part 6: For paid preparers only (optional)

Preparer's signature

Firm's name

Address EIN

ZIP code

Date Phone SSN/PTIN

Check if you are self-employed.

Exhibit D, Schedule B (Form 941) (6 x 10 Grid Version)

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<p>Schedule B (Form 941): Report of Tax Liability for Semiweekly Schedule Depositors (Rev. January 2005) OMB No. 1545-0029 9703 Department of the Treasury -- Internal Revenue Service Report for this Quarter</p> <p>Employer identification number _____</p> <p>Name (not your trade name) _____</p> <p>Use this schedule to show your tax liability for the quarter; DO NOT use it to show your deposits. You must fill out this form and attach it to Form 941 (or Form 941-SS) if you are a semiweekly schedule depositor or became one because your accumulated tax liability on any day was \$100,000 or more. Enter your daily tax liability on the numbered space that corresponds to the date wages were paid.</p>																																																																																									
<p>Report for this Quarter</p> <p><input type="checkbox"/> 1: January, February, March <input type="checkbox"/> 2: April, May, June <input type="checkbox"/> 3: July, August, September <input type="checkbox"/> 4: October, November, December</p>																																																																																									
<p>Month 1</p> <table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 10%;">1</td><td style="width: 10%;">9</td><td style="width: 10%;">17</td><td style="width: 10%;">25</td><td rowspan="8" style="width: 20%; text-align: center; vertical-align: middle;">Tax liability for Month 1</td> </tr> <tr> <td>2</td><td>10</td><td>18</td><td>26</td> </tr> <tr> <td>3</td><td>11</td><td>19</td><td>27</td> </tr> <tr> <td>4</td><td>12</td><td>20</td><td>28</td> </tr> <tr> <td>5</td><td>13</td><td>21</td><td>29</td> </tr> <tr> <td>6</td><td>14</td><td>22</td><td>30</td> </tr> <tr> <td>7</td><td>15</td><td>23</td><td>31</td> </tr> <tr> <td>8</td><td>16</td><td>24</td><td></td> </tr> </table>																																								1	9	17	25	Tax liability for Month 1	2	10	18	26	3	11	19	27	4	12	20	28	5	13	21	29	6	14	22	30	7	15	23	31	8	16	24																		
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<p>Fill in your total liability for the quarter (Month 1 + Month 2 + Month 3) = Total tax liability for the quarter Total must equal line 10 on Form 941 (or line 8 on Form 941-SS).</p> <table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 30%;"></td> <td style="width: 10%;"></td> <td style="width: 10%;"></td> <td style="width: 10%;"></td> <td style="width: 10%;"></td> <td style="width: 20%; text-align: center;">Total liability for the quarter</td> </tr> </table>																																													Total liability for the quarter																																												
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Rev. Proc. 2005-24

SECTION 1. PURPOSE AND SCOPE

.01 This revenue procedure applies to any charitable remainder annuity trust (CRAT) or charitable remainder unitrust (CRUT) that is created by the grantor, *G*, if, under applicable state law, *G*'s surviving spouse, *S*, has a right of election exercisable on *G*'s death to receive an elective, statutory share of *G*'s estate, and such share could be satisfied in whole or in part from assets of the CRAT or CRUT in violation of § 664(d)(1)(B) or (d)(2)(B) of the Internal Revenue Code. In general, only *inter vivos* CRATs or CRUTs are within the scope of this revenue procedure.

.02 This revenue procedure provides a safe harbor procedure under which the Internal Revenue Service will disregard the right of election for purposes of determining whether the CRAT or CRUT meets the requirements of § 664(d)(1)(B) or (d)(2)(B) continuously since its creation if *S* irrevocably waives the right of election in the manner prescribed in this revenue procedure. For trusts created before June 28, 2005, the Service will disregard the right of election, even without a waiver, but only if *S* does not exercise the right of election.

.03 The safe harbor procedure provided by this revenue procedure is not available to a CRAT or CRUT if *S* exercises the right of election.

SECTION 2. BACKGROUND

.01 In general, a testator is free to dispose of property in accordance with the testator's own wishes. However, in most jurisdictions, state statutes protect *S* from disinheritance. In most common law jurisdictions, these statutes are in the form of elective share provisions, many of which are based on the elective share provisions of the Uniform Probate Code (UPC), §§ 2-201-2-214 (amended 1993). Elective share statutes provide *S* the right to elect to receive a statutory share of *G*'s estate, regardless of whether *G* made any

bequests to *S*. For purposes of this revenue procedure, *S*'s statutory share of *G*'s estate will be referred to as an "elective share" and the right to elect to receive an elective share will be referred to as a "right of election", regardless of what terms different jurisdictions may use to describe these concepts.

.02 In some states, the elective share is based solely on the probate estate but, in others, *G*'s estate is defined more broadly for purposes of computing the elective share and may include assets of the CRAT or CRUT. In states that have adopted the elective share provisions of the UPC, *S* has the right of election to take a percentage (generally determined by the duration of the marriage, but subject to a minimum dollar amount in some cases) of the "augmented estate" provided that certain requirements are met. UPC § 2-202. The augmented estate includes *G*'s net probate estate, as well as certain nonprobate assets of *G*, certain property transferred by *G* to others (including to *S*) during life, and certain other property. UPC §§ 2-202 and 2-207. The assets of the CRAT or CRUT may be included in the augmented estate and, therefore, may be used to determine and satisfy the elective share amount. UPC § 2-209. In some states, the CRAT or CRUT assets may be used to satisfy the elective share only after other property in the augmented estate first has been exhausted.

.03 Sections 664(d)(1)(B) (in the case of a CRAT) and (d)(2)(B) (in the case of a CRUT) provide that no amount other than the annuity payments described in § 664(d)(1)(A) or the unitrust payments described in § 664(d)(2)(A), respectively, (other than qualified gratuitous payments described in §§ 664(d)(1)(C) and (d)(2)(C)) may be paid to or for the use of any person other than an organization described in § 170(c). The requirements of §§ 664(d)(1)(B) and (d)(2)(B) are not satisfied in situations in which *S* may exercise the right of election to receive an elective share and the share could include assets of the CRAT or CRUT, because the mere existence of the right of election under applicable law, whether or not exercised, and the resulting possibility that the CRAT or CRUT may be invaded for the benefit of *S*, causes the trust to fail to qualify under § 664(d).

.04 The Service believes that, in the interest of sound tax administration and to reduce the burden on taxpayers, it is appropriate to provide a safe harbor procedure that, if followed, will cause the right of election to be disregarded for purposes of determining whether a CRAT or CRUT that is within the scope of this revenue procedure meets the requirements of § 664(d) continuously from the date the trust is created. This procedure generally requires that *S* irrevocably waive the right of election with regard to the assets of the CRAT or CRUT to ensure that no part of the trust will be used to satisfy the elective share.

.05 No waiver of the right of election is required if the applicable state law does not provide *S* with a right of election, exercisable at the time of *G*'s death, to receive an elective share of *G*'s estate. For example, in community property jurisdictions, elective share provisions are generally unnecessary because *S* typically has vested ownership in one-half of the community property. Additionally, no waiver is required if, under applicable state law, *S*'s elective share of *G*'s estate may not include any assets of the CRAT or CRUT (other than the annuity or unitrust interest payable to *S* as the named recipient). For example, no waiver is required if, under applicable state law, the trust's property is excluded from the base for computing the elective share by reason of *G*'s receipt of adequate and full consideration for the transfer or the written consent to or joinder in the transfer by *S* and, in fact, the consideration is paid or the consent or joinder is given.

SECTION 3. APPLICATION OF SAFE HARBOR

.01 *In General.* With respect to any CRAT or CRUT within the scope of this revenue procedure, *S*'s right of election to receive an elective share of *G*'s estate, if the share could include any assets of a CRAT or CRUT created or funded by *G*, will be disregarded for purposes of determining whether the CRAT or CRUT has met the requirements of § 664(d)(1)(B) or (d)(2)(B) continuously since its creation if all of the requirements of section 3 of this revenue procedure are satisfied. For CRATs and CRUTs within the scope of this revenue procedure created by *G* on or after June 28, 2005, the failure of *S* to waive the right of election in accordance with

the requirements of this revenue procedure will result in the CRAT or CRUT failing to qualify under § 664(d) continuously since its creation, whether or not *S* exercises the right of election. For CRATs and CRUTs within the scope of this revenue procedure created by *G* before June 28, 2005, the failure of *S* to waive the right of election, combined with *S*'s exercise of that right of election, will result in the CRAT or CRUT failing to qualify under § 664(d) continuously since its creation. Thus, for all CRATs and CRUTs, regardless of when they were created, a waiver under this revenue procedure of *S*'s right of election will provide certainty that the right of election will not cause the trust to fail to qualify under § 664(d) continuously since its creation.

.02 *Waiver Effective Under State Law.* *S* must irrevocably waive the right of election to whatever extent necessary to ensure that no part of the trust (other than the annuity or unitrust interest of which *S* is the named recipient under the terms of the trust) may be used to satisfy the elective share. A valid waiver of the elective share or right of election will satisfy the requirements of the preceding sentence if the waiver is valid under applicable state law, in writing, and signed and dated by *S*. This revenue procedure does not require a waiver of *S*'s right as the named recipient to receive the annuity or unitrust payment from the CRAT or CRUT.

.03 *Timing of Waiver.* For CRATs or CRUTs created by *G* on or after June 28, 2005, section 3.02 of this revenue procedure must be satisfied on or before the date that is 6 months after the due date (excluding extensions of time to file actually granted) of Form 5227, *Split-Interest Trust Information Return*, for the year in which the later of the following occurs:

- (1) the creation of the trust;
- (2) the date of *G*'s marriage to *S*;
- (3) the date *G* first becomes domiciled or resident in a jurisdiction whose law provides a right of election that could be satisfied from assets of the trust; or
- (4) the effective date of applicable state law creating a right of election.

.04 *Trustee To Retain Copy.* A copy of the signed waiver must be provided to the trustee of the CRAT or CRUT. The trustee must retain the copy in the official records of the trust so long as the contents thereof may become material in the administration of any internal revenue law. *See*

§ 1.6001-1(e) of the Income Tax Regulations.

SECTION 4. EXAMPLES

In each of the following examples, *G* created a CRAT that provides an annuity to *G* for *G*'s life. Upon *G*'s death, the remainder of the trust will pass to an organization that meets the requirements of § 170(c). In each example (except *Example 3*), at the time the CRAT is created, applicable state law provides *S* a right of election to receive an elective share of *G*'s estate and the share would include (and could be satisfied from) assets of the trust.

.01 *Example 1.* *G* creates the trust in 2007 while married to *S*. On or before the date that is 6 months after the due date (excluding extensions of time to file actually granted) of the Form 5227 for the trust for calendar year 2007, *S* irrevocably waives *S*'s right of election to receive an elective share with regard to the assets in the trust (but does not waive the right of election with regard to *G*'s probate estate).

.02 *Example 2.* *G* creates the trust in 2006, and is unmarried on the date the trust is created. On May 1, 2007, *G* marries *S*. On or before the date that is 6 months after the due date (excluding extensions of time to file actually granted) of the Form 5227 for the trust for calendar year 2007, *S* irrevocably waives the right of election to receive an elective share with regard to the assets in the trust (but does not waive the right of election with regard to *G*'s probate estate).

.03 *Example 3.* *G* creates the trust in 2008 while married to *S*. Under applicable state law in effect on the date that *G* creates the trust, the elective share does not include the assets in the trust. Effective on March 1, 2009, applicable state law is amended to give *S* the right of election to receive an elective share of the "augmented estate," which, by definition, includes the assets of the trust. On or before the date that is 6 months after the due date (excluding extensions of time to file actually granted) of the Form 5227 for the trust for calendar year 2009, *S* irrevocably waives the right of election to receive an elective share with regard to the assets in the trust (but does not waive the right of election with regard to *G*'s probate estate).

In each of *Examples 1* through *3*, assuming that *S*'s timely waiver of the right

of election is valid under applicable state law and satisfies the other requirements of this revenue procedure, the existence of the right of election will be disregarded for the purpose of determining whether the trust has qualified continuously since its creation as a CRAT under § 664(d)(1)(B). Further, in each of *Examples 1* through *3*, the result would be the same if, instead of executing only a partial waiver, *S* had waived the full right of election with respect to all assets in *G*'s augmented estate.

.04 *Example 4.* *G* creates the trust in 2007 while married to *S*. Under applicable state law in effect on the date that *G* creates the trust, the elective share includes the assets in the trust. Later in the same year, applicable state law is amended to provide that the augmented estate does not include the assets of a CRAT or CRUT and the amendment applies retroactively to include the trust created by *G*. Accordingly, no waiver of the right of election is required with respect to the assets of the trust in order for the trust to continue to qualify as a CRAT.

.05 *Example 5.* The facts are the same as in *Example 2* except that the waiver is contained in, or is signed pursuant to the requirements of, a prenuptial agreement. Unless the agreement as a whole (or only the waiver) is subsequently found to be invalid or unenforceable, the waiver will satisfy the requirements of this revenue procedure.

.06 *Example 6.* The facts are the same as in *Example 1*, except that *S* dies in 2010. In 2012, *G* marries *S2*. *S2* refuses to waive *S2*'s right to receive an elective share with regard to the assets in the trust. The existence of *S*'s right of election will be disregarded for the purpose of determining whether the trust has qualified continuously since its creation up until *G*'s marriage to *S2*, as a CRAT under § 664(d)(1)(B). However, because *S2* did not timely and irrevocably waive *S2*'s right to receive an elective share with regard to the assets in the trust, the trust does not qualify as a CRAT under § 664(d)(1)(B).

If, in these examples, *G* had instead created a CRUT, the results would be the same for purposes of § 664(d)(2)(B).

SECTION 5. EFFECTIVE DATE

This revenue procedure is effective as of March 30, 2005.

SECTION 6. PAPERWORK REDUCTION ACT

The collection of information contained in this revenue procedure has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-1936.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid OMB control number.

The collection of information in this revenue procedure is in section 3. This information is required to be collected and retained in order to ensure that a trust

meets the requirements of § 664(d)(1) or (d)(2). This information will be used to determine whether the eligibility requirements under those statutes for treatment as a CRAT or CRUT have been met. The collection of information is required to obtain a benefit. The likely respondents are individuals.

The estimated total annual reporting burden is 150,000 hours.

The estimated annual burden per respondent varies from 1 hour to 2 hours, depending on individual circumstances, with an estimated average burden of 1½ hours to complete the statements required under this revenue procedure. The estimated number of respondents is 100,000.

The estimated annual frequency of responses is on occasion.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

SECTION 7. DRAFTING INFORMATION

The principal author of this revenue procedure is Susan H. Levy. For further information regarding this revenue procedure, contact Susan H. Levy at (202) 622-3090 (not a toll-free call) or Bradford R. Poston at (202) 622-3060 (neither a toll-free call).

Part IV. Items of General Interest

Notice of Proposed Rulemaking and Notice of Public Hearing

Revisions to Regulations Relating to Withholding of Tax on Certain U.S. Source Income Paid to Foreign Persons and Revisions of Information Reporting Regulations

REG-125443-01

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains amendments to final regulations relating to the withholding of income tax under sections 1441 and 1442 on certain U.S. source income paid to foreign persons and related requirements governing collection, deposit, refunds, and credits of withheld amounts under sections 1461 through 1463. Additionally, this document contains amendments to final regulations under sections 6049 and 6114. These regulations affect persons making payments of U.S. source income to foreign persons.

DATES: Written or electronic comments must be received by June 27, 2005. Requests to speak (with outlines of oral comments to be discussed) at the public hearing scheduled for July 20, 2005, at 10:00AM must be received by June 29, 2005.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-125443-01), room 5203, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions also may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:LPD:PR (REG-125443-01), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC, or sent electronically, via the IRS internet site www.irs.gov/regs or via the Federal eRulemaking Portal site at www.regulations.gov (IRS and

REG-125443-01). The public hearing will be held in the IRS Auditorium, Seventh Floor, Internal Revenue Building, 1111 Constitution Avenue, N.W., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Ethan Atticks, (202) 622-3840 (not a toll-free number); concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Robin Jones, (202) 622-7180 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information contained in this notice of proposed rulemaking have been previously reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) under control number 1545-1484.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number assigned by the Office of Management and Budget.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

In Treasury Decision 8734, 1997-2 C.B. 109 [62 FR 53387], the Treasury Department and the IRS issued comprehensive regulations (final regulations) under chapter 3 (sections 1441-1464) and subpart G of Subchapter A of chapter 61 (sections 6041 through 6050S) of the Internal Revenue Code. Those final regulations were amended by T.D. 8804, 1999-1 C.B. 793 [63 FR 72183], T.D. 8856, 2000-1 C.B. 298 [64 FR 73408], T.D. 8881, 2000-1 C.B. 1158 [65 FR 32152], and T.D. 9023, 2002-2 C.B. 955 [67 FR 70310].

In Notice 2001-4, 2001-1 C.B. 267, Notice 2001-11, 2001-1 C.B. 464, and Notice 2001-43, 2001-2 C.B. 72, the Treasury Department and the IRS announced the intention to amend the final regulations to address the matters discussed in those notices. These proposed regulations would implement certain changes announced in those notices and other changes.

Under section 1441 of the Internal Revenue Code (Code), as amended by the American Jobs Creation Act of 2004 (Public Law 108-357, 118 Stat. 1418), "interest-related dividends" and "short-term capital gain dividends" paid by regulated investment companies are exempt from withholding. These proposed regulations would amend the withholding rules in order to reflect the treatment of these new categories of dividends.

Explanation of Provisions

I. Notice 2001-4

A. TIN requirement for certain foreign grantor trusts

The final regulations provide that a withholding certificate that specifies certain payee information and that meets certain requirements may be used for a variety of purposes, including certifying a payee's status as a foreign person or foreign intermediary. Section 1.1441-1(e)(4)(vii)(G) of the final regulations provides that a taxpayer identification number (TIN) must be stated on a withholding certificate from a person representing to be a foreign grantor trust with 5 or fewer grantors.

After the final regulations took effect, some taxpayers requested documentation and reporting relief for simple and grantor trusts that hold an account with a qualified intermediary (QI). In response to this request, the Treasury Department and the IRS provided in section III.C of Notice 2001-4 that, if a foreign simple or grantor trust provides a QI with a Form W-8IMY, "Certificate of Foreign Intermediary, Foreign Flow-Through Entity, or Certain U.S. Branches for United States Tax Withholding," and the trust has 5 or fewer owners, the IRS will not require the trust to provide the QI with a TIN, notwithstanding

§1.1441-1(e)(4)(vii)(G). Section III.C of Notice 2001-4 was superseded by Rev. Proc. 2003-64, 2003-2 C.B. 306, which provides comprehensive guidance for withholding partnerships and withholding trusts. However, Rev. Proc. 2003-64 does not provide any relief from the TIN requirement of §1.1441-1(e)(4)(vii)(G) in the QI context.

In addition to requesting reinstatement of the previously granted relief from the TIN requirement in the QI context, withholding agents have requested relief from the TIN requirement beyond the QI context. In light of these requests, the Treasury Department and the IRS have reexamined the TIN requirement of §1.1441-1(e)(4)(vii)(G) and have concluded that the rule is not serving to enhance enforcement objectives. Therefore, the proposed regulations would reinstate the relief granted in section III.C of Notice 2001-4 for withholding certificates provided to a QI by a foreign grantor trust with 5 or fewer grantors. In addition, the proposed regulations would grant relief from the TIN requirement for withholding certificates that are executed after December 31, 2003, and that are provided to a withholding agent by a foreign grantor trust with 5 or fewer grantors.

B. Reporting relief for U.S. payors in U.S. possessions

U.S. payors that pay foreign source income outside the United States to U.S. non-exempt recipients generally must report these payments on Form 1099 and, if required, apply backup withholding. After the final regulations became effective, withholding agents requested that the Treasury Department and the IRS reconsider this rule to the extent it requires Form 1099 reporting and backup withholding with respect to income from sources within a possession of the United States paid to a U.S. citizen even if the income is exempt from tax under section 931, 932, or 933.

In response to this request, the Treasury Department and the IRS provided in section V.C of Notice 2001-4 that the final regulations would be amended to provide that income that is derived from sources within a possession of the United States, that is exempt from taxation under section 931, 932, or 933, and that a payor reasonably believes to be paid to a resident of a

possession of the United States is not required to be reported on Form 1099. Section V.C of Notice 2001-4 also provides that U.S. payors will not be required to report such income until the regulations are amended.

These proposed regulations would amend §1.6049-5(c) to implement section V.C. of Notice 2001-4, with modifications. The proposed regulations would provide that U.S. payors are not required to report on Form 1099 income from sources within a possession of the United States that is exempt from tax under section 931, section 932, or section 933. Under the proposed regulations, this exception from Form 1099 reporting would be applicable if the payor could reliably associate the payment of such income with valid documentation that supports a claim that the beneficial owner of the payment is a resident of the U.S. possession.

In addition, the proposed regulations would add new §1.1441-1(c)(30), which for these purposes would define *possessions of the United States* as Guam, American Samoa, the Northern Mariana Islands, Puerto Rico, and the Virgin Islands.

C. Use of documentary evidence in possessions of the United States

The final regulations provide certain exceptions from certain information reporting requirements. One such exception applies in cases in which, among other things, a payment is made outside the United States and the payor can rely on appropriate documentation to treat the payment as made to a foreign person. Section 1.6049-5(c)(1) allows a payor to rely on documentary evidence instead of an applicable withholding certificate described in §1.1441-1(c)(16) (Form W-8) in the case of a payment made to an offshore account. For this purpose, the term *offshore account* means an account maintained at an office or branch of a U.S. or foreign bank at any location outside the United States and outside of possessions of the United States.

When the final regulations took effect, taxpayers requested that the Treasury Department and the IRS consider allowing the use of documentary evidence for an account in a possession of the United States. In response to this request, the Treasury Department and the IRS pro-

vided in section V.D of Notice 2001-4 that documentary evidence may be used in lieu of Form W-8 in a possession of the United States and announced the intention to amend §1.6049-5(c)(1) accordingly.

These proposed regulations would implement Section V.D of Notice 2001-4.

D. Information reporting of foreign source services income

Under section 6041, a U.S. payor must report certain payments made for services performed outside the United States. However, §1.6041-4 provides that information reporting is not required if the payee has provided documentation to establish its status as a foreign beneficial owner or a foreign payee, or if the payee is presumed to be a foreign payee under the presumption rules. Under the presumption rules of §§1.6049-5(d)(2) and 1.1441-1(b)(3)(iii), a U.S. payor must presume that the payee is a U.S. payee if the payee is an individual.

When the final regulations took effect, U.S. payors commented that these rules were overly burdensome because they require U.S. payors making payments for services performed outside the United States to ask all payees to represent that such payees are not U.S. persons.

In response to this comment, the Treasury Department and the IRS provided in section V.E of Notice 2001-4 that a U.S. payor will not be required to report, under section 6041, income paid for services performed outside the United States if (1) the payee of the income is an individual, (2) the U.S. payor does not know that the payee is a U.S. citizen or resident, (3) the payor does not know, and has no reason to know, that the income is (or may be) effectively connected with the conduct of a trade or business within the United States, and (4) all of the services for which payment is made were performed by the payee outside the United States.

The proposed regulations would implement section V.E of Notice 2001-4. The Treasury Department and the IRS are considering whether there are appropriate circumstances, and if so, an appropriate manner, in which such an exception could be extended to payments made to foreign partnerships. Comments are requested on this issue.

*II. Notice 2001–11 —
Reporting/Withholding on Payments
to Financial Institutions in U.S.
Possessions*

Corporations and partnerships organized in a possession of the United States generally are treated as foreign persons for purposes of applying the final regulations. Accordingly, under the final regulations, a possessions financial institution acting as an intermediary is treated as a non-qualified intermediary that must provide documentation and allocation information for the beneficial owners on whose behalf it acts. In contrast, a U.S. branch of a foreign financial institution may agree with a withholding agent to be treated as a U.S. person. See §1.1441–1(b)(2)(iv)(A) and (E). Under §1.1441–1(b)(1), if such a U.S. branch agrees to be treated as a U.S. person, payments of U.S. source income made to it will be treated as made to a U.S. payee and therefore will not be subject to withholding under section 1441. Possessions financial institutions generally are subject to all of the withholding and reporting obligations of a U.S. withholding agent. Section 7651.

When the final regulations took effect, possessions financial institutions commented that the requirement to provide a withholding agent with customer information should not apply to them, because possessions financial institutions are subject to all of the withholding and information reporting requirements that apply to U.S. withholding agents under Chapters 3 and 61 and section 3406 of the Code, and because they are subject to direct audit supervision by the Internal Revenue Service.

In response to these comments, the Treasury Department and the IRS issued Notice 2001–11, which provided that a possessions financial institution will be treated as a U.S. branch that is subject to the rules of §1.1441–1(b)(2)(iv) and announced the intention to amend the final regulations accordingly.

These proposed regulations would implement Notice 2001–11.

III. Notice 2001–43

A. Reporting of treaty-based return positions

Section 301.6114–1(a) of the final regulations provides that, if a taxpayer takes a return position that a tax treaty overrules or modifies any provision of the Internal Revenue Code and thereby effects a reduction of any tax at any time, the taxpayer must disclose that return position, either on a statement attached to the return or on a return filed for the purpose of making such disclosure. Section 301.6114–1(b) provides that reporting is required unless it is expressly waived. It further provides a nonexclusive list of particular positions for which reporting is required. Section 301.6114–1(c) provides a list of specific exceptions from the general reporting requirements of §301.6114–1(a) and (b).

When the final regulations took effect, taxpayers requested guidance regarding the scope of the reporting required under §301.6114–1(a) and (b) in the case of claims for treaty-reduced withholding made by foreign persons that are not individuals or States. In particular, taxpayers requested the following clarification and relief.

First, because §301.6114–1(c)(1)(i) waives reporting only for individuals and States, clarification was requested regarding whether taxpayers that are not individuals or States and that do not meet the requirements to report under §301.6114–1(b)(4)(ii)(C) are nevertheless required to disclose treaty-based return positions described in subparagraph (b)(4)(ii) under the general rules of §301.6114–1(a) and (b).

Second, because §301.6114–1(c)(2) waives reporting only for individuals who receive less than the threshold amount, a *de minimis* exception was requested for taxpayers that are not individuals.

Third, because the representation under §1.1441–6(b)(1) (that the beneficial owner will file the statement required under §301.6114–1(d)) is required when the beneficial owner is related to the withholding agent within the meaning of section 482, and because the filing under §301.6114–1(b)(4)(ii)(C) is required when the beneficial owner is related to the person obligated to pay the income within the meaning of sections 267(b) and 707(b),

clarification was requested regarding coordination of the representation requirement with the filing requirement.

Finally, because §1.1441–6(b)(1) states that the filing requirement applies only to amounts received during the calendar year that exceed \$500,000 in the aggregate, and because §301.6114–1(a)(1) permits a taxpayer to adopt a taxable year for filing different from the calendar year, taxpayers requested clarification regarding a fiscal-year taxpayer's obligation to report such amounts.

In response to these and other comments, Treasury and the IRS issued Notice 2001–43. Section 2 of Notice 2001–43 provided that the following rules would apply, effective January 1, 2001.

First, reporting is waived for a treaty-based return position described in §301.6114–1(b)(4)(ii), unless the conditions in paragraph (b)(4)(ii)(A) and (B) of this section, paragraph (b)(4)(ii)(C) of this section, or paragraph (b)(4)(ii)(D) of this section are met.

Second, reporting under §301.6114–1(b)(4)(ii)(D) is waived for taxpayers that are not individuals or States and that receive amounts of income subject to withholding that do not exceed \$10,000 in the aggregate.

Third, the related-person test for purposes of applying the representation requirement of §1.1441–6(b)(i) was conformed to the related-person test that applies for purposes of the filing requirement of §301.6114–1(b)(4)(ii)(C).

Fourth, the calendar-year rule in §1.1441–6(b)(1) was replaced with a taxable-year rule to conform to §301.6114–1(a)(1).

These proposed regulations would implement Section 2 of Notice 2001–43.

B. Conversion of foreign currency amounts

Section 1.1441–3(e)(2) of the final regulations provides that if an amount subject to tax is paid in a currency other than the U.S. dollar, the amount of withholding under section 1441 shall be determined by applying the applicable rate of withholding to the foreign currency amount and by converting the amount withheld into U.S. dollars at the spot rate on the date of payment. A withholding agent that makes regular or frequent payments in foreign cur-

rency is permitted to use a month end spot rate or a monthly average spot rate.

After the final regulations took effect, some withholding agents that make regular and frequent payments in foreign currency commented that the permitted conversion conventions can expose them to currency risks that would require management by means of hedging transactions. Also, they commented that permitted conventions can require multiple accounting adjustments when payment amounts in the base currency are adjusted or corrected in the course of processing and settlement. They requested that they be permitted to use the spot rate on the date the amount of tax is deposited.

In response to this comment, in Section 3 of Notice 2001-43, the Treasury Department and the IRS provided that a withholding agent that makes regular or frequent payments in foreign currency is permitted to convert the amount withheld into U.S. dollars at the spot rate on the day the tax is deposited, provided that the deposit is made within seven days of the date of payment. Section 3 of Notice 2001-43 also provided that taxpayers using this alternative convention must do so consistently for all nondollar amounts withheld and from year to year. It also provided that such convention could not be changed without the consent of the Commissioner.

These proposed regulations would implement Section 3 of Notice 2001-43.

IV. The American Jobs Creation Act of 2004

The final regulations provide generally that if the amount of distributions designated by a regulated investment company as being subject to 852(b)(3)(C) (relating to capital-gain dividends) or 852(b)(5)(A) (relating to exempt-interest dividends) exceeds the amount that may be designated under those sections for the taxable year, then no penalties will be asserted for any resulting underwithholding if the designations were based on a reasonable estimate, as defined in regulations, and the adjustments to amount withheld are made in accordance with regulations. §1.1441-3(c)(3)(i). These proposed regulations would extend the reasonable-estimate rule to cover distributions designated as being subject to new section 871(k)(1)(C) (relating to in-

terest-related dividends) or 871(k)(2)(C) (relating to short-term capital gain dividends).

Proposed Effective Date

These regulations are proposed to be applicable when final regulations are published in the **Federal Register**.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and, because the regulations do not impose a new collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) that are submitted timely (in the manner described in the "ADDRESSES" portion of this preamble) to the IRS. The Treasury Department and the IRS request comments on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for July 20, 2005, beginning at 10:00 a.m. in the IRS Auditorium (7th Floor), Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Due to building security procedures, visitors must enter at the 10th Street entrance, located between Constitution and Pennsylvania Avenues, NW. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For information about

having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" portion of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments must submit written comments and an outline of the topics to be discussed and the time to be devoted to each topic (a signed original and eight (8) copies) by Wednesday, June 29. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for reviewing outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of the proposed regulations is Ethan Atticks, Office of Associate Chief Counsel (International). However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Proposed Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 301 are proposed to be amended as follows:

PART 1 — INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:
Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.1441-1 is amended as follows:

1. Paragraph (b)(2)(iv)(A) is revised.
2. Paragraph (b)(3)(iii)(E) is added.
3. Paragraph (c)(30) is added.
4. Paragraph (e)(4)(vii)(G) is revised.

The revisions and additions read as follows:

§1.1441-1 Requirement for the deduction and withholding of tax on payments to foreign persons.

* * * * *

(b) * * *

(2) * * *

(iv) *Payments to a U.S. branch of certain foreign banks or foreign insurance companies — (A) U.S. branch treated*

as a U.S. person in certain cases. A payment to a U.S. branch of a foreign person is a payment to a foreign person. However, a U.S. branch described in this paragraph (b)(2)(iv)(A) and a withholding agent (including another U.S. branch described in this paragraph (b)(2)(iv)(A)) may agree to treat the branch as a U.S. person for purposes of withholding on specified payments to the U.S. branch. Notwithstanding the preceding sentence, a withholding agent making a payment to a U.S. branch treated as a U.S. person under this paragraph (b)(2)(iv)(A) shall not treat the branch as a U.S. person for purposes of reporting the payment made to the branch. Therefore, a payment to such U.S. branch shall be reported on Form 1042-S under §1.1461-1(c). Further, a U.S. branch that is treated as a U.S. person under this paragraph (b)(2)(iv)(A) shall not be treated as a U.S. person for purposes of the withholding certificate it may provide to a withholding agent. Therefore, the U.S. branch must furnish a U.S. branch withholding certificate on Form W-8 as provided in paragraph (e)(3)(v) of this section and not a Form W-9. An agreement to treat a U.S. branch as a U.S. person must be evidenced by a U.S. branch withholding certificate described in paragraph (e)(3)(v) of this section furnished by the U.S. branch to the withholding agent. A U.S. branch described in this paragraph (b)(2)(iv)(A) is any U.S. branch of a foreign bank subject to regulatory supervision by the Federal Reserve Board or a U.S. branch of a foreign insurance company required to file an annual statement on a form approved by the National Association of Insurance Commissioners with the Insurance Department of a State, a Territory, or the District of Columbia. In addition, a financial institution organized in a possession of the United States will be treated as a U.S. branch for purposes of this paragraph (b)(2)(iv)(A). The Internal Revenue Service (IRS) may approve a list of U.S. branches that may qualify for treatment as a U.S. person under this paragraph (b)(2)(iv)(A) (see §601.601(d)(2) of this chapter). See §1.6049-5(c)(5)(vi) for the treatment of U.S. branches as U.S. payors if they make a payment that is subject to reporting under chapter 61 of the Internal Revenue Code. Also see §1.6049-5(d)(1)(ii) for the treatment of

U.S. branches as foreign payees under chapter 61 of the Internal Revenue Code.

* * * * *

- (3) * * *
- (iii) * * *

(E) *Certain payments for services.* A payment for services is presumed to be made to a foreign person if —

- (1) The payee is an individual;
- (2) The withholding agent does not know, or have reason to know, that the payee is a U.S. citizen or resident;
- (3) The withholding agent does not know, or have reason to know, that the income is (or may be) effectively connected with the conduct of a trade or business within the United States; and
- (4) All of the services for which the payment is made were performed by the payee outside of the United States.

* * * * *

- (c) * * *

(30) *Possessions of the United States.* For purposes of the regulations under chapter 3 and 61 of the Internal Revenue Code, *possessions of the United States* means Guam, American Samoa, the Northern Mariana Islands, Puerto Rico, and the Virgin Islands.

* * * * *

- (e) * * *
- (4) * * *
- (vii) * * *

(G) A withholding certificate executed on or before December 31, 2003, from a person representing to be a grantor trust with 5 or fewer grantors, except where such withholding certificate is provided to a qualified intermediary.

* * * * *

Par. 3. Section 1.1441-3 is amended by revising paragraphs (c)(3) and (e)(2) to read as follows:

§1.1441-3 Determination of amounts to be withheld.

* * * * *

- (c) * * *

(3) *Special rules in the case of distributions from a regulated investment company* — (i) *General rule.* If the amount of any distributions designated as being subject to section 852(b)(3)(C) or 5(A), or 871(k)(1)(C) or (2)(C), exceeds the amount that may be designated

under those sections for the taxable year, then no penalties will be asserted for any resulting underwithholding if the designations were based on a reasonable estimate (made pursuant to the same procedures as described in paragraph (c)(2)(ii)(A) of this section) and the adjustments to the amount withheld are made within the time period described in paragraph (c)(2)(ii)(B) of this section. Any adjustment to the amount of tax due and paid to the IRS by the withholding agent as a result of underwithholding shall not be treated as a distribution for purposes of section 562(c) and the regulations thereunder. Any amount of U.S. tax that a foreign shareholder is treated as having paid on the undistributed capital gain of a regulated investment company under section 852(b)(3)(D) may be claimed by the foreign shareholder as a credit or refund under §1.1464-1.

(ii) *Reliance by intermediary on reasonable estimate.* For purposes of determining whether a payment is a distribution designated as subject to section 852(b)(3)(C) or (5)(A), or 871(k)(1)(C) or (2)(C), a withholding agent that is not the distributing regulated investment company may, absent actual knowledge or reason to know otherwise, rely on the designations that the distributing company represents have been made in accordance with paragraph (c)(3)(i) of this section. Failure by the withholding agent to withhold the required amount due to a failure by the regulated investment company to reasonably estimate the required amounts or to properly communicate the relevant information to the withholding agent shall be imputed to the distributing company. In such a case, the IRS may collect from the distributing company any underwithheld amount and subject the company to applicable interest and penalties as a withholding agent.

* * * * *

- (e) * * *

(2) *Payments in foreign currency.* If the amount subject to withholding tax is paid in a currency other than the U.S. dollar, the amount of withholding under section 1441 shall be determined by applying the applicable rate of withholding to the foreign currency amount and converting the amount withheld into U.S. dollars on the date of payment at the spot rate (as defined in §1.988-1(d)(1)) in effect on that date. A

withholding agent making regular or frequent payments in foreign currency may use a month-end spot rate or a monthly average spot rate. In addition, such a withholding agent may use the spot rate on the date the amount of tax is deposited (within the meaning of §1.6302-2(a)), provided that such deposit is made within seven days of the date of the payment giving rise to the obligation to withhold. A spot rate convention must be used consistently for all non-dollar amounts withheld and from year to year. Such convention cannot be changed without the consent of the Commissioner. The U.S. dollar amount so determined shall be treated by the beneficial owner as the amount of tax paid on the income for purposes of determining the final U.S. tax liability and, if applicable, claiming a refund or credit of tax.

Par. 4. In §1.1441-6, paragraph (b)(1) is revised to read as follows:

§1.1441-6 Claim of reduced withholding under an income tax treaty.

(b) *Reliance on claim of reduced withholding under an income tax treaty* — (1) *In general.* The withholding imposed under section 1441, 1442, or 1443 on any payment to a foreign person is eligible for reduction under the terms of an income tax treaty only to the extent that such payment is treated as derived by a resident of an applicable treaty jurisdiction, such resident is a beneficial owner, and all other requirements for benefits under the treaty are satisfied. See section 894 and the regulations thereunder to determine whether a resident of a treaty country derives the income. Absent actual knowledge or reason to know otherwise, a withholding agent may rely on a claim that a beneficial owner is entitled to a reduced rate of withholding based upon an income tax treaty if, prior to the payment, the withholding agent can reliably associate the payment with a beneficial owner withholding certificate, as described in §1.1441-1(e)(2), that contains the information necessary to support the claim, or, in the case of a payment of income described in paragraph (c)(2) of this section made outside the United States with respect to an offshore account, documentary evidence described in paragraphs (c)(3), (4), and (5)

of this section. See §1.6049-5(e) for the definition of payments made outside the United States and §1.6049-5(c)(1) for the definition of offshore account. For purposes of this paragraph (b)(1), a beneficial owner withholding certificate described in §1.1441-1(e)(2)(i) contains information necessary to support the claim for a treaty benefit only if it includes the beneficial owner's taxpayer identifying number (except as otherwise provided in paragraph (c)(1) of this section and §1.1441-6(g)) and the representations that the beneficial owner derives the income under section 894 and the regulations thereunder, if required, and meets the limitation on benefits provisions of the treaty, if any. The withholding certificate must also contain any other representations required by this section and any other information, certifications, or statements as may be required by the form or accompanying instructions in addition to, or in place of, the information and certifications described in this section. Absent actual knowledge or reason to know that the claims are incorrect (and subject to the standards of knowledge in §1.1441-7(b)), a withholding agent may rely on the claims made on a withholding certificate or on documentary evidence. A withholding agent may also rely on the information contained in a withholding statement provided under §§1.1441-1(e)(3)(iv) and 1.1441-5(c)(3)(iv) and (e)(5)(iv) to determine whether the appropriate statements regarding section 894 and limitation on benefits have been provided in connection with documentary evidence. If the beneficial owner is related to the person obligated to pay the income, within the meaning of section 267(b) or 707(b), the withholding certificate must also contain a representation that the beneficial owner will file the statement required under §301.6114-1(d) of this chapter (if applicable). The requirement to file an information statement under section 6114 for income subject to withholding applies only to amounts received during the taxpayer's taxable year that, in the aggregate, exceed \$500,000. See §301.6114-1(d) of this chapter. The Internal Revenue Service (IRS) may apply the provisions of §1.1441-1(e)(1)(ii)(B) to notify the withholding agent that the certificate cannot be relied upon to grant benefits under an income tax treaty. See §1.1441-1(e)(4)(viii)

regarding reliance on a withholding certificate by a withholding agent. The provisions of §1.1441-1(b)(3)(iv) dealing with a 90-day grace period shall apply for purposes of this section.

Par. 5. Section 1.6049-5 is amended as follows:

1. Paragraph (c)(1) is revised.
2. Paragraphs (c)(5)(i), (ii), (iii), (iv), (v) and (vi) are redesignated as paragraphs (c)(5)(i)(A), (B), (C), (D), (E), and (F), respectively.
3. A new heading is added to paragraph (c)(5)(i).
4. New paragraph (c)(5)(ii) is added.

The revisions and additions read as follows:

§1.6049-5 Interest and original issue discount subject to reporting after December 31, 1982.

(c) *Applicable rules* — (1) *Documentary evidence for offshore accounts and for possessions accounts.* A payor may rely on documentary evidence described in this paragraph (c)(1) instead of a beneficial owner withholding certificate described in §1.1441-1(e)(2)(i) in the case of a payment made outside the United States to an offshore account, in the case of a payment made to a U.S. possessions account or, in the case of broker proceeds described in §1.6045-1(c)(2), in the case of a sale effected outside the United States (as defined in §1.6045-1(g)(3)(iii)(A)). For purposes of this paragraph (c)(1), an *offshore account* means an account maintained at an office or branch of a U.S. or foreign bank or other financial institution at any location outside the United States (*i.e.*, other than in any of the fifty States or the District of Columbia) and outside of possessions of the United States. Thus, for example, an account maintained in a foreign country at a branch of a U.S. bank or of a foreign subsidiary of a U.S. bank is an offshore account. For purposes of this paragraph (c)(1), a *U.S. possessions account* means an account maintained at an office or branch of a U.S. or foreign bank or other financial institution located within a possession of the United States. For the definition of a payment made outside the United States, see paragraph (e) of this section. A payor may

rely on documentary evidence if the payor has established procedures to obtain, review, and maintain documentary evidence sufficient to establish the identity of the payee and the status of that person as a foreign person (including, but not limited to, documentary evidence described in §1.1441-6(c)(3) or (4)); and the payor obtains, reviews, and maintains such documentary evidence in accordance with those procedures. A payor maintains the documents reviewed by retaining the original, certified copy, or a photocopy (or microfiche or similar means of record retention) of the documents reviewed and noting in its records the date on which and by whom the document was received and reviewed. Documentary evidence furnished for the payment of an amount subject to withholding under chapter 3 of the Code must contain all of the information that is necessary to complete a Form 1042-S for that payment. A payor may also rely on documentary evidence associated with a flow-through withholding certificate for payments treated as made to foreign partners of a nonwithholding foreign partnership, as defined in §1.1441-1(c)(28), the foreign beneficiaries of a foreign simple trust, as defined in §1.1441-1(c)(24), or foreign owners of a foreign grantor trust, as defined in §1.1441-1(c)(26), even though the partnership or trust account is maintained in the United States.

(5) *** (i) *Definition.* ***

(ii) *Reporting by U.S. payors in U.S. possessions.* U.S. payors are not required to report on Form 1099 income that is from sources within a possession of the United States and that is exempt from taxation under section 931, 932, or 933, each of which sections exempts certain income from sources within a possession of the United States paid to a *bona fide* resident of that possession. For purposes of this paragraph (c)(5)(ii), a U.S. payor may treat the beneficial owner as a *bona fide* resident of the possession of the United States from which the income is sourced if, prior to payment of the income, the U.S. payor can reliably associate the payment with valid documentation that supports the claim of residence in the possession of the United States from which the income is sourced. This paragraph (c)(5)(ii) shall not apply if the U.S. payor has actual knowledge or reason to know that the documentation is unreliable or incorrect or that the income does not satisfy the requirements for exemption under section 931, 932, or 933. For the rules determining whether income is from sources within a possession of the United States, see section 937(b) and the regulations thereunder.

PART 301 — PROCEDURE AND ADMINISTRATION

Par. 6. The authority citation for part 301 continues to read, in part, as follows:

Authority: 26 U.S.C. 7805 ***

Par. 7. In §301.6114-1 is amended as follows:

1. Paragraphs (c)(1)(i) through (c)(1)(vii) are redesignated as paragraphs (c)(1)(ii) through (c)(1)(viii), respectively.
2. New paragraph (c)(1)(i) is added.
3. Paragraph (c)(7) is added.

The additions and revision read as follows:

§301.6114-1 *Treaty-based return positions.*

(c) *** (1) ***

(i) For amounts received on or after January 1, 2001, return positions described in paragraph (b)(4)(ii) of this section, unless the conditions in paragraphs (b)(4)(ii)(A) and (B) of this section, paragraph (b)(4)(ii)(C) of this section, or paragraph (b)(4)(ii)(D) of this section are met;

(7) Reporting under paragraph (b)(4)(ii)(D) of this section is waived with respect to a taxable year for taxpayers that are not individuals or states and that, on or after January 1, 2001, receive amounts of income subject to withholding that do not exceed \$10,000 in the aggregate for such taxable year.

Mark E. Matthews,
Deputy Commissioner for
Services and Enforcement.

(Filed by the Office of the Federal Register on March 29, 2005, 8:45 a.m., and published in the issue of the Federal Register for March 30, 2005, 70 F.R. 16189)

Announcement and Report Concerning Advance Pricing Agreements

Announcement 2005-27

March 31, 2005

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 calendar years 2000, 2001, 2002, and 2003. This sixth report describes the experience, structure and activities of the APA Program during calendar year 2004. It does not provide guidance regarding the application of the arm's length standard.

Matthew W. Frank
Director, Advance Pricing Agreement Program

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 ADMINISTRATORS (1995). Transfer pricing issues by their nature are highly factual and have traditionally been one of the largest issues identified by the IRS in its audits of multinational corporations. The APA Program is designed to resolve actual or potential transfer pricing disputes in a principled, cooperative manner, as an alternative to the traditional examination process. An APA is a binding contract between the IRS and a taxpayer by which the IRS agrees not to seek a transfer pricing adjustment under IRC § 482 for a Covered Transaction if the taxpayer files its tax return for a covered year consistent with the agreed transfer pricing method (TPM). In 2004, the IRS and taxpayers executed 65 APAs and amended 4 APAs.

Since 1991, with the issuance of Rev. Proc. 91-22, 1991-1 C.B. 526, the IRS has offered taxpayers, through the APA Program, the opportunity to reach an agreement in advance of filing a tax return on the appropriate TPM to be applied to related party transactions. In 1996, the IRS issued internal procedures for processing APA requests. Chief Counsel Directives Manual (CCDM), ¶¶ 42.10.10 – 42.10.16 (November 15, 1996). Also in 1996, the IRS updated Rev. Proc. 91-22 with the release of Rev. Proc. 96-53, 1996-2 C.B. 375. In 1998, the IRS published Notice 98-65, 1998-2 C.B. 803, which set forth streamlined APA procedures for Small Business Taxpayers.

On July 1, 2004, the IRS updated the procedural rules for obtaining, processing, and administering APAs with the issuance of Rev. Proc. 2004-40, 2004-29 I.R.B. 50 (July 19, 2004). Rev. Proc. 2004-40 supersedes Rev. Proc. 96-53 and Notice 98-65 and is effective for all APA requests (including requests for renewals) filed on or after August 19, 2004. Rev. Proc. 96-53 continues to apply to APA requests filed before August 19, 2004, although a taxpayer with an APA request pending on that date may ask to apply Rev. Proc. 2004-40 to the pending APA.

Also in 2004, the APA Program published IRS Announcement 2004-98, 2004-50 I.R.B. 983 (December 13, 2004), announcing its intention to hold public hearings in early 2005 requesting comments on the state of, and ideas for improving, the APA Program.

Advance Pricing Agreements

An APA generally combines an agreement between a taxpayer and the IRS on an appropriate TPM for the transactions at issue (Covered Transactions) with an agreement between the U.S. and one or more foreign tax authorities (under the authority of the mutual agreement process of our income tax treaties) that the TPM is correct. With such a "bilateral" APA, the taxpayer ordinarily is assured that the income associated with the Covered Transactions will not be subject to double taxation by the IRS and the foreign tax authority. It is the policy of the United States, as reflected in §§ 2.08 and 6 of Rev. Proc. 2004-40, 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 foreign tax administrations from taking different positions on the appropriate TPM for a transaction. As stated in § 6.07 of Rev. Proc. 2004-40, should a transaction covered by a unilateral APA be subject to double taxation as the result of an adjustment by a foreign tax administration, the taxpayer may seek relief by requesting that the U.S. Competent Authority consider initiating a mutual agreement proceeding, provided there is an applicable income tax treaty in force with the other country.

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

The APA Program

An IRS team headed by an APA team leader is responsible for the consideration of each APA. As of December 31, 2004, the APA program had 17 team leaders. The team leader is responsible for organizing the IRS APA team. The IRS APA team leader arranges meetings with the taxpayer, secures whatever information is necessary from the taxpayer to analyze the taxpayer's related party transactions and the available facts under the arm's length standard of IRC § 482 and the regulations thereunder (Treas. Reg.), and leads the discussions with the taxpayer.

The APA team generally includes an economist, an international examiner, LMSB field counsel, and, in a bilateral case, a U.S. Competent Authority analyst who leads the discussions with the treaty partner. The economist may be from the APA Program or the IRS field organization. As of December 31, 2004, the APA Program had five economists. The APA team may also include an LMSB International Technical Advisor, other LMSB exam personnel, and an Appeals Officer.

The APA Process

The APA process is voluntary. Taxpayers submit an application for an APA, together with a user fee as set forth in Rev. Proc. 2004-40, § 4.12. The APA process can be broken into five phases: (1) application; (2) due diligence; (3) analysis; (4) discussion and agreement; and (5) drafting, review, and execution.

(1) Application

In many APA cases, the taxpayer's application is preceded by a pre-file conference with the APA staff in which the taxpayer can solicit the informal views of the APA Program. Pre-file conferences can occur on an anonymous basis, although a taxpayer must disclose its identity when it applies for an APA. Taxpayers must file the appropriate user fee on or before the due date of the tax return for the first taxable year that the taxpayer proposes to be covered by the APA. Many taxpayers file a user fee first and then follow up with a full application later. The procedures for pre-file conferences, user fees, and applications can be found in § 3 of Rev. Proc. 2004-40.

The APA application can be a relatively modest document for small businesses. Section 8 of Rev. Proc. 2004-40 describes the special APA procedures for Small Business Taxpayers. For most taxpayers, however, the APA application is a substantial document filling several binders. The APA Program makes every effort to reach an agreement on the basis of the information provided in the taxpayer's application.

The application is assigned to an APA team leader who is responsible for the case. The APA team leader's first responsibility is to organize the APA team. This involves contacting the appropriate LMSB International Territory Manager to secure the assignment of an international examiner to the APA case and the LMSB Counsel's office to secure a field counsel lawyer. In a bilateral case, the U.S. Competent Authority will assign a U.S. Competent Authority analyst to the team. In a large APA case, the international examiner may invite his or her manager and other LMSB personnel familiar with the taxpayer to join the team. When the APA may affect taxable years in Appeals, the appropriate appellate conferee will be invited to join the team. In all cases, the APA team leader contacts the Manager, LMSB International Technical Advisors, to determine whether to include a technical advisor on the team. The IRS APA team will generally include a technical advisor if the APA request concerns cost-sharing, intangibles, or services. The APA team leader then distributes copies of the APA application to all team members and sets up an opening conference with the taxpayer. The APA office strives to hold this opening conference within 45 days of the assignment of the case to a team leader. At the opening conference, the APA team leader proposes a case plan designed, if feasible, to complete a unilateral APA or, in the case of a bilateral APA, the recommended U.S. negotiating position within 12 months from the date the full application is filed. The actual median and average times for completing unilateral APAs, recommended negotiating positions for bilateral APAs, and APAs for Small Business Taxpayers are shown below in Tables 2, 5, and 10, respectively.

(2) Due Diligence

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

(3) Analysis

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

(4) Discussion and Agreement

The discussion and agreement phase differs for bilateral and unilateral cases. In a bilateral case, the discussions proceed in two parts and involve two IRS offices — the APA Program and the U.S. Competent Authority. In the first part, the APA team will attempt to reach a consensus with the taxpayer regarding the recommended position that the U.S. Competent Authority should take in negotiations with its treaty partner. This recommended U.S. negotiating position is a paper drafted by the APA team leader and signed by the APA Director that provides the APA Program's view of the best TPM for the Covered Transaction, taking into account IRC § 482 and the regulations thereunder, the relevant tax treaty, and the U.S. Competent Authority's experience with the treaty partner.

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

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

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

(5) Drafting, Review, and Execution

Once the IRS and the taxpayer reach agreement, the drafting of the final APA generally takes little time because the APA Program has developed standard language that is incorporated into every APA. The current versions of this language are found in Attachment A, with "Model 1" based on Rev. Proc. 96-53 and "Model 2" based on Rev. Proc. 2004-40. APAs are reviewed by the Branch Chief and the APA Director. In addition, the team leader prepares a summary memorandum for the Associate Chief Counsel (International) (ACC(I)). On March 1, 2001, the ACC(I) delegated to the APA Director the authority to execute APAs on behalf of the IRS. See Chief Counsel Notice CC-2001-016. The APA is executed for the taxpayer by an appropriate corporate officer.

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

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

The Current APA Office Structure, Composition, and Operation

In 2004, the APA office consisted of four branches with Branches 1 and 3 staffed with APA team leaders and Branch 2 staffed with economists and a paralegal. Branch 4, the APA West Coast branch, is headquartered in Laguna Niguel, California, with an additional office in San Francisco, and is presently staffed with both team leaders and an economist.

Overall, the APA staff declined in 2004 from 36 to 32. The number of APA team leaders fell from 18 to 17, the number of APA economists fell from seven to five, and a temporary vacancy reduced the number of APA branch chiefs from four to three.

As of December 31, 2004, the APA staff was as follows:

<i>Director's Office</i> 1 Director 1 Special Counsel to the Director 1 Secretary to the Director			
<i>Branch 1</i> 1 Branch Chief 1 Secretary 7 Team Leaders	<i>Branch 2</i> 1 Acting Branch Chief (also Special Counsel) 1 Paralegal 4 Economists	<i>Branch 3</i> 1 Branch Chief 1 Secretary 7 Team Leaders	<i>Branch 4</i> 1 Branch Chief 1 Secretary 3 Team Leaders 1 Economist

APA Training

In 2004, the APA office continued to emphasize training as a priority. Training sessions addressed APA-related current developments, new APA office practices and procedures, and international tax law issues. The APA New Hire Training materials were updated, as necessary, throughout the year. The updated materials are available to the public through the APA internet site at <http://www.irs.gov/businesses/corporations/article/0,,id=96221,00.html>. These materials do not constitute guidance on the application of the arm's length standard.

APA Program Statistical Data

[§ 521(b)(2)(C) and (E)]

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

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

	Unilateral	Bilateral	Multilateral	Year Total	Cumulative Total
APA applications filed during year 2004	35	45		80	846
APAs executed ¹					
Year 2004	27	37	1	65	557
1991–2003	227	258	7	492	
APA renewals executed during year 2004	8	13		21	129
Revised or Amended APAs executed during year 2004	4	0		4	29
Pending requests for APAs	63	163		226	
Pending requests for new APAs	40	112		152	
Pending requests for renewal APAs	23	51		74	
APAs canceled or revoked	0	0		0	5
APAs withdrawn	5	6		11	94

¹ Consistent with past practice, the "APAs executed" figures in this table include APA renewals, but exclude revised or amended APAs.

TABLE 2: MONTHS TO COMPLETE APAs²

Months to Complete Advance Pricing Agreements in Year 2004					
All New		All Renewals		All Combined	
Average	44.1	Average	30.1	Average	39.9
Median	36.4	Median	33.9	Median	33.9
Unilateral New		Unilateral Renewals		Unilateral Combined	
Average	25.7	Average	13.3	Average	22.3
Median	21.0	Median	12.1	Median	18.4
Bilateral/Multilateral New		Bilateral/Multilateral Renewals		Bilateral/Multilateral Combined	
Average	56.4	Average	40.4	Average	51.2
Median	48.0	Median	35.0	Median	43.0

² The one multilateral APA was treated as a bilateral APA for purposes of these calculations.

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		31	1	61		91	
2		32	1	62	1	92	
3		33		63		93	
4		34	4	64		94	
5		35	2	65		95	
6	1	36	1	66	1	96	1
7		37	3	67	1	97	
8	1	38		68		98	
9		39	1	69		99	
10	1	40		70	1	100	1
11	1	41		71		101	
12	2	42	2	72		102	
13	1	43		73		103	
14	3	44	1	74	1	104	
15	2	45		75		105	
16	1	46	2	76		106	
17	1	47		77		107	
18	1	48	2	78		108	
19		49	1	79	1	109	
20	3	50		80		110	
21	2	51		81	1	111	
22	1	52	1	82		112	
23	1	53		83	1	113	1
24		54		84		114	
25		55		85		115	
26	2	56		86		116	
27	1	57	2	87		117	
28		58		88		118	
29	1	59		89		119	1
30	2	60		90	1	120	

TABLE 4: RECOMMENDED NEGOTIATING POSITIONS

Recommended Negotiating Positions Completed in Year 2004	25
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TABLE 5: MONTHS TO COMPLETE RECOMMENDED NEGOTIATING POSITIONS

New		Renewal		Combined	
Average	18.20	Average	14.71	Average	16.80
Median	16.60	Median	15.31	Median	15.90

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

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

Tables 7 and 8 below are new from previous annual reports and show how long each APA request pending at the end of 2004 has been in the system as measured from the filing date of the APA submission. We believe that reporting the age of both completed cases and pending cases reflects more accurately the APA Program's success or failure in moving cases and improves the public's ability to evaluate the current timeliness of the APA process. (The numbers in Tables 7 and 8 for pending unilateral and bilateral cases differ from the numbers in Table 1 because whereas Table 1 includes any case for which a user fee has been paid, Tables 7 and 8 reflect only cases for which submissions have been received.)

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

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

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

TABLE 9: SMALL BUSINESS TAXPAYER APAs

Small Business Taxpayer APAs Completed in Year 2004	9
New	9
Renewals	0
Unilateral	7
Bilateral	2

TABLE 10: MONTHS TO COMPLETE SMALL BUSINESS TAXPAYER APAs

Months to Complete Small Business Taxpayer APAs in Year 2004	
Average	18.8
Median	19.7

TABLE 11: INDUSTRIES COVERED³

Industry Involved – NAICS Codes	Number
Computer and electronic product manufacturing – 334	10–12
Wholesale trade, durable goods – 421	7–9
Securities, commodity contracts and other intermediary and related activities – 523	7–9
Machinery manufacturing – 333	4–6
Transportation equipment manufacturing – 336	4–6
Electronic equipment, appliance and component manufacturing – 335	1–3
Wholesale trade, nondurable goods – 422	1–3
Chemical manufacturing – 325	1–3
Broadcasting and telecommunications – 513	1–3
Information service and data processing services – 514	1–3
Motor vehicle and parts dealers – 441	1–3
Food manufacturing – 311	1–3
Apparel manufacturing – 315	1–3
Plastics and rubber products manufacturing – 326	1–3
Miscellaneous manufacturing – 339	1–3
Air transportation – 481	1–3
Heavy construction – 234	1–3
Mining (except oil and gas) – 211	1–3
Beverage and tobacco manufacturing – 312	1–3
Health and personal care stores – 446	1–3
Clothing and clothing accessories stores – 448	1–3
Insurance carriers and related activities – 524	1–3
Professional, scientific and technical services – 545	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 2004 is set forth in Table 12 below:

³ The categories in this table are drawn from the North American Industry Classification System (NAICS), which has replaced the U.S. Standard Industrial Classification (SIC) system. NAICS was developed jointly by the U.S., Canada, and Mexico to provide new comparability in statistics about business activity across North America.

TABLE 12: NATURE OF RELATIONSHIPS BETWEEN RELATED ENTITIES

Relationship	Number of APAs
Foreign Parent – U.S. Subsidiary (-ies)	40
U.S. Parent – Foreign Subsidiary (-ies)	15
Foreign Company and U.S. Branch(es)	6
Partnership and Related Entity (-ies)	4

Covered Transactions

[§ 521(b)(2)(D)(ii)]

The controlled transactions covered by APAs executed in 2004 are set forth in Table 13 and Table 14 below:

TABLE 13: TYPES OF COVERED TRANSACTIONS

Transaction Type	Number
Sale of tangible property into the U.S.	42
Performance of services by U.S. entity	28
Sale of tangible property from the U.S.	11
Use of intangible property by Non-U.S. entity	10
Performance of services by Non-U.S. entity	10
Use of intangible property by U.S. entity	6
Financial products - Non-U.S. parent	5
Financial products - U.S. branch of foreign company	5
Loans	≤ 3
R&D cost sharing	≤ 3
Commodity trading on globally integrated basis	≤ 3
Other	4

TABLE 14: TYPES OF SERVICES INCLUDED IN COVERED TRANSACTIONS

Intercompany Services Involved in the Covered Transactions	Number
Distribution	11
Technical support services	11
Administrative	10
Marketing	9
Headquarters costs	7
Accounting	7
Sales support	7
Management	6

Intercompany Services Involved in the Covered Transactions — Continued	Number
Product support	6
Logistical support	5
Legal	5
Contract research & development	4
Billing services	4
Communication services	≤ 3
Assembly	≤ 3
Purchasing	≤ 3
Research and development	≤ 3
Testing and installation services	≤ 3
Manufacturing services	≤ 3
License administration services	≤ 3
Warranty services	≤ 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 2004 are set forth in Tables 15 and 16 below:

TABLE 15: FUNCTIONS PERFORMED BY THE TESTED PARTY

Functions Performed	Number
Distribution functions	58
Managerial, legal, accounting, finance, personnel, and other support services	29
Marketing functions	28
Manufacturing	28
Transportation and warehousing	18
Purchasing and materials management	16
Research and development	16
Product design and engineering	15
Product assembly and/or packaging	14
Product testing and quality control	13
Product services (repairs, etc.)	11
Trading and risk management of financial products	10
Consulting services	10
Technical training and tech support for sales staff (including sub-distributors)	9
Engineering and construction related services	7
Licensing of intangibles	7
Process engineering	5
Telecom services	≤ 3

TABLE 16: RISKS ASSUMED BY THE TESTED PARTY

Risks Assumed	Number
Market risks, including fluctuations in costs, demand, pricing, & inventory	91
General business risks (<i>e.g.</i> , related to ownership of PP&E)	78
Credit and collection risks	63
Financial risks, including interest rates & currency	48
Product liability risks	23
R&D risks	14

Discussion

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

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

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

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

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

[§ 521(b)(2)(D)(iii)]

The related organizations, trades, or businesses whose prices or results are tested to determine compliance with TPMs prescribed in APAs executed in 2004 are set forth in Table 17 below:

**TABLE 17: RELATED ORGANIZATIONS, TRADES,
OR BUSINESSES WHOSE PRICES OR RESULTS ARE TESTED⁴**

Type of Organization	Number
U.S. distributor	44
Multiple tested parties	19
U.S. provider of services	19
U.S. manufacturer	14
Non-U.S. distributor	6
Non-U.S. provider of services	6
Non-U.S. dealer in financial products	5
Non-U.S. licensee of intangible property	≤ 3
Non-U.S. manufacturer	≤ 3
U.S. licensor of intangible property	≤ 3
U.S. dealer in financial products	≤ 3
Non-U.S. licensor of intangible property	≤ 3
U.S. licensee of intangible property	≤ 3
Other	≤ 3

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 2004 are set forth in Tables 18–20 below:

**TABLE 18: TRANSFER PRICING METHODS USED FOR TRANSFERS OF
TANGIBLE AND INTANGIBLE PROPERTY⁵**

TPM Used	Number
CPM: PLI is operating margin	20
CPM: PLI is gross margin	15
CPM: PLI is Berry ratio	14
Resale Price Method (tangibles only)	11
Unspecified method	8
CUT (intangibles only)	8
CPM: PLI is markup on total costs	5
Residual profit split	≤ 3
Cost Plus Method (tangibles only)	≤ 3
CPM: PLI is other PLI	≤ 3

⁴ "Multiple tested parties" includes covered transactions that utilize profit splits, CUPs, and CUTs.

⁵ Profit Level Indicators (PLIs) used with the Comparable Profit Method of Treas. Reg. § 1.482-5, and as used in these TPM tables, are as follows: (1) operating margin (ratio of operating profit to sales); (2) gross margin (ratio of gross profit to sales); (3) Berry ratio (gross profit to operating expenses); (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).

TPM Used — Continued	Number
CPM: PLI is return on assets or capital employed	≤ 3
Comparable profit split	≤ 3
Other	4

TABLE 19: TRANSFER PRICING METHODS USED FOR SERVICES

TPM Used	Number
CPM: PLI is markup on total costs	10
Cost plus a markup	10
Cost with no markup	5
CPM: PLI is operating margin	≤ 3
CPM: PLI is return on assets	≤ 3
CPM: PLI is Berry ratio	≤ 3
CUT	≤ 3
Resale Price Method	≤ 3
Profit split	≤ 3
Other	4

TABLE 20: TRANSFER PRICING METHODS USED FOR FINANCIAL PRODUCTS

TPM Used	Number
Profit split	9
Other	≤ 3

Discussion

The TPMs used in APAs completed during 2004 were based on the section 482 regulations. Under Treas. Reg. § 1.482-3, the arm’s length amount for controlled transfers of tangible property may be determined using the Comparable Uncontrolled Price (CUP) method, the Resale Price Method, the Cost Plus Method, the Comparable Profits Method (CPM), or the Profit Split Method. Under Treas. Reg. § 1.482-4, the arm’s length amount for controlled transfers of intangible property may be determined using the Comparable Uncontrolled Transaction (CUT) method, CPM, or the Profit Split Method. An “Unspecified Method” may be used for both tangible and intangible property if it provides a more reliable result than the enumerated methods under the best method rule of Treas. Reg. § 1.482-1(c). For transfers involving the provision of services, Treas. Reg. § 1.482-2(b) provides that services performed for the benefit of another member of a controlled group should bear an arm’s length charge, either deemed to be equal to the cost of providing the services (when non-integral, see Treas. Reg. § 1.482-2(b)(3)) or which should be an amount that would have been charged between independent parties.

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

In reviewing the TPMs applicable to transfers of tangible and intangible property reflected in Table 18, the majority of the APAs followed the specified methods. However, several points should be made. The § 482 regulations note that for transfers of tangible property, the Comparable Uncontrolled Price (CUP) method will generally be the most direct and reliable measure of an arm's length price for the Controlled Transaction if sufficiently reliable comparable transactions can be identified. Treas. Reg. § 1.482-3(b)(2)(ii)(A). It was the experience of the APA Program in 2003, that in the cases that came into the APA Program, sufficiently reliable CUP transactions were difficult to find. In APAs executed in 2004, no Covered Transaction used the CUP method.

Similar to the CUP method, for transfers of intangible property, the CUT method will generally provide the most reliable measure of an arm's length result if sufficiently reliable comparables may be found. Treas. Reg. § 1.482-4(c)(2)(ii). It has generally been difficult to identify external comparables, and APAs using the CUT method tend to rely on internal transactions between the taxpayer and unrelated parties. In 2004, eight Covered Transactions utilized the CUT TPM.

The Cost Plus Method (tangibles only) and Resale Price Method were applied in 2004 in three or fewer APAs and 11 APAs, respectively. See Treas. Reg. § 1.482-3(c), (d).

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

Table 18 reflects more than 54 uses of the CPM (with varying PLIs) in Covered Transactions involving tangible or intangible property. In some APAs, the CPM was also used concurrently with other methods.

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

The CPM was also used regularly with services as the Covered Transactions in APAs executed in 2004. There were at least 13 services Covered Transactions using the CPM method with various PLIs according to the specific facts of the taxpayers involved. Table 19 reflects the methods used to determine the arm's length results for APAs involving services transactions.

In 2004, 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. Nine APAs executed in 2004 applied a profit split method.

Critical Assumptions

[§ 521(b)(2)(D)(v)]

Critical Assumptions used in APAs executed in 2004 are described in Table 21 below:

TABLE 21: CRITICAL ASSUMPTIONS

Critical Assumptions involving the following:	Number of APAs
Material changes to the business	65
Material changes to tax and/or financial accounting practices	65
Other financial ratio	5
Changes in affiliated companies	4

Critical Assumptions involving the following: — Continued	Number of APAs
Material sales fluctuations	4
Income and expense allocation and apportionment methods materially same	4
Use of Mark-to-Market method	≤ 3
Assets will remain substantially same	≤ 3
Catastrophic events	≤ 3
Major regulatory changes	≤ 3
Marketing conditions substantially same	≤ 3
Contracting practices to remain the same	≤ 3
Minimum and maximum sales volume	≤ 3
Interdesk and interbranch transactions/allocations done on arm's length basis	≤ 3
Responsibility of trading locations will not change materially	≤ 3
Other	5

Discussion

APAs include critical assumptions upon which their respective TPMs depend. A critical assumption is any fact (whether or not within the control of the taxpayer) related to the taxpayer, a third party, an industry, or business and economic conditions, the continued existence of which is material to the taxpayer's proposed TPM. Critical assumptions might include, for example, a particular mode of conducting business operations, a particular corporate or business structure, or a range of expected business volume. Rev. Proc. 2004-40, § 4.05. Failure to meet a critical assumption may render an APA inappropriate or unworkable.

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

If a critical assumption has not been met, the APA may be revised by agreement of the parties. If such an agreement cannot be achieved, the APA may be canceled. If a critical assumption has not been met, it requires taxpayer's notice to and discussion with the Service, and, in the case of a bilateral APA, competent authority consideration. Rev. Proc. 2004-40, § 10.05.

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 2004 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	76
Disclosure	37
Moody's	7
Worldscope	7
Internal comparables	4
Bureau Van Dijk's JADE (Japan)	≤ 3

Comparable Sources — Continued	Number of Times This Source Used
Global Vantage	≤ 3
Mergent	≤ 3
Japan Company Handbook	≤ 3
Global Researcher's SEC (database)	≤ 3
Other	10

TABLE 23: COMPARABLE SELECTION CRITERIA

Selection Criteria Considered	Number of Times This Criterion Used
Comparable functions	81
Comparable industry	47
Comparable risks	45
Comparable products	33
Comparable intangibles	32
Comparable terms	7

TABLE 24: ADJUSTMENTS TO COMPARABLES OR TESTED PARTIES

Adjustment	Number of Times Used
Balance sheet adjustments	
Receivables	48
Inventory	46
Payables	46
Property, plant, equipment	7
Other non-interest bearing liabilities	7
Accounting adjustments	
LIFO to FIFO inventory accounting	22
Accounting reclassifications (e.g., from COGS to operating expenses)	≤ 3
Other	≤ 3
Profit level indicator adjustments (used to “back into” one PLI from another)	
Operating expense	17
Return on investment backed into cost-plus	≤ 3
Berry ratio backed into operating margin	≤ 3
Other	≤ 3

Adjustment — Continued	Number of Times Used
Miscellaneous adjustments	
Goodwill value or amortization	≤ 3
Working capital adjustment	≤ 3
Research & development	≤ 3
Sales shock	≤ 3
Advertising	≤ 3
Other	≤ 3

Discussion

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

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

Sources of Comparables

Comparables used in APAs can be U.S. or foreign, depending on the relevant market, the type of transaction being evaluated, and the results of the functional and risk analyses. In general, comparables have been located by searching a variety of databases that provide data on U.S. publicly traded companies and on a combination of public and private non-U.S. companies. Table 22 shows the various databases and other sources used in selecting comparables for the APAs executed in 2004.

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

Selecting Comparables

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

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

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

In addition, the APA Program, consistent with the section 482 regulations, generally has looked at the results of comparables over a multi-year period. Sometimes this has been a three-year period, but it has been more or less, depending on the circumstances of the controlled transaction. Using a shorter period might result in the inclusion of comparables in different stages of economic development or use of atypical years of a comparable due to cyclical fluctuations in business conditions.

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

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

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

Table 25 shows the number of times various screens were used in APAs executed in 2004:

TABLE 25: COMPARABILITY SCREENS

Comparability/Financial Distress Screen	Times Used
Comparability screens used	
Sales	37
R&D/ sales	17
SG&A/ sales	9
Foreign sales/ total sales	8
Operating expenses/ sales	6
Retail Sales	6
Advertising/ sales	≤ 3
Non-startup or start-up	≤ 3
PP&E/ sales	≤ 3
Financial distress	
Bankruptcy	27
Losses in one or more years	17
Unfavorable auditor’s opinion	9

Adjusting Comparables

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

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

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

The APA Program also requires that data be compared on a consistent accounting basis. For example, although financial statements may be prepared on a first-in first-out (FIFO) basis, cross-company comparisons are less meaningful if one or more of the comparables use 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.

Still important in some cases is the adjustment for differences in relative levels of PP&E between a tested business activity and the comparables. Ideally, comparables and the business activity being tested will have fairly similar relative levels of PP&E, since major differences can be a sign of fundamentally different functions and risks. Typically, the PP&E adjustment is made using a medium term interest rate.

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

The adjustments made to comparables or tested parties in APAs executed in 2004 are reflected in Table 24 above.

Nature of Ranges and Adjustment Mechanisms

[§ 521(b)(2)(D)(viii)-(ix)]

The types of ranges and adjustment mechanisms used in APAs executed in 2004 are described in Table 26 and 27 below.

TABLE 26: TYPES OF RANGES⁶

Type of Range	Number
Interquartile range	58
Specific point (royalty)	9
Specific point within CPM range (not floor or ceiling)	9
Full range	8
Other specific point	7
Floor (<i>i.e.</i> , result must be no less than x)	≤ 3
Financial products - statistical confidence interval to test against internal CUPs	≤ 3
Specific point (CUT)	≤ 3
Other	7

⁶ The numbers do not include TPMs with cost or cost-plus methodologies.

TABLE 27: ADJUSTMENTS WHEN OUTSIDE OF THE RANGE

Adjustment mechanism	Number
Taxpayer makes an adjustment: to closest edge of single year	25
Taxpayer makes an adjustment: to closest edge of multi-year average	24
Taxpayer makes an adjustment: to specified point	24
Taxpayer makes an adjustment: to median of multi-year average	8
Taxpayer makes an adjustment: to median of current year	7
Taxpayer makes an adjustment: to other	4
Other	≤ 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,” called the “arm’s length range.” A taxpayer whose results fall within the arm’s length range will not be subject to adjustment.

Under Treas. Reg. § 1.482-1(e)(2)(i), such a range is normally derived by considering a set of more than one comparable uncontrolled transaction of similar comparability and reliability. If these comparables are of very high quality, as defined in the § 482 regulations, then under Treas. Reg. § 1.482-1(e)(2)(iii)(A), the arm’s length range includes the results of all of the comparables (from the least to the greatest). However, the APA Program has only rarely identified cases meeting the requirements for the full range. If the comparables are of lesser 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 58 times in 2004.

More than twenty-five Covered Transactions reflected on Table 26 specified a single, specific result. Nine of these Covered Transactions involved a CPM in which the taxpayer agreed to a “point.” Some APAs specify not a point or a range, but a “floor” or a “ceiling”. When a floor is used, the tested party’s result must be greater than or equal to some particular value. When a ceiling is used, the tested party’s result must be less than or equal to some particular value. Three or fewer APAs executed in 2004 used a floor and none used a ceiling.

Some APAs look to a tested party’s results over a period of years (multi-year averaging) to determine whether a taxpayer has complied with the APA. In 2004, rolling multi-year averaging was used for 14 Covered Transactions. Twelve of those used three-year averages and the other two used five-year averages. Five Covered Transactions used cumulative multi-year averages, while 26 other Covered Transactions used term averages.

Adjustments

Under Treas. Reg. § 1.482-1(e)(3), if a taxpayer’s results fall outside the arm’s length range, the Service may adjust the result “to any point within the arm’s length range.” Accordingly, an APA may permit or require a taxpayer and its related parties to make an adjustment after the year’s end to put the year’s results within the range, or at the point specified by the APA. Similarly, to enforce the terms of an APA, the Service may make such an adjustment. When the APA specifies a range, the adjustment is sometimes to the closest edge of the range, and sometimes to another point such as the median of the interquartile range. Depending on the facts of each case, 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.

Where a taxpayer’s actual transactions do not comply with the TPM, a taxpayer must nonetheless report its taxable income in an amount consistent with the TPM (an APA primary adjustment), as further discussed in § 10.02 of Rev. Proc. 2004-40.

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

The various term lengths for APAs executed in 2004 are set forth in Table 28 below:

TABLE 28: TERMS OF APAs

APA Term in Years	Number of APAs
1	1
2	0
3	3
4	5
5	34
6	10
7	4
8	7
9	1

The number of rollback years to which an APA TPM was applied in 2004 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	8
3	3
4	0
5 or more	4

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

APAs executed in 2004 required that taxpayers provide various documents with their annual reports. These documents are described in Table 30 below:

TABLE 30: NATURE OF DOCUMENTATION REQUIRED⁷

Documentation	Number of Times Required
Description of any failure to meet Critical Assumptions or, if there have been none, a statement to that effect	65
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	64
Statement identifying all material changes in Taxpayer's accounting methods and classifications, and methods of estimation, from those described or used in Taxpayer's request for APA, or if there have been none, statement to that effect	64
Financial analysis demonstrating Taxpayer's compliance with TPM	64
Description of, reason for, and financial analysis of, any Compensating Adjustments with respect to APA Year, including means by which any Compensating Adjustment has been or will be satisfied	62
Organizational chart	57
Financial statements as prepared in accordance with US GAAP	56
Certified public accountant's opinion that financial statements present fairly financial position of Taxpayer and the results of its operations, in accordance with US GAAP	56
Financial statements as prepared in accordance with a foreign GAAP	12
Various work papers	9
Book to tax reconciliations	8
Certified public accountant's opinion that financial statements present fairly financial position of Taxpayer and the results of its operations, in accordance with a foreign GAAP	8
Schedule of costs and expenses (<i>e.g.</i> , intercompany allocations)	5
Description of any changes in entity classification	4
Description of any changes in Taxpayer's financial accounting methods that were made to conform to US GAAP	4
Description of differences between foreign GAAP and US GAAP and their impact on the financial statements	4
Other	11

Approaches for Sharing of Currency or Other Risks

[§ 521(b)(2)(D)(xii)]

During 2004, there were 48 tested parties that faced financial risks, including interest rate and currency risks. In appropriate cases, APAs may provide specific approaches for dealing with currency risk, such as adjustment mechanisms and/or critical assumptions.

Efforts to Ensure Compliance with APAs

[§ 521(b)(2)(F)]

As described in Rev. Proc. 2004-40, § 10.01, 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.

⁷ The first eight categories of documentation listed in this table were drawn from the standard APA language used in 2004. The facts and circumstances of some APAs may eliminate the need for some standard documentation requirements.

All reports received by the APA office are tracked by one designated APA team leader who also has the primary responsibility for annual report review. Other APA team leaders and economists assist in this review, especially when the team leader who negotiated the case is available, since that person will already be familiar with the relevant facts and terms of the agreement. Once received by the APA office, the annual report is sent out to the district personnel with exam jurisdiction over the taxpayer.

The statistics for the review of APA annual reports are reflected in Table 31 below. As of December 31, 2004, there were 337 pending annual reports. In 2004, 143 reports were closed.

TABLE 31: STATISTICS OF ANNUAL REPORTS

Number of APA annual reports pending as of December 31, 2004	337
Number of APA annual reports closed in Year 2004	143
Number of APA annual reports requiring adjustment in Year 2004	5
Number of taxpayers involved in adjustments	1
Number of APA annual reports required to be filed in Year 2004	215
Number of APA annual reports actually filed in Year 2004	162
Number of APA annual report cases over one year old	101

ATTACHMENT A
Model 1 (Based on Revenue Procedure 96-53)

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

PARTIES

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

RECITALS

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

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

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

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

AGREEMENT

The Parties agree as follows:

1. Covered Transactions. This APA applies to the Covered Transactions, as defined in Appendix A.
2. Transfer Pricing Method. Appendix A sets forth the Transfer Pricing Method (TPM) for the Covered Transactions.
3. Term. This APA applies to Taxpayer's taxable years ending _____ through _____ (APA Term).
4. Operation.
 - a. Revenue Procedure 96-53 governs the interpretation, legal effect, and administration of this APA.
 - b. Nonfactual oral and written representations, within the meaning of sections 10.04 and 10.05 of Revenue Procedure 96-53 (including any proposals to use particular TPMs), made in conjunction with the APA Request constitute statements made in compromise negotiations within the meaning of Rule 408 of the Federal Rules of Evidence.
5. Compliance.
 - a. For each taxable year covered by this APA (APA Year), if Taxpayer complies with the terms and conditions of this APA, then the IRS will not make or propose any allocation or adjustment under I.R.C. section 482 to the Covered Transactions.
 - b. If Taxpayer does not comply 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 11.05 or 11.06 of Revenue Procedure 96-53; or
 - iii. revise this APA, if the Parties agree.
 - c. Taxpayer must timely file an Annual Report for each APA Year in accordance with Appendix C and section 11.01 of Revenue Procedure 96-53. Taxpayer must file an original and four copies of the Annual Report by the later of (a) 90 days after the time prescribed by law (including extensions) for filing its federal income tax return for the APA Year covered by the report, or (b) 90 days after the effective date of this APA. [The Service and the Taxpayer may agree to alternative filing dates.] The IRS may request additional information reasonably necessary to clarify or complete the Annual Report. Taxpayer will provide all requested information within 30 days. Additional time may be allowed for good cause.

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

e. In accordance with section 11.04 of Revenue Procedure 96-53, Taxpayer will (1) maintain its APA Records, and (2) make them available to 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.

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

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

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

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

h. The True Taxable Income within the meaning of Treasury Regulations 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 96-53, section 5.07, appear in Appendix B. Revenue Procedure 96-53, section 11.07, governs if any critical assumption has not been met.

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

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

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

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

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

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

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

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

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

WITNESS,

The Parties have executed this APA on the dates below.

[Taxpayer Name in all caps]

By: _____
Jane Doe
Sr. Vice President (Taxes)

Date: _____, 20 _____

IRS

By: _____
Matthew W. Frank
Director, Advance Pricing Agreement Program

Date: _____, 20 _____

APPENDIX A

COVERED TRANSACTIONS AND TRANSFER PRICING METHOD (TPM)

1. Covered Transactions.

[Define the Covered Transactions.]

2. TPM.

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

• CUP Method

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

• Resale Price Method (RPM)

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

• Cost Plus Method

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

• CPM with Berry Ratio PLI

The TPM is the comparable profits method (CPM). Taxpayer must realize, recognize, and report results on its U.S. Returns that clearly reflect a gross profit to operating expenses ratio (as those terms are defined in Treasury Regulations sections 1.482-5(d)(2) and (3)) of between _____ and _____ (the Arm's Length Range) for the Covered Transactions.

• CPM using an Operating Margin PLI

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

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

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

• **Residual Profit Split Method**

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

[Insert additional provisions as needed.]

3. Adjustments.

{For use with a CPM}

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

[Insert additional provisions as needed.]

**APPENDIX B
CRITICAL ASSUMPTIONS**

This APA's critical assumptions are:

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

[Insert additional provisions as needed.]

**APPENDIX C
APA RECORDS AND ANNUAL REPORT**

APA RECORDS

The APA Records will consist of:

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

ANNUAL REPORT

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

- i. the Parties to the APA;
- ii. the APA Term (defined in section 3 of this APA);
- iii. the APA's effective date (defined in section 14 of this APA);
- iv. whether the APA is a renewal, and if so the term of the prior APA;

- v. whether the APA has been amended, and if so the amendment's effective date;
- vi. any information needed to distinguish the APA at issue from any other APAs involving the same parties;
- vii. any changes to the Taxpayer notice information in section 13 of this APA.

The table of contents and the Annual Report will be organized as listed below. Taxpayer must include the following items in its Annual Report for each APA Year.

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

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

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

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

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

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

- i. the amounts paid or received by each affected entity;
- ii. the character (such as capital, ordinary, income, expense) and country source of the funds transferred, and the specific affected line item(s) of any affected U.S. Return; and
- iii. the date(s) and means by which the payments are or will be made.

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

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

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

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

APPENDIX D
DEFINITIONS

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

Term	Definition
Annual Report	A report within the meaning of Revenue Procedure 96-53, section 11.
APA	This Advance Pricing Agreement, which is an “advance pricing agreement” within the meaning of Revenue Procedure 96-53, section 1.
APA Records	The records specified in Appendix C.
APA Request	Taxpayer’s request for this APA dated _____, including any amendments or supplemental or additional information thereto.
Covered Transaction(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 96-53	Rev. Proc. 96-53, 1996-2 C.B. 375.
Transfer Pricing Method (TPM)	A transfer pricing method within the meaning of Treasury Regulations section 1.482-1(b) and Revenue Procedure 96-53, section 3.02.
U.S. GAAP	U.S. generally-accepted accounting principles.
U.S. Group	Worldwide Group members that are U.S. persons.
U.S. Return	For each taxable year, the “returns with respect to income taxes under subtitle A” that Taxpayer must “make” in accordance with I.R.C. section 6012. <i>{ Or substitute for partnership: For each taxable year, the “return” that Taxpayer must “make” in accordance with I.R.C. section 6031. }</i>
Worldwide Group	Taxpayer and all organizations, trades, businesses, entities, or branches (whether or not incorporated, organized in the United States, or affiliated) owned or controlled directly or indirectly by the same interests.

ATTACHMENT A
Model 2 (Based on Revenue Procedure 2004-40)

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

PARTIES

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

RECITALS

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

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

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

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

AGREEMENT

The Parties agree as follows:

1. Covered Transactions. This APA applies to the Covered Transactions, as defined in Appendix A.
2. Transfer Pricing Method. Appendix A sets forth the Transfer Pricing Method (TPM) for the Covered Transactions.
3. Term. This APA applies to Taxpayer's taxable years ending _____ through _____ (APA Term).
4. Operation.
 - a. Revenue Procedure 2004-40 governs the interpretation, legal effect, and administration of this APA.
 - b. Nonfactual oral and written representations, within the meaning of sections 9.04 and 9.05 of Revenue Procedure 2004-40 (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. For each taxable year covered by this APA (APA Year), if Taxpayer complies with the terms and conditions of this APA, then the IRS will not make or propose any allocation or adjustment under I.R.C. section 482 to the Covered Transactions.
 - b. If Taxpayer does not comply 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 10.06 or 10.07 of Revenue Procedure 2004-40; or
 - iii. revise this APA, if the Parties agree.
 - c. Taxpayer must timely file an Annual Report for each APA Year in accordance with Appendix C and section 10.01 of Revenue Procedure 2004-40. Taxpayer must file an original and four copies of the Annual Report by the later of (a) 90 days after the time prescribed by law (including extensions) for filing its federal income tax return for the APA Year covered by the report, or (b) 90 days after the effective date of this APA. [The Service and the Taxpayer may agree to alternative filing dates.] The IRS may request additional information reasonably necessary to clarify or complete the Annual Report. Taxpayer will provide all requested information within 30 days. Additional time may be allowed for good cause.

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

e. In accordance with section 10.04 of Revenue Procedure 2004-40, Taxpayer will (1) maintain its APA Records, and (2) make them available to IRS in connection with an examination under section 10.03. Compliance with this subparagraph constitutes compliance with the record-maintenance provisions of I.R.C. sections 6038A and 6038C for the Covered Transactions for any taxable year during the APA Term.

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

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

ii. May make compensating adjustments under Revenue Procedure 2004-40, section 10.02, subject to any modifications or restrictions in Appendix A or elsewhere in this APA.

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

h. The True Taxable Income within the meaning of Treasury Regulations section 1.482-1(a)(1) 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 2004-40, section 4.05, appear in Appendix B. Revenue Procedure 2004-40, section 10.05, governs if any critical assumption has not been met.

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

8. Disputes. If a dispute arises concerning the interpretation of this APA, the Parties will seek a resolution by the IRS Associate Chief Counsel (International), to the extent reasonably practicable, before seeking alternative remedies. If any dispute arises that is not related to interpreting this APA, the Parties will seek to resolve the dispute in a manner consistent with Revenue Procedure 2004-40, section 10.03(4).

9. Materiality. In this APA the terms "material" and "materially" will be interpreted consistently with the definition of "material facts" in Revenue Procedure 2004-40, section 10.07(1).

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

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

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

13. Notice. Any notices required by this APA or Revenue Procedure 2004-40 must be in writing. Taxpayer will send notices to the IRS at the address and in the manner set forth in Revenue Procedure 2004-40, 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: _____)

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

WITNESS,

The Parties have executed this APA on the dates below.

[Taxpayer Name in all caps]

By: _____
Jane Doe
Sr. Vice President (Taxes)

Date: _____, 20 _____

IRS

By: _____
Matthew W. Frank
Director, Advance Pricing Agreement Program

Date: _____, 20 _____

APPENDIX A

COVERED TRANSACTIONS AND TRANSFER PRICING METHOD (TPM)

1. Covered Transactions.

[Define the Covered Transactions.]

2. TPM.

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

• CUP Method

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

• Resale Price Method (RPM)

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

• Cost Plus Method

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

• CPM with Berry Ratio PLI

The TPM is the comparable profits method (CPM). Taxpayer must realize, recognize, and report results on its U.S. Returns that clearly reflect a gross profit to operating expenses ratio (as those terms are defined in Treasury Regulations sections 1.482-5(d)(2) and (3)) of between _____ and _____ (the Arm's Length Range) for the Covered Transactions.

• CPM using an Operating Margin PLI

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

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

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

• **Residual Profit Split Method**

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

[Insert additional provisions as needed.]

3. Adjustments.

{For use with a CPM}

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

[Insert additional provisions as needed.]

**APPENDIX B
CRITICAL ASSUMPTIONS**

This APA's critical assumptions are:

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

[Insert additional provisions as needed.]

**APPENDIX C
APA RECORDS AND ANNUAL REPORT**

APA RECORDS

The APA Records will consist of:

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

ANNUAL REPORT

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

- i. the Parties to the APA;
- ii. the APA Term (defined in section 3 of this APA);
- iii. the APA's effective date (defined in section 14 of this APA);
- iv. whether the APA is a renewal, and if so the term of the prior APA;

- v. whether the APA has been amended, and if so the amendment's effective date;
- vi. any information needed to distinguish the APA at issue from any other APAs involving the same parties;
- vii. any changes to the Taxpayer notice information in section 13 of this APA.

The table of contents and the Annual Report will be organized as listed below. Taxpayer must include the following items in its Annual Report for each APA Year.

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

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

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

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

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

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

- i. the amounts paid or received by each affected entity;
- ii. the character (such as capital, ordinary, income, expense) and country source of the funds transferred, and the specific affected line item(s) of any affected U.S. Return; and
- iii. the date(s) and means by which the payments are or will be made.

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

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

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

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

APPENDIX D
DEFINITIONS

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

Term	Definition
Annual Report	A report within the meaning of Revenue Procedure 2004–40, section 10.01.
APA	This Advance Pricing Agreement, which is an “advance pricing agreement” within the meaning of Revenue Procedure 2004–40, 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 2004–40	Rev. Proc. 2004–40, 2004–29 I.R.B. 50.
Transfer Pricing Method (TPM)	A transfer pricing method within the meaning of Treasury Regulations section 1.482–1(b) and Revenue Procedure 2004–40, section 2.04.
U.S. GAAP	U.S. generally-accepted accounting principles.
U.S. Group	Worldwide Group members that are U.S. persons.
U.S. Return	For each taxable year, the “returns with respect to income taxes under subtitle A” that Taxpayer must “make” in accordance with I.R.C. section 6012. <i>{ Or substitute for partnership: For each taxable year, the “return” that Taxpayer must “make” in accordance with I.R.C. section 6031. }</i>
Worldwide Group	Taxpayer and all organizations, trades, businesses, entities, or branches (whether or not incorporated, organized in the United States, or affiliated) owned or controlled directly or indirectly by the same interests.

ATTACHMENT B

FORMULAS FOR BALANCE SHEET ADJUSTMENTS

Definitions of Variables:

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

Equations:

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

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

If Sales are controlled (generally, costs in the denominator of PLI):⁸

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

Then Adjust Comparables as Follows:

adjusted sales _c	=	sales _c + RA
adjusted cogs _c	=	cogs _c + PA - IA
adjusted opex _c	=	opex _c - PPEA

⁸ Depending on the specific facts, the equations below may use total costs (“tc”) or cost of goods sold (“cogs”).

Definition of Terms

Revenue rulings and revenue procedures (hereinafter referred to as “rulings”) that have an effect on previous rulings use the following defined terms to describe the effect:

Amplified describes a situation where no change is being made in a prior published position, but the prior position is being extended to apply to a variation of the fact situation set forth therein. Thus, if an earlier ruling held that a principle applied to A, and the new ruling holds that the same principle also applies to B, the earlier ruling is amplified. (Compare with *modified*, below).

Clarified is used in those instances where the language in a prior ruling is being made clear because the language has caused, or may cause, some confusion. It is not used where a position in a prior ruling is being changed.

Distinguished describes a situation where a ruling mentions a previously published ruling and points out an essential difference between them.

Modified is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the new ruling holds that it applies to both A

and B, the prior ruling is modified because it corrects a published position. (Compare with *amplified* and *clarified*, above).

Obsoleted describes a previously published ruling that is not considered determinative with respect to future transactions. This term is most commonly used in a ruling that lists previously published rulings that are obsoleted because of changes in laws or regulations. A ruling may also be obsoleted because the substance has been included in regulations subsequently adopted.

Revoked describes situations where the position in the previously published ruling is not correct and the correct position is being stated in a new ruling.

Superseded describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the new ruling does more than restate the substance

of a prior ruling, a combination of terms is used. For example, *modified* and *superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case, the previously published ruling is first modified and then, as modified, is superseded.

Supplemented is used in situations in which a list, such as a list of the names of countries, is published in a ruling and that list is expanded by adding further names in subsequent rulings. After the original ruling has been supplemented several times, a new ruling may be published that includes the list in the original ruling and the additions, and supersedes all prior rulings in the series.

Suspended is used in rare situations to show that the previous published rulings will not be applied pending some future action such as the issuance of new or amended regulations, the outcome of cases in litigation, or the outcome of a Service study.

Abbreviations

The following abbreviations in current use and formerly used will appear in material published in the Bulletin.

A—Individual.
Acq.—Acquiescence.
B—Individual.
BE—Beneficiary.
BK—Bank.
B.T.A.—Board of Tax Appeals.
C—Individual.
C.B.—Cumulative Bulletin.
CFR—Code of Federal Regulations.
CI—City.
COOP—Cooperative.
Ct.D.—Court Decision.
CY—County.
D—Decedent.
DC—Dummy Corporation.
DE—Donee.
Del. Order—Delegation Order.
DISC—Domestic International Sales Corporation.
DR—Donor.
E—Estate.
EE—Employee.
E.O.—Executive Order.

ER—Employer.
ERISA—Employee Retirement Income Security Act.
EX—Executor.
F—Fiduciary.
FC—Foreign Country.
FICA—Federal Insurance Contributions Act.
FISC—Foreign International Sales Company.
FPH—Foreign Personal Holding Company.
F.R.—Federal Register.
FUTA—Federal Unemployment Tax Act.
FX—Foreign corporation.
G.C.M.—Chief Counsel’s Memorandum.
GE—Grantee.
GP—General Partner.
GR—Grantor.
IC—Insurance Company.
I.R.B.—Internal Revenue Bulletin.
LE—Lessee.
LP—Limited Partner.
LR—Lessor.
M—Minor.
Nonacq.—Nonacquiescence.
O—Organization.
P—Parent Corporation.
PHC—Personal Holding Company.
PO—Possession of the U.S.
PR—Partner.

PRS—Partnership.
PTE—Prohibited Transaction Exemption.
Pub. L.—Public Law.
REIT—Real Estate Investment Trust.
Rev. Proc.—Revenue Procedure.
Rev. Rul.—Revenue Ruling.
S—Subsidiary.
S.P.R.—Statement of Procedural Rules.
Stat.—Statutes at Large.
T—Target Corporation.
T.C.—Tax Court.
T.D.—Treasury Decision.
TFE—Transferee.
TFR—Transferor.
T.I.R.—Technical Information Release.
TP—Taxpayer.
TR—Trust.
TT—Trustee.
U.S.C.—United States Code.
X—Corporation.
Y—Corporation.
Z—Corporation.

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¹ A cumulative list of current actions on previously published items in Internal Revenue Bulletins 2004–27 through 2004–52 is in Internal Revenue Bulletin 2004–52, dated December 27, 2004.