Internal Revenue bulletin

Bulletin No. 2008-15
April 14, 2008

HIGHLIGHTS OF THIS ISSUE

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

SPECIAL ANNOUNCEMENT

Announcement 2008–27, page 751.

This document contains the annual report to the public concerning Advance Pricing Agreements (APAs) and the experience of the APA Program during calendar year 2007. This document does not provide guidance regarding the application of the arm's length standard. Instead, it reports on the structure and activities of the APA Program.

INCOME TAX

Rev. Rul. 2008–21, page 734.

Low-income housing credit; satisfactory bond; "bond factor" amounts for the period January through June 2008. This ruling provides the monthly bond factor amounts to be used by taxpayers who dispose of qualified low-income buildings or interests therein during the period January through June 2008.

T.D. 9383, page 738.
REG–137573–07, page 750.

Final, temporary, and proposed regulations amend regulations section 1.1502–13(c)(6)(ii)(C), which relates to the redetermination of intercompany gain as excluded from gross income.

T.D. 9385, page 735.

Final regulations under section 817(h) of the Code make changes to the regulations concerning diversification requirements. The changes expand the list of holders whose beneficial interests in an investment company, partnership, or trust do not prevent a segregated asset account from looking through to the assets of the investment company, partnership, or trust, to satisfy the requirements of section 817(h). The regulations also remove the sentence in regulations section 1.817–5(a)(2) that provides that the payment required to remedy an inadvertent diversification failure must be based on the tax that would have been owed by the policyholders if they were treated as receiving the income on the contract.

Notice 2008–41, page 742.

This notice clarifies, amends, supplements, and supersedes Notice 2008–27, 2008–10 I.R.B. 543, which modified certain special reissuance standards for "qualified tender bonds" under IRS Notice 88–130, 1988–2 C.B. 543, and modified certain aspects of the application of regulations section 1.1001–3 as they apply to tax-exempt bonds. This notice retains the basic rule framework outlined in Notice 2008–27 except that it makes certain technical changes and extends, temporarily, the period of time, from 90 days to 180 days, during which an issuer may hold qualified tender bonds prior to their remarketing without causing such bonds to be treated as retired. This notice also introduces a temporary rule which allows a governmental issuer to purchase and hold its own tax-exempt auction rate bonds for 180 days without causing a retirement or extinguishment of the debt represented by the purchased tax-exempt bonds. Notice 2008–27 clarified, amended, supplemented, and superseded.

Notice 2008–42, page 747.

This notice provides that a modification of a life insurance split-dollar arrangement that does not include any change to the life insurance contract underlying the arrangement will not be treated as a material change in the life insurance contract underlying the arrangement.

(Continued on the next page)

Finding Lists begin on page ii.

Department of the Treasury
Internal Revenue Service

ADMINISTRATIVE

Notice 2008–43, page 748.
This notice provides interim rules for contingent fees under section 10.27(b)(2) of Circular 230. Specifically, this notice provides (1) A clarification that the "within 120 days of the taxpayer receiving a written notice of the examination of, or a written challenge to the original tax return" language in section 10.27(b)(2)(ii) does not require the IRS to furnish the written notice of examination to a taxpayer as a prerequisite to a practitioner charging a contingent fee and (2) A new exception under section 10.27 that allows practitioners to charge a contingent fee with respect to whistleblower claims under section 7623(b) of the Code. The IRS will apply the interim rules under section 10.27(b)(2) in the notice until the Treasury Department and the IRS amend the regulations.

Announcement 2008–29, page 786.
This document contains corrections to final and temporary regulations (T.D. 9368, 2008–6 I.R.B. 382) regarding the reduction of the number of separate foreign tax credit limitation categories under section 904(d) of the Code. The regulations affect taxpayers claiming foreign tax credits and provide guidance needed to comply with the statutory changes made by the American Jobs Creation Act of 2004 (AJCA).

Announcement 2008–31, page 787.
This document cancels a public hearing on proposed regulations (REG–141399–07, 2008–8 I.R.B. 470) providing guidance relating to the recapture of overall foreign and domestic losses.

The IRS Mission

Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.

Introduction

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

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

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

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations, court decisions, rulings, and procedures must be considered, and Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

The Bulletin is divided into four parts as follows:

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

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

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

Part IV.—Items of General Interest.
This part includes notices of proposed rulemakings, disbarment and suspension lists, and announcements.

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

For sale by the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20402.

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

Section 42.—Low-Income Housing Credit

Low-income housing credit; satisfactory bond; "bond factor" amounts for the period January through June 2008. This ruling provides the monthly bond factor amounts to be used by taxpayers who dispose of qualified low-income buildings or interests therein during the period January through June 2008.

Rev. Rul. 2008–21

In Rev. Rul. 90–60, 1990–2 C.B. 3, the Internal Revenue Service provided guidance to taxpayers concerning the general methodology used by the Treasury Department in computing the bond factor amounts used in calculating the amount of bond considered satisfactory by the Secretary under § 42(j)(6) of the Internal Revenue Code. It further announced that the Secretary would publish in the Internal Revenue Bulletin a table of bond factor amounts for dispositions occurring during each calendar month.

Rev. Proc. 99–11, 1999–1 C.B. 275, established a collateral program as an alternative to providing a surety bond for taxpayers to avoid or defer recapture of the low-income housing tax credits under § 42(j)(6). Under this program, taxpayers may establish a Treasury Direct Account and pledge certain United States Treasury securities to the Internal Revenue Service as security.

This revenue ruling provides in Table 1 the bond factor amounts for calculating the amount of bond considered satisfactory under § 42(j)(6) or the amount of United States Treasury securities to pledge in a Treasury Direct Account under Rev. Proc. 99–11 for dispositions of qualified low-income buildings or interests therein during the period January through June 2008.

Table 1
Rev. Rul. 2008–21
Monthly Bond Factor Amounts for Dispositions Expressed As a Percentage of Total Credits

	Calendar Year Building Placed in Service or, if Section 42(f)(1) Election Was Made, the Succeeding Calendar Year										
Month of Disposition	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Jan '08	16.41	30.70	43.23	54.19	63.81	65.42	67.35	69.63	72.14	74.79	77.33
Feb '08	16.41	30.70	43.23	54.19	63.81	65.27	67.19	69.46	71.96	74.59	77.11
Mar '08	16.41	30.70	43.23	54.19	63.81	65.12	67.04	69.29	71.78	74.39	76.89
Apr '08	15.52	29.04	40.88	51.24	60.35	60.86	62.02	63.47	65.09	66.79	68.34
May '08	15.52	29.04	40.88	51.24	60.35	60.73	61.89	63.33	64.95	66.63	68.17
Jun '08	15.52	29.04	40.88	51.24	60.35	60.60	61.76	63.19	64.80	66.47	68.01

Table 1 (cont'd)
Rev. Rul. 2008–21
Monthly Bond Factor Amounts for Dispositions Expressed As a Percentage of Total Credits

	Calendar Year Building Placed in Service or, if Section 42(f)(1) Election Was Made, the Succeeding Calendar Year										
Month of Disposition	2005	2006	2007	2008							
Jan '08	79.56	81.57	83.59	83.98							
Feb '08	79.31	81.30	83.27	83.98							
Mar '08	79.07	81.05	82.99	83.98							
Apr '08	69.59	70.64	71.69	72.55							
May '08	69.41	70.47	71.53	72.55							
Jun '08	69.25	70.31	71.39	72.55							

For a list of bond factor amounts applicable to dispositions occurring during other calendar years, see: Rev. Rul. 98–3, 1998–1 C.B. 248; Rev. Rul. 2001–2, 2001–1 C.B. 255; Rev. Rul. 2001–53, 2001–2 C.B. 488; Rev. Rul. 2002–72, 2002–2 C.B. 759; Rev. Rul. 2003–117, 2003–2 C.B. 1051; Rev. Rul. 2004–100, 2004–2 C.B. 718; Rev. Rul. 2005–67, 2005–2 C.B. 771; Rev. Rul. 2006–51, 2006–2 C.B. 632; and Rev. Rul. 2007–62, 2007–41 I.R.B. 767.

DRAFTING INFORMATION

The principal author of this revenue ruling is David McDonnell of the Office of Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this revenue ruling, contact Mr. McDonnell at (202) 622–3040 (not a toll-free call).

Section 101.—Certain Death Benefits

A notice provides guidance regarding the application of §§ 101(j) and 264(f) of the Internal Revenue Code (Code) to life insurance contracts that are subject to split-dollar life insurance arrangements. See Notice 2008-42, page 747.

Section 264 .—Certain Amounts Paid in Connection With Insurance Contracts

A notice provides guidance regarding the application of §§ 101(j) and 264(f) of the Internal Revenue Code (Code) to life insurance contracts that are subject to split-dollar life insurance arrangements. See Notice 2008-42, page 747.

Section 817.—Treatment of Variable Contracts

26 CFR 1.817–5: Diversification requirements for variable annuity, endowment, and life insurance contracts.

T.D. 9385

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1

Diversification Requirements for Variable Annuity, Endowment, and Life Insurance Contracts

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations concerning the diversification requirements of section 817(h) of the Internal Revenue Code (Code). The regulations expand the list of holders whose beneficial interests in an investment company, partnership, or trust do not prevent a segregated asset account from looking through to the assets of the investment company, partnership, or trust, to satisfy the requirements of section 817(h). The regulations also remove the sentence in §1.817–5(a)(2) that provides that the payment required to remedy an inadvertent diversification failure must be based on the tax that would have been owed by the policyholders if they were treated as receiving the income on the contract. The regulations affect insurance companies that issue variable contracts and affect policyholders who purchase such contracts.

DATES: *Effective/applicability date:* These regulations are effective as of March 7, 2008.

FOR FURTHER INFORMATION CONTACT: James Polfer, (202) 622–3970 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

Section 817(d) defines a variable contract for purposes of part I of subchapter L of the Code (sections 801–818). For a contract to be a variable contract, it must provide for the allocation of all or a part of the amounts received under the contract to an account that, pursuant to state law or regulation, is segregated from the general asset accounts of the issuing insurance company. In addition, for a life insurance contract to be a variable contract, it must qualify as a life insurance contract for Federal income tax purposes, and the amount of the death benefits (or the period of coverage) must be adjusted on the basis of the investment return and the market value of the segregated asset account; for an annuity contract to be a variable contract, it must provide for the payment of annuities, and the amounts paid in, or the amount paid out, must reflect the investment return and the market value of the segregated asset account; for a contract that provides funding of insurance on retired lives to be a variable contract, the amounts paid in, or the amounts paid out, must reflect the investment return and the market value of the segregated asset account.

Section 817(h)(1) provides that a variable contract that is based on a segregated asset account is not treated as an annuity, endowment, or life insurance contract unless the segregated asset account is adequately diversified in accordance with regulations prescribed by the Secretary. If a segregated asset account is not adequately diversified for a calendar quarter, then the contracts supported by that segregated asset account are not treated as annuity, endowment, or life insurance contracts for that period and subsequent periods, even if the segregated asset account is adequately diversified in those subsequent periods. Under §1.817–5(a), if a segregated asset account is not adequately diversified, income earned by that segregated asset account is treated as ordinary income received or accrued by the policyholders. Section 1.817–5(a)(2) provides conditions an issuer of a variable contract must satisfy in order to correct an inadvertent failure to diversify. Rev. Proc. 92–25, 1992–1 C.B. 741, see §601.601(d)(2) of this chapter, sets forth in more detail the procedure by which an issuer may request the relief described in §1.817–5(a)(2).

Congress enacted the diversification requirements of section 817(h) to "discourage the use of tax-preferred variable annuity and variable life insurance primarily as investment vehicles." H.R. Conf. Rep. No. 98–861, at 1055 (1984). In section 817(h)(1), Congress granted the Secretary broad regulatory authority to develop rules to carry out this intent. Congress directed that these standards be imposed because "by limiting a customer's ability to select specific investments underlying a variable contract, [adequate diversification] will help ensure that a customer's primary motivation in purchasing the contract is more likely to be the traditional economic protections provided by annuities and life insurance." S. Prt. 98–169, Vol. I at 546

(1984). A primary directive from Congress to Treasury in enacting the standards was to "deny annuity or life insurance treatment for investments that are publicly available to investors." H.R. Conf. Rep. No. 98–861, at 1055 (1984).

Section 817(h)(4) provides a look-through rule under which taxpayers do not treat the interest in a regulated investment company (RIC) or trust as a single asset of the segregated asset account but rather apply the diversification tests by taking into account the assets of the RIC or trust. Section 817(h) further provides that the look-through rule applies only if all of the beneficial interests in a RIC or trust are held by one or more insurance companies (or affiliated companies) in their general account or segregated asset accounts, or by fund managers (or affiliated companies) in connection with the creation or management of the RIC or trust.

Under §1.817–5(f)(1), if look-through treatment is available, a beneficial interest in a RIC, real estate investment trust, partnership, or trust that is treated under sections 671 through 679 as owned by the grantor or another person ("investment company, partnership or trust") is not treated as a single investment of a segregated asset account for purposes of testing diversification. Instead, a *pro rata* portion of each asset of the investment company, partnership, or trust is treated as an asset of the segregated asset account. Section 1.817–5(f)(2)(i) provides that the look-through rule applies to any investment company, partnership, or trust if (1) all the beneficial interests in the investment company, partnership, or trust are held by one or more segregated asset accounts of one or more insurance companies; and (2) public access to the investment company, partnership, or trust is available exclusively through the purchase of a variable contract (except as otherwise permitted in §1.817–5(f)(3)).

Under §1.817–5(f)(3), look-through treatment is not prevented by reason of beneficial interests in an investment company, partnership, or trust that are

(1) Held by the general account of a life insurance company or a corporation related to a life insurance company, but only if the return on such interests is computed in the same manner as the return on an interest held by a segregated asset account is computed, there is no intent to sell such interests to the public, and a segregated asset account of such life insurance company also holds or will hold a beneficial interest in the investment company, partnership, or trust;

(2) Held by the manager, or a corporation related to the manager, of the investment company, partnership or trust, but only if the holding of the interests is in connection with the creation or management of the investment company, partnership or trust, the return on such interest is computed in the same manner as the return on an interest held by a segregated asset account is computed, and there is no intent to sell such interests to the public;

(3) Held by the trustee of a qualified pension or retirement plan; or

(4) Held by the public, or treated as owned by the policyholders pursuant to Rev. Rul. 81–225, see §601.601(d)(2) of this chapter, but only if (A) the investment company, partnership or trust was closed to the public in accordance with Rev. Rul. 82–55, 1982–1 C.B. 12, see §601.601(d)(2) of this chapter, or (B) all the assets of the segregated asset account are attributable to premium payments made by policyholders before September 26, 1981, to premium payments made in connection with a qualified pension or retirement plan, or to any combination of such premium payments.

On July 31, 2007, the Treasury Department and the IRS published a notice of proposed rulemaking (REG–118719–07, 2007–37 I.R.B. 593) under section 817 in the **Federal Register** (72 FR 41651). The proposed regulations would expand the list of holders whose beneficial interests in an investment company, partnership, or trust do not prevent a segregated asset account from looking through to the assets of the investment company, partnership, or trust, to satisfy the requirements of section 817(h). The proposed regulations also would remove the sentence in §1.817–5(a)(2) that provides that the payment required to remedy an inadvertent diversification failure must be based on the tax that would have been owed by the policyholders if they were treated as receiving the income on the contract. One written comment was received in response to the notice of proposed rulemaking, and no public hearing was requested or held. After consideration of the comment, the proposed regulations are adopted as final regulations with the change discussed below.

Summary of Comment and Explanation of Revisions

Comment on the Proposed Regulation

A. *Amendment to §1.817–5(a)(2) (remedy for inadvertent nondiversification).*

The regulations remove the sentence in §1.817–5(a)(2) that provides that the payment required to remedy an inadvertent diversification failure must be based on the tax that would have been owed by the policyholders if they were treated as receiving the income on the contract.

The commentator supports the removal of the sentence. The commentator also suggested that the correction procedures under section 817(h) should be modified to (1) provide flexibility to more appropriately address various fact patterns, (2) encourage taxpayers to establish compliance practices and procedures, (3) promote compliance by providing limited fees for voluntary corrections, (4) provide for fees and sanctions in graduated steps to ensure that there is always an incentive for prompt correction, and (5) provide for sanctions that are reasonable in light of the nature, extent, and severity of the violation. The Treasury Department and the IRS will consider these comments in the course of evaluating what steps, if any, to take in response to submissions received concerning correction procedures more generally under Notice 2007–15, 2007–7 I.R.B. 503 (February 12, 2007).

B. *Expansion of list of permitted investors under §1.817–5(f)(3)*

The regulations expand the list of permitted investors in §1.817–5(f)(3) to include (i) qualified tuition programs as defined in section 529, (ii) trustees of pension or retirement plans established and maintained outside of the United States primarily for the benefit of individuals substantially all of whom are nonresident aliens, and (iii) an account which, pursuant to Puerto Rican law or regulation, is segregated from the general asset accounts of the life insurance company that owns the account, provided the requirements of section 817(d) and (h) are satisfied.

The commentator supports such an expansion of the list of permitted investors and urged that the list be further expanded to include segregated asset accounts of any foreign insurer that makes an election under section 953(d) to be treated as a domestic corporation for U.S. tax purposes. A general rule to this effect would be beyond the scope of the proposed regulations and may require a more specific examination of the manner in which such accounts are segregated under the applicable foreign law. Accordingly, such an expansion is not provided in these regulations, but the Treasury Department and IRS will consider the issue for possible future published guidance.

The commentator also urged that guidance is needed concerning (1) what steps must be taken to verify that an entity is a permitted investor, and (2) what happens if, despite verification efforts, the entity in question was never a permitted investor or subsequently loses its status as such. The Treasury Department and IRS are aware of this issue, but have concluded it is beyond the scope of the proposed regulations and at this time might better be addressed by Internal Revenue Bulletin guidance or by letter ruling. Accordingly, the issue is not addressed in these final regulations, but the Treasury Department and IRS will consider the issue for possible future published guidance.

Finally, the commentator suggested that the language of the amendment that expands the list of permitted investors to include certain Puerto Rican accounts should be clarified to eliminate confusion. Specifically, in the notice of proposed rulemaking, the *proviso* clause of the amendment stated that such an account will be a permitted investor "provided the requirements of section 817(d) and (h) are satisfied." The commentator expressed concern that the language of the amendment as written in the notice of proposed rulemaking could be read to present an issue of circularity (that is, to be a permitted investor, the account must satisfy section 817(h), but to satisfy section 817(h), the account must be a permitted investor.) To eliminate this potential confusion, the final regulations state that, solely for purposes of §1.817–5(f)(3)(vi), the requirement under section 817(d)(1) that the account be segregated pursuant to State law or regulation shall be disregarded and §1.817–5(f)(1) shall be applied without regard to the Puerto Rican segregated asset account.

Special Analyses

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

Drafting Information

The principal author of these final regulations is James Polfer, Office of the Associate Chief Counsel (Financial Institutions and Products), Internal Revenue Service. However, personnel from other offices of the Treasury Department and the IRS participated in their development.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAX

Paragraph 1. The authority citation for part 1 is amended by adding an entry in numerical order to read in part as follows:

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

Section 1.817–5 also issued under 26 U.S.C. 817(h).

Par. 2. Section 1.817–5 is amended as follows:

1. The last sentence of paragraph (a)(2)(iii) is removed.

2. Paragraph (f)(3)(iii) is revised.

3. Paragraph (f)(3)(iv) is redesignated as paragraph (f)(3)(vii).

4. New paragraphs (f)(3)(iv) through (vi) are added.

The revisions and additions read as follows:

§1.817–5 Diversification requirements for variable annuity, endowment, and life insurance contracts.

* * * * *

(f) * * *

(3) * * *

(iii) Held by the trustee of a qualified pension or retirement plan;

(iv) Held by a qualified tuition program as defined in section 529;

(v) Held by the trustee of a pension plan established and maintained outside of the United States, as defined in section 7701(a)(9), primarily for the benefit of individuals substantially all of whom are nonresident aliens, as defined in section 7701(b)(1)(B);

(vi) Held by an account which, pursuant to Puerto Rican law or regulation, is segregated from the general asset accounts of the life insurance company that owns the account, provided the requirements of section 817(d) and (h) are satisfied. Solely for purposes of this paragraph (f)(3)(vi), the requirement under section 817(d)(1) that the account be segregated pursuant to State law or regulation shall be disregarded and §1.817–5(f)(1) shall be applied without regard to the Puerto Rican segregated asset account; or

* * * * *

Linda E. Stiff,
Deputy Commissioner for Services and Enforcement.

Approved February 29, 2008.

Eric Solomon,
Assistant Secretary of the Treasury (Tax Policy).

(Filed by the Office of the Federal Register on March 6, 2008, 8:45 a.m., and published in the issue of the Federal Register for March 7, 2008, 73 F.R. 12263)

Section 1502.—Regulations

26 CFR 1.1502–13: Intercompany transactions.

T.D. 9383

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Guidance Under Section 1502; Amendment of Matching Rule for Certain Gains on Member Stock

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains final and temporary regulations concerning the treatment of certain intercompany gain with respect to consolidated group member stock. These regulations revise §1.1502–13(c)(6)(ii)(C) to provide for the redetermination of an intercompany gain as excluded from gross income in certain member stock transactions. These regulations affect corporations filing consolidated returns. The text of these temporary regulations also serves as the text of the proposed regulations (REG–137573–07) set forth in the notice of proposed rulemaking on this subject in this issue of the Bulletin.

DATES: *Effective Date:* These regulations are effective on March 7, 2008.

Applicability Date: For dates of applicability, see §1.1502–13T(c)(6)(ii)(C)(*2*) and (f)(7)(ii).

FOR FURTHER INFORMATION CONTACT: John F. Tarrant or Ross E. Poulsen, (202) 622–7790 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

Section 1.1502–13 provides rules governing the timing and characterization of items resulting from transactions between consolidated group members. Section 1.1502–13(c) provides general rules under which the timing and character of such items can be deferred or recharacterized to clearly reflect the taxable income (and tax liability) of the group as a whole. These rules generally apply a "matching" principle under which, in a property transaction, the seller's (S) timing is linked to the buyer's (B) use of its basis in the property and S and B's characterizations are subject to redetermination in order to effectuate single entity principles.

Section 1.1502–13(c)(6)(i) provides a general rule that S's intercompany item might be redetermined under §1.1502–13(c)(1)(i) to be excluded from gross income or treated as a noncapital, nondeductible amount where B's corresponding item is excluded or nondeductible. However, §1.1502–13(c)(6)(ii) provides that, notwithstanding the general rule in paragraph (c)(1)(i), S's intercompany income or gain is redetermined to be excluded from gross income only to the extent it involves one of three specific situations. S's intercompany income or gain is redetermined to be excluded from gross income to the extent B's corresponding item is a deduction or loss and, in the taxable year the item is taken into account under §1.1502–13, it is permanently and explicitly disallowed under another provision of the Internal Revenue Code or regulations. §1.1502–13(c)(6)(ii)(A). For this purpose, an amount is not permanently and explicitly disallowed to the extent that, among other things, the Internal Revenue Code or regulations provide that the amount is not recognized (for example, a loss that is realized but not recognized under section 332 or section 355(c)). §1.1502–13(c)(6)(ii)(A)(*1*). S's intercompany income or gain is redetermined to be excluded from gross income to the extent B's corresponding item is a loss that is realized but not recognized under section 311(a) on a distribution to a nonmember. §1.1502–13(c)(6)(ii)(B). Finally, S's intercompany item of income or gain is redetermined to be excluded from gross income to the extent "[t]he Commissioner determines that treating S's intercompany item as excluded from gross income is consistent with the purposes of [§1.1502–13] and other provisions of the Internal Revenue Code and regulations." §1.1502–13(c)(6)(ii)(C).

The IRS has received ruling requests asking the Commissioner to determine that S's gain with respect to member stock should be redetermined as excluded from gross income, as described in §1.1502–13(c)(6)(ii)(C). In considering these requests, the IRS has concluded that the principles set out in §1.1502–13(c)(6)(ii)(C) guiding the Commissioner's exercise of discretion are not clear enough to justify the redetermination of such gain as excludible. In the context of gain with respect to member stock, the intercompany transaction regulations, and the consolidated return regulations in general, reflect a balancing of single and separate entity concerns. Gain with respect to member stock is often derivative and duplicative of potential gain with respect to the member's underlying assets. The consolidated return regulations permit but do not require the mitigation of this duplication. In many instances, the allowed mitigation is tailored very narrowly to protect against any possible implication of other consolidated return policies. See §§1.1502–13(c)(6)(ii)(A), 1.1502–13(f)(5), and 1.1502–13(f)(6). Thus, for example, although §1.1502–13(a) provides that the purpose of the intercompany transaction rules is to clearly reflect the taxable income of the group as a whole (which includes the elimination of duplicated gain), §1.1502–13(c)(6)(ii)(A)(*1*) explicitly contemplates possible gain duplication where S's intercompany item is taken into account due to a section 332 or section 355(c) transaction. Accordingly, the IRS generally does not foresee situations in which it would exercise its discretion to redetermine intercompany gain on member stock to be excludible under §1.1502–13(c)(6)(ii)(C).

The IRS and Treasury Department also do not foresee situations in which it should be necessary to invoke §1.1502–13(c)(6)(ii)(C) (the "Commissioner's Discretionary Rule") with respect to intercompany gain on property other than stock. Nevertheless, in this issue of the Bulletin (REG–137573–07), the IRS and Treasury Department request comments on whether any such situations are not appropriately addressed by other provisions of §1.1502–13. The Commissioner's Discretionary Rule will be retained while the IRS and Treasury Department consider such comments. However, absent compelling comments, the IRS and

Treasury Department anticipate ultimately eliminating the Commissioner's Discretionary Rule.

The IRS and Treasury Department, however, have identified one additional situation in which it would be appropriate to allow the exclusion of intercompany gain with respect to member stock. Accordingly, these temporary regulations redesignate current §1.1502–13(c)(6)(ii)(C) as §1.1502–13(c)(6)(ii)(D) and add a new specific exception to the rule limiting redetermination of intercompany income or gain in §1.1502–13(c)(6)(ii). This new rule has the advantage of clarity, and avoids requiring the IRS to exercise its discretion on an *ad hoc* basis.

Explanation of Provisions

These temporary regulations provide a rule under which, notwithstanding §1.1502–13(c)(6)(ii)(A)(*1*), an intercompany gain with respect to member stock is redetermined to be excluded from gross income to the extent that (1) such gain is the common parent's (P) intercompany item, (2) immediately before the intercompany gain is taken into account, P holds the member stock with respect to which the intercompany gain was realized, (3) P's basis in such member stock that reflects the intercompany gain that is taken into account is eliminated without the recognition of gain or loss (and that basis is not further reflected in the basis of any successor asset), (4) the group has not and will not derive any Federal income tax benefit from the intercompany transaction that gave rise to such intercompany gain or the redetermination of the intercompany gain (including any adjustment to basis in member stock under §1.1502–32), and (5) the effects of the intercompany transaction have not previously been reflected, directly or indirectly, on the group's consolidated return. For this purpose, the redetermination of P's intercompany gain is not in and of itself a Federal income tax benefit that would preclude redetermination under this rule.

The purpose of the provision is to prevent the effective duplication of gain within a consolidated group that would result from taking an intercompany gain into account without any corresponding tax basis (or other resulting tax benefit). The provision's five requirements are intended to ensure that any intercompany gain with respect to member stock may only be redetermined to be excluded from gross income to the extent that it is not reflected in basis after the transaction (or does not result in some other tax benefit). Accordingly, where some tax benefit has been derived from the intercompany transaction, a portion of the intercompany gain may still be redetermined to be excluded from gross income to the extent that no additional tax benefits were or would be derived and the provision's other requirements are satisfied. See §1.1502–13T(f)(7)(i) *Example 8*.

For this purpose, the term "Federal income tax benefit" is intended to be construed broadly. For example, the term includes, but is not limited to, the reduction of an excess loss account that would otherwise be taken into account in the transaction. The effects of the intercompany transaction may be reflected on the group's consolidated return, for example, to the extent that any increase in the basis of the member's stock as a result of the intercompany transaction is taken into account and alters the reduction of any member's attributes under sections 108 and 1017 and §1.1502–28.

In this issue of the Bulletin (REG–137573–07), the IRS and Treasury Department are requesting comments as to whether the rule should be broadened to apply to additional situations that would result in the effective duplication of gain. For example, should the rule be broadened to apply to other transactions involving member stock, or similar transactions involving nonmember stock?

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has been determined, pursuant to 5 U.S.C. 553(b)(B), that good cause exists for dispensing with the notice and public comment procedures and that, pursuant to 5 U.S.C. 553(d)(3), good cause exists to dispense with a delayed effective date. The regulations are necessary to provide immediate guidance and relief to taxpayers regarding certain intercompany gains with respect to member stock. For the applicability of the Regulatory Flexibility Act refer to the Special Analyses section of the preamble to the cross-reference notice of proposed rulemaking published in this issue of the Bulletin. Pursuant to section 7805(f) of the Internal Revenue Code, these regulations have been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal author of these regulations is John F. Tarrant, Office of Associate Chief Counsel (Corporate). However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding an entry in numerical order to read in part as follows:

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

Section 1.1502–13T also issued under 26 U.S.C. 1502. * * *

Par. 2. Section 1.1502–13 is amended as follows:

1. Paragraph (c)(6)(ii)(C) is redesignated as (c)(6)(ii)(D).

2. Paragraph (c)(6)(ii)(C) is added.

3. Paragraph (f)(7) is redesignated as paragraph (f)(7)(i) and a new paragraph heading is added.

4. Newly-designated paragraph (f)(7)(i) *Examples 7* and *8*, and paragraph (f)(7)(ii) are added.

The revisions and additions read as follows:

§1.1502–13 Intercompany transactions.

* * * * *

(c) * * *

(6) * * *

(ii) * * *

(C) [Reserved]. For further guidance, see §1.1502–13T(c)(6)(ii)(C).

* * * * *

(f) * * *

(7) *Examples*—(i) *In general*. * * *

* * * * *

Example 7 [Reserved]. For further guidance, see §1.1502–13T(f)(7)(i) *Example 7*.

Example 8 [Reserved]. For further guidance, see §1.1502–13T(f)(7)(i) *Example 8*.

(ii) [Reserved]. For further guidance, see §1.1502–13T(f)(7)(ii).

Par. 3. Section 1.1502–13T is added to read as follows:

§1.1502–13T Intercompany transactions (temporary).

(a) through (c)(6)(ii)(B) [Reserved]. For further guidance, see §1.1502–13(a) through (c)(6)(ii)(B).

(C) *Certain intercompany gains on member stock*—(*1*) *In general*. Notwithstanding paragraph (c)(6)(ii)(A)(*1*), intercompany gain with respect to member stock is redetermined to be excluded from gross income to the extent that—

(*i*) The gain is the common parent's (P) intercompany item;

(*ii*) Immediately before the intercompany gain is taken into account, P holds the member stock with respect to which the intercompany gain was realized;

(*iii*) P's basis in such member stock that reflects the intercompany gain that is taken into account is eliminated without the recognition of gain or loss (and such eliminated basis is not further reflected in the basis of any successor asset);

(*iv*) The group has not and will not derive any Federal income tax benefit from the intercompany transaction that gave rise to such intercompany gain or the redetermination of the intercompany gain (including any adjustment to basis in member stock under §1.1502–32); and

(v) The effects of the intercompany transaction have not previously been reflected, directly or indirectly, on the group's consolidated return. For this purpose, the redetermination of the intercompany gain is not in and of itself considered a Federal income tax benefit.

(*2*) *Effective/applicability date*—(*i*) *In general*. This paragraph (c)(6)(ii)(C) applies with respect to items taken into account on or after March 7, 2008.

(*ii*) *Expiration date*. The applicability of this paragraph (c)(6)(ii)(C) will expire on March 4, 2011.

(c)(6)(ii)(D) through (f)(7)(i) *Example 6* [Reserved]. For further guidance, see §1.1502–13(c)(6)(ii)(D) through (f)(7)(i) *Example 6*.

Example 7. Intercompany stock sale followed by section 332 liquidation into common parent. (i) *Facts*. P owns all of the stock of S, S owns all the stock of T, and T owns all of the stock of T1. On January 1 of Year 1, S distributes all of the T stock to P in a distribution to which section 301 applies. At the time of this distribution, the value of the T stock is $100 and S has a $40 basis in the T stock. Under section 311(b), S recognizes a $60 gain. Under section 301(d), P's basis in the T stock is $100. S will take its $60 gain into account under the matching rule in paragraph (c) of this section. On January 1 of Year 4, in an independent transaction, S distributes all of its assets to P in a complete liquidation to which section 332 applies, and, under paragraph (j)(2) of this section, P succeeds to S's $60 gain. On January 1 of Year 7, T distributes all of its T1 stock to P in a transaction to which section 355 applies. At the time of this distribution, P has a basis in the T stock of $100, the value of the T stock (without regard to T1) is $75, and the value of the T1 stock is $25. Under section 358, P allocates $25 of its $100 basis in the T stock to the T1 stock, and, under paragraph (j)(1) of this section, the T1 stock becomes a successor asset to the T stock. On January 1 of Year 9, in an independent transaction, when T's assets have a value of $75, T distributes all of its assets to P in a complete liquidation to which section 332 applies.

(ii) *Analysis*. Under paragraphs (b)(1) and (f)(2) of this section, S's distribution of the T stock to P is an intercompany transaction, S is the selling member, and P is the buying member. In Year 9 when T liquidates, P has $0 of unrecognized gain or loss under section 332 because P has a $75 basis in the stock of T and receives a $75 distribution with respect to its T stock. Under paragraph (b)(3)(ii) of this section, P's $0 of unrecognized gain or loss with respect to the T stock under section 332 is a corresponding item. P takes $45 of its intercompany gain into account under the matching rule in Year 9 to reflect the difference between P's $0 of unrecognized gain and P's $45 of recomputed unrecognized gain. (If P and S were divisions of a single corporation, P would have had a $40 basis in the T stock, and, after the Year 7 distribution of the T1 stock, would have held the T stock with a $30 basis.) Paragraph (c)(6) of this section does not prevent the redetermination of P's intercompany gain as excluded from gross income to the extent that the gain is P's intercompany item, P holds the T stock with respect to which this portion of the intercompany gain was realized, P's basis in the T stock that reflects the $45 intercompany gain taken into account is eliminated without the recognition of gain or loss (and this eliminated basis is not further reflected in the basis of any successor asset), the group has not derived any Federal income tax benefit from the basis in the T stock and will not derive any Federal income tax benefit from a redetermination of this portion of the gain, and the effects of the intercompany transaction have not previously been reflected, directly or indirectly, on the P group's consolidated return. (See paragraph (c)(6)(ii)(C) of this section). Accordingly, under paragraph (c)(6)(ii)(C) of this section, the $45 intercompany gain that P takes into account is redetermined to be excluded from gross income.

Example 8. Intercompany stock sale followed by section 355 distribution by the common parent. (i) *Facts*. The facts are the same as *Example 7*, except that T does not distribute the stock of T1, instead, in Year 7, T makes a distribution of $50 to P in a transaction to which section 301 applies. Under §1.1502–32, P's basis in its T stock is reduced by $50 and, under paragraph (f)(2)(ii) of this section, the intercompany distribution is excluded from P's gross income. Further, in Year 9, instead of liquidating T, P distributes the T stock to its shareholders in a transaction to which section 355 applies.

(ii) *Analysis*. On the distribution of the T stock, P has $0 of unrecognized gain under section 355(c) because P has a $50 basis in the stock of T which has a value of $50. Under paragraph (b)(3)(ii) of this section, P's $0 of unrecognized gain or loss with respect to the T stock under section 355(c) is a corresponding item. P takes its $60 intercompany gain into account under the matching rule in Year 9 to reflect the difference between P's $0 of unrecognized gain and P's $60 of recomputed gain ($50 unrecognized gain and $10 recognized gain). (If P and S were divisions of a single corporation, P would have had a $40 basis in the T stock, and, after the Year 7 distribution, would have held the T stock with a $10 excess loss account.) Paragraph (c)(6) of this section does not prevent the redetermination of P's intercompany gain as excluded from gross income to the extent that the gain is P's intercompany gain, P holds the T stock with respect to which this portion of the intercompany gain was realized, P's basis in the T stock that reflects the $60 intercompany gain taken into account is eliminated without the recognition of gain or loss (and this eliminated basis is not further reflected in any successor asset), the group has not derived any Federal income tax benefit from the basis in the T stock and will not derive any Federal income tax benefit from a redetermination of this portion of the gain, and the effects of the intercompany transaction have not previously been reflected, directly or indirectly, on the P group's consolidated return. (See paragraph (c)(6)(ii)(C) of this section). The intercompany transaction with respect to the T stock resulted in an increase in the basis of the T stock, and this increase in the basis of the T stock prevented P from holding the T stock with a $10 excess loss account (as a result of the Year 7 distribution) at the time of the section 355 distribution. Accordingly, the group derived a Federal income tax benefit from the intercompany transaction to the extent of $10. As such, under paragraph (c)(6)(ii)(C) of this section, only $50 of the $60 intercompany gain that P takes into account is redetermined to be excluded from gross income.

(iii) *Application of section 355(e)*. If it was determined that section 355(e) applied to P's distribution of the T stock, P would recognize $0 of gain and derive a Federal income tax benefit to the extent of the full $60 increase in the basis of the T stock. Therefore, no portion of P's intercompany gain would be redetermined to be excluded from gross income under paragraph (c)(6)(ii)(C) of this section.

(ii) *Effective/applicability date*—(A) *In general*. Paragraph (f)(7)(i) *Examples 7* and *8* of this section apply with respect to items taken into account on or after March 7, 2008.

(B) *Expiration date*. The applicability of paragraph (f)(7)(i) *Examples 7* and *8* of this section will expire on March 4, 2011.

(g) through (m) [Reserved]. For further guidance, see §1.1502–13(g) through (m).

Linda E. Stiff,
Deputy Commissioner for Services and Enforcement.

Approved March 3, 2008.

Eric Solomon,
Assistant Secretary of the Treasury (Tax Policy).

(Filed by the Office of the Federal Register on March 6, 2008, 8:45 a.m., and published in the issue of the Federal Register for March 7, 2008, 73 F.R. 12265)

Part III. Administrative, Procedural, and Miscellaneous

Reissuance Standards for State and Local Bonds

Notice 2008–41

SECTION 1. Purpose

This notice clarifies, amends, supplements, and supersedes Notice 2008–27, 2008–10 I.R.B. 543 (March 10, 2008), regarding reissuance standards for tax-exempt bonds. The Internal Revenue Service ("IRS") and the Treasury Department expect to issue regulations under § 150 of the Internal Revenue Code of 1986, as amended ("Code") to modify and clarify the determination of when tax-exempt bonds are treated as reissued or retired solely for purposes of § 103 and §§ 141 through 150. (Except as noted, section references in this notice are to the Code and the Income Tax Regulations). This notice provides interim guidance until the promulgation of such regulations. In part, this notice is intended to provide greater certainty and flexibility to address certain potential Federal tax issues that have arisen in the tax-exempt bond market as a result of recent rating agency downgrades of major municipal bond insurers and failures of auctions in the auction rate bond sector of the tax-exempt bond market.

In general, this notice clarifies, amends, supplements, and supersedes Notice 2008–27, which modified certain special reissuance standards for "qualified tender bonds" under IRS Notice 88–130, 1988–2 C.B. 543, for purposes of § 103 and §§ 141 through 150, and modified certain aspects of the application of § 1.1001–3 of the Income Tax Regulations as they apply to tax-exempt bonds.

The following discussion summarizes the changes and clarifications to Notice 2008–27 made in this notice:

Qualified Tender Bond Rules. With respect to the qualified tender bond provisions, this notice does the following: (1) it clarifies that the determination of whether a bond is a "qualified tender bond" is generally applied on a bond-by-bond basis, except to the extent that such test requires a determination of the weighted average maturity of the entire issue; (2) it adds qualified inflation rates and qualified inverse floating rates under § 1.1275–5(c) as eligible interest rates for qualified tender bonds; and (3) it clarifies how the 90-day remarketing requirement in the definition of a qualified tender right operates but also provides a temporary 180-day remarketing requirement.

New Temporary Rule Allowing Governmental Issuers to Purchase Their Own Auction Rate Bonds. In order to facilitate liquidity in the tax-exempt market in light of current market conditions, this notice introduces a temporary rule which allows a governmental issuer to purchase its own tax-exempt auction rate bonds on a temporary basis without causing a retirement or extinguishment of the debt represented by the purchased tax-exempt bonds.

Certain Arbitrage Rules. This notice also adds several rules which address the consequences of certain actions for purposes of the arbitrage investment restrictions under § 148, including actions taken pursuant to this notice relating to qualified hedges, purchases of tax-exempt bonds by conduit borrowers, and sales of bonds at a market premium pursuant to a qualified interest rate mode change under this notice. This notice supplements the arbitrage rule on the treatment of minor modifications of qualified hedges from Notice 2008–27 with a rule which provides that a deemed termination of an otherwise qualified hedge under § 1.148–4(h) will not result from bonds being held by or on behalf of a governmental issuer during the 90-day permitted holding period or the temporary 180-day permitted holding period for remarketing pursuant to a qualified tender right or during the 180-day permitted holding period for temporary purchases of auction rate bonds. With respect to a conduit borrower's purchase of tax-exempt bonds, the notice adds a special rule which provides that such a purchase will not cause a violation of a technical arbitrage restriction against purchases of tax-exempt bonds by conduit borrowers under the "program investment" definition in § 1.148–1(b) in certain circumstances. Further, with respect to certain permitted resales of bonds at a market premium upon a conversion of the interest rate to a fixed interest rate to maturity, this notice provides that, solely for arbitrage purposes, any premium properly received by an issuer pursuant to a qualified interest rate mode change is treated as additional sale proceeds (as defined in § 1.148–1(b)).

Certain Special Rules. Finally, with respect to two special rules from Notice 2008–27 which address certain temporary waivers of interest rate caps and certain nonrecourse debt, this notice continues those rules and extends the period during which interest rate caps may be waived without resulting in a significant modification under § 1.1001–3 until October 1, 2008.

Changes to Examples

This notice removes certain language from Example 2 of Notice 2008–27, because that language has proven confusing. No other inference should be drawn with respect to the transaction. In addition, this notice contains an additional example illustrating the temporary 180-day qualified tender bond remarketing requirement.

Scope and Effective Date. This notice applies solely for purposes of § 103 and §§ 141 through 150. No inference should be drawn regarding whether a debt modification described in this notice would constitute an exchange for purposes of § 1001. In addition, no inference should be drawn about whether similar consequences would obtain if a transaction falls outside the scope of this notice.

This notice is effective as of March 25, 2008. For the scope of application of this notice, see section 8 of this notice.

This notice invites public comment on the guidance provided herein.

SECTION 2. Background

Reissuance

Reissuance of a tax-exempt bond for purposes of the tax-exempt bond provisions triggers retesting of all the various program requirements for new issues of tax-exempt bonds. A reissuance of an issue of tax-exempt bonds may result in various negative consequences to a bond issuer, including, among other things, changes in yield for purposes of the arbitrage investment restrictions, acceleration of arbitrage rebate payment obligations, deemed terminations of integrated interest rate swaps under the qualified hedge rules for arbitrage purposes, new public approval requirements for qualified private activity bonds, and change in law risk.

In general, the standard for determining whether tax-exempt bonds are reissued, retired, or otherwise modified significantly enough to trigger a retesting of the program requirements for new issues of tax-exempt bonds under the tax-exempt bond provisions of the Code is based on the general Federal tax standards for debt exchanges under § 1001 and regulations thereunder.

In general, § 1.1001–3 employs a significant modification standard to determine whether modifications to a debt instrument in any form are sufficiently significant to cause the debt instrument to be treated as reissued or exchanged for purposes of § 1001. Section 1.1001–3 applies to modifications in the form of amendments to the terms of an existing debt instrument and to modifications in the form of actual exchanges of existing debt instruments for different debt instruments. The determination of whether a resulting debt instrument is treated as a reissued new debt instrument or a continuation of the original debt instrument depends on whether the result represents a "significant modification" of the original debt instrument, as defined in § 1.1001–3.

Notice 88–130 provides certain special reissuance rules for certain eligible tax-exempt bonds that are "qualified tender bonds," as defined therein. Notice 88–130 provides that qualified tender bonds will not be treated as reissued for purposes of § 103 and §§ 141 through 150 as a result of certain tender rights and certain changes in interest rate modes and other terms of bonds that are covered specifically by the detailed rules and limitations set forth in Notice 88–130.

Debt Extinguishment

Subject to limited exceptions, a debt instrument generally is treated as retired or extinguished when, among other circumstances, an issuer acquires its own debt because a merger of the interests of the issuer and the holder occurs. Notice 88–130 reflects this debt extinguishment principle in § 2.2(d) thereof, which generally treats a tax-exempt qualified tender bond as retired if it is purchased or otherwise acquired by or on behalf of an issuer which is a governmental unit or an agency or instrumentality thereof. If tax-exempt bonds treated as retired as a result of a debt extinguishment upon a governmental issuer's purchase of the tax-exempt bonds, that treatment may have different consequences depending on whether it is retired with the proceeds of another debt instrument or whether it is retired from equity or other non-borrowed funds.

A borrowing, whether taxable or tax-exempt, that is treated as retiring or reissuing a separate borrowing, generally constitutes an issue of refunding bonds which are viewed as financing the same governmental purpose or project as the original bonds (or "stepping into the shoes" of the original bonds) and trigger consequences involving the need to retest certain tax-exempt bond program requirements.

Tax-exempt bonds that are treated as retired through a debt extinguishment without a link to another borrowing, such as potentially an issuer's purchase of its own tax-exempt bonds using equity or other non-borrowed funds, may trigger additional consequences, including the potential adverse consequence of generally limiting the ability to refinance those extinguished bonds later with tax-exempt refunding bonds for the same governmental purpose as the original bonds.

Interest Rate Modes—Tender Option Modes and Auction Rate Modes

Issuers may issue fixed rate tax-exempt bonds that bear interest at fixed rates to maturity or variable rate bonds that bear interest at variable rates which float periodically in accordance with various market-based interest-rate setting mechanisms. Issuers often include multi-modal interest rate features in the preauthorized terms of the bond documents which provide issuers with the flexibility to change interest rate modes under parameters set forth in the bond documents.

One common interest rate mode employed with tax-exempt bonds is a tender option mode. "Tender option bonds" are also referred to commonly as "variable rate demand bonds." Tender option bonds have short-term interest features tied to current market rates necessary to remarket the bonds at par. Tender option bonds have ongoing tender options or put options associated with the interest rate-setting mechanism which allow bondholders to tender their bonds for purchase at par at specified intervals, typically every seven days. Tender option bonds generally have creditworthy third-party liquidity facilities from banks or other liquidity providers to support the tender options and may have credit enhancement from bond insurers or other providers. Tender option bonds also may have interest mode conversion options which grant to the issuer or a conduit borrower an option to change the interest rate mode on the bonds from a tender option mode to another short-term interest rate mode or to a fixed interest rate to maturity. At the time of a conversion to another interest rate mode, tender option bonds typically are subject to a mandatory tender for purchase but a bondholder may be allowed to elect to retain the bonds. Upon the exercise of ongoing tender options associated with the short-term interest rate-setting mechanism for tender option bonds and upon any mandatory or optional tender upon conversion of the interest rate on the bonds to another interest rate mode, a remarketing agent or a liquidity provider typically will acquire the bonds subject to the tender at par and resell the bonds either to the same bondholders or to others willing to purchase such bonds. In general, Notice 88–130 provides guidance for when the tenders associated with tender option bonds will not constitute reissuances if they meet the specific detailed eligibility requirements for "qualified tender bonds," as defined in Notice 88–130.

Another interest rate mode used with tax-exempt bonds is an auction rate mode. The interest rate on auction rate bonds is reset at predetermined intervals (generally under one year) using a modified Dutch auction process. Auction rate bonds generally trade at par and are callable at par on any interest payment date at the option of the issuer. Unlike bonds in a tender option mode, however, bonds in an auction rate mode have no ongoing tender options or put options to support the interest rate-setting process. Thus, auction rate bonds are viewed as long-term investments with a short-term interest rate-setting process. Auction rate bonds generally have maximum rates based on state law restrictions or certain formulas, such as a multiple of a tax-exempt or taxable index. Auction rate bonds may have credit enhancement from bond insurers or other providers. Auction rate bonds also may have interest mode conversion options similar to tender option bonds which grant to the issuer or a conduit borrower an option to change the interest rate mode on the bonds from an auction rate mode to another short-term interest rate mode or to a fixed interest rate to maturity. At the time of a conversion to another interest rate mode, auction rate bonds typically are subject to a mandatory tender for purchase in a process similar to mandatory tenders on conversions of interest rate modes used with tender option bonds.

Questions have arisen regarding whether or to what extent auction rate bonds can be treated as qualified tender bonds for purposes of Notice 88–130. In addition, in light of recent guidance by the Securities and Exchanges Commission which authorizes issuers of tax-exempt bonds to bid on and acquire their own auction rate bonds in an auction in certain circumstances, additional questions have arisen regarding the tax consequences of such acquisitions in various circumstances and whether such acquisitions would result in a retirement or extinguishment of such bonds.

SECTION 3. Reissuance Standards for State and Local Bonds

3.1. *Scope and General Rules.* The IRS and the Treasury Department expect to promulgate regulations under § 150 to provide guidance on whether tax-exempt bonds are treated as reissued or retired solely for purposes of § 103 and §§ 141 through 150. Specifically, for purposes of § 103 and §§ 141 through 150 only, in the case of a qualified tender bond (as defined herein), any qualified interest rate mode change (as defined herein) and any qualified tender right (as defined herein) will not be treated as a modification under § 1.1001–3. Therefore, for these purposes, a qualified tender bond will not be treated as reissued or retired solely as a result of a qualified interest rate mode change or the existence or exercise of any qualified tender right. Further, in applying § 1.1001–3 to modifications of tax-exempt bonds, any interest rate variance directly resulting from a qualified interest rate mode change will not be treated as a modification under § 1.1001–3, and thus such interest rate variances need not be tested under the change in yield rule for determining significant modifications under § 1.1001–3(e)(2). Except as otherwise specifically provided in this notice, the determination of whether any modification to an issue of tax-exempt bonds causes a reissuance or retirement of the tax-exempt bonds for purposes of § 103 and §§ 141 through 150 is based on whether the modifications are significant modifications under § 1.1001–3.

Except as expressly provided herein in the special rules for the treatment of "qualified interest rate mode changes" and "qualified tender rights" on "qualified tender bonds" (all as redefined herein) under § 3 of this notice, the special temporary rule allowing governmental issuers to purchase their own tax-exempt auction rate bonds for a limited holding period under § 4 of this notice, the special arbitrage rules under § 5 of this notice, and the other special rules under § 6 of this notice, a tax-exempt bond generally is treated as reissued or retired on the first date on which: (1) a significant modification to the terms of the bond occurs under § 1.1001–3 or a disposition of the bond otherwise occurs under section 1001; (2) the bond is purchased or otherwise acquired by or on behalf of a governmental issuer (as defined herein); or (3) the bond is otherwise retired or redeemed.

For purposes of determining whether a bond is purchased or otherwise acquired by or on behalf of a governmental issuer, except as otherwise expressly provided in § 3.2(3) and § 4 of this notice, a bond is treated as purchased or otherwise acquired by or on behalf of a person if the bond is purchased or otherwise acquired by that person in a manner that liquidates the bondholder's investment.

A purchase of a tax-exempt bond by a third-party guarantor or third-party liquidity facility provider pursuant to the terms of a third-party guarantee or third-party liquidity facility is not treated as a purchase or other acquisition by or on behalf of a governmental issuer. Similarly, a purchase of a tax-exempt bond by a conduit borrower that is not a governmental issuer is not treated as a purchase or other acquisition by or on behalf of the governmental issuer.

3.2. *Definitions and Operating Rules.* The following definitions and special operating rules apply for purposes of this notice only:

(1). *Qualified Tender Bond.* The term "qualified tender bond" means a tax-exempt bond that has all of the following features: (a) for each interest rate mode that is preauthorized under the terms of the bond considered separately, the bond bears interest during the allowable term of that interest rate mode at either a fixed interest rate, a variable interest rate that constitutes a qualified floating rate on a variable rate debt instrument for a tax-exempt bond under § 1.1275–5(b) (*e.g.*, various interest rate indexes and rate-setting mechanisms that reasonably can be expected to measure contemporaneous variations in the cost of newly-borrowed funds, including, without limitation, interest rates determined by reference to eligible interest rate indexes *(e.g.*, the SIFMA index), tender option-based interest rate measures, or a Dutch auction process), or a variable interest rate that constitutes an eligible objective rate for a variable rate debt instrument that is a tax-exempt bond under § 1.1275–5(c)(5) (*i.e.*, a qualified inflation rate or a qualified inverse floating rate); (b) interest on the bond is unconditionally payable at periodic intervals at least annually; (c) the final maturity date of the bond is no longer than the lesser of 40 years after the issue date of the bond or the latest date that is reasonably expected as of the issue date of the issue of which the bond is a part to be necessary to carry out the governmental purpose of the issue of which the bond is a part (with the 120 percent weighted average economic life of financed facilities test under Section 147(b) with respect to the issue of which the bond is a part being treated as a safe harbor for this purpose); and (d) the bond is subject to an optional tender right or a mandatory tender requirement which allows or requires a bondholder to tender the bond for purchase in one or more prescribed circumstances under the terms of the bond.

(2). *Qualified Interest Rate Mode Change*. In general, a "qualified interest rate mode change" is a change in the interest rate mode on a bond that is authorized under the terms of the bond upon its original issuance. Further, in order to be a qualified interest rate mode change, the terms of the bond must require that the bond be purchased and resold at a price equal to par upon conversion to a new interest rate mode, except only that, upon a conversion to an interest rate mode that is a fixed interest rate for the remaining term of the bond to maturity, the bond may be resold at a market premium or a market discount from the stated principal amount of that bond.

(3). *Qualified Tender Right*.

(a) *In General*. A "qualified tender right" is a tender right for the purchase of a bond (regardless of whether the purchase is by or on behalf of a governmental issuer) that is authorized under the terms of a bond upon its original issuance and that meets all of the requirements of this § 3.2(3)(a). The tender right must involve either an optional tender right or a mandatory tender requirement which allows or requires the bondholder to tender the bond for purchase on at least one tender date before the final stated maturity date. The tender right must entitle a tendering bondholder to receive a purchase price equal to par (which may include any accrued interest). The terms of the tender right must require the issuer or its remarketing agent to use at least best efforts to remarket a bond upon a purchase pursuant to the tender right.

(b) *Operating Rules for Purchases Pursuant to a Qualified Tender Right*. A bond purchased by or on behalf of a governmental issuer pursuant to a qualified tender right is treated as not retired pursuant to and as a result of the qualified tender right until not later than the end of the 90-day period from and after the date of such purchase, and subsequent to the end of this 90-day period, a governmental issuer generally may not hold its own bond without causing a retirement of such bond under the general rules in § 3.1 of this notice. This 90-day period is extended to 180-days, however, with respect to any purchase by or on behalf of a governmental issuer pursuant to a qualified tender right as long as such purchase occurs before October 1, 2008.

Thus, with respect to such bonds purchased before October 1, 2008, during this 180-day period, a governmental issuer or its agent may hold the bond under the terms of the bond without causing a retirement of the bond. In addition, recognizing that the bond is treated as outstanding during this 180-day period, the governmental issuer may refund the bond with a refunding bond during this period upon a failed remarketing.

By contrast, third-party guarantors, third-party liquidity facility providers, and conduit borrowers (other than a conduit borrower that is a governmental issuer) are not treated as purchasers by or on behalf of a governmental issuer under the general rules in § 3.1 of this notice, and, accordingly, any such person may hold a bond purchased pursuant to the exercise of a qualified tender right for an unlimited holding period without causing a retirement of such bond. Further, for example, a governmental issuer may hold a bond purchased before October 1, 2008, pursuant to the exercise of a qualified tender right for a holding period of 179 days while using best efforts under the terms of the bonds to remarket the bond and then resell the bond to a third-party guarantor, third-party liquidity facility provider, or other independent third party before the expiration of the 180-day period in compliance with the operating rules in this § 3.2(3)(b).

(4). *Governmental issuer.* A "governmental issuer" is an issuer of a tax-exempt bond that is a governmental unit or an agency or instrumentality thereof.

SECTION 4. Temporary Rule Allowing Governmental Issuers to Purchase Their Own Auction Rate Bonds

Solely for purposes of § 103 and §§ 141 through 150, a governmental issuer may purchase its own tax-exempt auction rate bond on a temporary basis without resulting in a reissuance or retirement of the purchased tax-exempt bond if it meets the following requirements: (1) the governmental issuer holds the bond for not more than a 180-day period from and after the date of purchase; and (2) the governmental issuer purchases the bond before October 1, 2008. Similar to the treatment of a bond purchased pursuant to a qualified tender right under the operating rule in § 3.2(3)(b) of this notice, an auction rate bond purchased by a governmental issuer pursuant to this § 4 is treated as not retired pursuant to and as a result of this special rule until not later than the end of this 180-day period, and, subsequent to the end of this 180-day period, a governmental issuer generally may not hold its own bond without causing a retirement of such bond under the general rules in § 3.1 of this notice.

Thus, recognizing that the bond is treated as not retired during this 180-day period, the governmental issuer may refund the bond with a refunding bond, tender the bond for purchase in a qualified tender right in its capacity as a bondholder, or otherwise resell the bond during this 180-day period. After the end of this 180-day period, however, a governmental issuer generally may not hold its own bond without causing a retirement of such bond under the general rules in § 3.1 of this notice.

SECTION 5. Arbitrage Provisions

5.1. *Certain Special Rules on Qualified Hedges for Arbitrage Purposes*. Solely for purposes of the arbitrage investment restrictions (including, without limitation, both yield restriction and rebate) under § 148, in determining whether a modification of a qualified hedge results in a termination of the hedge under § 1.148–4(h), such a modification is not treated as a termination of the hedge if both: (1) the modification is not reasonably expected as of the date of the modification to change the yield on the affected hedged bonds over the remaining term of the hedged bonds by more than one quarter of one percent (.25 percent or twenty-five basis points) *per annum*; and (2) the payments and receipts on the qualified hedge, as modified, are fully taken into account as adjustments to the yield on those hedged bonds for arbitrage purposes under § 148. Further, for arbitrage purposes under § 148, a qualified hedge with respect to bonds is not deemed terminated under § 1.148–4(h) as a result of the governmental issuer's holding of the hedged bonds during either the 90-day permitted holding period or the 180-day temporary permitted holding period under § 3.2(3), or the 180-day permitted holding period under § 4 of this notice during which the governmental issuer is permitted to hold such bonds without resulting in a reissuance or retirement of such bonds.

5.2. *Special Rule for Certain Purchases by Conduit Borrowers*. In applying the special arbitrage rule for "program investments" under § 1.148–1(b) which restricts a conduit borrower's purchase of tax-exempt bonds for a governmental program in an amount "related" to the amount of its purpose investment financed by the program, a conduit borrower's purchase of a tax-exempt auction rate bond that financed its loan to facilitate liquidity under adverse market conditions is treated as not being so "related" for this purpose.

5.3. *Treatment of Certain Premiums as Proceeds for Arbitrage Purposes.* Solely for purposes of the arbitrage investment restrictions under § 148, any premium received by an issuer pursuant to a conversion of the interest rate on a qualified tender bond to a fixed interest rate for the remaining term of the bond to maturity in a qualified interest rate mode change under § 3.2(2) of this notice is treated as additional sale proceeds (as defined in § 1.148–1(b)) of such bonds.

SECTION 6. Special Rules

6.1. *Special Rule for Nonrecourse Debt*. Solely for purposes of § 103 and §§ 141 through 150, in applying § 1.1001–3(e)(4)(iv)(B) to determine whether a modification of the security or credit enhancement on a tax-exempt bond that is a nonrecourse debt instrument is a significant modification, such a modification is treated as a significant modification only if the modification results in a change in payment expectations under § 1.1001–3(e)(4)(vi).

6.2. *Special Temporary Relief for Certain Waivers of Interest Rate Caps on Auction Rate Bonds*. Solely for purposes of § 103 and §§ 141 through 150, in applying § 1.1001–3(e)(2) to determine whether a modification to the yield on tax-exempt bonds that bear interest based on an auction rate constitutes a significant modification, a temporary waiver, in whole or in part, of the terms of a cap on the maximum interest rate on such auction rate bonds is disregarded to the extent that any agreement to waive such a cap and the period during which such a waiver is in effect both are within the period between November 1, 2007 and October 1, 2008. Except for the special relief provided in this section, a waiver of a cap on an interest rate on a tax-exempt bond generally is required to be tested for whether it causes a significant modification under § 1.1001–3.

SECTION 7. Examples

The following examples illustrate the application of certain principles in this notice and § 1.1001–3 as they apply to tax-exempt bonds for purposes of this notice.

Example 1. Insignificant Change in Credit Enhancement and Impact on Floating Interest Rate. On July 1, 2007, a municipality (the "Issuer") issued $1 million in tax-exempt bonds that bear interest at an auction interest rate and that mature in 40 years (the "Bonds"). The Bonds are recourse obligations that are secured by the issuer's underlying primary A-rated investment grade credit. The Bonds are secured further by credit enhancement under a bond insurance policy provided by a AAA-rated bond insurer. Pursuant to the terms of the Bonds, the auction interest rate on the Bonds resets every 7 days. The terms of the Bonds grant the issuer the option to convert the interest rate mode on the Bonds from an auction rate mode to either a 7-day tender option rate mode or to a long-term fixed interest rate to maturity, subject to a mandatory tender of the Bonds upon such a conversion. The Bonds are qualified tender bonds under § 3.2 of this notice.

On January 3, 2008, the auction interest rate on the Bonds is set at 10% as a consequence of a downgrade in the bond insurer's credit rating from a AAA rating to a AA rating and associated market disruption. On January 10, 2008, the issuer amended the terms of the Bonds to replace the now AA-rated bond insurance with a AAA-rated bank letter of credit as credit enhancement, but otherwise made no other changes to the terms of the Bonds. On January 10, 2008, the auction rate on the Bonds floated down to 3% primarily as a result of the change in credit enhancement on the Bonds.

The amendment to the terms of the Bonds to change the credit enhancement is a modification to a recourse debt instrument that must be tested for significance under the change in security or credit enhancement rule in § 1.1001–3(e)(4)(iv). Because the change in security or credit enhancement did not cause a change in payment expectations on the Bonds (*i.e.*, the Bonds had an investment grade payment expectation before and after the change in credit enhancement), this change in credit enhancement is not a significant modification of the Bonds under § 1.1001–3 and thus does not cause a reissuance of the Bonds under § 103 and §§ 141 through 150. Further, the fact that the market impact of the change in credit enhancement caused the floating interest rate on the Bonds to float down from 10% to 3% is not required to be tested under the 25-basis point change in yield rule for significant modifications under § 1.1001–3(e)(2) because the Issuer has made no change to the interest rate-setting mechanism under the terms of the Bonds.

Example 2. Exchange of Bonds to Remove Bond Insurance.

Assume the same facts as in *Example 1* above, except that, instead of amending the terms of the existing Bonds (the "Old Bonds") to change the credit enhancement, on January 10, 2008, the Issuer issued new bonds with new Cusip numbers (the "New Bonds") and did an actual exchange of the New Bonds for the Old Bonds. The New Bonds are not backed by any bond insurance or other credit enhancement. The New Bonds without the bond insurance have an A credit rating. There are no other differences between the New Bonds and the Old Bonds. The result would be the same as in *Example 1* and no reissuance of the Bonds would occur. Section 1.1001–3 applies the same significant modification standard to amendments to the terms of an existing debt instrument and to actual exchanges of an existing debt instruments for a different debt instrument.

Example 3. Impact of Authorized Changes in Interest Rate Modes and Associated Mandatory Tenders and Effect of Serialization.

(i) Assume the same facts as in *Example 1* above, except that, on January 10, 2008, the Issuer also exercised its option under the terms of the Bonds to convert the interest rate mode on the Bonds from an auction rate mode to a fixed interest rate of 5% for the remaining term of the Bonds. The terms of the Bonds also required a mandatory tender and remarketing of the Bonds in connection with this interest rate mode change. The mandatory tender is a qualified tender right and the change in the interest rate mode is a qualified interest rate mode change. Thus, the Bonds are qualified tender bonds, as defined in § 3.2 of the notice, the conversion of the interest rate on the Bonds from an auction rate mode to a fixed interest rate is pursuant to a qualified interest rate mode change" and the associated tender is a qualified tender right, all as defined in § 3.2 of the notice. Thus, under § 3.1 of the notice, in determining whether the Bonds are reissued for purposes of the tax-exempt bond provisions of the Code, the qualified interest rate mode change and the qualified tender right are not treated as modifications under § 1.1001–3. Furthermore, the interest rate change on the Bonds from a floating auction rate of 10% to a fixed interest rate of 5% directly resulted from the qualified interest rate mode change and, under § 3.1 of the notice, also is not treated as a modification under § 1.1001–3. Finally, as in *Example 1*, no reissuance of the Bonds occurred for purposes of § 103 and §§ 141 through 150 as a result of the change in credit enhancement.

(ii) Assume the same facts as paragraph (i) above except that the Issuer also amended the terms of the Bonds to modify a term Bond which had a prescribed mandatory sinking fund redemption schedule with alternative Bonds with "serial" maturities instead of the sinking fund redemption schedule. This "serialization" of the term Bond does not directly result from the qualified interest rate mode change. Subject to the particular terms of the Bonds, the serialization of the term Bond generally would be a modification under § 1.1001–3 which would be required to be analyzed for significance under the change in yield rule in § 1.1001–3(e)(2) and the change in the timing of payments rule in § 1.1001–3(e)(3).

Example 4. Impact of Unauthorized Changes. Assume the same facts as in *Example 1*, except that the terms of the Bonds do not provide for any conversions of the interest rate modes. On January 7, 2008, Issuer amends the Bond documents to allow the Issuer to convert the interest rate mode on the Bonds from an auction rate mode to either a 7-day tender option rate mode or to a long-term fixed interest rate to maturity, subject to a mandatory tender of the Bonds upon such a conversion. On January 10, 2008, Issuer exercised its option under the amended terms of the Bonds to convert the interest rate mode on the Bonds from an auction rate mode to a fixed interest rate of 5% for the remaining term of the Bonds. The Issuer also required a mandatory tender and remarketing of the Bonds in connection with this interest rate mode change. Because the change in interest rate mode is not pursuant to the terms of the Bonds when originally issued, it is not a qualified interest rate mode change within the meaning of this notice. Similarly, the tender of the Bonds on January 10, 2008 was not pursuant to the terms of the Bond as originally issued and therefore was not a qualified tender right within the meaning of this notice. Accordingly, the provisions of this notice are not applicable either to the interest rate mode change on the Bonds or to the tender of the Bonds. Thus, to determine whether these modifications cause a reissuance or retirement of the Bonds for purposes of § 103 and §§ 141 through 150, the impact of these modifications must be analyzed under § 1.1001–3 to determine whether a significant modification of the terms of the Bonds occurred.

Example 5. Operation of the 180-Day Temporary Rule for Qualified Tender Rights.

(i) On July 1, 2007, a municipality (the "Issuer") issued $1 million in tax-exempt bonds that bear interest initially at a variable rate demand rate and that mature in 40 years (the "Bonds"). The interest rate on the Bonds resets every 7 days at the minimum interest rate necessary to remarket the Bonds at par. The Bonds have seven-day tender options exercisable by the holders while the Bonds are in the variable rate demand interest rate mode. The Bonds give the Issuer an option to convert the interest rate on the Bonds to other interest rate modes. The Bonds have a mandatory tender requirement upon an interest rate mode conversion. The Bonds are secured by a third-party liquidity facility in the form of a letter of credit (the "Liquidity Facility") from a bank (the "Bank"). The Bonds are further secured by a third-party guarantee in the form of a bond insurance policy from a bond insurer (the "Bond Insurer"). An investment bank serves as a remarketing agent ("Remarketing Agent") for the Issuer with respect to the Bonds. The terms of the remarketing arrangement require the Remarketing Agent to use at least its best efforts to remarket tendered Bonds. On May 1, 2008, the Issuer exercises its option to convert the interest rate on the Bonds to a fixed interest rate to maturity and the Bonds are subject to mandatory tender by the Bondholders. The Bonds are qualified tender bonds which have a qualified tender right and a qualified interest rate mode change within the meaning of § 3.2 of this notice. During the 180-day period after the date of purchase of the bonds pursuant to the qualified tender right, as a result of difficult market conditions and despite best efforts required pursuant to the terms of the Bonds, the Issuer and the Remarketing Agent are unsuccessful in remarketing the Bonds. The particular terms of the Liquidity Facility require that the qualified tender right be funded by the Bank under the Liquidity Facility, but that the Bank not hold the Bonds upon a draw on the Liquidity Facility. Instead, the Bank merely receives a pledge of the Bonds as collateral for the draw on the Liquidity Facility and the Issuer holds the Bonds upon a draw on the Liquidity Facility. During this 180-day period, the Bonds are treated as outstanding under the operating rules for qualified tender rights in § 3.2(3)(b) even if the Bonds are held by or on behalf of the Issuer. Thus, during this 180-day period, the Issuer may hold the Bonds under the terms of the Bonds without causing a retirement of the Bonds. In addition, recognizing that the Bonds are treated as outstanding during this 180-day period, the Issuer may refund the Bonds with proceeds from refunding bonds during this period or resell the bonds to a third party.

(ii) Assume the same facts as in paragraph (i), but further assume that the Issuer retains the Bonds beyond the 180-day permitted holding period for a governmental issuer under § 3.2(3)(b) of this notice. The Bonds are treated as retired as of the end of the 180th day from and after the date of the purchase of the Bonds pursuant to the exercise of the qualified tender right. Thus, the count of the 180-day permitted holding period for the Issuer starts on the date of the purchase pursuant to the qualified tender right (here, starting May 1, 2008) and ends at the end of the 180th day from and after the date of purchase (here, ending at the end of the day on October 27, 2008).

(iii) Assume the same facts as in paragraph (i), but further assume that the terms of the Liquidity Facility provide that the Bank will hold the Bonds upon a draw on the Liquidity Facility, rather than merely receive a pledge of the Bonds as collateral while the Issuer or its agent holds the Bonds. Here, since a third-party liquidity facility provider is not treated as a purchaser by or on behalf of a governmental issuer under the general rules in § 3.1 of this notice, the Bank may hold the Bonds during and beyond the 180-day period after the date of the purchase pursuant to the qualified tender right without causing a retirement of the Bonds.

(iv) Assume the same facts as in paragraph (i), but further assume that the Issuer holds the Bonds for 179 days after purchase of the Bonds pursuant to the exercise of a qualified tender right while using best efforts under the terms of the Bonds to remarket the Bonds, and then sells the Bonds to the Bank pursuant to the Liquidity Facility. This transaction complies with the operating rules for qualified tender rights in § 3.2(3)(b) of this notice and does not result in a retirement of the Bonds.

SECTION 8. Interim Guidance and Reliance

The effective date of this notice is March 25, 2008. This notice provides interim guidance. Issuers of tax-exempt bonds may apply and rely on this notice for any actions taken with respect to tax-exempt bonds on or after November 1, 2007 and before the effective date of any future regulation under § 150 that implement the guidance with respect to any particular applicable provision in this notice or other public guidance that withdraws or supersedes any particular applicable provision in this notice. Issuers also may continue to rely on Notice 88–130 until the effective date of such future regulations. Notice 2008–27 is superseded and may not be relied upon after the effective date of this notice. The IRS and the Treasury Department may amend or supplement the guidance in this notice as circumstances warrant.

SECTION 9. Request for Comments

Before any notice of proposed rulemaking is issued with respect to the guidance provided in this notice, consideration will be given to any written public comments on this notice that are submitted timely by May 19, 2008, and a signed original and eight (8) copies of such comments should be sent to the IRS. Send submissions to: CC:PA:LPD:PR (NOT–2008–41), room 5203, IRS, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be sent electronically, via the IRS Internet site at *www.irs.gov/regs* or via the Federal eRulemaking Portal at *www.regulations.gov* (indicate IRS and REG–118788–06). All comments will be available for public inspection and copying.

SECTION 10. Drafting Information

The principal author of this notice is Aviva M. Roth, Office of the Chief Counsel (Financial Institutions and Products). However, other personnel from the IRS and the Treasury Department participated in its development. For further information regarding this notice, contact Aviva M. Roth at (202) 622–3980 (not a toll-free call).

Modifications of Split-Dollar Life Insurance Arrangements

Notice 2008–42

SECTION 1. PURPOSE

This notice provides guidance regarding the application of §§ 101(j) and 264(f) of the Internal Revenue Code (Code) to life insurance contracts that are subject to split-dollar life insurance arrangements. Specifically, this notice provides that a modification of a split-dollar life insurance arrangement that does not entail any change to the life insurance contract underlying the arrangement will not be treated as a material change in the life insurance contract for purposes of §§ 101(j) and 264(f).

SECTION 2. BACKGROUND

Split dollar life insurance arrangements

In general, a split-dollar life insurance arrangement is an arrangement between two or more parties to allocate the policy benefits and, in some cases, the costs of a life insurance contract. Sections 1.61–22, 1.301–1(q), and 1.7872–15 of the Income

Tax Regulations provide rules for the taxation of participants in a split-dollar life insurance arrangement. Those regulations generally apply to any split-dollar life insurance arrangement entered into after September 17, 2003. For this purpose, if an arrangement entered into on or before September 17, 2003, is materially modified after September 17, 2003, the arrangement is treated as a new arrangement entered into on the date of the modification. Section 1.61–22(j)(2)(ii) sets forth a non-exclusive list of changes that are not treated as material modifications for this purpose.

Section 101(j)

Section 101(j) was added to the Code by § 863(a) of the Pension Protection Act of 2006, Public Law 109–280. Section 101(j)(1) generally provides that in the case of an employer-owned life insurance contract, the amount of death benefits excluded from gross income of an applicable policyholder under § 101(a)(1) shall not exceed an amount equal to the sum of the premiums and other amounts paid by the policyholder for the contract. For this purpose, an employer-owned life insurance contract is a life insurance contract that (i) is owned by a person engaged in a trade or business and under which such person is directly or indirectly a beneficiary under the contract, and (ii) covers the life of an insured who is an employee with respect to the trade or business on the date the contract is issued. An applicable policyholder is generally a person who owns an employer-owned life insurance contract, or a related person as described in § 101(j)(3).

Section 101(j)(2) provides exceptions to the general rule of § 101(j)(1) in the case of certain employer-owned life insurance contracts with respect to which certain notice and consent requirements are met. Those exceptions are based either on (i) the insured's status as an employee within 12 months of death or as a director, a highly compensated employee or a highly compensated individual; or (ii) the extent to which death benefits are paid to a family member, trust, or estate of the insured employee, or are used to purchase an equity interest in the applicable policyholder from a family member, trust or estate.

Section 101(j) applies to life insurance contracts issued after August 17, 2006, except for a contract issued after that date pursuant to a § 1035 exchange for a contract issued on or before that date. For this purpose, a material increase in the death benefit or other material change generally causes the contract to be treated as a new contract. Other than as described above, contracts issued on or before August 17, 2006, are grandfathered and not subject to the requirements of § 101(j). *See* Pub. L. No. 109–280, § 863(d).

Section 264(f)

Section 264(f) was added to the Code by § 1084(c) of the Taxpayer Relief Act of 1997, Pub. L. No. 105–34. Section 264(f)(1) provides that "[n]o deduction shall be allowed for that portion of the taxpayer's interest expense which is allocable to unborrowed policy cash value" with respect to a life insurance policy or an annuity or endowment contract. Section 264(f)(4) identifies those policies and contracts that are excepted from the rule of § 264(f)(1).

Section 264(f) applies to contracts issued after June 8, 1997, in taxable years ending after such date; any material increase in the death benefit or other material change in the contract is treated as a new contract for this purpose. Other than as described above, contracts issued on or before June 8, 1997, are grandfathered and not subject to the requirements of § 264(f). *See* Pub. L. No. 105–34, § 1084(d) (as amended by Pub. L. No. 105–206, § 6010).

SECTION 3. APPLICATION OF SECTIONS 101(j) AND 264(f) TO CONTRACTS THAT ARE SUBJECT TO SPLIT-DOLLAR LIFE INSURANCE ARRANGEMENTS

Both §§ 101(j) and 264(f) apply to "life insurance contracts," which are defined in § 7702 for all purposes of the Internal Revenue Code as any contract that is a life insurance contract under the applicable law, but only if such a contract either meets the cash value accumulation test of § 7702(b), or both meets the guideline premium requirements of § 7702(c) and falls within the cash value corridor of § 7702(d). Under § 7702, the term "life insurance contract" generally does not encompass the terms of an arrangement, such as a split-dollar arrangement, of which the contract is a part. Accordingly, if the parties to a split-dollar life insurance arrangement modify the terms of the arrangement but do not modify the terms of the life insurance contract underlying the arrangement, the modification will not be treated as a material change in the life insurance contract for purposes of §§ 101(j) and 264(f), even if the modification is treated as a material modification of the split-dollar arrangement for purposes of § 1.61–22(j).

DRAFTING INFORMATION

The principal author of this notice is Linda K. Boyd of the Office of Associate Chief Counsel (Financial Institutions and Products). For further information regarding this notice, contact Ms. Boyd at (202) 622–3970 (not a toll-free call).

Contingent Fees Under Circular 230

Notice 2008–43

This notice provides guidance to practitioners concerning contingent fees under Treasury Department Circular No. 230, 31 C.F.R. part 10 (Circular 230). Specifically, this notice provides interim guidance clarifying when a practitioner may charge a contingent fee under section 10.27(b)(2) of Circular 230 for services rendered in connection with any matter before the Internal Revenue Service.

The Treasury Department and the IRS intend to revise section 10.27 to reflect the clarifications described in this notice. The IRS will follow the interim rules in this notice for purposes of enforcing section 10.27 until further guidance is provided.

BACKGROUND

In general, 31 U.S.C. section 330 authorizes the Secretary to regulate attorneys, certified public accountants, enrolled agents, enrolled actuaries, and others who practice before the Service. Regulations under section 330 are promulgated in 31 C.F.R. part 10 and are reprinted as Treasury Department Circular No. 230.

On September 26, 2007, the Treasury Department and the IRS published final regulations (T.D. 9359, 2007–45 I.R.B.

931) in the **Federal Register** (72 FR 54540) modifying rules governing the general standards of practice before the IRS. These final regulations generally preclude a practitioner from charging a contingent fee for services rendered in connection with any matter before the Internal Revenue Service, including the preparation or filing of a tax return, amended tax return or claim for refund or credit.

The final regulations, however, permit a practitioner to charge a contingent fee for services rendered in connection with the IRS examination of, or challenge to, (i) an original tax return, or (ii) an amended return or claim for refund or credit when the amended return or claim for refund or credit was filed within 120 days of the taxpayer receiving a written notice of the examination of, or a written challenge to, the original tax return. Contingent fees are also permitted for interest and penalty reviews and for services rendered in connection with a judicial proceeding arising under the Internal Revenue Code. The final amendments to section 10.27 made by the final regulations apply to fee arrangements entered into after March 26, 2008.

Section 406 of the Tax Relief and Health Care Act of 2006, Pub. L. No. 109–432 (120 Stat. 2958) (the Act), which was enacted on December 20, 2006, amended section 7623 of the Internal Revenue Code concerning the payment of awards to certain persons who detect underpayments of tax. Prior statutory authority to pay awards at the discretion of the Secretary was re-designated as section 7623(a), and a new section 7623(b) was added to the Code. Additional off-Code provisions in section 406 of the Act established a Whistleblower Office within the IRS and addressed reward program administration issues. *See* Notice 2008–4, 2008–2 I.R.B. 253, for interim guidance applicable to award claims submitted under the authority of section 7623(b).

INTERIM GUIDANCE

Several practitioners have contacted the Treasury Department and the IRS to request a clarification of the exception in section 10.27(b)(2)(ii) of Circular 230 permitting a practitioner to charge a contingent fee for services rendered in connection with an IRS examination of, or challenge to, an amended return or claim for refund or credit when the amended return or claim for refund or credit was filed within 120 days of the taxpayer receiving a written notice of the examination of, or a written challenge to, the original tax return. Specifically, the practitioners are concerned that the "within 120 days of the taxpayer receiving a written notice of the examination of, or a written challenge to the original tax return" language in section 10.27(b)(2)(ii) requires the IRS to furnish the written notice of examination to a taxpayer as a prerequisite to a practitioner charging a contingent fee. Other practitioners contacted the Treasury Department and the IRS to discuss whether section 10.27 permits practitioners to charge a contingent fee with respect to whistleblower claims under section 7623.

In response to these requests, the Treasury Department and the IRS have determined that section 10.27(b)(2) should be clarified and amended. Accordingly, the IRS will apply the following interim rules as revised below under section 10.27(b)(2) until the Treasury Department and the IRS amend the regulations:

§ 10.27 Fees.

* * * * *

(b) * * *

(2) A practitioner may charge a contingent fee for services rendered in connection with the Service's examination of, or challenge to—

(i) An original tax return; or

(ii) An amended return or claim for refund or credit filed before the taxpayer received a written notice of examination of, or a written challenge to, the original tax return; or filed no later than 120 days after the receipt of such written notice or written challenge. The 120 days is computed from the earlier of a written notice of the examination, if any, or a written challenge to the original return.

(3) A practitioner may charge a contingent fee for services rendered in connection with a claim for credit or refund filed solely in connection with the determination of statutory interest or penalties assessed by the Internal Revenue Service.

(4) A practitioner may charge a contingent fee for services rendered in connection with a claim under section 7623 of the Internal Revenue Code.

(5) A practitioner may charge a contingent fee for services rendered in connection with any judicial proceeding arising under the Internal Revenue Code.

* * * * *

EFFECTIVE DATE FOR INTERIM GUIDANCE

These interim rules regarding contingent fees are applicable to fee arrangements entered into after March 26, 2008.

DRAFTING INFORMATION

The principal author of this notice is Matthew S. Cooper of the Office of the Associate Chief Counsel (Procedure and Administration). For further information regarding this notice, contact Matthew S. Cooper at 202–622–4940 (not a toll-free call).

Part IV. Items of General Interest

Notice of Proposed Rulemaking by Cross-Reference to Temporary Regulations

Guidance Under Section 1502; Amendment of Matching Rule for Certain Gains on Member Stock

REG–137573–07

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations.

SUMMARY: In this issue of the Bulletin, the IRS is issuing temporary regulations (T.D. 9383) concerning the treatment of certain intercompany gains with respect to member stock within a consolidated group. The text of those regulations also serves as the text of these proposed regulations. These regulations affect corporations filing consolidated returns.

DATES: Written or electronic comments and requests for a public hearing must be received by June 5, 2008.

ADDRESSES: Send submissions to CC:PA:LPD:PR (REG–137573–07), room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG–137573–07), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC 20224, or sent electronically via the Federal eRulemaking Portal at *www.regulations.gov* (IRS REG–137573–07).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, John F. Tarrant or Ross E. Poulsen, (202) 622–7790; concerning submission of comments and/or requests for a public hearing, Kelly Banks, (202) 622–0932 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background and Explanation of Provisions

Temporary regulations in this issue of the Bulletin amend the Income Tax Regulations (26 CFR part 1) under section 1502 relating to the filing of consolidated returns. The temporary regulations revise §1.1502–13(c)(6)(ii)(C) to provide for the redetermination of an intercompany gain as excluded from gross income in certain member stock transactions. The text of those regulations also serves as the text of these proposed regulations. The preamble to the temporary regulations explains the amendments.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. It is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that these regulations primarily affect affiliated groups of corporations, which tend to be larger businesses. Moreover, the number of taxpayers affected is minimal and the regulations provide relief in certain narrow circumstances. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Internal Revenue Code, these regulations have been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Comments and Requests for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The IRS and Treasury Department request comments on the clarity of the proposed rules and how they can be made easier to understand. In particular, the IRS and Treasury Department do not foresee situations in which it should be necessary to invoke §1.1502–13(c)(6)(ii)(C) (the "Commissioner's Discretionary Rule") with respect to intercompany gain on property other than stock. Nevertheless, the IRS and Treasury Department request comments on whether any such situations are not appropriately addressed by other provisions of §1.1502–13. The Commissioner's Discretionary Rule will be retained while the IRS and Treasury Department consider such comments. However, absent compelling comments, the IRS and Treasury Department anticipate ultimately eliminating the Commissioner's Discretionary Rule. All comments will be available for public inspection and copying. A public hearing will be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the **Federal Register**.

Drafting Information

The principal author of these regulations is John F. Tarrant, Office of Associate Chief Counsel (Corporate). However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding an entry in numerical order to read in part as follows:

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

Section 1.1502–13 also issued under 26 U.S.C. 1502. * * *

Par. 2. Section 1.1502–13 is amended by revising paragraphs (c)(6)(ii)(C), (f)(7)(i) and (f)(7)(ii)(A) to read as follows:

§1.1502–13 Intercompany transactions.

(c) * * *

(6) * * *

(ii) * * *

(C) [The text of proposed §1.1502–13(c)(6)(ii)(C) is the same as the text of §1.1502–13T(c)(6)(ii)(C) published elsewhere in this issue of the Bulletin].

(1) [The text of proposed §1.1502–13(c)(6)(ii)(C)(1) is the same as the text of §1.1502–13T(c)(6)(ii)(C)(1) published elsewhere in this issue of the Bulletin].

(C)(2) [The text of proposed §1.1502–13(c)(6)(ii)(C)(2) is the same as the text of §1.1502–13T(c)(6)(ii)(C)(2) published elsewhere in this issue of the Bulletin].

(C)(2)(i) [The text of proposed §1.1502–13(c)(6)(ii)(C)(2)(i) is the same as the text of §1.1502–13T(c)(6)(ii)(C)(2)(i) published elsewhere in this issue of the Bulletin].

* * * * *

(f) * * *

(7) [The text of proposed §1.1502–13(f)(7) is the same as the text of §1.1502–13T(f)(7) published elsewhere in this issue of the Bulletin].

(i) [The text of proposed §1.1502–13(f)(7)(i) is the same as the text of §1.1502–13T(f)(7)(i) published elsewhere in this issue of the Bulletin].

(ii) [The text of proposed §1.1502–13(f)(7)(ii) is the same as the text of §1.1502–13T(f)(7)(ii) published elsewhere in this issue of the Bulletin].

(A) [The text of proposed §1.1502–13(f)(7)(ii)(A) is the same as the text of §1.1502–13T(f)(7)(ii)(A) published elsewhere in this issue of the Bulletin].

* * * * *

Linda E. Stiff,
Deputy Commissioner for Services and Enforcement.

(Filed by the Office of the Federal Register on March 6, 2008, 8:45 a.m., and published in the issue of the Federal Register for March 7, 2008, 73 F.R. 12312)

Announcement and Report Concerning Advance Pricing Agreements

Announcement 2008–27

March 27, 2008

This Announcement is issued pursuant to § 521(b) of Pub. L. 106–170, the Ticket to Work and Work Incentives Improvement Act of 1999, which requires the Secretary of the Treasury to report annually to the public concerning Advance Pricing Agreements (APAs) and the APA Program. The first report covered calendar years 1991 through 1999. Subsequent reports covered separately each calendar year 2000 through 2006. This ninth report describes the experience, structure and activities of the APA Program during calendar year 2007. It does not provide guidance regarding the application of the arm's length standard.

Matthew W. Frank
Director, Advance Pricing Agreement Program

Background

Internal Revenue Code (IRC) § 482 provides that the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among two or more commonly controlled businesses if necessary to reflect clearly the income of such businesses. Under the § 482 regulations, the standard to be applied in determining the true taxable income of a controlled business is that of a business dealing at arm's length with an unrelated business. The arm's length standard has also been adopted by the international community and is incorporated into the transfer pricing guidelines issued by the Organization for Economic Cooperation and Development (OECD). OECD, TRANSFER PRICING GUIDELINES FOR MULTINATIONAL ENTERPRISES AND TAX ADMINISTRATORS (1995). Transfer pricing issues by their nature are highly factual and have traditionally been one of the largest issues identified by the IRS in its audits of multinational corporations. The APA Program is designed to resolve actual or potential transfer pricing disputes in a principled, cooperative manner, as an alternative to the traditional examination process. An APA is a binding contract between the IRS and a taxpayer by which the IRS agrees not to seek a transfer pricing adjustment under IRC § 482 for a covered transaction if the taxpayer files its tax return for a covered year consistent with the agreed transfer pricing method (TPM). In 2007, the IRS and taxpayers executed 81 APAs and amended eight APAs.

Since 1991, with the issuance of Rev. Proc. 91–22, 1991–1 C.B. 526, the IRS has offered taxpayers, through the APA Program, the opportunity to reach an agreement in advance of filing a tax return on the appropriate TPM to be applied to related party transactions. In 1996, the IRS issued internal procedures for processing APA requests. Chief Counsel Directives Manual (CCDM), ¶¶ 42.10.10 — 42.10.16 (November 15, 1996).[1] Also in 1996, the IRS updated Rev. Proc. 91–22 with the release of Rev. Proc. 96–53, 1996–2 C.B. 375.[2] In 1998, the IRS published Notice 98–65, 1998–2 C.B. 803,[3] which set forth streamlined APA procedures for small business taxpayers. Then on July 1, 2004, the IRS updated and superseded both Rev. Proc. 96–53 and Notice 98–65 by issuing Rev. Proc. 2004–40, 2004–2 I.R.B. 50,[4] effective for all APA requests filed on or after August 19, 2004.

On December 19, 2005, the IRS again updated the procedural rules for processing and administering APAs with the release of Rev. Proc. 2006–9, 2006–1 C.B. 278.[5] Rev. Proc. 2006–9 supersedes Rev. Proc. 2004–40 and is effective for all APA requests filed on or after February 1, 2006.

Advance Pricing Agreements

An APA generally combines an agreement between a taxpayer and the IRS on an appropriate TPM for the transactions at issue (Covered Transactions) with an agreement between the U.S. and one or more foreign tax authorities (under the authority of the mutual agreement process of our income tax treaties) that the TPM is correct. With such a "bilateral" APA, the taxpayer ordinarily is assured that the income associated with the Covered Transactions will not be subject to double taxation by both the U.S. and the foreign jurisdiction. It is the policy of the United States, as reflected in §§ 2.08 and 7 of Rev. Proc. 2006–9, to encourage taxpayers that enter the APA Program to seek bilateral or multilateral APAs when competent authority procedures are available with respect to the foreign country or countries involved. However, the IRS may execute an APA with a taxpayer without reaching a competent authority agreement (a "unilateral" APA).

A unilateral APA is an agreement between a taxpayer and the IRS establishing an approved TPM for U.S. tax purposes. A unilateral APA binds the taxpayer and the IRS, but does not prevent foreign tax administrations from taking different positions on the appropriate TPM for a transaction. As stated in § 7.07 of Rev. Proc. 2006–9, 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 pursuant to an applicable income tax treaty (if any).

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

The APA Program

An IRS team headed by an APA team leader is responsible for the consideration of each APA. As of December 31, 2007, the APA Program had 19 team leaders. The team leader is responsible for organizing the IRS APA team. The IRS APA team leader arranges meetings with the taxpayer, secures whatever information is necessary from the taxpayer to analyze the taxpayer's related party transactions and the available facts under the arm's length standard of IRC § 482 and the regulations thereunder, and leads the discussions with the taxpayer.

The APA team generally includes an economist, an international examiner, LMSB field counsel, and, in a bilateral case, a U.S. Competent Authority analyst who leads the discussions with the treaty partner. The economist may be from the APA Program or the IRS field organization. As of December 31, 2007, the APA Program had seven economists. The APA team may also include an LMSB International Technical Advisor, other LMSB exam personnel, and an Appeals Officer.

The APA Process

The APA process is voluntary. Taxpayers submit an application for an APA, together with a user fee as set forth in Rev. Proc. 2006–9, § 4.12. The APA process can be broken into five phases: (1) application; (2) due diligence; (3) analysis; (4) discussion and agreement; and (5) drafting, review, and execution.

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

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

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

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

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

(1) *Application*

In many APA cases, the taxpayer's application is preceded by a pre-file conference with the APA staff in which the taxpayer can solicit the informal views of the APA Program. Pre-file conferences can occur on an anonymous basis, although a taxpayer must disclose its identity when it applies for an APA. Taxpayers must file the appropriate user fee on or before the due date, including extensions, of the tax return for the first taxable year that the taxpayer proposes to be covered by the APA. (If the taxpayer receives an extension to file its tax return, it must file its user fee no later than the actual filing date of the return.) Many taxpayers file a user fee first and then follow up with a full application later. The procedures for pre-file conferences, user fees, and applications can be found in §§ 3 and 4 of Rev. Proc. 2006–9.

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

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

(2) *Due Diligence*

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

(3) *Analysis*

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

(4) *Discussion and Agreement*

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

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

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

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

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

Once the IRS and the taxpayer reach agreement, the final APA is drafted. The APA Program has developed standard language that is incorporated into every APA. The current version of this language is found in Attachment A. APAs are reviewed by the APA Branch Chief and the APA Director. In addition, the team leader prepares a summary memorandum for approval by the Associate Chief Counsel (International) (ACC(I)). On March 1, 2001, the ACC(I) delegated to the APA Director the authority to execute APAs on behalf of the IRS. *See* Chief Counsel Notice CC–2001–016. The APA is executed for the taxpayer by an appropriate corporate officer.

Model APA at Attachment A

[§ 521(b)(2)(B)]

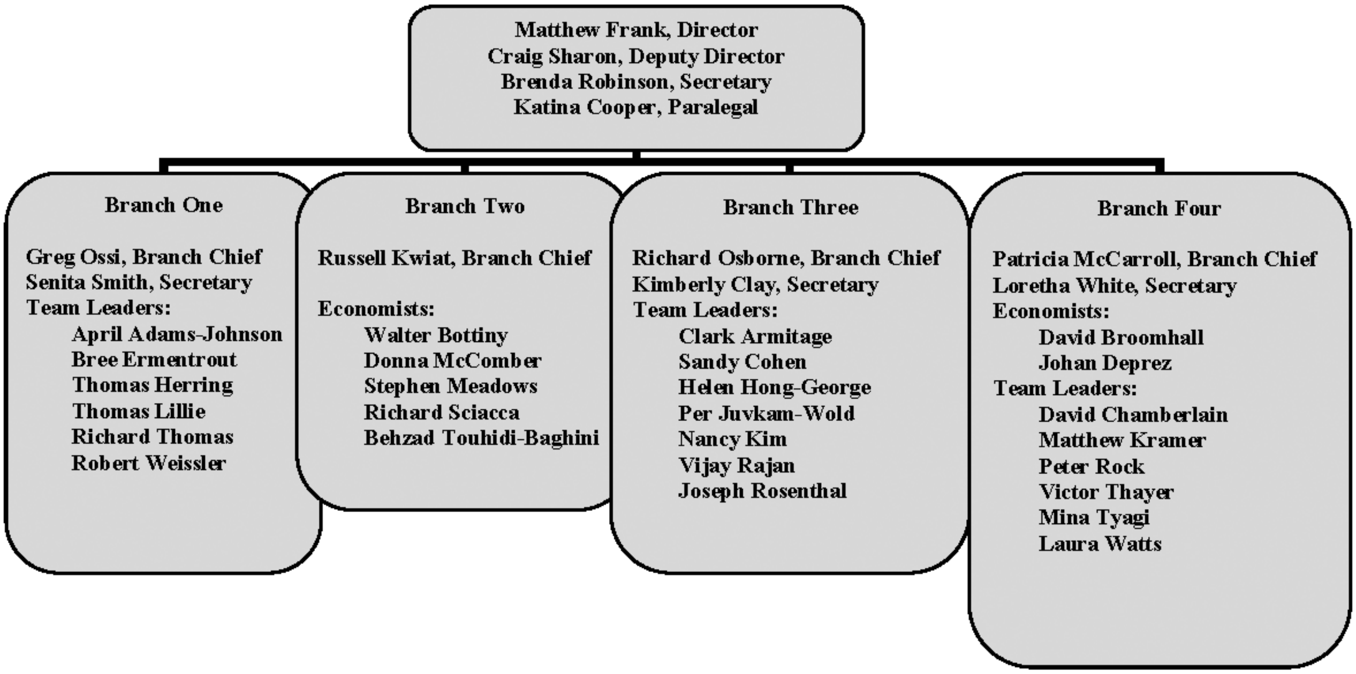
Attachment A contains the current version of the model APA language.

The Current APA Office Structure, Composition, and Operation

In 2007, the APA office consisted of four branches, with Branches 1 and 3 staffed with APA team leaders and Branch 2 staffed with economists. Branch 4, the APA West Coast branch, is headquartered in Laguna Niguel, California, with an additional office in San Francisco, and is staffed with both team leaders and economists.

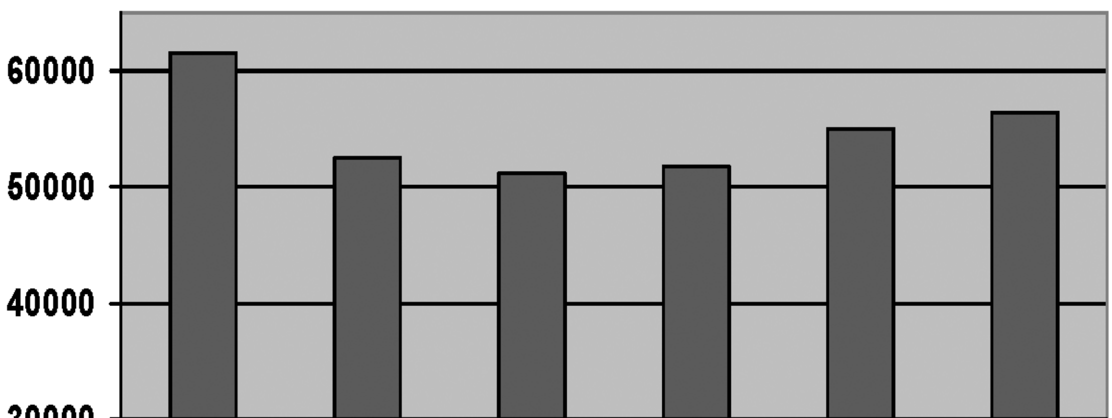
Overall, the APA staff decreased from 40 at the end of 2006 to 37 at the end of 2007. The decrease of three resulted from the departure of a team leader, an economist, and a special counsel.

As of December 31, 2007, the APA staff was as follows:



Notwithstanding the decrease in the number of persons on staff from the end of 2006 to the end of 2007, total staffing measured by hours rose three percent in 2007 over the prior year due to the full-year presence of several persons hired in mid–2006. The change in APA staffing levels over the last six years is reflected in the table below.

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



	2002	2003	2004	2005	2006	2007
APA staff hours	61528	52495	51170	51744	54970	56410

APA Issue/Industry Coordination Teams

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

The APA Program selected five categories of cases for specialization — cases involving cost sharing arrangements, financial products, the semiconductor industry, the automotive industry, and the pharmaceutical industry. These categories were selected because they each had a sufficient number of cases and commonality of issues to warrant their assignment to teams. Cases falling within these five categories have historically accounted for about 40 percent of the APA Program's case load and more than half of its total case time. At the end of 2007, cases within these five categories account for 43 of the 105 cases pending in the office that were either unilateral APAs or bilateral APAs that had not yet been forwarded to Competent Authority.

Staffing of the coordination teams at the end of 2007 is indicated below.

Auto & Auto Parts

Greg Ossi, Reviewer

Tom Herring, Team Leader
Per Juvkam-Wold, Team Leader
Vijay Rajan, Team Leader
Victor Thayer, Team Leader
Walt Bottiny, Principal Economist

Pharmaceuticals & Medical Devices

Craig Sharon, Reviewer

Clark Armitage, Team Leader
Peter Rock, Team Leader
Victor Thayer, Team Leader
Stephen Meadows, Principal Economist

Cost Sharing

Patricia McCarroll, Reviewer

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

Financial Products

Richard Osborne, Reviewer

Clark Armitage, Team Leader
Per Juvkam-Wold, Team Leader
Donna McComber, Principal Economist

Semiconductors

Patricia McCarroll, Reviewer

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

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

APA Training

In 2007, the APA office continued its training activities. Training sessions addressed APA-related current developments, regulatory developments, new APA office practices and procedures, and international tax law issues. APA economists also received training on a new spreadsheet model that performs calculations in a Comparable Profits Method ("CPM") analysis. This model was built by APA economists and is now routinely used by the APA office when performing CPM analyses. The training materials used for new hires are available to the public through the APA internet site at *http://www.irs.gov/businesses/corporations/article/0,,id=96221,00.html*.[6] These materials do not constitute guidance on the application of the arm's length standard and are not to be relied upon or cited as precedent.

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

APA Program Statistical Data
[§ 521(b)(2)(C) and (E)]

The statistical information required under § 521(b)(2)(C) is contained in Tables 1 and 10 below; the information required under § 521(b)(2)(E) is contained in Tables 2 and 3 below:

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

	Unilateral	Bilateral	Multilateral	Year Total	Cumulative Total
APA applications filed during year 2007	28	64		92	1129
All APAs executed[7]					
Year 2007	26	54	1	81	773
1991–2006	324	359	9	692	
APA renewals executed during year 2007	13	16		29	209
APAs revised or amended during year 2007	6	2		8	41
Pending requests for APAs	40	209		249	
Pending requests for new APAs	29	141		170	
Pending requests for renewal APAs	11	68		79	
APAs canceled or revoked	3	0		3	8
APAs withdrawn	0	5		5	126

TABLE 2: MONTHS TO COMPLETE APAS

Months to Complete Advance Pricing Agreements in Year 2007					
All New		All Renewals		All Combined	
Average	38.2	Average	25.5	Average	33.7
Median	35.9	Median	26.6	Median	31.2
Unilateral New		Unilateral Renewals		Unilateral Combined	
Average	18.7	Average	13.3	Average	16.0
Median	16.7	Median	12.2	Median	14.6
Bilateral/Multilateral New		Bilateral/Multilateral Renewals		Bilateral/Multilateral Combined	
Average	44.7	Average	35.4	Average	42.0
Median	42.3	Median	38.3	Median	40.4

[7] All APAs executed include APA renewals but not APAs revised or amended.

TABLE 3: APA COMPLETION TIME – MONTHS PER APA

Months	Number of APAs	Months	Number of APAs	Months	Number of APAs	Months	Number of APAs
1		**23**	1	**45**	1	**67**	2
2		**24**		**46**	1	**68**	1
3		**25**		**47**		**69**	
4		**26**	1	**48**		**70**	
5		**27**	2	**49**	1	**71**	
6		**28**	1	**50**	1	**72**	
7		**29**	3	**51**	2	**73**	
8		**30**		**52**	3	**74**	
9	2	**31**	2	**53**	2	**75**	
10	2	**32**		**54**		**76**	1
11	3	**33**	3	**55**	1	**77**	
12	2	**34**		**56**	1	**78**	
13	2	**35**	1	**57**	1	**79**	
14	2	**36**	1	**58**		**80**	
15	2	**37**	1	**59**		**81–90**	
16	3	**38**	2	**60**		**91–100**	
17	4	**39**	2	**61**	1	**101–110**	
18	3	**40**	2	**62**		**111–120**	
19	1	**41**		**63**		**121–130**	1
20	2	**42**	4	**64**		**131–140**	
21	2	**43**	1	**65**		**141–150**	
22	1	**44**	2	**66**	1	**151–160**	

TABLE 4: RECOMMENDED NEGOTIATING POSITIONS

Recommended Negotiating Positions Completed in Year 2007	62

TABLE 5: MONTHS TO COMPLETE RECOMMENDED NEGOTIATING POSITIONS

New		Renewal		Combined	
Average	17.0	Average	17.8	Average	17.4
Median	14.7	Median	15.7	Median	14.7

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

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

Tables 7 and 8 below show how long each APA request pending at the end of 2007 has been in the system as measured from the filing date of the APA submission. The numbers for pending unilateral and bilateral cases differ from the numbers in Table 1 because Tables 7 and 8 reflect only cases for which submissions have been received while Table 1 includes any case for which a user fee has been paid.

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

Months	Number of APAs	Months	Number of APAs	Months	Number of APAs	Months	Number of APAs
1	5	7	1	13	1	19	4
2	2	8		14		20	1
3		9	1	15		21	
4	1	10	3	16	1	22	
5	1	11	1	17		23	2
6	1	12		18	1	24	

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

Months	Number of APAs	Months	Number of APAs	Months	Number of APAs	Months	Number of APAs
1	11	27	5	53		79	1
2	2	28	2	54		80	
3	7	29	4	55		81	
4	2	30	2	56	1	82	
5	4	31	1	57		83	1

Months	Number of APAs	Months	Number of APAs	Months	Number of APAs	Months	Number of APAs
6	8	**32**	1	**58**		**84**	
7	4	**33**	3	**59**	1	**85**	
8	5	**34**	3	**60**		**86**	
9	11	**35**	4	**61**	2	**87**	
10	2	**36**	6	**62**		**88**	
11	9	**37**	1	**63**	1	**89**	
12	4	**38**	1	**64**		**90**	
13	2	**39**	4	**65**		**91**	
14		**40**		**66**		**92**	
15	2	**41**	2	**67**	3	**93**	
16	7	**42**	1	**68**		**94**	
17	7	**43**	2	**69**		**95**	
18	4	**44**	2	**70**	1	**96**	
19	5	**45**	1	**71**	1	**97**	
20	6	**46**	4	**72**		**98**	
21	5	**47**		**73**		**99**	
22	1	**48**	1	**74**		**100**	
23	5	**49**	1	**75**		**101**	2
24	4	**50**	1	**76**		**102**	
25	4	**51**		**77**		**103**	
26	4	**52**		**78**		**104**	

Of the 217 cases in the APA Program's inventory shown in Tables 7 and 8, 112 cases (all of which are reflected in Table 8) are bilateral cases that have been forwarded to the Competent Authority office for discussion with a treaty partner. This leaves 105 cases in the APA Program's active inventory at the end of 2007 that are either unilateral APAs (26 cases) or bilateral APAs for which the APA Program has not yet completed a recommended negotiating position (79 cases).

The table below shows the average age (in months) of the 105 active cases in inventory at the end of 2007, along with a comparison of the number of active cases and their average age at year-end for each year back to 2003. The table also shows the same information for cases that were at least 6 months old or 1 year old (the latter being a subset of the former) at the end of each year to allow comparison without potential distortions caused by year-to-year variations in the number of cases received in the latter half or during the course of the year.

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

	2003	2004	2005	2006	2007
Active cases	106	130	133	110	105
Average age (months)	15.1	15.2	13.2	10.6	9.1
Active cases 6+ months	78	106	87	81	66

	2003	2004	2005	2006	2007
Average age (months)	19.4	17.8	18.5	13.0	13.0
Active cases 1+ year	46	60	55	32	27
Average age (months)	26.8	24.2	23.3	19.4	18.5

TABLE 10: SMALL BUSINESS TAXPAYER APAs

Small Business Taxpayer APAs Completed in Year 2007	11
New	6
Renewals	5
Unilateral	8
Bilateral	3

TABLE 11: MONTHS TO COMPLETE SMALL BUSINESS TAXPAYER APAs

Months to Complete Small Business Taxpayer APAs in Year 2007					
New		Renewal		Combined	
Average	23.5	Average	17.8	Average	20.9
Median	17.8	Median	13.3	Median	14.1

TABLE 12: INDUSTRIES COVERED[8]

Industry Involved – NAICS Codes	Number
Wholesale trade, durable goods – 421	16–18
Computer and electronic product manufacturing – 334	10–12
Miscellaneous manufacturing – 339	10–12
Electronic equipment, appliance and component manufacturing – 335	7–9
Transportation equipment manufacturing – 336	4–6
Chemical manufacturing – 325	4–6
Professional, scientific and technical services – 545	4–6
Food manufacturing – 311	1–3
Securities, commodity contracts and other intermediary and related activities – 523	1–3
Motor vehicle and parts dealers – 441	1–3
General merchandise stores – 452	1–3
Beverage and tobacco manufacturing – 312	1–3
Apparel manufacturing – 315	1–3
Air transportation – 481	1–3

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

Industry Involved – NAICS Codes — Continued	Number
Machinery manufacturing – 333	1–3
Plastics and rubber products manufacturing – 326	1–3
Health and personal care stores – 446	1–3
Oil and gas extraction – 212	1–3
Accommodation – 721	1–3

Trades or Businesses
[§ 521(b)(2)(D)(i)]

The nature of the relationships between the related organizations, trades, or businesses covered by APAs executed in 2007 is set forth in Table 13 below:

TABLE 13: NATURE OF RELATIONSHIPS BETWEEN RELATED ENTITIES

Relationship	Number of APAs
Foreign Parent – U.S. Subsidiary (-ies)	52
Unilateral	*21*
Bilateral	*31*
U.S. Parent – Foreign Subsidiary (-ies)	28
Unilateral	*5*
Bilateral	*23*
Foreign Company and U.S. branch(es)	≤ 3
Unilateral	*0*
Bilateral	*≤ 3*
U.S. Company and non-U.S. branch(es)	0
Unilateral	*0*
Bilateral	*0*
Partnership	0
Unilateral	*0*
Bilateral	*0*

Covered Transactions
[§ 521(b)(2)(D)(ii)]

The controlled transactions covered by APAs executed in 2007 are set forth in Table 14 and Table 15 below:

TABLE 14: TYPES OF COVERED TRANSACTIONS

Transaction Type	Number
Sale of tangible property into the U.S.	47
Performance of services by U.S. entity	33
Sale of tangible property from the U.S.	20

Transaction Type — Continued	Number
Performance of services by Non-U.S. entity	17
Use of intangible property by Non-U.S. entity	14
Use of intangible property by U.S. entity	14
R&D cost sharing – Non-U.S. parent	5
Financial products – U.S. branch of foreign company	≤ 3
R&D cost sharing – U.S. parent	≤ 3
Sale of intangible property from the U.S.	≤ 3

TABLE 15: TYPES OF SERVICES INCLUDED IN COVERED TRANSACTIONS

Intercompany Services Involved in the Covered Transactions	Number
Marketing	20
Distribution	20
Technical support services	17
Sales support	12
Administrative	11
Management	9
Contract research & development	9
Product support	8
Research and development	7
Logistical support	7
Assembly	7
Headquarters costs	6
Accounting	5
Communication service	5
Purchasing	5
Legal	4
“Destination services” – hotel & reservations	4
Manufacturing services	4
Billing services	≤ 3
Warranty services	≤ 3
License administration services	≤ 3
Consulting	≤ 3
Testing and installation services	≤ 3

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

The general descriptions of the business functions performed and risks assumed by the organizations, trades, or businesses whose results are tested in the Covered Transactions in the APAs executed in 2007 are set forth in Tables 16 and 17 below:

TABLE 16: FUNCTIONS PERFORMED BY THE TESTED PARTY

Functions Performed	Number
Distribution functions	71
Marketing functions	37
Manufacturing	33
Technical training and tech support for sales staff (including sub-distributors)	30
Managerial, legal, accounting, finance, personnel, and other support services	25
Transportation and warehousing	23
Product assembly and/or packaging	22
Research and development	17
Product testing and quality control	17
Product design and engineering	16
Purchasing and materials management	14
Product service (repairs, etc.)	12
Process engineering	10
Licensing of intangibles	8
Consulting services	5
Telecom services	≤ 3
Engineering and construction related services	≤ 3
Trading and risk management of financial products	≤ 3

TABLE 17: RISKS ASSUMED BY THE TESTED PARTY

Risks Assumed	Number
Market risks, including fluctuations in costs, demand, pricing, & inventory	98
General business risks (*e.g.*, related to ownership of PP&E)	80
Credit and collection risks	67
Financial risks, including interest rates & currency	37
Product liability risks	26
R&D risks	14

Discussion

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

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

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

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

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

[§ 521(b)(2)(D)(iii)]

The related organizations, trades, or businesses whose prices or results are tested to determine compliance with TPMs prescribed in APAs executed in 2007 are set forth in Table 18 below:

TABLE 18: RELATED ORGANIZATIONS, TRADES, OR BUSINESSES WHOSE PRICES OR RESULTS ARE TESTED[9]

Type of Organization	Number
U.S. distributor	41
U.S. provider of services	22
U.S. manufacturer	18
Multiple tested parties	17
Non-U.S. distributor	16
Non-U.S. provider of services	15
Non-U.S. manufacturer	8
U.S. participant in cost sharing agreement	4
U.S. licensee of intangible property	≤ 3
U.S. licensor of intangible property	≤ 3
Non-U.S. licensee of intangible property	≤ 3

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

Type of Organization — Continued	Number
Non-U.S. participant in cost sharing agreement	≤ 3
Non-U.S. purchaser of intangible property	≤ 3
Other	≤ 3

Transfer Pricing Methods and the Circumstances Leading to the Use of Those Methods
[§ 521(b)(2)(D)(iv)]

The TPMs used in APAs executed in 2007 are set forth in Tables 19–20 below:

TABLE 19: TRANSFER PRICING METHODS USED FOR TRANSFERS OF TANGIBLE AND INTANGIBLE PROPERTY[10]

TPM Used	Number
CPM: PLI is operating margin	43
CPM: PLI is Berry ratio	16
CPM: PLI is markup on total costs	13
Residual profit split	11
CPM: PLI is gross margin	10
CUT (intangibles only)	9
CPM: PLI is return on assets or capital employed	5
Comparable profit split	≤ 3
Cost with no markup	≤ 3
Cost Plus Method (tangibles only)	≤ 3
Resale Price Method (tangibles only)	≤ 3
CUP (tangibles only) – not based on published market data	≤ 3
Other	≤ 3

TABLE 20: TRANSFER PRICING METHODS USED FOR SERVICES

TPM Used	Number
Cost plus a markup	13
CPM: PLI is markup on total costs	12
Comparable Uncontrolled Transaction	6
CPM: PLI is Berry ratio	5
Cost with no markup	4
CPM: PLI is operating margin	≤ 3
CPM: PLI is return on assets	≤ 3
Other	≤ 3

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

<u>*Discussion*</u>

The TPMs used in APAs completed during 2007 were based on the section 482 regulations. Under Treas. Reg. § 1.482–3, the arm's length amount for controlled transfers of tangible property may be determined using the Comparable Uncontrolled Price (CUP) method, the Resale Price Method, the Cost Plus Method, the Comparable Profits Method (CPM), or the Profit Split Method. Under Treas. Reg. § 1.482–4, the arm's length amount for controlled transfers of intangible property may be determined using the Comparable Uncontrolled Transaction (CUT) method, the CPM, or the Profit Split Method. An "Unspecified Method" may be used for transfers of either tangible or intangible property if it provides a more reliable result than the enumerated methods under the best method rule of Treas. Reg. § 1.482–1(c).

For transfers involving the provision of services, Treas. Reg. § 1.482–2(b) provided that services performed for the benefit of another member of a controlled group should bear an arm's length charge, either deemed to be equal to the cost of providing the services or an amount that would have been charged between independent parties. Generally effective beginning 2007, Temp. Reg. § 1.482–9T provides that the arm's length charge for controlled services transactions may be determined under the Services Cost Method, the Comparable Uncontrolled Services Price (CUSP) method, the Gross Services Margin method, the Cost of Services Plus method, the CPM, the Profit Split Method, or an Unspecified Method. In addition, Treas. Reg. § 1.482–2(a) provides rules concerning the proper treatment of loans or advances.

Treas. Reg. § 1.482–7 provides rules for qualified cost sharing arrangements under which the parties agree to share the costs of developing intangibles in proportion to their shares of reasonably anticipated benefits. APAs involving cost sharing arrangements generally address both the method of allocating costs among the parties as well as determining the appropriate amount of the "buy-in" payment due for the transfer of pre-existing intangibles to the controlled participants. In 2007, the APA Program completed four cost sharing and/or buy-in APAs, split between outbound and inbound transactions and unilateral and bilateral. The APA Program also completed its recommendations on three or fewer additional bilateral cost sharing/buy-in cases and sent those on to Competent Authority. The buy-in cases included both initial and subsequent buy-in/buy-out transactions. The methods used in the completed and pending buy-in cases included valuations based on discounted cash flows and other types of analyses. In addition, the Program is currently working on approximately half a dozen more cases involving cost sharing/buy-ins, split evenly between bilateral and unilateral.

In reviewing the TPMs applicable to transfers of tangible and intangible property reflected in Table 19, the majority of the APAs followed the specified methods. However, several points should be made. The section 482 regulations note that for transfers of tangible property, the CUP method will generally be the most direct and reliable measure of an arm's length price for the controlled transaction if sufficiently reliable comparable transactions can be identified. Treas. Reg. § 1.482–3(b)(2)(ii)(A). It was the experience of the APA Program in 2007, that in the cases that came into the APA Program, sufficiently reliable CUP transactions were difficult to find.

Similar to the CUP method, for transfers of intangible property the CUT method will generally provide the most reliable measure of an arm's length result if sufficiently reliable comparables may be found. Treas. Reg. § 1.482–4(c)(2)(ii). It has generally been difficult to identify external comparables, and APAs using the CUT method tend to rely on internal transactions between the taxpayer and unrelated parties. In 2007, nine Covered Transactions utilized the CUT TPM.

The Cost Plus Method (tangibles only) and Resale Price Method were each applied in 2007 in three or fewer APAs. See Treas. Reg. § 1.482–3(c), (d).

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

Table 19 reflects 87 uses of the CPM (with varying PLIs) in Covered Transactions involving tangible or intangible property. In some APAs, the CPM was also used concurrently with other methods.

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

The CPM was also used regularly with services as the Covered Transactions in APAs executed in 2007. There were at least 19 services Covered Transactions using the CPM method with various PLIs according to the specific facts of the taxpayers involved. Table 20 reflects the methods used to determine the arm's length results for APAs involving services transactions.

In 2007, 11 APAs involving tangible or intangible property used the Residual Profit Split Method. Treas. Reg. § 1.482–6(c)(3). In residual profit split cases, routine contributions by the controlled parties are allocated routine market returns, and the residual income is allocated among the controlled taxpayers based upon the relative value of their contributions of non-routine intangible property to the relevant business activity.

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

Critical Assumptions

[§ 521(b)(2)(D)(v)]

Critical Assumptions used in APAs executed in 2007 are described in Table 21 below:

TABLE 21: CRITICAL ASSUMPTIONS

Critical Assumptions involving the following:	Number of APAs
Material changes to the business	81
Material changes to tax and/or financial accounting practices	81
Assets will remain substantially same	9
Other financial ratio	8
Catastrophic events	4
Material sales fluctuations	≤ 3
Minimum sales volume	≤ 3
Currency fluctuations	≤ 3
Major regulatory changes	≤ 3
Major technological changes	≤ 3
Changes in market shares	≤ 3
Sales territories substantially same	≤ 3
Inventory fluctuations	≤ 3
Terms of business with related party that is not covered by APA	≤ 3
Risks assumed will remain substantially the same	≤ 3
Limit on royalties	≤ 3
Other	≤ 3

Discussion

APAs include critical assumptions upon which their respective TPMs depend. A critical assumption is any fact (whether or not within the control of the taxpayer) related to the taxpayer, a third party, an industry, or business and economic conditions, the continued existence of which is material to the taxpayer's proposed TPM. Critical assumptions might include, for example, a particular mode of conducting business operations, a particular corporate or business structure, or a range of expected business volume. Rev. Proc. 2006–9, § 4.05. Failure to meet a critical assumption may render an APA inappropriate or unworkable. Most APAs contain only the standard critical assumption language set forth in Appendix B of the Model APA (Attachment A to this Announcement and Report). Where appropriate, additional critical assumption language may be added but the APA Program generally seeks to limit additional critical assumption language to objective, measurable benchmarks.

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

If a critical assumption has not been met, the APA may be revised by agreement of the parties. If such an agreement cannot be achieved, the APA is canceled. If a critical assumption has not been met, the taxpayer must notify and discuss the APA terms with the Service, and, in the case of a bilateral APA, competent authority consideration is initiated. Rev. Proc. 2006–9, § 11.05, 11.06.

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

The sources of comparables, selection criteria, and rationale used in determining the selection criteria for APAs executed in 2007 are described in Tables 22 through 24 below. Various formulas for making adjustments to comparables are included as Attachment B.

TABLE 22: SOURCES OF COMPARABLES

Comparable Sources	Number of Times This Source Used
Compustat	98
Disclosure	32
Mergent	14
Worldscope	8
Japanese Accounts and Data on Enterprises ("JADE")	8
Internal CUTs	6
Interpreter and OneSource	5
Taxpayer's information on competition	4
Amadeus	≤ 3
Japan Company Handbook	≤ 3
Teikoku Databank (TDB) database	≤ 3
S&P's GlobalVantage	≤ 3
Tokyo Shoko Research	≤ 3
Yuka Shoken Hokokusho ("Japanese SEC Report")	≤ 3

TABLE 23: COMPARABLES SELECTION CRITERIA

Selection Criteria Considered	Number of Times This Criterion Used
Comparable functions	121
Comparable risks	102
Comparable industry	94
Comparable intangibles	65
Comparable products	57
Comparable terms	10

TABLE 24: ADJUSTMENTS TO COMPARABLES OR TESTED PARTIES

Adjustment	Number of Times Used
Balance sheet adjustments	
Payables	78
Inventory	77
Receivables	77
Property, plant, equipment	7
Other	≤ 3
Accounting adjustments	
LIFO to FIFO inventory accounting	34
Accounting reclassifications (*e.g.*, from COGS to operating expenses)	11
Stock option	9
Reclassifying certain amortization	≤ 3
Special items	≤ 3
US GAAP to foreign GAAP	≤ 3
Other	≤ 3
Profit level indicator adjustments (used to "back into" one PLI from another)	
Operating expense	6
Other	≤ 3
Miscellaneous adjustments	
Goodwill value or amortization	6
Foreign exchange	≤ 3
Geographic adjustments	≤ 3
Marketing allowance	≤ 3
Other	≤ 3

Discussion

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

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

Sources of Comparables

Comparables used in APAs can be U.S. or foreign, depending on the relevant market, the type of transaction being evaluated, the availability of relevant data, and the results of the functional and risk analyses. In general, comparables have been located by searching a variety of databases that provide data on U.S. publicly traded companies and on a combination of public and private non-U.S. companies. Table 22 shows the various databases and other sources used in selecting comparables for the APAs executed in 2007.

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

Selecting Comparables

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

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

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

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

Many Covered Transactions have been tested with comparables that have been chosen using additional criteria and/or screens. These include sales level criteria and tests for financial distress and product comparability. These common selection criteria and screens have been used to increase the overall comparability of a group of companies and as a basis for further research. The sales level screen, for example, has been used to remove companies that, due to their smaller size, might face fundamentally different economic conditions from those of the transaction or business activities being tested. In addition, APA analyses have incorporated selection criteria designed to identify and remove companies experiencing "financial distress" because of concerns that companies in financial distress face unusual circumstances and operational constraints that render them not comparable to the business activity being tested. These "financial distress" criteria may include an unfavorable auditor's opinion, bankruptcy, failure to comply with financial obligations (*e.g.*, debt covenants), and, in certain circumstances, operating losses in a given number of years.

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

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

Table 25 shows the number of times various screens were used in APAs executed in 2007:

TABLE 25: COMPARABILITY SCREENS

Comparability/Financial Distress Screen	Times Used
Comparability screens used	
Sales	57
R&D/ sales	54
Foreign sales/ total sales	26
SG&A/ sales	24
Advertising/ sales	10
Non-startup or start-up	8
Inventory/ sales	7
Operating expenses/ sales	4
Sales to specific customer segment/ total sales	4
Market value/ book value	≤ 3
PP&E/ sales	≤ 3
Specific type of segmented sales (*e.g.*, parts)/ total sales	≤ 3
Book value of intangibles/ total assets	≤ 3
SG&A/ COGS	≤ 3
Stock option compensation/ total compensation	≤ 3
PP&E/ total assets	≤ 3
Financial distress	
Bankruptcy	54
Unfavorable auditor's opinion	37
Losses in one or more years	33

Adjusting Comparables

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

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

To compare the profits of two business activities with different relative levels of receivables, inventory, or payables, the APA Program estimates the carrying costs of each item and adjusts profits accordingly. Although different formulas have been used in specific APA cases, Attachment B presents one set of formulas used in many APAs. Underlying these formulas are the notions that (1) balance sheet items normally should be expressed as mid-year averages, (2) formulas should try to avoid using data items that are being tested by the TPM (for example, if sales are controlled, then the denominator of the balance sheet ratio should not be sales), (3) a short term interest rate should be used, and (4) an interest factor should recognize the average holding period of the relevant asset. As in 2006, during the course of 2007 the APA Program used an interest rate equal to LIBOR (3 months) plus 200 basis points for purposes of calculating adjustments for accounts receivable and accounts payable for U.S. companies in many cases. In addition, the APA Program often used an interest rate equal to the Corporate Bonds (Moody's) Baa rate for purposes of calculating inventory adjustments for U.S. companies. However, the facts and circumstances surrounding a given case will ultimately determine the reliability of making balance sheet adjustments and the selection of the most reliable interest rate.

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

In some cases the APA Program has made an adjustment to account for differences in relative levels of PP&E between a tested business activity and the comparables. Ideally, comparables and the business activity being tested will have fairly similar relative levels of PP&E, since major differences can be a sign of fundamentally different functions and risks. Typically, the PP&E adjustment is made using a medium term interest rate. During the course of 2007, the APA Program often used the Corporate Bonds (Moody's) Baa rate as the interest rate for purposes of calculating adjustments for inventory and PP&E for U.S. companies. Again, however, the facts and circumstances surrounding a given case will ultimately determine the reliability of making balance sheet adjustments and the selection of the most reliable interest rate.

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

The adjustments made to comparables or tested parties in APAs executed in 2007 are reflected in Table 24 above.

Ranges, Targets, and Adjustment Mechanisms
[§ 521(b)(2)(D)(viii)–(ix)]

The types of ranges, targets, and adjustment mechanisms used in APAs executed in 2007 are described in Table 26 and 27 below.

TABLE 26: RANGES AND TARGETS[11]

Type of Range	Number
Interquartile range	87
Specific point (royalty)	15
Specific point within CPM range (not floor or ceiling)	12
Specific point (CUP)	8
Full range	4
Specific Point (royalty) with PLI limitations	≤ 3
Ceiling or Floor (*i.e.*, result must be no more or no less than x)	≤ 3
Residual profit split	≤ 3
Range from one quartile to the median	≤ 3
Specific point based on results of residual profit split TPM	≤ 3
Financial products profit split	≤ 3
Other	≤ 3

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

TABLE 27: ADJUSTMENT MECHANISMS

Adjustment mechanism	Number
Taxpayer makes an adjustment: to specified point or royalty rate	38
Taxpayer makes an adjustment: to closest edge of multi-year average	37
Taxpayer makes an adjustment: to median of current year	26
Taxpayer makes an adjustment: to closest edge of single year	22
Taxpayer makes an adjustment: to median of multi-year average	5
APA cancelled if results are beyond certain limits (*i.e.*, not merely outside of the range)	≤ 3
Other	≤ 3

Discussion

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

Under Treas. Reg. § 1.482–1(e)(2)(i), such a range is normally derived by considering a set of more than one comparable uncontrolled transaction of similar comparability and reliability. If these comparables are of very high quality, as defined in the section 482 regulations, then under Treas. Reg. § 1.482–1(e)(2)(iii)(A), the arm's length range includes the results of all of the comparables (from the least to the greatest). However, the APA Program has only rarely identified cases meeting the requirements for the full range. If the comparables are of lesser quality, then under Treas. Reg. § 1.482–1(e)(2)(iii)(B), "the reliability of the analysis must be increased, when it is possible to do so, by adjusting the range through application of a valid statistical method to the results of all of the uncontrolled comparables." One such method, the "interquartile range," is ordinarily acceptable, although a different statistical method "may be applied if it provides a more reliable measure." The "interquartile range" is defined as, roughly, the range from the 25th to the 75th percentile of the comparables' results. See Treas. Reg. § 1.482–1(e)(2)(iii)(C). The interquartile range was used 87 times in 2007.

More than 36 Covered Transactions reflected on Table 26 were tested against a single, specific result. Some APAs — deliberately infrequent — specify not a point or a range, but a "floor" or a "ceiling". When a floor is used, the tested party's result must be greater than or equal to some particular value. When a ceiling is used, the tested party's result must be less than or equal to some particular value. Three or fewer APAs executed in 2007 used a floor or a ceiling.

Some APAs look to a tested party's results over a period of years (multi-year averaging) to determine whether a taxpayer has complied with the APA. In 2007, rolling multi-year averaging was used for seven Covered Transactions. Five of those used three-year averages. Seven Covered Transactions used a cumulative multi-year average, while 40 Covered Transactions used term averages and three or fewer Covered Transactions used partial term averages.

Adjustments

Where a taxpayer's actual transactions do not produce results that conform to the TPM, a taxpayer must nonetheless report its taxable income in an amount consistent with the TPM (an APA primary adjustment), as further discussed in § 11.02 of Rev. Proc. 2006–9. When the TPM specifies an arm's length range, an APA primary adjustment is necessary only if the taxpayer's actual transactional result falls outside the specified range.

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

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

The various term lengths for APAs executed in 2007 are set forth in Table 28 below:

TABLE 28: TERMS OF APAs

APA Term in Years	Number of APAs
1	0
2	0
3	1
4	5
5	51
6	12
7	4
8	6
9	0
10 or more	2

The number of rollback years to which an APA TPM was applied in 2007 is set forth in Table 29 below:

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

Number of Rollback Years	Number of APAs
1	4
2	3
3	6
4	4
5 or more	6

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

APAs executed in 2007 required that taxpayers provide various documents with their annual reports. These documents are described in Table 30 below:

TABLE 30: NATURE OF DOCUMENTATION REQUIRED

Documentation	Number of Times Required
Statement identifying all material differences between Taxpayer's business operations during APA Year and description of Taxpayer's business operations contained in Taxpayer's request for APA, or if there have been no such material differences, a statement to that effect	81

Documentation — Continued	Number of Times Required
Description of any failure to meet Critical Assumptions or, if there have been none, a statement to that effect	81
Statement identifying all material changes in Taxpayer's accounting methods and classifications, and methods of estimation, from those described or used in Taxpayer's request for APA, or if there have been none, statement to that effect	81
Description of, reason for, and financial analysis of, any Compensating Adjustments with respect to APA Year, including means by which any Compensating Adjustment has been or will be satisfied	81
Financial analysis demonstrating Taxpayer's compliance with TPM	81
Organizational chart	81
Copy of the APA	81
Financial statements as prepared in accordance with US GAAP	75
Certified public accountant's opinion that financial statements present fairly financial position of Taxpayer and the results of its operations, in accordance with US GAAP	75
Book to tax reconciliations	15
Financial statements as prepared in accordance with a foreign GAAP	13
Certified public accountant's opinion that financial statements present fairly financial position of Taxpayer and the results of its operations, in accordance with a foreign GAAP	9
Various work papers	5
United States income tax return	≤ 3
Changes in entity classifications	≤ 3
Changes in Taxpayer notice information	≤ 3
Officer's opinion (substitute for outside CPA audit)	≤ 3
Schedule of costs and expenses (*e.g.*, intercompany allocations)	≤ 3
Certified public accountant's review of financial statements	≤ 3
Pertinent intercompany agreements	≤ 3
Reconciliation of foreign to US GAAP	≤ 3
Other	5

Approaches for Sharing of Currency or Other Risks
[§ 521(b)(2)(D)(xii)]

During 2007, there were 37 tested parties that faced financial risks, including interest rate and currency risks. In appropriate cases, APAs may provide specific approaches for dealing with currency risk, such as adjustment mechanisms and/or critical assumptions.

Efforts to Ensure Compliance with APAs
[§ 521(b)(2)(F)]

As described in Rev. Proc. 2006–9, § 11.01, APA taxpayers are required to file annual reports to demonstrate compliance with the terms and conditions of the APA. The filing and review of annual reports is a critical part of the APA process. Through annual report review, the APA Program monitors taxpayer compliance with the APA on a contemporaneous basis. Annual report review provides current information on the success or problems associated with the various TPMs adopted in the APA process.

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

The statistics for the review of APA annual reports are reflected in Table 31 below. As of December 31, 2007, there were 222 pending annual reports. In 2007, 334 reports were closed.

TABLE 31: STATISTICS OF ANNUAL REPORTS

Number of APA annual reports pending as of December 31, 2007	222
Number of APA annual reports closed in Year 2007	334
Number of APA annual reports requiring adjustment in Year 2007	17
Number of taxpayers involved in adjustments	5
Number of APA annual report cases over one year old	100

Attachment A
Model APA — Based on Revenue Procedure 2006–9

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

PARTIES

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

RECITALS

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

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

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

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

AGREEMENT

The Parties agree as follows:

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

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

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

4. *Operation*.

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

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

5. *Compliance*.

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

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

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

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

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

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

iii. revise this APA, if the Parties agree.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

WITNESS,

The Parties have executed this APA on the dates below.

[Taxpayer Name in all caps]

By: ____ Date: ________, 20 _____

Jane Doe
Sr. Vice President (Taxes)

IRS

By: ____ Date: ________, 20 _____

Matthew W. Frank
Director, Advance Pricing Agreement Program

APPENDIX A

COVERED TRANSACTIONS AND TRANSFER PRICING METHOD (TPM)

1. Covered Transactions.

[*Define the Covered Transactions*.]

2. TPM.

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

[The Tested Party is __________.]

• **CUP Method**

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

• **CUT Method**

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

• **Resale Price Method (RPM)**

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

- **Cost Plus Method**

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

- **CPM with Berry Ratio PLI**

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

- **CPM using an Operating Margin PLI**

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

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

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

- **Residual Profit Split Method**

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

[*Insert additional provisions as needed*.]

3. Application of TPM.

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

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

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

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

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

4. APA Revenue Procedure Treatment

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

[*Insert additional provisions as needed.*]

APPENDIX B

CRITICAL ASSUMPTIONS

This APA's critical assumptions are:

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

[*Insert additional provisions as needed.*]

APPENDIX C

APA RECORDS AND ANNUAL REPORT

APA RECORDS

The APA Records will consist of:

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

ANNUAL REPORT

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

5. A copy of the APA.

APPENDIX D

DEFINITIONS

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

Term	Definition
Annual Report	A report within the meaning of Revenue Procedure 2006–9, section 11.01.
APA	This Advance Pricing Agreement, which is an "advance pricing agreement" within the meaning of Revenue Procedure 2006–9, section 2.04.
APA Records	The records specified in Appendix C.
APA Request	Taxpayer's request for this APA dated ________, including any amendments or supplemental or additional information thereto.
Covered Transaction(s)	This term is defined in Appendix A.
Financial Statements	Financial statements prepared in accordance with U.S. GAAP and stated in U.S. dollars.
Foreign Group	Worldwide Group members that are not U.S. persons.
Foreign Participants	[name the foreign entities involved in Covered Transactions].
I.R.C.	The Internal Revenue Code of 1986, 26 U.S.C., as amended.
Pub. L. 106–170	The Ticket to Work and Work Incentives Improvement Act of 1999.
Revenue Procedure 2006–9	Rev. Proc. 2006–9, 2006–1 C.B. 278.
Transfer Pricing Method (TPM)	A transfer pricing method within the meaning of Treasury Regulations section 1.482–1(b) and Revenue Procedure 2006–9, section 2.04.
U.S. GAAP	U.S. generally-accepted accounting principles.
U.S. Group	Worldwide Group members that are U.S. persons.
U.S. Return	For each taxable year, the "returns with respect to income taxes under subtitle A" that Taxpayer must "make" in accordance with I.R.C. section 6012. {*Or substitute for partnership:* For each taxable year, the "return" that Taxpayer must "make" in accordance with I.R.C. section 6031.}
Worldwide Group	Taxpayer and all organizations, trades, businesses, entities, or branches (whether or not incorporated, organized in the United States, or affiliated) owned or controlled directly or indirectly by the same interests.

APPENDIX E

APA ANNUAL REPORT SUMMARY FORM

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

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

APA Information

Taxpayer Name: ________________________

Taxpayer EIN:__________ NAICS:__________

APA Term: Taxable years ending ______ to ______.

Original APA [ ] Renewal APA [ ]

Annual Report due dates:
______, 200__ for all APA Years through APA Year ending in 200__; for each APA Year thereafter, on ____ [month and day] immediately following the close of the APA Year.

Principal foreign country(ies) involved in covered transaction(s): ____________

Type of APA: [ ] unilateral [ ] bilateral with __________

Tested party is [ ] US [ ] foreign [ ] both

Approximate dollar volume of covered transactions (on an annual basis) involving tangible goods and services:
[ ] N/A [ ] <$50 million [ ] $50–100 million [ ] $100–250 million [ ] $250–500 million
[ ] >$500 million

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

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

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

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

APA Annual Report Checklist of Key Contents (to be completed by the Taxpayer)	Financial analysis reflecting TPM calculations	[ ] yes [ ] no
	Financial statements showing compliance with TPM(s)	[ ] yes [ ] no
	Schedule M–1 or M–3 book-tax differences	[ ] yes [ ] no
	Current organizational chart of relevant portion of world-wide group	[ ] yes [ ] no
	Attach copy of APA	[ ] yes [ ] no
	Other APA records and documents included:	
	[The information required in the following section should be tailored to the particular case]	
	________________	[ ] yes [ ] no
	________________	[ ] yes [ ] no
	________________	[ ] yes [ ] no
	________________	[ ] yes [ ] no
	________________	[ ] yes [ ] no

Contact Information	Authorized Representative	Phone Number	Affiliation and Address

ATTACHMENT B

EXAMPLE FORMULAS FOR BALANCE SHEET ADJUSTMENTS

The formulas below provide examples of the balance sheet adjustment formulas used in the APA Program's CPM spreadsheet model.[12] The formulas below are applicable to the operating margin profit level indicator. The APA Program's calculations measure balance sheet intensity by reference to the denominator of the profit level indicator (*e.g.*, for the Berry ratio, the denominator used is operating expenses). Therefore, the formulas vary for each profit level indicator.

Definitions of Variables:

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

Equations:

Example Assuming Profit Level Indicator is Operating Margin:

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

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

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

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

Then Adjust Comparables as Follows:

adjusted $sales_c = sales_c + RA$

adjusted $cogs_c = cogs_c + PA - IA$

adjusted $opex_c = opex_c - PPEA$

Reduction of Foreign Tax Credit Limitation Categories Under Section 904(d); Correction

Announcement 2008–29

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Correcting amendments.

SUMMARY: This document contains corrections to final and temporary regulations (T.D. 9368, 2008–6 I.R.B. 382) that were published in the **Federal Register** on Friday, December 21, 2007 (72 FR 72582) regarding the reduction of the number of separate foreign tax credit limitation categories under section 904(d) of the Internal Revenue Code. These regulations affect taxpayers claiming foreign tax credits and provide guidance needed to comply with the statutory changes made by the American Jobs Creation Act of 2004 (AJCA).

DATES: The correction is effective March 21, 2008.

FOR FURTHER INFORMATION CONTACT: Jeffrey L. Parry, (202) 622–3850 (not a toll-free number).

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

SUPPLEMENTARY INFORMATION:

Background

The final and temporary regulations (T.D. 9368) that are the subject of the correction are under section 904 of the Internal Revenue Code.

Need for Correction

As published, final and temporary regulations (T.D. 9368) contain errors that may prove to be misleading and are in need of clarification.

* * * * *

Correction of Publication

Accordingly, 26 CFR part 1 is corrected by making the following amendments:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read, in part, as follows:

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

Par. 2. Section 1.904–4 is amended as follows:

1. In paragraph (h)(4) *Example 3*, in the first sentence, the language "Example (3)" is removed and the language "Example 2" is added in its place.

2. In paragraph (i), in the last sentence, the language "dividends received or accrued by the taxpayer from each separate noncontrolled section 902 corporation" is removed and the language "income in each separate category" is added in its place.

Par. 3. Section 1.904–7T(g) is amended as follows:

3. In paragraph (2), in the last sentence, the language "Similar rules shall apply to characterize any deficits in the pre-2007 pools and previously-taxed earnings and profits described in section 959(c)(1)(A) that are attributable to earnings in the pre-2007 pools." is removed and the language "Similar rules shall apply to characterize any deficits in the pre-2007 pools and previously-taxed earnings and profits described in section 959(c)(1) and (2) that are attributable to earnings in the pre-2007 pools." is added in its place.

4. In paragraph (4), in the last sentence, the language "Similar rules shall apply to characterize any deficits or previously-taxed earnings and profits described in section 959(c)(1)(A) that are attributable to pre-1987 accumulated profits." is removed and the language "Similar rules shall apply to characterize any deficits or previously-taxed earnings and profits described in section 959(c)(1) and (2) that are attributable to pre-1987 accumulated profits." is added in its place.

* * * * *

LaNita Van Dyke,
Chief, Publications and Regulations Branch,
Legal Processing Division,
Associate Chief Counsel
(Procedure and Administration).

(Filed by the Office of the Federal Register on March 20, 2008, 8:45 a.m., and published in the issue of the Federal Register for March 21, 2008, 73 F.R. 15063)

Treatment of Overall Foreign and Domestic Losses; Hearing

Announcement 2008–31

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Cancellation of notice of public hearing on proposed rulemaking by cross-reference to temporary regulations.

SUMMARY: This document cancels a public hearing on proposed rulemaking by cross-reference to temporary regulations (REG–141399–07, 2008–8 I.R.B. 470) providing guidance relating to the recapture of overall foreign and domestic losses.

DATES: The public hearing, originally scheduled for April 10, 2008, at 10 a.m., is cancelled.

FOR FURTHER INFORMATION CONTACT: Richard A. Hurst of the Publications and Regulations Branch, Legal Processing Division, Associate Chief Counsel (Procedure and Administration), at *Richard.A.Hurst@irscounsel.treas.gov.*

SUPPLEMENTARY INFORMATION:

A notice of public hearing that appeared in the **Federal Register** on Friday, December 21, 2007 (72 FR 72646), announced that a public hearing was scheduled for April 10, 2008, at 10 a.m., in the auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. The subject of the public hearing is under section 904 of the Internal Revenue Code.

The public comment period for these regulations expired on March 20, 2008. Outlines of topics to be discussed at the hearing were due on March 20, 2008. The notice of proposed rulemaking by cross-reference to temporary regulations and notice of public hearing instructed those interested in testifying at the public hearing to submit an outline of the topics to be addressed. As of Friday, March 21, 2008, no one has requested to speak. Therefore, the public hearing scheduled for April 10, 2008, is cancelled.

LaNita Van Dyke,
Chief, Publications and Regulations Branch,
Legal Processing Division,
Associate Chief Counsel
(Procedure and Administration).

(Filed by the Office of the Federal Register on March 27, 2008, 8:45 a.m., and published in the issue of the Federal Register for March 28, 2008, 73 F.R. 16611)

Definition of Terms

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

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

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

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

Modified is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the new ruling holds that it applies to both A and B, the prior ruling is modified because it corrects a published position. (Compare with *amplified* and *clarified*, above).

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

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

Superseded describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the new ruling does more than restate the substance of a prior ruling, a combination of terms is used. For example, *modified* and *superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case, the previously published ruling is first modified and then, as modified, is superseded.

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

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

Abbreviations

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

A—Individual.
Acq.—Acquiescence.
B—Individual.
BE—Beneficiary.
BK—Bank.
B.T.A.—Board of Tax Appeals.
C—Individual.
C.B.—Cumulative Bulletin.
CFR—Code of Federal Regulations.
CI—City.
COOP—Cooperative.
Ct.D.—Court Decision.
CY—County.
D—Decedent.
DC—Dummy Corporation.
DE—Donee.
Del. Order—Delegation Order.
DISC—Domestic International Sales Corporation.
DR—Donor.
E—Estate.
EE—Employee.
E.O.—Executive Order.
ER—Employer.
ERISA—Employee Retirement Income Security Act.
EX—Executor.
F—Fiduciary.
FC—Foreign Country.
FICA—Federal Insurance Contributions Act.
FISC—Foreign International Sales Company.
FPH—Foreign Personal Holding Company.
F.R.—Federal Register.
FUTA—Federal Unemployment Tax Act.
FX—Foreign corporation.
G.C.M.—Chief Counsel's Memorandum.
GE—Grantee.
GP—General Partner.
GR—Grantor.
IC—Insurance Company.
I.R.B.—Internal Revenue Bulletin.
LE—Lessee.
LP—Limited Partner.
LR—Lessor.
M—Minor.
Nonacq.—Nonacquiescence.
O—Organization.
P—Parent Corporation.
PHC—Personal Holding Company.
PO—Possession of the U.S.
PR—Partner.
PRS—Partnership.
PTE—Prohibited Transaction Exemption.
Pub. L.—Public Law.
REIT—Real Estate Investment Trust.
Rev. Proc.—Revenue Procedure.
Rev. Rul.—Revenue Ruling.
S—Subsidiary.
S.P.R.—Statement of Procedural Rules.
Stat.—Statutes at Large.
T—Target Corporation.
T.C.—Tax Court.
T.D. —Treasury Decision.
TFE—Transferee.
TFR—Transferor.
T.I.R.—Technical Information Release.
TP—Taxpayer.
TR—Trust.
TT—Trustee.
U.S.C.—United States Code.
X—Corporation.
Y—Corporation.
Z —Corporation.

Numerical Finding List[1]

Bulletins 2008–1 through 2008–15

Announcements:

Notices:

Notices— Continued:

Proposed Regulations:

Revenue Procedures:

Revenue Procedures— Continued:

Revenue Rulings:

Tax Conventions:

Treasury Decisions:

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[1] A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 2007–27 through 2007–52 is in Internal Revenue Bulletin 2007–52, dated December 26, 2007.

Finding List of Current Actions on Previously Published Items[1]

Bulletins 2008–1 through 2008–15

Announcements:

2006-88
Clarified and superseded by
Notice 2008-35, 2008-12 I.R.B. *647*
Notice 2008-36, 2008-12 I.R.B. *650*

2008-6
Superseded by
Ann. 2008-19, 2008-11 I.R.B. *624*

Notices:

2001-16
Modified by
Notice 2008-20, 2008-6 I.R.B. *406*

2001-60
Modified and superseded by
Notice 2008-31, 2008-11 I.R.B. *592*

2002-44
Superseded by
Notice 2008-39, 2008-13 I.R.B. *684*

2003-51
Superseded by
Rev. Proc. 2008-24, 2008-13 I.R.B. *684*

2006-27
Clarified and superseded by
Notice 2008-35, 2008-12 I.R.B. *647*

2006-28
Clarified and superseded by
Notice 2008-36, 2008-12 I.R.B. *650*

2006-52
Clarified and amplified by
Notice 2008-40, 2008-14 I.R.B. *725*

2006-77
Clarified and amplified by
Notice 2008-25, 2008-9 I.R.B. *484*

2006-107
Modified by
Notice 2008-7, 2008-3 I.R.B. *276*

2007-30
Modified and superseded by
Notice 2008-14, 2008-4 I.R.B. *310*

2007-54
Clarified by
Notice 2008-11, 2008-3 I.R.B. *279*

2008-27
Clarified, amended, supplemented, and superseded by
Notice 2008-41, 2008-15 I.R.B. *742*

Proposed Regulations:

REG-209020-86
Corrected by
Ann. 2008-11, 2008-7 I.R.B. *445*

REG-107592-00
Partial withdrawal by
Ann. 2008-25, 2008-14 I.R.B. *732*

REG-149856-03
Hearing scheduled by
Ann. 2008-26, 2008-13 I.R.B. *693*

REG-113891-07
Hearing scheduled by
Ann. 2008-4, 2008-2 I.R.B. *269*

REG-127770-07
Hearing scheduled by
Ann. 2008-24, 2008-13 I.R.B. *692*

REG-141399-07
Hearing cancelled by
Ann. 2008-31, 2008-15 I.R.B. *787*

Revenue Procedures:

97-36
Modified by
Rev. Proc. 2008-23, 2008-12 I.R.B. *664*

2001-23
Modified by
Rev. Proc. 2008-23, 2008-12 I.R.B. *664*

2002-9
Modified by
Rev. Proc. 2008-18, 2008-10 I.R.B. *573*
Modified and amplified by
Rev. Proc. 2008-25, 2008-13 I.R.B. *686*

2007-1
Superseded by
Rev. Proc. 2008-1, 2008-1 I.R.B. *1*

2007-2
Superseded by
Rev. Proc. 2008-2, 2008-1 I.R.B. *90*

2007-3
Superseded by
Rev. Proc. 2008-3, 2008-1 I.R.B. *110*

2007-4
Superseded by
Rev. Proc. 2008-4, 2008-1 I.R.B. *121*

2007-5
Superseded by
Rev. Proc. 2008-5, 2008-1 I.R.B. *164*

2007-6
Superseded by
Rev. Proc. 2008-6, 2008-1 I.R.B. *192*

Revenue Procedures— Continued:

2007-7
Superseded by
Rev. Proc. 2008-7, 2008-1 I.R.B. *229*

2007-8
Superseded by
Rev. Proc. 2008-8, 2008-1 I.R.B. *233*

2007-26
Obsoleted in part by
Rev. Proc. 2008-17, 2008-10 I.R.B. *549*

2007-31
Obsoleted in part by
Rev. Proc. 2008-19, 2008-11 I.R.B. *594*

2007-39
Superseded by
Rev. Proc. 2008-3, 2008-1 I.R.B. *110*

2007-52
Superseded by
Rev. Proc. 2008-9, 2008-2 I.R.B. *258*

2008-13
Corrected by
Ann. 2008-15, 2008-9 I.R.B. *511*

Revenue Rulings:

58-612
Clarified and amplified by
Rev. Rul. 2008-15, 2008-12 I.R.B. *633*

64-250
Amplified by
Rev. Rul. 2008-18, 2008-13 I.R.B. *674*

89-42
Modified and superseded by
Rev. Rul. 2008-17, 2008-12 I.R.B. *626*

92-19
Supplemented in part by
Rev. Rul. 2008-19, 2008-13 I.R.B. *669*

97-31
Modified and superseded by
Rev. Rul. 2008-17, 2008-12 I.R.B. *626*

2001-48
Modified and superseded by
Rev. Rul. 2008-17, 2008-12 I.R.B. *626*

2007-4
Supplemented and superseded by
Rev. Rul. 2008-3, 2008-2 I.R.B. *249*

Treasury Decisions:

9362
Corrected by
Ann. 2008-9, 2008-7 I.R.B. *444*
Ann. 2008-12, 2008-7 I.R.B. *446*

[1] A cumulative list of current actions on previously published items in Internal Revenue Bulletins 2007–27 through 2007–52 is in Internal Revenue Bulletin 2007–52, dated December 26, 2007.

Treasury Decisions— Continued:

9363

Corrected by

Ann. 2008-10, 2008-7 I.R.B. *445*

9368

Corrected by

Ann. 2008-29, 2008-15 I.R.B. *786*

9375

Corrected by

Ann. 2008-16, 2008-9 I.R.B. *511*

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