

Part III - Administrative, Procedural and Miscellaneous

Small Business Taxpayer Advance Pricing Agreements

Notice 98-65

INTRODUCTION

On February 9, 1998, the Internal Revenue Service ("Service") issued Notice 98-10, 1998-6 I.R.B. 9, which set forth proposed special procedures for small business taxpayer ("SBT") Advance Pricing Agreements ("APAs"). Notice 98-10 also solicited comments from the public prior to finalizing the special procedures for SBT APAs.

After consideration of all the comments received, the final procedures for SBT APAs are adopted as revised by this Notice. It is the Service's intention to incorporate the final SBT procedures in any revisions or successor to the general procedures for obtaining an APA from the Service, currently contained in Rev. Proc. 96-53, 1996-2 C.B. 375.

EXPLANATION OF REVISIONS AND SUMMARY OF COMMENTS

Most of the comments focused on expanding the situations in which the SBT special procedures could be employed, including (i) expanding the definition of an SBT to permit more taxpayers to qualify; (ii) clarifying that small transactions (as defined in § 5.14(4) of Rev. Proc. 96-53), without regard to the size of the taxpayer, would qualify; and (iii) permitting transactions that involve non-routine intangibles to qualify. This Notice doubles

the gross income amount from \$100 million to \$200 million for determining which entities will be considered an SBT for purposes of implementing SBT APA special procedures. So that all taxpayers who qualify as SBTs are treated uniformly with respect to APA user fees, this Notice also increases, from \$100 million to \$200 million, the gross income amount in the definition of taxpayers that qualify for the reduced user fee of \$5,000 contained in § 5.14(3) of Rev. Proc. 96-53.

This Notice also clarifies that the special procedures can apply, when appropriate, to the small transactions described in § 5.14(4) of Rev. Proc. 96-53. With respect to applying the special procedures to transactions involving intangibles, this Notice clarifies that the Service will consider such application on a case by case basis.

In addition, the Service believes the SBT procedures could be beneficial for start-up companies and new lines of business for existing companies. Accordingly, transactions involving such companies or such lines of business are mentioned among the types of transactions for which SBT procedures would be appropriate.

It was also requested that the initial term of an SBT APA have the potential to be greater than three years. As reflected in this Notice, depending on the facts and circumstances of each case, an SBT APA term can generally range from three to five years.

Other commentators requested that the Notice address the policy for "rollbacks" (i.e., rolling back the transfer pricing

methodology ("TPM") to years prior to those covered in the APA). The requests involved clarifying how rollback requests would be treated in an SBT APA context generally, and more specifically, in situations where a rollback year in a bilateral SBT APA request is under the jurisdiction of Appeals and the simultaneous Appeals and competent authority procedure as described in § 8 of Rev. Proc. 96-13, 1996-1 C.B. 616, 622, is applicable. As with all policies and procedures not specifically addressed by this Notice, such policies and procedures, including the rollback procedures, remain the same as described in Rev. Proc. 96-53. (For the rollback procedures, see § 8 of Rev. Proc. 96-53).

Other comments expressed concern regarding coordination with treaty partners in the case of bilateral SBT APA requests. As with all bilateral APA requests, the Service has worked, and will continue to work, diligently with treaty partners to effectuate bilateral APAs (SBT or otherwise) as quickly as possible.

Finally, some comments addressed internal Service procedures, such as the staffing of APA Teams. The APA Program appreciates all suggestions to make the APA process more efficient. However, since the purpose of this Notice is to provide guidance to SBTs seeking an APA and not to address internal procedures, these comments have not been addressed in this Notice.

#### PURPOSE

The Service instituted the APA Program to assist all taxpayers in their efforts to comply with I.R.C. § 482. Under an

APA, the Service and a taxpayer agree on a TPM to be prospectively applied to an apportionment or allocation of income, deductions, credits, or allowances between or among two or more organizations, trades, or businesses owned or controlled, directly or indirectly, by the same interests. Provided the taxpayer complies with the terms and conditions of the APA, the Service will regard the results of applying the TPM as satisfying the arm's length standard under § 482. Rev. Proc. 96-53, 1996-2 C.B. 375, explains how a taxpayer may secure an APA from the Service.

To date, the Service has concluded more than 160 APAs with U.S. taxpayers, the majority of which have been large business taxpayers with substantial income and/or assets. In an effort to reduce the § 482 compliance burden of, and to make the APA Program more accessible to, small business taxpayers ("SBTs"), the Service is adopting special APA procedures for SBTs ("SBT procedures"). For purposes of this Notice, a "small business taxpayer" is any U.S. taxpayer with total gross income of \$200 million or less (determined pursuant to § 5.14(7) of Rev. Proc. 96-53 or its successor). In addition, for taxpayers not able to meet the gross income threshold, if deemed appropriate by the Service, SBT procedures will be available for the small transactions described in § 5.14(4) of Rev. Proc. 96-53, subject to the limitations regarding intangibles discussed below.

The SBT procedures seek to address the SBT's need to achieve the compliance certainty an APA provides at a cost that is

reasonable relative to the size and complexity of the transactions involved. This Notice describes the circumstances under which an SBT may request special procedures in seeking an APA, the nature of the special procedures, and other provisions designed to assist SBTs in the APA process.

#### BACKGROUND

The Service has indicated a desire to alleviate the § 482 compliance burden for SBTs. For example, under the 1993 temporary regulations, § 1.482-1T set forth a safe harbor for small taxpayers. That provision, however, was not retained in the final regulations due to deficiencies with the safe harbor. See "Explanation of Revisions and Summary of Comments" of the § 482 final regulations, T.D. 8552, 1994-2 C.B. 93, 104. At that time, the Service solicited suggestions from the public for alternative approaches to assist small taxpayers with their § 482 compliance burden. Id. No comments were received as a result of this solicitation.

The Service also attempted to assist all taxpayers, including SBTs, with their § 482 compliance efforts by implementing the APA Program under Rev. Proc. 91-22, 1991-1 C.B. 526. The Program's experience, however, indicates that SBTs are not participating in the Program to the same extent as larger taxpayers, due at least in part to cost concerns (in terms of internal staff time, external legal, accounting, and consulting fees, and Service user fees).

As a consequence, the Service established additional

incentives for SBTs to seek APAs. Section 3.09 of Rev. Proc. 96-53 provides that the Service and a small business taxpayer may agree to special procedures for obtaining an APA, including simplified procedures that depart from standard procedures, to meet the needs of the particular SBT. In addition, § 5.14 of Rev. Proc. 96-53 establishes a reduced user fee for many SBTs seeking an APA. The APA Program has successfully applied the approach referenced in § 3.09 in several cases to assist SBTs in receiving APAs.

The Service believes that maintaining the ability to adapt procedures to the facts and circumstances of a particular SBT is better than establishing formal procedures that may not be applicable to all SBTs. However, it is important for the Service to furnish guidance regarding the types of procedures it deems appropriate for SBT APAs. Accordingly, the provisions in this Notice expand upon § 3.09 of Rev. Proc. 96-53 by providing examples of simplified procedures the Service believes may be appropriate. It is hoped that the flexibility underlying this approach will encourage more small business taxpayers to participate in the APA Program.

#### PRINCIPLES FOR SMALL BUSINESS TAXPAYER APA REQUESTS

The Service intends to maintain flexibility in the APA process to address the particular needs of SBTs. Accordingly, the special procedures set forth below are the types of procedures the Service will entertain for SBT APA requests; they are not exclusive, and the Service will consider other procedures

that are consistent with the objectives of the APA Program and the SBT. In addition, different procedures may apply to different SBTs, depending upon the facts and circumstances of each APA case.

To address the concern that the perceived costs to secure an APA are high in proportion to the size of the transactions involved, the special procedures focus on simplifying the APA process for SBT transactions. This simplification is intended to reduce costs in terms of the amount of time required to evaluate the request, while permitting the Service to satisfy its due diligence requirements.

This objective can be accomplished, and use of special procedures is encouraged, when the SBT proposes to cover less complicated transactions with which the APA Program has had experience (such as those involving the manufacture or distribution of tangible property under § 1.482-3 and the performance of administrative and technical services under § 1.482-2(b)) and proposes a "best method" that is specified under the regulations. In addition, use of special procedures is encouraged for start-up companies or lines of business. Although transactions involving non-routine intangibles, including research and development cost sharing arrangements under § 1.482-7, would not ordinarily be amenable to such special procedures due to the complexity of valuing such intangibles, the Service will consider employing special procedures for such transactions on a case by case basis.

In addition, to the extent practical, the Service will coordinate the special procedures with the SBT's other tax compliance efforts so as to minimize the costs to the SBT. For example, an SBT's I.R.C. § 6662(e) documentation may be accepted as the APA submission materials, and such documentation could form the primary foundation for the Service's evaluation of the SBT's APA request.

#### SPECIAL PROVISIONS FOR SBT APAs

At the request of an SBT, the Service will apply any or all of the following provisions under the principles of this Notice, if deemed appropriate by the APA Director:

1. Under ordinary conditions, a taxpayer contemplating an APA may (but is not required to) request a prefiling conference with the Service. If a prefiling conference is requested, the Service provides informal advice to the taxpayer regarding the taxpayer's proposal, but ordinarily does not begin its due diligence evaluation in earnest until the taxpayer formally files an APA request along with the appropriate user fee. Once the formal APA request is received, the APA Program targets finalizing the negotiating position for bilateral APAs in nine months and concluding unilateral APAs in 12 months. In contrast, for SBT transactions the Service intends, if requested, to commence its due diligence analysis at the front-end of the process to accelerate the conclusion of the APA negotiations.
  - (a) The Service and SBT may hold a prefiling conference



(before a user fee is paid) to determine as early as possible the best method for the SBT's proposed covered transactions. To accomplish this, the Service will need a detailed description of the underlying facts of, and the proposed TPM for, the SBT's requested covered transactions at least 60 days prior to the scheduled conference. For purposes of this Notice, the SBT may provide the information it is required to maintain under I.R.C. § 6662(e) to satisfy this requirement. Prior to its prefiling submission, the SBT must consult with APA Program personnel to determine the information the Service deems necessary to evaluate the SBT's particular covered transactions.

- (b) An APA Team will evaluate the SBT APA prefiling submittal to determine items of concern and the additional documentation, if any, needed to evaluate the request. The SBT will be advised of the APA Team's initial conclusions before the prefiling conference so that it can address these items before or at the conference.
- (c) At the prefiling conference, the SBT and Service will negotiate the case management plan with the objective of concluding a unilateral APA, or finalizing the recommended negotiating position for a bilateral APA, within six months of the date the SBT files its APA request. The Service's efforts to perform more of its

analysis earlier in the process should result in a reduced number of post-filing meetings and supplemental information requests.

2. The Service and SBT may negotiate the reduction or elimination of specific elements otherwise required under § 5 of Rev. Proc. 96-53. Examples of the types of information that the Service may determine the SBT could exclude from its APA request include those described in the following subsections of Rev. Proc. 96-53: (a) § 5.04(3); (b) § 5.04(5); (c) § 5.04(6); (d) § 5.08; and (e) § 5.09.
3. The Service will hold all meetings with the SBT at a location convenient to the SBT. To minimize the number of meetings, teleconferences will be employed whenever feasible.
4. The Service will reasonably assist the SBT in the selection and evaluation of comparables or the computation of adjustments to comparables under § 1.482-1(e), as well as, if appropriate, assist the SBT in determining other adjustments.
5. The initial term of an SBT APA will generally be from three to five years, depending upon the facts and circumstances of the SBT.
6. For unilateral APA requests, an SBT may submit a proposed draft APA in a form substantially identical to the current APA model agreement attached to this Notice (the APA model is subject to change; SBTs should check with the APA Program

for updated versions). To expedite review of the proposed draft APA, the SBT should also include a "redline" version showing the differences between the APA model and the SBT's proposed draft. In addition, SBTs should also submit the draft on a computer disk in a word processing format acceptable to the Service.

7. The Service will consider other procedures suggested by the SBT to reduce the SBT's administrative and financial burden, consistent with the objectives of the APA Program and the requirements of § 482.

#### EFFECT ON OTHER DOCUMENTS

Section 5.14(3) of Rev. Proc. 96-53, 1996-2 C.B. 375, 379, is modified by increasing the gross income amount contained therein from \$100,000,000 to \$200,000,000.

#### EFFECTIVE DATE

This Notice is effective immediately and will apply to all SBT APA requests, including requests for renewal, received on or after the date this Notice is published.

#### DRAFTING INFORMATION

The principal author of this Notice is David J. Canale of the Advance Pricing Agreement Program, Office of Associate Chief Counsel (International). For further information regarding this Notice, contact Mr. Canale or Mr. Karl Kellar at (202) 874-4360 (not a toll-free call).

**ADVANCE PRICING AGREEMENT**

**between**

**TAXPAYER**

**and**

**THE INTERNAL REVENUE SERVICE**

**THIS ADVANCE PRICING AGREEMENT** ("APA") is made by and between Taxpayer and the Internal Revenue Service ("Service"), acting through the Associate Chief Counsel (International).

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

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

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

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

**3. Legal Effect.**

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

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

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

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

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

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

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

**5. Financial Statements and APA Records.** The determination whether Taxpayer has complied with this APA will be based on its United States income tax return; its financial statements as prepared in accordance with generally accepted accounting principles ("GAAP") on a consistent basis (the "Financial Statements"); the additional records ("APA Records") specified in Appendix B; and all information referenced in section 8 of this APA. Taxpayer will be in compliance with the TPM only if a certified public accountant renders an opinion that the Financial Statements present fairly, in all material respects, the financial position of Taxpayer and the results of its operations, in accordance with GAAP. Taxpayer agrees to maintain the Financial Statements and APA Records and to make them available within thirty days of a request by the Service in connection with an examination described in section 11.03 of Rev. Proc. 96-53. Compliance with this section 5 will constitute compliance with the provisions of sections 6038A and 6038C of the Code, with respect to the Covered Transactions during the APA Years.

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

**7. Compensating Adjustments.** To the extent necessary to bring Taxpayer into compliance with this APA, Taxpayer may make Compensating Adjustments as described in and subject to the rules of section 11.02 of Rev. Proc. 96-53, and subject to any restrictions stated in this APA.

**8. Annual Report.** Taxpayer shall file a timely Annual Report for each APA Year pursuant to the rules of section 11.01 of Rev. Proc. 96-53. However, no Annual Report will be due less than 90 days after this APA becomes effective. The Annual Report shall contain the information described in Appendix D. In connection with an examination described in section 11.03 of Rev. Proc. 96-53, the District Director may request and Taxpayer shall provide additional facts, computations, data or information reasonably necessary to clarify the Annual Report or verify compliance with the APA.

**9. Disputes.** Should a dispute arise concerning the interpretation, application or enforcement of this APA, the Parties agree to seek resolution of the dispute by the Associate Chief Counsel (International), to the extent reasonably practicable, prior to seeking alternative remedies.

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

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

**12. Effective Date.** This APA shall become binding when both Parties have executed the APA.

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

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

**TAXPAYER**

By: \_\_\_\_\_

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

**INTERNAL REVENUE SERVICE**

By: \_\_\_\_\_

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

Associate Chief Counsel (International)

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**APPENDIX A**

**TRANSFER PRICING METHODOLOGY**

For each APA Year:

**A. Covered Transactions.**

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

**B. Transfer Pricing Methodology (“TPM”).**

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**APPENDIX B**

**APA RECORDS**

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

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**APPENDIX C**

**CRITICAL ASSUMPTIONS**

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



**APPENDIX D**

**ANNUAL REPORT**

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

1. A statement identifying all material differences between Taxpayer's business operations during the APA Year and the description of Taxpayer's business operations contained in Taxpayer's request for this APA, or if there have been no such material differences a statement to that effect.
2. A statement identifying all material changes in the Taxpayer's accounting methods and classifications, and methods of estimation, from those described or used in Taxpayer's request for this APA, or if there have been no such material changes a statement to that effect.
3. The Financial Statements.
4. A financial analysis demonstrating Taxpayer's compliance with the TPM.
5. A description of any failure to meet Critical Assumptions or, if there have been no such failures, a statement to that effect.
6. A description of the reason for, and financial analysis of, any Compensating Adjustments with respect to the APA Year, including the means by which any such Compensating Adjustment has been or will be satisfied.
7. A copy of the certified public accountant's opinion, described in section 5 of this APA, for the APA Year.
8. [Insert here other items to be included in Annual Report.]
- 9.