Internal Revenue
bulletin

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HIGHLIGHTS OF THIS ISSUE

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

SPECIAL ANNOUNCEMENT

Announcement 2011–22, page 672.

This document contains the annual report to the public concerning Advance Pricing Agreements (APAs) and the experience of the APA Program during calendar year 2010. 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

Notice 2011–29, page 663.

This notice provides that, pending the resolution of a number of legal and factual issues, the IRS will not challenge a taxpayer's position that the Puerto Rican excise tax is a tax in lieu of an income tax under section 903 of the Code.

Rev. Proc. 2011–26, page 664.

This procedure provides guidance with respect to the 100–percent additional first year depreciation deduction under sections 168(k)(5) of the Code, and the extension of the 50–percent bonus depreciation deduction for qualified property placed in service in 2010. This procedure defines which property is eligible for the 100–percent bonus depreciation deduction and provides guidance regarding the time and manner for making certain elections under sections 168(k)(2) and (5). The procedure also provides a safe harbor method of accounting for passenger automobiles that qualify for the 100–percent additional first year depreciation deduction and that are subject to first-year limitations under section 280F. Rev. Proc. 2011–21 amplified.

EXEMPT ORGANIZATIONS

Notice 2011–20, page 652.

This notice addresses the application of section 501(c)(3) of the Code to tax-exempt organizations participating in the Medicare Shared Savings Program (MSSP) through an accountable care organization (ACO) as described in section 3022 of the Patient Protection and Affordable Care Act. In addition, the notice includes a request for public comments.

ADMINISTRATIVE

Notice 2011–28, page 656.

This notice provides interim guidance to employers with respect to reporting the cost of coverage under an employer-sponsored group health plan on Form W-2, *Wage and Tax Statement,* pursuant to § 6051(a)(14) of the Code.

Finding Lists begin on page ii.

Department of the Treasury
Internal Revenue Service

The IRS Mission

Provide America's taxpayers top-quality service by helping them understand and meet their tax responsibilities and enforce the 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 III. Administrative, Procedural, and Miscellaneous

Notice Regarding Participation in the MSSP through an ACO

Notice 2011–20

The Internal Revenue Service (IRS) is considering the application of the provisions of the Internal Revenue Code (Code) governing tax-exempt organizations to hospitals or other health care organizations that are recognized as organizations described in § 501(c)(3) of the Code (referred to herein as "tax-exempt organizations") participating in the Medicare Shared Savings Program (MSSP) described in § 3022 of the Patient Protection and Affordable Care Act, Pub. L. 111–148, 124 Stat. 119 (Affordable Care Act), enacted March 23, 2010. Accordingly, the IRS is soliciting comments as to whether existing guidance relating to the Code provisions governing tax-exempt organizations is sufficient for those tax-exempt organizations planning to participate in the MSSP through an "accountable care organization" (ACO) and, if not, what additional guidance is needed. The IRS is also soliciting comments concerning whether guidance is needed regarding the tax implications for tax-exempt organizations participating in activities unrelated to the MSSP, including shared savings arrangements with commercial health insurance payers, through ACOs.

BACKGROUND ON ACOS AND THE MSSP

Section 3022 of the Affordable Care Act amends Title XVIII of the Social Security Act (SSA) (42 U.S.C. 1395 *et seq.*) by adding a new § 1899, which directs the Secretary of the Department of Health and Human Services (HHS) to establish a Medicare shared savings program that promotes accountability for care of Medicare beneficiaries, improves the coordination of Medicare fee-for-service items and services, and encourages investment in infrastructure and redesigned care processes for high quality and efficient service delivery. Under § 1899(b)(1) of the SSA, groups of health care service providers and suppliers that have established a mechanism for shared governance and that meet criteria specified by HHS are eligible to participate as ACOs under the program.

Section 1899(b)(1) of the SSA provides examples of groups of service providers and suppliers that may form an ACO, including (i) physicians and other health care practitioners (ACO professionals) in a group practice, (ii) a network of individual practices, (iii) a partnership or joint venture arrangement between hospitals and ACO professionals, and (iv) a hospital employing ACO professionals. ACOs eligible to participate in the MSSP will manage and coordinate care for their assigned Medicare fee-for-service beneficiaries. Health care service providers and suppliers participating in an ACO will continue to receive Medicare fee-for-service payments in the same manner as such payments would otherwise be made. In addition, an ACO that meets quality performance standards established by HHS and demonstrates that it has achieved savings against an appropriate benchmark of expected average *per capita* Medicare fee-for-service expenditures will be eligible to receive payments for Medicare shared savings (MSSP payments) under § 1899(d)(2) of the SSA. Section 1899(i) of the SSA also authorizes the use of other payment models that the HHS Secretary determines will improve the quality and efficiency of items and services for Medicare.

Section 1899(b)(2) of the SSA establishes the following requirements for an ACO to participate in the program:

1. The ACO shall be willing to become accountable for the quality, cost, and overall care of the Medicare fee-for-service beneficiaries assigned to it.
2. The ACO shall enter into an agreement with the HHS Secretary to participate in the program for not less than a 3-year period (the MSSP agreement period).
3. The ACO shall have a formal legal structure that would allow the organization to receive and distribute payments for shared savings under § 1899(d)(2) to participating providers of services and suppliers.
4. The ACO shall include primary care ACO professionals that are sufficient for the number of Medicare fee-for-service beneficiaries assigned to the ACO under § 1899(c). At a minimum, the ACO shall have at least 5,000 such beneficiaries assigned to it under § 1899(c) in order to be eligible to participate in the MSSP.
5. The ACO shall provide the HHS Secretary with such information regarding ACO professionals participating in the ACO as the Secretary determines necessary to support the assignment of Medicare fee-for-service beneficiaries to an ACO, the implementation of quality and the other reporting requirements under § 1899(b)(3), and the determination of payments for shared savings under § 1899(d)(2).
6. The ACO shall have in place a leadership and management structure that includes clinical and administrative systems.
7. The ACO shall define processes to promote evidence-based medicine and patient engagement, report on quality and cost measures, and coordinate care, such as through the use of telehealth, remote patient monitoring, and other such enabling technologies.
8. The ACO shall demonstrate to the HHS Secretary that it meets patient-centeredness criteria specified by the Secretary, such as the use of patient and caregiver assessments or the use of individualized care plans.

Section 1899(b)(3) of the SSA requires the HHS Secretary to establish quality performance standards to assess the quality of care furnished by ACOs and requires ACOs to report data, in a form and manner specified by the HHS Secretary, on measures the Secretary determines necessary to evaluate the quality of care furnished by the ACO. Section 1899(d)(3) of the SSA requires the HHS Secretary to monitor ACOs for avoidance of at-risk patients. If the HHS Secretary determines that an ACO has taken steps to avoid at-risk patients to reduce the likelihood of increasing costs to the ACO, the Secretary may impose appropriate sanctions, including termination from the MSSP.

On March 31, 2011, the Centers for Medicare & Medicaid Services (CMS), the agency within HHS that administers the Medicare program, released a Notice of Proposed Rulemaking (NPRM) addressing § 1899 of the SSA and soliciting comments. The NPRM contains specific, proposed eligibility criteria (including patient and program safeguards) that entities would have to meet to qualify as ACOs under the MSSP, and describes proposed quality measures, reporting requirements, and monitoring by CMS. Consistent with the eligibility requirements under §1899(b), the NPRM proposes requiring an ACO to be an organization that is recognized under applicable State law and that has a governing body with adequate authority to execute the statutory functions of an ACO. The NPRM also proposes requiring an ACO's governing body to include ACO participants (or their designated representatives) and to include Medicare patients who are served by the ACO and do not have a financial connection to the ACO.

In the NPRM, CMS proposes to require potential ACOs seeking to participate in the MSSP to submit written applications to CMS and to describe in their applications how they plan to use and distribute any MSSP payments, and how that plan would contribute to achieving the specific goals of the MSSP and the general aims of better care for individuals, better health for populations, and lower growth in expenditures. The NPRM proposes that CMS would evaluate the ACO's proposal in determining its eligibility to participate in the program.

The NPRM further proposes that CMS will monitor and assess the performance of ACOs and their participants by making site visits, analyzing beneficiary and provider complaints, conducting audits, and analyzing specific financial and quality measurement data reported by the ACO, as well as aggregated annual and quarterly reports. CMS will use these methods to monitor such matters as the ACOs' avoidance of at-risk beneficiaries and its compliance with quality performance standards and eligibility requirements.

In addition, the NPRM proposes to require participating ACOs to comply with public reporting and transparency requirements. For example, each participating ACO would be required to publicly report information about its participating providers of services and suppliers, leadership, quality performance, and shared savings, including MSSP payments (if any) received by the ACO and the total proportion of shared savings distributed among ACO participants and the total proportion used to support quality performance and program goals.

Finally, consistent with the language in § 1899(i) of the SSA that authorizes the use of alternative payment models, the NPRM proposes a "two-sided model," under which participating ACOs would not only be eligible to share in cost savings at higher rates but would also have to repay losses resulting from spending that exceeds a benchmark of expected average *per capita* Medicare fee-for-service expenditures (MSSP losses). ACOs will be able to elect to participate in the two-sided model during the first two years of their initial MSSP agreement period, with all ACOs operating under the two-sided model by the third year of their initial MSSP agreement period, and during any subsequent MSSP agreement period.

LAW

Exemption under § 501(c)(3) of the Code

Section 501(c)(3) of the Code provides, in part, for the exemption from federal income tax of corporations organized and operated exclusively for charitable, scientific, or educational purposes, provided no part of the organization's net earnings inures to the benefit of any private shareholder or individual.

Treas. Reg. § 1.501(c)(3)–1(c)(1) states that an organization will be regarded as operated exclusively for one or more exempt purposes only if it engages primarily in activities that accomplish one or more of such exempt purposes specified in § 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

Treas. Reg. § 1.501(c)(3)–1(c)(2) states that an organization is not operated exclusively for charitable purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals. Courts have interpreted the term "net earnings" as referring to an "advantage, profit, fruit, privilege, gain [or] interest" derived from the organization. *Harding Hospital v. United States*, 505 F.2d 1068, 1072 (6th Cir. 1964); *Retired Teachers Legal Defense Fund v. Commissioner*, 78 T.C. 280, 286 (1982).

Treas. Reg. § 1.501(a)–1(c) defines "private shareholder or individual" as referring to persons having a personal and private interest in the activities of the organization. Such persons are commonly referred to as "insiders."

Treas. Reg. § 1.501(c)(3)–1(d)(1)(ii) states that an organization is not organized exclusively for any of the purposes specified in § 501(c)(3) unless it serves public, rather than private interests. Thus, an organization applying for tax exemption under § 501(c)(3) must establish that it is not organized or operated for the benefit of private interests.

Treas. Reg. § 1.501(c)(3)–1(d)(2) provides that the term "charitable" is used in § 501(c)(3) in its generally accepted legal sense and includes such purposes as relief of the poor and distressed or of the underprivileged; advancement of religion; advancement of education or science; and lessening of the burdens of Government. A determination of whether an organization is lessening the burdens of government requires consideration of whether the organization's activities are ones that a government unit considers to be its burden, and whether such activities actually lessen that burden, based on all the facts and circumstances. *See* Rev. Rul. 85–1 (organization that assists a county's law enforcement agencies in policing illegal narcotics traffic lessens burdens of government); Rev. Rul. 85–2 (organization that provides legal counsel and training to volunteers who serve as guardians *ad litum* in a juvenile court dependency program lessens the burdens of government).

Rev. Rul. 81–276, 1981–2 C.B. 128, describes a professional standards review organization established pursuant to a federal statute to review health care practitioners' and institutions' provision of health care services and items for which payment is made under Medicare and Medicaid, and determine whether the quality of services met professionally recognized standards of care. The IRS ruled that by taking on the government's burden of reviewing the quality of services provided under Medicare and Medicaid, the organization lessened the burdens of government within the meaning of Treas. Reg. § 1.501(c)(3)–1(d)(2). Any benefit to members of the medical profession from such activities was incidental to the benefit the organization provided in lessening the burdens of government. Therefore, the organization qualified for exemption under § 501(c)(3) of the Code.

The "promotion of health has long been recognized as a charitable purpose." Rev. Rul. 98–15, 1998–1 C.B. 718; *see also* Rev. Rul. 69–545, 1969–2 C.B. 117 (noting that "[i]n the general law of charity, the promotion of health is considered to be a charitable purpose"). However, not every activity that promotes health supports tax exemption under § 501(c)(3). For example, selling prescription pharmaceuticals promotes health, but pharmacies cannot qualify for recognition of exemption under § 501(c)(3) on that basis alone. *Federation Pharmacy Services, Inc. v. Commissioner*, 72 T.C. 687 (1979), *aff'd*, 625 F.2d 804 (8th Cir. 1980); *see also IHC Health Plans Inc. v. Commissioner*, 325 F.3d 1188, 1197 (10th Cir. 2003) (noting that "engaging in an activity that promotes health, standing alone, offers an insufficient indicium of an organization's purpose," as "[n]umerous for-profit enterprises offer products or services that promote health"). Furthermore, "an institution for the promotion of health is not a charitable institution if it is privately owned and is run for the profit of the owners." Rev. Rul. 98–15.

In Rev. Rul. 98–15, the IRS recognized that the activities of a limited liability company (LLC) "treated as a partnership for federal income tax purposes are considered to be the activities of a nonprofit organization that is an owner of the LLC when evaluating whether the nonprofit organization is operated exclusively for exempt purposes within the meaning of § 501(c)(3)." *See also* Rev. Rul. 2004–51, 2004–1 C.B. 974 (noting that the activities of an LLC treated as a partnership for tax purposes are attributed to a university that owns 50 percent of the LLC for purposes of determining whether the university "operates exclusively for educational purposes and therefore continues to qualify for exemption under § 501(c)(3)").

Tax on Unrelated Business Income

Section 511(a) of the Code, in part, provides for the imposition of tax on the unrelated business taxable income (as defined in § 512) of organizations described in § 501(c)(3).

Section 512(a)(1) of the Code defines "unrelated business taxable income" as the gross income derived by any organization from any unrelated trade or business (as defined in § 513) regularly carried on by it less the deductions allowed, both computed with the modifications provided in § 512(b).

Section 512(c) of the Code provides that, if a trade or business regularly carried on by a partnership of which an organization is a member is an unrelated trade or business with respect to the organization, in computing its unrelated business taxable income, the organization shall, subject to the exceptions, additions, and limitations contained in § 512(b), include its share (whether or not distributed) of the gross income of the partnership from the unrelated trade or business and its share of the partnership deductions directly connected with the gross income.

Section 513(a) of the Code defines the term "unrelated trade or business" as any trade or business the conduct of which is not substantially related (aside from the need of the organization for income or funds or the use it makes of the profits derived) to the exercise or performance by the organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under § 501.

Treas. Reg. § 1.513–1(d)(2) provides that a trade or business is "related" to an organization's exempt purposes only if the conduct of the business activities has a causal relationship to the achievement of exempt purposes (other than through the production of income). A trade or business is "substantially related" for purposes of § 513, only if the causal relationship is a substantial one. Thus, to be substantially related, the activity "must contribute importantly to the accomplishment of [exempt] purposes." Treas. Reg. § 1.513–1(d)(2).

Rev. Rul. 2004–51 describes a § 501(c)(3) university that, together with a video technology company, formed an LLC with the sole purpose of offering teacher training seminars at off-campus locations using interactive video technology. The university and the company each held a 50 percent ownership interest in the LLC, which was proportionate to the value of their respective capital contributions to the LLC. In addition, the governing documents of the LLC provided that (1) all returns of capital, allocations and distributions were to be made in proportion to the members' respective ownership interests; (2) the LLC would be managed by a governing board comprised of three directors chosen by the university and three directors chosen by the company; (3) the university had the exclusive right to approve the curriculum, training materials, and instructors, and to determine the standards for successful completion of the seminars; and (4) the terms of all contracts and transactions entered into by the LLC with the university and the company and any other parties had to be at arm's length and all contract and transaction prices had to be at fair market value. The IRS noted that because the LLC was treated as a partnership for federal tax purposes, its activities were attributed to the university for purposes of determining whether the university was engaged in an unrelated trade or business. Under these facts and circumstances, the IRS ruled that the university's activities conducted through the LLC constituted a trade or business that was substantially related to the exercise and performance of the university's exempt purposes.

DISCUSSION

Participation in the MSSP Through ACOs by Tax-Exempt Organizations

The IRS anticipates that tax-exempt organizations typically will be participating in the MSSP through an ACO along with private parties, including some that might be considered insiders with respect to the tax-exempt organization. The IRS further anticipates that a tax-exempt organization's participation may take a variety of forms, including membership in a nonprofit membership corporation, ownership of shares in a corporation, ownership of a partnership interest in a partnership (or a membership interest in an LLC), and contractual arrangements with the ACO and/or its other participants.

To avoid adverse tax consequences, the tax-exempt organization must ensure that its participation in the MSSP through an ACO is structured so as not to result in its net earnings inuring to the benefit of its insiders or in its being operated for the benefit of private parties participating in the ACO. The IRS must determine whether prohibited inurement or impermissible private benefit has occurred on a case-by-case basis, based on all the facts and circumstances. Because of CMS regulation and oversight of the MSSP, as a general matter, the IRS expects that it will not consider a tax-exempt organization's participation in the MSSP through an ACO to result in inurement or impermissible private benefit to the private party ACO participants where:

- The terms of the tax-exempt organization's participation in the MSSP through the ACO (including its share of MSSP payments or losses and expenses) are set forth in advance in a written agreement negotiated at arm's length.
- CMS has accepted the ACO into, and has not terminated the ACO from, the MSSP.
- The tax-exempt organization's share of economic benefits derived from the ACO (including its share of MSSP payments) is proportional to the benefits or contributions the tax-exempt organization provides to the ACO. If the tax-exempt organization receives an ownership interest in the ACO, the ownership interest received is proportional and equal in value to its capital contributions to the ACO and all ACO returns of capital, allocations and distributions are made in proportion to ownership interests.
- The tax-exempt organization's share of the ACO's losses (including its share of MSSP losses) does not exceed the share of ACO economic benefits to which the tax-exempt organization is entitled.
- All contracts and transactions entered into by the tax-exempt organization with the ACO and the ACO's participants, and by the ACO with the ACO's participants and any other parties, are at fair market value.

An additional issue raised by the participation of tax exempt organizations in ACOs is whether the share of the MSSP payments received by a tax-exempt organization will be subject to unrelated business income tax (UBIT) under § 511. Whether the MSSP payments will be subject to UBIT depends on whether the activities generating the MSSP payments are substantially related to the exercise or performance of the tax-exempt organization's charitable purposes constituting the basis for its exemption under § 501.

The IRS expects that, absent inurement or impermissible private benefit, any MSSP payments received by a tax-exempt organization from an ACO would derive from activities that are substantially related to the performance of the charitable purpose of lessening the burdens of government within the meaning of Treas. Reg. § 1.501(c)(3)–1(d)(2), as long as the ACO meets all of the eligibility requirements established by CMS for participation in the MSSP. *See, e.g.*, Rev. Rul. 81–276 (recognizing that the federal government considers the provision of Medicare to be its burden). Congress established the MSSP to be conducted through ACOs in order to promote quality improvements and cost savings, thereby lessening the government's burden associated with providing Medicare benefits.

The IRS is soliciting comments regarding what additional guidance, if any, is needed to facilitate participation by tax-exempt organizations in the MSSP through ACOs. If additional guidance is needed, the IRS is soliciting comments regarding what criteria or requirements should be analyzed in determining whether participation by a tax-exempt organization in the MSSP through an ACO is consistent with tax-exempt status under § 501(c)(3) and whether the tax-exempt organization is receiving unrelated business income.

ACO's Conduct of Activities Unrelated to the MSSP

The IRS understands that some tax-exempt organizations might participate in ACOs conducting activities unrelated to the MSSP, including entering into and operating under shared savings arrangements with other types of health insurance payers (non-MSSP activities). The IRS anticipates that, in contrast to activities conducted as part of the MSSP, many non-MSSP activities conducted by or through an ACO are unlikely to lessen the burdens of government within the meaning of Treas. Reg. § 1.501(c)(3)–1(d)(2). For example, negotiating with private health insurers on behalf of unrelated parties generally is not a charitable activity, regardless of whether the agreement negotiated involves a program aimed at achieving cost savings in health care delivery. However, the IRS recognizes that certain non-MSSP activities may further or be substantially related to an exempt purpose. For example, the NPRM released by CMS anticipates that ACOs may also participate in shared savings arrangements with Medicaid, which may further the charitable purpose of relieving the poor and distressed or the underprivileged. *See* Treas. Reg. § 1.501(c)(3)–1(d)(2). This notice does not address whether and under what circumstances a tax-exempt organization's participation in non-MSSP activities through an ACO will be consistent with an organization's tax-exemption under § 501(c)(3) or not result in UBIT. However, the IRS requests comments regarding what guidance, if any, is necessary or appropriate regarding a tax-exempt organization's participation in non-MSSP activities through an ACO.

Specifically, the IRS requests comments regarding how a tax-exempt organization's participation in particular non-MSSP activities through an ACO further or are substantially related to an exempt purpose. Comments should describe the activities a tax-exempt organization might expect to participate in through an ACO and address under what rationale participation in such non-MSSP activities might further exempt purposes and also what criteria, requirements, and safeguards would ensure the furtherance of these exempt purposes. In particular, comments should address how a participating tax-exempt organization will ensure that non-MSSP activities further exempt purposes in the absence of safeguards similar to those present in the MSSP, such as (1) any regulatory requirements imposing quality performance and other standards on the non-MSSP activities and (2) any oversight and monitoring of the non-MSSP activities by a government agency such as CMS.

Comments should also take into account two principles under existing law. First, although the promotion of health has been recognized as a charitable purpose, not every activity that promotes health supports tax exemption under § 501(c)(3). *See IHC Health Plans*, 325 F.3d at 1197;

Fed'n Pharmacy Serv., 72 T.C. at 691–92; Rev. Rul. 98–15. Second, if a tax-exempt organization is a partner (or member, in the case of an LLC) of an ACO treated as a partnership for federal tax purposes, the ACO's activities will be attributed to the tax-exempt organization for purposes of determining both whether the organization operates exclusively for exempt purposes and whether it is engaged in an unrelated trade or business. *See, e.g.*, Rev. Rul. 2004–51; Rev. Rul. 98–15.

REQUEST FOR PUBLIC COMMENT

Public comments should be submitted in writing on or before May 31, 2011. Comments should be sent to the following address:

Internal Revenue Service
SE:T:EO:RA:G (Notice 2011–20)
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044

Comments may be hand delivered to:

SE:T:EO:RA:G (Notice 2011–20)
Courier's Desk
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Comments may also be sent electronically to *notice.comments@irscounsel.treas.gov*. Please include "Notice 2011–20" in the subject line.

All comments will be available for public inspection.

DRAFTING INFORMATION

The principal author of this notice is Mackenzie McNaughton of Exempt Organizations, Tax Exempt and Government Entities Division. For further information regarding this notice, contact Mackenzie McNaughton at (202) 283–9484 (not a toll-free call).

Interim Guidance on Informational Reporting to Employees of the Cost of Their Group Health Insurance Coverage

Notice 2011–28

I. PURPOSE

This notice provides interim guidance on informational reporting to employees of the cost of their employer-sponsored group health plan coverage. This informational reporting is required under § 6051(a)(14) of the Code, enacted as part of the Affordable Care Act to provide useful and comparable consumer information to employees on the cost of their health care coverage. As more fully described below —

- This reporting to employees is for their information only, to inform them of the cost of their health care coverage, and does not cause excludable employer-provided health care coverage to become taxable. Nothing in § 6051(a)(14), this notice, or the additional guidance that is contemplated under § 6051(a)(14), causes or will cause otherwise excludable employer-provided health care coverage to become taxable.

- This notice provides interim guidance that generally applies beginning with 2012 Forms W–2 (that is, the forms required for the calendar year 2012 that employers generally are required to furnish to employees in January 2013 and then file with the Social Security Administration (SSA)). Employers are not required to report the cost of health coverage on any forms required to be furnished to employees prior to January 2013. See Notice 2010–69. However, any employers that choose to report earlier (on the 2011 Forms W–2 generally furnished to employees in January 2012) may look to this notice for guidance regarding that voluntary earlier reporting.

- This notice also provides additional transition relief for certain employers and with respect to certain types of employer-sponsored coverage. This transition relief will continue at least through the 2012 Forms W–2 which are required to be furnished to employees in January 2013. In other words, those employers to which the additional transition relief applies (which includes smaller employers that are required to file fewer than 250 2011 Forms W–2) will not be required to report the cost of health care coverage on any forms required to be furnished to employees prior to January 2014. This transition relief will continue until the issuance of further guidance.

- Comments are invited on this interim guidance.

Section 6051(a)(14) was added to the Code by § 9002 of the Patient Protection and Affordable Care Act of 2010 (the Affordable Care Act), Public Law 111–148, enacted March 23, 2010, and provides that the reporting be made on Form W–2, *Wage and Tax Statement.* Notice 2010–69, 2010–44 I.R.B. 567, provides that this reporting will not be mandatory for 2011 Forms W–2 (that is, the forms required for the calendar year 2011 that employers are generally required to give employees in January 2012 and then file with the Social Security Administration).

As explained above, this notice provides interim guidance that generally is applicable beginning with 2012 Forms W–2. In addition, employers may rely on the guidance provided in this notice if they voluntarily choose to report the cost of coverage on 2011 Forms W–2, even though this reporting is not required for 2011. This interim guidance is applicable until further guidance is issued. To the extent that future guidance applies the reporting requirement to additional employers or categories of employers or additional types of coverage that guidance will apply prospectively only and will not apply to any calendar year beginning within six months of the date the guidance is issued. Also as explained above, this notice provides transition relief for certain employers and with respect to certain types of employer-sponsored coverage. See section IV of this notice. This transition relief will be extended at least through the 2012 Forms W–2 and the availability of this transition relief through the 2012 Forms W–2 will not be affected by the issuance of any further guidance. Thus, reporting by these employers and with respect to these types of coverage will not be required for calendar year 2012 (that is, on the Forms W–2 that employers generally are required to furnish to employees in January 2013 and then file with the SSA). For example, as provided in Q&A–3 of this notice, employers that are required to file fewer than 250 2011 Forms W–2 will not be subject to the reporting requirement for 2012 Forms W–2.

The interim guidance is set forth in section III of this notice. Q&A–1 and Q&A–2 discuss the general requirements. Q&A–3 identifies the employers subject to the reporting requirements. Q&A–4 through Q&A–10 provide the methods for reporting the cost of the coverage on the Form W–2. Q&A–11 through Q&A–15 define certain terms related to the cost of coverage required to be reported on the Form W–2. Q&A–16 through Q&A–23 set forth the types of coverage the cost of which is required to be included in the amount reported on the Form W–2. Q&A–24 through Q&A–27 discuss several calculation methods that may be used to determine the cost of the coverage. Q&A–28 through Q&A–31 address a number of other issues employers may encounter in determining the cost of the coverage. Section IV of this notice contains transition relief for certain employers and with respect to certain types of employer-sponsored coverage. Section V of this notice contains a request for comments on all aspects of this guidance, including any areas to be addressed in further guidance or future regulations that will provide the final rules under § 6051(a)(14).

II. BACKGROUND

Section 6051(a) provides generally that an employer must provide a written statement to each employee showing the remuneration paid by such person to such employee during the calendar year, on or before January 31 of the succeeding year (or, if the employee terminates employment during the year, within 30 days after the date of receipt of a request from such employee submitted before January 2). Form W–2, *Wage and Tax Statement*, is the form used to provide an employee this information.

Section 6051(a)(14) provides generally that the aggregate cost of applicable employer-sponsored coverage must be included in the information reported on Form W–2, effective for taxable years beginning on or after January 1, 2011. Section 6051(a)(14), provides that, for this purpose, the aggregate cost is to be determined under rules similar to the rules of § 4980B(f)(4), referring to the definition of the "applicable premium" for purposes of COBRA continuation coverage.

Section 6051(a)(14) does not apply to reporting the amount contributed to any Archer MSA (as defined in § 220(d)) or to any health savings account (as defined in § 223(d)) of an employee or an employee's spouse. See § 6051(a)(11) and (a)(12). Section 6051(a)(14) also does not apply to the amount of any salary reduction contributions to a flexible spending arrangement (within the meaning of §§ 106(c)(2) and 125).

Section 6051(a)(14) provides that the aggregate cost of applicable employer-sponsored coverage (the amount required to be reported on Form W–2) has the same meaning as in § 4980I(d)(1). Section 4980I(d)(1)(A) provides that the term "applicable employer-sponsored coverage" means, with respect to any employee, coverage under any group health plan made available to the employee by an employer which is excludable from the employee's gross income under § 106, or would be so excludable if it were employer-provided coverage (within the meaning of § 106). Section 4980I(f)(4) provides that, for purposes of § 4980I(d)(1) the term "group health plan" has the same meaning as under § 5000(b)(1).

Under section 4980I(d)(1)(B), the term "applicable employer-sponsored coverage" does not include (i) any coverage (whether through insurance or otherwise) described in § 9832(c)(1) (other than coverage for on-site medical clinics described in subparagraph (G) thereof) or for long-term care, or (ii) any coverage under a separate policy, certificate, or contract of insurance which provides benefits substantially all of which are for treatment of the mouth (including any organ or structure within the mouth) or for treatment of the eye, or (iii) any coverage described in § 9832(c)(3) the payment for which is not excludable from gross income and for which a deduction under § 162(l) is not allowable.

The types of coverage described in § 9832(c)(1) (providing that certain "excepted benefits" are not subject to the requirements of chapter 100 of the Code) that are not subject to this reporting requirement are as follows:

- Coverage only for accident, or disability income insurance, or any combination thereof;
- Coverage issued as a supplement to liability insurance;
- Liability insurance, including general liability insurance and automobile liability insurance;
- Workers' compensation or similar insurance;
- Automobile medical payment insurance;
- Credit-only insurance;
- Other similar insurance coverage, specified in regulations, under which benefits for medical care are secondary or incidental to other insurance benefits.

The types of coverage described in § 9832(c)(3) include the following, provided that such coverage is offered as independent, noncoordinated benefits:

(A) coverage only for a specified disease or illness; and

(B) hospital indemnity or other fixed indemnity insurance.

Section 4980I(d)(1)(C) provides that coverage shall be treated as applicable employer-sponsored coverage without regard to whether the employer or employee pays for the coverage.

Section 4980I(d)(1)(E) provides that applicable employer-sponsored coverage shall include coverage under any group health plan established and maintained primarily for its civilian employees by the Government of the United States, by the government of any State or political subdivision thereof, or by any agency or instrumentality of any such government.

Section 4980B(f)(4)(A) provides that the term "applicable premium" means, with respect to any period of continuation coverage of qualified beneficiaries, the cost to the plan for such period of the coverage for similarly situated beneficiaries with respect to whom a qualifying event has not occurred (without regard to whether such cost is paid by the employer or employee). Section 4980B(f)(4)(B) provides a special rule for self-insured plans, generally requiring that such plans calculate the applicable premium through one of two methods — the actuarial method or the past cost method. Section 4980B(f)(4)(C) provides that the determination of any applicable premium shall be made for a period of 12 months and shall be made before the beginning of such period.

Section 54.4980B–1, Q&A–2 of the Miscellaneous Excise Tax Regulations, provides that, for purposes of § 4980B, for topics relating to the COBRA continuation coverage requirements of § 4980B that are not addressed in §§54.4980B–1 through 54.4980B–10 (such as methods for calculating the applicable premium), plans and employers must operate in good faith compliance with a reasonable interpretation of the statutory requirements in § 4980B.

III. INTERIM GUIDANCE

This interim guidance generally is applicable beginning with 2012 Forms W–2 (that is, the forms required for the calendar year 2012 that employers generally are required to furnish to employees in January 2013 and then file with the SSA). In addition, employers may rely on the guidance provided in this notice if they voluntarily choose to report the cost of coverage on 2011 Forms W–2, even though such reporting is not required for 2011. This interim guidance is applicable until further guidance is issued. To the extent that future guidance applies the reporting requirement to additional employers or categories of employers, additional types of coverage, or otherwise applies the reporting requirement more expansively, that guidance will apply prospectively only and will not apply to any calendar year beginning within six months of the date the guidance is issued. See also Section IV of this notice for certain transition relief that will be extended at least through the 2012 Forms W–2.

Except as otherwise specified, the interim guidance in this section applies solely for purposes of § 6051(a)(14) and no inference should be drawn concerning any other provision of the Code.

In General (Q&A–1 and Q&A–2)

Q–1: What does § 6051(a)(14) require?

A–1: Section 6051(a)(14) generally requires the aggregate cost of applicable employer-sponsored coverage to be reported on Form W–2.

Q–2: Does the new requirement under § 6051(a)(14) to report the aggregate cost of employer-sponsored coverage on Form W–2, or compliance with this requirement, have any impact on whether such coverage is taxable?

A–2: No. The new requirement is informational only. The provisions of § 6051(a)(14) do not affect whether any particular coverage is excludable from gross income under § 106 or any other Code provision, and the reporting of any amount on Form W–2 in compliance with the requirements of § 6051(a)(14) will not affect the amount includable in income or the amount reported in any other box on Form W–2. The purpose of the reporting is to provide useful and comparable consumer information to employees on the cost of their health care coverage.

Employers Subject to the Reporting Requirement (Q&A–3)

Q–3: What employers are subject to the reporting requirement under § 6051(a)(14)?

A–3: Except as provided in this Q&A–3, all employers that provide applicable employer-sponsored coverage (see Q&A–12) during a calendar year are subject to the reporting requirement under § 6051(a)(14). This includes federal, state and local government entities, churches and other religious organizations, and employers that are not subject to the COBRA continuation coverage requirements under § 4980B, to the extent such employers provide applicable employer-sponsored coverage under a group health plan, but does not include Federally recognized Indian tribal governments. (Notice 2010–69 provides that reporting by these employers is not mandatory until the 2012 Forms W–2 (that is, the forms required for the calendar year 2012 that employers generally are required to furnish to employees in January 2013 and then file with the Social Security Administration (SSA))).

However, in the case of the 2012 Forms W–2 and until the issuance of further guidance, an employer is not subject to the reporting requirement for any calendar year if the employer was required to file fewer than 250 Forms W–2 for the preceding calendar year. (This rule is based upon the rule in § 6011(e) that exempts employers from filing returns electronically if they file fewer than 250 returns.) Therefore, if an employer files fewer than 250 2011 Forms W–2 (meaning the Forms W–2 for the 2011 calendar year that employers generally furnish to employees In January 2012 and then file with SSA), the employer would not be subject to the reporting requirement for Forms W–2 for the 2012 calendar year (meaning the Forms W–2 for the 2012 calendar year that employers generally furnish to employees in January, 2013 and then file with SSA). See also Q&A–21 for an exception to the reporting requirement for coverage under a self-insured plan that is not subject to any federal continuation coverage requirements, and see also Q&A–22 for an exception from the reporting requirement for plans maintained primarily for members of the military, or primarily for members of the military and their families.

Method of Reporting on the Form W–2 (Q&A–4 through Q&A–10)

Q–4: Is the reporting of the aggregate cost of applicable employer-sponsored coverage required for Forms W–2 issued for the 2010 or 2011 calendar years?

A–4: No. Section 6051(a)(14) does not apply to Forms W–2 for calendar years prior to 2011 and, accordingly, reporting of the aggregate cost of applicable employer-sponsored coverage is not required for Forms W–2 issued for the 2010 calendar year. Moreover, Notice 2010–69 provides that reporting will not be mandatory for the 2011 calendar year and, accordingly, an employer will not be treated as failing to meet the requirements of § 6051 for 2011, and will not be subject to any penalties for failure to meet such requirements, merely because it does not report the aggregate cost of applicable employer-sponsored coverage on Forms W–2 for 2011.

Q–5: How is the aggregate reportable cost reported on Form W–2?

A–5: The aggregate reportable cost is reported on Form W–2 in box 12, using code DD.

Q–6: What rules apply in the case of coverage provided by the employer for a period during a calendar year after an employee has terminated employment?

A–6: An employer may apply any reasonable method of reporting the cost of coverage provided under a group health plan for an employee who terminated employment during the calendar year, provided that the method is used consistently for all employees receiving coverage under that plan who terminate employment during the calendar year. However, regardless of the method of reporting used by the employer for other terminated employees, an employer is not required to report any amount in box 12, Code DD for an employee who, pursuant to §31.6051–1(d)(1)(i), has requested before the end of the calendar year during which the employee terminated employment to receive a Form W–2.

Example 1. Employee is an employee of Employer on January 1, and continues in employment through April 25. During that entire period and through April 30, Employee had individual coverage for himself under a group health plan with a cost of coverage of $350 per month. Employee elects continuation coverage for the six months following termination of employment, covering the period May 1 through October 31, for which the Employee pays $350 per month. Employer reports $1,400 as the reportable cost under the plan for the calendar year, covering the four months during which Employee performed services and had coverage as an active employee. Employer applies this method consistently for all employees terminating during the calendar year who have coverage under that group health plan. Employer has applied a reasonable method of reporting Employee's reportable cost under the plan.

Example 2. Same facts as *Example 1*, except that Employer reports $3,500 as the reportable cost under the plan for the calendar year, covering both the monthly periods during which Employee performed services and had coverage as an active employee, and the monthly periods during which Employee retained continuation coverage under the plan. Employer applies this method consistently for all employees terminating during the calendar year who retained coverage under that group health plan. Employer has applied a reasonable method of reporting Employee's reportable cost under the plan.

Q–7: In the case of an individual who is an employee of multiple employers within a calendar year, must each employer provide a Form W–2 reporting the aggregate reportable cost?

A–7: Each employer providing employer-sponsored coverage must report the aggregate reportable cost of coverage it provides. However, if the employers are related employers within the meaning of § 3121(s) and one such employer is a common paymaster within the meaning of § 3121(s) for wages paid to the employee, the common paymaster must include the aggregate reportable cost of the coverage provided to that employee by all the employers for whom it serves as the common paymaster on the Form W–2 issued by the common paymaster. In such case, the related employers that are not the common paymaster must not report the cost of coverage they provide. For employers participating in a multiemployer healthcare plan, see Q&A–17.

Q–8: In the case of an individual who transfers to a new employer that qualifies as a successor employer under § 3121(a)(1), must both the predecessor and successor employers report the aggregate reportable cost of coverage each provided?

A–8: Yes, unless the successor employer follows the optional procedure in Rev. Proc. 2004–53, 2004–2 C.B. 320, and issues one Form W–2 reflecting wages paid to the employee during the calendar year by both the predecessor employer and the successor employer. Consistent with the rules applicable to reporting of wages, the successor employer following the optional procedure must include the aggregate reportable cost of coverage provided by both employers on the Form W–2 that it issues, and the predecessor employer must not report the cost of coverage it provides.

Q–9: Must an employer issue a Form W–2 including the aggregate reportable cost to an individual to whom the employer is not otherwise required to issue a Form W–2, such as a retiree or other former employee receiving no compensation required to be reported on a Form W–2?

A–9: No. An employer is not required to issue a Form W–2 including the aggregate reportable cost to an individual to whom the employer is not otherwise required to issue a Form W–2.

Q–10: Is the total of the aggregate reportable costs attributable to an employer's employees required to be reported on Form W–3, *Transmittal of Wage and Tax Statements*?

A–10: No. The total of the aggregate reportable costs attributable to an employer's employees is not required to be reported on Form W–3, *Transmittal of Wage and Tax Statements*.

Aggregate Cost of Applicable Employer-Sponsored Coverage (Q&A–11 through Q&A–15)

Q–11: What is the aggregate cost of applicable employer-sponsored coverage and how is the aggregate cost of applicable employer-sponsored coverage referred to in this notice?

A–11: The aggregate cost of applicable employer-sponsored coverage is the total cost of coverage under all applicable employer-sponsored coverage (as defined in Q&A–12 of this notice) provided to the employee. In this notice, the cost of coverage under a group health plan is referred to as the reportable cost and the aggregate cost of applicable employer-sponsored coverage is referred to as the aggregate reportable cost.

Q–12: What is applicable employer-sponsored coverage?

A–12: Applicable employer-sponsored coverage means, with respect to any employee, coverage under any group health plan (see Q&A–13) made available to the employee by an employer that is excludable from the employee's gross income under § 106, or would be so excludable if it were employer-provided coverage (within the meaning of such § 106), except that applicable employer-sponsored coverage does not include:

(1) any coverage for long-term care,

(2) any coverage (whether through insurance or otherwise) described in § 9832(c)(1) (other than subparagraph (G) thereof (coverage for on-site medical clinics)),

(3) any coverage under a separate policy, certificate, or contract of insurance which provides benefits substantially all of which are for treatment of the mouth (including any organ or structure within the mouth) or for treatment of the eye, and

(4) any coverage described in § 9832(c)(3) the payment for which is not excludable from gross income and for which a deduction under § 162(l) is not allowable

See Q&A–16 through Q&A–23 for guidance on applicable employer-sponsored coverage that is not required to be included in the aggregate reportable cost.

Q–13: What is a group health plan?

A–13: A group health plan is a plan (including a self-insured plan) of, or contributed to by, an employer (including a self-employed person) or employee organization to provide health care (directly or otherwise) to the employees, former employees, the employer, others associated or formerly associated with the employer in a business relationship, or their families. For purposes of identifying whether a specific arrangement is a group health plan, taxpayers may rely upon a good faith application of a reasonable interpretation of the statutory provisions and applicable guidance, including §54.4980B–2, Q&A–1.

Q–14: Does the aggregate reportable cost include both the portion of the cost paid by the employer and the portion of the cost paid by the employee?

A–14: Yes. The aggregate reportable cost generally includes both the portion of the cost paid by the employer and the portion of the cost paid by the employee, regardless of whether the employee paid for that cost through pre-tax or after-tax contributions. However, see Q&A–19 regarding contributions to a health FSA.

Q–15: Does the aggregate reportable cost include any portion of the cost of coverage under an employer-sponsored group health plan that is includible in the employee's gross income, for example, the cost of coverage for a person other than an employee, the employee's spouse, the employee's dependent, or the employee's child who will not have attained age 27 by the end of the taxable year?

A–15: Yes. The aggregate reportable cost includes the cost of coverage under the employer-sponsored group health plan of the employee and any person covered by the plan because of a relationship to the employee, including any portion of the cost that is includible in an employee's gross income. Thus, the aggregate reportable cost is not reduced by the amount of the cost of coverage included in the employee's gross income.

Example. An employee has family health coverage under an employer-sponsored group health plan for himself, his spouse and dependents, and an adult child age 28, with a cost of coverage of $15,000. The fair market value of the health coverage for the adult child age 28 is included in the income and wages of the employee. The aggregate reportable cost with respect to the family health coverage is $15,000.

Cost of Coverage Required to be Included in the Aggregate Reportable Cost (Q&A–16 through Q&A–23)

Q–16: Is the cost of coverage under all applicable employer-sponsored coverage required to be included in the aggregate reportable cost?

A–16: Except as provided in this Q&A and in Q&A–17 through Q&A–23, the cost of coverage under all applicable employer-sponsored coverage must be included in the aggregate reportable cost. However, the following amounts are not included in the aggregate reportable cost and are not permitted to be reported under § 6051(a)(14):

(1) the amount contributed to any Archer MSA (as defined in § 220(d)),

(2) the amount contributed to any Health Savings Account (as defined in § 223(d)), and

(3) the amount of any salary reduction election to a flexible spending arrangement (within the meaning of §§ 106(c)(2) and 125).

Q–17: Is the cost of coverage under a multiemployer plan (as defined in § 54.4980B–2, Q&A–3) required to be included in the aggregate reportable cost reported on Form W–2?

A–17: No. An employer that contributes to a multiemployer plan is not required to include the cost of coverage provided to an employee under that multiemployer plan in determining the aggregate reportable cost. If the only applicable employer-sponsored coverage provided to an employee is provided under a multiemployer plan, the employer is not required to report any amount under § 6051(a)(14) on the Form W–2 for that employee.

Q–18: Is the cost of coverage under a Health Reimbursement Arrangement (HRA) required to be included in the aggregate reportable cost reported on Form W–2?

A–18: No. An employer is not required to include the cost of coverage under an HRA in determining the aggregate reportable cost. If the only applicable employer-sponsored coverage provided to an employee is an HRA, the employer is not required to report any amount under § 6051(a)(14) on the Form W–2 for that employee.

Q–19: If an employer offers a health flexible spending arrangement (health FSA) through a § 125 cafeteria plan, is the amount of the health FSA required to be included in the aggregate reportable cost reported on Form W–2?

A–19: The amount of a health FSA for a cafeteria plan year equals the amount of salary reduction (as defined in Proposed Treas. Reg. §1.125–1(r)) elected by the employee for the plan year, plus the amount of any optional employer flex credits (as defined under Proposed Treas. Reg. §1.125–5(b), expressed as a fixed amount, or as a formula such as matching salary reduction), that the employee elects to apply to the health FSA. In determining the aggregate reportable cost, the amount of the health FSA is reduced (but not below zero) by the employee's salary reduction election (see Q&A–16).

If the amount of salary reduction (for all qualified benefits) elected by an employee equals or exceeds the amount of the health FSA for the plan year, the employer does not include the amount of the health FSA for that employee in the aggregate reportable cost. However, if the amount of the health FSA for the plan year exceeds the salary reduction elected by the employee for the plan year, then the amount of that employee's health FSA minus the employee's salary reduction election for the health FSA must be included in the aggregate reportable cost and reported under § 6051(a)(14).

For purposes of this Q&A–19, a health FSA means an FSA (as defined in Proposed Treas. Reg. §1.125–5(a)) that is a medical reimbursement arrangement.

Example 1: Employer maintains a § 125 cafeteria plan that offers permitted taxable benefits (including cash) and qualified nontaxable benefits (including a health FSA). The plan offers an employer flex credit of $1,000. Employee makes a $2,000 salary reduction election for several qualified benefits under the plan, including a health FSA for $1,500. The cost of the qualified benefits for Employee under the plan for the year is $3,000. The amount of Employee's salary reduction election ($2,000) for the plan year equals or exceeds the amount of the health FSA ($1,500) for the plan year. Thus, for purposes of reporting on Form W–2, none of the health FSA amount is taken into account for purposes of determining the aggregate reportable cost.

Example 2: Employer maintains a § 125 cafeteria plan that offers permitted taxable benefits (including cash) and qualified nontaxable benefits (including a health FSA). The plan offers a flex credit in the form of a match of each employee's salary reduction contribution. Employee makes a $700 salary reduction election for a health FSA. Employer provides an additional $700 to the health FSA to match Employee's salary reduction election. The amount of the health

FSA for Employee for the plan year is $1,400. The amount of Employee's health FSA ($1,400) for the plan year exceeds the salary reduction election ($700) for the plan year. The employer must include $700 ($1,400 health FSA amount minus $700 salary reduction) in determining the aggregate reportable cost.

Q–20: Is the cost of coverage under a dental plan or a vision plan included in the aggregate reportable cost, if that plan is not integrated into a group health plan providing other types of health coverage subject to the reporting requirements of § 6051(a)(14)?

A–20: No. An employer is not required to include the cost of coverage under a dental plan or a vision plan if such plan is not integrated into a group health plan providing additional health care coverage subject to the reporting requirements of § 6051(a)(14). An employer must include the cost of coverage under a dental plan or a vision plan if such plan is integrated into a group health plan providing such additional health care coverage.

Q–21: Is the cost of coverage provided under a self-insured group health plan that is not subject to any federal continuation coverage requirements (for example, a church plan within the meaning of § 4980B(d)(3) that is a self-insured group health plan) required to be included in the aggregate reportable cost reported on Form W–2?

A–21: No. An employer is not required to include in the aggregate reportable cost the cost of coverage provided under a self-insured group health plan that is not subject to any federal continuation coverage requirements. If the only group health plan coverage provided to an employee by the employer is provided under a self-insured group health plan that is not subject to any federal continuation coverage requirements, the employer is not required to report any amount under § 6051(a)(14) on the Form W–2 for that employee. Employers who provide coverage under a self-insured group health plan that is subject to Federal continuation coverage requirements must report the cost of coverage on Form W–2. For this purpose, federal continuation coverage requirements include the COBRA requirements under the Code, the Employee Retirement Income Security Act of 1974 or the Public Health Service Act and the temporary continuation coverage requirement under the Federal Employees Health Benefits Program.

Q–22: Is the cost of coverage provided by the federal government, the government of any State or political subdivision thereof, or any agency or instrumentality of any such government, under a plan maintained primarily for members of the military or for members of the military and their families, required to be included in the aggregate reportable cost reported on Form W–2?

A–22: No.

Q–23: In determining the aggregate reportable cost, how should an employer treat an excess reimbursement of a highly compensated individual that is included in gross income under § 105(h)?

A–23: The cost of applicable employer-sponsored coverage is not modified because of excess reimbursements of highly compensated individuals that are included in gross income under § 105(h); that is, an excess reimbursement that is included in income is neither added to the cost of coverage, nor subtracted from the cost of coverage, in determining the aggregate reportable cost.

Example: Employer provides self-insured health coverage with a cost of coverage of $12,000 under which a highly compensated individual receives a $4,000 excess reimbursement. As a result, under § 105(h), that individual must include the $4,000 excess reimbursement in gross income. The excess reimbursement does not modify the determination of the aggregate reportable cost, so that Employer must include $12,000 as the cost of coverage under the plan in determining the aggregate reportable cost for that individual.

Methods of Calculating the Cost of Coverage (Q&A–24 through Q&A–27)

Q–24: How may an employer calculate the reportable cost under a plan?

A–24: An employer may calculate the reportable cost under a plan using the COBRA applicable premium method (Q&A–25). Alternatively, (1) an employer that is determining the cost of coverage for an employee covered by the employer's insured plan may calculate the reportable cost using the premium charged method (Q&A–26); and (2) an employer that subsidizes the cost of coverage or that determines the cost of coverage for a year by applying the cost of coverage in a prior year may calculate the reportable cost using the modified COBRA premium method (Q&A–27). For employers that charge employees a composite rate (the same premium for different types of coverage under a plan, for example, a premium for self-only coverage versus family coverage), see Q&A–28.

The reportable cost for an employee receiving coverage under the plan is the sum of the reportable costs for each period (such as a month) during the year as determined under the method used by the employer. An employer is not required to use the same method for every plan, but must use the same method with respect to a plan for every employee receiving coverage under that plan.

Q–25: How does an employer calculate the reportable cost for a period under the COBRA applicable premium method?

A–25: Under the COBRA applicable premium method, the reportable cost for a period equals the COBRA applicable premium for that coverage for that period. If the employer applies this method, the employer must calculate the COBRA applicable premium in a manner that satisfies the requirements under § 4980B(f)(4). Under current guidance, the COBRA applicable premium calculation would meet these requirements if the employer made such calculation in good faith compliance with a reasonable interpretation of the statutory requirements under § 4980B (see §54.4980B–1, Q&A–2).

Q–26: How does an employer calculate the reportable cost for a period under the premium charged method?

A–26: The premium charged method may be used to determine the reportable cost only for an employee covered by an employer's insured group health plan. In such a case, if the employer applies this method, the employer must use the premium charged by the insurer for that employee's coverage (for example, for single-only coverage or for family coverage, as applicable to the employee) for each period as the reportable cost for that period.

Q–27: How does an employer calculate the reportable cost for a period under the modified COBRA premium method?

A–27: An employer may use the modified COBRA premium method with respect to a plan only where it subsidizes the cost of COBRA (so that the premium charged to COBRA qualified beneficiaries is less than the COBRA applicable premium) or where the actual premium charged by the employer to COBRA qualified beneficiaries for each period in the current year is equal to the COBRA applicable premium for each period in a prior year. If the employer subsidizes the cost of COBRA, the employer may determine the reportable cost for a period based upon a reasonable good faith estimate of the COBRA applicable premium for that period, if such reasonable good faith estimate is used as the basis for determining the subsidized COBRA premium. If the actual premium charged by the employer to COBRA qualified beneficiaries for each period in the current year is equal to the COBRA applicable premium for each period in a prior year, the employer may use the COBRA applicable premium for each period in the prior year as the reportable cost for each period in the current year.

Example 1: For the calendar year 2012, Employer A subsidizes 50% of a reasonable good faith estimate of the COBRA applicable premium. Employer A's reasonable good faith estimate of the COBRA applicable premium for self-only coverage for each month in 2012 is $300. Accordingly, the actual COBRA premium Employer A charges individuals eligible for COBRA continuation coverage electing self-only coverage is $150 per month. Solely for purposes of § 6051(a)(14) reporting, if Employer A uses the modified COBRA premium method, it must treat $300 per month (the reasonable good faith estimate of the COBRA applicable premium) as the monthly reportable cost for self-only coverage for the calendar year 2012.

Example 2: Employer B determined that the COBRA applicable premium for each month in calendar year 2011 for individuals eligible for COBRA continuation coverage electing self-only coverage would be $350 per month, and charged an actual COBRA premium for such coverage of $357 per month ($350 x 102%). Employer B knows that the cost of coverage for 2012 is not less than the COBRA applicable premium for 2011 and decides not to make a new determination of the COBRA applicable premium for the calendar year 2012 but rather to continue to charge an actual COBRA premium for self-only coverage of $357 per month ($350 x 102%). Solely for purposes of § 6051(a)(14) reporting, if Employer B uses the modified COBRA premium method, it must treat $350 per month ($357 charged — $7 increase permissible under COBRA) as the monthly reportable cost for self-only coverage for the calendar year 2012.

Example 3: Employer C makes a good faith estimate of the COBRA applicable premium for the calendar year 2012 for individuals eligible for COBRA continuation coverage electing self-only coverage of $500 per month. To ensure compliance with the COBRA requirements despite not calculating a precise COBRA applicable premium, Employer C charges an actual COBRA premium of $350 per month for individuals eligible for COBRA coverage electing self-only coverage. Solely for purposes of § 6051(a)(14) reporting, if Employer C uses the modified COBRA premium method, it must treat $500 per month as the monthly reportable cost for self-only coverage for the calendar year 2012.

Other Issues Relating to Calculating the Cost of Coverage (Q&A–28 through Q&A–31)

Q–28: How may an employer charging an employee a composite rate calculate the reportable cost for a period?

A–28: An employer is considered to charge employees a composite rate (1) if there is a single coverage class under the plan (that is, if an employee elects coverage, all individuals eligible for coverage under the plan because of their relationship to the employee are included in the elections and no greater amount is charged to the employee regardless of whether the coverage will include only the employee or the employee plus other such individuals), or (2) if there are different types of coverage under a plan (for example, self-only coverage and family coverage, or self-plus-one coverage and family coverage) and employees are charged the same premium for each type of coverage. In such a case, the employer using a composite rate may calculate and use the same reportable cost for a period for (1) the single class of coverage under the plan, or (2) all the different types of coverage under the plan for which the same premium is charged to employees, provided this method is applied to all types of coverage provided under the plan.

For example, if a plan charges one premium for either self-only coverage, or self-and-spouse coverage (the first coverage group), and also charges one premium for family coverage regardless of the number of family members covered (the second coverage group), an employer may calculate and report the same reportable cost for all of the coverage provided in the first coverage group, and the same reportable cost for all of the coverage provided in the second coverage group. In such a case, the reportable costs under the plan must be determined under one of the methods described in Q&A–25 through Q&A–27 for which the employer is eligible.

Q–29: If the reportable cost for a period changes during the year, must the reportable cost under the plan for the year for an employee reflect the increase or decrease?

A–29: If the cost for a period changes during the year (for example, under the COBRA applicable premium method because the 12-month period for determining the COBRA applicable premium is not the calendar year), the reportable cost under the plan for an employee for the year must reflect the increase or decrease for the periods to which the increase or decrease applies. For examples of the application of this rule, see Q&A–30 below.

Q–30: How is the reportable cost under a plan calculated if an employee commences, changes or terminates coverage during the year?

A–30: If an employee changes coverage during the year, the reportable cost under the plan for the employee for the year must take into account the change in coverage by reflecting the different reportable costs for the coverage elected by the employee for the periods for which such coverage is elected. If the change in coverage occurs during a period (for example, in the middle of a month where costs are determined on a monthly basis), an employer may use any reasonable method to determine the reportable cost for such period, such as using the reportable cost at the beginning of the period or at the end of the period, or averaging or prorating the reportable costs, provided that the same method is used for all employees with coverage under that plan. Similarly, if an employee commences coverage or terminates coverage during a period, an employer may use any reasonable method to calculate the reportable cost for that period, provided that the same method is used for all employees with coverage under the plan.

The following examples illustrate the principles set forth in Q&A–29 and Q&A–30:

Example 1: Employer determines that the monthly reportable cost under a group health plan for self-only coverage for the calendar year 2012 is $500. Employee is employed by employer for the entire calendar year 2012, and had self-only coverage under the group health plan for the entire year. For purposes of reporting for the 2012 calendar year, Employer must treat the 2012 reportable cost under the plan for Employee as $6,000 ($500 x 12).

Example 2: Employer determines that the monthly reportable cost under a group health plan for self-only coverage for the period October 1, 2011 through September 30, 2012 is $500, and that the monthly reportable cost under a group health plan for self-only coverage for the period October 1, 2012 through September 30, 2013 is $520. Employee is employed by employer for the entire calendar year 2012 and had self-only coverage under the group health plan for the entire year. For purposes of reporting for the 2012 calendar year, Employer must treat the 2012 reportable cost under the plan for Employee as $6,060 (($500 x 9) + ($520 x 3)).

Example 3: Employer determines that the monthly reportable cost under a group health plan for self-only coverage for the calendar year 2012 is $500, and that the monthly reportable cost under the same group health plan for self-plus-spouse coverage for the calendar year 2012 is $1,000. Employee is employed by Employer for the entire calendar year 2012. Employee had self-only coverage under the group health plan from January 1, 2012 through June 30, 2012, and then had self-plus-spouse coverage from July 1, 2012 through December 31, 2012. For purposes of reporting for the 2012 calendar year, Employer must treat the 2012 reportable cost under the plan for Employee as $9,000 (($500 x 6) + ($1,000 x 6)).

Example 4: Employer determines that the monthly reportable cost under a group health plan for self-only coverage for the calendar year 2012 is $500. Employee commences employment and self-only coverage under the group health plan on March 14, 2012, and continues employment and self-only coverage through the remainder of the calendar year. For purposes of reporting for the 2012 calendar year, Employer treats the cost of coverage under the plan for Employee for March 2012 as $250 ($500 x 1/2). Because Employer's method of calculating the reportable cost of under the plan for March 2012 by prorating the reportable cost for March 2012 to reflect Employee's date of commencement of coverage is reasonable, Employer must treat the 2012 reportable cost under the plan for Employee as $4,750 (($500 x 1/2) + ($500 x 9)).

Q–31: If an employer has used a 12-month determination period that is not the calendar year for purposes of applying the COBRA applicable premium under a plan, may the employer also use that 12-month determination period for purposes of calculating the reportable cost for the year under the plan?

A–31: No. The reportable cost under a plan must be determined on a calendar year basis. For rules on translating the COBRA applicable premium to a calendar year amount, see Q&A–29 and Q&A–30.

IV. TRANSITION RELIEF

Certain provisions of this interim guidance provide transition relief intended to facilitate compliance with the reporting requirement under § 6051(a)(14). See Q&A–3 (relief for employers filing fewer than 250 Forms W–2); Q&A–6 (relief with respect to certain Forms W–2 furnished to terminated employees before the end of the year); Q&A–17 (relief with respect to multiemployer plans); Q&A–18 (relief for HRAs); Q&A–20 (relief with respect to certain dental and vision plans); and Q&A–21 (relief with respect to self-insured plans of employers not subject to COBRA continuation coverage or similar requirements). Future guidance may limit the availability of some or all of this transition relief; however, such guidance will be prospective only and will not be applicable earlier than January 1 of the calendar year beginning at least six months after its date of issuance. In no case will such guidance limit the availability of this transition relief for the 2012 Forms W–2 (meaning Forms W–2 for the calendar year 2012 that employers generally are required to furnish to employees in January 2013 and then file with the SSA). For example, in no event will reporting be required for 2012 Forms W–2 for any employer required to file fewer than 250 2011 Forms W–2.

V. REQUEST FOR COMMENTS

The Treasury Department and the IRS request comments on all aspects of this interim guidance and the reporting requirements under § 6051(a)(14), including areas that should be addressed in proposed and final regulations or other future guidance. Comments are requested on how future guidance could further reduce the burden of compliance with the reporting requirements while still providing useful and comparable consumer information to employees on the cost of their health care coverage. In addition, the Treasury Department and the IRS request comments on any challenges employers may face in implementing the reporting requirements for the 2012 Forms W–2, and how further guidance could address those challenges, including through the provision of additional transition relief. In particular, Treasury and IRS request comments on issues that would arise in applying the reporting requirements to employers contributing to multiemployer plans (see Q&A–17), such as the potential methods by which the coverage provided to an employee could be allocated among the contributing employers and the potential methods by which contributing employers could obtain the requisite information to report the reportable cost. Comments are also particularly requested as to issues that would arise in applying the reporting requirements to employers that filed fewer than 250 Forms W–2 for the previous calendar year (see Q&A–3), and to employers that sponsor a self-insured plan that is not subject to any federal continuation coverage requirements (see Q&A–21).

Comments must be submitted by July 18, 2011. All materials submitted will be available for public inspection and copying. Comments should be submitted to Internal Revenue Service, CC:PA:LPD:RU (Notice 2011–28), Room 5203, PO Box 7604, Ben Franklin Station, Washington, DC 20224. Submissions may also be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to the Courier's Desk, 1111 Constitution Avenue, NW, Washington, DC 20224, Attn: CC:PA:LPD:RU (Notice 2011–28), Room 5203. Submission may also be sent electronically via the internet to the following email address: *Notice.comments@irscounsel.treas.gov*. Include the notice number (Notice 2011–28) in the subject line.

VI. DRAFTING INFORMATION

The principal author of this notice is Leslie Paul of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities), though other Treasury Department and IRS officials participated in its development. For further information, contact Leslie Paul at (202) 622–6080 (not a toll-free number).

Puerto Rican Excise Tax

Notice 2011–29

On October 25, 2010, Puerto Rico enacted legislation amending the Puerto Rico Internal Revenue Code of 1994 ("PR IRC"). The legislation adds new rules ("Expanded ECI Rules") to section 1123 of the PR IRC that characterize certain income of nonresident corporations, partnerships, and individuals (collectively, "nonresidents") as effectively connected with the conduct of a trade or business in Puerto Rico ("PR ECI") and therefore subject to Puerto Rican income tax. The legislation also adds new section 2101 to the PR IRC to impose an excise tax ("Excise Tax") on a controlled group member's acquisition from another group member of certain personal property manufactured or produced in Puerto Rico and certain services performed in Puerto Rico. Technical corrections to the legislation were enacted on October 28, 2010, and January 31, 2011. Final regulations relating to the Expanded ECI Rules and the Excise Tax were published on December 29, 2010. The Expanded ECI Rules and the Excise Tax are generally effective for income accruing and acquisitions occurring, respectively, after December 31, 2010.

Section 901 allows a credit against U.S. income tax for the amount of any income, war profits and excess profits tax (collectively, an "income tax") paid or accrued during the taxable year to any foreign country or to any possession of the United States. A foreign levy is an income tax only if (a) it is a tax and (b) the predominant character of that tax is that of an income tax in the U.S. sense. §1.901–2(a)(1) of the Income Tax Regulations.

Under section 903, an income tax includes a tax paid or accrued in lieu of an income tax that is otherwise generally imposed by any foreign country or by any possession of the United States. Section 1.903–1(a) provides that a foreign levy is a tax in lieu of an income tax only if it is a tax within the meaning of §1.901–2(a)(2) and it meets the "substitution requirement" of §1.903–1(b). A foreign levy satisfies the substitution requirement only if it operates in substitution for and not in addition to a generally imposed income tax or series of income taxes and only to the extent that liability for the foreign tax is not dependent (by its terms or otherwise) on the availability of a credit for the foreign tax against income tax liability to another country. §1.903–1(b)(1) and (2).

The IRS and the Treasury Department are evaluating the Excise Tax. The provisions of the Excise Tax are novel. The determination of the creditability of the Excise Tax requires the resolution of a number of legal and factual issues. Pending the resolution of these issues, the IRS will not challenge a taxpayer's position that the Excise Tax is a tax in lieu of an income tax under section 903. This notice is effective for Excise Tax paid or accrued on or after January 1, 2011. Any change in the foreign tax credit treatment of the Excise Tax after resolution of the pending issues will be prospective, and will apply to Excise Tax paid or accrued after the date that further guidance is issued.

Various personnel from the IRS and the Treasury Department participated in the development of this notice. For further information regarding this notice, contact Richard L. Chewning at (202) 622–3850 (not a toll-free call).

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26 CFR 601.105: Examination of returns and claims for refund, credit, or abatement; determination of correct tax liability.
(Also Part I, §§ 168, 280F; 1.168(k)–1.)

Rev. Proc. 2011–26

SECTION 1. PURPOSE

This revenue procedure provides guidance under § 2022(a) of the Small Business Jobs Act of 2010, Pub. L. No. 111–240, 124 Stat. 2504 (September 27, 2010) (SBJA), and § 401(a) and (b) of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111–312, 124 Stat. 3296 (December 17, 2010) (TRUIRJCA). Sections 2022(a) of the SBJA and 401(a) of the TRUIRJCA amend § 168(k)(2) of the Internal Revenue Code by extending the placed-in-service date for property to qualify for the 50-percent additional first year depreciation deduction. Section 401(b) of the TRUIRJCA amends § 168(k) by adding § 168(k)(5), which temporarily allows a 100-percent additional first year depreciation deduction for certain new property.

SECTION 2. BACKGROUND

.01 Prior to the enactment of the SBJA, § 168(k)(1) allowed a 50-percent additional first year depreciation deduction for qualified property acquired by a taxpayer after 2007 and placed in service by the taxpayer before 2010 (before 2011 in the case of property described in § 168(k)(2)(B) and (C)). Section 2022(a) of the SBJA amends § 168(k)(2) by extending the placed-in-service date to before 2011 (before 2012 in the case of property described in § 168(k)(2)(B) and (C)), and extending other dates in § 168(k)(2) from "January 1, 2010" to "January 1, 2011" (for example, the self-constructed property rules in § 168(k)(2)(E)(i)). Section 2022(c) of the SBJA provides that these amendments apply to property placed in service after December 31, 2009, in taxable years ending after that date.

.02 Section 401(a) of the TRUIRJCA further amends § 168(k)(2) by extending the placed-in-service date to before 2013 (before 2014 in the case of property described in § 168(k)(2)(B) and (C)), and extending other dates in § 168(k)(2) from "January 1, 2011" to "January 1, 2013" (for example, the self-constructed property rules in § 168(k)(2)(E)(i)). Section 401(e)(1) of the TRUIRJCA provides that these amendments apply to property placed in service after December 31, 2010, in taxable years ending after that date.

.03 Section 401(b) of the TRUIRJCA also amends § 168(k) by adding § 168(k)(5) to the Code. It allows a 100-percent additional first year depreciation deduction for qualified property acquired by a taxpayer (under rules similar to the rules of § 168(k)(2)(A)(ii) and (iii)) after September 8, 2010, and before January 1, 2012, and placed in service by the taxpayer before January 1, 2012 (before January 1, 2013, in the case of property described in § 168(k)(2)(B) and (C)). Section 401(e)(2) of the TRUIRJCA provides that § 168(k)(5) applies to property placed in service after September 8, 2010, in taxable years ending after such date. Section 3 of this revenue procedure defines which property is eligible for the 100-percent additional first year depreciation deduction.

.04 Sections 1.168(k)–1(b)(4)(iii)(C)(*1*) and (*2*) of the Income Tax Regulations provide that if the manufacture, construction, or production of the larger self-constructed property begins before December 31, 2007 (as modified by the dates in § 168(k)(2)(E)(i)), for qualified property, the larger self-constructed property and any acquired or self-constructed components related to the larger self-constructed property do not qualify for the 50-percent additional first year depreciation deduction. Because of the policies underlying the enactment of an unprecedented 100-percent additional first year depreciation provision, rules similar to, but not necessarily the same as, the acquisition rules under § 168(k)(2)(A)(iii) for qualified property are warranted solely for purposes of § 168(k)(5). Accordingly, the Treasury Department and the Internal Revenue Service ("the Service") will allow, solely for purposes of § 168(k)(5), a limited exception to this rule in §§ 1.168(k)–1(b)(4)(iii)(C)(*1*) and (*2*) for certain components. See section 3.02(2)(b) of this revenue procedure for this limited exception.

.05 Section 168(k)(2)(D)(iii) provides that a taxpayer may elect not to deduct additional first year depreciation for any class of property placed in service by the taxpayer during the taxable year. The term "class of property" is defined in § 1.168(k)–1(e)(2)(i) to mean, in general, each class of property described in § 168(e) (for example, 5-year property). If the taxpayer makes this election, it applies to all qualified property that is in the same class and placed in service in the same taxable year. This revenue procedure provides a limited exception for a taxpayer to elect the 50-percent, instead of the 100-percent, additional first year depreciation deduction for certain qualified property placed in service by the taxpayer in its taxable year that includes September 9, 2010 (see section 4.02 of this revenue procedure). Section 4.03 of this revenue procedure specifies the time and manner for making this election.

.06 Section 1.168(k)–1(e)(3)(i) provides that the election not to deduct additional first year depreciation must be made by the due date (including extensions) of the federal tax return for the taxable year in which the taxpayer places the property in service. Section 1.168(k)–1(e)(3)(ii) provides that this election generally must be made in the manner prescribed on Form 4562, *"Depreciation and Amortization,"* and its instructions. The instructions to Form 4562 for the 2009 and 2010 taxable years provide that the election is made by attaching a statement to the taxpayer's timely filed tax return indicating that the taxpayer is electing not to deduct the additional first year depreciation and the class of property for which the taxpayer is making the election. Section 1.168(k)–1(e)(7)(i) provides that once the election is made, it generally may be revoked only with the written consent of the Commissioner of Internal Revenue. Some taxpayers with a taxable year beginning in 2009 and ending in 2010 that filed their 2009 federal tax returns before the enactment of the SBJA are uncertain how to claim or not claim the 50-percent additional first year depreciation for qualified property placed in service after December 31, 2009, in taxable years ending in 2010. Section 5 of this revenue procedure provides the procedures for claiming or not claiming the 50-percent additional first year depreciation for this property.

SECTION 3. 100-PERCENT ADDITIONAL FIRST YEAR DEPRECIATION DEDUCTION

.01 *In General*. Depreciable property is eligible for the 100-percent additional first year depreciation deduction if the property is qualified property (as defined in § 168(k)(2), as amended by the SBJA and the TRUIRJCA) and also meets the additional requirements in section 3.02 of this revenue procedure. For purposes of determining whether depreciable property is qualified property, rules similar to the rules in § 1.168(k)–1 for "qualified property" or for "30-percent additional first year depreciation deduction" apply.

.02 *Application of Additional Requirements and Revised Dates*.

(1) *In general*. For purposes of § 168(k)(5), qualified property is eligible for the 100-percent additional first year depreciation deduction if the property meets all of the following additional requirements in the first taxable year in which the property is subject to depreciation by the taxpayer, whether or not depreciation deductions for that property are allowable:

(a) The taxpayer acquires the qualified property after September 8, 2010, and before January 1, 2012 (before January 1, 2013, in the case of qualified property described in § 168(k)(2)(B) or (C)). Solely for purposes of § 168(k)(5) and this section 3.02(1)(a), a taxpayer acquires the qualified property when the taxpayer pays or incurs the cost of the property. Qualified property that a taxpayer manufactures, constructs, or produces (as defined under § 1.168(k)–1(b)(4)(iii)(A) and modified by this section 3.02(1)(a) solely for purposes of § 168(k)(5)) for use in its trade or business or for its production of income is acquired by the taxpayer for purposes of § 168(k)(5) and this section 3.02(1)(a) when the taxpayer begins constructing, manufacturing, or producing that property (as determined under § 1.168(k)–1(b)(4)(iii)(B)). If a taxpayer enters into a written binding contract (as defined in § 1.168(k)–1(b)(4)(ii)) after September 8, 2010, and before January 1, 2012, to acquire (including to manufacture, construct, or produce) qualified property described in § 168(k)(2)(B) or (C), the property will be treated as having met the acquisition requirement of this section 3.02(1)(a). See section 3.02(2) of this revenue procedure for additional rules applicable to self-constructed property.

(b) The taxpayer places the qualified property in service after September 8, 2010, and before January 1, 2012 (before January 1, 2013, in the case of qualified property described in § 168(k)(2)(B) or (C)). For this purpose, rules similar to the rules in § 1.168(k)–1(b)(5) apply. However, in applying § 1.168(k)–1(b)(5)(ii), "December 31, 2007" is substituted for "September 10, 2001."

(c) The original use of the qualified property commences with the taxpayer after September 8, 2010. For this purpose, rules similar to the rules in § 1.168(k)–1(b)(3) apply. However, in applying § 1.168(k)–1(b)(3)(i), "September 8, 2010" is substituted for "September 10, 2001" and, in applying § 1.168(k)–1(b)(3)(iii), "December 31, 2007" is substituted for "September 10, 2001."

(2) *Self-constructed property*.

(a) *Application of § 1.168(k)–1(b)(4)(iii)*. If a taxpayer manufactures, constructs, or produces qualified property for use by the taxpayer in its trade or business or for its production of income, rules similar to the self-constructed property rules in § 1.168(k)–1(b)(4)(iii) apply for determining whether this property meets the acquisition requirement of section 3.02(1)(a) of this revenue procedure. However, see section 3.02(2)(b) of this revenue procedure for a limited exception for certain components of a larger self-constructed property. Further, in applying § 1.168(k)–1(b)(4)(iii)(C)(*1*) solely for purposes of § 168(k)(5), an acquired component that is qualified property is not required to be acquired pursuant to a written binding contract (as defined in § 1.168(k)–1(b)(4)(ii)) to satisfy the acquisition requirement of section 3.02(1)(a) of this revenue procedure. For purposes of the additional first year depreciation deduction, the term "component" is intended to refer to any part used in the manufacture, construction, or production of the larger self-constructed property, which may or may not be the same as the asset for depreciation purposes or the same as the unit of property for purposes of other Code sections.

(b) *Limited exception for components acquired or self-constructed after September 8, 2010, and before January 1, 2012, when the manufacture, construction, or production of larger self-constructed property begins before September 9, 2010*. Solely for purposes of § 168(k)(5) and section 3.02(1)(a) of this revenue procedure, the Treasury Department and the Service will allow a limited exception to the rule described in section 2.04 of this revenue procedure for the components described in this section 3.02(2)(b). If before September 9, 2010, a taxpayer begins the manufacture, construction, or production of the larger self-constructed property that is qualified property for use in its trade or business or for its production of income, but this larger self-constructed property meets the requirements of sections 3.02(1)(b) and (c) of this revenue procedure, the taxpayer may elect to treat any acquired or self-constructed component of that larger self-constructed property as being eligible for the 100-percent additional first year depreciation deduction if the component is qualified property and is acquired or self-constructed by the taxpayer after September 8, 2010, and before January 1, 2012 (before January 1, 2013, in the case of qualified property described in § 168(k)(2)(B) or (C)). The taxpayer may make this election for one or more components that are described in this section 3.02(2)(b). The taxpayer must make the election in this section 3.02(2)(b) by the due date (including extensions) of the federal tax return for the taxpayer's taxable year in which the larger self-constructed property is placed in service by the taxpayer, and by attaching a statement to that return indicating that the taxpayer is making the election provided in section 3.02(2)(b) of Rev. Proc. 2011–26 and whether the taxpayer is making the election for all or some of the components described in section 3.02(2)(b) of Rev. Proc. 2011–26. If a taxpayer has timely filed its federal tax return for the taxpayer's taxable year in which the larger self-constructed property is placed in service by the taxpayer on or before April 18, 2011, see § 301.9100–2(b) of the Procedure and Administration Regulations for an automatic extension of 6 months from the due date of that federal return (excluding extensions) to make the election specified in this section 3.02(2)(b).

(3) *Disqualified transactions*. A rule similar to the rule in § 168(k)(2)(E)(iv) applies for determining whether qualified property fails the acquisition requirement of section 3.02(1)(a) of this revenue procedure. Solely for purposes of § 168(k)(5):

(a) Section 168(k)(2)(E)(iv)(I) and (II) is applied by substituting "September 8, 2010" for "December 31, 2007;"

(b) Section 1.168(k)–1(b)(4)(iv)(A) is applied by substituting "September 9, 2010" for "September 11, 2001;" and

(c) In determining when the qualified property was originally placed in service for purposes of § 1.168(k)–1(b)(4)(iv), this determination includes the operation of § 1.168(k)–1(b)(5)(ii) as modified by section 3.02(1)(b) of this revenue procedure, § 1.168(k)–1(b)(5)(iii), and § 1.168(k)–1(b)(5)(iv).

.03 *Special Rules*.

(1) *Application of § 1.168(k)–1(f)*.

(a) *In general*. Solely for purposes of § 168(k)(5), the rules of § 168(k)–1(f) apply to depreciable property that is qualified property and that also meets the requirements of section 3.02 of this revenue procedure. For example, for purposes of the redetermination of basis rules of § 1.168(k)–1(f)(2), the 100-percent additional first year depreciation deduction applies to the increase or decrease in basis of qualified property if the underlying property is eligible for the 100-percent additional first year depreciation deduction. In addition, in applying § 1.168(k)–1(f) for purposes of § 168(k)(5), the taxpayer should make the following substitutions:

(i) "September 8, 2010" is substituted for "September 10, 2001;"

(ii) "January 1, 2012" is substituted for "May 6, 2003;"

(iii) "December 31, 2011" is substituted for "December 31, 2004;"

(iv) "January 1, 2012" is substituted for "January 1, 2005;"

(v) "December 31, 2012" is substituted for "December 31, 2005;" and

(vi) "January 1, 2013" is substituted for "January 1, 2006."

(b) *Limitation of amount of depreciation for certain passenger automobiles*. For purposes of applying § 1.168(k)–1(f)(8) to passenger automobiles (as defined in § 280F(d)(5)), the limitation under § 280F(a)(1)(A)(i) is increased by $8,000 for a passenger automobile that is eligible for the 100-percent additional first year depreciation deduction.

(2) *Property described in § 168(k)(2)(B)*. For property that is qualified property solely by reason of § 168(k)(2)(B)(i) and that is eligible for the 100-percent additional first year depreciation deduction, only the property's adjusted basis attributable to the manufacture, construction, or production before January 1, 2013, is eligible for the 100-percent additional first year depreciation deduction. Section 168(k)(2)(B)(ii).

(3) *Qualified restaurant property and qualified retail improvement property*. Qualified property that meets the definition of both qualified leasehold improvement property (as defined in §§ 168(e)(6), 168(k)(3), and 1.168(k)–1(c)) and qualified restaurant property (as defined in § 168(e)(7)) or qualified retail improvement property (as defined in § 168(e)(8)) is eligible for the 50-percent or 100-percent additional first year depreciation deduction (assuming all other requirements in § 168(k) are met). For example, if in 2011 a taxpayer constructs and places in service qualified property that is an improvement to a restaurant building and that improvement meets the definition of both qualified restaurant property and qualified leasehold improvement property, the improvement is eligible for the 100-percent additional first year depreciation deduction (assuming all other requirements in § 168(k) are met). However, if in 2011 a taxpayer constructs and places in service a new restaurant building, that building is not qualified leasehold improvement property and is not eligible for any additional first year depreciation deduction.

(4) *Mid-quarter convention*. The depreciable basis (as defined in § 1.168(d)–1(b)(4)) of qualified property that is eligible for any additional first year depreciation deduction is taken

into account in determining whether the mid-quarter convention applies to the property placed in service during the taxable year.

(5) *Coordination with other Code sections*.

(a) *Tax credits and section 1603 payments*. Except for the rehabilitation credit under § 47, the 100-percent additional first year depreciation deduction is determined for qualified property eligible for the 100-percent additional first year depreciation deduction after the reduction to the property's basis by the amount of any credits claimed for the property that require an adjustment to basis (for example, the disabled access credit under § 44 or the energy credit under § 48) or any payments received for specified energy property under § 1603 of the American Recovery and Reinvestment Tax Act of 2009, Division B, Pub. L. 111–5, 123 Stat. 115 (section 1603 payments). For the treatment of the rehabilitation credit and the 100-percent additional first year depreciation deduction, a rule similar to the rule in § 1.168(k)–1(f)(10) applies.

(b) *Application of § 50(d)(5)*. For purposes of applying § 50(d)(5), the shortest recovery period under § 168 that is applicable to qualified property eligible for the 100-percent additional first year depreciation deduction is the recovery period assigned to that property under § 168(c).

(c) *Section 280F(a) limitations on passenger automobiles*.

(i) *In general*. If the unadjusted depreciable basis (as defined in § 1.168(b)–1(a)(3)) of a passenger automobile (as defined in § 280F(d)(5)) that is qualified property eligible for the 100-percent additional first year depreciation deduction exceeds the first year limitation amount under § 280F(a)(1)(A)(i), the excess amount is the unrecovered basis of the passenger automobile for purposes of § 280F(a)(1)(B)(i) and, therefore, is treated as a deductible expense in the first taxable year succeeding the end of the recovery period subject to the limitation under § 280F(a)(1)(B)(ii). For example, if a calendar-year taxpayer places in service in December 2010 a passenger automobile that cost $20,000, is not a truck or van, and is eligible for the 100-percent additional first year depreciation deduction, the 100-percent additional first year depreciation deduction for this property is limited to $11,060 under § 280F(a)(1)(A)(i) (see Table 7 of Rev. Proc. 2011–21, 2011–12 I.R.B. 560) and the excess amount of $8,940 is recovered by the taxpayer beginning in taxable year 2016, subject to the limitation under § 280F(a)(1)(B)(ii).

(ii) *Safe harbor method of accounting*. To mitigate the anomalous result that occurs in the taxable years subsequent to the placed-in-service year and before the first taxable year succeeding the end of the recovery period for a passenger automobile that is qualified property eligible for the 100-percent additional first year depreciation deduction, the Treasury Department and the Service are providing a safe harbor method of accounting under this section 3.03(5)(c)(ii). A taxpayer adopts this safe harbor method of accounting by applying it to deduct depreciation of its passenger automobile (as defined in § 280F(d)(5)) on its federal tax return for the first taxable year succeeding the placed-in-service year of the passenger automobile. For a taxpayer with a passenger automobile that has an unadjusted depreciable basis exceeding the first year limitation amount under § 280F(a)(1)(A)(i) and that is qualified property eligible for the 100-percent additional first year depreciation, the safe harbor method of accounting operates as follows:

(A) In the placed-in-service year of the passenger automobile, the taxpayer will deduct the lesser of the 100-percent additional first year depreciation for the passenger automobile or the first year limitation amount under § 280F(a)(1)(A)(i). See Rev. Proc. 2011–21, 2011–12 I.R.B. 560, for the first year limitation amount under § 280F(a)(1)(A)(i) for a passenger automobile placed in service in 2010 or 2011 if either the 50-percent or 100-percent additional first year depreciation deduction applies.

(B) Next, the taxpayer will determine the unrecovered basis of the passenger automobile for its placed-in-service year as though the taxpayer claimed the 50-percent, instead of the 100-percent, additional first year depreciation for the passenger automobile. For this purpose, the unrecovered basis is equal to the depreciation that would be allowable for the passenger automobile had the taxpayer claimed the 50-percent additional first year depreciation deduction less the amount determined under section 3.03(5)(c)(ii)(A) of this revenue procedure.

(C) If there is any unrecovered basis for the passenger automobile in its placed-in-service year (as determined under section 3.03(5)(c)(ii)(B) of this revenue procedure), the taxpayer will determine the depreciation deductions for the passenger automobile for the taxable years subsequent to the placed-in-service year as though the taxpayer claimed the 50-percent, instead of the 100-percent, additional first year depreciation for the passenger automobile, subject to the limitation amounts under § 280F(a)(1)(A). Accordingly, for purposes of § 1.168(k)–1(d)(2), the remaining adjusted depreciable basis of the passenger automobile is equal to its unadjusted depreciable basis reduced by the amount of the 50-percent additional first year depreciation deemed allowed or allowable, whichever is greater, for the passenger automobile.

(D) If there is no unrecovered basis for the passenger automobile in its placed-in-service year (as determined under section 3.03(5)(c)(ii)(B) of this revenue procedure), the taxpayer will determine the depreciation deduction for the passenger automobile for any 12-month taxable year subsequent to the placed-in-service year by multiplying the adjusted depreciable basis (as defined in § 1.168(b)–1(a)(4)) of the passenger automobile by the applicable depreciation rate for each taxable year (as determined under sections 6.03, 6.04, 6.05, and 6.06 of Rev. Proc. 87–57, 1987–2 C.B. 687, 692). If any taxable year is less than 12 months, the depreciation deduction determined under this section 3.03(5)(c)(ii)(D) must be adjusted for a short taxable year (for further guidance, see Rev. Proc. 89–15, 1989–1 C.B. 816). The taxpayer must not use the optional depreciation tables for computing the depreciation deductions for the passenger automobile. For purposes of determining the applicable depreciation rate, the applicable depreciation method is the method under § 168(b), and the applicable convention is the convention under § 168(d), that would apply in the placed-in-service year for the passenger automobile had the taxpayer claimed the 50-percent additional first year depreciation deduction.

.04 *Examples*.

(1) *Example 1 — Acquired property and self-constructed property not eligible for the 100-percent additional first year depreciation deduction*. In June 2008, X began constructing an electric generation power plant for its own use. In February 2009, prior to the completion of the power plant, X and Y (an unrelated party) entered into a written binding contract under which X transferred the rights to own and use this power plant to Y for $2 million. On March 1, 2009, Y began construction to complete the power plant. Between March 2009 and August 2010, Y incurred another $10 million to complete the construction of the power plant. This $10 million includes amounts for acquired components that were acquired by Y pursuant to written binding contracts entered into after March 1, 2009, and for self-constructed components, the construction, manufacturing, or production of which began after March 1, 2009. Y completed construction of the power plant in August 2010. On October 1, 2010, Y placed the power plant in service. The power plant is included in asset class 49.13 of Rev. Proc. 87–56, 1987–2 C.B. 674, and has a recovery period of 20 years under § 168(c).

First, Y must determine if the power plant is qualified property and if its components are qualified property. Y acquired the $2 million portion of the total $12 million unadjusted depreciable basis pursuant to a written binding contract entered into after December 31, 2007. Further, Y began construction to complete the power plant after December 31, 2007, and all of its components were self-constructed beginning, or acquired pursuant to written binding contracts entered into, after December 31, 2007. Also, the original use of the power plant began with Y after December 31, 2007, and Y placed the power plant in service before January 1, 2014 (the power plant is property described in § 168(k)(2)(B)). Thus, the power plant is qualified property and all of its components are qualified property.

Y must next determine if the power plant and any of its components are eligible for the 100-percent additional first year depreciation deduction. Because X and Y are not related parties, the transaction between X and Y will not be a disqualified transaction pursuant to § 1.168(k)–1(b)(4)(iv), as modified by section 3.02(3) of this revenue procedure. Although the original use of the power plant began with Y after September 8, 2010, and Y placed the power plant in service after September 8, 2010, and before January 1, 2013 (the power plant is property described in § 168(k)(2)(B)), the power plant does not meet the acquisition rule in § 168(k)(5) and section 3.02(1)(a) of this revenue procedure. Y acquired the $2 million portion of the total $12 million unadjusted depreciable basis before September 9, 2010. Further, Y began construction to complete the power plant before September 9, 2010, and Y acquired or self-constructed all of the components to complete the construction of the power plant before September 9, 2010. Accordingly, Y's total expenditures of $12 million for the power plant do not qualify for the 100-percent additional first year depreciation deduction. Instead, Y's total expenditures of $12 million for the power plant qualify for the 50-percent additional first year depreciation deduction.

(2) *Example 2 — Acquired property and self-constructed property partially eligible for the 100-percent additional first year depreciation deduction*. In August 2009, X began constructing an electric generation power plant for its own use. On September 1, 2010, prior to the completion of the power plant, X and Y (an unrelated party) entered into a written binding contract and X transferred the rights to own and use this power plant to Y for $5 million. On September 15, 2010, Y began construction to complete the power plant. Between September 15, 2010, and November 2011, Y incurred another $10 million to complete the construction of the power plant. This $10 million includes amounts for acquired components that were acquired by Y after September 15, 2010, and for self-constructed components, the construction, manufacturing, or production of which began after September 15, 2010. All acquired components to complete the construction of the power plant were acquired by Y pursuant to written binding contracts entered into after September 1, 2010. Y completed construction of the power plant in November 2011. On December 15, 2011, Y placed the power plant in service. The power plant is included in asset class 49.13 of Rev. Proc. 87–56, and has a recovery period of 20 years under § 168(c).

First, Y must determine if the power plant is qualified property and if its components are qualified property. Y acquired the $5 million portion of the total $15 million unadjusted depreciable basis pursuant to a written binding contract entered into after December 31, 2007. Further, Y began construction to complete the power plant after December 31, 2007, and all of its components were self-constructed beginning, or acquired pursuant to written binding contracts entered into, after December 31, 2007. Also, the original use of the power plant began with Y after December 31, 2007, and Y placed the power plant in service before January 1, 2014 (the power plant is property described in § 168(k)(2)(B)). Thus, the power plant and its components are qualified property.

Y must next determine if the power plant and any of its components are eligible for the 100-percent additional first year depreciation deduction. X and Y are not related parties; therefore, the transaction between X and Y will not be a disqualified transaction pursuant to § 1.168(k)–1(b)(4)(iv), as modified by section 3.02(3) of this revenue procedure. Although the original use of the power plant began with Y after September 8, 2010, and Y placed the power plant in service after September 8, 2010, and before January 1, 2013 (the power plant is property described in § 168(k)(2)(B)), not all of Y's total expenditures of $15 million qualify for the 100-percent additional first year depreciation deduction. Given that Y acquired the $5 million portion of the total $15 million unadjusted depreciable basis before September 9, 2010, that portion qualifies only for the 50-percent additional first year depreciation deduction. However, because Y began construction to complete the power plant after September 8, 2010, and Y acquired or began self-constructing all of the components to complete the construction of the power plant after September 8, 2010, the $10 million portion of the total $15 million unadjusted depreciable basis qualifies for the 100-percent additional first year depreciation deduction.

(3) *Example 3 — Component election made*. X, a calendar-year taxpayer, began constructing a ship for its own use in March 2010. Between March 2010 and June 2012, X incurred $25 million to complete the construction of the ship. This $25 million includes $15 million for acquired components that were acquired by X after September 8, 2010, and before January 1, 2013, and for self-constructed components, the construction, manufacturing, or production of which began after September 8, 2010, and before January 1, 2013 (the ship is property described in § 168(k)(2)(B)). All acquired components of the ship were acquired by X pursuant to written binding contracts entered into after March 2010. The original use of all components of the ship commences with X. X completed construction of the ship in June 2012, and placed it in service in August 2012. On its 2012 federal tax return, X makes the election provided under section 3.02(2)(b) of this revenue procedure. The ship is included in asset class 00.28 of Rev. Proc. 87–56, and has a recovery period of 10 years under § 168(c).

First, X must determine if the ship is qualified property and if its components are qualified property. X began construction of the ship after December 31, 2007, and all of its components were self-constructed beginning, or acquired pursuant to written binding contracts entered into, after December 31, 2007. Also, the original use of the ship began with X after December 31, 2007, and X placed the ship in service before January 1, 2014 (the ship is property described in § 168(k)(2)(B)). Thus, the ship and its components are qualified property.

X must next determine if the ship and any of its components are eligible for the 100-percent additional first year depreciation deduction. Although the original use of the ship began with X after September 8, 2010, and X placed the ship in service after September 8, 2010, and before January 1, 2013 (the ship is property described in § 168(k)(2)(B)), not all of X's total expenditures of $25 million qualify for the 100-percent additional first year depreciation deduction. X began construction of the ship before September 9, 2010, but made the election provided under section 3.02(2)(b) of this revenue procedure. As a result, the $15 million portion (of the total $25 million unadjusted depreciable basis for the ship) incurred for the components that were acquired or self-constructed by X after September 8, 2010, and before January 1, 2013, qualifies for the 100-percent additional first year depreciation deduction. The remaining $10 million portion of the total $25 million unadjusted depreciable basis qualifies only for the 50-percent additional first year depreciation deduction.

(4) *Example 4 — Component election not made*. The facts are the same as in *Example 3*, except X did not make the election provided under section 3.02(2)(b) of this revenue procedure on its 2012 federal tax return. As a result, X's total expenditures of $25 million for the ship do not qualify for the 100-percent additional first year depreciation deduction. Although the original use of the ship began with X after September 8, 2010, and X placed the ship in service after September 8, 2010, and before January 1, 2013 (the ship is property described in § 168(k)(2)(B)), the ship does not meet the acquisition rule in § 168(k)(5) and section 3.02(1)(a) of this revenue procedure because X began construction of the ship before September 9, 2010. Accordingly,

X's total expenditures of $25 million for the ship qualify only for the 50-percent additional first year depreciation deduction.

(5) *Example 5 — Application of § 280F(a) safe harbor method of accounting when there is unrecovered basis*. In December 2010, X, a calendar-year taxpayer, purchased and placed in service for use in its business a new passenger automobile that cost $20,000. The passenger automobile is not a truck or van, is 5-year property under § 168(e), and is eligible for the 100-percent additional first year depreciation deduction. X does not claim any § 179 deduction for the passenger automobile. For 2010, X deducts $11,060 for the 100-percent additional first year depreciation for this property, which is the depreciation limitation for 2010 under § 280F(a)(1)(A)(i) (see Table 7 in Rev. Proc. 2011–21). X adopts the safe harbor method of accounting provided in section 3.03(5)(c)(ii) of this revenue procedure.

Under the safe harbor method of accounting, X is deemed to have claimed the 50-percent additional first year depreciation deduction for purposes of determining the unrecovered basis and the remaining adjusted depreciable basis of the passenger automobile. Accordingly, for 2010, the total depreciation allowable for the passenger automobile is deemed to be $12,000 [(50 percent multiplied by unadjusted depreciable basis of $20,000) + (20 percent multiplied by the remaining adjusted depreciable basis of $10,000)]. Thus, the unrecovered basis for the passenger automobile for 2010 is $940 ($12,000 deemed depreciation allowable less the $11,060 depreciation deduction for 2010) and that amount is recovered by X beginning in the 2016 taxable year, subject to the limitation under § 280F(a)(1)(B)(ii).

For 2011, the total depreciation allowable for the passenger automobile is deemed to be $3,200 (32 percent multiplied by the remaining adjusted depreciable basis of $10,000). Because this amount is less than the depreciation limitation of $4,900 for 2011 (see Table 7 in Rev. Proc. 2011–21), X deducts $3,200 as depreciation on its federal income tax return for the 2011 taxable year.

(6) *Example 6 — Application of § 280F(a) safe harbor method of accounting when there is no unrecovered basis*. The facts are the same as in *Example 5*, except the cost of the passenger automobile is $18,400. For 2010, X deducts $11,060 for the 100-percent additional first year depreciation for this property, which is the depreciation limitation for 2010 under § 280F(a)(1)(A)(i) (see Table 7 in Rev. Proc. 2011–21).

Under the safe harbor method of accounting, X is deemed to have claimed the 50-percent additional first year depreciation deduction for purposes of determining the unrecovered basis and the remaining adjusted depreciable basis of the passenger automobile. As a result, for 2010, the total depreciation allowable for the passenger automobile is deemed to be $11,040 [(50 percent multiplied by unadjusted depreciable basis of $18,400) + (20 percent multiplied by the remaining adjusted depreciable basis of $9,200)]. Thus, there is no unrecovered basis for the passenger automobile for 2010 because the 2010 deemed depreciation allowable of $11,040 is less than the 2010 depreciation deduction of $11,060.

Pursuant to section 3.03(5)(c)(ii)(D) of this revenue procedure, X must not use the optional depreciation tables for computing the depreciation deductions for the passenger automobile for the taxable years subsequent to the placed-in-service year. Therefore, assuming the applicable depreciation method and convention for the passenger automobile is the 200-percent declining balance method and the half-year convention, respectively, the total depreciation allowable for the passenger automobile for 2011 is $2,936 (40 percent multiplied by the adjusted depreciable basis of $7,340 [unadjusted depreciable basis of $18,400 less the total depreciation allowable for prior taxable years of $11,060]). Because this amount is less than the depreciation limitation of $4,900 for 2011 (see Table 7 in Rev. Proc. 2011–21), X deducts $2,936 as depreciation on its federal income tax return for the 2011 taxable year.

SECTION 4. ELECTION NOT TO DEDUCT ADDITIONAL FIRST YEAR DEPRECIATION

.01 *In General*. The election under § 168(k)(2)(D)(iii) not to deduct additional first year depreciation for a class of property applies to all qualified property that is in that class of property and placed in service in the same taxable year. *See* § 1.168(k)–1(e)(1). For example, if a calendar-year taxpayer for its taxable year ending December 31, 2010, makes the election not to deduct additional first year depreciation for 5-year property, all 5-year property placed in service by the taxpayer during its 2010 taxable year is not qualified property under § 168(k)(2) and, therefore, is not eligible for the 50-percent or the 100-percent additional first year depreciation deduction for the 2010 taxable year. However, see section 4.02 of this revenue procedure for a limited exception.

.02 *Limited Exception*. The Treasury Department and the Service recognize that a taxpayer may have difficulty determining the exact date during a month on which the taxpayer acquires and places in service property. To minimize disputes regarding whether a taxpayer acquired or placed in service particular property after September 8, 2010, the Treasury Department and the Service will allow a taxpayer to elect to deduct the 50-percent, instead of the 100-percent, additional first year depreciation for all qualified property that is in the same class of property and placed in service by the taxpayer in its taxable year that includes September 9, 2010, provided the taxpayer does not make an election not to deduct additional first year depreciation for that class of property for that taxable year under § 168(k)(2)(D)(iii) or section 5.04 of this revenue procedure. If the taxpayer makes the election under this section 4.02, the allowable additional first year depreciation deduction is determined for the class of property based on the 50-percent additional first year depreciation deduction. For example, if a calendar-year taxpayer for its taxable year ending December 31, 2010, placed in service 5-year property before September 9, 2010, and other 5-year property after September 8, 2010, the taxpayer may elect to claim the 50-percent additional first year depreciation for all of its 5-year property that is qualified property and placed in service during the 2010 taxable year.

.03 *Time and Manner for Making Election*. The election specified in section 4.02 of this revenue procedure must be made by the due date (including extensions) of the federal tax return for the taxpayer's taxable year that includes September 9, 2010, and must be made in the same manner as the § 168(k)(2)(D)(iii) election is made. *See* § 1.168(k)–1(e)(3). If a taxpayer has timely filed its federal tax return for the taxpayer's taxable year that includes September 9, 2010, on or before April 18, 2011, see § 301.9100–2(b) of the Procedure and Administration Regulations for an automatic extension of 6 months from the due date of that federal return (excluding extensions) to make the election specified in section 4.02 of this revenue procedure.

SECTION 5. SBJA RETROACTIVE APPLICATION OF 50-PERCENT ADDITIONAL FIRST YEAR DEPRECIATION DEDUCTION

.01 *Scope*. This section 5 applies to a taxpayer that did not claim the 50-percent additional first year depreciation for some or all qualified property placed in service by the taxpayer after December 31, 2009, on its federal tax return for its taxable year beginning in 2009 and ending in 2010 (2009 taxable year) or its taxable year of less than 12 months beginning and ending in 2010 (2010 short taxable year). For purposes of this section 5:

(1) Except as provided in section 5.04(3) of this revenue procedure, the term "qualified property" has the same meaning as provided in § 168(k)(2) before the enactment of the TRUIRJCA;

(2) The term "2009 qualified property" means qualified property placed in service by the taxpayer before January 1, 2010, in its 2009 taxable year; and

(3) The term "2010 qualified property" means qualified property placed in service by the taxpayer after December 31, 2009, in its 2009 taxable year or 2010 short taxable year, as applicable.

.02 *No Election Made To Not Deduct 50-Percent Additional First Year Depreciation*. If a taxpayer timely filed its federal tax return for the 2009 taxable year or the 2010 short taxable year, as applicable, did not deduct on that return the 50-percent additional first year depreciation for a class of property that is qualified property or for some or all of its 2010 qualified property, and did not make an election within the time and in the manner described in either section 2.06 or section 5.04(2) of this revenue procedure not to deduct the 50-percent additional first year depreciation for the class of property in which the qualified property or the 2010 qualified property, as applicable, is included, the taxpayer may claim the 50-percent additional first year depreciation for that property by filing either:

(1) An amended federal tax return (or a qualified amended return under Rev. Proc. 94–69, 1994–2 C.B. 804 (or its successor), if applicable) for the 2009 taxable year or the 2010 short taxable year, as applicable, before the taxpayer files its federal tax return for the first taxable year succeeding the 2009 taxable year or the 2010 short taxable year, as applicable; or

(2) A Form 3115, *Application for Change in Accounting Method*, under section 6.01 of the Appendix of Rev. Proc. 2011–14, 2011–4 I.R.B. 330, 361, with the taxpayer's timely filed federal tax return for the first or second taxable year succeeding the 2009 taxable year or the 2010 short taxable year, as applicable, if the taxpayer owns the property as of the first day of the year of change (as defined in section 3.06 of Rev. Proc. 2011–14).

.03 *Consent Granted to Revoke Election to Not Deduct 50-Percent Additional First Year Depreciation*. If, on its timely filed federal tax return for the 2009 taxable year or the 2010 short taxable year, as applicable, a taxpayer made an election within the time and in the manner described in section 2.06 of this revenue procedure to not deduct the 50-percent additional first year depreciation for a class of property that is qualified property, the Commissioner grants the taxpayer consent to revoke that election, provided the taxpayer files an amended federal tax return for the 2009 taxable year or the 2010 short taxable year, as applicable, in a manner that is consistent with the revocation of the election and by the later of (1) June 17, 2011, or (2) before the taxpayer files its federal tax return for the first taxable year succeeding the 2009 taxable year or the 2010 short taxable year.

.04 *Election To Not Deduct 50-Percent Additional First Year Depreciation*.

(1) *In general*. A taxpayer that timely filed its federal tax return for the 2009 taxable year or the 2010 short taxable year, as applicable, has made the election to not deduct the 50-percent additional first year depreciation for a class of property that is qualified property if the taxpayer made the election within the time and in the manner provided in section 2.06 of this revenue procedure and did not revoke that election within the time and in the manner provided in section 5.03 of this revenue procedure.

(2) *Deemed election*. If section 5.04(1) of this revenue procedure does not apply, a taxpayer that timely filed its federal tax return for the 2009 taxable year or the 2010 short taxable year, as applicable, also will be treated as making the election to not deduct the 50-percent additional first year depreciation for a class of property that is qualified property if the taxpayer:

(a) on that return, did not deduct the 50-percent additional first year depreciation for that class of property but did deduct depreciation; and

(b) does not file an amended federal tax return (or a qualified amended return) or a Form 3115 within the time and in the manner provided in section 5.02 or section 5.03 of this revenue procedure, as applicable, to claim the 50-percent additional first year depreciation for the class of property.

(3) *Application*. If the taxpayer makes the election under section 5.04(1) or (2) of this revenue procedure for its 2009 taxable year, the election applies to both 2009 qualified property and 2010 qualified property in the same class of property for which the election is made. If the taxpayer makes the election under section 5.04(1) or (2) of this revenue procedure for its 2010 short taxable year, the election applies to 2010 qualified property in the same class of property for which the election is made. The election under section 5.04(1) or (2) of this revenue procedure also applies to qualified property (as defined in § 168(k), as amended by the SBJA and the TRUIRJCA) in that class of property that is eligible for the 100-percent additional first year depreciation deduction and placed in service during the taxpayer's 2009 taxable year or 2010 short taxable year, as applicable, and, therefore, this property is not eligible for the 50-percent or 100-percent additional first year depreciation deduction.

SECTION 6. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 2011–21 is amplified as provided in section 3.03(5)(c) of this revenue procedure.

SECTION 7. EFFECTIVE DATE

This revenue procedure is effective March 29, 2011.

SECTION 8. PAPERWORK REDUCTION ACT

The collections of information contained in this revenue procedure have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–2207.

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

The collections of information in this revenue procedure are in sections 3.02(2)(b) and 4.03. This information is required to make the elections provided under these sections. This information will be used by the Service for examination purposes. The collections of information are required to obtain a benefit. The likely respondents are individuals, business or other for-profit institutions, and small businesses.

The estimated total annual reporting burden is 125,000 hours.

The estimated annual burden per respondent varies from .25 hours to 1 hour, depending on individual circumstances, with an estimated average of .5 hours. The estimated number of respondents is 250,000.

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

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

DRAFTING INFORMATION

The principal author of this revenue procedure is Kathleen Reed of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information regarding the additional first year depreciation deduction, contact Douglas Kim at (202) 622–4930 (not a toll-free call). For further information regarding the depreciation deduction limitations under § 280F(a), contact Bernard P. Harvey at (202) 622–4930 (not a toll-free call).

Part IV. Items of General Interest

ANNOUNCEMENT AND REPORT CONCERNING ADVANCE PRICING AGREEMENTS

Announcement 2011–22

March 29, 2011

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 2009. This twelfth report describes the experience, structure, and activities of the APA Program during calendar year 2010. It does not provide guidance regarding the application of the arm's length standard.

John E. Hinding
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 ADMINISTRATIONS (2010). Transfer pricing issues by their nature are highly factual and have traditionally been one of the largest issues identified by the IRS in its audits of multinational corporations. The APA Program is designed to resolve actual or potential transfer pricing disputes in a principled, cooperative manner, as an alternative to the traditional examination process. An APA is a binding 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 2010, the IRS and taxpayers executed 69 APAs and 9 amended 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 C.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. 2006–09, 2006–1 C.B. 278.[5] Rev. Proc. 2006–09 supersedes Rev. Proc. 2004–40 and is effective for all APA requests filed on or after February 1, 2006. On May 21, 2008, the IRS released Rev. Proc. 2008–31, 2008–1 C.B. 1133, which revised Rev. Proc. 2006–09 to describe further the types of issues that may be resolved in the APA process.[6] Specifically, Rev. Proc. 2008–31 added a new sentence to Section 2.01 of Rev. Proc. 2006–09, to advise that the APA process may be used to resolve any issue for which transfer pricing principles may be relevant, such as attribution of profit to a permanent establishment under certain U.S. income tax treaties, the amount of income effectively connected with the conduct of a U.S. trade or business, and the amount of income derived from sources partly within and partly without the United States.

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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*.

[6] Available at *http://www.irs.gov/pub/irs-irbs/irb08–31.pdf*.

Advance Pricing Agreements

An APA generally combines an agreement between a taxpayer and the IRS with an agreement between the United States and one or more foreign tax authorities (under the authority of the mutual agreement process of our income tax treaties) on an appropriate TPM for the transactions at issue (Covered Transactions). With such "bilateral" APAs, the taxpayer ordinarily is assured that the income associated with the Covered Transactions will not be subject to double taxation by the combination of the United States and the foreign jurisdictions. The policy of the United States, as reflected in §§ 2.08 and 7 of Rev. Proc. 2006–09, is to encourage taxpayers that enter the APA Program to seek bilateral or multilateral APAs when competent authority procedures are available with respect to the foreign country or countries involved. However, the IRS may execute an APA with a taxpayer without reaching a competent authority agreement (a unilateral APA).

A unilateral APA is an agreement between a taxpayer and the IRS establishing an approved TPM for U.S. tax purposes. A unilateral APA binds the taxpayer and the IRS, but does not prevent a foreign tax administration from taking a different position on the appropriate TPM for a transaction. As stated in § 7.07 of Rev. Proc. 2006–09, should a transaction covered by a unilateral APA be subject to double taxation as the result of an adjustment by a foreign tax administration, the taxpayer may seek relief by requesting that the U.S. Competent Authority (USCA) consider initiating a mutual agreement proceeding pursuant to an applicable income tax treaty (if any).

The policy generally preferring bilateral (or multilateral) over unilateral APAs is grounded in the APA Program's goal to achieve certainty and the avoidance of double taxation through an early dispute resolution process that is most efficient from both taxpayer and government perspectives. Consistent with that policy, the IRS is reviewing both initial and renewal submissions for factors weighing in favor of bilateral or multilateral APAs (*e.g.*, potentially large amounts of income; complex issues; a high risk of adjustment in a foreign country; or other indications in the interests of efficient tax administration) or unilateral APAs (*e.g.*, small amounts at stake relative to the additional transaction costs of a bilateral or multilateral APA; a multiplicity of smaller foreign situs operations covered by unilateral APAs while bilateral or multilateral APAs cover major intercompany transaction flows; or other indications in the interests of efficient tax administration). To date no request for a unilateral APA has been rejected on the sole basis that the submission sought a unilateral rather than a bilateral or multilateral process.

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

The APA Program

An IRS team headed by an APA team leader is responsible for the consideration of each APA. As of the last statutory report (for the period ending December 31, 2009), the APA Program had nineteen team leaders; by December 31, 2010, that number declined to sixteen. The team leader is responsible for organizing the IRS APA team. The IRS APA team leader arranges meetings with the taxpayer, secures necessary information from the taxpayer to analyze the taxpayer's Covered Transactions and the available facts under the arm's length standard of IRC § 482 and the regulations thereunder, and leads the discussions with the taxpayer.

The APA team generally includes an economist, an IRS Large Busines and International Division (LB&I) international examiner, LB&I field counsel, and, in a bilateral case or multilateral APA case, a USCA analyst. The economist may be from the APA Program or the IRS field organization. As in the last statutory report, as of December 31, 2010, the APA Program had seven economists on staff, plus one economist manager. The APA team may also include an LB&I International Technical Advisor, other LB&I 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. 2006–09, § 4.12. The APA process can be broken into five phases: (1) application; (2) due diligence; (3) analysis; (4) discussion and agreement; and (5) drafting, review, and execution.

(1) *Application*

In many APA cases, the taxpayer's application is preceded by a pre-file conference (PFC) with the APA staff in which the taxpayer can solicit the informal views of the APA Program. Pre-file conferences can occur on an anonymous basis, although a taxpayer must disclose its identity when it applies for an APA. The APA Program has been requiring taxpayers interested in an APA under Rev. Proc. 2008–31 to schedule a PFC before submitting a formal APA application.

Even outside the expanded jurisdiction conferred in Rev. Proc. 2008–31, PFCs are useful tools for the early exchange of ideas and expectations on complex, novel, and potentially contentious issues that will be present in an APA submission. The APA Program believes that discussions with the IRS in PFCs, when followed in an APA submission, has the potential to shorten the period of time required to complete an APA by identifying issues that will require specific development and providing preliminary views on acceptable methodologies and analytical concepts. The APA Program has recently revised its internal practices concerning PFCs to improve efficiency, including better tracking of PFCs and, most notably, assigning some of the PFCs presenting the most complex or novel issues to senior staff.

As part of a taxpayer's APA application, the taxpayer must file the appropriate user fee on or before the due date, including extensions, of the tax return for the first taxable year that the taxpayer proposes to be covered by the APA. (If the taxpayer receives an extension to file its tax return, it must file its user fee no later than the actual filing date of the return.) Many taxpayers file a user fee first and then follow up with a full application later — a "dollar file" in APA parlance. The procedures for PFCs, user fees, and applications can be found in §§ 3 and 4 of Rev. Proc. 2006–09.

The APA application can be a relatively modest document for small businesses. Section 9 of Rev. Proc. 2006–09 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 LB&I International Territory Manager to secure the assignment of an international examiner to the APA case and the LB&I Counsel's office to secure a field counsel lawyer. In a bilateral or multilateral case, the USCA will assign a USCA analyst to the team. In a large APA case, the international examiner may invite his or her manager and other LB&I personnel familiar with the taxpayer to join the team. If the APA may affect taxable years in Appeals, the appropriate appellate conferee will be invited to join the team. In cases involving cost-sharing arrangements, other complex intangibles and services transactions, or novel issues, the APA team leader contacts the Manager, LB&I International Technical Advisors, to determine whether or not to include a technical advisor on the team. The multi-functional nature of APA teams combines the APA Program's transfer pricing expertise and APA experience with other elements of the IRS that possess complementary or supplementary knowledge about the taxpayer, the taxpayer's industry, related or ancillary tax issues, the foreign competent authority, and other relevant issues. By bringing all relevant parties to the table in a single proceeding, the APA process is able to resolve transfer pricing issues early on in a more principled, efficient, consistent, and comprehensive manner than the standard administrative process (*i.e.*, audit, appeals, litigation).

The APA team leader distributes copies of the APA application to all team members, makes initial contact with the taxpayer to confirm the APA Program's receipt of the taxpayer's application, and sets up an opening conference with the taxpayer. Under past APA case management procedures, the APA office strived to (i) make initial contact with the taxpayer within 21 days of its receipt of the APA application and (ii) hold the opening conference within 45 days from the date that the APA team expects to begin actively working the case — the "Start Date" under the revised case management procedures. However, limited Program resources have led to delays, so, for example, opening conferences are now frequently held six months or more after a completed application is received.

On or about the opening conference, the APA team leader proposes a case plan appropriate for the case. Case plans are generally targeted to complete a unilateral APA or, in the case of a bilateral APA, the U.S. recommended negotiating position (RNP) within 12 months from the date of the opening conference. The targeted completion date in a particular case, however, may vary from the 12-month benchmark, depending on the complexity of the case, APA team workloads, taxpayer schedules, and other factors. Case plans are signed by both an APA manager and an authorized official of the taxpayer and are intended to be adhered to except in unforeseen or exceptional circumstances. Implementation and adherence to case plans has been uneven, at best. The rapidly increasing workloads have resulted in the actual median and average times for completing unilateral and bilateral APAs, recommended negotiating positions for bilateral APAs, and APAs for small business taxpayers to increase significantly. These APA inventory and case completion times are described in greater detail below in Tables 2 through 11. The APA Program is taking steps to increase its tracking of and adherence to case plans and, as discussed below, is endeavoring to increase efficiencies and augment resources through a pooling with USCA.

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 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 have typically proceeded in two parts and involve two IRS offices — the APA Program and the USCA. In the first part, the APA team attempted to reach a consensus with the taxpayer regarding the RNP that the USCA should take in negotiations with its treaty partner. This U.S. RNP was a paper drafted by the APA team leader, reviewed by APA management, and signed by the APA Director that provides the APA Program's view of the best TPM for the Covered Transactions, taking into account IRC § 482 and the regulations thereunder, the relevant tax treaty, and the USCA's experience with the treaty partner.

The experience of the APA office and the USCA has been 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 has worked with the taxpayer in developing the U.S. RNP. Often, however, the taxpayer has disagreed with part or all of the RNP. In these cases, the APA office will send an RNP to the USCA that identifies and explains the elements of the RNP with which the taxpayer disagrees. The APA team leader also solicited the views of the other members of the APA team, and, in the vast majority of APA cases, the other members of the APA team concur in the position prepared by the APA team leader. If there was any disagreement that cannot be resolved, it is noted in the RNP.

After the APA Program completed the recommended U.S. negotiating position, the APA process shifted from the APA Program to the USCA — the "hand-off." The USCA analyst assigned to the APA took the U.S. RNP and prepared the final U.S. negotiating position, which was then transmitted to the foreign competent authority. The negotiations with the foreign competent authority were conducted by the USCA analyst, most often in face-to-face negotiating sessions conducted periodically throughout the year. At the request of the USCA, APA Program staff members have assisted in the negotiations.

Both in response to the inherent inefficiencies of the "hand-off" and because of resource constraints, the APA Program and USCA have commenced efforts towards a pooling of resources and better managing their shared bilateral caseload as a single inventory. These efforts are still at the initial stage. Practices that are under consideration include the possible assignment of a single APA team leader, or USCA analyst, from either the APA Program or the USCA to work a bilateral case through both offices from inception through to conclusion, consistent with the applicable revenue procedures. By the end of 2010, a few cases were identified for carrying forward under the pooling approach.

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, IRS field personnel assigned to a case 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) *Drafting, Review, and Execution*

Once the IRS, competent authorities, 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. It is anticipated that under the pooling practice between the APA Program and USCA, RNPs and final APAs would continue to be reviewed and approved by the APA Director and ACC(I), while the mutual agreement reached between competent authorities would continue to be reviewed and approved by the USCA.

Model APA at Attachment A

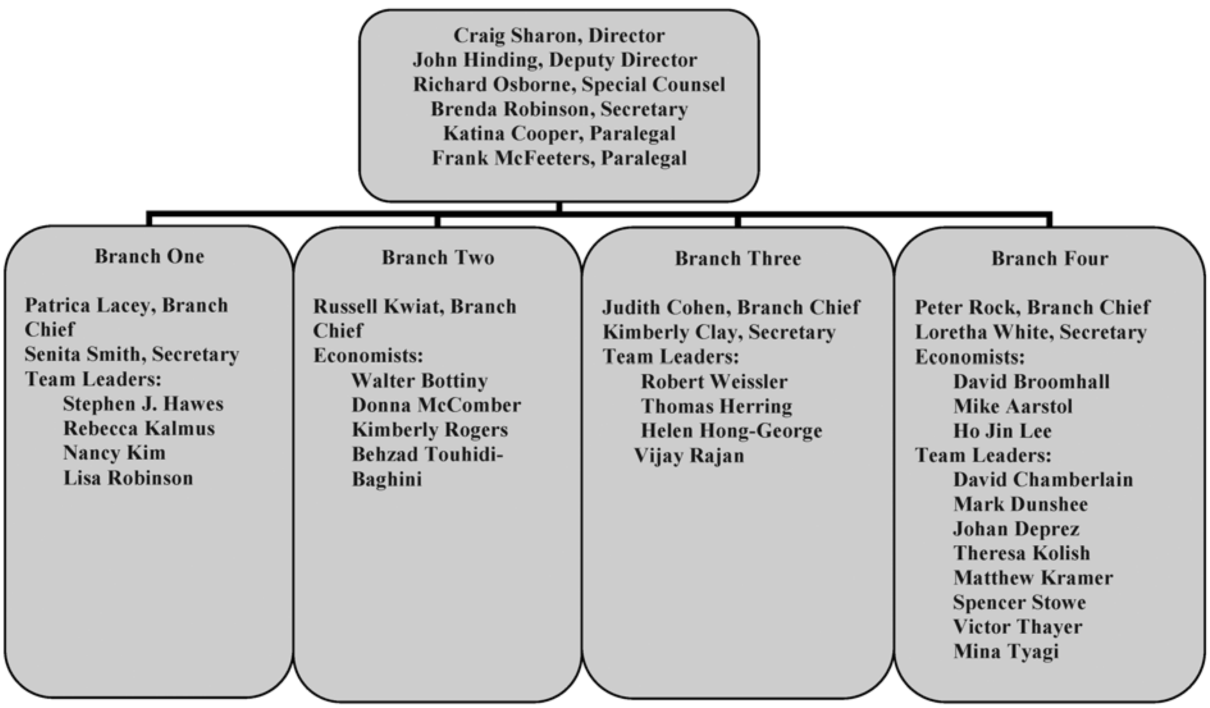
[§ 521(b)(2)(B)]

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

The Current APA Office Structure, Composition, and Operation

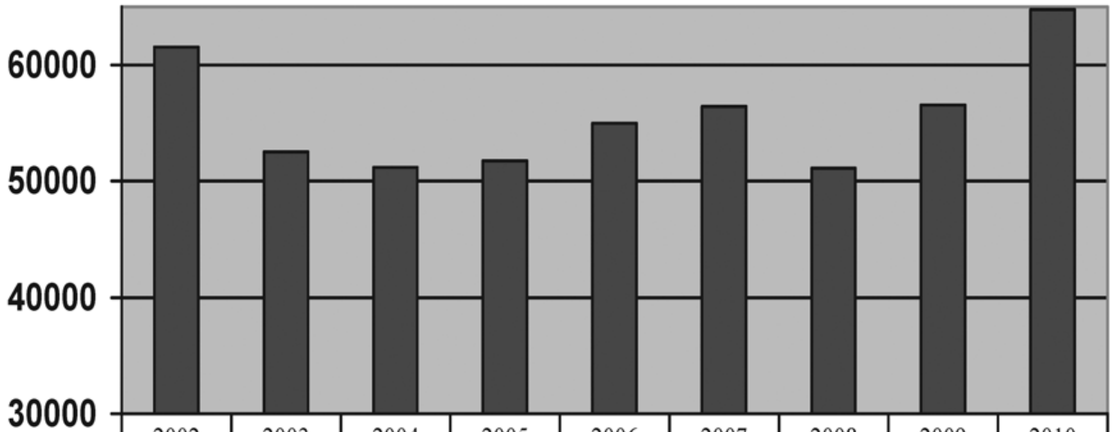
In 2010, the APA office consisted of four branches, with Branches 1 and 3 staffed with APA team leaders and Branch 2 staffed with economists based in Washington, D.C. Branch 4, the APA West Coast branch, is headquartered in San Francisco, California, with an additional office in Laguna Niguel, California, and is staffed with both team leaders and economists.

APA full-time staffing decreased during 2010, starting at 39 at the end of 2009, falling to 35 by the end of the year. As of December 31, 2010, the APA staff was as follows:



Total hours spent by APA professional staff increased in 2010 by roughly 14.5% over the previous year. The decrease in the staff near the end of 2010 is yet to be reflected in staff hours due to the timing of the departures. The change in APA hours spent over the last nine years is reflected in the table below.

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



	2002	2003	2004	2005	2006	2007	2008	2009	2010
APA staff hours	61528	52495	51170	51744	54970	56410	51077	56549	64763

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 about half of its total case time. At the end of 2010, cases within these five categories accounted for 86 of the 243 cases pending in the office that were either unilateral APAs or bilateral APAs that had not yet been forwarded to the USCA.

Staffing of the coordination teams at the end of 2010 is indicated below:

Auto & Auto Parts

Peter Rock, Reviewer

Tom Herring, Team Leader
Vijay Rajan, Team Leader
Johan Deprez, Team Leader
Victor Thayer, Team Leader
Walt Bottiny, Principal Economist

Pharmaceuticals & Medical Devices

Victor Thayer, Reviewer

David Chamberlain, Team Leader
Tom Herring, Team Leader
Helen Hong-George, Team Leader
Mark Dunshee, Team Leader
Jamie Hawes, Team Leader
Richard Sciacca, Principal Economist

Cost Sharing

Judith Cohen, Reviewer

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

Financial Products

Richard Osborne, Reviewer

Rebecca Kalmus, Team Leader
Lisa Robinson, Team Leader
Robert Weissler, Team Leader
Donna McComber, Principal Economist

Semiconductors

Peter Rock, Reviewer

Matthew Kramer, Team Leader
Vijay Rajan, 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 2010, the APA office continued its training activities. Training sessions addressed APA-related current developments, the application of Rev. Proc. 2008–31, regulatory developments, new APA office practices and procedures, OECD study on restructuring, review of novel or unique APAs or RNPs, and international tax law issues. The training materials used for new hires are available to the public through the APA internet site at *http://www.irs.gov/businesses/corporations/article/0,,id=96221,00.html*. The APA's new-hire materials, which were originally prepared in 2003 and have not been updated, do not constitute guidance on the application of the arm's length standard and are not to be relied upon or cited as precedent. Also available to the public is a spreadsheet model that performs calculations in a Comparable Profits Method (CPM) analysis, which APA economists developed in 2007 and which is now routinely used by the APA office when performing APA analyses. An electronic version of the model may be obtained by contacting the APA office in Washington, D.C. at (202) 435–5220 (not a toll-free number).

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

The statistical information required under § 521(b)(2)(C) is contained in Tables 1 and 10 below; the information required under § 521(b)(2)(E) is contained in Tables 2 and 3 below. The 144 APA applications during 2010 represented a new one-year high for the Program, following record-breaking years in 2008 (123) and 2009 (127).[7] From 2000–2007, the APA Program averaged 91 applications per year, and it had never received more than 110 applications in a single year. The APA Program expects APA applications to continue in 2011 at the same high levels as in 2008–2010.

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

	Unilateral	Bilateral	Multilateral	Year Total	Cumulative Total
APA applications filed during 2010	46	98		144	1523
All APAs executed[8]					
Year 2010	20	49	0	69	973
1991–2010	385	506	13	904	
APA renewals executed during 2010	14	18		32	293
APAs revised or amended during 2010	5	4		9	70
Pending requests for APAs	85	315		400	
Pending requests for new APAs	38	186		224	
Pending requests for renewal APAs	47	129		176	
APAs canceled or revoked	0	0		0	9
APAs withdrawn	8	11		19	165

TABLE 2: MONTHS TO COMPLETE APAS

Months to Complete Advance Pricing Agreements in 2010					
All New		All Renewals		All Combined	
Average	40.7	Average	33.1	Average	37.2
Median	37.3	Median	31.0	Median	33.2
Unilateral New		Unilateral Renewals		Unilateral Combined	
Average	26	Average	23.3	Average	24.1
Median	26.9	Median	24.2	Median	24.4

[7] Of the 127 new APA applications in 2009 — the first full year in which Rev. Proc. 2008–31 was in effect — approximately ten submissions invoked APA jurisdiction under Rev. Proc. 2008–31. In 2010, the APA Program completed three or fewer APAs falling within APA jurisdiction because of Rev. Proc. 2008–31.

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

Months to Complete Advance Pricing Agreements in 2010					
Bilateral/Multilateral New		**Bilateral/Multilateral Renewals**		**Bilateral/Multilateral Combined**	
Average	43.6	Average	40.7	Average	42.5
Median	39.2	Median	34.1	Median	37.3

TABLE 3: APA COMPLETION TIME — MONTHS PER APA

Months	Number of APAs	Months	Number of APAs	Months	Number of APAs
1		**26**	3	**51**	1
2		**27**	2	**52**	1
3		**28**	2	**53**	
4		**29**	1	**54**	
5	1	**30**	5	**55**	1
6		**31**	2	**56**	
7		**32**	3	**57**	1
8	1	**33**	2	**58**	
9		**34**	2	**59**	1
10		**35**	2	**60**	1
11		**36**	2	**61**	1
12	1	**37**	3	**62**	
13		**38**	1	**63**	
14		**39**	1	**64**	
15	1	**40**	1	**65**	
16		**41**	1	**66**	1
17	1	**42**		**67**	
18	3	**43**	1	**68**	
19		**44**		**69**	1
20		**45**	2	**70**	1
21	2	**46**		**71–80**	
22		**47**	1	**81**	1
23	1	**48**	1	**82–118**	
24	4	**49**	2	**119**	1
25	1	**50**	1		

TABLE 4: RECOMMENDED NEGOTIATING POSITIONS

Recommended Negotiating Positions Completed in 2010	58

Table 5: MONTHS TO COMPLETE RECOMMENDED NEGOTIATING POSITIONS

New		Renewal		Combined	
Average	25.4	Average	22.9	Average	24.4
Median	25.8	Median	24.8	Median	25.4

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

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

TABLES 7 AND 8 BELOW SHOW HOW LONG EACH APA REQUEST PENDING AT THE END OF 2010 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	**10**	2	**19**	3	**28**	1
2	6	**11**	4	**20**	0	**30**	2
3	5	**12**	5	**21**	0	**31**	1
4	2	**13**	4	**22**	1	**32**	1
5	3	**14**	0	**23**	1	**33**	1
6	6	**15**	3	**24**	0	**35**	1
7	1	**16**	2	**25**	1	**36**	2
8	3	**17**	3	**26**	1	**37**	1
9	4	**18**	0	**27**	0	**44**	1

TABLE 8: BILATERAL APAS — TIME IN INVENTORY — MONTHS PER APA

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

Of the 350 cases in the APA Program's inventory shown in Tables 7 and 8, 107 cases (all of which are reflected in Table 8) are bilateral cases that have been forwarded to the USCA office for discussion with a treaty partner. This leaves 243 cases in the APA Program's active inventory at the end of 2010 that are either unilateral APAs (76 cases) or bilateral APAs for which the APA Program has not yet completed a recommended negotiating position (167 cases). Of the 243 active APA cases, 36 involve small business taxpayer (SBT) cases, as defined in Rev. Proc. 2006–9, § 4.12(5).

The table below shows the average age (in months) of the 243 active cases in inventory at the end of 2010, along with a comparison of the number of active cases and their average age at year-end for each year back to 2004. The table also shows the same information for cases that were at least 6-months old or 1-year old (the latter being a subset of the former) at the end of each year to allow comparison without potential distortions caused by year-to-year variations in the number of cases received in the latter half or during the course of the year. The build-up in inventory during 2010 primarily reflects the delays caused by the significant fluctuations in APA personnel in 2009 combined with the record number of new APA applications during the past three years. The increases in APA applications and inventory levels have, in fact, masked improvements in recent years in APA productivity, as measured by the number of completed APA items (*e.g.*, APAs, APA amendments, and recommended US negotiating positions) divided by total APA staff hours during a year.

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

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

TABLE 10: SMALL BUSINESS TAXPAYER APAs

Small Business Taxpayer APAs Completed in 2010	7
New	4
Renewals	3
Unilateral	3
Bilateral	4

TABLE 11: MONTHS TO COMPLETE SMALL BUSINESS TAXPAYER APAs

Months to Complete Small Business Taxpayer APAs in 2010					
New		Renewal		Combined	
Average	37.9	Average	30.0	Average	34.5
Median	37.3	Median	24	Median	29

Although the APA Program strives to complete SBT cases on an expedited basis, our experience is that such cases require nearly the same level of resources and the same commitment of time as non-SBT cases. This phenomenon may be explained by a number of factors, including the fact that the complexity or novelty of transfer pricing issues do not necessarily depend on the dollar volume of the related-party transactions, the lesser transfer pricing experience and/or resources of many SBTs, and the importance to both SBTs and non-SBTs of obtaining APA outcomes that reflect each taxpayer's particular facts and circumstances (as opposed to an analysis based on streamlined factual development and general transfer pricing principles). The Program completed four SBT RNPs during 2010 with average and median lengths of 20.1 and 21.1 months, respectively.

TABLE 12: INDUSTRIES COVERED[9]

Industry Involved — NAICS Codes	Number
Wholesale trade, durable goods – 421	16–18
Computer and electronic product manufacturing – 334	7–9
Professional, scientific and technical services – 545	4–6
Wholesale trade, nondurable goods – 422	1–3
Transportation equipment manufacturing – 336	1–3
Motor vehicle and parts dealers – 441	1–3
Chemical manufacturing – 325	1–3
Electronic equipment, appliance and component manufacturing – 335	1–3
Machinery manufacturing – 333	1–3
Oil and gas extraction – 212	1–3
Publishing industries – 511	1–3
Miscellaneous manufacturing – 339	1–3
Information service and data processing services – 514	1–3
Beverage and tobacco manufacturing – 312	1–3
Air transportation – 481	1–3
Plastics and rubber products manufacturing – 326	1–3
Securities, commodity contracts and other intermediary and related activities – 523	1–3
Clothing and clothing accessories stores – 448	1–3
Food manufacturing – 311	1–3
Sporting goods, hobby, book and music stores – 451	1–3
Broadcasting and telecommunications – 513	1–3
Insurance carriers and related activities – 524	1–3
Paper manufacturing – 322	1–3
Nonmetallic mineral product manufacturing – 327	1–3
Water transportation – 483	1–3
Electronic and appliance stores – 443	1–3
Data Processing, Hosting, and Related Services – 518	1–3

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

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 2010 set forth in Table 13 below:

TABLE 13: NATURE OF RELATIONSHIPS BETWEEN RELATED ENTITIES

Relationship	Number of APAs
Foreign Parent — U.S. Subsidiary (-ies)	44
Unilateral	*14*
Bilateral	*30*
U. S. Parent — Foreign Subsidiary (-ies)	20
Unilateral	*4*
Bilateral	*16*
Foreign Company and U.S. branch(es)	≤ 3
Unilateral	*0*
Bilateral	≤ 3
U.S. Company and non-U.S. branch(es)	≤ 3
Unilateral	*0*
Bilateral	≤ 3
Partnership	≤ 3
Unilateral	≤ 3
Bilateral	≤ 3

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

The controlled transactions covered by APAs executed in 2010 are set forth in Tables 14 and 15 below:

TABLE 14: TYPES OF COVERED TRANSACTIONS

Transaction Type	Number
Sale of tangible property into the United States	40
Performance of services by U.S. entity	28
Performance of services by non-U.S. entity	21
Use of intangible property by U.S. entity	19
Use of intangible property by non-U.S. entity	11
Sale of tangible property from the United States	11
Cost Sharing — U.S. parent/foreign subsidiary	≤ 3
Cost Sharing -non U.S. parent/domestic subsidiary	≤ 3
Other	≤ 3

TABLE 15: TYPES OF SERVICES INCLUDED IN COVERED TRANSACTIONS

Intercompany Services Involved in the Covered Transactions	Number
Marketing	29
Distribution	26
Logistical support	19
Technical support services	18
Sales support	15
IT	11
Management	10
Headquarters costs	9
Product support	9
Legal	7
Health, safety, environmental, and regulatory affairs	6
Purchasing	6
Research and development	6
Corporate and public relations	5
Treasury activities	5
Tax compliance activities/services	5
Warranty services	≤ 3
Assembly	≤ 3
Accounting and auditing	≤ 3
Benefits	≤ 3
Staffing and recruiting	≤ 3
Accounts receivable	≤ 3
Accounts payable	≤ 3
Payroll	≤ 3
Budgeting	≤ 3
Contract manufacturing	≤ 3
Others	≤ 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 2010 are set forth in Tables 16 and 17 below:

TABLE 16: FUNCTIONS PERFORMED BY THE TESTED PARTY

Functions Performed	Number
Distribution	78
Product service	62
Marketing functions	47
Manufacturing	41
Managerial, legal, accounting, finance, personnel, and other support services	29
Transportation and warehousing	28
Purchasing and materials management	18
Licensing of intangibles	17
Research and development	15
Product design and engineering	14
Product assembly or packaging	13
Technical training and technical support	12
Consulting Services	8
Trading and risk management of financial products	7
Process engineering	≤ 3
Engineering and construction related services	≤ 3
Mining and extraction	≤ 3
Telecom Services	≤ 3

TABLE 17: RISKS ASSUMED BY THE TESTED PARTY

Risks Assumed	Number
Market risks, including fluctuations in costs, demand, pricing, and inventory	104
General business risks (*e.g.*, related to ownership of PP&E)	62
Credit and collection risks	84
Product liability risks	35
Financial risks, including interest rates and currency	47
Research and development risks	18

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 (R&D), engage in product design and engineering, manufacture the product, market and distribute the product, and perform support functions such as legal, finance, and human resources services. 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 profit level indicator (PLI)). In conjunction with evaluating the functional analysis, the APA Program considers contractual terms between the controlled parties, the allocation of risk between the parties, the relevant economic conditions, and the type of property or services at issue. In assessing contractual terms and risk allocations, the APA Program considers not only written agreements between the parties, but also the economic substance of the transactions as indicated by the conduct of the parties over time, the financial capacity of each party to fund losses arising from risks, and the managerial or operational control each party exercises over activities giving rise to risk. Relevant economic conditions reviewed often include the geographic market and the level of the market in which the functions are performed, and the business cycle or general economic condition of the industry under review.

During 2010, the APA Program received numerous inquiries about the potential effect of the economic downturn on existing and pending APAs. On existing APAs, the APA Program, in consultation with the USCA, has adopted a general policy not to re-open closed cases absent a special Critical Assumption on point.[10] The APA Program has dealt with pending APA applications (whether pending with the USCA or the APA Program) on a case-by-case basis. Whether or not a special "down-economy adjustment" might be appropriate depends on a variety of factors, including whether or not the tested party and the comparables have been similarly affected by the downturn, the tested party's historic risk profile and performance, and a taxpayer's willingness to accept a symmetrical adjustment (*e.g.*, in a renewal APA) when the economy improves. Approaches to the down economy that have been considered include changing the APA term, waiting for more current financial data, using a different set of comparables, and/or applying a longer testing period.

The APA Program's evaluation of the functional analysis also considers the assets or other resources employed by each controlled party. In this evaluation, each party's ownership or investment in 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 2010 are set forth in Table 18 below:

TABLE 18: RELATED ORGANIZATIONS, TRADES, OR BUSINESSES WHOSE PRICES OR RESULTS ARE TESTED[11]

Type of Organization	Number
U.S. distributor	46
Non-U.S. provider of services	21

[10] See Table 21 and accompanying text.

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

U.S. provider of services	20
Non-U.S. distributor	12
U.S. manufacturer	9
Non-U.S. manufacturer	9
U.S. licensor of intangible property	≤ 3
Non-U.S. licensor of intangible property	≤ 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 2010 are set forth in Tables 19 and 20 below:

TABLE 19: TRANSFER PRICING METHODS USED FOR TRANSFERS OF TANGIBLE AND INTANGIBLE PROPERTY[12]

TPM Used	Number
CPM: PLI is operating margin	55
Unspecified method	21
CUT (intangibles only)	6
CPM: PLI is Berry ratio	5
Residual profit split	5
CPM: PLI is other PLI	5
CPM: PLI is markup on total costs	≤ 3
Other profit split	≤ 3

TABLE 20: TRANSFER PRICING METHODS USED FOR SERVICES

TPM Used	Number
CPM: PLI is operating profit-to-total services cost ratio	46
Comparable Uncontrolled Services Price Method	16
Gross Services Margin Method	9
Services Cost Method: Specified Covered Services	7
CPM: PLI is return on assets or capital involved	5
Services Cost Method: Low Margin Covered Services	≤ 3
CPM: PLI is Berry ratio	≤ 3
Other profit split	≤ 3
Unspecified method	≤ 3

[12] 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).

Discussion

The TPMs used in APAs completed during 2010 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. § 1.482–9(a) provides that the arm's length amount charged must be determined under one of six specified methods or an unspecified method. The six specified methods are the Services Cost Method, the Comparable Uncontrolled Services Price (CUSP) Method, the Gross Services Margin Method, the Cost of Services Plus Method, the CPM, and the Profit Split Method. Treasury Reg. § 1.482–2(a) provides rules concerning the proper treatment of loans or advances.

On January 5, 2009, the IRS issued new temporary regulations, Treas. Reg. § 1.482–7T, which provide 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 payment for "platform contribution transactions" (PCTs) due for the transfer of pre-existing intangibles, and the commitment of services with embedded intangibles, among the controlled participants (known as "buy ins" in the previous cost-sharing regulations). As in 2009, in 2010 the APA Program completed its recommendations on three or fewer bilateral cost sharing/PCT cases and sent those on to the USCA. In addition, the APA Program is currently working on roughly 10 cases involving cost-sharing/PCTs, split almost evenly between bilateral and unilateral. The PCT cases include both initial and subsequent buy-in/buy-out transactions. The methods used in the completed and pending PCT cases include valuations based on the income method, including cases involving a split of the discounted present value of platform contributions made by two or more parties, and other types of analyses.

In reviewing the TPMs applicable to transfers of tangible and intangible property reflected in Table 19, the majority of the APAs followed the specified methods. However, several points should be 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 an uncontrolled transaction has no differences with the controlled transaction that would affect the price, or if there are only minor differences that have a definite and reasonably ascertainable effect on price and for which appropriate adjustments are made. Treas. Reg. § 1.482–3(b)(2)(ii)(A). As in earlier years, it was the experience of the APA Program in 2010 that CUP transactions meeting these criteria were difficult to find.

Similar to the CUP Method, for transfers of intangible property the CUT Method will generally provide the most direct and reliable measure of an arm's length result if an uncontrolled transaction involves the transfer of the same intangible under the same, or substantially the same, circumstances as the controlled transaction. Treas. Reg. § 1.482–4(c)(2)(ii). Under the regulation, circumstances between the controlled and uncontrolled transaction will be considered substantially the same if there are at most only minor differences that have a definite and reasonably ascertainable effect on the amount charged and for which appropriate adjustments are made. *Id*. It has generally been difficult to identify external comparables, and APAs using the CUT Method tend to rely on internal transactions (those between the taxpayer and uncontrolled parties). In 2010, six Covered Transactions utilized the CUT TPM.

The Resale Price Method was not applied in 2010. 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 (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 Method or the Cost Plus Method. 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 at least 65 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 2010. There were at least fifty-one services Covered Transactions using the CPM Method with various PLIs according to the specific facts of the taxpayers involved. At least seven services-related APAs completed in 2010 applied the new Services Cost Method under the § 1.482–9 regulations. Table 20 reflects the methods used to determine the arm's length results for APAs involving services transactions.

In 2010, five 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 2010 are described in Table 21 below:

TABLE 21: CRITICAL ASSUMPTIONS

Critical Assumptions involving the following:	Number of APAs
Material changes to tax and/or financial accounting practices	69
Material changes to the business	69
Assets will remain substantially same	7
Other	7
Other financial ratios	6
Changes in affiliated companies	≤ 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. 2006–09, § 4.05. Failure to meet a critical assumption may render an APA inappropriate or unworkable. Most APAs contain only the standard critical assumption language set forth in Appendix B of the Model APA (Attachment A to this Announcement and Report). Where appropriate, additional critical assumption language may be added, but the APA Program generally seeks to limit additional critical assumption language to objective, measurable benchmarks.

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

If a critical assumption has not been met, the 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. 2006–09, §§ 11.05, 11.06.

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

The sources of comparables, selection criteria, and rationale used in determining the selection criteria for APAs executed in 2010 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	73
No Comparables used	37
Disclosure	21
Mergent	15
Other	10
Worldscope	7
Amadeus	5
Moody's	5
Austrailian Business Who's Who	4
Capital IO	≤ 3
Global Vantage	≤ 3
SEC	≤ 3
Osiris	≤ 3
Japan Accounts and Data on Enterprises (JADE)	≤ 3

TABLE 23: COMPARABLES SELECTION CRITERIA

Selection Criteria Considered	Number of Times This Criterion Used
Comparable functions	85
Comparable risks	72
Comparable industry	50
Comparable intangibles	37
Comparable products	41
Comparable terms	17

TABLE 24: ADJUSTMENTS TO COMPARABLES OR TESTED PARTIES

Adjustment	Number of Times Used
Balance sheet adjustments	
Payables	52
Receivables	51
Inventory	52
Property, plant, equipment	8
Other	≤ 3
Accounting adjustments	
LIFO to FIFO inventory accounting	37
Other	24
Accounting reclassifications (*e.g.*, from COGS to operating expenses)	≤ 3
Profit level indicator adjustments (used to "back into" one PLI from another PLI)	
Miscellaneous adjustments	
Goodwill value or amortization	22
Stock-based compensation	19
Research and development	≤ 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 from the United States or foreign countries, depending on the relevant market, the type of transaction being evaluated, the availability of relevant data, and the results of the functional and risk analyses. In general, comparables have been located by searching a variety of databases that provide data on U.S. publicly traded companies and on a combination of public and private non-U.S. companies. Table 22 shows the various databases and other sources used in selecting comparables for the APAs executed in 2010.

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 (the analysis window). Often this has been a three-year or a five-year period, but other periods are sometimes used depending on the circumstances of the controlled transaction. Using a shorter period might result in the inclusion of comparables in different stages of economic development or use of atypical years of a comparable due to cyclical fluctuations in business conditions. The economic downturn has focused particular attention on the appropriate analysis window for APAs with terms that include 2008 and 2009, and to a lesser extent 2010, given the different economic conditions that may have confronted the comparables during the years comprising the analysis window, which typically lags behind the years covered by an APA (*e.g.*, the comparables results for 2004–08 may be used to test the taxpayer's results under the APA from 2008–2012). As noted in the discussion following Table 17, the APA Program has been dealing with the economic downturn in various ways, including waiting for more current comparables' financial data to develop a more contemporaneous analysis window.

Many Covered Transactions 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 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 2010:

TABLE 25: COMPARABILITY AND FINANCIAL DISTRESS SCREENS

Comparability/Financial Distress Screen	Times Used
Comparability screens used	
R&D/sales	37
Sales	33
Foreign sales/total sales	18
Other	14
Related party transactions	12
Insufficient detail	9
PP&E/sales	9
SG&A/sales	8
Non-routine intangibles	7
Inventory/sales	5
Non-startup or start-up	4
Government sales	≤ 3
Employees	≤ 3
PP&E total assets	≤ 3
Operating expense/sales	≤ 3
Advertising/sales	≤ 3
Geographic market	≤ 3
Financial distress	
Bankruptcy	62
Unfavorable auditor's opinion	32
Losses in one or more years	14
Other	11
Stopped filing public documents	4

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 it has since 2007, during the course of 2010, 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 2010, 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 2010 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 2010 are described in Tables 26 and 27 below.

TABLE 26: RANGES AND TARGETS[13]

Type of Range	Number
Interquartile range	71
Other	13
Cost-only services	11
Specific point within CPM range (not floor or ceiling)	8
Floor (*i.e.*, result must be less than x)	8
Ceiling (*i.e.*, result must be no more than x)	7
Specific point (royalty)	5
Financial products statistical confidence interval to test against internal CUPs	≤ 3

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

TABLE 27: ADJUSTMENTS WHEN OUTSIDE THE RANGE

Adjustment mechanism	Number
Taxpayer makes an adjustment: to specified point or royalty rate	58
Taxpayer makes an adjustment: to closest edge of multi-year average	41
Taxpayer makes an adjustment: to closest edge of single year	13
Taxpayer makes an adjustment: to median of current year	≤ 3
Taxpayer makes an adjustment: to median of multi-year average	≤ 3
Taxpayer makes an adjustment: to a specific dollar amount	≤ 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 seventy-one times in 2010.

Eight 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. Fifteen APAs executed in 2010 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 2010, rolling multi-year averaging was used for seven Covered Transactions. All seven of these Covered Transactions used rolling averages from three to five years. Seven Covered Transactions used cumulative multi-year averaging, while twenty-seven Covered Transactions used 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. 2006–09. When the TPM specifies an arm's length range, an APA primary adjustment is necessary only if the taxpayer's actual transactional result falls outside the specified range.

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

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

The various term lengths for APAs executed in 2010 are set forth in Table 28 below:

TABLE 28: TERMS OF APAS

APA Term in Years	Number of APAs
2	≤ 3
3	≤ 3
4	≤ 3
5	30
6	10
7	14
8	5
9	≤ 3
10 or more	≤ 3
	≤ 3

The number of rollback years to which an APA TPM was applied in 2010 is set forth in Table 29 below:

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

Number of Rollback Years	Number of APAs
1	≤ 3
2	9
3	≤ 3
4	≤ 3
5 or more	5

Together, Tables 28 and 29 indicate that the 69 APAs completed in 2010 covered more than 427 taxable years, and potentially more than 500 taxable years. In terms of dollar value, 38 of the 69 completed APAs involved Covered Transactions exceeding $100 million per year, with 21 APAs covering transactions exceeding $250 million per year. Combining the total covered years and the total dollar-value of Covered Transactions represents one measure of the effectiveness of the APA Program.

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

APAs executed in 2010 required that taxpayers provide various documents with their annual reports. These documents are described in Table 30 below:

TABLE 30: NATURE OF DOCUMENTATION REQUIRED

Documentation	Number
Statement identifying all material differences between Taxpayer's business operations during APA Year and description of Taxpayer's business operations contained in Taxpayer's request for APA, or if there have been no such material differences, a statement to that effect.	69
Statement of all material changes in the Taxpayer's accounting methods and classifications, and methods of estimation, from those described or used in Taxpayer's request for the APA. If there has been no material change in accountings methods and classifications or methods of estimation, a statement to that effect.	69
Description of any failure to meet Critical Assumptions or, if there have been none, a statement to that effect.	69
Copy of the APA	69
Financial analysis demonstrating Taxpayer's compliance with TPM.	69
Organizational chart	69
Any change to the taxpayer notice information in section 14 of the APA.	69
The amount, reason for, and financial analysis of any compensating adjustment under Paragraph 4 of Appendix A and Rev. Proc. 2006–9, § 11.02(3), for the APA year, including but not limited to: the amounts paid or received by each affected entity; the character (such as capital or ordinary expense) and country source of the funds transferred, and the specific line item(s) of any affected U.S. tax return; and any change to any entity classification for federal income tax purposes of any member of the Taxpayer's group that is relevant to the APA.	69
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.	69
Financial Statements and any necessary account detail to show compliance with the TPM, with a copy of the opinion from an independent CPA required by paragraph 5(f) of the APA.	63
Certified public accountant's opinion that financial statements present fairly the financial position of Taxpayer and the results of its operations, in accordance with a foreign GAAP.	8
CPA review of Taxpayer's financial statements	5
Various work papers	4
Schedule of costs and expenses (*e.g.* intercompany allocations)	≤ 3
Profit and loss statement	≤ 3
Foreign tax return	≤ 3
Pertinent intercompany agreements	≤ 3

Approaches for Sharing of Currency or Other Risks

[§ 521(b)(2)(D)(xii)]

During 2010, there were forty-seven 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. 2006–09, § 11.01, APA taxpayers are required to file annual reports to demonstrate compliance with the terms and conditions of the APA. The filing and review of annual reports is a critical part of the APA process. Through annual report review, the APA Program monitors taxpayer compliance with the APA on a contemporaneous basis. Annual report review provides current information on the success or problems associated with the various TPMs adopted in the APA process.

All reports received by the APA Program are assigned to a designated APA team leader. Whenever possible, annual report reviews are assigned to the team leader who negotiated the case, 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, 2010, there were 245 pending annual reports. In 2010, 336 annual reports were closed.

TABLE 31: STATISTICS OF ANNUAL REPORTS

Number of APA annual reports pending as of December 31, 2010	245
Number of APA annual reports closed in 2010	336
Number of APA annual reports requiring adjustment in 2010	3
Number of taxpayers involved in adjustments	3
Number of APA annual report cases over one-year old	126

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 _____

John E. Hinding
Director, Advance Pricing Agreement Program

APPENDIX A

COVERED TRANSACTIONS AND TRANSFER PRICING METHOD (TPM)

1. Covered Transactions.

[*Define the Covered Transactions.*]

2. TPM.

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

[The Tested Party is __________.]

- **CUP Method**

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

- **CUT Method**

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

- **Resale Price Method (RPM)**

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

• **Cost Plus Method**

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

• **CPM with Berry Ratio PLI**

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

• **CPM using an Operating Margin PLI**

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

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

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

• **Residual Profit Split Method**

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

[*Insert additional provisions as needed.*]

3. Application of TPM.

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

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

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

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

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

4. APA Revenue Procedure Treatment

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

[*Insert additional provisions as needed.*]

APPENDIX B

CRITICAL ASSUMPTIONS

This APA's critical assumptions are:

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

[*Insert additional provisions as needed.*]

APPENDIX C

APA RECORDS AND ANNUAL REPORT

APA RECORDS

The APA Records will consist of:

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

ANNUAL REPORT

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

5. A copy of the APA.

APPENDIX D

DEFINITIONS

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

Term	Definition
Annual Report	A report within the meaning of Revenue Procedure 2006–9, section 11.01.
APA	This Advance Pricing Agreement, which is an "advance pricing agreement" within the meaning of Revenue Procedure 2006–9, section 2.04.
APA Records	The records specified in Appendix C.
APA Request	Taxpayer's request for this APA dated ________, including any amendments or supplemental or additional information thereto.
Covered Transaction(s)	This term is defined in Appendix A.
Financial Statements	Financial statements prepared in accordance with U.S. GAAP and stated in U.S. dollars.
Foreign Group	Worldwide Group members that are not U.S. persons.
Foreign Participants	[name the foreign entities involved in Covered Transactions].
I.R.C.	The Internal Revenue Code of 1986, 26 U.S.C., as amended.
Pub. L. 106–170	The Ticket to Work and Work Incentives Improvement Act of 1999.
Revenue Procedure 2006–9	Rev. Proc. 2006–9, 2006–1 C.B. 278.
Transfer Pricing Method (TPM)	A transfer pricing method within the meaning of Treasury Regulations section 1.482–1(b) and Revenue Procedure 2006–9, section 2.04.
U.S. GAAP	U.S. generally-accepted accounting principles.
U.S. Group	Worldwide Group members that are U.S. persons.
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

	Authorized Representative	Phone Number	Affiliation and Address
Contact Information			

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.[14] 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 $opex_c = opex_c - PPEA$

[14] 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.

Definition of Terms

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

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

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

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

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

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

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

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

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

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

Abbreviations

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

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

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