Internal Revenue
bulletin

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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 2002–40, page 747.
This announcement concerns Advance Pricing Agreements (APAs) and the experience of the APA Program during calendar year 2001.

TAX CONVENTIONS

Rev. Rul. 2002–16, page 740.
This ruling confirms that the Netherlands investment yield tax is a tax for which a credit may be allowed under Article 25(4) of the U.S.–Netherlands income tax convention because, under Article 2(2), it is substantially similar to a prior Dutch tax that was a covered tax under the convention.

Rev. Proc. 2002–23, page 744.
This document describes new procedures under Article XVIII(7) of the U.S. – Canada income tax convention whereby U.S. taxpayers may elect to defer U.S. income taxation on income accruing in certain Canadian pension plans until a distribution is made from such plans. Rev. Proc. 89–45 superseded.

EMPLOYEE PLANS

Notice 2002–23, page 742.
Form 5500; DOL delinquent filer program. This notice provides relief from certain penalties under sections 6652 and 6692 of the Code for late filers of Form 5500 who are eligible for and satisfy the requirements of the Department of Labor's (DOL's) Delinquent Filer Voluntary Compliance (DFVC) program.

Notice 2002–26, page 743.
Weighted average interest rate update. The weighted average interest rate for the first quarter of 2002 and the resulting permissible range of interest rates used to calculate current liability for purposes of the full funding limitation of section 412(c)(7) of the Code are set forth.

Announcement 2002–31, page 747.
Proposed class exemption; non-enforcement policy. This announcement describes the Service's position on the imposition of the prohibited transaction excise taxes during the pendency of a class exemption from the prohibited transaction rules (Application No. D–10933) proposed by the U.S. Department of Labor.

ADMINISTRATIVE

Notice 2002–25, page 743.
Charitable contributions, substantiation, relief. Due to the unique circumstances of the September 11th tragedy, taxpayers who made charitable contributions of $250 or more after September 10, 2001, and before January 1, 2002, are provided with partial relief from the "contemporaneous written acknowledgement" requirement of section 170(f)(8) of the Code with respect to those contributions.

(Continued on the next page)

Finding Lists begin on page ii.

Department of the Treasury
Internal Revenue Service

Rev. Proc. 2002–23, page 744.
This document describes new procedures under Article XVIII(7) of the U.S. – Canada income tax convention whereby U.S. taxpayers may elect to defer U.S. income taxation on income accruing in certain Canadian pension plans until a distribution is made from such plans. Rev. Proc. 89–45 superseded.

Rev. Proc. 2002–26, page 746.
This procedure provides updated information about how the Service applies partial undesignated payments against assessed tax, penalty, and interest. Rev. Ruls. 73–304, 73–305, and 79–284 superseded.

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 consolidated 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 first 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 first Bulletin of the succeeding semiannual period, respectively.

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This page is reserved for missing children Alicia Stathes and Kalil Smith-Nuevelle

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

United States — Kingdom of the Netherlands Income Tax Convention

This ruling confirms that the Netherlands investment yield tax is a tax for which a credit may be allowed under Article 25(4) of the U.S.-Netherlands income tax convention because, under Article 2(2), it is substantially similar to a prior Dutch tax that was a covered tax under the convention.

Rev. Rul. 2002–16

ISSUE

Whether the newly enacted Dutch tax on an individual's imputed income from savings and investment in the Netherlands, Box 3 of the Netherlands Individual Income Tax Act of 2001, is a tax for which a credit may be allowed against U.S. income tax liability under the Convention Between the United States of America and the Kingdom of the Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, effective December 31, 1993 (the "Treaty").

FACTS

Prior to January 1, 2001, the Netherlands individual income tax (*de inkomstenbelasting*) was imposed on a single taxable income base, which comprised all the income that a taxpayer received in a year. Various deductions were allowed against this income. Additionally, a dividend and interest allowance could be used against income from savings and investments.

Effective January 1, 2001, the Netherlands introduced a schedular system of individual taxation that applies to both residents and nonresidents. Under the new system, instead of a single taxable income base there are three separate bases. These are referred to as "Boxes," and are organized as follows:

> Box 1 includes taxable income from work (including profits and losses from business and professions and sales of business property, wages, pensions, and income from partnerships), dividends received by security dealers, and imputed income from an owner-occupied home. Expenses related to business profits are deductible. Nonresidents are subject to tax on the income in this box from Dutch sources, including imputed income from a home within the Netherlands.
>
> Box 2 includes taxable income derived from a substantial business interest in corporations. Substantial is defined as a 5% or more interest. Two types of income are taxed: dividends and capital gain realized on selling assets that form a substantial holding. Acquisition (margin) interest is deductible. Nonresidents are subject to tax on the income in this box with regard to substantial interests in Dutch companies.
>
> Box 3 includes taxable income from savings and investments. Taxable income is the fixed yield (imputed income) set at 4% of the value of the investment assets reduced by certain liabilities. Taxpayers cannot reduce their tax burden by proving that their actual rate of return on investments was in fact less than 4%. If income imputed from investment assets is subject to tax under Box 3, any actual interest, dividend, and rental income will not be taxed. The investment yield tax applies to assets such as real estate (other than the taxpayer's personal residence), stocks and shares, savings deposits, and non-exempt endowment insurance. If income from an asset is subject to tax under Box 1 or 2, income will not be imputed with respect to that asset for purposes of Box 3. Also, income is not imputed with respect to assets without yield capacity (such as personal use property). Interest paid and other expenses relating to imputed income taxed under Box 3 are not deductible. However, debt that exceeds 2,500 EUR and that is not related to the assets included within Box 1 and Box 2 can be deducted from the tax base on which the imputed income of 4% is computed; in addition, all taxpayers are entitled to a tax-free asset allowance of 17,600 EUR. Nonresidents are subject to tax on the income in this box from assets within the Netherlands minus related debt. Assets within the Netherlands include only immovable property, rights in immovable property, and rights in the profits of a company with a registered office within the Netherlands provided that the rights are not in the form of stock.

Under the new system, each form of income may be included in only one box. If there is a loss in one box, it may not offset positive income in the other two boxes. The loss may, however, be carried over and deducted against income in that box in a later year. In addition, if a taxpayer incurs a loss on the complete termination of his or her substantial interest that is subject to tax in Box 2, as much as 25% of that loss may be applied against the Box 1 tax.

Box 1 taxable income comprises approximately 95% of the total income tax base. Boxes 2 and 3 comprise approximately 1.5% and 3.5% respectively of the total income tax base.

Taxable income within the three boxes is reduced by personal deductions, such as medical expenses, educational expenses, donations, and alimony. Personal deductions are used to offset first income in Box 1, then income in Box 3, and finally income in Box 2. Any excess personal deductions may be carried forward.

After reduction by personal deductions, taxable income is subject to the following income tax rates in the three boxes as follows:

Box 1	Progressive rates of up to 52%
Box 2	25%
Box 3	30%

Various credits are allowed against the taxes of the three boxes combined. Some of these credits, such as the general tax credit, child credit, old-age credit, and the handicapped credit, are nonrefundable. Two additional credits, a wage credit and a credit for the dividend tax, also are allowed, and may, in some cases, lead to a refund.

LAW AND ANALYSIS

Under Article 25(4) of the Treaty, a credit may be allowed against U.S. tax liability for the Box 3 tax if, under Article 2(2), the Box 3 tax is a substantially similar tax imposed in place of a tax that was in force at the time the Treaty was signed. Under the general rule of Article 25(4) of the Treaty, Methods of Elimination of Double Taxation, the United States treats as an income tax, for which a credit may be allowed under Article 25, the appropriate amount of income tax paid or accrued to the Netherlands by or on behalf of a resident or national of the United States. For purposes of Article 25(4), the taxes referred to in paragraphs 1(a) and 2 of Article 2, Taxes Covered, are considered income taxes.

Article 2(1)(a) lists the Netherlands taxes that were in force at the time the Treaty was signed and that were covered under the Treaty. These included the Dutch individual income tax, *de inkomstenbelasting*.

Under Article 2(2), Netherlands taxes that were not in force at the time the Treaty was signed are nonetheless covered taxes, and thus taxes for which a credit may be allowed under Article 25(4), if they are identical or substantially similar taxes imposed after the date of signature of the Treaty in addition to, or in place of, the existing taxes.

In general, the purpose of a Taxes Covered Article is to ensure that tax treaties do not become obsolete due to changes in the tax systems of the parties to a treaty. Thus, if identical or substantially similar taxes are imposed in addition to, or in place of, the taxes that were in force and covered at the time a treaty was signed, it is appropriate to give effect to the intent of the Contracting States, and allow the treaty to continue to apply to the basic income tax structures of Contracting States. There is no definitive test for whether a tax is substantially similar to a covered tax; rather, the outcome rests on the facts and circumstances of each particular case. If it is concluded that a newly enacted tax is substantially similar to a covered tax, it also becomes a covered tax, but remains so only until such time as it is amended. When that occurs, a separate analysis must be made in order to determine whether the amended tax is substantially similar to the taxes in force at the time the treaty was signed.

HOLDINGS

Considered in its entirety, the Netherlands Individual Income Tax Act of 2001 imposes taxes that are substantially similar to the income tax referred to in Article 2(1)(a) of the Treaty. Because the taxes imposed pursuant to the Netherlands Individual Income Tax Act of 2001 are substantially similar to the income tax referred to in Article 2(1)(a) of the Treaty, those taxes are covered under Article 2(2), and therefore treated as income taxes for which a credit may be allowed under Article 25(4). Accordingly, the tax imposed under Box 3, which forms a part of the Netherlands Individual Income Tax Act of 2001, is treated as an income tax for which a credit may be allowed under Article 25(4).

Taxpayers generally may rely upon Revenue Rulings to determine the tax treatment of their own transactions, and need not request a ruling that would apply the principles of a published Revenue Ruling to their own particular cases. However, because each Revenue Ruling represents the conclusion of the Service as to the application of the law to the specific facts involved, taxpayers, Service personnel, and others concerned are cautioned against reaching the same conclusions in other cases unless those cases present facts and circumstances that are substantially the same as those in the Revenue Ruling. Treas. Reg. § 601.601 (d)(2)(v)(*e*). Accordingly, because the provisions of the Netherlands Individual Income Tax Act of 2001 described in this Revenue Ruling are facts on which this Ruling bases its holding, a taxpayer must verify that the description is still accurate before relying on the Ruling. A taxpayer may not rely on the Ruling if the Netherlands Individual Income Tax Act of 2001 has been altered or changed in any material respect by subsequent Dutch law.

EFFECTIVE DATE

This Revenue Ruling is effective with respect to taxable years beginning on or after January 1, 2001. This Revenue Ruling will cease to be effective if the Netherlands Individual Income Tax Act of 2001 is modified in any material respect for tax years that are affected by such change. Taxpayers are responsible for determining whether any such modifications have occurred.

DRAFTING INFORMATION

The principal author of this Revenue Ruling is Nina Chowdhry of the Office of the Associate Chief Counsel (International) (CC:INTL:Br1). For further information regarding this Revenue Ruling, contact Ms. Chowdhry at (202) 622–3880 (not a toll-free call).

Part III. Administrative, Procedural, and Miscellaneous

Relief From Internal Revenue Code Late Filer Penalties

Notice 2002–23

PURPOSE

This notice provides administrative relief from the penalties under §§ 6652 (c)(1), (d), (e), and 6692 of the Internal Revenue Code (the "Code") for failure to timely comply with the annual reporting requirements under §§ 6033(a), 6057, 6058, 6047, and 6059 of the Code. This administrative relief applies to late filers who both are eligible for and satisfy the requirements of the Delinquent Filer Voluntary Compliance Program ("DFVC Program"), which is administered by the Department of Labor's ("DOL") Pension and Welfare Benefits Administration ("PWBA"). The DFVC Program was published on April 27, 1995, in the Federal Register (60 FR 20874). A modification of the DFVC Program was published on March 28, 2002 (67 FR 15051).

BACKGROUND

Plan administrators who fail to file Form 5500 annual returns/reports on a timely basis can be subject to civil penalties under both Title I of the Employee Retirement Income Security Act of 1974 ("ERISA") and the Code. The Secretary of Labor has the authority under section 502(c)(2) of ERISA and 29 CFR 2575.502c–2 to assess civil penalties of up to $1,100 per day against plan administrators who fail or refuse to file complete and timely annual reports.

Pursuant to 29 CFR 2560.502c–2 and 29 CFR 2570.60 *et seq.*, PWBA maintains an administrative program for the assessment of civil penalties for noncompliance with the annual reporting requirements. Under this program, plan administrators filing late annual reports may be assessed a penalty of $50 per day for each day of noncompliance. Plan administrators who fail to file an annual report may be assessed a penalty of $300 per day, up to $30,000 per year, until a complete annual report is filed.

In addition to the civil penalties that may be assessed by DOL under section 502(c)(2) of ERISA, the Internal Revenue Service (the "Service") may assess penalties under §§ 6652(c)(1), (d), (e) and 6692 of the Code for the failure to satisfy the annual reporting requirements. Section 6652(c)(1) generally provides that in the case of any failure to file a return under § 6033(a), the exempt organization shall pay an amount equal to $20 for each day during which the failure continues, not to exceed the maximum amount specified under the Code. Section 6652(d)(1) generally provides that in the case of any failure to file an annual registration statement under § 6057(a), the late filer shall pay, upon notice and demand, a penalty of $1 for each participant with respect to whom there is a failure to file for each day the failure continues, up to $5,000 for any plan year. Section 6652(d)(2) generally provides that in the case of any failure to file a notification of change of status, the late filer shall pay, upon notice and demand, a penalty of $1 for each day the failure continues, up to $1,000. Section 6652(e) generally provides, in part, that in the case of any failure to file a return or statement required under §§ 6058 or 6047(e), the late filer shall pay, upon notice and demand, a penalty of $25 for each day the failure continues, up to $15,000 per return or statement. Section 6692 generally provides that in the case of any failure to file a report required by § 6059, the late filer shall pay a penalty of $1,000 for each failure.

DOL ADMINISTRATIVE RELIEF FROM PENALTY

In order to encourage voluntary compliance with the annual reporting requirements by late filers, DOL implemented the DFVC Program. Plan administrators who are subject to the assessment of civil penalties for failing to file a timely annual report and who are eligible for the DFVC program may pay reduced civil penalties by voluntarily complying with the terms of the DFVC Program.

ADMINISTRATIVE RELIEF FROM CERTAIN INTERNAL REVENUE CODE PENALTIES FOR DFVC PROGRAM PARTICIPANTS

The Service will not impose the penalties under §§ 6652(c)(1), (d), (e), and 6692 (as these sections relate to the filing of a Form 5500) on a person who is eligible for and satisfies the requirements of the DFVC Program with respect to the filing of a Form 5500. Once the late filer satisfies the requirements of the DFVC Program, including paying the reduced civil penalty under section 502(c)(2) of ERISA, the relief under this notice will apply. The late filer need not file a separate application for relief with the Service. The Service will coordinate with DOL in determining which late filers are eligible for the relief under this notice.

INAPPLICABILITY OF THE ABOVE RELIEF FOR CERTAIN FILERS

The relief under this notice is available only to the extent that a Form 5500 is required under Title I of ERISA. Therefore, for example, Form 5500–EZ filers and Form 5500 filers for plans without employees (as described in 29 CFR 2510.3–3(b) and (c)) are not eligible for the relief in this notice. Because such plans are not subject to Title I of ERISA, they are ineligible to participate in the DFVC Program.

DRAFTING INFORMATION

The principal drafters of this notice are Steven J. Linder of the Employee Plans, Tax Exempt and Government Entities Division and Pamela Kinard of the Office of the Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). For further information regarding this notice, please contact Employee Plans' taxpayer assistance telephone service at 1–877–829–5500 (a toll-free number) between the hours of 8:00 a.m. and 6:30 p.m. Eastern Time, Monday through Friday. Mr. Linder may be reached at (202) 283–9888; Ms. Kinard may be reached at (202) 622–6060. The telephone numbers in the preceding sentence are not toll-free.

Partial Relief From the Substantiation Requirements of Section 170(f)(8) of the Internal Revenue Code for Charitable Contributions Made After September 10, 2001, and Before January 1, 2002

Notice 2002–25

PURPOSE

Due to the unique circumstances of the September 11th tragedy, the Internal Revenue Service is providing taxpayers who made certain charitable contributions of $250 or more with partial relief from the "contemporaneous written acknowledgment" requirement of § 170(f)(8) of the Internal Revenue Code with respect to those contributions. Taxpayers will be treated as satisfying the contemporaneous written acknowledgment requirement with respect to contributions made after September 10, 2001, and before January 1, 2002, if, on or before October 15, 2002, they either obtain the required acknowledgment from the donee organization, or have evidence of a good faith effort to obtain it.

BACKGROUND

Section 170 generally allows a deduction for charitable contributions made during the taxable year. With respect to contributions of $250 or more, the deduction is allowable only if the donor obtains a written acknowledgment from the donee organization on or before the date the donor files the return reporting the contribution or on or before the due date (including extensions) of the return, whichever comes first. Section 170(f)(8).

A contemporaneous written acknowledgment is a timely written statement from the donee organization that contains the following information: (1) the amount of cash and a description (but not value) of any property other than cash contributed; (2) whether the donee organization provided any goods or services in consideration for the property contributed; and (3) a description and good faith estimate of the value of any goods or services provided by the donee organization in consideration for the property contributed. The donee organization may provide a paper copy of the acknowledgment to the donor, or the donee organization may provide the acknowledgment electronically, such as in an e-mail addressed to the donor. See Publication 1771, "Charitable Contributions—Substantiation and Disclosure Requirements."

The Service has become aware that, due to the overwhelming number of charitable contributions made in the wake of September 11th, many donee organizations are unable to supply donors with the required acknowledgments in a timely manner.

RELIEF

Under these unique circumstances, the following partial relief is provided: A donor that contributed $250 or more of cash or other property after September 10, 2001, and before January 1, 2002, and has not obtained a written acknowledgment by the date specified in § 170(f)(8), will be treated as having satisfied the requirements of that section if, on or before October 15, 2002, the donor either obtains the required acknowledgment, or has evidence of a good faith effort to obtain it. An example of a good faith effort is sending the donee organization a letter or e-mail requesting a written acknowledgment that meets the requirements of § 170(f)(8). A copy of that letter or e-mail is evidence of a good faith effort.

Donors are reminded that they must comply with all of the other requirements of § 170 in order to be allowed charitable contribution deductions. For example, donors must comply with the requirement that they maintain records to substantiate the fact and amount of a transfer to a qualified charity within the taxable year.

DRAFTING INFORMATION

The principal authors of this notice are Patricia Zweibel and Susan Kassell of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information regarding this notice, contact Ms. Zweibel or Ms. Kassell at (202) 622–5020 (not a toll-free call).

Weighted Average Interest Rate Update

Notice 2002–26

Sections 412(b)(5)(B) and 412(l)(7)(C)(i) of the Internal Revenue Code provide that the interest rates used to calculate current liability for purposes of determining the full funding limitation under § 412(c)(7) and the required contribution under § 412(l) must be within a permissible range around the weighted average of the rates of interest on 30-year Treasury securities during the four-year period ending on the last day before the beginning of the plan year.

Notice 88–73 (1988–2 C.B. 383) provides guidelines for determining the weighted average interest rate and the resulting permissible range of interest rates used to calculate current liability for the purpose of the full funding limitation of § 412(c)(7) of the Code.

Section 417(e)(3)(A)(ii)(II) of the Code defines the applicable interest rate, which must be used for purposes of determining the minimum present value of a participant's benefit under §§ 417(e)(1) and (2), as the annual rate of interest on 30-year Treasury securities for the month before the date of distribution or such other time as the Secretary may by regulations prescribe. Section 1.417(e)–1(d)(3) of the Income Tax Regulations provides that the applicable interest rate for a month is the annual interest rate on 30-year Treasury securities as specified by the Commissioner for that month in revenue rulings, notices or other guidance published in the Internal Revenue Bulletin.

The rate of interest on 30-year Treasury Securities for February 2002 is 5.40 percent. The Service has determined this rate as the average of the 30-year Treasury Constant Maturity interest rate determined each day through February 18, 2002 (as reported in § H.15 on the Federal Reserve website (*www.federalreserve.gov/releases*)), and the yield on the 30-year Treasury bond maturing in February 2031, determined each day for the balance of the month.

Effective for March 2002, the Service will determine and publish the rate of

interest on 30-year Treasury Securities solely on the basis of the monthly average of the daily determination of yield on the 30-year Treasury bond maturing in February 2031. The Service will determine and publish the average yield on such basis for an interim period, pending the enactment of legislative changes to §§ 412 and 417 that address the discontinuance of the 30-year Treasury bond.

Section 405 of the Job Creation and Worker Assistance Act of 2002 ("JCWAA") amended § 412(l)(7)(C) of the Code to provide that for plan years beginning in 2002 and 2003 the permissible range is extended to 120 percent.

The following rates were determined for the plan years beginning in the month shown below.

Month	Year	Weighted Average	90% to 120% Permissible Range	90% to 110% Permissible Range
January	2002	5.71	5.14 to 6.85	5.14 to 6.28
February	2002	5.70	5.13 to 6.84	5.13 to 6.27
March	2002	5.69	5.12 to 6.83	5.12 to 6.26

Drafting Information

The principal author of this notice is Todd Newman of the Employee Plans, Tax Exempt and Government Entities Division. For further information regarding this notice, please contact the Employee Plans' taxpayer assistance telephone service at 1–877–829–5500 (a toll-free number), between the hours of 8:00 a.m. and 6:30 p.m. Eastern time, Monday through Friday. Mr. Newman may be reached at 1–202–283–9888 (not a toll-free number).

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26 CFR 601.602: Tax forms and instructions.
(Also Part I, section 894; Part II, United States-Canada Income Tax Convention.)

Rev. Proc. 2002–23

SECTION 1. PURPOSE

This revenue procedure provides guidance for applying Article XVIII(7) of the United States-Canada Income Tax Convention, signed on September 26, 1980, as amended by Protocols signed on June 14, 1983, March 28, 1984, March 17, 1995, and July 29, 1997 (the "Convention"). It supersedes Revenue Procedure 89–45 (1989–2 C.B. 596), which provided guidance for applying former Article XXIX(5) of the Convention. Article XVIII(7), which was added to the Convention by the Protocol that was signed on March 17, 1995, expanded and replaced Article XXIX(5).

SECTION 2. BACKGROUND

.01 *Domestic Rules*. Under the domestic law of the United States, an individual who is a citizen or resident of the United States and a beneficiary of a Canadian retirement plan will be subject to current United States income taxation on income accrued in the plan even though the income is not currently distributed to the beneficiary, unless the plan is an employees' trust within the meaning of section 402(b) of the Internal Revenue Code and the individual is not a highly compensated employee subject to the rule of section 402(b)(4)(A). However, if the plan satisfies certain requirements under the domestic law of Canada, the income accrued in the plan will not be subject to Canadian income taxation until it is actually distributed from the plan (or from another plan to which it is transferred in a tax-free rollover). Thus, there may be a mismatch between the timing of the United States tax and the Canadian tax, with the result that the individual may be subject to double taxation for which no relief is available under Article XXIV of the Convention.

.02 *Former Article XXIX(5)*. Former Article XXIX(5) of the Convention addressed the timing mismatch in respect of a U.S. citizen who was a resident of Canada and a beneficiary of a Canadian registered retirement savings plan ("RRSP") by providing that such a U.S. citizen could elect, under rules established by the competent authority of the United States, to defer United States taxation with respect to any income accrued in the RRSP but not distributed by the RRSP, until such time as a distribution was made from such RRSP or any plan substituted therefor. The rules for making an election under former Article XXIX(5) were set forth in Revenue Procedure 89–45. Additional guidance was set forth in Revenue Ruling 89–95 (1989–2 C.B. 131), which provided that if the proceeds of a RRSP were rolled over to a Canadian registered retirement income fund ("RRIF"), the RRIF would be treated as a plan substituted for the RRSP, with the result that both the proceeds that were rolled over from the RRSP and the income subsequently accrued in the RRIF could qualify for deferral under former Article XXIX(5).

.03 *Article XVIII(7)*. Article XVIII(7) of the Convention now provides, effective for taxable years beginning on or after January 1, 1996, that a natural person who is a citizen or resident of either the United States or Canada and a beneficiary of a trust, company, organization, or other arrangement that is a resident of the other country that is generally exempt from income taxation in the other country (a "plan"), and is operated exclusively to provide pension, retirement, or employee benefits, may elect to defer taxation in the person's country of citizenship or residence, under rules established by the competent authority of that country, with respect to any income accrued in the plan but not distributed by the plan, until such time as and to the extent that a distribution is made from the plan or any plan substituted therefor.

SECTION 3. SCOPE

This revenue procedure applies to an individual who is a citizen or resident of the United States and a beneficiary of one of the following Canadian plans (an "eligible plan"): a RRSP, a RRIF, a registered pension plan, or a deferred profit sharing plan. This revenue procedure applies regardless of whether the individual was a resident of Canada at the time contributions were made to the eligible plan. For purposes of this revenue procedure, a "beneficiary" of an eligible plan is an individual who would, in the absence of an election under Article XVIII(7) of the Convention, be subject to current United States income taxation on income accrued in the plan. The revenue procedure applies only to income accrued in an eligible plan and not to any contributions to the plan.

SECTION 4. ELECTION PROCEDURES

.01 *In General*. If income accruing in an eligible plan would otherwise be subject to current United States income taxation, a beneficiary of the eligible plan may elect for the beneficiary's taxable year (the "current year") and all subsequent years to defer United States income tax on the beneficiary's share of income accrued in the plan until that income is distributed to the beneficiary. Beneficiaries shall make the election by attaching to their timely filed (including extensions) United States federal income tax return for the current year, a statement that includes the following information:

(i) A statement that the taxpayer is claiming the benefit of Article XVIII(7) of the Convention under this revenue procedure;

(ii) The name of the trustee of the plan and the plan account number, if any; and

(iii) The balance in the plan at the beginning of the current year.

.02 *Reporting*. Beneficiaries shall attach a copy of the statement required in paragraph 4.01 to their timely filed (including extensions) United States federal income tax return for each year subsequent to the current year, until the tax year in which a final distribution is made from the plan (or from any transferee plan within the meaning of paragraph 4.03).

.03 *Rollovers*. If an eligible plan for which an election has been made pursuant to paragraph 4.01 ("transferor plan") is rolled over to another eligible plan ("transferee plan") in a transfer that does not result in the current imposition of Canadian income tax (*e.g.*, a transfer such as that described in Revenue Ruling 89–95), the previous election is deemed to carry over to the transferee plan.

.04 *Transferee Plan Reporting*. In the case of a transferee plan, in addition to a copy of the statement required for the transferor plan under paragraph 4.02, in the tax year of the transfer ("transfer year"), beneficiaries shall attach an additional statement that includes the following information:

(i) A statement that the taxpayer is claiming the benefit of Article XVIII(7) of the Convention under this revenue procedure;

(ii) The name of the trustee of the transferee plan and the plan account number, if any;

(iii) The name of the trustee of the transferor plan and the plan account number, if any;

(iv) The total amount of income accrued in the transferor plan on which United States income tax was deferred under either Article XVIII(7) or former Article XXIX(5); and

(v) The initial balance in the transferee plan.

Beneficiaries of a transferee plan shall attach a copy of the statement required in paragraph 4.02 (transferor plan) and a copy of the statement required in this paragraph 4.04 (transferee plan) to their timely filed (including extensions) United States federal income tax return for each year subsequent to the transfer year, until the tax year in which a final distribution is made from the transferee plan.

.05 *Multiple Plans*. An individual who is a beneficiary of more than one eligible plan must make a separate election and file a separate statement for each eligible plan.

.06 *Extension Of Time For Making Elections*. An extension of time for making an election under paragraph 4.01 may be available under the procedures applicable under sections 301.9100–1 and 301.9100–3 of the Procedure and Administration Regulations.

.07 *Prospective Change of Election*. An election once made cannot be revoked except with the consent of the Commissioner.

SECTION 5. DISTRIBUTIONS FROM AN ELIGIBLE PLAN

Distributions received by a beneficiary from an eligible plan shall be included in gross income by the beneficiary in the manner provided under section 72 of the Internal Revenue Code, subject to any other applicable provision of the Convention.

SECTION 6. EFFECT ON OTHER DOCUMENTS

This revenue procedure supersedes Revenue Procedure 89–45 (1989–2 C.B. 596).

SECTION 7. EFFECTIVE DATE

This revenue procedure is effective for taxable years ending on or after December 31, 2001. For taxable years ending before such date and beginning on or after January 1, 1996, taxpayers may elect to apply either this revenue procedure or Revenue Procedure 89–45.

SECTION 8. 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 1545–1773.

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 4. This information is required to enable taxpayers to claim a benefit under the Convention. This information will be used to compute and collect the right amount of tax. The likely respondents are individuals.

The estimated total annual reporting burden is 10,000 hours. The estimated annual burden per respondent varies from

0.1 hour to 1 hour, depending on individual circumstances, with an estimated average of 0.5. The estimated number of respondents is 20,000.

The estimated annual frequency of responses is once per respondent.

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 authors of this revenue procedure are M. Grace Fleeman and Amanda A. Ehrlich of the Office of the Associate Chief Counsel (International). For further information regarding this revenue procedure, contact Amanda A. Ehrlich at (202) 622–3880 (not a toll-free call).

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26 CFR 601.105: Examination of returns and claims for refund, credit or abatement; determination of correct tax liability.
(Also Part I, §§ 163, 6601, 7122; 1.163–9T, 301.6601–1, 301.7122–1)

Rev. Proc. 2002–26

SECTION 1. PURPOSE

The purpose of this revenue procedure is to update and restate the Internal Revenue Service's position regarding the application, by the Service, of a partial payment of tax, penalty, and interest for one or more taxable periods. This revenue procedure supersedes Rev. Rul. 73–304 (1973–2 C.B. 42); Rev. Rul. 73–305 (1973–2 C.B. 43); and Rev. Rul. 79–284 (1979–2 C.B. 83).

SECTION 2. SCOPE

This revenue procedure applies to all taxes under the Internal Revenue Code, except alcohol, tobacco, and firearms taxes and the harbor maintenance tax. For purposes of this revenue procedure, the term "penalty" includes any additional amount, addition to tax, or assessable penalty.

SECTION 3. PROCEDURE

.01 If additional taxes, penalty, and interest for one or more taxable periods have been assessed against a taxpayer (or have been mutually agreed to as to the amount and liability but are unassessed) at the time the taxpayer voluntarily tenders a partial payment that is accepted by the Service and the taxpayer provides specific written directions as to the application of the payment, the Service will apply the payment in accordance with those directions.

.02 If additional taxes, penalty, and interest for one or more taxable periods have been assessed against a taxpayer (or have been mutually agreed to as to the amount and liability but are unassessed) at the time the taxpayer voluntarily tenders a partial payment that is accepted by the Service and the taxpayer does not provide specific written directions as to the application of payment, the Service will apply the payment to periods in the order of priority that the Service determines will serve its best interest. The payment will be applied to satisfy the liability for successive periods in descending order of priority until the payment is absorbed. If the amount applied to a period is less than the liability for the period, the amount will be applied to tax, penalty, and interest, in that order, until the amount is absorbed.

.03 Payments made pursuant to the terms of offers in compromise (or offers in compromise and collateral agreements) that have been accepted by the Government in compromise of outstanding tax liabilities, in accordance with § 7122 of the Internal Revenue Code, will be applied as follows:

(1) If an offer in compromise and collateral agreement have been accepted by the Government in compromise of an outstanding liability and the offer in compromise and collateral agreement provide for the allocation of payments made pursuant thereto, payments made pursuant to the agreements will be applied by the Service in accordance with the terms of the agreements.

(2) In all other cases, the Service will apply payments, whether paid in installments or in a lump sum and whether paid pursuant to the offer or a collateral agreement, to periods in the order of priority that the Service determines will serve its best interest. The payment will be applied to satisfy the liability for successive periods in descending order of priority until the payment is absorbed. If the amount applied to a period is less than the liability for the period, the amount will be applied to tax, penalty, and interest, in that order, until the amount is absorbed.

.04 If any part of a payment is applied to interest under the rules set forth in this revenue procedure, the amount applied to interest is treated for purposes of § 163 of the Code as interest paid in the year in which the payment is made. Under § 163, interest paid or accrued in a taxable year may be deducted in calculating taxable income for the year except to the extent such interest is personal interest as defined in § 163(h) and § 1.163–9T(b)(2) of the Income Tax Regulations or is otherwise disallowed under applicable provisions of the Internal Revenue Code and Income Tax Regulations.

SECTION 4. EFFECT ON OTHER DOCUMENTS

Rev. Rul. 73–304, Rev. Rul. 73–305, and Rev. Rul. 79–284 are hereby superseded.

SECTION 5. DRAFTING INFORMATION

The principal author of this revenue procedure is Inga Plucinski of the Office of Associate Chief Counsel (Procedure and Administration), Administrative Provisions and Judicial Practice. For further information regarding this revenue procedure, contact Emly Berndt at (202) 622–4940 (not a toll-free call).

Part IV. Items of General Interest

Prohibited Transactions — Proposed Class Exemption and the Voluntary Fiduciary Correction Program

Announcement 2002–31

On March 15, 2000, the U.S. Department of Labor (the “DOL”) published at 65 **Fed. Reg**. 14164, its interim Voluntary Fiduciary Correction (“VFC”) program. On March 28, 2002, the DOL adopted its permanent VFC program. In conjunction with that program, the DOL, which, generally, has the authority to determine whether a transaction is prohibited under § 4975 of the Internal Revenue Code, published a notice of a proposed class exemption (Application No. D–10933) from the prohibited transaction rules pertaining to four of the enumerated transactions that come under the VFC program.

The proposed class exemption when finalized will provide relief from the sanctions of § 4975 (a) and (b) of the Internal Revenue Code, *i.e.*, the application of the excise taxes described therein applied as a result of § 4975(c)(1)(A) through (E),[1] with respect to the four enumerated transactions. Among the conditions for an applicant to be eligible for the proposed class exemption are the following: (1) meeting the requirements of the VFC program pertaining to the particular transaction, (2) receiving a no action letter from the DOL regarding the transaction, and (3) providing notice to all interested persons.

The Service recognizes that a disqualified person who meets the conditions described in the proposed class exemption could nevertheless be subject to the sanctions of § 4975 during the pendency of the proposed class exemption despite the fact that the proposed class exemption when finalized will cause those sanctions not to apply with respect to the transactions enumerated in the class exemption (assuming all of the conditions of the class exemption are met). In order to encourage fiduciaries that meet the terms of the proposed class exemption to participate in the DOL’s VFC program and to remove a significant disincentive from participating in that program, the Service will not seek to impose the § 4975 (a) and (b) excise taxes with respect to any prohibited transaction that is covered by the proposed class exemption notwithstanding any subsequent changes to the proposed class exemption when it is finalized, provided that all of the requirements specified in the proposed class exemption are met.

Drafting Information

The principal author of this announcement is Michael Rubin of the Tax Exempt and Government Entities Division, Employee Plans. For further information regarding this announcement, please contact the Employee Plans’ taxpayer assistance telephone service at 1–877–829–5500 (a toll-free number), between the hours of 8:00 a.m. and 6:30 p.m. Eastern Time, Monday through Friday. Mr. Rubin can be contacted at 202–283–9888 (not a toll-free number).

[1] The prohibited transactions described in § 4975(c)(1)(F), *i.e.*, the receipt of any consideration for his of her own personal account by any disqualified person who is a fiduciary from any party dealing with the plan in connection with a transaction involving the income or assets of the plan, does not come within the framework of the DOL’s proposed class exemption or this announcement.

Announcement and Report Concerning Advance Pricing Agreements

Announcement 2002–40

March 29, 2002

This Announcement is issued pursuant to § 521(b) of Pub. L. 106–170, the Ticket to Work and Work Incentives Improvement Act of 1999, requiring that the Secretary of the Treasury annually report to the public concerning Advance Pricing Agreements (APAs) and the APA Program. The first report, in Announcement 2000–35 (2000–1 C.B. 922), covered calendar years 1991 through 1999. The second report, in Announcement 2001–32 (2001–17 I.R.B. 1113), described the experience of the APA Program during calendar year 2000. This third report describes the experience of the APA Program during calendar year 2001 consistent with the mandate of § 521(b). This document does not provide general guidance regarding the application of the arm’s length standard; rather, it reports on the structure and activities of the APA program.

Sean F. Foley
Director, Advance Pricing Agreement Program

Background

IRC § 482 provides that the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among two or more commonly controlled businesses if necessary to reflect clearly the income of such businesses. Under the regulations, the standard to be applied in determining the true taxable income of a controlled business is that of a business dealing at arm’s length with an unrelated business. The arm’s length standard also has been adopted by the international community

and is incorporated into the transfer pricing guidelines issued by the Organization for Economic Cooperation and Development (OECD). OECD, TRANSFER PRICING GUIDELINES FOR MULTINATIONAL ENTERPRISES AND TAX ADMINISTRATORS (1995). Transfer pricing issues by their nature are highly factual and have traditionally been one of largest issues identified by the IRS in its audits of multinational corporations. The Advance Pricing Agreement (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. In year 2001, the IRS and taxpayers executed 55 APAs and amended 7 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 transfer pricing methodology (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)0 (November 15, 1996). Also in 1996, the IRS updated Rev. Proc. 91–22 with the release of Rev. Proc. 96–53 (1996–2 C.B. 375). The APA Program continues to operate under the provisions of Rev. Proc. 96–53, which provides taxpayers with instructions of how to apply for an APA, and what to expect in the processing of the case.[1] In addition, in 1998, the IRS published Notice 98–65 (1998–2 C.B. 803), which set forth streamlined APA procedures for Small Business Taxpayers (SBTs). That Notice also expanded the availability of the lowest APA user fee in an effort to attract taxpayers who may not have the resources to do the sophisticated economic studies normally required in APA submissions.

Advance Pricing Agreements

An APA generally combines an agreement between a taxpayer and the IRS on an appropriate transfer pricing methodology (TPM) for the transactions at issue (Covered Transactions) with an agreement between the U.S. and one or more foreign tax authorities (under the authority of the mutual agreement process of our income tax treaties) that the TPM is correct. With such a "bilateral" APA, the taxpayer ordinarily is assured that the income associated with the Covered Transactions will not be subject to double taxation by the IRS and the foreign tax authority. It is the policy of the United States, as reflected in § 7 of Rev. Proc. 96–53 to encourage taxpayers that enter the APA program to seek bilateral or multilateral APAs when competent authority procedures are available with respect to the foreign country or countries involved. However, the IRS may execute an APA with a taxpayer without reaching a competent authority agreement (a "unilateral" APA).

A unilateral APA is an agreement between a taxpayer and the IRS establishing an approved transfer pricing methodology for U.S. tax purposes. A unilateral APA binds the taxpayer and the IRS, but obviously does not prevent foreign tax administrations from taking different positions on the appropriate transfer pricing methodology for a transaction. As stated in Rev. Proc. 96–53, should a transaction covered by a unilateral APA be subject to double taxation as the result of an adjustment by a foreign tax administration, the taxpayer may seek relief by requesting that the U.S. competent authority consider initiating a mutual agreement proceeding, provided there is an applicable income tax treaty in force with the other country.

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

The APA Program

APAs are negotiated with the taxpayer by an IRS team headed by an APA team leader. As of December 31, 2001, the APA program had 22 team leaders, of whom 21 were attorneys and 1 was a former international examiner. The team leader is responsible for organizing the IRS APA team, arranging meetings with the taxpayer, securing whatever information is necessary from the taxpayer to analyze the taxpayer's related party transactions, analyzing the available facts under the arm's length standard of § 482 and the regulations, and negotiating with the taxpayer.

The APA team generally includes an economist, an international examiner and, in a bilateral case, a competent authority analyst who leads the discussions with the treaty partner. The economist may be from the APA Program or from the IRS field organization. The APA team may include LMSB field counsel, other LMSB exam personnel, and an appeals officer.

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[1] In an effort to encourage taxpayers to utilize the APA process, in 1997 the IRS instituted an Early Referral Program by which, in appropriate cases, field examination teams may suggest to taxpayers that APAs be pursued before substantial time is spent examining transfer pricing issues. Since the reorganization of the IRS in 2000 into separate business units, the Large & Midsize Business (LMSB) Division has encouraged taxpayers to resolve their issues through a variety of pre-filing programs, including APAs. As a result, the IRS is no longer separately tracking APA cases under the 1997 Early Referral Program.

The APA Process

The APA process is voluntary. Taxpayers submit an application for an APA, together with a user fee as set forth in Rev. Proc. 96–53. The APA process can be broken into five phases: (1) application; (2) due diligence; (3) analysis; (4) discussion and agreement; and (5) drafting and execution.

(1) The APA Application

In many APA cases, the taxpayer's application is preceded by a pre-file conference with the APA staff in which the taxpayer can solicit the informal views of the APA Program. Pre-file conferences can occur on an anonymous basis, although a taxpayer must disclose its identity when it applies for an APA. Taxpayers must file the appropriate user fee on or before the due date of the tax return for the first taxable year that the taxpayer proposes to be covered by the APA. Many taxpayers file a user fee first and then follow up with a full application later. The procedures for pre-file conferences, user fees, and delayed applications can be found in Rev. Proc. 96–53.

The APA application can be a relatively modest document for a small business taxpayer. Notice 98–65 describes the special APA procedures for small businesses. For most taxpayers, however, the APA application is a substantial document filling several binders. The APA Program makes every effort to reach agreement on the basis of the information provided in the taxpayer's application.

The application is assigned to an APA team leader who will be 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 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. The APA team leader will then distribute copies of the APA application to all team members and will set up an opening conference with the taxpayer. The APA office strives to hold this opening conference within 45 days of the receipt of the complete application. At the opening conference, the APA team leader will propose a schedule designed to complete the recommended U.S. negotiating position for a bilateral APA within 9 months from the date the full application was filed and to complete a unilateral APA within 12 months from the application date. In 2001, the median for completing negotiating positions was 22.9 months (average 25.6), and the median for completing unilateral APAs was 16.0 months (average 16.8).

(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, but in a large case the taxpayer and the APA team typically will agree to a meeting, or more often to a series of meetings on dates, established in the opening conference. In advance of the meeting, the APA team leader will submit a list of questions to the taxpayer for discussion at the meeting. The meeting may result in a second set of questions. These questions from the IRS are developed jointly by the APA team leader and the IRS field. It is important to note that this due diligence is not an audit and is focused only on the transfer pricing issues associated with the transactions in the taxpayer's application, or such other transactions that the taxpayer and the IRS may agree to add.

(3) Analysis

A significant part of the analytical work associated with an APA is done typically by the APA or IRS field economist assigned to the case. The analysis may result in the need for additional information. Once the APA team has completed its due diligence and analysis, the APA team leader will begin negotiations with the taxpayer over the various aspects of the APA including the selection of comparable transactions, asset intensity and other adjustments, the transfer pricing methodology, 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 in the main the APA team leader is empowered to negotiate the APA.

(4) Discussion and Agreement

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

The experience of the APA office and the U.S. Competent Authority is that APA negotiations are likely to proceed more rapidly with a foreign competent authority if the taxpayer fully supports the U.S. negotiating position. Consequently, the APA Office works together with the taxpayer in developing the recommended U.S. 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 will take the recommended U.S. negotiating position and prepare the final U.S. negotiating position, which is then transmitted to the foreign competent authority. The negotiations with the foreign competent authority are conducted by the U.S. Competent Authority analyst, most often in face-to-face negotiating sessions conducted periodically throughout the year. At the request of the U.S. Competent Authority analyst, the APA team leader may continue to assist the negotiations.

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

(5) *Drafting, Review, and Execution*

Once the IRS and the taxpayer reach agreement, the drafting of the final APA generally takes little time because the APA Program has developed standard language that is incorporated into every APA. The current version of this language is found in Attachment A. APAs are reviewed by the Branch Chief and the APA Director. In addition, the substance of each APA is briefed to 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.

The Current APA Office Structure, Composition, and Operation

In 2001, the APA Office was restructured into four branches. Branches 1 and 3 are staffed with APA team leaders. Branch 2 is a new economist branch and also includes the team leader with the principle responsibility for annual report review. Branch 4 is the new APA West Coast office, located in San Francisco and staffed with a mix of APA team leaders and an economist. Also new in 2000 is a Special Counsel to the Director. As of December 31, 2001, the APA staff was as follows:

<table>
<tr><td colspan="4" align="center">Director's Office
1 Director
1 Special Counsel to the Director
1 Secretary to the Director</td></tr>
<tr><td>Branch 1
1 Branch Chief
1 Secretary
9 Team Leaders</td><td>Branch 2
1 Branch Chief
1 Team Leader
6 Economists</td><td>Branch 3
1 Branch Chief
1 Secretary
9 Team Leaders</td><td>Branch 4
1 Branch Chief
3 Team Leaders
1 Economist</td></tr>
</table>

The APA staffing grew dramatically in 2001, rising from 25 persons at the end of 2000 to 38 as of December 31, 2001. The APA Office also continued to experience relatively high turnover in the past year, although lower than the turnover experienced in 2000. Of the 25 people on the APA staff at the end of 2000, 6 were no longer on the staff at the end of 2001. The hiring and turnover combined to create a significant training challenge in 2001. As of December 31, 2001, 10 of the 22 team leaders and 5 of the 7 economists had been with the program less than a year. In addition, 3 of the 4 branch chiefs were new.

The number of team leaders grew from 16 to 22, while the number of economists increased from 3 to 7. Thus the relative number of economists increased substantially, from a ratio of 5 team leaders per economist, to almost 3 team leaders per economist. This increase in the relative number of APA economists is expected to have a salutary affect on APA case processing time. Historically, APA team leaders have reported that lack of economist support is one of the major impediments to timely case processing. Average caseloads fell from 13 APAs per team leader as of December 31, 2000, to 10 per team leader as of December 31, 2001. This should also help in case timeliness as relatively high case loads in prior years had made it difficult for APA team leaders to give adequate attention to all pending cases. As set forth in Table 1 below, new APA filings declined by 15% to 77 as compared to 91 in the prior year.

APA New Hire Training

In 2001, the APA Office greatly increased the size of its professional staff. To ensure the most immediate benefits from its new staff, provide the highest quality service to the program's customers, and increase the program's efficient use of its new resources, the APA Program worked with the Training and Communications Division of the Office of Associated Chief Counsel (Finance & Management) to develop an APA New Hire Training Program. The APA managers, senior Team Leaders and APA Economists participated in the training by developing a list of topics, preparing and reviewing course materials, and serving as class presenters.

The APA New Hire Training consisted of 19 three to four hour sessions presented throughout June, July, August, and September. The session topics included the history of the APA Program, general administrative matters, APA case management procedures, and substantive transfer pricing/APA topics.

The APA Office has released the written course materials to the public. These training materials and other APA related documents can be found at the IRS website, *www.irs.gov*, under an APA hyperlink under the Business/Corporate webpage. The APA Office will periodically update these training materials as appropriate.

APA West Coast Branch

In September 2001, the APA Program opened its new Branch 4 in California, implementing its plan to be more easily accessible to taxpayers located west of the Mississippi. Approximately 25% of APA caseload comes from such taxpayers, with the majority of these in California, divided almost evenly between Northern and Southern California. The APA Program determined that having Western cases serviced from California would benefit both taxpayers and APA staff by reductions in travel time, costs, and time zone complications, and by closer relations with Western taxpayers and taxpayer organizations.

The first of Branch 4's two planned offices is located in San Francisco and is already fully functional, staffed with a branch manager, three team leaders, and an economist. Numerous taxpayer representatives have contacted the office from its first days of operation; after six months, Branch 4 is handling a significant inventory of APA submissions and pre-filing conferences for Western cases. Plans for the second Branch 4 office are in the final stages. The office is expected to open during the first half of 2002 in Laguna Niguel in Orange County, about one hour south of Los Angeles. After hiring is complete, this office, like the San Francisco office, will have three team leaders and an economist. In addition, the branch chief of Branch 4 will be resident at the Southern California office, while continuing to manage the San Francisco office. The APA Program expects that its office in Southern California will meet with the same positive reaction among Western taxpayers, taxpayer organizations and their representatives that Branch 4's Northern California office is enjoying.

Model APA at Attachment A

[§ 521(b)(2)(B)]

Once the IRS and the Taxpayer reach agreement, the drafting of the final APA generally takes little time because the APA Program has developed model language. Attachment A contains the current version of this language. As part of its continuing effort to improve its work products, the APA Program has revised the model language to reflect the program's collective experience with substantive and drafting issues.

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 2001	31	46		77	569
APAs executed					
•Year 2001	36	19		55	349
•1991–2000	143	144 [2]	7	294	
APA renewals executed during year 2001	14	2		16	70
Revised or Amended APAs executed during year 2001 [3]	6	1		7	12
Pending requests for APAs	40	177		217	
Pending requests for new APAs	34	132		166	
Pending requests for renewal APAs	6	45		51	
APAs canceled [4]	3	1		4	5
APAs withdrawn	1	4		5	54

TABLE 2: MONTHS TO COMPLETE APAs

Months to Complete Advance Pricing Agreements in Year 2001	
Combined Unilateral, Bilateral, Multilateral: Average	23.3
Combined Unilateral, Bilateral, Multilateral: Median	18.0

Unilateral New		Unilateral Renewal		Unilateral Combined	
Average	16.0	Average	18.1	Average	16.8
Median	15.5	Median	17.0	Median	16.0

Bilateral/Multilateral New		Bilateral/Multilateral Renewal		Bilateral/Multilateral Combined[5]	
Average	37.2	Average	21.0	Average	35.5
Median	42.0	Median	21.0	Median	42.0

[2] One 1996 APA involving a US Possession is counted as a bilateral APA.

[3] In 2001, the APA Office and taxpayers agreed to amend 7 APAs (*i.e.*, six unilateral and one bilateral). Generally, the APA Office and taxpayers amended APAs to clarify the agreement. For example, five APA amendments related to: conforming the language of the APA to reflect the parties' agreement; conforming the language of the APA to the language of the mutual agreement letter; clarifying the definition of a term; clarifying non-covered transactions; and clarifying the length of the APA term. Failure to meet a critical assumption precipitated the amendment of two other APAs. In one of the APAs, the taxpayer failed to have minimum annual gross sales. In the other APA, the taxpayer reorganized its business.

[4] In the history of the APA Program, no APAs have been revoked. In 2001, the APA Office and taxpayers agreed to cancel 4 APAs (*i.e.*, three unilateral and one bilateral). The circumstances of these cancellations were the sale of the taxpayer's covered business operations, the failure of the taxpayer to have minimum covered transaction-related revenue, and the taxpayer's inability to operate due to equipment failure, and the takeover of the taxpayer resulting in a material change of its accounting systems.

[5] The average time required to conclude a bilateral APA has historically been split roughly equally between the APA and Competent Authority Offices.

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	2	**16**	4	**31**	0	**46**	3
2	0	**17**	2	**32**	2	**47**	2
3	1	**18**	3	**33**	0	**48**	1
4	0	**19**	0	**34**	0	**49**	0
5	0	**20**	1	**35**	0	**50**	0
6	2	**21**	0	**36**	0	**51**	0
7	1	**22**	0	**37**	0	**52**	0
8	3	**23**	4	**38**	0	**53**	0
9	3	**24**	2	**39**	0	**54**	0
10	1	**25**	0	**40**	0	**55**	0
11	2	**26**	0	**41**	0	**56**	2
12	1	**27**	2	**42**	5	**57**	0
13	2	**28**	0	**43**	0	**58**	0
14	1	**29**	1	**44**	1	**59**	0
15	1	**30**	0	**45**	0	**60**	0

TABLE 4: RECOMMENDED NEGOTIATING POSITIONS

Recommended Negotiating Positions Completed in Year 2001	43

TABLE 5: MONTHS TO COMPLETE RECOMMENDED NEGOTIATING POSITIONS

Combined		New		Renewal	
Average	25.6	Average	22.2	Average	30.0
Median	22.9	Median	17.8	Median	23.3

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

Months	Number	Months	Number	Months	Number	Months	Number
1	0	**26**	0	**51**	0	**76**	0
2	0	**27**	2	**52**	1	**77**	0
3	0	**28**	0	**53**	0	**78**	0
4	2	**29**	0	**54**	0	**79**	0
5	0	**30**	0	**55**	0	**80**	0
6	0	**31**	0	**56**	0	**81**	0
7	0	**32**	0	**57**	0	**82**	0
8	0	**33**	1	**58**	0	**83**	0
9	1	**34**	1	**59**	0	**84**	0
10	1	**35**	0	**60**	1	**85**	0
11	2	**36**	0	**61**	0	**86**	0
12	1	**37**	1	**62**	0	**87**	0
13	1	**38**	0	**63**	0	**88**	0
14	7	**39**	1	**64**	0	**89**	0
15	2	**40**	0	**65**	0	**90**	0
16	0	**41**	0	**66**	0	**91**	0
17	0	**42**	0	**67**	0	**92**	0
18	1	**43**	1	**68**	0	**93**	1
19	0	**44**	1	**69**	0	**94**	0
20	1	**45**	0	**70**	0	**95**	0
21	0	**46**	0	**71**	0	**96**	0
22	4	**47**	1	**72**	0	**97**	0
23	4	**48**	1	**73**	0	**98**	0
24	1	**49**	0	**74**	0	**99**	0
25	2	**50**	0	**75**	0	**100**	0

TABLE 7: SMALL BUSINESS TAXPAYER APAs[6]

Small Business Taxpayer APAs Completed in Year 2001	11
Renewals	1
New	10
Unilateral	10
Bilateral	1

TABLE 8: MONTHS TO COMPLETE SMALL BUSINESS TAXPAYER APAs

Months to Complete Small Business Taxpayer APAs in Year 2001					
New		**Renewal**		**Combined**	
Average	15.4	Average	9.0	Average	14.8
Median	17.0	Median	9.0	Median	17.0

[6] A "small business taxpayer" is a U.S. taxpayer with a total gross income of $200 million or less, and the APA is processed under the special procedures set forth in Notice 98–65.

TABLE 9: INDUSTRIES COVERED

Industry Involved — NAICS Codes[7]	Number
Computer and electronic product manufacturing – 334	13–15
Machinery manufacturing – 333	4–6
Electrical equipment, appliance and component manufacturing – 335	4–6
Transportation equipment manufacturing – 336	4–6
Chemical manufacturing – 325	4–6
Wholesale trade, durable goods – 421	1–3
Securities, commodity contracts and other intermediary and related activities – 523	1–3
Apparel manufacturing – 315	1–3
Motor vehicle and parts dealers – 441	1–3
Air transportation – 481	1–3
Publishing industries – 511	1–3
Information service and data processing services – 514	1–3
Beverage and tobacco manufacturing – 312	1–3
Furniture and related products manufacturing – 337	1–3
Miscellaneous manufacturing – 339	1–3
Wholesale trade, nondurable goods – 422	1–3
Health and personal care stores – 446	1–3
Broadcasting and telecommunications – 513	1–3
Professional, scientific and technical services – 541	1–3

Trades or Businesses

[§ 521(b)(2)(D)(i)]

The nature of the relationship between the related organizations, trades, or businesses covered by APAs executed in Year 2001 are set forth in Table 10 below:

TABLE 10: NATURE OF RELATIONSHIPS BETWEEN RELATED ENTITIES

Relationship	Number of APAs
Foreign Parent – U.S. Subsidiary (-ies)	34
U.S. Parent – Foreign Subsidiary (-ies)	12
Foreign company and U.S. Branch (-es)	6
U.S. Company and Non-U.S. Branch (-es)	2
Partnership	1

Covered Transactions

[§ 521(b)(2)(D)(ii)]

The controlled transactions covered by APAs executed in Year 2001 are set forth in Table 11 and Table 12 below:

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

TABLE 11: TYPES OF COVERED TRANSACTIONS

Transaction Type	Number
Sale of tangible property into the US	29
Performance of services by US entity	19
Performance of services by Non-US entity	11
Sale of tangible property from the US	10
Use of intangible property by US entity	8
Use of intangible property by Non-US entity	7
Financial products — US branch of foreign company	3
R&D cost sharing — Non-US parent	2
Other	4

TABLE 12: TYPES OF COVERED TRANSACTIONS – SERVICES

Intercompany Services Involved in the Covered Transactions	Number
Distribution	16
Marketing	9
Headquarters costs	8
Assembly	7
Product support	7
Sales support	6
Warranty services	6
Accounting	5
Administrative	5
Research and development	5
Technical support services	5
Billing services	3
Contract research & development	3
Purchasing	3
Testing and installation services	3
Communication service	2
Legal	2
Management	2
Logistical support	1
Other	4

Business Functions Performed and Risks Assumed
[§ 521(b)(2)(D)(ii)]

The general descriptions of the business functions performed and risks assumed by the organizations, trades, or businesses whose results are tested in the covered transactions in the APAs executed in Year 2001 are set forth in Tables 13 and 14 below:

TABLE 13: FUNCTIONS PERFORMED BY THE TESTED PARTY

Functions Performed	Number
Marketing and distribution functions	49
Manufacturing	20
Product assembly and/or packaging	14
Research and development	12
Transportation and warehousing	12
Product service (repairs, etc.)	12
Product design and engineering	10
Managerial, legal, accounting, finance, personnel, and other support services	10
Technical training and tech support for sales staff (including sub-distributors)	9
Process engineering	8
Product testing and quality control	7
Purchasing and materials management	6
Engineering and construction related services	3
Licensing of intangibles	2
Trading and risk management of financial products	2
Consulting services	1
Telecom services	1
Other	3

TABLE 14: RISKS ASSUMED BY THE TESTED PARTY

Risks Assumed	Number
Market risks, including fluctuations in costs, demand, pricing, & inventory	43
General business risks (*e.g.*, related to ownership of PP&E)	36
Credit and collection risks	29
Financial risks, including interest rates & currency	27
R&D risks	7
Product liability risks	7
Warranty replacement risk	1

Discussion

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

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

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

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

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

[§ 521(b)(2)(D)(iii)]

The related organizations, trades, or businesses whose prices or results are tested to determine compliance with TPMs prescribed in APAs executed in Year 2001 are set forth in Table 15 below:

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

Type of Organization	Number[8]
US distributor	31
US provider of services	11
Non-US distributor	9
Non-US manufacturer	6
Non-US provider of services	6
US licensee of intangible property	6
US manufacturer	5
Non-US licensee of intangible property	5
US licensor of intangible property	4
US dealer in financial products	2
US participant in cost sharing agreement	2
Non-US participant in cost sharing agreement	2
Non-US licensor of intangible property	1
Non-US dealer in financial products	1

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

[§ 521(b)(2)(D)(iv)]

The TPMs used in APAs executed in Year 2001 are set forth in Tables 16–20 below:

[8] For purposes of this report, both sides are counted as tested parties for certain transactions, such as those involving the use of the Comparable Uncontrollod Price, Comparable Uncontrolled Transaction, profit split methods, as well as cost sharing agreements.

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

TPM used	Number[9]
Comparable Profits Method (CPM): PLI is operating margin	22
Comparable Profits Method (CPM): PLI is Berry ratio	7
CUT (intangibles only)	6
Comparable Profits Method (CPM): PLI is markup on total costs	6
Transactional Cost Plus Method (tangibles only)	5
Royalty implementing a CUT TPM	5
Royalty implementing a residual profit split TPM	5
Transactional Resale Price Method (tangibles only)	4
Royalty implementing a profit split TPM	3
Comparable Profits Method (CPM): PLI is Other	3
Unspecified method (except unspecified profit split)	2
Residual profit split	2
CUP (tangibles only) not based on published market data	1
Other profit split	1
Comparable Profits Method (CPM): PLI is return on assets or capital employed	1
Comparable Profits Method (CPM): PLI is gross margin	1
Comparable Profits Method (CPM): PLI is markup on other costs	1

TABLE 17: TRANSFER PRICING METHODS USED FOR SERVICES

TPM used	Number[10]
Cost plus a markup	13
CPM: PLI is operating margin	5
CPM: PLI is markup on total costs	4
Cost with no markup	4

TABLE 18: TRANSFER PRICING METHODS USED FOR FINANCIAL PRODUCTS

TPM used	Number
Interbranch allocation (*e.g.*, foreign exchange separate enterprise with statistical test of interbranch trades)	3

TABLE 19: TRANSFER PRICING METHODS USED FOR CONTRIBUTIONS TO COST SHARING ARRANGEMENTS

TPM used	Number
Costs allocated based on units produced, used, or sold	1
Cost allocated based on cost of raw materials	1

[9] 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) rate of return on assets or capital employed is the ratio of operating profit to operating assets, (2) operating margin is the ratio of operating profit to sales, (3) gross margin is the ratio of gross profit to sales, (4) Berry ratio is the ratio of gross profit to operating expenses, and (5) markup on total costs is generally a comparative markup on total costs involved.
[10] Some of the service transactions were covered by the transfer pricing methods used in tangible/intangible property transactions.

TABLE 20: TRANSFER PRICING METHODS USED FOR COST SHARING BUY-IN PAYMENTS

TPM used	Number
Buy-in based on residual profit split	1
Buy-in based on capitalized R&D	1

Discussion

The transfer pricing methods used in APAs completed during Year 2001 were based on those in the § 482 Treasury Regulations. Under § 1.482–3, the arm's length amount for controlled transfers of tangible property are determined using the Comparable Uncontrolled Price (CUP) method, the Resale Price Method, the Cost Plus Method, the Comparable Profits Method (CPM), and the Profit Split method. Under § 1.482–4, the arm's length amount for controlled transfers of intangible property are determined using the Comparable Uncontrolled Transaction (CUT) method, CPM, and 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 § 1.482–1(c). For transfers involving the provision of services, § 1.482–2(b) provides that services performed for the benefit of another member of a controlled group should ordinarily bear an arm's length charge, either deemed to be equal to the cost of providing the services (when non-integral) or which should be an amount that would have been charged between independent parties.

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

In reviewing the TPMs applicable to transfers of tangible and intangible property reflected in Table 16, it is clear that the majority of the APAs followed the specified methods. However, there are several distinguishing points that should be made. The Regulations note that for transfers of tangible property, the Comparable Uncontrolled Price (CUP) method will generally be the most direct and reliable measure of an arm's length price for the controlled transaction when sufficiently reliable comparable transactions can be identified. § 1.482–3(b)(2)(ii)(A). It was the experience of the APA Program in Year 2001 that in the cases that come into the APA Program, sufficiently reliable CUP transactions are difficult to find. In APAs executed in Year 2001, there was only one APA that used the CUP method; it did not look to published market data in setting the arm's length price.

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 when sufficiently reliable comparables may be found. § 1.482–4(c)(2)(ii). It has generally been difficult to identify external comparables, and APAs using the CUT method tend to rely on internal transactions between the taxpayer and unrelated parties. In Year 2001, there were six APAs that utilized the CUT method, and four of those also used one or more other methods for different covered transactions by the same taxpayer in the same APA.

The transactional Cost Plus Method (tangibles only) and Resale Price Method were applied in Year 2001 in five and four APAs respectively. See § 1.482–3(c), (d). The transactional nature of these methods distinguishes them from the CPM method using either a gross margin PLI (as compared to the Resale Price Method) or a markup on total costs PLI (as compared to the Cost Plus Method). A strict transactional method focuses on prices for individual or narrow groups of transactions, while a CPM looks at profits from broader groups of transactions or all of a company's transactions. In Year 2001, only two of the Cost Plus Method APAs used that method alone. The other three APAs using this method were supplemented by a CPM. In Year 2001, only two of the Resale Price Method APAs used that method alone. The other two APAs using this method were supplemented by a CPM.

The CPM is frequently applied in APAs. This is because reliable public data on comparable business activities of independent companies may be more readily available than potential CUP data, and comparability of resources employed, functions, risks, and other relevant considerations is more likely to exist than comparability of product. The CPM also tends to be less sensitive than other methods to differences in accounting practices between the tested party and comparable companies, *e.g.* classification of expenses as cost of goods sold or operating expenses. § 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. § 1.482–5(c)(2).

There were 39 covered transactions involving tangible or intangible property that used some form of the CPM (with varying PLIs). The CPM was also used in some APAs concurrently with other methods. For example, the CPM was used with two out of the four APAs that used the resale price method.

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. In two covered transactions, an operating margin PLI was used in conjunction with another PLI, the markup on total costs.

The CPM also was used regularly with services as the covered transactions in APAs executed in Year 2001. There were a total of nine services covered transactions using the CPM method with various PLIs according to the specific facts of the taxpayers involved. Table 17 reflects the methods used to determine the arm's length results for APAs involving services transactions.

In Year 2001, there were two APAs involving tangible or intangible property that used some form of a profit split. Both APAs used the Residual Profit Split, § 1.482–6(c)(3), in which routine contributions by the controlled parties are allocated routine market returns, and the residual income is allocated among the controlled taxpayers based upon the relative value of their contributions of intangible property to the relevant business activity. One of those APAs also used a second type of profit split. Profit splits are generally considered in cases in which the parties to the controlled transaction own valuable, non-routine, intangible property.

There were three financial product APAs involving interbranch allocations. These involve a single taxpayer with branches that act autonomously with respect to the covered transactions, generally involving foreign currency exchanges. These particular APAs determine the appropriate amount of profits attributable to each branch from the activity by reference to the branches' internal accounting methods. The results take into account all trades, and test the arms length results using statistical tests to verify that controlled trades are priced the same as uncontrolled trades.

There were two cost sharing APAs during Year 2001. Cost sharing APAs under § 1.482–7 generally address the methods used for determining each participant's share of costs (consistent with the reasonably anticipated benefits) for the development of intangibles. When there is also the transfer of existing intangibles, the APA will also generally address the appropriate buy-in amount. Tables 19 and 20 reflect the methods applied in cost sharing APAs executed in Year 2001.

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

Critical Assumptions used in APAs executed in Year 2001 are described in Table 21 below:

TABLE 21: CRITICAL ASSUMPTIONS

Critical Assumptions involving the following:	Number of APAs
Material changes to the business	55
Material changes to tax and/or financial accounting practices	55
Assets will remain substantially same	17
Changes in affiliated companies	14
Catastrophic events	5
Major regulatory changes	4
Use of Mark-to-Market method	3
Minimum sales volume	3
Changes in market shares	3
Major contract remains in force	3
Other financial ratio	3
Changes in sharing of risks of currency fluctuations	2
Interest rate changes	2
Material sales fluctuations	2
Marketing conditions substantially same	2
New import/ export non-tariff barriers	2
Ratio of R&D to sales	2
Currency fluctuations	1
Sales territories substantially same	1
Changes involving anti-dumping/ countervailing duties	1
Changes in other duties or tariffs	1
Major technological changes	1
Licensing agreements remain in effect	1
Other	11

Discussion

APAs include critical assumptions upon which their respective TPMs depend. Critical assumptions are objective business and economic criteria that form the basis of a taxpayer's proposed TPM. A critical assumption is any fact (whether or not within the control of the taxpayer) related to the taxpayer, a third party, an industry, or business and economic conditions, the continued existence of which is material to the taxpayer's proposed TPM. Critical assumptions might include, for example, a particular mode of conducting business operations, a particular corporate or business structure, or a range of expected business volume. Rev. Proc. 96–53, § 5.07. Failure to meet a critical assumption may render an APA inappropriate or unworkable.

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

If a critical assumption has not been met, the APA may be revised by agreement of the parties. If such agreement cannot be achieved, the APA may be canceled. If a critical assumption has not been met, it requires taxpayer's notice to and discussion with the Service, and, in the case of a bilateral APA, Competent Authority consideration. Rev. Proc. 96–53, § 11.07.

Sources of Comparables, Selection Criteria, and the Nature of Adjustments to Comparables and Tested Parties
[§ 521(b)(2)(D)(v), (vi), and (vii)]

The sources of comparables, selection criteria, and rationale used in determining the selection criteria for APAs executed in Year 2001 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 [11]
Compustat	39
Disclosure	13
Moody's	2
Japan Company Handbook	1
Global Vantage	1
Taxpayer's information on competition	1
Other	9

TABLE 23: COMPARABLE SELECTION CRITERIA

Selection Criteria Considered	Number of Times This Criterion Used
Comparable functions	46
Comparable industry	36
Comparable risks	31
Comparable products	27
Comparable geographic market	13
Comparable intangibles	11
Contractual terms	3
Other	4

TABLE 24: ADJUSTMENTS TO COMPARABLES OR TESTED PARTIES

Adjustment	Number of Times This Adjustment Used
Asset intensity adjustments	34
Receivables	34
Inventory	33
Payables	33
Property, plant, equipment	6
Other	2
Accounting adjustments	8
LIFO to FIFO inventory accounting	7
Accounting reclassifications (*e.g.*, from COGS to operating expenses)	2
Other	1
Profit level indicator adjustments (used to "back into" one PLI from another)	7
Operating expense	5
Other	2
Miscellaneous adjustments	3
Advertising	1
Other	2

[11] Although still guided by the arm's length standard, some APAs do not use comparables, for example, when there is a residual profit or in the case of certain financial products.

Discussion

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

For profit-based methods in which comparable business activities or functions of independent companies are sought, the APA Program typically has applied a three-part process. First, a pool of potential comparables has been identified through broad searches. From this pool, companies having transactions that are clearly not comparable to those of the tested party have been eliminated through the use of quantitative and qualitative analyses, *i.e.*, quantitative screens and business descriptions. Then, based on a review of available descriptive and financial data, a set of comparable companies or transactions 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 companies. This depends on the relevant market, the type of transaction being evaluated, and the results of the functional and risk analyses. In general, comparables have been located by searching a variety of databases that provide data on U.S. publicly traded companies and on a combination of public and private non-U.S. companies. Table 22 shows the various databases and other sources used in selecting comparables for the APAs executed in Year 2001.

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 and comparables derived from taxpayer information on competitors.

Selecting Comparables

Initial pools of potential comparables generally have been derived from the databases using a combination of industry and keyword identifiers. Then, the pool has been refined using a variety of selection criteria specific to the transaction or entity being tested and the transfer pricing method being used.

The listed databases allow for searches by industrial classification (generally, U.S. Standard Industrial Classification (SIC)), by keywords, or by both. These searches can yield a number of companies whose business activities may or may not be comparable to those of the entity being tested. Therefore, comparables based solely on SIC 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 companies that are not comparable, but yet not so restrictive as to have no comparables remaining. The APA Program normally has begun with relatively strict comparability criteria and then has relaxed them slightly if necessary to derive a pool of reliable comparables. A determination on the appropriate size of the comparables set, as well as the companies that comprise the set, is highly fact specific and depends on the reliability of the results.

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

Many covered transactions have been tested with comparables that have been chosen using additional criteria and/or screens. These include sales level criteria and tests for financial distress and product comparability. These common selection criteria and screens have been used to increase the overall comparability of a group of companies and as a basis for further research. The sales level screen, for example, has been used to remove companies that, due to their size, might face fundamentally different economic conditions from those of the entity or transaction being tested. In addition, some APA analyses have incorporated selection criteria related to removing companies experiencing "financial distress" due to concerns that companies in financial distress often have experienced unusual circumstances that would render them not comparable to the entity 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 entity being tested is a manufacturer, several criteria have been used to ensure, for example, that if the controlled entity does not own significant manufacturing intangibles or conduct research and development (R&D), neither will the comparables. These selection criteria have included determining the importance of patents to a company or screening for R&D expenditures as a percentage of sales or costs. Another criterion used in some cases has been a comparison of the book and market values of a company; this can be another indicator of intangible value. Again, quantitative screens related to identifying comparables with significant intangible property generally have been used in conjunction with an understanding of the comparable derived from publicly available business information.

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

Table 25 shows the number of times various screens were used in APAs executed in Year 2001:

TABLE 25: COMPARABILITY SCREENS

Comparability Screen Used	Number of Times Used
Comparability screens used	—
Sales	18
Operating expenses/ sales	12
Non-startup or start-up	12
R&D/ sales	8
Foreign sales/ total sales	3
Financial distress	—
Bankruptcy	15
SG&A/ sales	7
Unfavorable auditor's opinion	7
Losses in Three Years	5
Losses in Two Years	3
PP&E/ sales	1

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 profit level indicators (PLIs), certain "asset intensity" or "balance sheet" adjustments for factors that have generally agreed-upon effects on profits have been carried out. In addition, in specific cases, additional adjustments have been performed to improve reliability.

The most common asset intensity adjustments used in APAs 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 holding assets such as receivables benefits customers in a way that increases the entity's operating profit. Such adjustments are based on the assumption that the increase in operating profit is equal to the carrying cost of the assets. Conversely, the holding of accounts payable is considered to burden suppliers in a way that decreases the entity's profit. The decrease in operating profit has generally been assumed to be equal to the cost of funds implicitly borrowed from suppliers.

To compare the profits of two entities with different relative levels of receivables, inventory, or payables, the APA Program has estimated the carrying costs of each item and adjusted profits accordingly. Although 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 transfer pricing method (for example, if sales are controlled, then the denominator of the balance sheet ratio should not be sales), (3) a short term interest rate should be used, and (4) an interest factor should recognize the average holding period of the relevant asset.

The APA Program has also required that data must be compared on a first-in first-out (FIFO) accounting basis. Although financial statements may be prepared on a last-in first-out (LIFO) basis, cross-company comparisons are less meaningful when one or more companies use LIFO inventory accounting methods. This adjustment directly affects costs of goods sold and inventories, and therefore affects both profitability measures and inventory adjustments.

Less commonly used but still important in some cases is the adjustment for differences in relative levels of PP&E between a tested entity and the comparables. Ideally, comparables and the entity being tested will have fairly similar relative levels of PP&E, since major differences can be a sign of fundamentally different functions and risks. Typically, the PP&E adjustment is made using a medium term interest rate, while short-term interest rates are used for receivables, inventories, and payables.

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

The adjustments made to comparables or tested parties in APAs executed in Year 2001 are reflected in table 24 above.

Nature of Ranges and Adjustment Mechanisms

[§ 521(b)(2)(D)(viii)–(ix)]

The types of ranges used in APAs executed in Year 2001 are described in Tables 26 and 27 below.

TABLE 26: TYPES OF RANGES

Type of Range	Number [12]
Interquartile range	23
Floor (*i.e.*, result must be no less than x)	8
Specific point within CPM range	7
Specific point (royalty)	6
Financial products – statistical confidence interval to test against internal cups	3
Ceiling (*i.e.*, result must be no more than x)	3
Full range	1
Specific point (CUP)	1
Other	1

TABLE 27: ADJUSTMENTS WHEN OUTSIDE OF THE RANGE

Adjustment Mechanism	Number
Taxpayer makes an adjustment: to closest edge	15
Taxpayer makes an adjustment: to specified point	14
Competent Authority process invoked if results are outside the range	5
Taxpayer makes an adjustment: to median	4
Other	7

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

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 § 1.482–1(e)(2)(i), such a range is normally derived by considering a set of more than one comparable uncontrolled transaction of similar comparability and reliability. If these comparables are of very high quality, as defined in the Regulations, then under § 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. There was one APA executed in Year 2001 that used a full range. If the comparables are of lesser quality, then under § 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 § 1.482–1(e)(2)(iii)(C). The interquartile range was used 23 times in Year 2001.

In fourteen APAs executed in Year 2001, the APA specified a single, specific result, or "point." Seven of these APAs involved a CPM in which the taxpayer agreed to a specific result. 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. Eight APAs executed in Year 2001 used a floor and three used a ceiling.

Some APAs involving financial products have employed a statistical confidence interval to compare pricing of a large set of controlled transactions with a comparable set of uncontrolled transactions. A statistical confidence interval is typically applied to a financial institution with autonomous branches in several countries. Pursuant to the business profits article of the applicable income tax treaties and Prop. Reg. § 1.482–8(b), APAs have been executed allowing the taxpayer to allocate profits between branches with reference to the branches' internal accounting methods, taking into account all trades, including interbranch and/or interdesk trades. In order for this method to provide a reliable result, however, it is necessary to ensure that all such controlled trades be priced on the same market basis as uncontrolled trades. To test whether this is so, a branch's controlled trades are matched with that branch's comparable uncontrolled trades made at times close to the controlled trades. A statistical test is performed to detect pricing bias, by which the controlled trades might as a whole be priced higher or lower than the uncontrolled trades. This has been accomplished by construction of a statistical confidence interval (typically 95%), with the tested hypothesis being that controlled trades are priced on the same basis as uncontrolled trades. An adjustment is necessary if the results of the controlled trades fall outside of this confidence interval. During Year 2001, there were three APAs executed that employed the statistical confidence interval.

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 2001, rolling multi-year averaging was used for 11 covered transactions. Three of those used two-year averages, and the other eight used three-year averages. Cumulative multi-year averages were used for 18 covered transactions. Of those 18 transactions, four used two-year averages, three used three-year averages,[13] two used four-year averages, four used five-year averages, one used a six-year average, one used a seven-year average, two used nine-year averages, and one used a ten-year average.

Adjustments

Under § 1.482–1(e)(3), if a taxpayer's results fall outside the arm's length range, the Service may adjust the result "to any point within the arm's length range." Accordingly, an APA may permit or require a taxpayer and its related parties to make an adjustment after the year's end to put the year's results within the range, or at the point, specified by the APA. Similarly, to enforce the terms of an APA, the Service may make such an adjustment. When the APA specifies a range, the adjustment is sometimes to the closest edge of the range, and sometimes to another point such as the median of the interquartile range. Depending on the facts of each case, such automatic adjustments are not always permitted. Some bilateral APAs specify that in such a case there will be a negotiation between the Competent Authorities involved to determine whether and to what extent an adjustment should be made. Some APAs permit automatic adjustments unless the result is far outside the range specified in the APA. Thus they provide flexibility and efficiency (permitting adjustments when normal business fluctuations and uncertainties push the result somewhat outside the range).

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[13] One of the three-year cumulative averages applied a three-year cumulative average twice, once at the end of year three and once at the end of year six. A second covered transaction that used a three-year cumulative average also used a five-year cumulative average at the end of five years. To avoid double counting, that covered transaction is not included in the count of covered transactions using five-year averages.

In order to conform the taxpayer's books to these tax adjustments, the APA usually permits a "compensating adjustment" as long as certain requirements are met. Such compensating adjustments may be paid between the related parties with no interest, and the amount transferred will not be considered for purposes of penalties for failure to pay estimated tax. See § 11.02, Rev. Proc. 96–53.

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

The various term lengths for APAs executed in Year 2001 are set forth in Table 28 below:

TABLE 28: TERMS OF APAs

APA Term in Years	Number of APAs
1	1
2	1
3	5
4	7
5	30
6	5
7	0
8	2
9	3
10	1

Number of rollback years to which an APA TPM was applied in Year 2001 are 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	2
2	7
3	3
4	1
5 or more	2

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

APAs executed in Year 2001 required that various documents be provided with the Annual Reports filed by the taxpayers. These documents are described in Table 30 below:

TABLE 30: NATURE OF DOCUMENTATION REQUIRED

Documentation	Number of Times This Documentation Required [14]
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	55
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	55
Financial analysis demonstrating Taxpayer's compliance with TPM	55
Description of any failure to meet Critical Assumptions or, if there have been none, a statement to that effect	55
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	53
Financial statements as prepared in accordance with US GAAP	47
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	47
United States income tax return	14
Financial statements as prepared in accordance with foreign GAAP	8
Certified public accountant's opinion that financial statements present fairly financial position of Taxpayer and the results of its perations, in accordance with foreign GAAP	8
Profit & Loss statement	8
Schedule of costs and expenses (*e.g.*, intercompany allocations)	8
Various workpapers	6
Certified public accountant's review of financial statements	6
Book to tax reconciliations	6
Form 5471 or 5472	4
Organizational chart	4
Description of any matters economically or substantively related to the covered transactions, but that are not subject to the APA	4
Cash Flow statement	3
Pertinent intercompany agreements	2
Narrative description of taxpayer's business	1
Other	17

Approaches for Sharing of Currency or Other Risks

[§ 521(b)(2)(D)(xii)]

During Year 2001, there were 27 tested parties that faced financial risks, including interest rate and currency risks. One case that explicitly addressed currency risk adjusted a resale price interquartile range by a currency adjustment factor.

Efforts to Ensure Compliance with APAs

[§ 521(b)(2)(F)]

As described in Rev. Proc. 96–53, section 11, APA taxpayers are required to file annual reports to demonstrate compliance with the terms and conditions of the APA. The filing and review of annual reports is a critical part of the APA process. Through annual report review, the APA program monitors taxpayer compliance with the APA on a contemporaneous basis. Annual report review provides current information on the success or problems associated with the various TPMs adopted in the APA process.

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[14] The first seven categories of documentation listed in this table were drawn from the standard APA language used in 2001. In some financial product APAs, the taxpayer agrees to maintain certain records, but the compliance with the TPM is determined by a later audit under an agreed statistical methodology. In these cases, some of the standard documentation requirements may not be appropriate.

All reports received by the APA Office are tracked by one designated APA team leader who also has the prime responsibility for annual report review. Other APA team leaders also assist in this review, especially when the team leader who negotiated the case is available, since that person will already be familiar with the relevant facts and terms of the agreement. Once received by the APA Office, the annual report is sent out to the district personnel with exam jurisdiction over the taxpayer. This process changed in November 2001; previously reports were held until reviewed by an APA team leader. This change has facilitated simultaneous review of the reports and allowed the APA office to eliminate much of the backlog of annual reports.

The statistics for the review of APA annual reports are reflected in Table 31 below. As of December 31, 2001, there were 187 pending annual reports. In Year 2001, there were 320 reports closed.

TABLE 31: STATISTICS OF ANNUAL REPORTS

Number of APA annual reports pending as of December 31, 2001	187
Number of APA annual reports closed in Year 2001	320
Number of APA annual reports requiring adjustment in Year 2001	7
Number of taxpayers involved in adjustments	3
Number of APA annual reports required to be filed in Year 2001	252
Number of APA annual reports actually filed in Year 2001	207 [15]
Number of APA annual report cases over one year old	84

[15] Many of the reports that were due in Year 2001, but not received by Dec. 31, 2001, were timely filed but held up as a result of the new screening procedures of the mail.

ATTACHMENT A

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

PARTIES

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

RECITALS

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

This APA contains the Parties' agreement on the best method for determining arm's-length prices of the Covered Transactions under I.R.C. section 482 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. <u>*Covered Transactions*</u>. This APA applies to the Covered Transactions, as defined in Appendix A.

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

3. <u>*Term*</u>. This APA applies to Taxpayer's taxable years ending ___________ through ________(APA Term).

4. <u>*Operation*</u>.

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 Rev. Proc. 96–53 (including any proposals to use particular TPMs), made in conjunction with this request constitute statements made in compromise negotiations within the meaning of Rule 408 of the Federal Rules of Evidence.

5. <u>*Compliance*</u>.

a. For each taxable year covered by this APA (APA Year), if Taxpayer complies with the terms and conditions of this APA, then the IRS will not make or propose any allocation or adjustment under I.R.C. section 482 to the Covered Transactions.

b. If Taxpayer does not comply, then the IRS may:

i. enforce the terms and conditions of this APA and make or propose allocations or adjustments under I.R.C. section 482 consistent with this APA;
ii. cancel or revoke this APA under Revenue Procedure 96–53, section 11.05 or 11.06; 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 Rev. Proc. 96–53. The IRS may request additional information reasonably necessary to clarify the Annual Report or verify compliance with the APA. Taxpayer will provide all requested information within a reasonable time.

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 Rev. Proc. 96–53, Taxpayer will (1) maintain its APA Records, and (2) make them available to IRS in connection with an examination under section 11.03. Compliance with this subparagraph constitutes compliance with the record-maintenance provisions of I.R.C. sections 6038A and 6038C for the Covered Transactions for any taxable year during the APA Term.

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

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

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

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

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

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

6. *Critical Assumptions*. This APA's critical assumptions, within the meaning of Revenue Procedure 96–53, section 5.07, appear in Appendix B. Revenue Procedure 96–53, section 11.07, governs if any critical assumption has not been met.

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

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

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

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

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

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

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

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

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

WITNESS,

The Parties have executed this APA on the dates below.

[**Taxpayer Name in all caps**]

By: ______________________________ Date: __________, 20 _____

Jane Doe
Sr. Vice President (Taxes)

IRS

By: ______________________________ Date: __________, 20 _____

Sean F. Foley
Director, Advance Pricing Agreement Program

APPENDIX A

COVERED TRANSACTIONS AND TRANSFER PRICING METHOD (TPM)

1. **Covered Transactions**.

[*Define the Covered Transactions.*]

2. **TPM**.

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

- **CUP Method**

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

- **Resale Price Method (RPM)**

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

- **Cost Plus Method**

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

- **CPM with Berry Ratio PLI**

The TPM is the comparable profits method (CPM). Taxpayer must realize, recognize, and report results on its U.S. Returns that clearly reflect a gross profit to operating expenses ratio (as those terms are defined in Treasury Regulations sections 1.482–5(d)(1) and (2)) 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

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

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

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

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

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

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

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

f. The amount, reason for, and financial analysis of any compensating adjustments under paragraph 5(e)(2) of this APA for the APA Year, including the means by which any such compensating adjustment has been or will be satisfied.

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 with a copy of each independent certified public accountant's opinion required by paragraph 5(c) of this APA.

3. A financial analysis that reflects Taxpayer's TPM calculations for the APA Year in sufficient 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 otherwise relevant to the TPM.

APPENDIX D

DEFINITIONS

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

Term	Definition
Annual Report	A report within the meaning of Revenue Procedure 96–53, section 11.
APA	This Advance Pricing Agreement, which is an "advance pricing agreement" within the meaning of Revenue Procedure 96–53, section 1.
APA Records	The records specified in Appendix C.
APA Request	Taxpayer's request for this APA dated ___/___/___, including any amendments or supplemental or additional information thereto.
Covered Transaction	This term is defined in Appendix A.
Financial Statements	The financial statements prepared in accordance with U.S. GAAP and stated in U.S. dollars.
Foreign Group	Worldwide Group members that are not U.S. persons.
Foreign Participants	[Name the foreign entities involved in Covered Transactions.]
I.R.C.	The Internal Revenue Code of 1986, 26 U.S.C., as amended.
Pub. L. 106–170	The Ticket to Work and Work Incentives Improvement Act of 1999.
Revenue Procedure 96–53	Rev. Proc. 96–53 (1996–2 C.B. 375).
Transfer Pricing Method (TPM)	A transfer pricing method within the meaning of Treasury Regulations section 1.482–1(b) and Revenue Procedure 96–53, section 3.02.
U.S. GAAP	U.S. generally-accepted accounting principles.
U.S. Group	Worldwide Group members that are U.S. persons.
U.S. Return	For each taxable year, the "returns with respect to income taxes under subtitle A" that Taxpayer must "make" in accordance with I.R.C. section 6012. *{Or substitute for partnership:* For each taxable year, the "return" that Taxpayer must "make" in accordance with I.R.C. section 6031.}
Worldwide Group	Taxpayer and all organizations, trades, businesses, entities, or branches (whether or not incorporated, organized in the United States, or affiliated) owned or controlled directly or indirectly by the same interests.

ATTACHMENT B

FORMULAS FOR BALANCE SHEET ADJUSTMENTS

Definitions of Variables:

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

Equations:

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

Receivables Adjustment ("RA"): $RA = \{[AR_t / sales_t) \times sales_c] - AR_c\} \times \{i/[1+(i \times h_c)]\}$

Payables Adjustment ("PA"): $PA = \{[AP_t / sales_t) \times sales_c] - AP_c\} \times \{i/[1+(i \times h_c)]\}$

Inventory Adjustment ("IA"): $IA = \{[(INV_t / sales_t) \times sales_c\} - INV_c\} \times i$

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

If Sales are controlled (generally, costs in the denominator of PLI):[16]

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 $opex_c$ = $opex_c - PPEA$

[16] 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 law 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 the 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.—Intemal 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.—Statements 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.

Numerical Finding List[1]

Bulletins 2002–1 through 2002–14

Announcements:

2002–1, 2002–2 I.R.B. *304*
2002–2, 2002–2 I.R.B. *304*
2002–3, 2002–2 I.R.B. *305*
2002–4, 2002–2 I.R.B. *306*
2002–5, 2002–4 I.R.B. *420*
2002–6, 2002–5 I.R.B. *458*
2002–7, 2002–5 I.R.B. *459*
2002–8, 2002–6 I.R.B. *494*
2002–9, 2002–7 I.R.B. *536*
2002–10, 2002–7 I.R.B. *539*
2002–11, 2002–6 I.R.B. *494*
2002–12, 2002–8 I.R.B. *553*
2002–13, 2002–7 I.R.B. *540*
2002–14, 2002–7 I.R.B. *540*
2002–15, 2002–7 I.R.B. *540*
2002–16, 2002–7 I.R.B. *541*
2002–17, 2002–8 I.R.B. *561*
2002–18, 2002–10 I.R.B. *621*
2002–19, 2002–8 I.R.B. *561*
2002–20, 2002–8 I.R.B. *561*
2002–21, 2002–8 I.R.B. *562*
2002–22, 2002–8 I.R.B. *562*
2002–23, 2002–8 I.R.B. *563*
2002–24, 2002–9 I.R.B. *606*
2002–25, 2002–10 I.R.B. *621*
2002–26, 2002–11 I.R.B. *629*
2002–27, 2002–11 I.R.B. *629*
2002–28, 2002–11 I.R.B. *630*
2002–29, 2002–11 I.R.B. *631*
2002–30, 2002–11 I.R.B. *632*
2002–32, 2002–12 I.R.B. *664*
2002–33, 2002–12 I.R.B. *666*
2002–34, 2002–13 I.R.B. *702*
2002–35, 2002–12 I.R.B. *667*
2002–36, 2002–13 I.R.B. *703*
2002–37, 2002–13 I.R.B. *703*
2002–38, 2002–14 I.R.B. *738*
2002–39, 2002–14 I.R.B. *738*
2002–41, 2002–14 I.R.B. *739*
2002–42, 2002–14 I.R.B. *739*

Court Decisions:

2073, 2002–14 I.R.B. *718*

Notices:

2002–1, 2002–2 I.R.B. *283*
2002–2, 2002–2 I.R.B. *285*
2002–3, 2002–2 I.R.B. *289*
2002–4, 2002–2 I.R.B. *298*
2002–5, 2002–3 I.R.B. *320*
2002–6, 2002–3 I.R.B. *326*
2002–7, 2002–6 I.R.B. *489*
2002–8, 2002–4 I.R.B. *398*
2002–9, 2002–5 I.R.B. *450*
2002–10, 2002–6 I.R.B. *490*
2002–11, 2002–7 I.R.B. *526*

Notices:—Continued

2002–12, 2002–7 I.R.B. *526*
2002–13, 2002–8 I.R.B. *547*
2002–14, 2002–8 I.R.B. *548*
2002–15, 2002–8 I.R.B. *548*
2002–16, 2002–9 I.R.B. *567*
2002–17, 2002–9 I.R.B. *567*
2002–18, 2002–12 I.R.B. *644*
2002–19, 2002–10 I.R.B. *619*
2002–21, 2002–14 I.R.B. *730*
2002–22, 2002–14 I.R.B. *731*

Proposed Regulations:

REG–209135–88, 2002–4 I.R.B. *418*
REG–209114–90, 2002–9 I.R.B. *576*
REG–107100–00, 2002–7 I.R.B. *529*
REG–107366–00, 2002–12 I.R.B. *645*
REG–118861–00, 2002–12 I.R.B. *651*
REG–105344–01, 2002–2 I.R.B. *302*
REG–112991–01, 2002–4 I.R.B. *404*
REG–115054–01, 2002–7 I.R.B. *530*
REG–119436–01, 2002–3 I.R.B. *377*
REG–120135–01, 2002–8 I.R.B. *552*
REG–125450–01, 2002–5 I.R.B. *457*
REG–125626–01, 2002–9 I.R.B. *604*
REG–142299–01, 2002–4 I.R.B. *418*
REG–159079–01, 2002–6 I.R.B. *493*
REG–102740–02, 2002–13 I.R.B. *701*

Revenue Procedures:

2002–1, 2002–1 I.R.B. *1*
2002–2, 2002–1 I.R.B. *82*
2002–3, 2002–1 I.R.B. *117*
2002–4, 2002–1 I.R.B. *127*
2002–5, 2002–1 I.R.B. *173*
2002–6, 2002–1 I.R.B. *203*
2002–7, 2002–1 I.R.B. *249*
2002–8, 2002–1 I.R.B. *252*
2002–9, 2002–3 I.R.B. *327*
2002–10, 2002–4 I.R.B. *401*
2002–11, 2002–7 I.R.B. *526*
2002–12, 2002–3 I.R.B. *374*
2002–13, 2002–8 I.R.B. *549*
2002–14, 2002–5 I.R.B. *450*
2002–15, 2002–6 I.R.B. *490*
2002–16, 2002–9 I.R.B. *572*
2002–17, 2002–13 I.R.B. *676*
2002–18, 2002–13 I.R.B. *678*
2002–19, 2002–13 I.R.B. *696*
2002–20, 2002–14 I.R.B. *732*
2002–22, 2002–14 I.R.B. *733*

Revenue Rulings:

2002–1, 2002–2 I.R.B. *268*
2002–2, 2002–2 I.R.B. *271*
2002–3, 2002–3 I.R.B. *316*

Revenue Rulings:—Continued

2002–4, 2002–4 I.R.B. *389*
2002–5, 2002–6 I.R.B. *461*
2002–6, 2002–6 I.R.B. *460*
2002–7, 2002–8 I.R.B. *543*
2002–8, 2002–9 I.R.B. *564*
2002–9, 2002–10 I.R.B. *614*
2002–10, 2002–10 I.R.B. *616*
2002–11, 2002–10 I.R.B. *608*
2002–12, 2002–11 I.R.B. *624*
2002–13, 2002–12 I.R.B. *637*
2002–14, 2002–12 I.R.B. *636*
2002–15, 2002–13 I.R.B. *668*
2002–17, 2002–14 I.R.B. *716*

Tax Conventions:

2002–14 I.R.B. *725*

Treasury Decisions:

8968, 2002–2 I.R.B. *274*
8969, 2002–2 I.R.B. *276*
8970, 2002–2 I.R.B. *281*
8971, 2002–3 I.R.B. *308*
8972, 2002–5 I.R.B. *443*
8973, 2002–4 I.R.B. *391*
8974, 2002–3 I.R.B. *318*
8975, 2002–4 I.R.B. *379*
8976, 2002–5 I.R.B. *421*
8977, 2002–6 I.R.B. *463*
8978, 2002–7 I.R.B. *500*
8979, 2002–6 I.R.B. *466*
8980, 2002–6 I.R.B. *477*
8981, 2002–7 I.R.B. *496*
8982, 2002–8 I.R.B. *544*
8983, 2002–9 I.R.B. *565*
8984, 2002–13 I.R.B. *668*
8985, 2002–14 I.R.B. *707*

[1] A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 2001–27 through 2001–53 is in Internal Revenue Bulletin 2002–1, dated January 7, 2002.

Finding List of Current Actions on Previously Published Items[2]

Bulletins 2002–1 through 2002–14

Announcements:

2001–83
Modified by
Ann. 2002–36, 2002–13 I.R.B. *703*

2002–9
Corrected by
Ann. 2002–30, 2002–11 I.R.B. *632*
Ann. 2002–35, 2002–12 I.R.B. *667*

Notices:

98–31
Supplemented by
Ann. 2002–37, 2002–13 I.R.B. *703*

98–43
Modified and superseded by
Notice 2002–5, 2002–3 I.R.B. *320*

2000–11
Obsoleted by
Notice 2002–3, 2002–2 I.R.B. *289*

2001–10
Revoked by
Notice 2002–8, 2002–4 I.R.B. *398*

2001–61
Supplemented by
Notice 2002–15, 2002–8 I.R.B. *548*

2001–68
Supplemented by
Notice 2002–15, 2002–8 I.R.B. *548*

Proposed Regulations:

REG–209135–88
Corrected by
Ann. 2002–15, 2002–7 I.R.B. *540*
Ann. 2002–30, 2002–11 I.R.B. *632*

REG–251502–96
Withdrawn by
Ann. 2002–33, 2002–12 I.R.B. *666*

REG–107100–00
Corrected by
Ann. 2002–30, 2002–11 I.R.B. *632*

REG–105344–01
Corrected by
Ann. 2002–7, 2002–5 I.R.B. *459*

REG–112991–01
Corrected by
Ann. 2002–30, 2002–11 I.R.B. *632*
Ann. 2002–38, 2002–14 I.R.B. *738*

Proposed Regulations:—Continued

REG–115054–01
Corrected by
Ann. 2002–30, 2002–11 I.R.B. *632*

REG–119436–01
Corrected by
Ann. 2002–30, 2002–11 I.R.B. *632*

REG–120135–01
Corrected by
Ann. 2002–30, 2002–11 I.R.B. *632*

REG–125450–01
Corrected by
Ann. 2002–30, 2002–11 I.R.B. *632*

REG–125626–01
Corrected by
Ann. 2002–30, 2002–11 I.R.B. *632*

REG–126485–01
Corrected by
Ann. 2002–30, 2002–11 I.R.B. *632*

REG–137519–01
Corrected by
Ann. 2002–30, 2002–11 I.R.B. *632*

REG–142299–01
Corrected by
Ann. 2002–15, 2002–7 I.R.B. *540*
Ann. 2002–30, 2002–11 I.R.B. *632*

REG–142686–01
Corrected by
Ann. 2002–30, 2002–11 I.R.B. *632*

REG–159079–01
Corrected by
Ann. 2002–30, 2002–11 I.R.B. *632*

Revenue Procedures:

84–37
Modified by
Rev. Proc. 2002–1, 2002–1 I.R.B. *1*

84–57
Obsoleted by
T.D. 8976, 2002–5 I.R.B. *421*

87–50
Modified by
Rev. Proc. 2002–10, 2002–4 I.R.B. *401*

96–13
Modified by
Rev. Proc. 2002–1, 2002–1 I.R.B. *1*

97–27
Modified and amplified by
Rev. Proc. 2002–19, 2002–13 I.R.B. *696*

98–49
Obsoleted by
T.D. 8976, 2002–5 I.R.B. *421*

Revenue Procedures:—Continued

99–49
Modified and superseded by
Rev. Proc. 2002–9, 2002–3 I.R.B. *327*

2000–20
Modified by
Rev. Proc. 2002–6, 2002–1 I.R.B. *203*

2000–46
Superseded by
Rev. Proc. 2002–22, 2002–14 I.R.B. *733*

2001–1
Superseded by
Rev. Proc. 2002–1, 2002–1 I.R.B. *1*

2001–2
Superseded by
Rev. Proc. 2002–2, 2002–1 I.R.B. *82*

2001–3
Superseded by
Rev. Proc. 2002–3, 2002–1 I.R.B. *117*

2001–4
Superseded by
Rev. Proc. 2002–4, 2002–1 I.R.B. *127*

2001–5
Superseded by
Rev. Proc. 2002–5, 2002–1 I.R.B. *173*

2001–6
Superseded by
Rev. Proc. 2002–6, 2002–1 I.R.B. *203*

2001–7
Superseded by
Rev. Proc. 2002–7, 2002–1 I.R.B. *249*

2001–8
Superseded by
Rev. Proc. 2002–8, 2002–1 I.R.B. *252*

2001–13
Corrected by
Ann. 2002–5, 2002–4 I.R.B. *420*

2001–16
Modified by
Ann. 2002–26, 2002–11 I.R.B. *629*

2001–27
Supplemented by
Rev. Proc. 2002–20, 2002–14 I.R.B. *732*

2001–36
Superseded by
Rev. Proc. 2002–3, 2002–1 I.R.B. *117*

2001–41
Superseded by
Rev. Proc. 2002–2, 2002–1 I.R.B. *82*

[2] A cumulative list of current actions on previously published items in Internal Revenue Bulletins 2001–27 through 2001–53 is in Internal Revenue Bulletin 2002–1, dated January 7, 2002.

Revenue Procedures:—Continued

2001–51
Superseded by
Rev. Proc. 2002–3, 2002–1 I.R.B. *117*

2002–3
Modified by
Rev. Proc. 2002–22 I.R.B. *733*

2002–6
Modified by
Notice 2002–1, 2002–2 I.R.B. *283*

2002–8
Modified by
Notice 2002–1, 2002–2 I.R.B. *283*

2002–9
Modified and clarified by
Ann. 2002–17, 2002–8 I.R.B. *561*

Modified and amplified by
Rev. Rul. 2002–9, 2002–10 I.R.B. *614*
Rev. Proc. 2002–17, 2002–13 I.R.B. *676*
Rev. Proc. 2002–19, 2002–13 I.R.B. *696*

Revenue Rulings:

55–747
Revoked by
Notice 2002–8, 2002–4 I.R.B. *398*

61–146
Distinguished by
Rev. Rul. 2002–3, 2002–3 I.R.B. *316*

64–328
Modified by
Notice 2002–8, 2002–4 I.R.B. *398*

66–110
Modified by
Notice 2002–8, 2002–4 I.R.B. *398*

89–29
Obsoleted by
T.D. 8976, 2002–5 I.R.B. *421*

92–19
Supplemented in part by
Rev. Rul. 2002–12, 2002–11 I.R.B. *624*

2002–7
Corrected by
Ann. 2002–13, 2002–7 I.R.B. *540*

Treasury Decisions:

8971
Corrected by
Ann. 2002–20, 2002–8 I.R.B. *561*

8972
Corrected by
Ann. 2002–23, 2002–8 I.R.B. *563*

8973
Corrected by
Ann. 2002–14, 2002–7 I.R.B. *540*

Treasury Decisions:—Continued

8975
Corrected by
Ann. 2002–21, 2002–8 I.R.B. *562*

8976
Corrected by
Ann. 2002–21, 2002–8 I.R.B. *562*

8978
Corrected by
Ann. 2002–39, 2002–14 I.R.B. *738*