

## **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.

### **INCOME TAX**

#### **Rev. Rul. 2001-18, page 1092.**

**LIFO; price indexes; department stores.** The February 2001 Bureau of Labor Statistics price indexes are accepted for use by department stores employing the retail inventory and last-in, first-out inventory methods for valuing inventories for tax years ended on, or with reference to, February 28, 2001.

### **EXEMPT ORGANIZATIONS**

#### **Announcement 2001-33, page 1137.**

Request for comments regarding the instructions for Form 990, *Return of Organization Exempt From Income Tax*, Form 990-EZ, *Short Form Return of Organization Exempt From Income Tax*, and Form 990-PF, *Return of Private Foundation or Section 4947(a)(1) Nonexempt Charitable Trust Treated as a Private Foundation*.

### **ESTATE TAX**

#### **Announcement 2001-40, page 1141.**

This document contains corrections to final regulations (T.D. 8912, 2001-5 I.R.B. 452) relating to the retention of a trust's exempt status for generation-skipping transfer tax purposes in the case of modifications, etc., to a trust.

### **ADMINISTRATIVE**

#### **Notice 2001-31, page 1093.**

**Credit for sales of fuel produced from a nonconventional source, inflation adjustment factor, and reference price.** This notice publishes the nonconventional source fuel credit, the inflation adjustment factor, and the reference price under section 29 of the Code for calendar year 2000. This data is used to determine the credit allowable on sales of fuel produced from a nonconventional source.

#### **Rev. Proc. 2001-26, page 1093.**

Specifications are set forth for the private printing of paper substitutes for tax year 2001 Form W-2, *Wage and Tax Statement*, and Form W-3, *Transmittal of Wage and Tax Statements*. Rev. Proc. 2000-23 superseded.

#### **Announcement 2001-31, page 1113.**

This document contains corrections to final regulations (T.D. 8933, 2001-11 I.R.B. 794) providing guidance on qualified transportation fringes (vanpooling, transit passes, and qualified parking) provided by employers to their employees.

#### **Announcement 2001-32, page 1113.**

This announcement concerns Advance Pricing Agreements (APAs) and the experience of the APA Program during calendar year 2000.

#### **Announcement 2001-38, page 1138.**

This document contains the annual report concerning pre-filing agreements under the Pre-Filing Agreement Program of the Large and Mid-Size Business Division for calendar year 2000.

#### **Announcement 2001-39, page 1141.**

The Service announces the release, in March 2001, of new Publication 584-B, *Business Casualty, Disaster, and Theft Loss Workbook*.

Finding Lists begin on page ii.



# 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 proce-

dures 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 1100.—Treaties and Tax Legislation.**

This part is divided into two subparts as follows: Subpart A, Tax Conventions, 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.

The contents of this publication are not copyrighted and may be reprinted freely. A citation of the Internal Revenue Bulletin as the source would be appropriate.

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

## Section 472.—Last-in, First-out Inventories

26 CFR 1.472-1: Last-in, first-out inventories.

**LIFO; price indexes; department stores.** The February 2001 Bureau of Labor Statistics price indexes are accepted for use by department stores employing the retail inventory and last-in, first-out inventory methods for valuing inventories for tax years ended on, or with reference to, February 28, 2001.

## Rev. Rul. 2001-18

The following Department Store Inventory Price Indexes for February 2001 were issued by the Bureau of Labor Statistics. The indexes are accepted by the Internal Revenue Service, under § 1.472-1(k) of the Income Tax Regulations and Rev. Proc. 86-46, 1986-2 C.B. 739, for appropriate application to inventories of department stores employing the retail inventory and last-in, first-out inventory methods for tax years ended on,

or with reference to, February 28, 2001.

The Department Store Inventory Price Indexes are prepared on a national basis and include (a) 23 major groups of departments, (b) three special combinations of the major groups – soft goods, durable goods, and miscellaneous goods, and (c) a store total, which covers all departments, including some not listed separately, except for the following: candy, food, liquor, tobacco, and contract departments.

BUREAU OF LABOR STATISTICS, DEPARTMENT STORE  
INVENTORY PRICE INDEXES BY DEPARTMENT GROUPS  
(January 1941 = 100, unless otherwise noted)

Groups	Feb. 2000	Feb. 2001	Percent Change from Feb. 2000 to Feb. 2001 <sup>1</sup>
1. Piece Goods . . . . .	502.6	507.2	0.9
2. Domestic and Draperies . . . . .	611.8	606.8	-0.8
3. Women's and Children's Shoes . . . . .	612.7	642.9	4.9
4. Men's Shoes . . . . .	893.0	881.9	-1.2
5. Infants' Wear . . . . .	648.8	620.5	-4.4
6. Women's Underwear . . . . .	577.0	563.4	-2.4
7. Women's Hosiery . . . . .	330.8	351.5	6.3
8. Women's and Girls' Accessories . . . . .	542.1	550.1	1.5
9. Women's Outerwear and Girls' Wear . . . . .	381.7	388.0	1.7
10. Men's Clothing . . . . .	622.6	594.4	-4.5
11. Men's Furnishings . . . . .	619.2	608.1	-1.8
12. Boys' Clothing and Furnishings . . . . .	496.2	484.7	-2.3
13. Jewelry . . . . .	973.4	943.6	-3.1
14. Notions . . . . .	763.6	794.5	4.0
15. Toilet Articles and Drugs . . . . .	967.0	986.1	2.0
16. Furniture and Bedding . . . . .	700.0	685.9	-2.0
17. Floor Coverings . . . . .	604.0	630.2	4.3
18. Housewares . . . . .	787.3	774.9	-1.6
19. Major Appliances . . . . .	233.9	227.8	-2.6
20. Radio and Television . . . . .	61.5	56.3	-8.5
21. Recreation and Education <sup>2</sup> . . . . .	94.2	90.7	-3.7
22. Home Improvements <sup>2</sup> . . . . .	128.1	128.0	-0.1
23. Auto Accessories <sup>2</sup> . . . . .	107.3	108.8	1.4
Groups 1 - 15: Soft Goods . . . . .	593.9	592.0	-0.3
Groups 16 - 20: Durable Goods . . . . .	444.9	433.1	-2.7
Groups 21 - 23: Misc. Goods <sup>2</sup> . . . . .	101.3	99.2	-2.1
Store Total <sup>3</sup> . . . . .	537.7	532.4	-1.0

<sup>1</sup>Absence of a minus sign before the percentage change in this column signifies a price increase.

<sup>2</sup>Indexes on a January 1986=100 base.

<sup>3</sup>The store total index covers all departments, including some not listed separately, except for the following: candy, food, liquor, tobacco, and contract departments.

### DRAFTING INFORMATION

The principal author of this revenue ruling is Alan J. Tomsic of the Office of Associate Chief Counsel (Income Tax

and Accounting). For further information regarding this revenue ruling, contact Mr. Tomsic at (202) 622-4970 (not a toll-free call).

## Part III. Administrative, Procedural, and Miscellaneous

### Nonconventional Source Fuel Credit, Section 29 Inflation Adjustment Factor, and Section 29 Reference Price

#### Notice 2001-31

This notice publishes the nonconventional source fuel credit, inflation adjustment factor, and reference price under § 29 of the Internal Revenue Code for calendar year 2000. These are used to determine the credit allowable on fuel produced from a nonconventional source under § 29. The calendar year 2000 inflation-adjusted credit applies to the sales of barrel-of-oil equivalent of qualified fuels sold by a taxpayer to an unrelated person during the 2000 calendar year, the domestic production of which is attributable to the taxpayer.

#### BACKGROUND

Section 29(a) provides for a credit for producing fuel from a nonconventional source, measured in barrel-of-oil equivalent of qualified fuels, the production of which is attributable to the taxpayer and sold by the taxpayer to an unrelated person during the tax year. The credit is equal to the product of \$3.00 and the appropriate inflation adjustment factor.

Section 29(b)(1) and (2) provides for a phaseout of the credit. The credit allowable under § 29(a) must be reduced by an amount which bears the same ratio to the amount of the credit (determined without regard to § 29(b)(1)) as the amount by which the reference price for the calendar year in which the sale occurs exceeds \$23.50 bears to \$6.00. The \$3.00 in § 29(a) and the \$23.50 and \$6.00 must each be adjusted by multiplying these amounts by the 2000 inflation adjustment factor. In the case of gas from a tight formation, the \$3.00 amount in § 29(a) must not be adjusted.

Section 29(c)(1) defines the term "qualified fuels" to include oil produced from shale and tar sands; gas produced from geopressurized brine, Devonian shale, coal seams, or a tight formation, or biomass; and liquid, gaseous, or solid synthetic fuels produced from coal (including lignite), including such fuels when used as feedstocks.

Section 29(d)(1) provides that the credit is to be applied only for sale of qualified fuels the production of which is within the United States (within the meaning of § 638(1)) or a possession of the United States (within the meaning of § 638(2)).

Section 29(d)(2)(A) requires that the Secretary, not later than April 1 of each calendar year, determine and publish in the Federal Register the inflation adjustment factor and the reference price for the preceding calendar year.

Section 29(d)(2)(B) defines "inflation adjustment factor" for a calendar year as the fraction the numerator of which is the GNP implicit price deflator for the calendar year and the denominator of which is the GNP implicit price deflator for calendar year 1979. The term "GNP implicit price deflator" means the first revision of the implicit price deflator for the gross national product as computed and published by the Department of Commerce.

Section 29(d)(2)(C) defines "reference price" to mean with respect to a calendar year the Secretary's estimate of the annual average wellhead price per barrel for all domestic crude oil the price of which is not subject to regulation by the United States.

Section 29(d)(3) provides that in the case of a property or facility in which more than one person has an interest, except to the extent provided in regulations prescribed by the Secretary, production from the property or facility (as the case may be) must be allocated among the persons in proportion to their respective interests in the gross sales from the property or facility.

Section 29(d)(5) and (6) provides that the term "barrel-of-oil equivalent" with respect to any fuel generally means that amount of the fuel which has a Btu content of 5.8 million.

#### INFLATION ADJUSTMENT FACTOR AND REFERENCE PRICE

The inflation adjustment factor for calendar year 2000 is 2.0454. The reference price for calendar year 2000 is \$26.73. These amounts were published in the Federal Register on April 5, 2001.

#### PHASEOUT CALCULATION

Because the calendar year 2000 reference price does not exceed \$23.50 multiplied by the inflation adjustment factor, the phaseout of the credit provided for in § 29(b)(1) does not occur for any qualified fuel sold in calendar year 2000.

#### CREDIT AMOUNT

The nonconventional source fuel credit under § 29(a) is \$6.14 per barrel-of-oil equivalent of qualified fuels (\$3.00 x 2.0454). This amount was published in the Federal Register on April 5, 2001.

#### DRAFTING INFORMATION CONTACT

The principal author of this notice is David McDonnell of the Office of Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this notice contact Mr. McDonnell at (202) 622-3120 (not a toll-free call).

#### Publication 1141 (04/2001)

#### General Rules and Specifications for Private Printing of Substitute Forms W-2 and W-3

*26 CFR 601.602: Tax forms and instructions. (Also Part I, sections 6041, 6051, 6071, 6081, 6091; 1.6041-1, 1.6041-2, 31.6051-1, 31.6051-2, 31.6071(a)-1, 31.6081(a)-1, 31.6091-1.)*

#### Rev. Proc. 2001-26

#### PART A. GENERAL

#### SECTION 1. PURPOSE

.01 The purpose of this revenue procedure is to provide the general rules for filing and to state the requirements of the Internal Revenue Service (IRS) and the Social Security Administration (SSA) for reproducing paper substitutes for Form W-2, *Wage and Tax Statement*, and Form W-3, *Transmittal of Wage and Tax Statements*, for amounts paid during the 2001 calendar year. The information reported on Forms W-2 and W-3 is required to establish tax liability for employees

and their eligibility for Social Security and Medicare benefits.

.02 Forms W-2 and W-3 have significant changes for year **2001**. Please see “Nature of Changes” (Section 2 below) and the exhibits at the end of this revenue procedure for changes to Forms W-2 and W-3.

.03 For the purpose of this revenue procedure, a substitute form is one that is not printed by the IRS. **A substitute Form W-2 or W-3 MUST conform to the specifications in this revenue procedure to be acceptable to the IRS and the SSA.** No IRS office is authorized to allow deviations from this revenue procedure. Preparers should also refer to the separate, 2001 Instructions for Forms W-2 and W-3, for details on how to complete these forms. See Part C, Sec. 4.01 for information on obtaining the official IRS forms and instructions. See Part B, Sec. 2, for requirements for substitute forms furnished to employees.

.04 IRS maintains its centralized call site at Martinsburg Computing Center (IRS/MCC) to answer questions related to information returns (Forms W-2, W-3, 1099, etc.). The call site phone number is 304-263-8700 (**not a toll-free number**). The Telecommunication Device for the Deaf (TDD) number is 304-267-3367 (**not a toll-free number**). The hours of operation are Monday through Friday from 8:30 A.M. to 4:30 P.M. Eastern Time. You may also send questions to the Call Site via the Internet at [mccirp@irs.gov](mailto:mccirp@irs.gov).

.05 This revenue procedure supersedes Rev. Proc. 2000-23, 2000-21 I.R.B. 1018, dated May 22, 2000. (Reprinted as Publication 1141).

## SEC. 2. NATURE OF CHANGES

.01 Increased width of Form W-2 from 6.5 inches to 8.0 inches (exclusive of left and right margin measurements) (printed on standard size paper 8.5 by 11 inches) to accommodate widened boxes, specifically state/local wage and tax information.

.02 Added four (4) corner **black** register marks, and **red** dropout ink shading, and **red** dropout ink dollar signs to Copy A of Form W-2 (excluding Copies B, C, D, 1, and 2) for SSA processing.

.03 Reformatted Box e (Employee’s name) of Form W-2. The red vertical line

shown on Copy A is not included on Copies B, C, D, 1, and 2 thereby providing for greater flexibility in reporting employees’ names.

.04 Deleted former Box 12 of Form W-2 (Benefits included in box 1). Reformatted new Box 12 as Boxes 12a, 12b, 12c, and 12d for enhanced scanning of four entries for SSA processing. Added new Code “V” Employee Stock Option.

.05 Changed 4 year-digit designation (i.e., #2000) to 2 year-digit designation (i.e., #00) for reporting prior year data on Forms W-2 (Box 12) regarding the Uniformed Services Employment and Reemployment Rights Act of 1994.

.06 Changed relative positions of Boxes 13 and 14 of Form W-2.

.07 Moved checkboxes from Box 15 of Forms W-2 to Box 13. Changed one checkbox title from “Pension plan” to “Retirement plan”, added a “Third-party sick pay” checkbox; and deleted “Deceased, Legal rep., and Deferred compensation” checkboxes.

.08 Renumbered Form W-2 Boxes 16-18 as 15-17. Renumbered Boxes 19-21 as 20, 18, and 19.

.09 Specified 12-Point Courier font is preferred for all data entries on Form W-2.

.10 Increased the width size of Form W-3 from 6.5 inches to 8.0 inches (exclusive of left and right margin measurements) to accommodate widened boxes specifically state/local wage and tax information. The document/forms will be printed on standard 8 1/2 x 11 inches paper.

.11 Added four (4) corner register marks, shading, and dollar signs to Form W-3 for SSA processing.

.12 Added “Third-party sick pay” checkbox to Box b of Form W-3 and labeled Box 13 as “For third party sick pay use only”.

.13 Renumbered Box 15 of Form W-3 as Box 14.

.14 Created Boxes 15 - 19 of Form W-3 for reporting of state/local wages and income tax information.

.15 Widened Form W-3 box sizes for “Contact person,” “Telephone number,” “E-mail address,” and “Fax number”.

.16 Specified 12-Point Courier font size is preferred for all data entries to Form W-3.

.17 Added new laser print formats, specifications, and dimensions (Exhibits

G and H) black/white versions of the official Forms W-2 and W-3.

.18 Added new Section 1.B within Part B providing requirements and specifications for new laser printed black/white Forms W-2 and W-3.

.19 An Electronic Filing (E-File) logo has been added to copies B and C. The E-File logo is **not** required on any Substitute Forms W-2 copies.

.20 Other editorial section title changes distinguishing between the standard red/white Copy (A) and the alternative black/white laser printed Copy (A) characteristics, requirements, and formats.

## SEC. 3. GENERAL RULES FOR FILING PAPER FORMS W-2

.01 Employers **must** use magnetic or electronic media for filing with the SSA if they file 250 or more Year 2001 Forms W-2 (Copy A). This requirement applies unless:

1. The employer can establish that filing on magnetic media or electronically will result in undue hardship, **AND**

2. The employer is granted a waiver of the requirement by the IRS.

To request a waiver of the magnetic media or electronic filing requirement, for the current tax year only, send Form 8508, *Request for Waiver From Filing Information Returns on Magnetic Media*, to:

IRS - Martinsburg Computing Center  
Information Reporting Program  
ATTN: Extension of Time Coordinator  
240 Murall Drive  
Kearneysville, WV 25430.

Martinsburg Computing Center  
(304) 263-8700 Call Site

Form 8508 may be obtained electronically on the IRS Web Site at <http://www.irs.gov> or by calling 1-800-829-3676. It is recommended that completed requests for waivers (Form 8508) be submitted at least 45 days before, but no later than the due date, of the return (see Sec. 3.07, below). The requester will receive an approval or denial letter from IRS/MCC, but must allow a minimum of **30** days for IRS/MCC to respond. If you have any questions concerning Form 8508, contact IRS/MCC at the address or phone number shown above. **Employers who do not comply with the magnetic media or electronic filing re-**

**requirements for Form W-2 and who are not granted a waiver may be subject to penalties.** Since many state and local governments accept Form W-2 data on magnetic media or electronically, savings may be obtained if magnetic media or electronic data is used for filing with both the SSA and state or local governments. In many instances, the state or local government is willing to accept the data format specifications set out in the SSA's publication "Magnetic Media Reporting and Electronic Filing (MMREF-1)". You **must** contact each individual state or local taxing agency to receive approval and make arrangements to file electronically or on magnetic media.

**EMPLOYERS WHO FILE FORM W-2 INFORMATION ON MAGNETIC MEDIA OR ELECTRONICALLY (USING MMREF-1 INSTRUCTIONS) WITH THE SSA MUST NOT SEND THE SAME DATA TO THE SSA ON PAPER FORMS W-2.** This would result in duplicate reporting and may subject the filer to unnecessary contacts by the SSA or IRS.

.02 MMREF-1, *Magnetic Media Reporting and Electronic Filing* (SSA Pub. No. ICN, revised, 2001) contains specifications and procedures for filing Form W-2 information electronically or on magnetic media with the SSA. The MMREF-1 format is mandatory beginning with TY 2001 wage reports regardless of the media utilized including magnetic tape, tape cartridge, diskette, or electronic.

.03 MMREF-1 may be obtained by writing to:

Social Security Administration  
OCO, DES  
Attn: Employer Reporting  
Services Center  
300 North Greene Street  
Baltimore, MD 21290-0300.

Employers may also call their local SSA Employer Service Liaison Officer (ESLO) to obtain the MMREF-1 (see list of Employer Service Liaison Officers' telephone numbers at the end of this document). The MMREF-1 is also available on the SSA Online Wage Reporting Service (OWRS) dial up or via the SSA Web Site <http://www.ssa.gov/employer>. The number for the OWRS dial up is (410) 966-4105 (**not a toll-free number**). Em-

ployers using magnetic or electronic media are cautioned to obtain the most recent revision of the MMREF-1 *and supplements* due to possible changes in the specifications and procedures.

.04 Employers not filing on magnetic media or electronically **must** file a paper Copy A of Form W-2 with the SSA using either the IRS printed official form or a privately printed substitute paper form that exactly meets the specifications shown in Parts B and C of this revenue procedure.

.05 Employers may design their own statements to give to employees. This applies to employers who file with the SSA on magnetic media, electronically, or on paper. Employee statements designed by employers **must** comply with the requirements shown in Parts B and C, below.

**.06 Employers who terminate their business must provide their employees with Form W-2 on or before the due date of their final Form 941. Employers must also file Forms W-2 and W-3 with the SSA by the last day of the month that follows the due date of their final Form 941. See Rev. Proc. 96-57, 1996-2 C.B. 389, for information on automatic extensions.**

**Note: Use of a reporting agent or other third-party payroll service provider does not relieve an employer of the responsibility to ensure that Forms W-2 are provided to employees and filed correctly with the SSA on time.**

.07 Forms W-2 for **2001**, filed on paper or magnetic media must be filed with the SSA on or before **February 28, 2002**. Employers who file electronic Forms W-2 for **2001 must file them on or before April 1, 2002**. Copies B, C, 1, and 2 must be furnished to the employee by **January 31, 2002**. If employment ended before December 31, 2001, the employee may be furnished his/her copy any time after employment ends, but no **later than January 31, 2002**. However, if the employee requests Form W-2, you **must** furnish him or her the completed copies within 30 days of the request or within 30 days of the final wage payment, whichever is later. This requirement is met if the form is properly addressed, mailed, and postmarked on or before the due date. Failure to timely file with the SSA or to

timely provide the employee copies may subject the employer to penalties. Employers needing additional time to file Form W-2 (paper, magnetic media, or electronic) with the SSA may request an extension of time to file by submitting Form 8809, *Request for Extension of Time to File Information Returns*, to the IRS/MCC "ATTN: Extension of Time Coordination" at the address listed in Sec. 3.01, *above*. The extension request should be filed as early as possible, but **must** be postmarked (for paper or magnetic media) no later than the due date of the forms (**February 28, 2002**). Extensions for electronically filed Forms W-2 **must** be postmarked no later than **April 1, 2002. DO NOT SEND FORM 8809 TO THE SSA.**

NOTE: APPROVAL OF THE EXTENSION IS NOT AUTOMATIC. Approval or denial is based on administrative criteria and guidelines. The requestor will receive an approval or denial letter from the IRS and **must** allow a minimum of 30 days from the date of the request for the IRS to respond. You do not have to wait for a response before filing your return. File your return as soon as it is ready. If you have received a response, positive or negative, **do not** send a copy of the letter or Form 8809 with your return. Form 8809 may be obtained on the IRS Web Site at <http://www.irs.gov> or by using the IRS Fax Forms Program at 703-368-9694, or by calling 1-800-829-3676.

.08 When requesting extensions of time for more than 10 employers, the IRS encourages filers to submit the request on tape, tape cartridge (4mm, 8mm, or Quarter Inch Cartridge), 3-1/2 inch diskette, or electronically. **Transmitters requesting an extension of time to file for more than 50 employers are required to file the extension request on magnetic media or electronically.** Transmitters who submit requests for multiple employers will receive one approval letter with an attached list of employers covered under that approval. Publication 1220, *Specifications for Filing Forms 1098, 1099, 5498, and W-2G Magnetically or Electronically*, provides information on how to file requests for extensions of time on tape, tape cartridge (4mm, 8mm, or Quarter Inch Cartridge), 3 -1/2 inch diskette, or electronically.

**NOTE: To file a request for extension of time magnetically or electronically for multiple payers, third party filers/transmitters must have an IRS Transmitter Control Code (TCC) (authorization to file information returns).**

**SEC. 4. GENERAL RULES FOR FILING FORM W-3 (Standard Red Ink Format)**

.01 Employers submitting Form(s) W-2 (Copy A) to the SSA on *paper* must also file a Form W-3.

.02 Form W-3 must be the same width (8.0 inches) as the Form(s) W-2. The Form W-3 is printed on standard size paper 8.5 by 11 inches.

.03 Form W-3 now contains “four corner **black** register marks,” and **red** dropout ink shading, and **red** dropout ink dollar signs for all money boxes.

.04 Form W-3 has a new checkbox “Third-party sick pay” within Box b (Kind of Payer). Also a new Box 13 “For third-party sick pay use only” has been added.

.05 Box 14 has been opened/unzipped to include “Income tax withheld by payer of third-party sick pay” which was formerly box 15. The new Box 15 becomes “State and Employer’s state ID number”. The new boxes 15, 16, 17, 18, and 19 will now report state/local wage and income tax information.

.06 Also the “Contact person”, “Telephone number”, “E-mail address”, and “Fax number” information boxes at the bottom have been expanded.

.07 Separate instructions for the Form W-3 are provided in the **Instructions for 2001 Forms W-2 and W-3**. Form W-3 is a single sheet including only essential filing information. **Be sure to make a copy of Form W-3 for your records.**

.08 Form W-3 should be used only to transmit paper Forms W-2 (Copy A). **Magnetic media or electronic filers do not file Form W-3.** Employers submitting Form(s) W-2 data via magnetic media must transmit Form(s) W-2 data with **Form 6559, Transmitter Report and Summary of Magnetic Media, and Form 6559-A, Continuation Sheet for Form 6559, if necessary.** Employers submitting Form(s) W-2 data electronically using the MMREF-1 via OWRS, Electronic Data Transfer (EDT), or diskette need not submit a Form 6559. However, employers **must** have com-

pleted a PIN registration process that replaces the signature on Form 6559. If employers submit wage reports/Form(s) W-2 data in the MMREF-1 file using OWRS, EDT, or diskette, a Form 6559 will not be required upon completion of the PIN registration process. If employers submit MMREF-1 file on magnetic tape cartridge, a Form 6559 is required. Please refer to the latest edition of MMREF-1 for further information.

**PART B. REQUIREMENTS FOR FILING PAPER SUBSTITUTES WITH THE SOCIAL SECURITY ADMINISTRATION (SSA)**

**SEC. 1.A. REQUIREMENTS FOR SUBSTITUTE “PRIVATELY PRINTED” FORMS SUBMITTED TO THE SSA (FORM W-2 (COPY A), AND FORM W-3 STANDARD RED INK FORMAT)**

.01 Employers may file privately printed substitute Forms W-2 and W-3 with the SSA. The substitute form **must** be an exact replica of the IRS printed form with respect to layout and contents because it will be read by scanner equipment. The Government Printing Office (GPO) symbol **must** be deleted (see Sec. 1.16, below). The specifications and allowable tolerances for Copy A of substitute Forms W-2 are provided later in this revenue procedure. See Exhibit A for the Form W-2 specifications. The specifications for Forms W-3 are provided in Exhibit B.

.02 Paper used for substitute Forms W-2, Copy A, and Form W-3 (cut sheets and continuous pinfeed forms) that are to be filed with the SSA must be white 100% bleached chemical wood, **18-20 pound paper only**, optical character recognition (OCR) bond produced in accordance with the specifications shown as follows:

**Paper Requirements**

- 1 Acidity: pH value, average, not less than . . . . .4.5
- 2 Basis Weight 17 x 22 inch 500 cut sheets, pound, 18-20 Metric equivalent grams per. sq. meter . . . . .68-75  
A tolerance of +5 pct. is allowed.
- 3 Stiffness: Average, each direction, not less than Gurley milligrams —  
Cross direction . . . . .50  
Machine direction . . . . .80

- 4 Tearing Strength: Average, each direction, not less than—  
Grams . . . . .40
- 5 Opacity: Average, not less than — Percent . . . . .82
- 6 Reflectivity: Average not less than — percent . . . . .68
- 7 Thickness:  
Average. Inch 0.0038  
Metric equivalent. . . . .mm 0.097  
A tolerance of +0.0005 inch (0.0127mm) is allowed. Paper can not vary more than 0.0004 inch (0.012mm) from one edge to the other.
- 8 Porosity:  
Average, not less than —  
seconds . . . . .10
- 9 Finish (smoothness):  
Average, each side —  
seconds . . . . .20-55  
(For information only),  
the Sheffield equivalent  
unit . . . . .170-d200
- 10 Dirt: Average, each side,  
not to exceed —Parts  
per million . . . . .8

NOTE: Reclaimed fiber in any percentage is permitted, provided the requirements of this standard are met.

.03 All printing of Copy A of Forms W-2 and Form W-3 **must** be in Red OCR drop-out Flint Ink, **except** as specified below.

The following **must** be printed in non-reflective black ink:

- 1. **Identifying control number “2222” (Exhibit C) at the top of Form W-2.**
- 2. **Tax year at the bottom of the Form W-2 (see Exhibit C).**
- 3. **The four (4) corner register marks on Form W-2 (Exhibit A).**
- 4. **Identifying control number “3333” (Exhibit D) at the top of Form W-3.**
- 5. **Tax year at the bottom of Form W-3 (Exhibit D).**
- 6. **Form identification “W-3” at the bottom of Form W-3 (Exhibit D).**
- 7. **The four (4) corner register marks on Form W-3 (Exhibit B).**
- 8. **The Jurat and “Signature, Title, Date” line at middle of Form W-3 (Exhibit B).**
- 9. **All instructions beginning with the “Send this entire page....” Line to the bottom of Form W-3 (Exhibit B).**

As in the past, Forms W-2 (Copy A) and Form W-3 may be generated by use of a laser printer following all the guidelines and specifications per Exhibit A. The printing of the data should be centered. All other printing on Forms W-2, Copy A, and W-3 **must** be in **Red** OCR drop-out Flint Ink J-6983 (formerly Sinclair and Valentine) or an exact match. This is the same ink that is used for Copy A of the Form 1099 series (see Pub. 1179), Rules and Specifications for Private Printing of Substitute Forms 1096, 1098, 1099, 5498, and W-2G. The use of this ink is required for **2001** Forms W-3 and W-2 (Copy A).

.04 Type **must** be substantially identical in size and shape with corresponding type on the official form. The form identifying number **must** be printed in non-reflective black ink using an OCR-A font; **10** characters per inch.

1. On Form W-3 and Copy A of Forms W-2, all the perimeter rules **must** be 1-point (0.014 inch), while all other rules must be one-half point (0.007 inch).
2. Vertical rules **must** be parallel to the left edge of the form; horizontal rules parallel to the top edge.

.05 Two official Forms W-2 (Copy A) or one official Form W-3 are contained on a single page that is 8.5 inches wide (exclusive of any snap-stubs) by 11 inches deep. The official Form W-2 is 8.0 inches in width printed on single sheet 8.5 inches in width. The form identifying control number for the official forms (8.0 inches wide) is "22222" (5 digits) for Form W-2 and "33333" (5 digits) for Form W-3. The top margin for the **2001** Forms W-3 and W-2 Copy A is .375 inch (3/8 inch). The right margin **must** be .2-inch and the left margin .3-inch (plus or minus .0313 inch). The margins have **changed** from Tax Year 2000. Margins **must** be free of all printing. **No printing should appear anywhere near the Form ID control number (33333 or 22222).** For Forms W-2, Copy A, the combination width of **Box a**, "Control number," and the box containing the form identifying number (22222) **must** always be 2.54 inches. For Form W-3, the combined width of these boxes **must** always be 2.54 inches.

**NOTE:** All form identifying numbers **must** be printed in non-reflective black ink, using OCR-A font, printed **10** characters per inch.

.06 The depth of the individual scannable image on a page **must** be the same as that on the IRS printed forms. For Form W-2, the depth of one individual form is 4.92 inches (see Exhibit A). The scannable image depth of the Form W-3 on a page **must** be 4.8 inches (see Exhibit B).

.07 The words "Do Not Cut, Fold, or Staple Forms on This Page" **must** be printed **twice** in Red OCR drop-out Flint Ink between the two Forms W-2 on Copy A only (see Exhibit A). **Perforations are required on all copies (except Copy A) to enable the separation of individual forms. Continuous pinfeed Copy A forms must be separated at the page perforation into individual 11 inch deep pages before submission to the SSA. The pinfeed strips must also be removed. However, the two Forms W-2 documents contained on the 11 inch deep page must not be separated.**

.08 Box 12 of Copy A, Form W-2, has been broken down into four entry boxes 12a, 12b, 12c, and 12d. Do not make more than one entry per box. **If more than four items** need to be reported in **box 12**, use a separate Form W-2 to report the additional items (see "**Multiple forms**" in the **2001 Instructions for Forms W-2 and W-3**). Do not report the same Federal tax data to the SSA on more than one Copy A, Form W-2.

.09 The words "**For Privacy Act and Paperwork Reduction Act Notice, see separate instructions,**" **must** be printed in Red OCR drop-out Flint Ink on Forms W-2, Copy A (see Exhibit A for format and location). **The 2001 Instructions for Forms W-2 and W-3 contain the Privacy Act Notification previously shown on the Form W-3.**

.10 The Office of Management and Budget (OMB) Number **must** be printed on *each* ply of Forms W-2 and on W-3 (see Exhibits A and B for format and location).

.11 The instructions on the official Form W-3, **must** be printed in their entirety on all substitute Forms W-3 (see Exhibit B).

**Note: Household employers, even those with only one household employee, must file a Form W-3 with Form W-2. On Form W-3 mark the "Hshld Emp." box in Box b.**

.12 *Privately printed continuous substitute Form W-2, Copy A, must be perforated at each 11 inch page depth. No perforations are allowed between the individual forms (5-1/2 inch Forms W-2) on a single copy page of Copy A. Continuous pinfeed Copy A forms must be separated at the page perforation prior to submitting them to the SSA. Two Copy A forms are contained on each page. The two copies must remain together on one page. Only the pages are to be separated (burst). Perforations are required between all the other individual copies on a page (Copies B, C, D, 1, and 2) included in the set.*

.13 The back of substitute Form W-2, Copy A, and Form W-3 **must** be free of all printing.

.14 Spot carbons are *NOT permitted* for Copy A of Forms W-2. Interleaved carbon should be black and **must** be of good quality to assure legibility of information on all copies and to preclude smudging.

.15 Chemical transfer paper is permitted for Form W-2, Copy A, only if the following standards are met:

1. Only *chemically backed* paper is acceptable for Copy A.
2. Chemically transferred images must be black in color.
3. Carbon-coated forms *are not* permitted. Front and back chemically treated paper cannot be processed properly by scanning equipment.

In general, the use of black ink for data submitted on Forms W-2 and W-3 provides better readability for processing by the scanning equipment. Colors other than black are not easily read by the scanner and/or may result in delays/errors in the processing of Forms W-2 and W-3. "Spot carbons" are NOT permitted.

.16 The GPO symbol must not be placed on substitute Copy A of Forms W-2.

.17 The Catalog Numbers, shown on the 2001 Forms W-2 as "Cat. No. **10134D**," and Form W-3 as "Cat. No. **10159Y**," are used for IRS distribution purposes and should **not** be printed on substitute forms.

.18 Form W-3, box 13 is now labeled as "For third-party sick pay use only" for quick identification.

**SEC. 1.B. REQUIREMENTS FOR 8-1/2 INCH "LASER PRINTED BLACK AND WHITE FORMS" FOR SUBMISSION TO THE SSA (FORMS W-2 COPY A AND W-3).**



.01 Specifications for the laser printed black and white forms are the same as the red and white forms with the exception of the following items and the actual form dimensions as shown in the Exhibits G and H respectively.

1. Forms are printed on 8.5 by 11-inches single/page sheet paper not continuous feed. There must not be any horizontal perforations between the two copies.
2. All forms and data print must be in non-reflective black ink.
3. The forms must not contain any corner register marks.
4. The forms must not contain any shaded areas including entirely shaded boxes.
5. It is preferred that the preprinted Form ID Numbers on both the Form W-2 (22222) and the Form W-3 (33333) be printed in 12-point (10 characters per inch) Courier font.
6. The form numbers "W-2" and "W-3" preceding the form title and the tax year at the bottom of the form font size must be 14-point Courier bold print (**W-2 W-3 2001**).
7. No part of the box titles or the data printed on the forms may touch any of the vertical or horizontal lines, nor should any of the data intermingle with the box titles.
8. The word "Code" must not appear in box 12 on the W-2.
9. A four (4) digit vendor code must appear under the tax year and above the catalogue number on the Form W-2 (see Exhibit G) and on the Form W-3 at the bottom of "For Official Use Only" box (see Exhibit H). The catalogue number below the tax year on Form W-2 is not required to be printed.
10. Do not print the check boxes on the Forms W-3 Kind of Payer (box b), W-2 Box 13, or the Void box. The Forms W-3, Kind of Payer, designation "X" should be placed directly below the applicable title and centered as best possible. Box 13 instructions should say place an "X" below the applicable title. The Form W-2 Void Box designation "X" must be positioned to the right of the title be-

cause of the limited space underneath the title.

11. Do not print dollar signs in any of the money amounts.
12. See Exhibits G and H for specific dimensions and box size specifications.
13. Exhibits are for sample only and must not be downloaded to meet tax obligations.
14. **You must submit samples of your laser printed forms to the SSA for approval. Send one set of blank laser printed Forms W-3 and W-2, and one set of dummy data laser printed Forms W-3 and W-2. Sample data entries should be filled in to the maximum length for each box entry using numeric data or alpha data depending upon the type of the data being entered. Include in your submission the name and telephone number of a contact person who can answer questions regarding your sample forms. The four-position vendor code must appear on the sample forms. You can expect approval or disapproval within 30 days of receipt of sample.**
15. **You may send your laser printed sample forms to:**  
**Social Security Administration**  
**Data Operations Center**  
**ATTN: Program Analyst Office**  
**Room 449**  
**1150 E. Mountain Drive**  
**Wilkes-Barre, PA 18702-7997.**
16. **Send your sample forms to the above address via private mail carrier or certified mail in order to be able to verify receipt of your sample forms.**
17. Forms W-2 and W-3 are not required to display the form producer's EIN to the left of the "Department of the Treasury" statement. **The vendor code will be used to identify the forms producer.** The data and forms must be produced simultaneously. Forms can not be produced separately from wage data entries.
18. Vendor code must be present on all laser printed (black/white) forms to identify the company

producing the forms. If you do not have a vendor code, you may contact the National Association of Computerized Tax Processors at 816-504-1188 or via EMail address at MNolan@hrblock.com. "Forms not containing a vendor code will be rejected". Sample forms without a vendor code will not be submitted for testing or approval.

## **SEC. 2. REQUIREMENTS FOR SUBSTITUTE FORMS FURNISHED TO EMPLOYEES (COPIES B, C, AND 2 OF FORMS W-2)**

.01 All employers (including those who file on magnetic media or electronically) must furnish employees with at least two copies of the Forms W-2 (three or more for employees required to file a state, city, or local income tax return). The dimensions of these copies (Copies B, C, and 2), but not Copy A, may be expanded from the dimensions of the official form to allow space for conveying additional information, including additional entries for Box 14, such as withholding from pay for health insurance, union dues, bonds, or charity. The limitation that a maximum of **four items** are permitted in Box 12 of Form W-2 applies **only** to the paper **Copy A** that is filed with the SSA. Also, on these copies (Copies B, C, and 2), the size of these boxes may be adjusted. (However, see the minimum sizes for certain boxes, below). This may permit the employer to eliminate other statements or notices that would otherwise be furnished to employees.

1. The **MAXIMUM** allowable dimensions for employee copies of Forms W-2 are:

- (a) Depth should be no more than 6.5 inches;
- (b) Width should be no more than 8.5 inches.

2. The **MINIMUM** allowable dimensions for employee copies of Forms W-2 are:

- (a) 2.67 inches deep by 4.25 inches wide;
- (b) Horizontal or vertical format is permitted.

NOTE: These maximum and minimum size specifications are for the Tax Year 2001 only and may change in future

years. The maximum width of 8.5 inches is for employee copies of Form W-2 only. The width of the paper Copy A, submitted to the SSA, is specified in Part B, Sec.1. A.05 above. Also, the electronic tax logo has been added to the employee copies; however, the logo is **not** required on any of the substitute forms copies.

.02 The paper for all copies **must** be white. The substitute Copy B (or its equal), which employees are instructed to attach to their Federal income tax return, must be at least 12 pound paper (basis 17 x 22-500), while the other copies furnished the employee must be at least 9 pound paper (basis 17 x 22-500).

.03 Interleaved carbon and chemical transfer paper for employee copies **must** meet the following standards:

1. All copies **must** be CLEARLY LEGIBLE,
2. All copies **must** have the capability to be photocopied, and
3. Fading **must not** be of such a degree as to preclude legibility and the ability to photocopy.

.04 The following requirements govern the private printing of employee copies of Forms W-2. All substitutes **must** be a form that contains boxes, box numbers, and box titles that, when applicable, match the IRS printed form. **The employee copy of Forms W-2 (Copy C) must contain the note "This information is being furnished to the Internal Revenue Service. If you are required to file a tax return, a negligence penalty or other sanction may be imposed on you if this income is taxable and you fail to report it."** The placement, numbering, and size of certain boxes (the "core" information) is specified as follows:

1. The items and box numbers that constitute the core data are:

- Box 1 - Wages, tips, other compensation,
- Box 2 - Federal income tax withheld,
- Box 3 - Social security wages,
- Box 4 - Social security tax withheld,
- Box 5 - Medicare wages and tips, and
- Box 6 - Medicare tax withheld.

NOTE: Railroad employees may not be subject to social security coverage but are subject to Railroad Retirement Tax Act (RRTA) Tier 1 and Tier 2 coverage. Railroad employers covered by RRTA Tier 1 and Tier 2 **must** report taxes withheld in box 14 of Form(s) W-2 and mark check-

box "CT-1" within **box b** of Form W-3.

The "core" boxes **must** be printed in the exact order shown on the IRS printed form (see the Exhibits at the end of this revenue procedure). Boxes 1 and 2 **must** be next to each other, with boxes 3 and 4 below on the next line, and boxes 5 and 6 on the line below boxes 3 and 4.

2. The block of core data (boxes 1 through 6) **must** be placed in the upper right of the form. Substitute employee copies of Form(s) W-2 that are printed using a vertical format with dimensions smaller than the IRS printed form may have the core data entirely on the top of the form (see Exhibit F). **In no instance** will boxes or other information be permitted to the right of the core data. Standard margins or a small amount of other blank space may appear to the top or right of this data.

The form title, number, or copy (Copy B, C, or 2) may be at the top of the form. Also, a reversed or blocked-out area to accommodate a postal permit number or other postal considerations is permitted at the upper right of the form.

3. Boxes 1 through 6 each **must** be a minimum of 1 3/8 inches wide and 1/4 inch deep.

4. Other required boxes:

- Employer identification number (EIN),
- Employer's name, address, and ZIP code,
- Employee's social security number, and
- Employee's name, address, and ZIP code.

These items are required to be present on the form and **must** be in boxes similar to those on the IRS printed form. However, they may be placed in any location, other than the top or upper right. The lettering system used on the IRS printed form ("a" through "f") **need not be used**. The employer identification number may be included in the box for the employer's name and address. If this is done, a separate box for the EIN is not required. The "Control number" box (box "a" on the IRS printed form) is not required.

5. The Tax Year (2001) **must** be clearly printed (**in non-reflective black ink**) on all copies of substitute Forms W-2. It is recommended (but not required) that this information be located to the right of the

form title on the lower left of the Form W-2. **The use of 24 pt. OCR-A font is recommended but not required.**

6. If applicable, box 7, "Social security tips", **must** be shown separately from "Social security wages." A separate box is not required unless social security tips are to be reported. Boxes 1 and 2 on Copy B are required to be outlined in bold 2-point rule (see Exhibit E) or highlighted in some manner to distinguish these boxes.

7. If box 9 for "Advance EIC" payment (Advance Earned Income Credit) is present, the box **must** be outlined in bold 2-point rule or highlighted in some manner to distinguish this box. However, if no amounts are paid for "Advance EIC", this box is not required and may be omitted by printers. Do not use box 9 for any other purpose than reporting Advance EIC payments.

8. If box 8 "Allocated tips" are being reported for an employee (or class of employees that are being provided Forms W-2), it is recommended (but not required) that this box also be outlined in bold 2-point rule or highlighted on Copy B. However, if allocated tips are not being reported, this box may be omitted by printers.

9. Employers who are required to withhold and report state income tax information are required to include the following boxes on substitute Forms W-2:

- Box 15 - State and Employer's state I.D. number.
- Box 16 - State wages, tips, etc.
- Box 17 - State income tax.

10. Employers who are required to withhold and report local income tax information are required to include the following boxes on substitute Forms W-2:

- Box 18 - Local wages, tips, etc.
- Box 19 - Local income tax.
- Box 20 - Locality name.

11. If state or local tax information is required, this information is also considered "core data." The state and local information **must** be placed at the bottom of the form. See the exhibits at the end of this revenue procedure.

12. Other boxes on the IRS printed form (boxes 7 through 14) need not appear on substitute Forms W-2 provided to employees **unless** an employer has that item of information to report to an employee. For example, if an employee did

not have Social security tips (box 7), Allocated tips (box 8), or Advance EIC payment (box 9), the form could be printed without those boxes. However, if the employer provided amounts for (box 10) Dependent care benefits, those amounts would be required to be reported separately and shown in a box labeled "Dependent care benefits" as on the IRS printed form and the exhibits in this revenue procedure.

13. Employers may provide multiple entries in box 12, but each entry **must** use the same code as assigned by the IRS for that type of item. (See the "Reference Guide for Box 12 Codes" in the 2001 Instructions for Forms W-2 and W-3.) For example, employers reporting elective deferrals to a section 401(k) plan **must** enter in box 12 "D" and not "A", even though it is the first or only item to go in this box. Use the codes shown with the dollar amount. **Employers may enter more than four codes in box 12 of Copies 1, 2, B, C, and D of Forms W-2.** Do not report in box 12 any items that are not listed as **Codes A-T or the new Code "V" in the 2001 Instructions for Forms W-2.**

14. For codes D, E, F, G, H, and S, if any elective deferrals, salary reduction amounts, or non-elective contributions to a section 457(b) plan during the year are make-up amounts under the **Uniformed Services Employment and Reemployment Rights Act of 1994 (USERRA)** for a prior year, you must enter the prior year contributions separately. You **must** enter the code, the year (**two positions only**), and the amount. For example, elective deferrals under USERRA to a section 401(k) plan are reported in box 12 as follows: D 00 2250.00, D 99 1250.00. The 2001 contribution does not require a year designation; enter it as D 7000.00.

15. If you are a military employer and provide your employee with basic housing, subsistence allowances, and combat zone compensation, report the amount in box 12, Form W-2, using code **Q**.

16. Employer contributions to an employee's Medical Savings Accounts (MSA), **must** be reported in box 12, Form W-2, using code **R**.

17. An employee elective contribution to a salary reduction SIMPLE retirement account **must** be included in box 12, Form W-2, using code **S**. However, if the amount is contributed to a SIMPLE retirement that

is part of a section 401(k) arrangement, that amount **must** be reported in box 12, Form W-2, using code **D**.

18. Amounts paid or expenses incurred on behalf of an employee for qualified adoption expenses **must** be reported in box 12, Form W-2, using code **T**.

19. Code **V** (optional) for 2001, shows the spread (i.e., fair market value of stock over the exercise price of option(s) granted to your employee with respect to that stock) from your employee's exercise of non-statutory stock option(s). The spread is to be included in boxes 1, 3 (up to the social security wage base), 5, and 12.

20. Employers may use box 14 for any other information they wish to give their employee. Each item must be labeled. Examples are union dues, health insurance premiums deducted, nontaxable income, voluntary after-tax contributions, or educational assistance payments.

21. If you are reporting prior year contributions under USERRA (see item 14 above), you may report in box 14 makeup amounts for nonelective employer contributions, voluntary after-tax contributions, required employee contributions, and employer matching contributions. Report such amounts separately for each year.

22. If the employer has employees who are subject to any of the three categories/check boxes within box 13, the entire box 13 (ballot boxes) is required to be reported with the proper check mark designation. For example, if an employer provides a retirement plan, box 13 **must** be reported and check marked for retirement plan designation.

.05 Substitute forms for employees (Copies B, C, and 2 of Forms W-2) **must** also meet the following requirements:

1. All copies of Form W-2 **must** clearly show the form number, the form title, and the tax year prominently displayed together in one area of the form. The title of Form W-2 is "Wage and Tax Statement." It is recommended (but not required) that this be located on the bottom left of Form W-2. The reference to the "Department of the Treasury - Internal Revenue Service" **must** be on all copies of Form W-2 provided to the employee. It is recommended (but not required) that this be located on the bottom right of Form W-2.

2. If the substitute forms are *not la-*

*beled* as to the disposition of the copies, then written notification **must** be provided to each employee as specified below:

(a) The first copy of the form (Copy B) is filed with the employee's Federal tax return.

(b) The second copy of the form (Copy C) is for the employee's records.

(c) If applicable, the third copy (Copy 2) of the form is filed with the employee's state, city, or local income tax return.

3. If the substitute forms are *labeled*, the forms **must** contain the applicable description:

"Copy B, To Be Filed With Employee's FEDERAL Tax Return," and "Copy C, for EMPLOYEES RECORDS." It is recommended (but not required) that this be located on the lower left of Form W-2. "Copy 2, To Be Filed with Employee's State, City, or Local Income Tax Return".

4. Instructions similar to those contained on the back of Copies B and C of the official Form W-2 **must** be provided to each employee. Employers may modify or delete certain information in these instructions (such as modification for employees of railroads to cover Railroad Retirement Tier 1 and Tier 2 compensation and taxes). Employers are allowed to delete instructions that do not apply to the employee. For example, if none of the employees have dependent care benefits (box 10), the employer may delete the instructions for that item. Also, if an employer will only be reporting amounts for a 401(k) plan in box 13, those instructions may be modified to cover only Code D and its instructions.

5. Employers **must** notify employees who have no income tax withheld that they may be able to claim a tax refund because of the earned income credit (EIC). You will meet this notification requirement if you issue the official IRS Form W-2 with the EIC notice on the back of the Copy B, or a substitute Form W-2 with the same statement. You may also meet the requirement by providing a substitute Form W-2 without the EIC notification by including **Notice 797, Possible Federal Tax Refund Due to the Earned Income Credit (EIC)**, or your own statement that contains the same wording. You may change the font on

Copy C (back page only) so that the EIC notification and W-2 instructions fit entirely on the back of Copy C. For more information about notification requirements, see **Notice 1015** (formerly Pub. 1325), *Have You Told Your Employees About the Earned Income Credit (EIC)?*

**NOTE:** Printers are cautioned that the rules set forth here (Part B., Sec. 2) apply to employee copies (Copies B, C, and 2) only. Paper filers who send Copy A of Form W-2 to the SSA **must** follow the requirements in Parts B, Sec. 1 and Sec. 3, for those paper submissions.

### **SEC. 3. GENERAL RULES FOR FILING "PAPER SUBSTITUTES" FOR FORMS W-2 AND W-3 (STANDARD RED INK FORMAT)**

.01 Paper substitutes that conform **TOTALLY** to the specifications contained in this revenue procedure may be privately printed **without** the prior **approval** of the IRS. **Please do not mail your paper Forms W-2 or W-3 tax year submissions to the IRS address below. The address below is for correspondence or questions relating to specifications in this publication only. Penalties may be assessed for not complying with the form specifications set forth in this publication. SUBSTITUTE FORMS THAT DO NOT CONFORM TOTALLY TO THESE SPECIFICATIONS ARE NOT ACCEPTABLE.** This applies to both paper substitutes that are filed with the SSA and those that are given to employees. **Forms W-2 (Copy A) and W-3 filed with the SSA that do not conform totally to the specifications, may be returned. Forms cannot be submitted to the IRS or the SSA for specific approval with exception to the laser printed (black/white) forms only.** If you are uncertain of any specification set forth herein and want that specification clarified, you may submit a letter citing the specification in question, your interpretation of that specification, and an example of how the form would appear if produced using your understanding of the specification. Any questions about Copies B, C, and 2 of Forms W-2 should be sent to:

Internal Revenue Service  
ATTN: Substitute Form  
W-2 Coordinator  
Forms and Publications  
W:CAR:MP:FP:S:SP

1111 Constitution Ave., N.W.  
Washington, DC 20224

Any questions about Copy A, Form W-2, and Form W-3 should be forwarded to:

Social Security Administration  
Data Operations Center  
ATTN: Program Analyst Office,  
Room 449  
1150 E. Mountain Drive  
Wilkes-Barre, PA 18702-7997

**NOTE:** You should allow at least **30** days for the IRS or the SSA to respond.

.02 Forms W-2 and W-3 are subject to annual review and possible change. Employers are cautioned against overstocking supplies of privately printed substitutes.

.03 Copies of the current year IRS printed Forms W-2 and W-3, and the instructions for these forms may be obtained using IRS Web Site *www.irs.gov*, or from most IRS offices, or by calling 1-800-829-3676. The IRS provides only cut-sheet sets of Forms W-2 and W-3.

.04 Substitute Forms W-2 and W-3 filed with the SSA should contain only data that is required according to the 2001 Instructions for Forms W-2 and W-3 and this revenue procedure.

.05 Substitute Forms W-2, Copy A, and W-3 are machine imaged and scanned by the SSA; therefore, these forms **must** meet the same specifications as Forms W-2 and W-3 produced by the IRS. The vertical and horizontal spacing for all Federal payment and data boxes on Form W-2 **must** be in compliance with the specifications contained herein.

.06 The ballot boxes in box 13 of Forms W-2, Copy A **must** be point-14 inch (.14) boxes (see Exhibit A). The spacing on each side of the the three ballot boxes are point-36 inch (.36) (see Exhibit A). The space after the last/third ballot box is point-46 inch (.46) (see Exhibit A). The Form W-3 box b **must** be point-14 inch (.14) ballot boxes (see Exhibit B). Please insure you adhere to the dimensions provided in the exhibits.

**NOTE:** If a box is marked, more than 50 percent of the applicable ballot box **must** be covered by an "X".

.07 Copy A of Forms W-2 and Form W-3 **must** have the form producer's EIN entered to the left of the "Department of the Treasury."

## **PART C. ADDITIONAL INSTRUCTIONS**

### **SEC. 1. INSTRUCTIONS FOR FORMS PRINTERS**

.01 Except as provided below, if magnetic or electronic media is not used for filing with the SSA, the substitute copies of Forms W-2 assembly should be arranged in the same order as the IRS printed Forms W-2. Copy A (**red/white**) should be first, followed sequentially by perforated sets (Copies 1, B, C, 2, and D). The substitute form to be filed by the employer with the SSA **must** carry the designation "Copy A" for the **red/white forms. The black/white laser printed forms require the "Copy A" designation also. See Part B, Sec. 1. B for laser specifications along with exhibits G and H.**

**NOTE:** Magnetic media/electronic filers do not submit paper Copy A (red/white or black/white) of Form W-2 or Form W-3 (red/white or black/white) to SSA. MMREF-1 specifications require a Form 6559 transmittal for magnetic media tape and cartridge filers of Forms W-2. MMREF-1 specifications do not require Form 6559 if filed on diskette or electronically if the employer has registered for a PIN and Password.

1. Privately printed substitute forms are not required to contain a copy to be retained by employers (Copy D). However, employers **must** be prepared to verify or duplicate this information if it is requested by the IRS or the SSA. Paper filers who do not keep Copy D should be able to generate a Facsimile of Copy A (red/white or black/white) in case of loss.

2. Except as provided in the arrangement of the official assemblies, additional copies that may be prepared by employers shall not be placed ahead of the copy "FOR EMPLOYEE'S RECORDS," on Form W-2 (Copy C).

3. Instructions similar to those contained on the back of **Copies B and C** of the official form **must** be provided to each employee. These instructions may be printed on the back of the substitute Copies B and C or may be provided to employees on a separate statement. Do not print these instructions on the back of Copy 1 or 2 that is to be filed with the employee's state or local income tax return.

.02 All privately printed Forms W-2 (Copy A red/white) and **W-3** (red/white)

**must have the tax year** form number, and form title printed on the bottom face of each form using identical type to that of the official format. **The tax year must be printed in non-reflective black ink using 24-point OCR-A font on Copy A (red/white) of Forms W-2 and Form W-3 (red/white).** See Part B, Sec. 1.B “**REQUIREMENTS FOR 8-1/2 INCH LASER PRINTED BLACK AND WHITE FORMS**” for specifications for the black/white laser printed form Copy A. **The form titles for Forms W-2 (Copy A red/white) and W-3 (red/white) respectively, e.g., “Wage and Tax Statements” and “Transmittal of Wage and Tax Statements” must be printed in Red OCR drop-out Flint Ink. The form identifying control number for Forms W-2 (red/white) and Form W-3 (red/white) must be printed in non-reflective black ink, using OCR-A font printed 10 characters per inch. The word “Form” on the W-2 (red/white) and W-3 (red/white) must be printed in Red OCR drop-out Flint Ink. The four corner black register marks on the Forms W-3 (red/white) and W-2 (Copy A red/white) must be printed in non-reflective black ink.**

.03 The substitute Form W-2, Copy B, which employees attach to their Federal income tax return, **must** be printed on at least 12-pound paper (basis 17 x 22-500) while the other copies furnished to employee should be at least 9-pound paper (basis 17 x 22-500).

.04 Employee copies of Forms W-2 (Copies B, C, etc.), including those that are printed on a single sheet of paper, **must** be easily separated by the employee. Perforations between the individual copies that are printed on a single sheet of paper satisfy this requirement. The use of scissors to separate Copies B, C, etc., indicates that they are *not* easily separated forms.

.05 The Form W-2, Copy A (red/white or black/white), and Form W-3 (red/white or black/white) that are filed with the SSA **must** have no printing on the reverse side.

.06 Instructions similar to those provided as part of the official forms **must** be provided as part of any substitute Form W-2 or W-3.

## **SEC. 2. INSTRUCTIONS FOR EMPLOYERS**

.01 Only originals of Copy A (red/white and black/white) Form W-2 and Form W-3 (red/white and black/white) may be filed with the SSA.

### ***CARBON COPIES AND PHOTOCOPIES ARE NOT ACCEPTABLE.***

.02 Employers should type or machine print entries on non-laser generated forms whenever possible and provide good quality data entries by using a high quality type face, inserting data in the middle of blocks that are well separated from other printing and guidelines, and taking any other measures that will guarantee clear, sharp images. **USE 12-point Courier font (data entries).**

**Note: (SSA prefers 12-point Courier font.)**

**Form W-2 Copy A (red/white and black/white) requires decimal entries for wage data. Dollar signs are preformatted on Forms W-2 (red/white) and W-3 (red/white) and should not be entered as part of money amounts. The employer must provide a machine scannable Form W-2 (Copy A red/white or black/white.) The employer must refrain from printing any data in the top margin of the forms. UNLESS ABSOLUTELY NECESSARY, DO NOT PRINT ANYTHING IN THE CONTROL NUMBER BOX ON ANY OF THE FORMS W-2 OR W-3.** The employer must also provide payee copies (Copies B, C, and 2) that are legible and capable of being photocopied (by the employee). When non-laser Form W-2 or W-3 is typed, black ink **must** be used with no script type, inverted font, italics or dual case alpha characters used.

.03 The Employer Identification Number (EIN) **must** be entered in box b of Form W-2. The EIN **must** also be entered in box e of Form W-3. **Note: The EIN entered on Form W-3 in box e must be the same EIN entered on Forms W-2 in box b, and on Forms 941, 943, CT-1, Schedule H (Form 1040), or any other corresponding forms filed with the IRS.**

.04 The employer's name, and address may be preprinted.

.05 Generally, an agent that has an approved Form(s) 2678, *Employer Appointment of Agent*, should enter its name as

the employer in **box c** of Form W-2 and file one Form W-2. However, if the agent is (a) acting as an agent for two or more employers, or is an employer and is acting as an agent for another employer; and (b) pays social security wages in excess of the wage base to an individual, special reporting for payments to that individual may be needed. The agent should file separate Forms W-2 reflecting the wages paid by each employer. **Box c** of Forms W-2 should include the name of the agent, agent for (name of employer), and address of agent. Each Form W-2 should reflect the EIN of the agent in box b. In addition, the employer's EIN should be shown in **box h** of Form W-3.

.06 The preparation and filing instructions for Forms W-2 and W-3 are included in the 2001 Instructions for Forms W-2 and W-3.

.07 To avoid confusion and questions by employees, employers are encouraged to delete the following items from the employee copies of Forms W-2 that are provided to employees:

- 1 Form identifying number (e.g., 22222),
- 2 The word “Void” and associated box, and
- 3 Any other captions or box numbers that would not be of any informational use to employees (unless otherwise required).

.08 Employers should use the IRS preprinted Form W-3 they received with Pub. 393 or 2184 if available when filing (red/white) Form W-2(s) with the SSA.

## **SEC. 3. OFFICE OF MANAGEMENT AND BUDGET (OMB) REQUIREMENTS FOR SUBSTITUTE FORMS (STANDARD RED INK FORMAT AND BLACK/WHITE LASER PRINTED FORMAT)**

.01 The Paperwork Reduction Act requires: (1) OMB approval of IRS tax forms, (2) that each form (all copies) show the OMB approval number, and (3) that the form (or its instructions) state why the IRS needs the information, how it will be used and whether it must be furnished. The official IRS form and instructions will contain this information.

.02 As it applies to substitute IRS forms, this means:

1. All substitute forms (all copies) **must** show the OMB number as it appears

on the official IRS printed form (see Exhibits A and B).

2. The OMB number **must** be in one of the following formats:

OMB No. 1545-0008 (preferred), or  
OMB # 1545-0008

3. You **must** inform the users of your substitute forms of the reasons for IRS use and collection requirements as stated in the instructions for the official IRS form. If you provide your users or customers with the official IRS instructions, page 1 of each form must retain either the Privacy Act/Paperwork Reduction Act Notice, or a reference to it as the IRS does on the official forms.

#### **SEC. 4. FORMS and PUBLICATIONS (STANDARD RED INK FORMAT AND BLACK/WHITE LASER PRINTED FORMAT)**

.01 Electronic access to IRS tax forms, instructions, publications, and other tax data is available through the following:

**WWW** - *http://www.irs.gov*

**Fax Forms: (703) 368-9694**

**Note: Forms W-2 and W-3 obtained as specified above cannot be filed with the SSA nor can they be used to meet personal tax obligations. Tax forms obtained in this manner are for informational purposes only.**

.02 A list of the Social Security Administrations ESLO Coordinators is included at the end of this document.

#### **SEC. 5. EFFECT ON OTHER REVENUE PROCEDURES**

.01 Rev. Proc. 2000-23, 2000-21, dated May 22, 2000 (Reprinted as Publication 1141, Revised 7-00), is superseded.

# Exhibit A Form W-2

a Control number 22222		Void <input type="checkbox"/>		For Official Use Only OMB No. 1545-0008	
b Employer identification number		1 Wages, tips, other compensation \$	2 Federal income tax withheld \$		
c Employer's name, address, and ZIP code		3 Social security wages \$	4 Social security tax withheld \$		
		5 Medicare wages and tips \$	6 Medicare tax withheld \$		
		7 Social security tips \$	8 Allocated tips \$		
d Employee's social security number		9 Advance EIC payment \$	10 Dependent care benefits \$		
e Employee's first name and initial		11 Nonqualified plans \$		12a See instructions for box 12 \$	
Last name		13 Statutory employee <input type="checkbox"/>	Retirement plan <input type="checkbox"/>	Third-party sick pay <input type="checkbox"/>	12b \$ 4.54"
		14 Other <input type="checkbox"/>			12c \$
				12d \$	
f Employee's address and ZIP code					
15 State	Employer's state ID number	16 State wages, tips, etc. \$	17 State income tax \$	18 Local wages, tips, etc. \$	19 Local income tax \$
					20 Locality name

Form **W-2 Wage and Tax Statement** **2001** Department of the Treasury—Internal Revenue Service  
 Copy A For Social Security Administration—Send this entire page with Form W-3 to the Social Security Administration; photocopies are not acceptable.  
 For Privacy Act and Paperwork Reduction Act Notice, see separate instructions.  
 Cat. No. 10134D 11"

**Do Not Cut, Fold, or Staple Forms on This Page — Do Not Cut, Fold, or Staple Forms on This Page**

a Control number 22222		Void <input type="checkbox"/>		For Official Use Only OMB No. 1545-0008	
b Employer identification number		1 Wages, tips, other compensation \$	2 Federal income tax withheld \$		
c Employer's name, address, and ZIP code		3 Social security wages \$	4 Social security tax withheld \$		
		5 Medicare wages and tips \$	6 Medicare tax withheld \$		
		7 Social security tips \$	8 Allocated tips \$		
d Employee's social security number		9 Advance EIC payment \$	10 Dependent care benefits \$		
e Employee's first name and initial		11 Nonqualified plans \$		12a See instructions for box 12 \$	
Last name		13 Statutory employee <input type="checkbox"/>	Retirement plan <input type="checkbox"/>	Third-party sick pay <input type="checkbox"/>	12b \$
		14 Other <input type="checkbox"/>			12c \$
				12d \$	
f Employee's address and ZIP code					
15 State	Employer's state ID number	16 State wages, tips, etc. \$	17 State income tax \$	18 Local wages, tips, etc. \$	19 Local income tax \$
					20 Locality name

Form **W-2 Wage and Tax Statement** **2001** Department of the Treasury—Internal Revenue Service  
 Copy A For Social Security Administration—Send this entire page with Form W-3 to the Social Security Administration; photocopies are not acceptable.  
 For Privacy Act and Paperwork Reduction Act Notice, see separate instructions.  
 Cat. No. 10134D

**Exhibit  
B  
Form  
W-3**

DO NOT STAPLE OR FOLD

<b>a</b> Control number 1.6" → 33333 94	<b>For Official Use Only</b> MB No. 1545-9088 5.46"	
<b>b</b> Kind of Payer 1.4" → 941, 36" Military, 36" 943, .46" Ashld. emp., Medicare gov. emp., Third-party sick pay .36" CT-1 .14"	<b>1</b> Wages, tips, other compensation \$	<b>2</b> Federal income tax withheld \$
<b>c</b> Total number of Forms W-2 1.64" →	<b>3</b> Social security wages \$	<b>4</b> Social security tax withheld \$
<b>d</b> Establishment number 1.86" → .14"	<b>5</b> Medicare wages and tips \$	<b>6</b> Medicare tax withheld \$
<b>e</b> Employer identification number 3.5" →	<b>7</b> Social security tips \$ 2.3" →	<b>8</b> Allocated tips \$ 2.2" →
<b>f</b> Employer's name 8.0" →	<b>9</b> Advance EIC payments \$	<b>10</b> Dependent care benefits \$
<b>g</b> Employer's address and ZIP code	<b>11</b> Nonqualified plans \$	<b>12</b> Deferred compensation \$
<b>h</b> Other EIN used this year	<b>13</b> For third-party sick pay use only	
<b>15</b> State Employer's state ID number	<b>14</b> Income tax withheld by payer of third-party sick pay \$	
	<b>16</b> State wages, tips, etc. \$	<b>17</b> State income tax \$
	<b>18</b> Local wages, tips, etc. \$	<b>19</b> Local income tax \$
Contact person	Telephone number ( )	<b>For Official Use Only</b>
E-mail address	Fax number ( )	

Under penalties of perjury, I declare that I have examined this return and accompanying documents, and, to the best of my knowledge and belief, they are true, correct, and complete.

Signature \_\_\_\_\_ Title \_\_\_\_\_ Date \_\_\_\_\_

Form **W-3 Transmittal of Wage and Tax Statements** **2001**

Department of the Treasury  
Internal Revenue Service

Send this entire page with the entire Copy A page of Form(s) W-2 to the Social Security Administration. Photocopies are not acceptable.

Do not send any payment (cash, checks, money orders, etc.) with Forms W-2 and W-3.

**An Item To Note**

**Separate instructions.** See the separate **2001 Instructions for Forms W-2 and W-3** for information on completing this form.

**Purpose of Form**

Use this form to transmit Copy A of **Form(s) W-2, Wage and Tax Statement**. Make a copy of Form W-3, and keep it with Copy D (For Employer) of Form(s) W-2 for your records. Use Form W-3 for the correct year. **File Form W-3 even if only one Form W-2 is being filed.** If you are filing Form(s) W-2 on magnetic media or electronically, **do not** file Form W-3.

**When To File**

File Form W-3 with Copy A of Form(s) W-2 by February 28, 2002.

**Where To File**

Send this entire page with the entire Copy A page of Form(s) W-2 to:

**Social Security Administration  
Data Operations Center  
Wilkes-Barre, PA 18769-0001**

**Note:** If you use "Certified Mail" to file, change the ZIP code to "18769-0002." If you use an IRS approved private delivery service, add "ATTN: W-2 Process, 1150 E. Mountain Dr." to the address and change the ZIP code to "18702-7997." See **Circular E, Employer's Tax Guide (Pub. 15)**, for a list of IRS approved private delivery services.

For Privacy Act and Paperwork Reduction Act Notice, see the 2001 Instructions for Forms W-2 and W-3.

Cat. No. 10159Y





**Exhibit  
C  
Form  
W-2  
Box  
Layout**

a Control number 22222		Void <input type="checkbox"/>		For Official Use Only ▶ OMB No. 1545-0008			
b Employer identification number				1 Wages, tips, other compensation \$		2 Federal income tax withheld \$	
c Employer's name, address, and ZIP code				3 Social security wages \$		4 Social security tax withheld \$	
				5 Medicare wages and tips \$		6 Medicare tax withheld \$	
				7 Social security tips \$		8 Allocated tips \$	
				9 Advance EIC payment \$		10 Dependent care benefits \$	
d Employee's social security number				11 Nonqualified plans \$		12a See instructions for box 12 \$	
e Employee's first name and initial		Last name		13 Statutory employee \$		12b \$	
f Employee's address and ZIP code				Retirement plan \$		12c \$	
				14 Other \$		12d \$	
15 State Employer's state ID number		16 State wages, tips, etc. \$		17 State income tax \$		18 Local wages, tips, etc. \$	
		19 Local income tax \$		20 Locality name			

Form **W-2** **Wage and Tax Statement**  
 Copy A For Social Security Administration—Send this entire page with Form W-3 to the Social Security Administration; photocopies are not acceptable.

2001

Department of the Treasury—Internal Revenue Service  
 For Privacy Act and Paperwork Reduction Act Notice, see separate instructions.

Cat. No. 10134D

**Exhibit  
D  
Form  
W-3**

DO NOT STAPLE OR FOLD

<b>a</b> Control number		33333		For Official Use Only OMB No. 1545-0008	
<b>b</b> Kind of Payer	<input type="checkbox"/> 941	<input type="checkbox"/> Military	<input type="checkbox"/> 943	<b>1</b> Wages, tips, other compensation	<b>2</b> Federal income tax withheld
	<input type="checkbox"/> CT-1	<input type="checkbox"/> Hshld. emp.	<input type="checkbox"/> Medicare govt. emp.	<input type="checkbox"/> Third-party sick pay	<input type="checkbox"/>
<b>c</b> Total number of Forms W-2		<b>d</b> Establishment number		<b>3</b> Social security wages	<b>4</b> Social security tax withheld
<b>e</b> Employer identification number		<b>5</b> Medicare wages and tips		<b>6</b> Medicare tax withheld	<b>7</b> Social security tips
<b>f</b> Employer's name		<b>8</b> Allocated tips		<b>9</b> Advance EIC payments	<b>10</b> Dependent care benefits
<b>g</b> Employer's address and ZIP code		<b>11</b> Nonqualified plans		<b>12</b> Deferred compensation	<b>13</b> For third-party sick pay use only
<b>h</b> Other EIN used this year		<b>14</b> Income tax withheld by payer of third-party sick pay		<b>15</b> State	<b>16</b> State wages, tips, etc.
<b>15</b> State		Employer's state ID number		<b>17</b> State income tax	<b>18</b> Local wages, tips, etc.
<b>16</b> State wages, tips, etc.		<b>17</b> State income tax		<b>18</b> Local wages, tips, etc.	<b>19</b> Local income tax
<b>17</b> State income tax		<b>18</b> Local wages, tips, etc.		<b>19</b> Local income tax	
<b>18</b> Local wages, tips, etc.		<b>19</b> Local income tax		For Official Use Only	
<b>19</b> Local income tax		Contact person		Telephone number	
Contact person		E-mail address		Fax number	

Under penalties of perjury, I declare that I have examined this return and accompanying documents, and, to the best of my knowledge and belief, they are true, correct, and complete.

Signature \_\_\_\_\_ Title \_\_\_\_\_ Date \_\_\_\_\_

Form **W-3 Transmittal of Wage and Tax Statements** **2001** Department of the Treasury Internal Revenue Service

Send this entire page with the entire Copy A page of Form(s) W-2 to the Social Security Administration. Photocopies are not acceptable.

Do not send any payment (cash, checks, money orders, etc.) with Forms W-2 and W-3.

**An Item To Note**

Separate instructions. See the separate 2001 Instructions for Forms W-2 and W-3 for information on completing this form.

**Purpose of Form**

Use this form to transmit Copy A of Form(s) W-2, Wage and Tax Statement. Make a copy of Form W-3, and keep it with Copy D (For Employer) of Form(s) W-2 for your records. Use Form W-3 for the correct year. **File Form W-3 even if only one Form W-2 is being filed.** If you are filing Form(s) W-2 on magnetic media or electronically, **do not** file Form W-3.

**When To File**

File Form W-3 with Copy A of Form(s) W-2 by February 28, 2002.

**Where To File**

Send this entire page with the entire Copy A page of Form(s) W-2 to:

**Social Security Administration  
Data Operations Center  
Wilkes-Barre, PA 18769-0001**


**Note:** If you use "Certified Mail" to file, change the ZIP code to "18769-0002." If you use an IRS approved private delivery service, add "ATTN: W-2 Process, 1150 E. Mountain Dr." to the address and change the ZIP code to "18702-7997." See **Circular E, Employer's Tax Guide (Pub. 15)**, for a list of IRS approved private delivery services.

For Privacy Act and Paperwork Reduction Act Notice, see the 2001 Instructions for Forms W-2 and W-3.

Cat. No. 10159Y



# Exhibit E Form W-2 (Copy B)

a Control number		OMB No. 1545-0008		Safe, accurate, FAST! Use 		Visit the IRS Web Site at <a href="http://www.irs.gov">www.irs.gov</a> .		
b Employer identification number			1 Wages, tips, other compensation		2 Federal income tax withheld			
c Employer's name, address, and ZIP code			3 Social security wages		4 Social security tax withheld			
			5 Medicare wages and tips		6 Medicare tax withheld			
			7 Social security tips		8 Allocated tips			
d Employee's social security number			9 Advance EIC payment		10 Dependent care benefits			
e Employee's first name and initial Last name			11 Nonqualified plans			12a See instructions for box 12		
			13 Statutory employee Retirement plan Third-party sick pay <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/>		12b			
			14 Other			12c		
						12d		
f Employee's address and ZIP code								
15 State	Employer's state ID number	16 State wages, tips, etc.	17 State income tax	18 Local wages, tips, etc.	19 Local income tax	20 Locality name		

Form **W-2** Wage and Tax Statement

2001

Department of the Treasury—Internal Revenue Service

Copy B To Be Filed with Employee's FEDERAL Tax Return.  
This information is being furnished to the Internal Revenue Service.

**Exhibit  
F  
Form  
W-2  
Alternative  
Employee  
Copies**

		<b>1</b> Wages, tips, other compensation	<b>2</b> Federal income tax withheld
		<b>3</b> Social security wages	<b>4</b> Social security tax withheld
		<b>5</b> Medicare wages and tips	<b>6</b> Medicare tax withheld
<b>15</b> State	Employer's state I.D. no.	<b>16</b> State wages, tips, etc.	<b>17</b> State income tax
		<b>18</b> Local wages, tips, etc.	<b>19</b> Local income tax
			<b>20</b> Locality name

▲  
**Horizontal Format**

<b>1</b> Wages, tips, other compensation	<b>2</b> Federal income tax withheld
<b>3</b> Social security wages	<b>4</b> Social security tax withheld
<b>5</b> Medicare wages and tips	<b>6</b> Medicare tax withheld
<b>15</b> State	Employer's state I.D. no.
<b>17</b> State income tax	<b>18</b> Local wages, tips, etc.
<b>19</b> Local income tax	<b>20</b> Locality name

▲  
**Vertical Format**

**Note:** Exhibit F provides examples of employee copies of Form W-2 only. Copy A, which is sent to SSA, MUST conform to the dimensions in Exhibit A.

The core data boxes are 1 through 6 and, if applicable, 15 through 20. The core data must be similarly positioned, exactly numbered, and exactly titled as shown for each format. Other data may be placed in unoccupied areas based upon the employer's needs. Form identification may be placed before or after the core data. However, the employer's non-core elements may be positioned only between the sections of core data.

**Exhibit  
G  
Form  
W-2**

a Control number 22222		Void	For Official Use Only ▶ OMB No. 1545-0008				
b Employer identification number		1 Wages, tips, other compensation		2 Federal income tax withheld			
c Employer's name, address, and ZIP code		3 Social security wages		4 Social security tax withheld			
		5 Medicare wages and tips		6 Medicare tax withheld			
		7 Social security tips		8 Allocated tips			
d Employee's social security number		9 Advance EIC payment		10 Dependent care benefits			
e Employee's first name and initial	Last name	11 Nonqualified plans		12a See instructions for box 12			
f Employee's address and ZIP code		13 Statutory employee	Retirement plan	Third-party sick pay	12b		
		14 Other	12c	12d			
		15 State Employer's state ID number	16 State wages, tips, etc.	17 State income tax	18 Local wages, tips, etc.	19 Local income tax	20 Locality name

**Wage and Tax Statement** 2001  
 Form W-2  
 Copy A For Social Security Administration—Send this entire page with Form W-3 to the Social Security Administration; photocopies are not acceptable.  
 Department of the Treasury—Internal Revenue Service  
 For Privacy Act and Paperwork Reduction Act Notice, see separate instructions.  
 Cat. No. 10134D 11"

**Do Not Cut, Fold, or Staple Forms on This Page**

a Control number 22222		Void	For Official Use Only ▶ OMB No. 1545-0008				
b Employer identification number		1 Wages, tips, other compensation		2 Federal income tax withheld			
c Employer's name, address, and ZIP code		3 Social security wages		4 Social security tax withheld			
		5 Medicare wages and tips		6 Medicare tax withheld			
		7 Social security tips		8 Allocated tips			
d Employee's social security number		9 Advance EIC payment		10 Dependent care benefits			
e Employee's first name and initial	Last name	11 Nonqualified plans		12a See instructions for box 12			
f Employee's address and ZIP code		13 Statutory employee	Retirement plan	Third-party sick pay	12b		
		14 Other	12c	12d			
		15 State Employer's state ID number	16 State wages, tips, etc.	17 State income tax	18 Local wages, tips, etc.	19 Local income tax	20 Locality name

**Wage and Tax Statement** 2001  
 Form W-2  
 Copy A For Social Security Administration—Send this entire page with Form W-3 to the Social Security Administration; photocopies are not acceptable.  
 Department of the Treasury—Internal Revenue Service  
 For Privacy Act and Paperwork Reduction Act Notice, see separate instructions.  
 Cat. No. 10134D .5"

**Exhibit  
H  
Form  
W-3**

a Control number ← 1.6" → 33333 ← .9" →		For Official Use Only ▶ ← OMB No. 1545-0008 → 5.0" →	
b Kind of Payer 941 Military 943 CT-1 Hshld. emp. Medicare govt. emp. Third-party sick pay ← 3.2" →		1 Wages, tips, other compensation	2 Federal income tax withheld
c Total number of Forms W-2 ← 1.6" →		d Establishment number ← 1.6" →	3 Social security wages
e Employer identification number ← 3.2" →		4 Social security tax withheld	5 Medicare wages and tips
f Employer's name ← 7.5" →		6 Medicare tax withheld	7 Social security tips
		8 Allocated tips ← 2.15" →	9 Advance EIC payments
		10 Dependent care benefits	11 Nonqualified plans
		12 Deferred compensation	13 For third-party sick pay use only
g Employer's address and ZIP code		14 Income tax withheld by payer of third-party sick pay	
h Other EIN used this year			
15 State	Employer's state ID number	16 State wages, tips, etc.	17 State income tax
		18 Local wages, tips, etc.	19 Local income tax
Contact person	Telephone number ( )	For Official Use Only	
E-mail address	Fax number ( )		

Under penalties of perjury, I declare that I have examined this return and accompanying documents, and, to the best of my knowledge and belief, they are true, correct, and complete.

Signature ▶ Title ▶ Date ▶

Form **W-3 Transmittal of Wage and Tax Statements** 2001 Department of the Treasury Internal Revenue Service

Send this entire page with the entire Copy A page of Form(s) W-2 to the Social Security Administration. Photocopies are not acceptable. DO NOT STAPLE OR FOLD

Do not send any payment (cash, checks, money orders, etc.) with Forms W-2 and W-3.

**An Item To Note**

Separate instructions. See the separate 2001 Instructions for Forms W-2 and W-3 for information on completing this form.

**Purpose of Form**

Use this form to transmit Copy A of Form(s) W-2, Wage and Tax Statement. Make a copy of Form W-3, and keep it with Copy D (For Employer) of Form(s) W-2 for your records. Use Form W-3 for the correct year. **File Form W-3 even if only one Form W-2 is being filed.** If you are filing Form(s) W-2 on magnetic media or electronically, do not file Form W-3.

**When To File**

File Form W-3 with Copy A of Form(s) W-2 by February 28, 2002.

**Where To File**

Send this entire page with the entire Copy A page of Form(s) W-2 to:

**Social Security Administration  
Data Operations Center  
Wilkes-Barre, PA 18769-0001**

**Note:** If you use "Certified Mail" to file, change the ZIP code to "18769-0002." If you use an IRS approved private delivery service, add "ATTN: W-2 Process, 1150 E. Mountain Dr." to the address and change the ZIP code to "18702-7997." See

**Circular E, Employer's Tax Guide (Pub. 15), for a list of IRS approved private delivery services.**

For Privacy Act and Paperwork Reduction Act Notice, see the 2001 Instructions for Forms W-2 and W-3.

Cat. No. 10159Y

↓ .5"

## Social Security's Employer Service Liaison Officers (formerly Regional Magnetic Media Coordinators)

Social Security's employer service liaison officers and staff can help you understand wage reporting requirements, procedures, and reporting methods. Contact the liaison officer in your geographic area at the phone number listed below.

<u>Calls from:</u>	<u>Telephone:</u>		<u>Calls from:</u>	<u>Telephone:</u>	
Alabama . . . . .	(334) 233-7013	(Montgomery)*	Nevada . . . . .	(510) 970-8247	(San Francisco)
Alaska . . . . .	(206) 615-2125	(Seattle)	New Hampshire . . . . .	(617) 565-2895	(Boston)
American Samoa . . . . .	(510) 970-8247	(San Francisco)	New Jersey . . . . .	(212) 264-5643	(New York)
Arizona . . . . .	(510) 970-8247	(San Francisco)	New Mexico . . . . .	(505) 346-6651	(Albuquerque)**
Arkansas . . . . .	(501) 324-5466	(Little Rock)**	New York . . . . .	(212) 264-5643	(New York)
California . . . . .	(510) 970-8247	(San Francisco)	North Carolina . . . . .	(919) 790-2877 x3007	(Raleigh)*
Colorado . . . . .	(303) 844-2364	(Denver)	North Dakota . . . . .	(800) 314-1964	(Denver)**
Connecticut . . . . .	(617) 565-2895	(Boston)	Ohio . . . . .	(312) 575-4244	(Chicago)
Delaware . . . . .	(215) 597-4632	(Philadelphia)	Oklahoma . . . . .	(405) 273-1041	(Bartlesville)
Dist. of Columbia . . . . .	(215) 597-4632	(Philadelphia)	Oregon . . . . .	(206) 615-2125	(Seattle)
N. Florida . . . . .	(850) 942-8975	(Tallahassee)*	Pennsylvania . . . . .	(215) 597-4632	(Philadelphia)
S. Florida . . . . .	(305) 672-4517	(Miami Beach)*	Puerto Rico . . . . .	(787) 766-5574	(San Juan)
Georgia . . . . .	(706) 827-7327 x201	(Waycross)*	Rhode Island . . . . .	(617) 565-2895	(Boston)
Guam . . . . .	(510) 970-8247	(San Francisco)	South Carolina . . . . .	(864) 582-1091 x260	(Spartanburg)*
Hawaii . . . . .	(510) 970-8247	(San Francisco)	South Dakota . . . . .	(800) 314-1964	(Denver)**
Idaho . . . . .	(206) 615-2125	(Seattle)	Tennessee . . . . .	(615) 907-9501	(Murfreesboro)*
Illinois . . . . .	(312) 575-4244	(Chicago)	Texas—Central/South . . . . .	(512) 346-6651	(Austin)
Indiana . . . . .	(312) 575-4244	(Chicago)	Texas—Dallas—North . . . . .	(817) 978-3123	(Fort Worth)**
Iowa . . . . .	(816) 936-5649	(Kansas City)	Texas—East . . . . .	(713) 718-3015	(Houston)**
Kansas . . . . .	(816) 936-5649	(Kansas City)	Texas—West . . . . .	(505) 346-6651	(Albuquerque)**
Kentucky . . . . .	(502) 875-8315	(Frankfort)*	Utah . . . . .	(800) 314-1964	(Denver)**
Louisiana . . . . .	(504) 389-0426	(Baton Rouge)**	Vermont . . . . .	(617) 565-2895	(Boston)
Maine . . . . .	(617) 565-2895	(Boston)	Virgin Islands . . . . .	(787) 766-5574	(San Juan)
Maryland . . . . .	(215) 597-4632	(Philadelphia)	Virginia . . . . .	(215) 597-4632	(Philadelphia)
Massachusetts . . . . .	(617) 565-2895	(Boston)	Washington . . . . .	(206) 615-2125	(Seattle)
Michigan . . . . .	(312) 575-4244	(Chicago)	West Virginia . . . . .	(215) 597-4632	(Philadelphia)
Minnesota . . . . .	(312) 575-4244	(Chicago)	Wisconsin . . . . .	(312) 575-4244	(Chicago)
Mississippi . . . . .	(601) 693-4859	(Meridian)*	Wyoming . . . . .	(800) 314-1964	(Denver)**
Missouri . . . . .	(816) 936-5649	(Kansas City)			
Montana . . . . .	(800) 314-1964	(Denver)**			
Nebraska . . . . .	(816) 936-5649	(Kansas City)			

\* Or, (404) 562-1315 (Atlanta)

\*\* Or, (303) 844-2364 (Denver)

## Part IV. Items of General Interest

### Qualified Transportation Fringes; Correction

#### Announcement 2001–31

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Correction to final regulations.

SUMMARY: This document contains a correction to final regulations that were published in the **Federal Register** on Thursday, January 11, 2001 (66 FR 2241) that ensure that transportation benefits provided to employees are excludable from gross income.

DATES: This correction is effective January 11, 2001.

FOR FURTHER INFORMATION CONTACT: John Richards at (202) 622-6040 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

#### Background

The final regulations that are the subject of this correction are under section

132(f) of the Internal Revenue Code.

#### Need for Correction

As published, the final regulations (T.D. 8933, 2001–11 I.R.B. 794), do not address what taxable year is used for purposes of the applicability dates in the regulations. These final regulations are being corrected to clarify that the applicability dates in the regulations are based on the employee taxable year and that, for this purpose, an employer may assume that the employee taxable year is the calendar year.

#### Correction of Publication

Accordingly, the publication of the final regulations (T.D. 8933), which were the subject of FR Doc. 01–294, is corrected as follows:

1. On page 2251, column 3, §1.132–9(b), paragraph (a) of A–25, last two lines of the paragraph, the language “section is applicable for taxable years beginning after December 31, 2001.” is corrected to read “section is applicable for employee taxable years beginning after

December 31, 2001. For this purpose, an employer may assume that the employee taxable year is the calendar year”.

2. On page 2251, column 3, §1.132–9(b), paragraph (b) of A–25, last three lines of the paragraph, the language “transit passes are readily available) is effective for taxable years beginning after December 31, 2003.” is corrected to read “transit passes are readily available) is applicable for employee taxable years beginning after December 31, 2003. For this purpose, an employer may assume that the employee taxable year is the calendar year.”

LaNita Van Dyke,  
Acting Chief, Regulations Unit,  
*Office of Special Counsel*  
(*Modernization & Strategic Planning*).

(Filed by the Office of the Federal Register on April 5, 2001, 8:45 a.m., and published in the issue of the Federal Register for April 6, 2001, 66 F.R. 18190)

### Announcement and Report Concerning Advance Pricing Agreements

#### Announcement 2001–32

March 30, 2001

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, 2000–16 I.R.B. 922, covered calendar years 1991 through 1999. This second report describes the experience of the APA Program during calendar year 2000 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 the 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 adversarial 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 2000, the IRS and taxpayers executed 63 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. 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. 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 set forth 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.

### **The APA Program**

APAs are negotiated with the taxpayer by an IRS team headed by an APA team leader. As of December 31, 2000, the APA program had 16 team leaders, of whom 14 were attorneys and 2 were former international examiners. 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 Large and Mid-Size Business (LMSB) field counsel, other LMSB exam personnel, and an appeals officer.

### **The APA Process**

The APA process is voluntary. Taxpayers submit an application for an APA, together with a user fee as set forth in Rev. Proc. 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. The APA Program’s jurisdiction over a particular year is established by the filing of the appropriate user fee on or before the due date of the tax return for that year. 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 consisting of about 30 to 50 pages. 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 taxpayer’s application. Two recent applications from two taxpayers in the same industry illustrate this point. Each taxpayer has proposed differing algorithms, within the same transfer pricing method, for valuing a service associated with the development of a product. The APA Program believes that both algorithms, if applied correctly, should converge and provide an accurate measure of the value of the service. As a consequence, the APA Program will work with both algorithms proposed by the two taxpayers, and will not insist that taxpayers adopt one algorithm over another.

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 Division 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.<sup>1</sup>

### *(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 Associate Chief Counsel (International) or his designee 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 often will 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

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<sup>1</sup> The average time for completing a negotiating position in year 2000 was 16.1 months for a new APA. Although statistics regarding negotiating positions were not published for year 1999, 16.1 months, represents an improvement and progress towards this goal compared to past years. A similar improvement was seen with unilateral APAs, with an average processing time of 14.1 months for year 2000, as compared to 18.9 months for year 1999.

disagreement, are noted in a cover memorandum prepared by the APA team leader that accompanies the final APA sent forward for execution by the Associate Chief Counsel (International) or his designee.

*(5) Drafting 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. As noted above, APAs are executed by the Associate Chief Counsel (International) or his designee for the IRS. The APA is executed for the taxpayer by an appropriate corporate officer.

**The Current APA Office Structure, Composition, and Operation**

For the past three years, the APA Office has been structured into two branches, each staffed with a mix of APA team leaders, economists, and support staff and headed by a branch chief. The two branch chiefs report to the Director, APA. As of December 31, 2000, the APA staff was as follows:

<i>Director's Office</i> 1 Director 1 Secretary to the Director	
<i>Branch 1</i> 1 Branch Chief (vacant) 1 Secretary 11 Team Leaders 1 Economist	<i>Branch 2</i> 1 Branch Chief 1 Secretary 5 Team Leaders 2 Economists 1 Paralegal

The APA staffing grew modestly in 2000, rising from 23 persons at the end of 1999 to 25 as of December 31, 2000. The APA Office, however, had significant turnover in the past year. Of the 25 members of the APA staff, 9 were new to the program in 2000, replacing 7 people who left for other positions. The number of team leaders grew from 14 to 16, while the number of economists dropped from 4 to 3. Average caseloads per team leader remained essentially unchanged from year-end to year-end at 13 APAs per team leader. The affect of the two additional team leaders was mitigated by significantly higher total inventory. As set forth in Table 1 below, new APA filings rose 32% to 91 as compared to 69 in the prior year.

In August 2000, the General Accounting Office published *Tax Administration: IRS' Advance Pricing Agreement Program*, GGD-00-168. The report found that the APA program was not meeting consistently its goal of processing unilateral APA cases within 12 months and completing recommended U.S. negotiating positions within 9 months. In his response to the GAO, which was also published in the August report, the Commissioner of Internal Revenue stated:

The main reason APA cases take longer than the ideal to process is resource constraints. In this way, the APA Program has been a victim of its own success. As the Program's reputation for reaching principled, even-handed, practical solutions to some of the most difficult cases facing the IRS and taxpayers has grown, demand for APAs has also grown. Even though we are processing APAs at a record pace, this demand has outstripped the Program's resources.

Recognizing these resource constraints, the Chief Counsel in June 2000 approved an initiative to expand the APA program from two to four branches. These additional positions have been announced and applications are now being processed.

Approximately 25% of the APA caseload comes from taxpayers located west of the Mississippi. The majority of these cases (ranging between 50% and 75% depending on the year) are from California. Servicing these Western cases involves significant travel by both APA staff and taxpayers. The processing of Western cases from Washington, D.C. also is more difficult due to time zone differences. To better service these Western cases, the APA Program plans to establish a new Branch Four located in California. The California APA cases are divided almost evenly between northern and southern California. As a consequence, the APA Program plans to establish a split branch with two offices. One office would be located in Los Angeles and one would be located in the San Francisco Bay area. The San Francisco office will open first, with the Los Angeles office to follow as resources are available. Establishing a Western branch is expected to have a number of benefits to the APA Program and taxpayers including more rapid case processing, reduction in travel cost, and closer relations with Western taxpayers and taxpayer organizations.

The planned APA Program structure, as memorialized in Chief Counsel Notice N(30)000-346, Nov. 19, 2000, (Organization and Function of the Office of Associate Chief Counsel (International)) is as follows:

Director				
Branch 1	Branch 2	Branch 3	Branch 4	
Washington, DC Office			San Francisco Office	Los Angeles Office

The August GAO report also noted that the APA Program was not systematically tracking the reasons why particular APA cases had required more time to process. In response, the APA Program this past fall adopted a procedure by which APA team leaders periodically record whether each APA case assigned to them is proceeding within the timeliness goals, and if not, identifies the reason for the delay. This information is recorded in the central case processing computer data base of the IRS Chief Counsel and will be available for analysis by management.

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

**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 2000	24	67		91	492
APAs executed					
• Year 2000	31	30	2	63	294
• 1991–1999	112	114 <sup>2</sup>	5	231	
APA renewals executed during year 2000	10	10	1	21	54
Revised or Amended APAs executed during year 2000	2			2	5
Pending requests for APAs	45	166		211	211
Pending requests for renewal APAs	14	45		59	59
APAs revoked or canceled				0	1
APAs withdrawn				3	49

<sup>2</sup> One 1996 APA involving a US Possession is counted as a bilateral APA.

**TABLE 2: MONTHS TO COMPLETE APAs**

Months to Complete Advance Pricing Agreements in Year 2000					
Combined Unilateral, Bilateral, Multilateral: Average					24.0
Combined Unilateral, Bilateral, Multilateral: Median					20.5
Unilateral New		Unilateral Renewal		Unilateral Combined	
Average	16.3	Average	12.8	Average	15.2
Median	11.0	Median	11.5	Median	11.0
Bilateral/Multilateral New		Bilateral/Multilateral Renewal		Bilateral/Multilateral Combined <sup>3</sup>	
Average	34.4	Average	27.4	Average	32.5
Median	34.0	Median	24.0	Median	33.0

<sup>3</sup> Although the time required to complete a negotiating position has substantially improved in the past year, the average time required to conclude a bilateral or multilateral 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 APA	Months	Number of APAs	Months	Number of APAs
1	1	16	1	31	0	46	0
2	3	17	1	32	1	47	2
3	1	18	2	33	2	48	2
4	0	19	0	34	4	49	0
5	4	20	2	35	0	50	0
6	1	21	1	36	0	51	1
7	0	22	2	37	0	52	0
8	1	23	2	38	0	53	0
9	2	24	2	39	0	54	0
10	3	25	2	40	0	55	2
11	3	26	0	41	0	56	0
12	4	27	1	42	2	57	1
13	0	28	0	43	2	58	1
14	0	29	0	44	0	59	0
15	4	30	2	45	1	60	0

**TABLE 4: RECOMMENDED NEGOTIATING POSITIONS**

Recommended Negotiating Positions Completed in Year 2000	36
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**TABLE 5: MONTHS TO COMPLETE RECOMMENDED NEGOTIATING POSITIONS**

Combined		New		Renewal	
Average	14.9	Average	16.1	Average	11.9
Median	15.0	Median	15.0	Median	12.5

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

Months	Number	Months	Number	Months	Number	Months	Number
1	1	11	2	21	1	31	0
2	0	12	2	22	0	32	0
3	0	13	2	23	2	33	0
4	0	14	3	24	0	34	1
5	0	15	2	25	0	35	0
6	2	16	0	26	1	36	1
7	2	17	2	27	0	37	0
8	1	18	3	28	4	38	0
9	2	19	1	29	0	39	0
10	0	20	0	30	0	40	1

**TABLE 7: SMALL BUSINESS TAXPAYER APAs <sup>4</sup>**

<b>Small Business Taxpayer APAs Completed in Year 2000</b>	10
Renewals	2
New	8
Unilateral	10
Bilateral	0

<sup>4</sup> A "small business taxpayer" is a U.S. taxpayer with total gross income of \$200 million or less, and the APA is processed under the special procedures set forth in Notice 98-65.

**TABLE 8: MONTHS TO COMPLETE SMALL BUSINESS TAXPAYER APAs**

<b>Months to Complete Small Business Taxpayer APAs in Year 2000</b>					
<b>New</b>		<b>Renewal</b>		<b>Combined</b>	
Average	8.5	Average	6.5	Average	8.1
Median	7.5	Median	6.5	Median	7.0

**TABLE 9: INDUSTRIES COVERED**

<b>Industry Involved</b>	<b>Number <sup>5</sup></b>
Financial institutions and products	10 - 13
Industrial and commercial machinery	7 - 9
Food, beverages, and related products	7 - 9
Transportation equipment	7 - 9
Consumer electronics, not including computers	4 - 6
Computer hardware, components, and related products, and computer software	4 - 6
Photographic equipment and supplies	1 - 3
Chemicals and related products (industrial, pharmaceutical, cosmetics)	1 - 3
Transportation services	1 - 3
Petroleum refining and related industries	1 - 3
Hotel and related services	1 - 3
Electrical equipment and components (excluding computers and consumer electronics)	1 - 3
Information services	1 - 3
Construction services; construction, ground moving, and mining equipment	1 - 3
Mining	1 - 3
Measuring, analyzing, and controlling instruments	1 - 3
Jewelry, sporting equipment, and toys	1 - 3
Printing, publishing, and related industries	1 - 3
Metal industries and metal products (not machinery)	1 - 3
Engineering, research, consulting, accounting, management, legal, real estate, subscription, and related services	1 - 3
Telecommunications equipment, components, and services	1 - 3

<sup>5</sup> Several APAs listed in this table covered more than one industry.

### 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 2000 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)	39
U.S. Parent — Foreign Subsidiary (-ies)	16
Foreign Company and U.S. Branch	8
U.S. Company and Non-U.S. Branch	0
Partnership	0
U.S. Parent, U.S. Possessions subsidiary	0

### Covered Transactions

[§ 521(b)(2)(D)(ii)]

The controlled transactions covered by APAs executed in Year 2000 are set forth in Table 11 and Table 12 below:

**TABLE 11: TYPES OF COVERED TRANSACTIONS**

Transaction Type	Number
Sale of tangible property into the U.S.	25
Use of intangible property by a U.S. entity	16
Performance of services by a U.S. entity	16
Performance of services by a Non- U.S. entity	12
Use of intangible property by a Non- U.S. entity	10
Sale of tangible property from the U.S.	8
Financial products – U.S. branch of foreign company	7
Financial products – U.S. parent company	4
Financial products – Non- U.S. parent company	3
Research & Development cost sharing – Non-U.S. parent company	3

**TABLE 12: TYPES OF COVERED TRANSACTIONS – SERVICES**

Intercompany Services Involved in the Covered Transactions	Number
Marketing and/or Distribution	12
Headquarters and Administrative Services	10
Management Services	5
Research and Development	5
Technical and Product Support Services	5
Warranty Services	4
Product Assembly	2
Communication Services	1
Purchasing	1
Other Services	2

### 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 2000 are set forth in Tables 13 and 14 below:

**TABLE 13: FUNCTIONS PERFORMED BY THE TESTED PARTY**

<b>Functions Performed</b>	<b>Number</b>
Marketing and distribution functions	38
Manufacturing	23
Product assembly and/or packaging	23
Licensing of intangibles	23
Purchasing and materials management	21
Product testing and quality control	21
Research and development	20
Transportation and warehousing	19
Process engineering	17
Managerial, legal, accounting, finance, personnel, and other support services	17
Product design and engineering	16
Trading and risk management of financial products	15
Technical training and tech support for sales staff	13
Product service (repairs, etc.)	11
Consulting services	7
Other services	4

**TABLE 14: RISKS ASSUMED BY THE TESTED PARTY**

<b>Risks Assumed</b>	<b>Number</b>
Market risks, including fluctuations in costs, demand, pricing, and inventory	40
Financial risks, including interest rates and currency	32
General business risks (e.g., related to ownership of Property, Plant, and Equipment)	24
Credit and collection risks	18
Product liability risks	17
Research & Development risks	16

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 2000 are set forth in Table 15 below:

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

<b>Type of Organization</b>	<b>Number <sup>6</sup></b>
U.S. Distributor	26
U.S. Manufacturer	14
Non-U.S. Manufacturer	9
U.S. Provider of Services	8
U.S. Licensee of Intangible Property	8
Non-U.S. Distributor	7
Non-U.S. Provider of Services	7
U.S. Licensor of Intangible Property	6
Non-U.S. Licensee of Intangible Property	5
Non-U.S. Licensor of Intangible Property	4
Non-U.S. Dealer in Financial Products	3
U.S. Participant in Cost-Sharing Agreement	2
U.S. Dealer in Financial Products	2

<sup>6</sup> For purposes of this report, both sides are counted as tested parties for transactions involving the use of the Comparable Uncontrolled Price, Comparable Uncontrolled Transaction, and profit split methods, as well as for cost sharing agreements. There was no “tested party” counted for purposes of interbranch allocations in financial product cases (see Table 18).

**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 2000 are set forth in Tables 16–20 below:

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

<b>TPM used</b>	<b>Number <sup>7</sup></b>
Comparable Uncontrolled Price (CUP) (tangible property only) – based on published market data	2
Comparable Uncontrolled Transaction (CUT) (intangible property only)	6
Resale Price Method (tangible property only)	3
Cost Plus Method (tangible property only)	2
Comparable Profits Method (CPM): PLI is return on assets or capital employed	4
Comparable Profits Method (CPM): PLI is operating margin	22
Comparable Profits Method (CPM): PLI is gross margin	1
Comparable Profits Method (CPM): PLI is Berry ratio	2
Comparable Profits Method (CPM): PLI is a markup on total costs	1
Comparable Profits Method (CPM) PLI is net margin	1
Residual Profit Split	5
Other Profit Split	3
Royalty	6

<sup>7</sup> 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, (5) markup on total costs is generally a comparative markup on total costs involved, (6) SG&A to sales refers to the ratio of the costs of sales, general, and administrative expenses to sales, and (7) net margin is the ratio of net (before tax) profit over sales.

**TABLE 17: TRANSFER PRICING METHODS USED FOR SERVICES**

TPM used	Number <sup>8</sup>
Cost Plus Method	9
Cost Method	3
Comparable Profits Method: PLI is SG&A to Sales ratio	2
Comparable Profits Method: PLI is return on assets or capital employed	2
Comparable Profits Method: PLI is a markup on total costs	1
Comparable Profits Method: PLI is operating margin	1
Comparable Uncontrolled Transaction Method	1
Other Method	3

<sup>8</sup> Some of the service transactions were covered by the transfer pricing methods used in cost sharing arrangements and tangible/intangible property transactions.

**TABLE 18: TRANSFER PRICING METHODS USED FOR FINANCIAL PRODUCTS**

TPM used	Number <sup>9</sup>
Interbranch allocation (e.g., foreign exchange separate enterprise)	8
Residual profit split	5
Profit split under Notice 94-40	2

<sup>9</sup> Some of the financial product APAs used more than one TPM.

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

TPM used	Number <sup>10</sup>
Costs allocated based on sales	3
Costs allocated based on total costs of R&D, manufacturing, and distribution	1

<sup>10</sup> One of the cost sharing APAs involved two TPMs.

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

TPM used	Number
Capitalized R&D	1
Other	2

### *Discussion*

The transfer pricing methods used in APAs completed during Year 2000 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 2000 that in the cases that come into the APA Program, sufficiently reliable CUP transactions are difficult to find. In APAs executed in Year 2000, there were only two APAs that used the CUP method, and they both looked to published market data in setting the arm's length price. See § 1.482-3(b)(5).

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 2000, 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.

Some cases in the past have utilized a "step royalty" arrangement to determine the proper transfer price for use of a unique intangible. For example, taxpayers have argued that an intangible was very valuable and therefore a high royalty rate was appropriate. Because there were no exact or closely similar comparables, it was difficult to demonstrate objectively whether the taxpayer was correct. A sliding scale, or step royalty, in conjunction with a CPM analysis, has been used to resolve such cases. The premise of such APAs was that, if the intangible truly had great value, the taxpayer would earn higher than normal return from its activities utilizing the intangible. Conversely, as the value of the intangible decreased, the taxpayer's pre-royalty results would be in the routine arm's-length range. Therefore, the royalty rate adopted in these APAs increases as the licensee's profitability increases.

The Cost Plus Method and Resale Price Method were applied in Year 2000 in two and three 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 2000, only one of the Resale Price Method APAs used only that method alone. The four other APAs using these methods all 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 31 APAs 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, in the eight APAs involving the use of a profit split method, the CPM was used in five of them to measure routine returns or other discreet parts of the covered transactions. The CPM similarly was used with two out of the three APAs that used the resale price method, including one of those three that used the resale price method, the cost plus method, and the CPM. The CPM was used with two out of the six APAs that used the CUT method. Finally, in two APAs the royalty payments were tested according to a CPM with an operating margin PLI, and were subject to adjustment based on the taxpayer's results compared to the CPM range.

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 three APAs, an operating margin PLI was used in conjunction with other PLIs (rate of return on assets or capital employed in two and a gross margin in one). In one APA, a Berry ratio<sup>11</sup> was used to measure the distribution function, while a markup on total costs was used for the manufacturing function. There was one APA that used a gross margin PLI, but also employed an operating margin PLI in a critical assumption.

The CPM also was used regularly with services as the covered transactions in APAs executed in Year 2000. There were a total of six service APAs using the CPM method with various PLIs according to the specific facts of the taxpayers involved. Two APAs used a SG&A to sales PLI, and did not combine these methods with any others (services being the only covered transactions). Both of these also allocated various overhead expenses based on a percentage of worldwide sales by geographic region. In addition, and similar to the overlap of PLIs with tangible and intangible property, one APA involving services used separate PLIs for different U.S. subsidiaries of the foreign parent (return on assets or capital employed and operating margin). Table 17 reflects the methods used to determine the arm's length results for APAs involving services transactions.

In Year 2000, there were eight APAs involving tangible or intangible property that used some form of a profit split, primarily 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. Profit splits are generally considered in cases in which the parties to the controlled transaction own valuable, non-routine, intangible property. Of the eight profit split APAs, none of them involved the use of the Compa-

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<sup>11</sup> Named after Professor Charles Berry, who used the Berry ratio when serving as an expert witness in *E.I. DuPont de Nemours & Co. v. United States*, 608 F.2d445 (Ct. Cl. 1979).

able Profit Split under § 1.482–6(c)(2). Five APAs made use of a Residual Profit Split method. One APA used an unspecified method profit split based on the proportion of each country’s total manufacturing, research and development, and distribution costs. See § 1.482–4(d) (unspecified methods for transfers of intangible property). Another APA used a profit split in which only the U.S. taxpayer’s income was split at a ratio of 25% to the U.S. subsidiary and 75% to the foreign parent (the APA also used a CPM with an operating margin PLI, and involved royalty payments by the U.S. taxpayer). Lastly, one APA used a profit split based on a range developed with the use of a CPM with an operating margin PLI. This APA also required the taxpayer to annually update the data set of comparable companies.

Profit splits have also been used in a number of financial product APAs in which the primary income-producing functions are performed in more than one jurisdiction. Two APAs executed in Year 2000 applied a profit split as described in Notice 94–40. Five APAs applied Residual Profit Splits as described in Prop. Reg. § 1.482–8(e)(6).

There were eight 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 ensure that all controlled trades are priced the same as uncontrolled trades.

There were three cost sharing APAs during Year 2000. 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 2000.

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

Critical Assumptions used in APAs executed in Year 2000 are described in Table 21 below:

**TABLE 21: CRITICAL ASSUMPTIONS**

<b>Critical Assumptions involving the following:</b>	<b>Number of APAs</b>
Material changes to the business	59
Material changes to tax and/or financial accounting practices	45
Changes in affiliated companies	18
Use of Mark-to-Market method	13
Assets will remain substantially the same	5
Major technological changes	5
Cost sharing and licensing agreements remain in effect	4
Catastrophic events	4
Currency fluctuations	4
Risks assumed and functions performed remain the same	3
Minimum sales volume	3
Material sales fluctuations	3
Changes in market shares	3
Change in market pricing policies	3
Change in ratio of SG&A to sales	2
Changes in sharing of risks of currency fluctuations	2
Marketing conditions remain substantially the same	2
Major regulatory changes	2
Change in compensation policy that affects the covered entity or transaction	2
Changes in sharing of risks of currency fluctuations	2
Limitation on R&D expenditures	2
Litigation hazards	2
Changes in the interest rate	1
Variation in budgeted versus actual expense	1
Changes involving antidumping/countervailing duties	1
Changes in other duties or tariffs	1
New import/export non-tariff barriers	1
Changes in ratio of R&D to sales	1
Renewal of the APA	1

## 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 possible Competent Authority activity. Rev. Proc. 96-53, § 11.07.

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

### **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 2000 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**

<b>Comparable Sources</b>	<b>Number of Times This Source Used<sup>12</sup></b>
Compustat (database) <sup>13</sup>	29
Disclosure (database) <sup>14</sup>	8
Moody's (database) <sup>15</sup>	4
Global Vantage (database) <sup>16</sup>	3
Worldscope (database) <sup>17</sup>	1
Global Researcher's SEC (database) <sup>18</sup>	1
Public exchange or quotation media	1
Other sources	7

<sup>12</sup> Although still guided by the arm's length standard, some APAs do not use comparables, for example, when there is a residual profit split or in the case of certain financial products.

<sup>13</sup> See <http://www.compustat.com>

<sup>14</sup> See <http://www.primark.com/pfid/content/disclosure.shtml>.

<sup>15</sup> See <http://www.fisonline.com>.

<sup>16</sup> See <http://www.standardpoor.com>.

<sup>17</sup> See <http://www.bvdep.com>.

<sup>18</sup> See <http://www.bvdep.com>.

**TABLE 23: COMPARABLE SELECTION CRITERIA**

<b>Selection Criteria Considered</b>	<b>Number of Times This Criterion Used</b>
Comparable functions	39
Comparable risks	30
Comparable industry	32
Comparable products	27
Comparable intangibles	17
Comparable geographic market	9
Contractual terms	4
Comparable market levels	2

**TABLE 24: ADJUSTMENTS TO COMPARABLES OR TESTED PARTIES**

<b>Adjustment</b>	<b>Number of Times This Adjustment Used</b>
Asset Intensity: receivables	24
Asset Intensity: payables	24
Asset Intensity: inventory	23
Asset Intensity: property, plant, equipment	9
Accounting: LIFO to FIFO inventory	7
Accounting: reclassification of expenses (e.g., from COGS to operating expenses)	2
Accounting: reclassification of non-operating intangibles	1
PLI: operating expense	3
R&D adjustments	2
Foreign exchange	1
Commission expense adjustment to tested party	1

*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 2000.

Although comparables were most often identified from the databases cited in Table 22, in some cases comparables were found from other sources. For example, comparables derived internally from taxpayer transactions with third parties, those provided by the taxpayer's representative using an in-house database, comparables from trade publications in specific industries, 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).

In virtually all cases, 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. Of the APAs executed in Year 2000 in which financial data over a period of years was used, 5 APAs looked at data over 1 year, 28 looked at data over 3 years, 1 looked at data over a period of 5 years, 1 over 6 years, and 2 over 7 years.

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 2000:

**TABLE 25: COMPARABILITY SCREENS**

<b>Comparability Screen Used</b>	<b>Number of Times Used</b>
Sales	18
Ratio of R&D/Sales	12
Non-Startup or Startup Company	7
Ratio of Foreign Sales/Total Sales	6
Ratio of Operating Expenses/Sales	5
Ratio of PP&E/Sales	2
<b>Financial Distress Screens</b>	
Bankruptcy	7
Unfavorable Auditor’s Opinion	4
Losses in One or More Years	7

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 2000 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 2000 are described in Table 26 and 27 below.

**TABLE 26: TYPES OF RANGES**

Type of Range	Number <sup>19</sup>
Interquartile range	14
Floor (i.e., result must be no less than x)	14
Financial products – statistical confidence interval to test for internal CUP	8
Specific result (“point”)	7
Agreed range	4
Ceiling (i.e., result must be no more than x)	2

<sup>19</sup> This table does not include royalties, cost sharing agreements, and cost plus TPMs. In Year 2000, TPMs involving these methodologies did not use ranges.

**TABLE 27: ADJUSTMENTS WHEN OUTSIDE OF THE RANGE**

Adjustment mechanism	Number
Taxpayer makes an adjustment to the closest edge of the range	24
Taxpayer makes an adjustment to a specific point	17
Competent Authority process invoked if results are outside the range	4
Taxpayer makes an adjustment to the median of the range	3
APA canceled or revoked if results are outside the range, subject to renegotiation, cancellation, or revocation	2
APA canceled or revoked if results beyond certain limits, otherwise taxpayer makes an adjustment to the closest edge	1
Taxpayer adjusts to specific point each year (annual comparables adjustment)	1

*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 were no APAs executed in Year 2000 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 14 times in Year 2000.

A variant on the interquartile range involves a "Tukey filter," which is described as follows. First, the set of comparables is used to derive a standard interquartile range. Then the difference D between the top and bottom of the interquartile range is computed. Next, all comparables whose results are more than a certain multiple of D (often the multiple 1.5 is used) outside the interquartile range are discarded as "outliers." Finally, the reduced set of comparables (without the outliers) is used to compute a second interquartile range, which is then used as the arm's length range. The Tukey filter's primary purpose has been to eliminate companies that were so anomalous that they arguably should not have been included as comparables in the first place. In the past, this approach has only occasionally been used for APAs, and it was not used for any of the APAs executed in Year 2000.

In 7 APAs executed in Year 2000, the APA specified a single, specific result, or "point." Five of these involved profit splits in which the taxpayer's results for a given APA year under the TPM depended on the amount of system profit. Another of these specific result APAs involved a bilateral APA with a term encompassing entirely filed years. In the absence of any prospectivity, the Competent Authorities agreed on a particular result for each year. Finally, one APA 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. Fourteen APAs executed in Year 2000 used a floor and 2 used a ceiling. Finally, 4 APAs used an agreed range other than interquartile range.

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 2000, there were 8 APAs executed that employed the statistical confidence interval.

### *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 APAs specify that if a taxpayer's results fall outside the applicable point or range, the APA will be canceled or revoked. Some bilateral APAs specify that in such a case there will be a negotiation between the Competent Authorities involved to determine whether and to what extent an adjustment should be made. Some APAs permit automatic adjustments unless the result is far outside the range specified in the APA. Thus they provide flexibility and efficiency (permitting adjustments when normal business fluctuations and uncertainties push the result somewhat outside the range).

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 2000 are set forth in Table 28 below:

**TABLE 28: TERMS OF APAs**

<b>APA Term in Years</b>	<b>Number of APAs</b>
1	2
2	3
3	7
4	6
5	37
6	4
7	0
8	1
9	0
10 or more	3

Number of rollback years to which an APA TPM was applied in Year 2000 are set forth in Table 29 below:

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

<b>Number of Rollback Years</b>	<b>Number of APAs</b>
1	2
2	6
3	3
4	1
5	2
6	1
7	2
8	0
9	1
10 or more	1

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

APAs executed in Year 2000 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**

<b>Documentation</b>	<b>Number of Times This<sup>20</sup> Documentation Required</b>
Financial analysis demonstrating compliance with the TPM	60
Statement identifying all material differences between the taxpayer's business operations during the APA year and the description of the business operations contained in the request for the APA, and if there have been no such material differences, a statement to that effect	61
Statement identifying all material changes in the taxpayer's accounting methods and classifications, and methods of estimations, from those described or used in the request for the APA, or if there have been none, a statement to that effect	62
Description of any failure to meet critical assumptions, or if there have been none, a statement to that effect	62
Financial statements as prepared in accordance with GAAP	59
Certified Public Accountant's opinion that the financial statements present fairly the financial position of the taxpayer and the results of its operations, in accordance with GAAP	59
Description of, reason for, and financial analysis of any compensating adjustments with respect to any APA year, including the means by which any compensating adjustment has been or will be satisfied	58
Profit and Loss statement	29
Various workpapers	27
United States income tax return	19
Schedule of costs and expenses (e.g., intercompany allocations)	17
Certified Public Accountant's review of financial statements	11
Narrative description of the taxpayer's business	8
Book to tax reconciliation	7
Cash flow statement	6
Description of any matters economically or substantively related to the covered transactions, but that are not subject to the APA	5
Form 5471 or 5472	4
Organizational chart	4
Pertinent intercompany agreements	5
Royalty computations	2
R&D costs as a percentage of WW sales	2
Various other documents or statements <sup>21</sup>	33

<sup>20</sup> The first seven categories of documentation listed in this table are drawn from the standard APA language found in Attachment A. Certain APAs did not include this standard language, typically when all of the years covered by the APA were already past and the taxpayer's results were known. In addition, under 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, a number of the standard documentation requirements may not be appropriate.

<sup>21</sup> This category includes particular documents that were highly fact specific to the particular taxpayer involved.

## Approaches for Sharing of Currency or Other Risks

[§ 521(b)(2)(D)(xii)]

During Year 2000, there were three APAs that specifically addressed the sharing of currency risks. In one, there was an adjustment to the tested party's cost of goods sold if the exchange rate changed by more than a certain amount, in which case the adjustment was a percentage of the change in the exchange rate. In a second APA, there was an adjustment for currency fluctuations through a change in the operating margin range. Finally, in a third all currency risk was specifically allocated to the foreign parent.

Other explicit risk sharing in APAs completed in Year 2000 included one APA in which it was provided that if the U.S. licensor's worldwide ratio of research and development expenses to sales changed, the royalty paid by the foreign subsidiary to the U.S. parent changed too. In another, all risks were specifically allocated to the foreign parent, and in a third, the market and inventory risk on all tangibles purchased from the foreign parent were assumed by the U.S. subsidiary.

In addition, there were three APAs that specifically addressed the risks of a business start-up. The first provided that the risk of start-up losses was allocated to the foreign parent. The second allowed for the start-up businesses to have a three year phase-in, and the third APA allowed for losses during the startup phase.

## Efforts to Ensure Compliance with APAs

[§ 521(b)(2)(F)]

As described in Rev. Proc. 96-53, § 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.

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 2000; previously reports were held until reviewed by an APA team leader. This change has facilitated simultaneous review of the reports and sped up processing time.

The statistics for the review of APA annual reports are reflected in Table 31 below. As of December 31, 2000, there were 374 pending annual reports. In Year 2000, there were 118 reports closed. This is up considerably from the 211 reports closed in the 1994-1999 period. As noted below, annual report review in 2000 resulted in agreed adjustments involving 8 taxpayers for 38 APAs.

**TABLE 31: STATISTICS OF ANNUAL REPORTS**

Number of APA annual reports pending as of December 31, 2000	374
Number of APA annual reports closed in Year 2000	118
Number of APA annual reports requiring adjustment in Year 2000	38
Number of taxpayers involved in adjustments	8
Number of APA annual reports required to be filed in Year 2000	273
Number of APA annual reports actually filed in Year 2000	239 <sup>22</sup>
Number of APA annual report cases over one and less than two years old	197
Number of APA annual report cases two or more years old	89

<sup>22</sup> Of the 34 reports that were due in Year 2000, but not filed by Dec. 31, 2000, there were 28 filed late after January 1, 2001.

## ATTACHMENT A

### MODEL ADVANCE PRICING AGREEMENT

between  
TAXPAYER  
and

THE INTERNAL REVENUE SERVICE

THIS ADVANCE PRICING AGREEMENT ("APA") is made by and between Taxpayer and the Internal Revenue Service ("Service"), acting through the Director, Advance Pricing Agreement Program.

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

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

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

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

3. *Legal Effect.*

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

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

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

- i. enforce the terms of this APA and propose adjustments to the income, expenses, deductions, credits, or allowances reported on Taxpayer's U.S. federal income tax return in keeping with the terms of this APA;
- ii. cancel or revoke this APA pursuant to section 11.05 or 11.06 of Rev. Proc. 96-53; or
- iii. revise this APA, upon agreement on revision with Taxpayer.

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

3.5. The Parties agree that nonfactual oral and written representations, within the meaning of sections 10.04 and 10.05 of Rev. Proc. 96-53 (including any proposals to use particular TPMs), made in conjunction with this request constitute statements made in compromise negotiations within the meaning of Rule 408 of the Federal Rules of Evidence.

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

5. *Financial Statements and APA Records.* The determination whether Taxpayer has complied with this APA will be based on its United States income tax return; its financial statements as prepared in accordance with generally accepted accounting principles ("GAAP") on a consistent basis (the "Financial Statements"); the additional records ("APA Records") specified in Appendix B; and all information specified in section 8 of this APA. Taxpayer will not be in compliance with the TPM unless an independent certified public accountant renders an opinion that the Financial Statements present fairly, in all material respects, the financial position of Taxpayer and the results of its operations, in accordance with GAAP. Taxpayer agrees to maintain the Financial Statements and APA Records and to make them available within thirty days of a request by the Service in connection with an examination described in section 11.03 of Rev. Proc. 96-53. Compliance with this section 5 of the APA will constitute compliance with the record maintenance provisions of sections 6038A and 6038C of the Code, with respect to Covered Transactions during the APA Years.

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

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

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

9. *Disclosure.* This APA, and the information, data, and documents related to this APA and Taxpayer's APA request are: (1) considered return information pursuant to section 6103(b)(2)(C) of the Code; and (2) not subject to public inspection as a written determination pursuant to section 6110(b)(1) of the Code. Pursuant to section 521(b) of the Ticket to Work and Work Incentives Improvement Act of 1999, Pub. L. 106-170, however, the Secretary of the Treasury is obligated to prepare a report for public disclosure that would include certain specifically designated information concerning all APAs, including this APA, in such form as not to reveal taxpayers' identities, trade secrets, and proprietary or confidential business or financial information.

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

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

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

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

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

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

TAXPAYER

By: \_\_\_\_\_  
[Name of Signature]  
[Title]

Date: \_\_\_\_\_

INTERNAL REVENUE SERVICE

By: \_\_\_\_\_  
[Name of Signature]  
Director, Advance Pricing Agreement Program

Date: \_\_\_\_\_

APPENDIX A  
TRANSFER PRICING METHODOLOGY

For each APA Year:

*Covered Transactions.*

The Covered Transactions for this APA consist of \_\_\_\_\_.

*Transfer Pricing Methodology ("TPM").*

APPENDIX B  
APA RECORDS

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

APPENDIX C  
CRITICAL ASSUMPTIONS

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

APPENDIX D  
ANNUAL REPORT

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

1. A statement identifying all material differences between Taxpayer's business operations (including functions performed, risks

assumed and assets employed) during the APA Year and the description of the same contained in Taxpayer's request for this APA, or if there have been no such material differences, a statement to that effect.

2. A statement identifying all material changes in Taxpayer's accounting methods and classifications [and methods of estimation] from those described or used in Taxpayer's request for this APA, or if there have been no such material changes, a statement to that effect.
3. The Financial Statements.
4. A financial analysis demonstrating Taxpayer's compliance with the TPM.
5. A description of any failure to meet Critical Assumptions, or if there have been no such failures, a statement to that effect.
6. A description of the reason for, and financial analysis of, any Compensating Adjustments with respect to the APA Year, including the means by which any such Compensating Adjustment has been or will be satisfied.
7. A copy of the certified public accountant's opinion, described in section 5 of this APA, for the APA Year.
8. [Insert here other items to be included in Annual Report.]

## 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):<sup>23</sup>*

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 <sub>c</sub>	=	sales <sub>c</sub> + RA
adjusted cogs <sub>c</sub>	=	cogs <sub>c</sub> + PA - IA
adjusted opex <sub>c</sub>	=	opex <sub>c</sub> - PPEA

<sup>23</sup>Depending on the specific facts, the equations below may use total costs ("tc") or cost of goods sold ("cogs").

**Request for Comments  
Regarding the Instructions for  
Form 990, Return of  
Organization Exempt From  
Income Tax, Form 990-EZ,  
Short Form Return of  
Organization Exempt From  
Income Tax, and Form 990-PF,  
Return of Private Foundation or  
Section 4947(a)(1) Nonexempt  
Charitable Trust Treated as a  
Private Foundation.**

**Announcement 2001-33**

**INTRODUCTION**

The Internal Revenue Service (IRS) requests comments on the nature and extent of information about certain compensation arrangements that tax-exempt organizations should report on their annual information returns. The IRS seeks comments on whether Forms 990, 990-EZ, and 990-PF should continue to require tax-exempt organizations to report payments for contracted management services as if the organization had directly paid the individuals providing the services.

**BACKGROUND**

Part IV of Form 990-EZ, *Short Form Return of Organization Exempt From Income Tax*, and Part V of Form 990, *Return of Organization Exempt From Income Tax*, require reporting organizations to list the names and addresses for contact of officers, directors, trustees and key employees. Line 1 of Part VIII of Form 990-PF, *Return of Private Foundation or Section 4947(a)(1) Nonexempt Charitable Trust Treated as a Private Foundation*, requires foundations to list the same information for officers, directors, trustees, or foundation managers. Organizations are also required to report the title of each listed individual and the hours the individual spends per week performing the duties of the position.

The forms also require information on compensation packages for individuals listed as officers, directors, trustees or key employees/foundation managers. The forms ask for amounts paid to each individual as compensation, contributions made to employee benefit plans and other deferred compensation, and payments made to expense accounts and for other allowances.

Since 1999, the instructions to the forms have stated, "If you pay any other person, such as a management services company, for the services provided by any of your officers, directors, trustees, or key employees [or foundation managers for private foundations], report the compensation and other items as if you had paid them directly."

The Internal Revenue Service has received a number of comments on these instructions. These comments have either criticized the instructions or expressed concern that the Service might reduce their effectiveness.

Some comments have expressed concern that the reporting requirements are too burdensome on tax-exempt organizations, requiring the organization to obtain detailed information from third-party contractors to accurately complete the form.

Other comments expressed concern that the requirements invade the privacy of individuals who are not employees of the reporting organization. These comments concede, however, that the Service must protect against individuals who incorporate to avoid reporting.

Comments in support of the current reporting requirements expressed concern that allowing tax-exempt organizations to report only the gross amounts they pay for management would deprive the public sources of critical information about the reporting organization.

**PUBLIC COMMENTS**

This Announcement seeks further public comments on these instructions. Comments should address such issues as:

1. Whether contracting with third parties who provide the reporting organization with allocations for completing the form is consistent with current practices?
2. How can the instructions be revised to simplify reporting, yet protect against abuse by an individual officer, director, trustee, key employee, or private foundation manager who incorporates to avoid reporting?

The period for comments will be 90 days from the date this Announcement is published in the Internal Revenue Bulletin.

Comments should be sent to the following address:

Internal Revenue Service  
1111 Constitution Ave., N.W.  
Washington, DC 20224

Attn: David W. Jones,  
1750 Penn. Ave., NW  
T:EO:RA, Room 3T3

Comments may also be sent electronically via the Internet to \*TE/GE-EO-1@irs.gov.

**REASONABLE CAUSE UNDER  
SECTION 6652**

Until the Service notifies organizations otherwise, by an Announcement published in the Bulletin, organizations that **pay** other persons, such as management services companies, for the services of officers, directors, trustees, or key employees/foundation managers, will be deemed to have reasonable cause for purposes of the penalty under Section 6652(a)(1)(a)(ii) of the Internal Revenue Code for the failure to provide the information required by the relevant portions of Parts IV, V or VIII of the forms, if:

1. Where the form asks for the name of officers, directors, trustees, or key employees/foundation managers, the reporting organization enters the name of the person (e.g., management services company) that performs those services under contracts and services that it performs;
2. Where the form asks for the address of officers, directors, trustees or key employees/foundation managers, the reporting organization enters the address where the IRS can contact such person (management services company);
3. Where the form asks for compensation paid to officers, directors, trustees or key employees/foundation managers, the reporting organization enters the amount paid to the person (management services company) for the services listed in response to inquiry 1, above.

**DRAFTING INFORMATION**

The principal author of this announcement is David W. Jones of the Exempt Organizations Technical Division. For further information regarding this announcement contact David W. Jones at (202) 283-8907 (not a toll-free call).



## **Announcement and Report Concerning Pre-Filing Agreements**

### **Announcement 2001–38**

#### **Introduction**

This Announcement is issued pursuant to the Conference Report to H.R. 4577 (Pub. L. 106–554), *The Community Renewal Tax Relief Act of 2000*, which requires that the Secretary of the Treasury make publicly available an annual report relating to the Pre-Filing Agreement (“PFA”) program operations for the preceding calendar year. The Conference Report states that the report is to include: (1) the number of pre-filing agreements completed, (2) the number of applications received, (3) the number of applications withdrawn, (4) the types of issues which are resolved by completed agreements, (5) whether the program is being utilized by taxpayers who were previously subject to audit, (6) the average length of time required to complete an agreement, (7) the number, if any, and subject of technical advice and Chief Counsel advice memoranda issued to address issues arising in connection with any pre-filing agreement, (8) any model agreements, and (9) any other information the Secretary deems appropriate. The PFA pilot program was announced in Notice 2000–12, 2000–9 I.R.B. 727. This is the first report issued and sets forth information on the PFA pilot program, including information on (i) the applications received for the PFA pilot program, and (ii) the closing agreements entered into pursuant to the pilot program.

#### **Background**

The Large and Mid-Size Business Division (“LMSB”) within the Internal Revenue Service serves corporations and partnerships with assets greater than \$5 million. In 2000, approximately 248,000 corporations and partnerships filed returns reporting assets in this range. The returns filed by these taxpayers present a wide variety of complex issues. Taxpayers served by LMSB paid more than \$700 billion in taxes to the federal government during 2000. The largest of the taxpayers deal with the IRS on a continuous basis.

One of LMSB’s strategic initiatives is issue management. Through effective

issue management, LMSB seeks to reduce the time necessary to complete an examination, to conduct examinations on a more current basis, and to ensure consistency of issue resolution for all taxpayers. The Pre-Filing Agreement program was designed to support LMSB’s issue management strategy. LMSB believes the Pre-Filing Agreement program will reduce taxpayer burden and make more effective use of IRS resources by resolving or eliminating tax controversy earlier in the examination process.

#### **Pre-Filing Agreement Program**

The PFA program is designed to permit a taxpayer to resolve, before the filing of a return, the treatment of an issue that otherwise would likely be disputed in a post-filing examination. The PFA program is intended to reach agreement on factual issues and apply settled legal principles to those facts. Execution of a PFA that resolves issues prior to filing will permit taxpayers to avoid a portion of the costs, burdens and delays that are frequently incident to post-filing examination disputes between taxpayers and the IRS.

In calendar year 2000, a pilot program was implemented which resulted in the execution of seven PFAs. A PFA is a specific matter closing agreement under § 7121. These PFAs permanently and conclusively resolve the subject of the PFA for a taxable period. Based upon input from internal and external participants in the pilot program, the IRS has implemented the PFA program on a continuing and expanded basis. Rev. Proc. 2001–22, 2001–9 I.R.B. 745.

#### *PFA Pilot Program (Notice 2000–12)*

Notice 2000–12, 2000–9 I.R.B. 727, dated February 11, 2000, announced the PFA pilot program, which was administered by LMSB. The PFA pilot program was open to Coordinated Examination Program<sup>1</sup> (“CEP”) taxpayers that had a CEP examination team currently on site. The notice provided a description of a PFA, the procedures for requesting a PFA, and the procedures for LMSB to select taxpayers for the PFA pilot program. The IRS believed that this PFA pilot program offered significant benefits for taxpayers, as well as for the

<sup>1</sup> This program has recently been renamed. Such cases are now classified as Coordinated Industry Cases.

IRS, and invited large business taxpayers to participate. Notice 2000–12 requested interested taxpayers to submit applications for the PFA pilot program by March 15, 2000, through the on site LMSB team manager.

#### *PFA Process*

The PFA process was managed and conducted by LMSB Industry Directors and field staff, with support from the Office of Pre-Filing and Technical Guidance in LMSB Headquarters. LMSB team managers reviewed all applications and made their recommendations to their respective Industry Directors. The Office of Chief Counsel reviewed all applications to ensure the issues presented were appropriate for inclusion in the PFA pilot program.

The Industry Director with jurisdiction over the taxpayer made the final decision whether to accept a taxpayer’s request for participation in the PFA pilot program. The criteria for selecting a request included:

- a. The suitability of the issue presented by the taxpayer;
- b. The direct or indirect impact of a PFA upon other years, issues, taxpayers, or related cases;
- c. The selection of a cross-section of issues and industries for the pilot program; and
- d. The probability of completing the examination of the issue and entering into a PFA by the target date.

For the cases selected, a mandatory orientation session for the CEP examination team and the taxpayer was conducted. Subsequently, the taxpayer and CEP examination team held a joint planning meeting to seek agreement on a proposed timeframe, to identify and arrange for IRS access to relevant records and testimony, and to define the potential scope and nature of the PFA.

The CEP examination team conducted the factual and issue development consistent with IRS auditing standards. Based upon an examination of the issue, the Team Manager prepared a PFA recommendation for the Industry Director. The Industry Director’s decision to enter into a PFA was based on the Team Manager’s recommendation and discussions with the PFA Program Manager, Chief Counsel attorneys, and the taxpayer. Following Chief Counsel review to ensure that the proposed PFA conformed with guidance provided in Rev. Proc. 68–16, 1968–1

C.B. 770 (regarding closing agreements), the Industry Director could execute a PFA if he or she determined that:

- a. Entering into the PFA was consistent with the goals of the PFA pilot program as stated in the Notice;
- b. The tax results in the PFA reflected settled legal principles and correctly applied those principles (or positions authorized under Delegation Order Nos. 236 or 247) to facts found by the Examination Team; and
- c. There appeared to be an advantage in having the issue(s) permanently and conclusively closed for the taxable

period covered by the PFA, or that the taxpayer showed good and sufficient reasons for desiring a closing agreement and that the United States would sustain no disadvantage through consummation of such an agreement (see section 301.7121-1(a) of the Regulations on Procedure and Administration).

*Program Oversight*

A designated PFA Program Manager and analyst assigned to the Office of Pre-Filing and Technical Guidance in LMSB Headquarters provided oversight for the

PFA pilot program. The PFA Program Manager provided assistance to taxpayers, Industry Directors and Team Managers throughout the process and personally conducted the orientation session at each taxpayer location.

**Pre-Filing Agreement Pilot Program Accomplishments**

*Applications Received*

Nineteen applications were received for the PFA pilot program. Applications were received from each LMSB industry segment and involved a variety of issues.

Industry Segment	Received
Financial Services & Healthcare	1
Retailers, Food & Pharmaceuticals	4
Natural Resources	3
Communications, Technology & Media	2
Heavy Manufacturing, Construction & Transportation	9
<b>Total</b>	<b>19</b>

Issue	Received
Valuation of Assets	5
Research Credit	7
Expense vs. Capitalization	2
Tax Motivated Transaction	1
Method of Accounting	2
Stock Basis Computation	1
Investigatory Costs	1
<b>Total</b>	<b>19</b>

*Applications Not Accepted*

Seven applications were not considered appropriate for the PFA pilot program.

Reasons for Non-acceptance	Applications
Examination team not on site	1
Absence of Agreement on Controlling Legal Principles	5
Excluded subject (Tax Motivated Transaction)	1
<b>Total</b>	<b>7</b>

*Applications Accepted*

Twelve applications from eleven taxpayers were accepted into the PFA pilot program. The status of these applications on December 31, 2000, was as follows:

Status of PFAs	Applications
Request Withdrawn by Taxpayer	1
PFAs In-process	4
PFAs Executed	7
<b>Total</b>	<b>12</b>

*Taxpayer Withdrawal (1)*

One taxpayer, in accordance with the procedures set forth in Section 7 of Notice 2000-12, withdrew from the PFA pilot

program after its request had been accepted into the PFA pilot program. This withdrawal occurred after the Director, Field Operations, met with the taxpayer and the CEP examination team to deter-

mine whether the objective of the PFA pilot program could be achieved. Several reasons contributed to the taxpayer's withdrawal, including the complexity of the issue, the time required to complete

the analysis and a misunderstanding by the taxpayer of the purpose of the PFA process.

*PFAs In Process (4)*

The taxpayers and the respective Industry Directors, in accordance with the provisions of Notice 2000–12<sup>2</sup>, have agreed

<sup>2</sup> Section 6, Continuation of process after filing, coordination with Accelerated Issue Resolution procedures, and Appeals.

to continue discussions relating to four PFA applications in an effort to reach agreement.

*PFAs Executed (7)*

Seven PFAs were completed in calendar year 2000.

Notice 2000–12, Section 1, *Introduction of Pilot Program* states in part, “In its pilot phase, the program is open to large businesses that currently have a Co-

ordinated Examination Team on site.” Each of the taxpayers accepted into the PFA pilot program met this requirement.

The Office of Chief Counsel provided advice to the CEP examination teams and assisted in the drafting and review of the PFAs. No Technical Advice or Chief Counsel Advice Memoranda were issued for issues addressed in the PFA process. The executed PFAs covered the following issues.

<b>PFAs Executed by Issue</b>	
Valuation of Assets	2
Expense vs. Capitalization	1
Method of Accounting	2
Stock Basis Computation	1
Investigatory Costs	1
<b>Total</b>	<b>7</b>

*Valuation of Assets (2)*

One application concerned the valuation of a “covenant not to compete.” The other application concerned the valuation of patents contributed to a charity. Each of the taxpayers supported its proposed valuation with a study conducted by an independent appraiser. IRS Engineers and Valuation Specialists assisted the CEP examination team in the review of the issues. In the first application, the CEP examination team and the taxpayer agreed that, in a particular purchase transaction, no amount was allocable to a “covenant not to compete.” In the second application, the CEP examination team and the taxpayer reached a determination on the valuation of the patents based on market values.

*Expense vs. Capitalization (1)*

The taxpayer sought to determine the amount to be capitalized in a large repair expense account. The taxpayer proposed a statistical model for purposes of determining the amount subject to capitalization. An IRS Computer Audit Specialist assisted the CEP examination team in a review of the issue. The issue was resolved on the basis of a methodology that had been utilized in earlier examinations. The CEP examination team and the taxpayer agreed on the portion of the account that would be subject to capitalization.

*Method of Accounting (2)*

One application concerned whether a contract newly entered into by the tax-

payer was required to be accounted for as a long-term contract under § 460. The issue was whether to account for the contract using an accrual method and not a long-term contract method. A technical advisor assisted the CEP examination team. The CEP examination team concluded that an accrual method of accounting was the appropriate method. A change in method of accounting pursuant to § 446 was not required because the change in treatment resulted from a change in the underlying facts.

The other application concerned the determination of the appropriate asset classes for depreciable property placed in service in prior years. The taxpayer proposed to change its method of accounting for certain depreciable property that the taxpayer believed had been misclassified. An IRS Engineer and a Computer Audit Specialist assisted the CEP examination team. The CEP examination team agreed with the taxpayer’s revised classifications and with the taxpayer’s proposal automatically to change its method of accounting for depreciation pursuant to Rev. Proc. 99–49, 1999–2 C.B. 725. The CEP examination team and the taxpayer reached an agreement as to the appropriate § 481 adjustment.

*Stock Basis Computation (1)*

This application concerned the tax basis of stock acquired in a transaction that qualified under § 368(a)(1)(B). An IRS Economist and a Computer Audit Specialist assisted the CEP examination

team. The CEP examination team agreed with the taxpayer’s computation of the amount of the stock basis under § 362(b).

*Investigatory Costs (1)*

This application concerned costs incurred to acquire a business. The taxpayer proposed that certain of the costs were investigatory in nature and therefore deductible under §162. Based on the principles contained in Rev. Rul. 99–23, 1999–1 C.B. 998, the CEP examination team and the taxpayer agreed as to which items were §162 costs and which were § 263 costs.

*Closing Agreements*

Seven PFAs were concluded as of December 31, 2000. A *pro forma* or model agreement does not exist for a PFA. A PFA represents a specific matter closing agreement under §7121. The closing agreements entered into under this pilot program were prepared with assistance from the Office of Chief Counsel and conform to the guidance provided in Rev. Proc. 68–16, *supra*.

*Processing Statistics*

The total average time to complete the seven PFAs executed in calendar 2000 was 166.1 days.

Average Time for PFAs	Number Of Cases	Range (Elapsed Days)	Average (Elapsed Days)
Phase I – Application Screening Process	19	19 – 86	37.2
Phase II - PFA Evaluation Process	7	91 – 186	140.6
Total Time to Complete a PFA	7	110 – 228	166.1

#### Phase I – Application Screening Process

Nineteen applications were received for the PFA pilot program. The initial phase was the screening process to determine if an application was appropriate for inclusion in the PFA pilot program. This screening process included obtaining comments from various LMSB functions and Chief Counsel, the review of these comments, and the decision making process on the acceptance/rejection of an application by the Industry Director. The

average time from the date an application was received by the IRS until the Industry Director rendered a decision to accept or reject an application was 37.2 days.

#### Phase II - PFA Evaluation Process

The second (and final) phase in the PFA pilot program process was the evaluation phase. This phase began when the Industry Director accepted an application into the PFA pilot program and ended when a PFA was executed.

#### Program Evaluation

The PFA Program Manager conducted process evaluations of all of the PFA pilot program cases based on feedback from LMSB employees and taxpayer participants. As a part of this program evaluation, participants were asked to provide an estimate of the direct examination time expended to complete the PFA and an estimate of the direct examination time it would have taken to resolve the issue in a post-filing context.

Cumulative Hours (7 Completed PFAs)	Taxpayer (Hours)	LMSB (Hours)
Actual – PFA Process	1,114	1,976
Projected (Issue resolved post-filing)	3,379	7,344
Estimated Savings	2,265	5,368
Estimated Savings Percentage (Average)	67.0%	73.1%
Estimated Savings Percentage (Range)	34.6% - 96.0%	12.9% - 90.4%

#### Pre-Filing Agreement Pilot Program Summary

After evaluating the PFA pilot program and receiving input from internal and external participants, the IRS has concluded that the PFA program does further LMSB's issue management strategy by assisting taxpayers to resolve issues in a cost efficient and cooperative environment. Accordingly, the IRS issued Rev. Proc. 2001-22, *supra*, dated February 26, 2001, which implemented the PFA program on a continuing and expanded basis.

The PFA program is now available to all LMSB taxpayers, including taxpayers that are not currently under examination. While the PFA program will continue to be limited to issues that involve settled legal principles, the list of recommended issues has been expanded, and will now include certain international issues. Generally, the operational procedures used during the PFA pilot program were adopted and enhanced in the current PFA program.

The principal author of this announcement is Robert Kastl, in the Office of LMSB Division Counsel. For further information regarding this announcement

contact Mr. Kastl at (202) 283-8620 (not a toll-free call).

#### New Publication 584-B, Business Casualty, Disaster, and Theft Loss Workbook

#### Announcement 2001-39

New Publication 584-B, *Business Casualty, Disaster, and Theft Loss Workbook*, is available from the Internal Revenue Service.

This publication is a workbook that is designed to help you figure your loss on business and income-producing property in the event of a disaster, casualty, or theft.

You can get a copy of this publication by calling 1-800-TAX-FORM (1-800-829-3676). You can also write to the IRS Forms Distribution Center nearest you. Check your income tax package for the address. This publication is also available on the IRS Internet web site at [www.irs.gov](http://www.irs.gov).

#### Generation-Skipping Transfer Issues; Correction

#### Announcement 2001-40

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Correction to final regulations.

SUMMARY: This document contains a correction to final regulations (T.D. 8912, 2001-5 I.R.B. 452) that were published in the **Federal Register** on Wednesday, December 20, 2000 (65 FR 79735) relating to the generation-skipping transfer (GST) tax imposed under chapter 13 of the Internal Revenue Code.

DATES: This correction is effective December 20, 2000.

FOR FURTHER INFORMATION CONTACT: James F. Hogan (202) 622-3090 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

#### Background

The final regulations that are the subject of this correction are under section 2601 of the Internal Revenue Code.

#### Need for Correction

As published, the final regulations contain an error that may prove to be misleading and is in need of clarification.

**Correction of Publication**

Accordingly, the publication of the final regulations (T.D. 8912), that were the subject of FR Doc. 00-31757, is corrected as follows:

**§26.2601-1 [Corrected]**

On page 79740, column 2, §26.2601-1, paragraph (b)(4)(i)(E), *Example 9.*, line 6, the language “is to pass to the A’s issue, per stirpes. Under” is corrected to read

“is to pass to A’s issue, per stirpes. Under”.

LaNita Van Dyke,  
Acting Chief, Regulations Unit,  
*Office of Special Counsel*  
(*Modernization and Strategic Planning*).

(Filed by the Office of the Federal Register on February 21, 2001, 8:45 a.m., and published in the issue of the Federal Register for February 22, 2001, 66 F.R. 11108)

## 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 ap-

plies 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.—Internal Revenue Bulletin.  
LE—Lessee.  
LP—Limited Partner.  
LR—Lessor.  
M—Minor.  
Nonacq.—Nonacquiescence.  
O—Organization.  
P—Parent Corporation.

PHC—Personal Holding Company.  
PO—Possession of the U.S.  
PR—Partner.  
PRS—Partnership.  
PTE—Prohibited Transaction Exemption.  
Pub. L.—Public Law.  
REIT—Real Estate Investment Trust.  
Rev. Proc.—Revenue Procedure.  
Rev. Rul.—Revenue Ruling.  
S—Subsidiary.  
S.P.R.—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<sup>1</sup>

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